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Preserving Homeownership: Community-Development Implications of the New Mortgage Market

A Report Prepared by Neighborhood Housing Services of Chicago

March 25, 2004

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EXECUTIVE SUMMARY AND OVERVIEW

The recent rise in subprime mortgage foreclosures threatens to undermine the historic homeownership gains made by low-income and minority households during the 1990s. Particularly problematic is the fact that the wave of foreclosures sweeping the country is concentrated in low-income communities. Foreclosures have devastating financial and psychological impacts on borrowers, damaging their credit reputations and ability to secure credit in the future.

Yet the negative impact of foreclosures extends beyond individual borrowers, lenders, and investors. Foreclosed properties often represent an eyesore, a site for illicit activity, and a drag on local house prices in vulnerable neighborhoods, and contribute to negative perceptions of these places. These factors can, in turn, generate a vicious cycle in which the presence of several foreclosed properties in a concentrated geographic area increases the likelihood that loans on neighboring properties will be defaulted on as well.

Obviously, a run-up in foreclosures can impose unanticipated costs on mortgage industry participants. For investors and insurers of securities issues, foreclosures represent a direct reduction in cash flows and can reduce the market value of their securities. Foreclosure is also damaging to servicers, who incur significant expense pursuing and attempting to rectify problem loans. In addition, a servicer's bottom line deteriorates as the value of servicing rights must be written down as loans drop out of the pools backing securities issues.

Funded by the Neighborhood Reinvestment Corporation and building on the work of Neighborhood Housing Services (NHS) of Chicago, this report seeks to chart new ways that community-based organizations — working cooperatively with private industry and federal, state, and local governments — can develop new national-scale foreclosure prevention initiatives. Through its Home Ownership Preservation Initiative (HOPI), the NHS of Chicago has forged a new partnership with the city of Chicago and key lending, in-

vestment and servicing institutions doing business in the city. The partnership seeks to preserve homeownership whenever possible and keep families in their homes through pre- and postpurchase counseling, prudent application of loan workouts, and in some cases by providing opportunities to refinance into more affordable NHS loans. When foreclosure is unavoidable, the partners seek to preserve the vacant properties as neighborhood assets.[1]

1. PRINCIPAL FINDINGS

Based on careful review of existing public policy and mortgage industry literature and extensive interviews with mortgage industry experts, as well as key government officials and leaders of innovative community-based organizations, this report examines how the emergence of a highly automated and technologically sophisticated mortgage market has helped to promote rapid growth in lending to low-income and low-wealth borrowers. At the same time, it documents the troubling rise in foreclosures that threatens to undermine decades of efforts to expand homeowner opportunity. In particular, this report seeks:

- To explain subprime mortgage securitization, loan servicing business models, and other relevant components of the subprime mortgage funding system to interested community-development professionals and policymakers;
- To better understand the industry's institutional and legal relationships, examine assumptions driving behavior, and test how participants in the process influence outcomes low-income and low-wealth communities;
- To diagnose issues and create innovative partnership solutions around tools, strategies, and business models that serve to better manage mortgage delinquencies and foreclosures in distressed neighborhoods.

To achieve these goals, this report documents how the rising number of foreclosures threatens to undermine the stability of low-income and low-wealth communities. Though the rise in foreclosures results from many factors, in part it reflects the adverse consequences of a mortgage origination system that fails to allocate mortgage credit efficiently.

[1] The HOPI initiative will be discussed throughout the report. See Appendix A for a brief summary of the goals of this initiative and its accomplishments to date.

In addition, subprime securitization, servicing, and disposition of foreclosed assets all too often generate negative results. In particular the report documents how:

Rising Foreclosures Threaten Low-income People and Communities. There can be little doubt that foreclosures are on the rise in low-income and low-wealth communities across the country. Not only do rising foreclosures threaten already vulnerable people and communities, they also call into question whether the recent increase in homeownership — built in part on the rapid growth in subprime lending — is sustainable or even desirable. Key findings include:

- Though hardly in evidence a decade ago, subprime loans are the most default-prone segment of the market.
- Mortgage defaults and foreclosures tend to cluster in low-income and low-wealth communities, and threaten to undermine decades of community revitalization efforts.
- In the nine target areas served by NHS of Chicago, the foreclosure rate reached 7.7 percent in 2001 — more than 20 times larger than the national average foreclosure rate for prime mortgages.
- Subprime foreclosures are high and on the rise in communities across the country according to detailed studies of the problem in Atlanta, Baltimore, Boston, New York, and other locations.

Mortgage Credit is Not Being Allocated Efficiently. A home is the largest financial asset most consumers purchase in their lifetime, and obtaining mortgage financing represents the most significant and complex transaction most consumers ever encounter. Once low-income and low-wealth borrowers had difficulty gaining access to mortgages of any type. Today, mortgages are readily available, but borrowers may become saddled with mortgage debt that they cannot sustain. In particular:

- Equally creditworthy and otherwise similarly situated borrowers pay differing prices to obtain a mortgage of given characteristics and terms.
- The rise in the number of mortgage brokers and other third-party originators (TPOs) promotes mispricing of mortgages due to incentives to charge borrowers as much as possible, while stretching the underwriting rules which lenders and in-

vestors rely on to price securities. This can result in growing numbers of problematic loans and ultimately contributes to rising foreclosures.

There Is No Effective Demand-Side Check Due to Consumer Confusion. This report argues that, lacking effective regulations and recognizing the limited capacity for consumers to shop in today's complex mortgage market, there is no effective demand-side check to the aggressive practices. In particular:

- Consumers are ill-equipped to resist the 'push marketing tactics of mortgage brokers and lenders.
- Given the lack of detailed pricing information and the complexity of current mortgage products, even the most sophisticated borrowers struggle to be effective shoppers for mortgage products.

Rigidities in the System Hold Back Best Practices. While the emergence of highly automated approaches to securitization and servicing have been key to the 'revolution in mortgage finance,' the subprime mortgage market is still identifying 'best practices' that effectively address the special challenges posed by higher-risk subprime lending. Inefficiencies and rigidities in the current system need to be addressed to stem the rising foreclosures. In particular, this report suggests:

- With securitization, most investors are distanced from borrowers, weakening the feedback mechanisms that enable investors to sanction poorly performing mortgage brokers or practices.
- Subprime servicers play a key role in managing the higher risks associated with subprime lending, but industry participants — including the rating agencies — are in the early stages of discovering what constitutes best practices in subprime servicing.

Foreclosure Avoidance, Loan Loss Mitigation and REO Procedures Need Further Development. Challenged with rapidly rising defaults and foreclosures, many servicers of subprime loans are applying best practices developed in the prime market to seek to stem the rising tide of subprime defaults and foreclosures, and to more efficiently and effectively dispose of foreclosed properties. While much progress is being made, practices

persist that generate outcomes that are not in the best interest of the borrower, the investor, the neighborhood or society at large. In particular:

- The high costs of maintaining contact with distressed borrowers limits the effects of standard loan loss mitigation efforts.
- In the subprime market, it is very common for delinquent loans to move into foreclosure without the borrower being made aware in a timely fashion of possible loan modifications and workout options, not to mention publicly available foreclosure avoidance programs.
- The disposition of foreclosed assets does not take into account any negative impacts of real estates owned (REO) sales on neighborhood stability.

2. PROPOSED SOLUTIONS

Having identified the negative impact that foreclosures can have on borrowers, communities, and investors alike, the report presents a series of proposed solutions that identify various roles that business, government, and community-based nonprofits can play in foreclosure avoidance efforts.

Improved Data Collection Can Enhance Foreclosure Monitoring and Avoidance Efforts. The rapid rise of subprime lending and associated rise in foreclosures has caught many off guard. This is due in no small way to the fact that there is surprisingly little data on subprime originations, defaults and foreclosures. To help fill this data void, this report proposes:

- Creation of a national loan origination, performance, default, and foreclosure database.
- Efforts to identify foreclosure hot spots and to create a series of hot-spot protocols designed to enable businesses, governments, and community-based organizations to undertake more coordinated and effective efforts to avoid foreclosure.
- Expanded research to assess the neighborhood impacts of foreclosure.

Help Borrowers in Distress. The dramatic increases in subprime foreclosures have highlighted the need to help borrowers in distress. Specific proposals include:

- Partnering to increase contact rates that will enhance the ability of subprime loan servicers to present distressed borrowers with appropriate loan modifications and/or workout plans.
- Restructuring regulations that limit servicers' ability to help borrowers.
- Creating programs that better connect borrowers to existing sources of assistance.
- Integrating effective credit counseling into loss mitigations strategies.
- Identifying and effectively utilizing additional subsidies for foreclosure avoidance.
- Helping victims refinance out of predatory loans.

Make Foreclosures Less Damaging to Neighborhoods. When foreclosure is unavoidable, lenders, municipalities and community-based organizations must focus on preserving the properties for affordable homeownership. This report proposes several new initiatives to mitigate the adverse impact of foreclosure on already distressed communities. Specific proposals include efforts to:

- Eliminate counterproductive regulations.
- Create programs to transfer properties to community-based developers.
- Develop a queue of loan-ready borrowers that will foster the rapid transfer of foreclosed properties to new homebuyers.

Enhance the Capacity of Mortgage Industry to Respond. The rise of subprime defaults and foreclosures has surprised many in the private sector, including investors, servicers, and the rating agencies. While investors and servicers were obviously aware of the potential for higher losses in the subprime sector, the magnitude of these potential losses was not fully appreciated. As a result, the subprime industry and its investor base have an incentive to improve understanding of default and loan failure from the perspective of both their bottom lines and their reputations. Specific proposals include efforts to:

- Host an industry summit on foreclosure avoidance.
- Increase investor accountability to help drive unscrupulous players out of the industry.

- Work with rating agencies to improve ratings rationale and accuracy.
- Disseminate best practices approaches for servicing subprime loans.

Engineer Foreclosure Out of the System. This report documents how the subprime market does not necessarily allocate credit efficiently or fairly. In particular, the market is characterized by 'principal-agent problems' that serve to siphon off funds that would normally accrue to borrowers or investors. Finally, the inability of consumers to shop effectively for mortgages leaves them vulnerable to abusive lending and enhances the likelihood that they will get involved in a default-prone mortgage transaction. Specific proposals in this area include efforts to:

- Enhance consumer capacity to shop more wisely and to avoid abusive lending practices.
- Provide consumers with better information to make more informed mortgage choices.
- Make use of escrow funds a standard feature of all subprime loans to help borrowers avoid the payment shock associated with property tax payments and other lumpy housing-related expenses.
- Create a national center to focus attention on foreclosure avoidance activities.

3. HOW TO READ THIS REPORT

Following this executive summary and introduction, the report begins with a description of national foreclosure trends, and then discusses the findings from a handful of published studies examining foreclosures at the city level. It then presents a brief case study of foreclosures in NHS of Chicago's target neighborhoods, and concludes with a discussion of industry and policy issues as well as potential strategies to mitigate the negative effects of foreclosure. The remaining sections of the report detail the workings of the mortgage industry, paying particular attention to how current industry practices with respect to subprime loan origination, securitization, and servicing may limit the effective utilization of foreclosure avoidance tools. These sections are designed for those who

would like a thorough understanding of the functioning of primary and secondary mortgage market operations.

Those already familiar with the basic structure of mortgage industry may chose to skim or even skip entirely the detailed discussion of industry practices presented in sections two to five. All readers, however, are strongly encouraged to carefully review the final section of this report — section six. This section presents a series of recommendations to improve the capacity for business, government, and community-based organizations (CBOs) to respond to the surge in foreclosures that threatens to undermine decades of neighborhood revitalization and homeownership expansion efforts, and further threatens the stability of already distressed communities.

Section 1: SUBPRIME LENDING AND THE RISE OF FORECLOSURES

An unintended side effect of the ongoing efforts to extend homeownership opportunities to less creditworthy consumers is a commensurate increase in foreclosure rates. This outcome is not surprising given the fact many lower-income and lower-wealth borrowers have trouble making timely mortgage payments and are more likely to slip into delinquency and default. The fact that much of the recent expansion in homeownership has occurred among historically underserved borrower groups has served to concentrate homebuying in lower-income neighborhoods with relatively fragile housing markets. This coupled with the sometimes aggressive and abusive marketing and origination practices described in other sections of this report produce geographic concentrations of foreclosures, potentially giving rise to a 'contagion' effect in which foreclosures above some threshold level can depress prices in an area and set off a cycle of further foreclosures and decline. Recognizing these factors, this section describes the rise in foreclosures in Chicago and communities across the country.

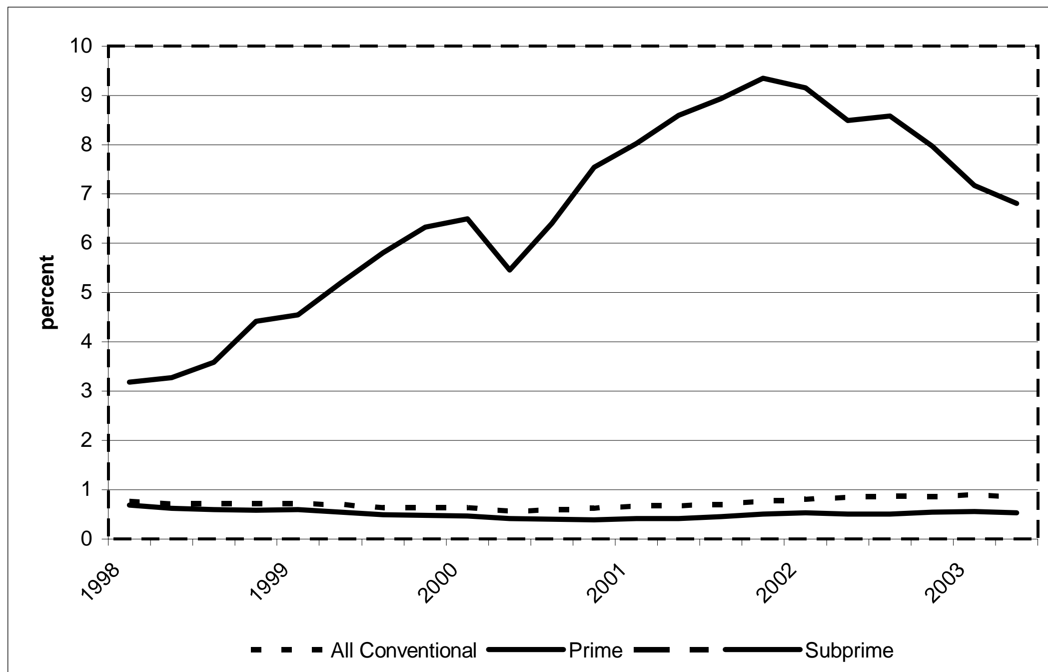
1.1. NATIONAL TRENDS

The link between the increase in foreclosures and the growth of subprime lending, while not unexpected, is dramatic. Researchers at Freddie Mac estimated that, as of mid-2002, the serious delinquency rate for conventional prime loans was 0.55 percent (Cutts and VanOrder 2003).[2] In contrast, subprime loans had a serious delinquency rate of 10.44 percent, nearly 20 times higher. Subprime serious delinquency rates were thus more than twice those of FHA insured mortgages (4.45 percent), historically the source of many foreclosure problems. More risky subprime loan examined by the Freddie Mac researchers (labeled in the study as 'C' or 'CC' loans) had rates topping 21 percent. Though hardly in evidence a decade ago, subprime lending has now joined manufactured home lending as the most default-prone mortgage segment of the home loan market.

[2] Cutts and VanOrder defined serious delinquency as loans that are already in foreclosure and/or those with payments that are 90 days or more late.

The success of the subprime segment of the mortgage industry in extending credit to ever more risky borrowers has combined with the weak economy to push the national serious delinquency rate to its highest level in decades. As shown in Figure 1, Collins, Belsky and Case (2003) present estimates of serious delinquency rates by market segment for the period 1998 to 2003, showing that the percentage of subprime delinquencies and foreclosures nearly doubled between 1998 and 2001, before falling off slightly. Further, subprime foreclosures are a larger problem today than in 1998 because subprime's share of conventional loan originations now exceeds 5 percent — a 50 percent increase over its mid-1998 share. During this period the overall mortgage market grew substantially. As noted earlier, higher foreclosures among subprime loans are a natural outgrowth of the lower credit quality that characterizes the subprime market. This effect is reinforced by the fact that collateral value in the subprime market is generally weaker.

Figure 1: Trends in Conventional Loan Foreclosure Rates, 1998 to 2003



Source: MBA.

1.2. FORECLOSURE PROBLEMS FOUND IN MANY CITIES

While no study has systematically examined foreclosures for a large sample of MSAs, a handful of existing studies demonstrate increasing foreclosure rates in low-income communities across the country. While differing in terms of the quality and extent of available foreclosure data, studies of foreclosure activity in particular metropolitan areas conducted to date, , paint a consistent picture of the rising incidence of foreclosure, especially in lower-income and minority neighborhoods. This section briefly reviews the results of these studies.

A study of Baltimore noted that the number of foreclosures increased from 1,900 in 1995 to over 5,000 in 1999 and that the growth was particularly pronounced in African American areas (HUD/Treasury 2000). The researchers also found that over a quarter of the subprime loans in foreclosure in the first quarter of 2000 were less than a year old and over half were less than two years old. In contrast, relatively fewer prime loans entered into foreclosure at all, and among those in foreclosure, a relative handful entered into foreclosure during the first two years after origination. The fact that so many subprime loans were in foreclosure less than two years after origination suggests that many subprime borrowers may not have had the capacity to repay the loan at the time it was made.

In Atlanta, researchers from Abt Associates examined loans entering foreclosure and found that the share of foreclosures attributable to subprime lending increased from 5 percent in 1996 to 16 percent in 1999 (Abt Associates 2000). Moreover, they noted that almost half of the foreclosed subprime loans were 'high-cost,' that is they had interest rates more than 4 percentage points above the 30-year Treasury rate at the time of origination. As was true in Baltimore, more than half of these subprime loans went into foreclosure less than two years after being originated.

In a study of Boston, researchers noted that subprime originations more than quadrupled from 1994 to 1998, with strongest growth in areas with high concentrations of low-income minorities. They also showed subprime as a growing share of all foreclosures be-

tween 1995 and 1999, even as aggregate foreclosures declined 30 percent (Gruenstein and Herbert 2000). Over the period, subprime foreclosures grew by some 154 percent, to account for 11 percent of the total.

While each study presents useful information on the foreclosure process and the extent to which rising foreclosures are linked to the growth of subprime lending or other factors, comparison across individual studies is difficult, in large measure because they are based on differing, locally generated data and often use differing definitions of key terms, including what constitutes a foreclosure or a subprime mortgage. Particularly problematic is the lack of consistent data on the characteristics of the borrower and loan in question. For example, some studies lack even basic information on loan terms, such as mortgage interest rate, and often are unable to determine whether a loan was prime, subprime, or FHA or otherwise government-backed. Even so, these studies and the results of others not reviewed here document the linkage between the growth of subprime lending and impacts on individuals and low-income communities across the country.

1.3. CHICAGO FORECLOSURES

Perhaps the most detailed examination of foreclosure trends was undertaken in Chicago by the National Training and Information Center (NTIC). Working collaboratively with the NHS of Chicago, NTIC has spearheaded the effort by community-based organizations nationwide to draw attention to the growing problem of foreclosures in vulnerable neighborhoods.

In a related report (Collins 2003) for NHS of Chicago, Neighborhood Reinvestment and NTIC analyzed foreclosure data available for the Chicago area. According to this study, while the foreclosure rate in Chicago stood at 4.7 percent in 2001, in the nine low-income neighborhoods served by NHS of Chicago, the foreclosure rate was 7.7 percent.[3] Overall, some 40 percent of all completed foreclosures in Chicago were in these nine targeted

[3] Collins used 2000 decennial census data to estimate the number of homes with mortgages at the census tract level. He then estimated foreclosure rates for Chicago as a whole and for selected Chicago neighborhoods by dividing the number of completed foreclosures by the estimated number of homes with mortgage loans outstanding.

neighborhoods. Yet, these communities represented only 5 percent of all mortgage originations in 2001 and account for just 18 percent of the city's population.

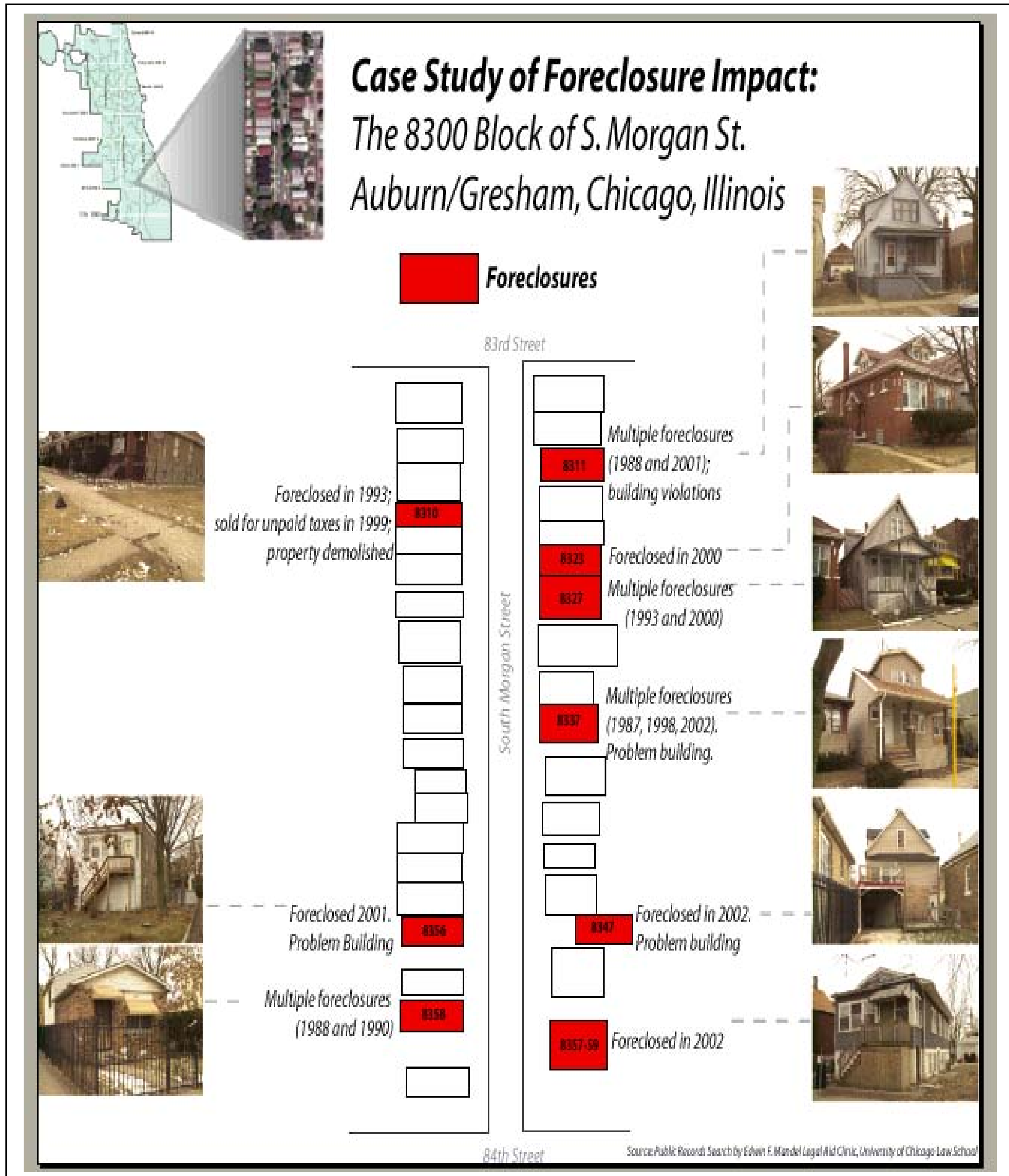
One of the most compelling, mortgage-related public policy issues today is the fact that concentrated foreclosures weaken revitalization efforts and may trigger or exacerbate neighborhood decline. Taking a fine-grained approach to the potential for 'foreclosure contagion,' Collins (2003) finds evidence supporting such a claim in the nine NHS of Chicago neighborhoods. He first argues that the timing of foreclosure increases is consistent with the growth of the subprime market. Between 1993 and 2001, foreclosures initiated increased at nearly double the rate (74 percent) of the increase in mortgage lending (38 percent). Examining potential causes of the increase, Collins shows that unemployment in the city was low and home prices were generally rising, indicating that two of the most common triggers of default and foreclosure were unlikely to account for the rise. Another possible explanation, an increased share and/or deteriorating performance of FHA/VA loans, is also not to blame; the number of these loans originated in the city actually fell by 3 percent, while FHA/VA foreclosures started dropped 25 percent. Finally, Collins (2003) shows that for the city as a whole, more than three-quarters of foreclosure proceedings initiated in 2001 were on loans with interest rates at least 300 basis points above the 30-year Treasury rate in the year they were originated.

Collins (2003) further shows that whereas the citywide average rate of completed foreclosures per single-family mortgage was 4.7 percent, six of the nine NHS of Chicago neighborhoods had rates exceeding 10 percent, the highest of which was fully 30 percent. Many of these apparently end up as vacant units, as indicated by the discrepancy between the differing trends in vacancy rates in the area and the rest of the city. Between 1990 and 2000 vacant units declined 20 percent citywide but increased 8 percent in these nine neighborhoods.

The Collins (2003) study then illuminates the extent of foreclosure concentration by mapping the foreclosure pattern in a section of the Auburn/Gresham neighborhood (Figure 2). Since 1990 the 37 homes on this block have experienced 14 foreclosures, affecting

9 separate properties. While not conclusive regarding the existence of a foreclosure 'contagion' effect in the way that an econometric study with full controls might be, the results of the Collins (2003) analysis are highly suggestive of such an effect and illustrate that, at a minimum, foreclosures in some of Chicago's most fragile neighborhoods have a tendency to cluster. The executive director of NHS of Chicago, Bruce Gottschall, is firmly convinced that the phenomenon of foreclosure contagion is a very real one in these neighborhoods. He describes the dynamic as one in which "one foreclosure often prompts another and another and in no time a decade of neighborhood revitalization work can be undone."

Figure 2: Block-Level Foreclosures



The fact that the subprime market accounts for the majority of recent foreclosures need not and does not serve as an indictment of the entire industry, but rather as a caution about the potential impact of a modest share of poorly underwritten loans, or higher-cost loans made with little regard concerning the ability of the borrower to repay. In fact, le-

gitimate subprime servicers and investors suffer from the contagion dynamic – as bad loans drag down individual borrowers, the rise of foreclosures can negatively influence what otherwise would have been successful loans made on nearby properties. Reinforcing the possibility for such a dynamic, Bunce and colleagues (2000) found that, while foreclosures per subprime loan were not higher in low-income neighborhoods than in other areas, subprime loans are much more likely in these neighborhoods. The danger to these neighborhoods therefore comes from their high concentrations of subprime lending, rather than worse loan performance there.

1.4. FORECLOSURE ISSUES

The rise in foreclosures raises a number of important policy issues. First and foremost it is important to understand the situation confronting low-income and low-wealth households forced out of their homes. These foreclosures also have a negative impact on the bottom lines of mortgage industry participants, including investors and insurers exposed to foreclosure-induced losses. Yet it is important to recognize that the cost of rising foreclosures extend beyond the parties to the mortgage transaction. In particular, foreclosures impose additional costs to the owners of other properties in the immediate vicinity of the foreclosed property, not to mention public agencies that must deal with the collateral damage associated with the clustering of foreclosures in specific areas. In some distressed urban neighborhoods that seemed to have turned a corner in the late 1990s, it is not an exaggeration to say that concentrated foreclosures threaten to reverse several decades of revitalization efforts by local governments, community-based organizations, and private industry.

To understand how best to engage in comprehensive foreclosure avoidance policies, it is important that all parties understand both the current strengths and inherent weaknesses of today's highly efficient mortgage market, from origination through securitization, servicing, and management of default mitigation, foreclosure avoidance and the disposition of foreclosed assets. Although the United States has one of the most efficient mortgage delivery systems in the world, there is room for improvement. For example, despite ex-

pectations by some borrowers to the contrary, mortgage brokers and other third-party originators neither represent the interest of the borrower, nor do they necessarily represent the interest of the purchaser or ultimate investor/funder of the loan. This misalignment of interests, in combination with the inherent difficulty individuals have in shopping for a product as complex and infrequently purchased as a mortgage, goes a long way toward explaining why efficiencies in the allocation of mortgage capital, not to mention abusive practices on behalf of some brokers, persist today. Understanding how to reduce the number of 'bad' mortgage originations is a key element of an overall program of foreclosure reduction.

But whatever may be done to improve origination of higher risk mortgages, public policy must focus on that fact that literally millions of highly default-prone mortgages already exist. To best address this reality, it is important to understand how the subprime market works, and particularly to consider whether the mortgage industry is well prepared to manage the inherent risk associated with subprime lending. This is an evolving area. Clearly procedures that worked well in prime mortgage market must be adapted to be effective in the subprime arena. For example, today there is no clear answer to the question about what constitutes the best business model for subprime mortgage servicing. In particular, the jury is out as to whether third-party servicers have sufficient incentives to effectively represent the best interests of the investor. Moreover, more needs to be known about what alignment of interests should exist to stimulate the creation of better loss mitigation, foreclosure avoidance and disposition of REO inventories. And finally, more needs to be known about the extent to which the lack of information or inappropriately designed regulations limit the capacity of mortgage servicers and investors, working alone or in conjunction with city and community-based partners, from engaging in foreclosure avoidance practices that seemingly could benefit borrower and investor alike.

The rise of foreclosure raises one final overarching policy issue: should there be limits placed on the extent to which borrowers and investors can engage in ever more risky lending? Even if a loan is properly priced, and the borrower is fully informed concerning the risks associated with the transaction, foreclosures do impose significant 'external

costs' on others. Whatever regulations emerge governing high-risk lending, it is important to remember that the goal of expanding access to capital to low-income and low-wealth communities is not simply getting people into a home, but enabling them to purchase a home that they can afford to remain in and, ideally, one that can help them build long-term assets. A foreclosed home is the American Dream shattered. Now is the time to rethink how best to make homebuying a benefit for individual consumers and communities alike, and not just the start of another costly cycle of deterioration and decline. To help in this effort, the report turns to a detailed examination of the subprime lending industry and uses the lessons learned to form a comprehensive series of proposals to enable business, government, and community-based organizations to mitigate the negative impact that foreclosures are now having on both low-income and low-wealth people and communities.

Section 2: BACKGROUND ON SUBPRIME MORTGAGE ORIGINATIONS

It is impossible to understand foreclosure-related issues without also understanding the nature of subprime lending and the process through which loans are originated. While purchase-money loans are an increasing share of the total, refinancing remains the core of business activity, and most subprime refinance loans involve taking cash out.[4] Consequently, from a public-policy perspective a foreclosed subprime loan represents the failure of a previously homeowning household and often reflects a loss of accumulated equity for the household.

A home is the largest financial asset most consumers purchase in their lifetime, and obtaining mortgage financing represents the most significant and complex series of transactions that most ever encounter. In addition, unlike simpler and more common consumer transactions, a consumer's decision to finance a home purchase, refinance an existing loan, or otherwise access home-secured credit occurs infrequently, giving them limited capacity to learn from experience.

Borrowers also have little information about or appreciation of the likelihood that they will default on the loan and risk foreclosure at some future date. Indeed, many consumers falsely conclude that being offered a mortgage represents the lender's assumption that they will be able to meet their mortgage obligation. In extending mortgage credit, lenders of course consider the extent to which a borrower is likely to default on a loan, but do so in order to price this likelihood appropriately so that they or subsequent investors can be compensated should the borrower default.

Equipped with a limited understanding of complexities of mortgage finance, today's borrower is put at a further disadvantage by a system that is not structured to ensure that he or she receives credit on best terms for which he or she qualifies. As explained more fully

[4] One large subprime lender interviewed for this report estimated that 90 percent of the company's refinance loans involved taking cash out.

later in this section, the growing reliance on mortgage brokers and mortgage correspondents weakens or severs normal market linkages through which competitive pressure ordinarily ensures efficient pricing. By increasing upfront and monthly carrying costs of the loan, mispricing further puts borrowers closer to the margin of failure and reduces the cash cushion available in emergencies, thereby increasing the likelihood of default and foreclosure. In addition to these market characteristics, a significant number of subprime loans are fraudulently or deceptively originated, further boosting foreclosure rates. By inflating property appraisals, failing to fully disclose loan terms, or overcharging unsuspecting borrowers for home improvements financed with subprime credit, unscrupulous originators may reap benefits at the expense of financially unsophisticated borrowers.[5]

The structure of the mortgage industry and the growing prominence of third-party originators (TPOs) enables and reinforces the tendency for abusive practices in some segments. Unlike investor-originators, TPOs are compensated at the outset of the mortgage delivery process, making them less interested in the long-term performance of the loan. Moreover, since their fees depend in part on placing the highest-cost mortgage the market will bear, they have strong incentives to 'push market' higher-cost mortgage products. While not all brokers or other TPOs avail themselves of the opportunities to work in opposition to the best interests of the investor and/or the borrower, evidence suggests that all too many do so. While aggressive broker monitoring on the part of reputable wholesale lenders, combined with tougher regulation, holds the promise of eliminating broker malfeasance, until such monitoring practices are universally deployed, brokers and other TPOs will continue to have the opportunity to sell problem loans to those lenders lacking the capacity to mount effective monitoring efforts. Moreover, even as a maturing market moves to check abusive practices on new loans, billions of dollars worth of problematic loans from prior vintages remain in the system and will cause problems for years to come.

[5] Unscrupulous behavior by borrowers, also a serious problem, is discussed later in this report.

Recognizing the linkage between origination practices and subsequent default and foreclosure problems, this section provides background on the origination portion of the subprime mortgage market. It begins by briefly tracing the development of subprime lending. It then moves to a discussion of issues and trends in originations. Finally, it reviews the principal public-policy issues related to subprime lending.

2.1. EVOLUTION OF THE SUBPRIME ORIGINATIONS INDUSTRY

While today subprime mortgage lending focuses on home refinancing and, increasingly, on home purchase lending (collectively called 'first-lien mortgages'), the industry emerged from the activities of finance companies extending debt consolidation loans, home improvement loans, and other types of second mortgages. This initial phase began in the 1970s and grew through the 1980s, receiving a boost from the Tax Reform Act of 1986, which repealed the tax-advantaged status of interest on non-housing consumer debt.[6] Second-lien home equity lending continued through the 1990s, but most of the major finance companies that had led the revolution in credit-sensitive lending were eventually purchased or ceased operation, and survivors now play a minor role in the market relative to refinance and purchase-money lenders (Fortowsky and LaCour-Little 2002).

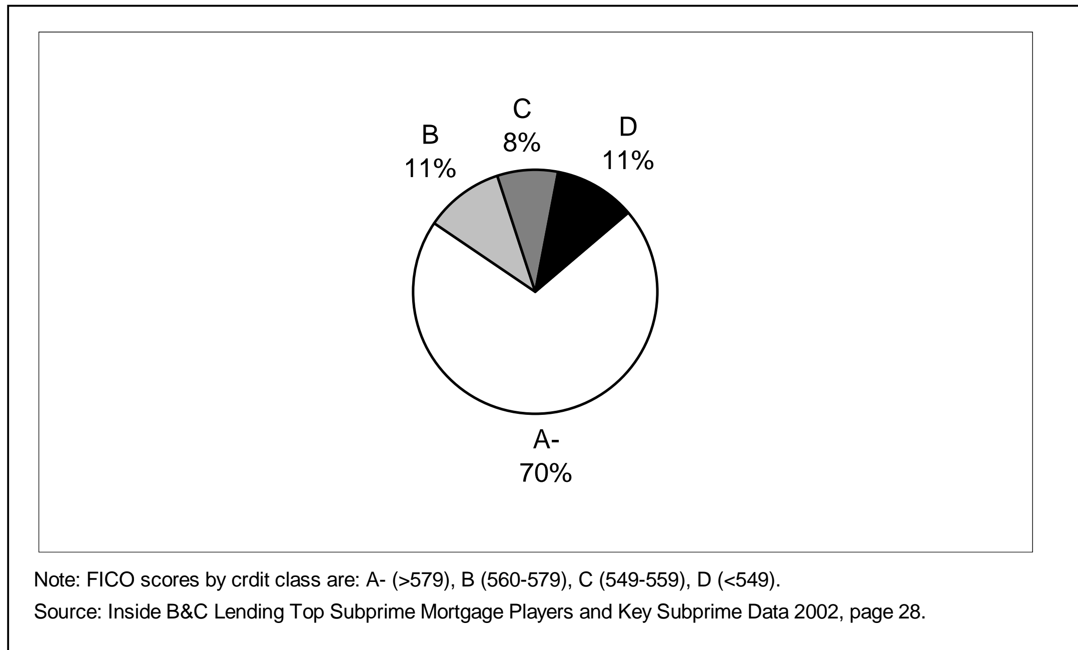
The subprime first-mortgage business emerged in the early 1990s as falling interest rates made it possible for home-equity lenders to refinance existing high-rate first mortgages and allow borrowers to cash out some of their accumulated equity to pay down credit card debt or finance other purchases. Instead of needing a second mortgage to pay off high-cost debt, borrowers were now able to do so with a single loan that lowered the interest on their primary housing debt and reduced other monthly interest expenses, while also converting consumer debt to tax-deductible housing debt. Due to their improved lien position (from second or third to first), these first-lien mortgages had lower levels of credit risk, broadening their appeal among secondary market investors. The final stage in this process, the purchase money subprime mortgage, emerged as industry expertise and

[6] As discussed later in this report, the 1986 tax law changes also contributed to the growth of subprime lending by creating Real Estate Mortgage Investment Conduits (REMICs), which helped expand the sources of funding for residential lending by streamlining the securitization of mortgage loans.

technological advances made it possible to price the combined risk associated with lower credit quality of the borrower, reduced down payment, and less certain collateral value of the home being financed.

The advent of risk-based pricing meant that, rather than charging a single rate to all qualified borrowers, the mortgage market sorts borrowers into risk ‘buckets’ based on factors such as their demonstrated ability to handle debt repayment, stability of employment, extent of financial documentation, and loan-to-value ratio. While the sorting algorithms and resulting classifications vary among lenders, the buckets for a given lender are typically labeled ‘A–,’ ‘B,’ ‘C,’ and ‘D,’ in order from highest to lowest credit quality. Often these are referred to in terms of FICO score ranges for each class. Figure 3 shows the share of the subprime market for each credit class in 2002.

Figure 3: Subprime Originations by Credit Class, 2002



Note: FICO scores by crdit class are: A- (>579), B (560-579), C (549-559), D (<549).

Source: Inside B&C Lending Top Subprime Mortgage Players and Key Subprime Data 2002, page 28.

Beginning in the late 1990s, prime lenders began moving heavily into subprime lending, a trend enhanced by the enactment of the 1999 Gramm, Leach, Bliley Financial Services Modernization Act (GLBA), which fostered the growth and development of large, diversified financial services corporations. For some this involved purchasing leading sub-

prime outfits, such as the purchase of The Associates by Citigroup. Other prominent acquisitions included the purchase of Household Finance International by HSBC Holdings Plc., The Money Store by First Union, and Long Beach Mortgage by Washington Mutual. Others among the current leading subprime originators, such as Ameriquest, Option One, and New Century, grew through a combination of mergers and acquisitions, as well by expanding existing operations — so-called organic growth. Some, such as Countrywide and IndyMac Bank, grew principally by expanding existing operations. Figure 4 shows the volume and market share of the 10 leading originators, who comprised nearly two-thirds of the market in 2002.

Figure 4: Top Ten Subprime Originators, 2002

Lender	2002 Volume ($bill.)	Market Share (%)
Household Financial Services	20.0	9.4
CitiFinancial	19.5	9.2
Washington Mutual	17.2	8.1
New Century Financial	14.2	6.7
Option One Mortgage	13.2	6.2
Ameriquest Mortgage	12.9	6.1
GMAC-RFC	11.5	5.4
Countrywide Financial	9.4	4.4
First Franklin Financial Corp	9.3	4.3
Wells Fargo Home Mortgage	7.5	3.5
Top 10 Total	**134.7**	**63.3**
Market Total	**213.0**	**100%**

Source: Inside B&C Lending.

Prime market players were drawn into subprime lending for several reasons. The first was their perception that profit opportunities surpassed those in the conforming market where commoditization, cutthroat competition, and the GSEs' market power keep margins tight. However, little is known about the profitability of the leading lenders' foray into subprime lending; some have clearly suffered as a result of their acquisitions. A second motivation for the move into subprime was the perception that economies of scale could be achieved either through larger subprime operations or, especially, if both prime and subprime loans could be originated through a single platform. Few lenders have yet been able to fulfill the promise of a unified prime and subprime origination platform, however. Explanations for this failure range from the mundane, such as challenges merging soft-

ware systems, to more fundamental issues concerning the distinctiveness of the two markets. It remains an open question whether a single-platform model will emerge as dominant.

Economies of scope in retail financial products and services are a third motivating factor for the move into subprime mortgage business by financial services conglomerates. ('Economies of scope' refers to the ability to sell multiple financial products and services to the same client, also known as 'cross-selling'). Economies of scope are also at work in the fact that originations can feed into related mortgage business lines, such as servicing and securities issuance, pursued by many subprime originators.

In addition to these business motivations, banking organizations may have seen subprime mortgage lending as a way to generate low- and moderate-income loans that count for CRA credit. If these organizations could also show that they were 'up referring' borrowers who applied for subprime mortgages but qualified for prime loans, it would improve their community commitment in periodic CRA exams. Being perceived by regulators and community groups as 'innovative' in this regard would go a long way toward managing the headline risk associated either with not extending 'enough' credit in low- and moderate-income neighborhoods or operating out of subprime shops there.

2.2. THE CURRENT NATURE OF SUBPRIME ORIGINATIONS

Broadly, there are currently three ways to originate a mortgage: through a retail outlet; through a mortgage banking correspondent; and through a mortgage broker.[7] Retail originations occur through bricks-and-mortar offices, through telemarketing, and over the Internet. The key point of distinction is that the borrower interacts directly with the primary funder of the loan in a transaction involving a retail lender. This funder also establishes underwriting guidelines defining who should be served and at what price. Correspondent originators also fund loans, often using a 'warehouse line of credit' from a larger lender, but do so with the intention of packaging and selling them as 'whole loans' to

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[7] For further discussion see Joint Center for Housing Studies, *Credit Capital and Communities,* a report prepared for the Ford Foundation, March 2004.

others, who consolidate them for sale to investors and/or for structuring into securities. (In theory, correspondents can devise their own underwriting criteria, but these are heavily dependent on the dictates of the purchaser of the loans.) Correspondent lenders sell these loans, typically on prearranged terms, for a mortgage delivery fee. They also earn any 'spread' generated by their ability to sell loans above par value (i.e., for an amount that exceeds the initial outstanding mortgage balance).

Finally, mortgage brokers are independent agents who find customers and match them to mortgage underwriting criteria, typically working with multiple lenders in order to expand their options for qualifying their clients for a loan. The broker's role is to help the borrower prepare the mortgage application and escort him or her to the closing table. At closing, the loan is funded by a 'wholesale lender' in a process known as 'table funding.' The sum of broker and correspondent activity is often referred to as 'wholesale lending' and, as noted earlier, these lenders are often called 'third-party originators' or 'TPOs.' Many organizations that are commonly referred to as 'subprime lenders' engage in two, or all three, types of lending.

Both prime and subprime mortgages are originated through each of these three channels. Estimates of the market share of each segment tend to be imprecise but generally place the retail share between 30 and 40 percent. There is a broad consensus that retail lending is less important in the subprime market. *Inside Mortgage Finance* (2003), for example, puts the retail share of 2002 subprime originations at 34 percent, compared with nearly 41 percent for the prime market.[8] The publication estimates that the broker channel accounted for 45 percent of subprime originations, a share fully 50 percent higher than for prime mortgages (30 percent).

TPO originations and especially the broker model are critical to the mortgage industry because of the importance of scalability. Because aggregate origination volume is largely a function of changes in interest rates and induced by declining interest rates, profitability at mortgage originators depends on being able to react quickly to changes in the interest

[8] Mingelgrin and colleagues (2002) put retail share of subprime originations at less than 20 percent.

rate environment while also avoiding heavy cost overhangs when volume subsequently declines. In this context, the broker model is highly efficient, enabling lenders to quickly expand their lending activity while limiting the need to hire additional permanent staff. As evidence of the substantial changes in employment that characterize the industry, the Mortgage Bankers Association recently projected losses of 65,000 jobs in the mortgage industry in 2004. This decline is 15 percent of total industry employment at the peak reached in August 2003.

2.3. CURRENT POLICY ISSUES IN SUBPRIME ORIGINATIONS

The explosive growth of lending to borrowers with lower credit quality and the importance of TPOs raise several critical public-policy issues. These stem from inefficiencies in the origination process linked to third-party originations, from complexity of existing mortgage products, and from the inherent difficulty of effectively shopping the subprime mortgage market. In light of the fact that the emphasis of this report is on mortgage delinquency, loss mitigation, and foreclosure avoidance, this subsection sheds light on how problems at the origination stage lead to subsequent servicing and loss-mitigation issues and, ultimately, to default and foreclosure.

Principal-Agent Problems in Third-Party Originations

Economists use the term ‘principal-agent’ relationship to describe a situation in which one party (the agent) acts on behalf of another (the principal). In these situations, an alignment of the interests between the two parties cannot be assumed, even if the principal compensates the agent for acting on his or her behalf. To the extent that the agent continues to have incentives to act in his or her own best interest (which may differ from that of the principal), additional mechanisms must be put in place to safeguard the interests of the principal.

Several recent papers examine ‘principle-agent’ issues in mortgage lending. Alexander and colleagues (2002) identify a principal-agent issue linked to subprime mortgage de-

fault.[9] Using data on fixed-rate loans from an unidentified 'national subprime mortgage-lending firm' for 1996 to 1998, they show that, all else being equal, TPO loans are more likely to fail than apparently equivalent retail-originated loans.[10] For this to be the case, brokers must be aware of information relevant to expected loan performance that they withhold from the loan funder in order to slip marginally unqualified applicants through cracks in the lender's underwriting framework.

The authors explain the discrepancy in defaults by the fact that "TPOs are compensated for writing loans, but are not completely held accountable for the subsequent performance of these loans." Since mortgage brokers have little long-term interest in loan performance, their economic incentive is to have every borrower qualify for a loan. Further, because brokers earn more for selling borrowers loans with higher rates and fees (the 'yield spread premium'), to the extent possible they will do so, irrespective of the implications for the likelihood that the loan will end in default. The repercussions of enhanced default probability are absorbed by the funder at the closing table. In contrast, retail lenders who must find a market for their loans have an additional incentive to make sure applications are filled out correctly, increasing their incentive to accurately evaluate the borrower's repayment ability.

Alexander and colleagues (2002) show that lenders appear to have diagnosed the agency problem midway through the 1996–98 study period and reacted by applying a discount to TPO loans of roughly 50 basis points. This response implicitly treats losses caused by broker malfeasance as a cost of doing business, rather than an error to be corrected. Such a response effectively severs any feedback loop that might be expected to correct the ten-

[9] LaCour-Little and Chun (1999) identify a principal-agent problem in the prime market, that TPO loans are about three times more likely to prepay than retail loans. They attribute this to the fact that TPOs have little or no long-term interest in the performance of the loan. As a result, brokers lack any incentive to avoid encouraging customers whose loans they originated for one lender to refinance with another (thereby generating a new fee from a different lender). In contrast, retail lenders retain a longer term stake in the loans they originate either through holding the loan in portfolio, retaining servicing rights on loans packaged and sold into the secondary market, holding a claim on the securities it backs, or through concerns for the performance of their securities among investors.

[10] Their model of the likelihood of delinquency holds other drivers of default – such as ability to pay, option incentives, and loan terms — constant.

dency of brokers to slip unqualified borrowers through the system, a tendency underlying an unknown but significant share of the elevated subprime foreclosure levels of the last several years. In order to avoid undermining the market for securities backed by subprime mortgages, issuers compensate for the increased defaults stemming from origination problems through pricing on the supply side and credit enhancement on the demand side.

Lenders also are turning to sophisticated broker monitoring systems to protect their own interests and those of their customers. By carefully tracking the performance of loans submitted by individual brokers, larger lenders have the capacity to identify and sanction brokers who fail to adhere to company policies and procedures. In addition, through a series of cross-checks and file audits, the best lenders have the capacity to identify and to reject problematic loan applications before they are funded. Unfortunately, these practices are not universally utilized in the industry. As a result, some brokers will avoid submitting questionable loans to those entities utilizing the most sophisticated fraud detection systems and instead simply pass them on to other firms that fail to extensively monitor broker behavior. As a result, there remains a tendency in many subprime securities transactions to simply price for the additional risk associated with broker originated loans, rather than correct the conditions that generated the risk in the first place.[11]

Allocative Efficiency in Mortgage Originations

The scope that TPOs have in determining the price paid by the borrower, in combination with the fact that the current solutions do relatively little to correct mispricing of mortgage credit, has the side effect of causing an apparent lack of 'allocative efficiency' in the subprime mortgage market. An allocatively efficient mortgage market is one that distributes the available stock of mortgage credit to its most highly valued uses. By implication, equally qualified borrowers should pay the same price for mortgage credit in such a market. This condition is widely thought not to occur in the subprime market. Guttentag (2001) traces the problem to the compensation structure for broker-originated loans and

[11] The prospectuses for some subprime securities issues note that the individual loans had likelihoods of moving to default and foreclosure that in many instances were 10 times as high as prime loans, but that such possibilities are accurately reflected in securities prices (Mansfield 2003).

presents information on broker profits to substantiate the point. He shows that for the subset of conventional prime loans in his dataset that happen to be for $100,000, broker profits ranged from $1,077 to $2,748 and had no relationship to the level of effort required to qualify the borrower (according to the brokers themselves).

A recent study by Calem, Gillen and Wachter (2002) examining spatial variation in subprime share of all home purchase and refinance lending at the census tract level in Chicago and Philadelphia is also suggestive of allocational inefficiency in mortgage markets. The authors model the share of loans that are subprime as a function of borrower characteristics, tract-level characteristics (e.g., education, income, racial/ethnic composition), and tract-level risk measures (share of properties in foreclosure, share of individuals with low or no credit rating). Most risk-related variables behave as expected, and, importantly, race/ethnicity at both the borrower and tract levels remains a significant predictor of the distribution of subprime lending. The authors concede that without more being done to control for individual characteristics of borrower risk, the results are not conclusive, but argue that they are nonetheless highly suggestive of a situation in which factors beyond borrower creditworthiness, loan type, and apparent collateral value help explain a portion of the price of mortgage credit. If true, this variation in prices paid by applicants presenting identical risks is supportive of a lack of allocative efficiency in the mortgage market.

Another recent paper (Courchane, Surette and Zorn, forthcoming) also finds evidence corroborating the existence of allocational inefficiency in the mortgage market. Using data from a survey of mortgage borrowers, the study examines whether borrowers are 'inappropriately' channeled into the subprime market segment. The authors do so by modeling the likelihood of ending up with a prime or subprime loan as a function of risk measures such as FICO score and "borrower self-assessed credit risk factors."[12] The paper confirms that the type of mortgage that borrowers obtain depends in large measure on risk-related mortgage underwriting variables (including FICO score, loan-to-value ratio,

[12] For example, the survey gathers data on whether borrowers believe that they "have good credit," "pay bills on time," and are "in control of their finances." It also collected data on search behavior and the occurrence of adverse life events such as loss of a job.

front-end ratio), and other well-known factors such as mortgage type and market channel, among others. However, when the authors added measures of market knowledge and search behavior, their ability to predict market segment improved significantly.[13] They conclude that the superior performance of the full model in explaining whether a borrower obtains a prime or subprime loan implies that risk-related factors alone may not fully explain why some borrowers end up in the subprime market. Rather, their study 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 pay different prices for mortgage credit.

Market Failures in Originations

Many challenges in subprime mortgage originations derive from an even more fundamental problem affecting market participants: the surprising difficulty of effective 'shopping.'[14] Several observers describe in detail the near impossibility of even the most sophisticated borrowers shopping for a mortgage effectively (Mansfield 2003, Guttentag 2001). At best, this may result from the inability of potential borrowers to access information that would allow them to determine which product best meets their needs at the lowest price. At worst, it implies that some originators seek out financially naïve individuals incapable of accurately evaluating loan terms. In either case the probability of the loan failing escalates, as payment burdens that are higher than necessary keep borrowers closer to the margin of failure.

As a starting point for this discussion, it is important to recognize that shopping for a mortgage is especially challenging when compared to shopping for other goods and services. In its essence, selecting a mortgage involves comparing discounted present value of alternatives over the expected duration of the loan. While a challenging task even for the rational consumer posited by the neo-Classical economic framework, the growing

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[13] The survey data suggest 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.

[14] In a market where 'shopping' is easy, consumers can effectively compare prices for comparable goods and services, and sellers are penalized for keeping costs too high by a loss of business.

body of literature in behavioral economics indicates that consumers 'reveal' differing and often *inconsistent* time preferences depending on how choices are framed.[15] In a recent paper Shu (2002) argues that given the complexity of the mathematics involved in discounting future payments, borrowers turn to alternative decision-making models, which she calls 'short cut methods.' For example, a consumer might estimate the total loan payments (i.e., number of payments times the payment size) and look for a loan that minimizes this amount. Indeed this method would find the loan with the lowest interest rate, but only if the term of the loans being compared were held constant. Note that for loans with different terms, the one with the lowest total payments may or may not be the not be the loan with the lowest annual percentage rate.[16] Instead of focusing on APR, minimizing the length of the loan term appeared most important for some study participants, while minimizing monthly payment was emphasized by others.

The fact that some consumers key in on a particular loan characteristic, such as monthly payment, makes them vulnerable to marketing that aggressively highlights that particular aspect of a mortgage product. A recent study of subprime refinance borrowers over the age of 65 by the AARP Public Policy Institute reveals that, in fact, many borrowers fail to search for the best loan available (Walters and Hermanson 2001).[17] The survey found that some 56 percent of subprime borrowers with broker-originated loans reported that the broker initiated contact with them (compared with only 24 percent of borrowers with loans originated by a retail lender). Overall a surprisingly large share of borrowers with both broker (70 percent) and retail (52 percent) loans "counted on lenders or brokers to

[15] This literature is summarized in Thaler and Cass (2003).

[16] Shu (2002) shows that the problems associated with deciding what is the best way to borrow money and repay over time are not limited to 'unsophisticated borrowers.' In experiments using a panel of students enrolled in the MBA program at the University of Chicago, she finds that even financially sophisticated individuals have trouble determining cost minimizing alternatives for a stream of future payments.

[17] The AARP study asked borrowers to classify their loan according to three broad categories: loans originated by a "lender," by a "mortgage broker," or by some other means (home improvement contractor or other source). Undoubtedly the AARP data reflect the more precise classification of "retail lender" versus "third-party originator" deployed elsewhere in this report, but admittedly consumers are often oblivious to the formal distinction between a "mortgage broker," or a "loan correspondent," since a key aspect of the distinction — namely, who actually funds the loan — is difficult for a consumer to discern.

find the best mortgage."[18] The AARP study supports the notion advanced by Mansfield (2003) and others that in many instances refinance loans are 'sold not sought' in that they result from extensive and often unsolicited outreach by brokers.

Survey data presented in a study by researchers at Freddie Mac (Courchane, Surette and Zorn, forthcoming) show that subprime borrowers are indeed less knowledgeable about the mortgage process than their prime counterparts. In particular, subprime borrowers say they are less likely to search for the best mortgage rates, and perhaps as a result were also less likely to be offered a choice among alternative mortgage terms and instruments.

While the AARP and Freddie Mac studies show that subprime borrowers *don't* shop, Guttentag (2001) claims that given the complexity of the mortgage products, in many ways consumers are actually *incapable* of effective shopping. He argues that "the core reason for market failure is that effective shopping for a mortgage is extraordinarily difficult for even sophisticated borrowers." Guttentag then presents a detailed discussion of the aspects of the mortgage market that constrain the ability of borrowers to shop effectively. These range from product complexity to the tendency for loan terms to change constantly and without borrowers having any ability to verify that changes in wholesale rates underlying such changes have indeed occurred. Most borrowers also do not appreciate the fact that the length of time before they prepay the loan has a tremendous influence on the effective interest rate generated by their point and rate combination. For example, the difference between a 30-year fixed-rate mortgage with an interest rate of 6.5 percent and 3 points and one at 7.25 percent and no points, while substantial if the loan is held to term, is negligible over a five-year time horizon.

Which loan has the best price that the borrower could potentially negotiate is also obscured from prospective borrowers by 'rebate pricing' in which lenders compensate brokers by allowing them to keep some portion of the margin above the wholesale mortgage

[18] The study shows that for those taking out broker loans this confidence was often misplaced, as they 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).

price. The borrower, therefore, knows from the settlement statement only how much he or she will pay the broker but not how much the broker receives from the lender for completing the deal (the 'yield spread premium'). This amount increases with the difference between the best rate the borrower qualifies for and the actual terms of the loan. In theory some of this fee could offset the borrower's payment to the broker, and the borrower's bargaining position would be greatly enhanced if this information were known to him or her. Guttentag (2001) observes that these and other structural features of the current mortgage market make it difficult to imagine that consumer education will correct the tendency for some brokers to overcharge unsuspecting borrowers.

Shopping for the best price is made even more difficult due to the fact that mortgage borrowing involves many participants, including loan officers, underwriters and processors, property appraisers and insurers, title insurers, credit reporting agencies, mortgage insurers, abstract companies, pest inspectors, and flood insurers, to name a few. In addition to the complexity of the product, the complexity of the process provides an opportunity for brokers to collude with some of these other participants to skim cash from the borrower. Relatedly, the sheer number of documents associated with mortgage lending provides ample opportunity for brokers to slip disadvantageous provisions into the loan without the borrower's knowledge.

Predatory Lending

Along with expanded credit access, subprime lending has exposed many low-income and low-wealth borrowers to abusive practices commonly referred to as predatory lending. Predatory origination practices may involve mortgage bankers and brokers, Realtors, appraisers, home improvement contractors, or others involved directly or indirectly in the process. Such practices include not only outright deception and fraud, but also include efforts to manipulate the borrower through aggressive sales tactics or to exploit their lack of understanding of loan terms. The list devised by the HUD/Treasury Joint Task Force

on Predatory Lending (1999) based on hearings in five cities[19] grouped abusive practices into four categories:

- *Loan Flipping:* Refinancing borrower loans repeatedly in a short period of time in order to drain or 'strip' equity from the borrower's home by charging excessive origination fees each time.
- *Excessive Fees/Packing:* Charging fees well beyond what could be justified on economic grounds and including unnecessary and poorly disclosed fees that are often added to the loan balance.
- *Lending Without Regard to Ability to Repay:* Lending in which the borrower is patently unable to afford the loan but the lender anticipates profiting by selling the foreclosed home following default.
- *Outright Fraud:* A range of practices that violate criminal laws (e.g., appraisal fraud whereby brokers and appraisers illegally inflate prices by doctoring loan application and/or settlement documents).

Engel and McCoy (2002) note that while abusive lending practices can and do occur in all market segments, they are most prevalent in the subprime market. In fact, they subdivide the mortgage market in three distinct segments: the prime market, the 'legitimate' subprime market, and the predatory market. They argue that predatory lenders target naïve clients — often low-income and low-wealth individuals — who are most vulnerable to abusive practices. Such vulnerable borrowers are typically disconnected from other credit markets, may be particularly disadvantaged in accessing information about best available products, and/or are subject to lingering mortgage market discrimination and other social and demographic forces.

Engel and McCoy (2002) document numerous predatory practices employed to strip the borrowers' home equity, burden them with higher interest rates and fees, or predispose them to default by disregarding their ability to repay. The most egregious examples involve unscrupulous real estate agents, mortgage brokers, appraisers, and lenders duping unsuspecting borrowers into purchasing a home at inflated prices and/or with significant

[19] Hearings were held in Atlanta, Baltimore, Chicago, Los Angeles, and New York.

undisclosed repairs. These practices harm borrowers and their communities, and they also impose costs on mortgage investors as most of the loans result in foreclosure.

Mortgage loans are priced in the secondary market based on assumptions concerning the underlying market value of the asset. By reducing true equity in the home (the true market value less the amount of the mortgage), an inflated appraisal makes it difficult for a borrower to sell the home and repay the mortgage in a time of distress. This, in turn, increases the likelihood that the mortgage will go into default and increases the magnitude of losses incurred by the investor and/or mortgage insurer during the foreclosure process.

2.4. CONCLUSION

While more aggressive monitoring of brokers and other third-party originators will help promote a greater alignment of interest in the marketplace, until such careful monitoring becomes universal, it seems likely that the subprime mortgage market will continue to be characterized by pricing the additional risk caused by TPO malfeasance, rather than eliminating it. Recent history suggests that TPOs will continue to originate mispriced loans that will continue to be delivered into the secondary market, and re-priced to reflect elevated risk via credit enhancement. As a result, even today the highly competitive secondary market fails to ensure that mortgage loans are priced to accurately reflect actual borrower risk; instead this function falls to regulators and to consumers.

As elaborated here, however, many consumers are not up to the task. Many consumers fail to shop around for mortgages, but instead naïvely believe that brokers will always provide them with accurate information. Given the complexity of current mortgage products, even the most sophisticated borrower will find it difficult to evaluate the details of the mortgage. Due to the fact that these more sophisticated borrowers have financial or legal advisors to guide them, they may have access to better information on mortgage pricing and terms. Even if they do not, higher-income borrowers have more extensive financial resources to draw upon and hence have greater capacity to bear any excessive

costs (for example those required to refinance out of a bad loan) and stave off mortgage default.

Section 3: BACKGROUND ON SECURITIZATION

No understanding of mortgage markets is complete without an understanding of the process through which mortgage loans are securitized. Reduced to its essence, securitizing mortgages is the process of taking individual loans, combining them into a 'pool,' and then issuing various types of securities whose payments derive from the cash flows generated by the loans in the pool (Cowan 2003, Singer 2001b). Structuring pools of mortgages into securities with a variety of payment schedules and levels of exposure to various types of risk has, along with the development of the subprime mortgage market, been the most important change in the mortgage industry in the past quarter century, and has led to many other substantial changes. This section explains the process and details its development, and then discusses the advantages of securitization to investors, lenders, and borrowers.

3.1. DEVELOPMENT OF SECURITIZATION

Mortgage securitization was devised in the 1970s in response to the fear that the (then healthy) thrift industry would not be capable of supplying sufficient capital to meet mortgage market demand as the Baby Boomers entered their peak homebuying years (Ranieri 1996).[20] After earlier fits and starts the first widely successful transactions were completed in the early 1980s, taking pools of existing loans from thrift balance sheets and lodging them with Freddie Mac to issue 'pass-through' securities based on the cash flow from monthly payments on the loans in the pool. The securities carried the agency's guarantee against credit risk (i.e., borrower delinquencies and defaults) and were underwritten by Wall Street firms who sold them to investors. The term 'pass-through' reflects the fact that both principal and interest paid on the mortgages were 'passed through' to investors in proportion to their ownership stake in the pool. As the challenges facing thrifts mounted through the 1980s, billions of dollars worth of loans in thrift portfolios were securitized, along with an ever-growing share of newly originated loans.

[20] The history of securitization presented here is drawn largely from Ranieri (1996) and to a lesser extent Brendsel (1996) and Fink (1996).

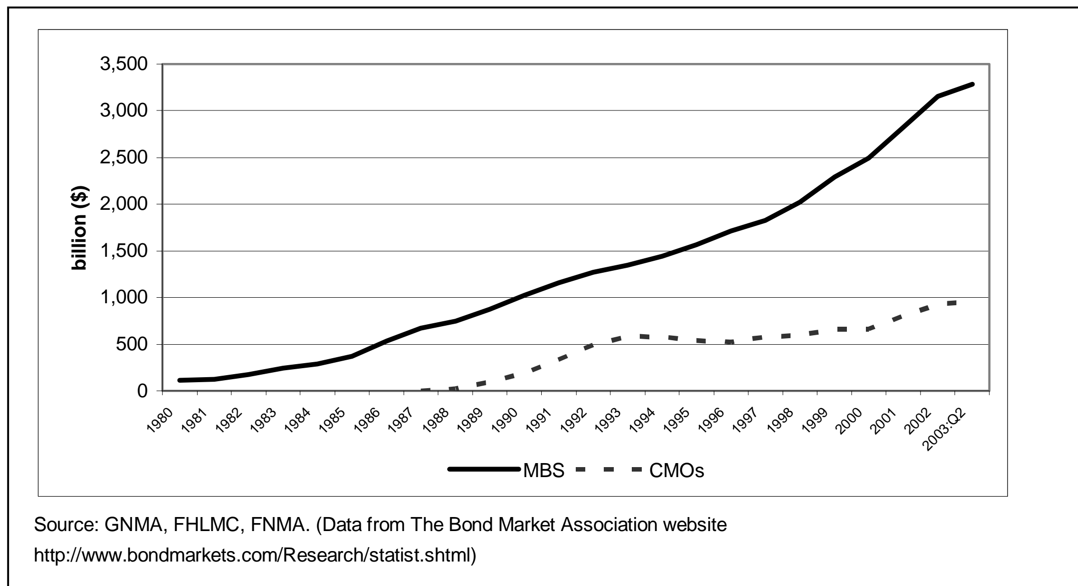
Despite playing an increasingly central role in the nation's housing finance system, the power of securitization to attract capital to the mortgage market remained limited by the fact that only 30-year fixed-rate mortgages could be securitized and only into one type of security (30-year pass-throughs) existed. In order to broaden the marketplace appeal of the product, Wall Street worked with the GSEs to devise new types of securities called collateralized mortgage obligations (CMOs), which divided or 'tranched' cash flows from a pool of mortgages into claims of differing lengths and payment periods. When issued with Freddie Mac or Fannie Mae guarantee of timely payment of principal and interest, these new securities offered nearly risk-free returns above Treasury Bonds of equivalent maturities and were priced at extremely competitive rates relative to investment alternatives such as corporate bonds. When issued by Ginnie Mae the securities carried the full faith and credit of the U.S. government and again were a competitive alternative for the investor looking for a return modestly above the U.S. Treasury rate.

While the financial innovation of varying maturities succeeded in attracting additional capital to the mortgage market, several key legal and regulatory impediments restricted securitization's full flowering. Among the most important were state-level restrictions on the ability of some investors to purchase pass-throughs and CMOs, limitations on the nature and extent of cash flow tranching imposed by the Department of the Treasury, and other tax issues (Ranieri 1996). The first problem was solved through the Secondary Mortgage Market Enhancement Act of 1984, which used federal powers of preemption to make investing in mortgage securities possible for virtually all investors, as long as the securities carried ratings from one of the credit rating agencies.

The second and third problems were dealt with in the Tax Reform Act of 1986, which created the Real Estate Mortgage Investment Conduit (REMIC). The REMIC structure at once cleared up lingering tax issues, and gave Wall Street tremendous flexibility to construct securities with widely ranging maturities and previously prohibited characteris-

tics.[21] New securities could now be tailored to meet the maturity, yield, and risk requirements of a broader range of institutional investors. These new securities included interest only (IO) and principal only (PO) payment 'strips,' and variable interest rate securities (floaters and inverse floaters). Today's issues include dozens of classes with an increasing variety of maturity and yield characteristics. The market's appetite for these products is evident from Figure 5, showing the growth in mortgage-backed security (MBS) and CMO issuance over the past two decades.

Figure 5: Agency Securities Have Exploded Since Their Introduction



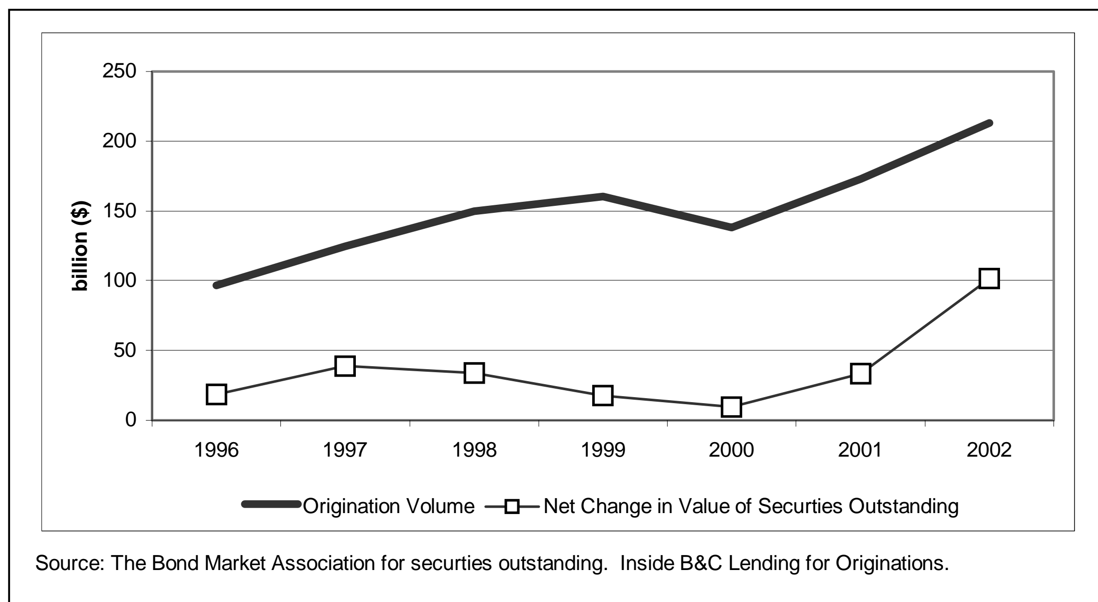
Source: GNMA, FHLMC, FNMA. (Data from The Bond Market Association website http://www.bondmarkets.com/Research/statist.shtml)

The successful securitization of conforming mortgages led to the securitization of other assets, such as auto loans, credit card receivables, equipment leases, student loans, and manufactured home loans. Issues backed by collateral other than conforming mortgages are collectively referred to as asset-backed securities (ABS). This includes those backed by subprime mortgages, which Wall Street calls Home Equity Lending (HEL), in refer-

[21] REMIC status simplifies the legal, regulatory, and accounting obstacles associated with issuing multiple asset classes and removes the threat of double taxation at the federal level for a securities issue backed by mortgages (Singer 2001b).

ence to the origins of the industry in second-mortgage lending and the continuing dominance of cash-out refinance loans.[22]

Figure 6: The Steady Growth of Subprime Mortgage Securitization



Source: The Bond Market Association for securties outstanding. Inside B&C Lending for Originations.

Securitization of subprime mortgages has increased steadily as the volume of originations has grown. Between 1995 and 2003 the value of home equity securities outstanding increased nearly tenfold, from $33.1 to $313.5 billion. As Figure 6 indicates, in 2002 the net increase in securitized loans outstanding was equal to nearly half of the $213 billion worth of subprime loans originated. While still dwarfed by the multitrillion dollar agency market, subprime mortgage securities (i.e., HEL ABS) are the now the second largest share of the $1.6 trillion in ABS outstanding, trailing only credit-card receivables ($402 billion), and ahead of auto loans ($229 billion).

3.2. SECURITIZATION'S APPEAL

Following the inclusion of REMIC provisions in the Tax Reform Act of 1986, mortgage securitization evolved rapidly. The process of carving up monolithic cash flows into

[22] The term HEL is sometimes used to include home equity lines of credit, closed-end second liens, and high-LTV lending, in addition to first-lien home purchase and home refinance subprime loans. Also somewhat confusingly, Wall Street generally reserves the term MBS for agency pass-throughs and CMO for agency multiclass issues.

payment streams bundled with different levels and types of risk that can be channeled to different types of investors has vastly increased the efficiency of the financial system relative to the era in which mortgages were funded by deposits and held in portfolio.

The benefits of securitization accrue because the process allows risk to be isolated and reallocated among investors most willing to assume it (Cowan 2003). Most investors in MBS and home equity ABS want to be protected from credit risk and, indeed, the credit enhancement process renders the majority of investors virtually immune from credit events. (A triple A-rated security, for example, is designed to be able to withstand an economic event matching the Great Depression in its severity (Taff 2003).) Those willing to take on some credit risk can purchase junior securities in varying loss positions. Because credit events pose minimal problems for most investors, the key source of differentiation among securities derives from prepayment risk, to which they are exposed in varying degrees over different time periods.

This is important because the financial system functions much more efficiently and raises funds more cheaply when risk is lodged with those best able to carry it. The savings and loan crisis, for example, is a case study in risk (of interest rate increases and consequent withdrawal of savings deposits) being held by the wrong players (thrifts whose funds were largely invested in long-term mortgage assets). When interest rates rose and thrifts' regulated deposit rates could not increase, customers withdrew their money, leaving thrifts insufficiently capitalized. This created a substantial asset-liability mismatch resulting from the requirement that long-term assets (mortgages) be funded by short-term liabilities (demand deposits). The thrift industry was forced into an untenable risk position that eventually contributed to its undoing. In contrast, if entities like pension funds can hold long-term assets like mortgages to offset relatively distant payment obligations, the systemic risk stemming from the asset-liability mismatch that doomed the thrifts can be substantially reduced.

For lenders, securitization conveys several key advantages (Roever 1998). The first of these is lower cost of funds. Through the combined effect of the diversification of risk

and credit enhancement, an issuer with a non–investment-grade rating is able to raise capital at investment-grade rates. A second benefit is that converting loans into securities and selling them moves loans off the lender's balance sheet. Doing so lowers on-balance sheet leverage, which improves return on equity (ROE) and other key financial measures by which lender health is assessed. A further benefit is the diversification of funding options. By expanding funding options beyond traditional sources such as deposits and the federal discount window, securitization allows funds to be raised regardless of conditions in these markets. Finally, securitization involves less public disclosure for the issuer, as some of the regulatory attention is diverted to the trust, the structure of the deal, and viability of the servicer. In addition, issuer disclosure is less than that required for other types of SEC-registered securities.

For borrowers, the promise of securitization is twofold. First, it increases credit access by bringing more capital to the mortgage market. It does so by increasing the pool of investors for whom investing in mortgages is possible and/or desirable and by recycling the capital raised by selling securities back through the mortgage market. The second benefit is lower mortgage costs. By designing mortgage securities meeting the risk and return requirements of a variety of investors, the cost of the capital that funds mortgage loans can be reduced. Some share of this reduction is passed on to borrowers.

3.3. THE STRUCTURE OF SECURITIZATION

Though the process is complex, securitization is designed simply to create market linkages between borrowers and investors (Singer 2001a).[23] In order for the process to work it must involve a 'true sale' of the assets by the issuer to a special-purpose vehicle (SPV), which uses funds raised by issuing debt securities to fund the purchase. A true sale is one that makes the assets (mortgages) 'bankruptcy remote' from the securities issuer.[24] That

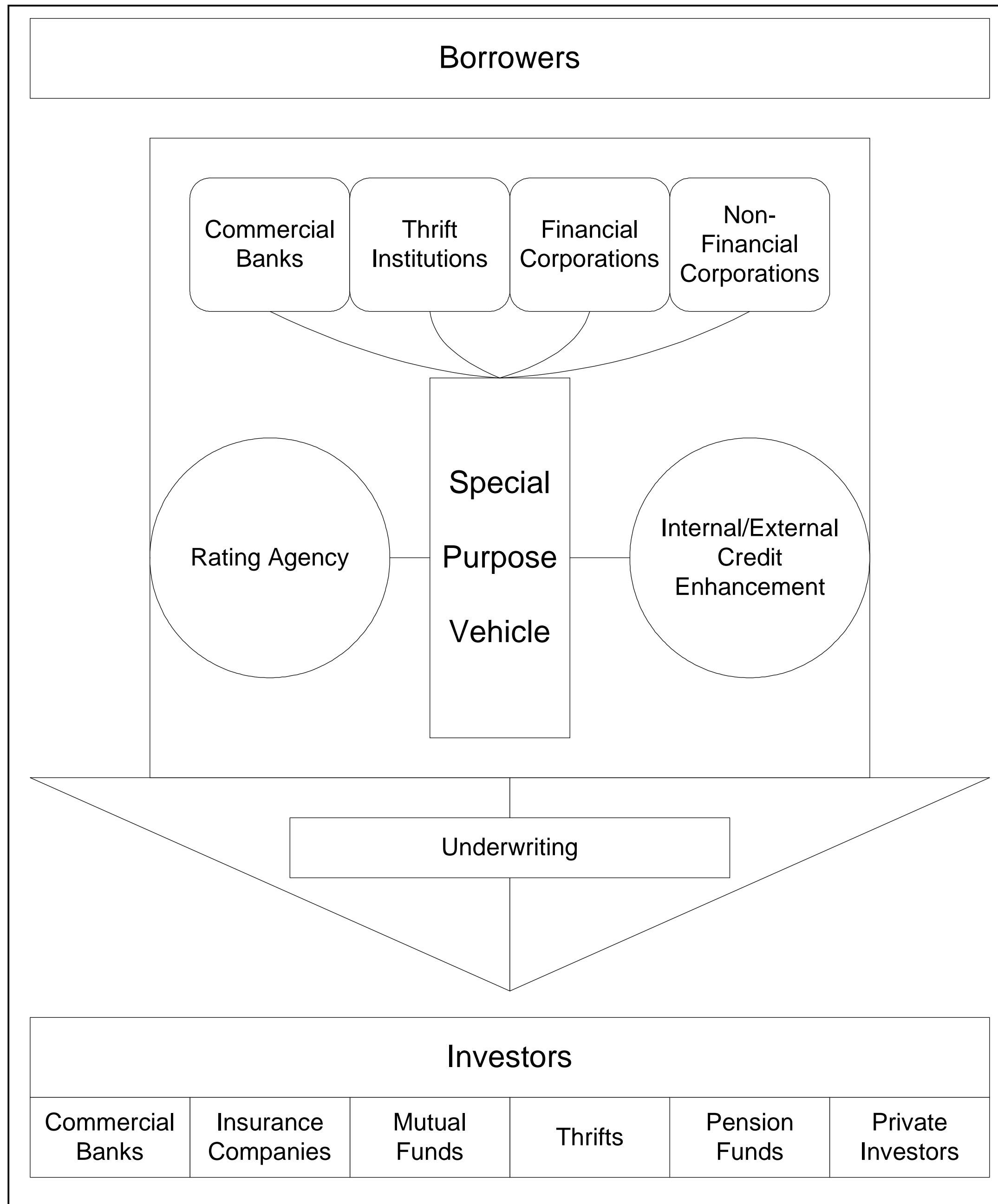
[23] In doing so securitization avoids traditional but less efficient *administrative* linkages (i.e., banks, thrifts, credit unions).

[24] Generally a true sale must satisfy the following: it must be a bona fide and arms-length transaction; the secured parties are not insiders; the grant of security interest is made for adequate (fair market value) compensation; the intent of the transaction is not fraudulent; and the security agreement conforms to relevant laws and regulations (Singer (2001b).

is, if the issuer were to fail, its bankruptcy receiver would have no legal basis to ‘attach’ or claim the assets backing the securities. In order to avoid double taxation, the SPV is typically structured as a trust and, as noted earlier, in the case of residential mortgages takes the specific form of a REMIC.

Figure 7 shows the process of a straightforward non-agency securitization. The structure of the diagram with borrowers on one end and investors on the other reflects the fact that the purpose of all of the intervening players is to enable the flow of capital from one to the other. Below the borrowers are various actors who fund subprime mortgages. Once originated, the loans must be assembled into pools, either by the entity that funded them or by another secondary mortgage market participant. The entity that pools the loans in preparation for structuring their cash flows into securities is called the ‘issuer’ of the security. Issuers must perform due diligence on the loans in the pool checking for fraud, faulty appraisals, violations of underwriting guidelines, and generally ensuring that the loans are originated in compliance with applicable federal and state laws and are described in a fair and accurate manner. The issuer makes ‘representations and warranties’ to this effect in the securities documents.

Figure 7: The Securitization Process[25]



The intensity of the due diligence function differs depending on the source of the loans and the origination channel. A retail lender pooling its own loans has devised the underwriting standards under which the loans are originated by its own employees. Because this issuer has controlled the entire production process, it is relatively knowledgeable

[25] Singer (2001a), page 7.

about the quality and characteristics of the loans in the pool. In such a case, review will be limited to a sample of the loans. In contrast, the quality of the loans in a pool assembled by a non-originating issuer that has purchased loans from dozens or hundreds of different brokers will necessarily be uneven.

In response to the recognition that the interests of third-party loan originators may diverge from those of the mortgage wholesaler or ultimate investor, in recent years the mortgage wholesalers and issuers have developed increasingly sophisticated technology to monitor the loans originated by third parties and to electronically verify some or all key data elements used to underwrite individual mortgages included in the pool. For example, the issuer could establish that the applicant has provided a valid address and phone number for his or her employer using electronic telephone databases. Similarly, using automated evaluation tools, some issuers may review the appraised value of the collateral backing the loans in a given portfolio. In contrast, other less automated forms of review include the verification of the physical condition of the property — performed manually and then completed for only a sample of loans, if indeed such a review is done at all.

The fate of loans that do not meet standards set by the issuer varies depending on the contract between the issuer and the originator. Some are assembled into 'scratch and dent' pools and securitized with more extensive credit enhancements than those used on a typical deal. Others are rejected by potential purchasers outright or later returned to the originator. In some cases they are kept in portfolio by the issuer until their performance is proven and they can be sold or securitized as seasoned loans.[26]

Once the pool is assembled and due diligence performed on the loans, preparations are made to transfer them to a SPV. This may be done by the issuer 'in house' or with the assistance of a separate investment banking organization that structures the cash flows into securities with characteristics designed to meet market demand. The investment

[26] Note that not all loan rejections occur due to quality concerns. Some investment-quality loans have characteristics that simply do not meet issuer needs at the time they are offered.

banker or underwriter may also guarantee the sale of the securities. The proposed securities are described in an investor prospectus that provides summary information about the underlying loans and details the characteristics of the securities to be issued, including the form and extent of credit enhancement to be applied.

In tandem with bankruptcy remoteness, credit enhancement is what enables investment-grade debt (triple B minus and above) to be constructed from loans pooled by and/or originated by companies without investment-grade ratings themselves or with ratings below those of the securities they issue (Hsu and Mohebbi 2001).[27] The level of credit enhancement is determined by credit rating agencies (Fitch Ratings, Moody's, and Standard & Poors) based on collateral quality, servicer rating, issuer reputation for due diligence, and other factors. According to one rating agency official interviewed for this project, collateral is the primary concern. Credit enhancements typically come in one of three forms: insurance, overcollateralization, and senior-subordinate structure. Insurance is the catchall name for external or third-party credit enhancement provided by bond insurers, corporate guarantees, or letters of credit. When employed, the insuring entity guarantees that holders of investment-grade tranches will receive their payments irrespective of the actual cash flowing into the trust. In exchange, they earn a fee that varies depending on the desired rating and the expectation of cash flow interruptions or termination. External forms of credit enhancement are generally not favored, however, because the rating of the securities becomes dependent on that of the enhancer.[28]

The second type of internal credit enhancement, overcollateralization, involves selling bonds to investors, the face value of which is less than the total collateral balance of the pool (a positive 'collateral-to-bond balance ratio'). In effect, this structure uses the excess collateral as a form of insurance should some of the individual loans default. The excess interest generated by the additional collateral can be used in part to accelerate principal pay-down. Overcollateralization protects higher-rated bonds against losses, however, by

[27] The issue of credit enhancement is treated in additional detail in Hsu and Mohebbi (2001), from which much of the material presented here is drawn.
[28] Because an insurer cannot guarantee a rating higher than its own, any downgrade in the insurer results in an automatic downgrade of the securities, independent of their actual cash flow performance.

using the excess spread (interest in addition to what is needed to pay bonds holders and cover fees) to maintain cash flows in the event of disruptions and, if necessary, by tapping the excess collateral.

Senior-subordinated structures provide credit enhancement by prioritizing payments such that losses are taken first by one or more junior classes, thus protecting the higher-rated senior securities. The level of protection required is determined by the rating agencies as a function of the desired ratings of the senior tranches, the characteristics of the collateral and the pay-down rules for principal and interest. Securities that are exposed to losses are typically referred to as 'B' tranches or non–investment-grade securities. Among these, securities not in line to take first losses are called 'mezzanine tranches.'

Figure 8 illuminates the preceding discussion with a basic example of a securitization enhanced through overcollateralization and senior-subordinate structure. At the top are senior, AAA bonds with little exposure to risk. The value of bonds that can be issued with AAA ratings based on the collateral in the pool is determined by the rating agencies. All else being equal, having a larger share of the total issue in the highest credit quality is advantageous to the issuer because these bonds maximize the spread between the interest rate on incoming cash flows and that on payments to investors. Lower down in the chart are bonds of increasing risk. For example, below the senior bonds are subordinate bonds, an overcollateralization layer, and the residual interest in the loans, as discussed above. As in this example, most issues employ several types of credit enhancement, with the goal of obtaining desired ratings for the securities at the lowest cost. External forms of credit enhancements are more often used for issues when new types of assets are securitized, for novel structures whose risk characteristics are not well established, or where the issuer itself is new to the marketplace (Hsu and Mohebbi 2001). In such cases it would be possible to enhance such issues internally, but this is usually the more expensive route.

As noted above, the actual level of credit enhancement required is determined by the rating agencies (Fitch, Moody's, and S&P). Their decision weighs a number of factors. Like the issuer, they evaluate collateral quality. They also factor in the performance of the is-

suer's previous bonds, the loss-mitigation strength of the servicer, and balance these against the types and ratings of the securities that the issuer proposes to structure out of the pool's cash flow.

Figure 8: Security Issue with Senior/Subordinated and Overcollateralization Credit Enhancements

Class	Description
A-1 A-2 A-3 A-4 A-5 A-6 A-7	Senior Bonds AAA Rated
M-1 M-2 M-3 B-1	Subordinate Bonds AA to B Rated
OC	Overcollateralization
N R	Residual

Source: GMAC-RFC.

As illustrated in Figure 7 earlier, once due diligence has been conducted on the pool, levels of enhancement determined, and ratings applied to the securities structured out of pool cash flows, the loans are transferred via a true sale to the SPV. In the case of subprime mortgages, this SPV is typically a trust structured as a REMIC. At this point the underwriter has responsibility for placing the securities, either privately or publicly, with investors. For public issues subsequent trading is done over the counter through market-making dealers who hold inventories and maintain bid and ask rates for the bonds (Cowan 2003).

The final step in the process is the investor. As shown in Figure 7, there are a variety of investor types and there are likewise a variety of motivations for investing in MBS and ABS. Often investors such as pension funds and insurance companies are seeking to gen-

erate cash inflows to match their own prospective cash outflows. Others use mortgage securities to hedge other positions, especially around interest-rate risk. Others, such as thrifts, may be looking for assets more liquid than their investment alternatives (thrifts will often swap whole loans to issuers in exchange for securities based on a pool formed from these same loans). MBS and ABS also have different regulatory capital requirements than whole loans, making them more attractive to banks and thrifts.[29] Most investors are seeking primarily consistency between expectations and securities' actual performance, though some are hoping to identify opportunities for above-market returns. Some investors are also concerned about the liquidity of the securities, that is, whether or not there is a market for them after their initial purchase from the underwriter.

In many cases, loan servicers will invest in (or retain if they are also the issuer) the riskiest part of the issue. Though doing so involves taking on risk or 'having skin in the game,' it also offers several rewards. Most obviously, a servicer holding a first-loss piece benefits if pool losses are small relative to the expectations driving the prices of these securities. In addition, investors may prefer that servicers have skin in the game as evidence of their commitment to loss mitigation, a commitment that should serve to protect other investors in the issue. At the margin, having an invested servicer should make the associated securities more desirable, as manifested by quicker sales, higher prices, and/or a more liquid secondary market.[30]

3.4. CONCLUSION

The advent of mortgage securitization has helped to link mortgage borrowers to international capital markets, and in doing so enhanced the liquidity and stability of the mortgage market. At the same time, it has added to the overall complexity of the mortgage process and raised important policy issues. Unlike a simple transaction between a bor-

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[29] Regulatory capital requirements for agency securities, for example, are 20 percent of those for whole loans.

[30] Other characteristics that make particular securities desirable to investors include the issuer being committed to the market long term; issuer performance and market reputation; and a servicer/issuer commitment to fight abusive lending practices (which undermine the quality of investors' collateral). Some of these may be more important to investors than having an invested servicer.

rower and lender, securitization adds numerous players to the process, which can make it difficult to sort out responsibility when loans go bad. Securitization has also made it difficult to pursue appropriate corrective actions to address problems in the mortgage industry. The specific mechanics of the securitization in terms of the alignment of risk and incentives are extremely important in creating the accountability structure that creates investor and public benefits. This can be challenging with respect to default and foreclosure, especially in situations where the foreclosure was triggered by mispricing of the loans or abusive practices on the part of the originator. As will be discussed in the following sections, the details of the securitization process may influence the ability of the servicer to engage in effective foreclosure-prevention and loan-loss mitigation activities.

Section 4: SUBPRIME MORTGAGE SERVICING

Describing subprime servicing practices succinctly is challenging because there is substantial variation in the business models employed by the major players and in the role servicing plays within these models. Consequently, it is difficult to definitively answer fundamental questions such as: Do subprime borrowers need to be serviced differently from prime borrowers in order to minimize losses? Are servicers who hold a financial interest in the loans they service more effective at loss mitigation? Can the apparent lack of alignment of interests between third-party servicers and investors be overcome?

Servicing managers from some of the nation's largest subprime servicers interviewed for this report gave conflicting answers to these questions. These differing perspectives underscore the heterogeneity of practices co-existing in the marketplace today. They also suggest that the subprime market in general, and subprime servicing in particular, have yet to fully mature. In the industry, bets are being made on different servicing business models — but the winners have not yet been revealed. As one executive explained it, "the industry has not yet been through a full loss cycle" that would shed additional light on market characteristics and help identify the most effective strategies.

Recognizing that competing models and practices exist, this section describes the state of play in the industry. It focuses first on practices and second on market characteristics. As appropriate, it highlights key areas of marketplace uncertainty and of policy interest.

4.1. SERVICING PRACTICES

In theory servicing practices should be designed to maximize cash flows from outstanding loans in order to maintain timely payment of principal and interest for the investors who put up the cash to fund the mortgages. Barring timely principal and interest payments, investors are best served by practices that mitigate losses to the greatest extent possible. This is not to say that servicing cannot be borrower-centric but instead to emphasize the fact that practices that do not meet the needs of investors who supply the cash

to fund mortgages are not sustainable. Fortunately for borrowers, servicers are increasingly focused on solutions for loss-minimizing outcomes. These solutions often involve a 'workout' that keeps the borrower in the home or eases him or her out with a less-than-devastating impact on credit reputation and reduces the amount of loss that the servicer and/or investor must take if a workout can be achieved. However, the complexity of the mortgage process may unintentionally create disincentives for the pursuit of loan workouts. To the extent that this is happening, it may also serve to obscure abusive practices.

The Servicer's Role

Most of what are typically thought of as servicing functions are performed by the primary servicer. This includes ensuring that cash flows reach their appropriate destination (i.e., security holders, either directly or by forwarding them to the master servicer or trustee) in a timely manner. The servicer is also responsible for escrow administration (though this is less of an issue in the subprime market, where escrows are less often required), and for investor reporting. The servicer can be the loan originator and/or the securities issuer, but need not be either. In cases where the originator sells loans into the secondary market with a clause allowing it to continue servicing the loans, servicing rights are said to be 'retained' by the originator. Because servicing produces revenue, all else being equal, loans with servicing released sell for more in the secondary market than those where servicing is retained. Issuers can also service the loans in the pool backing their securities, or a third party can be contracted to handle servicing for the issue. As a result, a mortgage issuance not only includes the details concerning loan characteristics, but also the servicing requirements associated with the underlying mortgages in the pool. Among other elements, these pooling and servicing agreements (P&S) specify when and how servicing can or must be transferred in the event that the servicer falters.

The P&S also specifies the nature of the servicer's responsibility during delinquency, default, and foreclosure.[31] (Industry divides these into 'collections,' which are loans less

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[31] The usage of these terms is often imprecise. A loan is technically in default when any of its terms are violated. Payment-based default occurs at the point where one payment has been missed and the second one comes due — typically the 60-day mark. The date at which foreclosure proceeding can be initiated varies from state to state (Cutts and Green 2003).

than 30 days past due, and anything more severe, called 'default management.') Often the primary servicer will be responsible for managing these processes, trying first to cure the loans though workouts and, potentially, through modifications, and then handling the foreclosure process for loans that cannot be cured. Sometimes these functions are referred to a special servicer who excels at dealing with problem loans. The primary servicer may also be obligated to advance delinquent principal and interest not received from the borrower, with repayment occurring only if the loan cures or when cash flow from one or more sources of credit enhancement is substituted for cash not supplied by the borrower (the nature of the servicer's 'advance requirements' are specified in the P&S). Even though they are later reimbursed, the opportunity cost of the funds advanced prior to repayment usually provides a strong incentive for the servicer to avoid foreclosure. At the same time, however, they imply that once loans are deemed unrecoverable, servicers should foreclose quickly to minimize losses.

The P&S typically also specifies a 'master servicer,' whose function is to protect the interests of investors by overseeing the actions of the primary servicers and any others involved in the issue and by ensuring timely remittance of funds (Pendley, Tillwitz, and Mistretta 2003). Under normal circumstances the master servicer's duties are modest and, according to one of our interviewees, involve compensation on the order of eight basis points in the prime market (whereas primary servicing in the subprime market typically is on the order of 50 basis points).[32] In cases where the primary servicer becomes unable to perform its duties, however, the master servicer will be responsible for collecting principal and interest and ensuring that they are transferred to the appropriate parties in a timely manner, either by performing the primary servicer role themselves or by ensuring the transition to a 'back-up servicer.' Depending on the specifics of the P&S, the master servicer may also be required to advance principal and interest to the trustee or investors in the event that they are not forthcoming from borrowers.

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[32] These servicing fees are approximate and included to provide an estimate of the difference between the fees for primary and master servicing. Actual fees vary based on pool characteristics, that is, on the expected difficulty of servicing the loans.

A third class of servicer is the 'special servicer' who is responsible for working the more difficult, often nonperforming loans, first-payment delinquencies, and/or handling the REO process. Special servicer compensation typically reflects the challenges of these more difficult loans. A special servicing contract might stipulate bonuses for loans in foreclosure proceedings that the servicer returns to cash flowing or to fully cured status, and penalties for underperformance. In a report addressing foreclosures it is worth noting that to an unknown but presumably substantial extent, the need for the special servicing function is driven by the sort of broker malfeasance discussed earlier. Minimally, first-payment delinquencies (those in which the borrower does not even send in the first check) are evidence of a mismatch between underwriting guidelines and the borrower's actual ability to pay, or between the borrower's and lender's understanding of the loan terms. (They may also be evidence of appraisal fraud, which relies on broker participation, or of borrower fraud, where repayment was never intended to be made.)

A final wrinkle in the servicing nomenclature is the subservicer. These participants perform much of the primary servicer's role on a fee basis, but do not actually own the servicing rights.[33] Subservicing and servicing are not mutually exclusive business lines and many servicers on both the prime and subprime side do both.

Performance of the Servicing Function

Under normal circumstances (i.e., outside of delinquency, default, and foreclosure) servicing is a fairly routine business — the servicer accepts the monthly payments, notes their receipt on the borrower's account, transfers the payments into accounts of investors on a specific day each month, and keeps records of this activity that are periodically provided to investors and regulators. At the more advanced facilities, the cash-flow maintenance function is technology-intensive, with payment envelopes opened robotically at 'lock box' facilities. The checks and payment coupon are scanned, the checks imaged, and in some cases accounts credited electronically. This lock box function can be per-

[33] Servicing rights are tradable assets with a strong financial component. All else being equal, interest-rate increases raise the value of servicing rights because they slow loan prepayments, thus maintaining a larger source of servicing fees. As such, servicing rights are sometimes called servicing 'strips' and their interest-rate behavior is similar to interest-only (IO) MBS and home-equity ABS strips.

formed by specialist vendors or run by the servicer. Checks that cannot be read electronically or for which a problem is detected are reserved and sent for human processing. Because the servicer earns interest on the float between the day the check is received and the day payments to investors are due, they have a strong incentive to streamline the payment posting process. Efficient practices also benefit the servicer through cost savings relative to manual processing and by avoiding the headline risk that comes with being perceived as trying to artificially generate revenue from late fees. The competing incentive to delay posting in order to collect a fee from borrowers or to trigger extra servicing fees for delinquencies also exists, but may be waning due to increased regulatory scrutiny deriving from the high-profile Fairbanks case (described in depth on page 59).

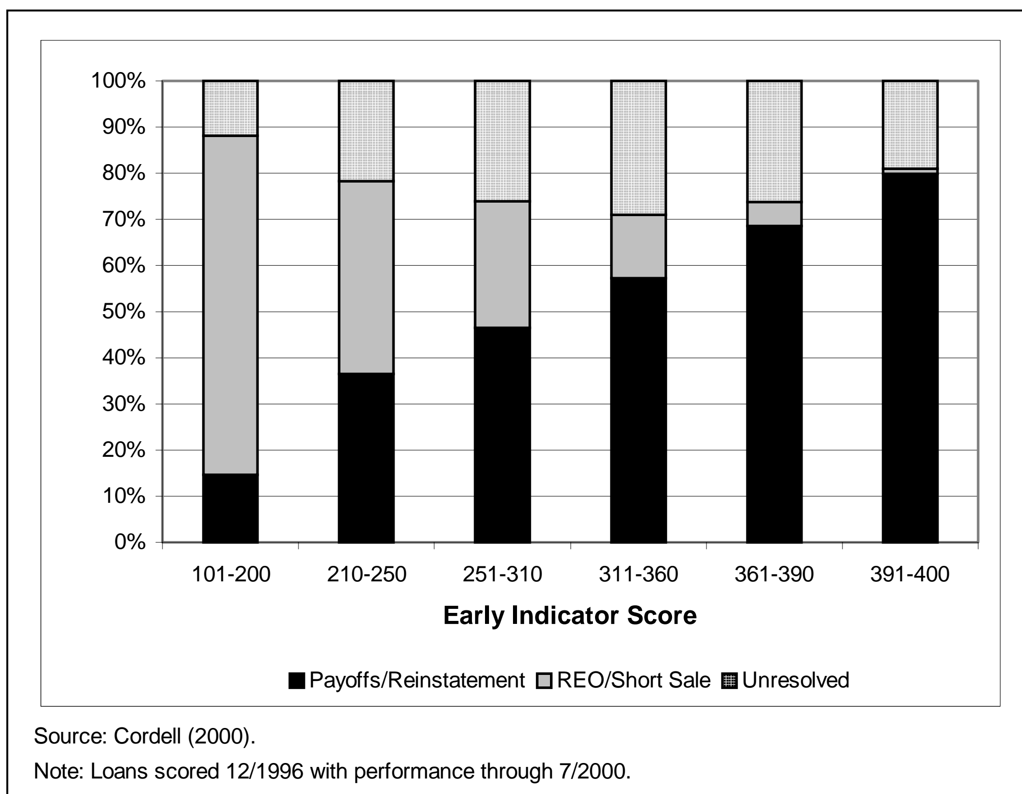
The technologically intensive nature of the servicing business is not limited to payment posting. Servicers employ ‘early detection’ software systems that track payment patterns for each loan in their portfolio and look for anomalies. In fact, servicers can carefully monitor late payments because they are able to track payment envelopes as soon as they have entered the postal system. This is possible due to the bar coding of remittance envelopes and the Postal Service’s computerized mail processing.

Because of the frequency of delinquency in the subprime market, some servicers go to great lengths to establish a relationship with their borrowers. This improves the likelihood of a successful contact should the servicer detect a problem. The effort to establish lines of communication with subprime borrowers includes sending initial welcome packs with the servicer’s contact information (one company sends coffee mugs) and materials encouraging the borrower to call at the earliest sign of trouble. Many servicers also make welcome calls designed to establish contact and to implant the message that borrowers should contact them at the first sign of trouble. In contrast, however, one interviewee described such early-and-often contact methods as “pestering the borrower.”

Software packages called ‘scoring tools’ are employed to help the servicer navigate the delinquency process with each borrower. As noted earlier, industry practice divides missed payments into ‘collections’ and ‘default management’ phases. Freddie Mac’s Ear-

ly*Indicator* and Fannie Mae's Risk Profiler are systems designed to manage these aspects of the process in the conforming market.[34] Early*Indicator* scores collections accounts from 000 to 099 based on past payment history, credit rating, and other factors. Higher scores are more likely to cure before reaching thirty days past due (DPD). These scores are used to structure staff time more efficiently and to queue automated dialers for collections campaigns (Freddie Mac 2000).

Figure 9: Performance Improves with Early*Indicator* Scores



Source: Cordell (2000).

Note: Loans scored 12/1996 with performance through 7/2000.

Early*Indicator* ranks loans more than 30 DPD from 101 through 400, with higher scores less likely to reach foreclosure. Based on these scores, servicing interventions such as attempting first contact, sending a foreclosure alternative letter, and initiating foreclosure proceedings are timed for different points in the delinquency cycle. For example, Early-

[34] Though the GSEs have recalibrated them for use in the subprime market, these software tools are used primarily in the conforming market. Deployment among subprime servicers is limited and industry perceptions as revealed in our interviews were not positive about current performance. The discussion here nonetheless focuses on Freddie Mac's product tools because information is publicly available and because the function they are designed to perform is the same as that of subprime-oriented systems.

Indicator recommends initiating foreclosure proceedings by 90 DPD for those with scores between 101 and 360 but waiting until day 120 for those with scores above 360. As shown in Figure 9, loans scored more highly do indeed encounter fewer problems.

Predatory Servicing

The notion of 'predatory servicing' now rivals 'predatory lending' as a concern of regulators, community advocates and mortgage industry officials alike. This new term is generally reserved for the subprime market and refers to unfair, deceptive, and illegal practices that harm borrowers' financial interests, especially in cases where their ability to remain in the home is affected. The most egregious accusation is that some servicers or servicer/investors 'profit from foreclosures,' though industry unanimously decries this claim. The recent settlement between the FTC and the largest subprime servicer, Fairbanks Capital Corp., has given weight to concerns over the fact that, for actors with substantial power to determine subprime borrowers' outcomes, servicers face little regulatory oversight, a concern compounded by the fact that borrowers cannot choose who services their loan.[35]

The Fairbanks settlement is a good place to begin looking at what might constitute predatory servicing. The company was accused of violating four federal statutes: the FTC Act, the Fair Debt Collection Practices Act (FDCPA), the Fair Credit Reporting Act (FCRA), and the Real Estate Settlement Procedures Act (RESPA). Specifically, the FTC alleged that Fairbanks did the following (FTC 2003).

- Failed to post consumers' mortgage payments in a timely and proper manner, and then charged late fees or additional interest for failing to make payments 'on time.'
- Charged consumers for placing casualty insurance on their loans when insurance was already in place ('force-placing of insurance').
- Assessed and collected improper or unwarranted fees, such as late fees, delinquency fees, attorney's fees, and other fees.

[35] Consumer Web sites contain tales of borrowers refinancing loans for the sole purpose of changing servicers.

- Misrepresented the amounts consumers owed.

In the recently announced settlement, Fairbanks agreed to cease these practices, abide by relevant legislation, and pay $40 million to address complaints and reimburse consumers.

While the suite of practices described in the settlement indeed sounds abusive, several industry insiders interviewed for this report voiced the opinion that, though the company undoubtedly made mistakes, Fairbanks was less an intentional purveyor of inappropriate practices and more a firm unable to manage the volume of work it had taken on. (Fairbanks' subprime portfolio more than tripled from $14.1 to $49.3 billion from 2001 to 2002 as the company bought the servicing rights to Bank of America's subprime portfolio and its EquiCredit subprime mortgage servicer.) The language of the settlement to some extent supports this interpretation. For example, in the settlement documents, Fairbanks is admonished to "take reasonable actions" to determine whether customers have casualty insurance (presumably a properly functioning servicer would know this information) or to perform several functions "in a timely manner."

Subprime servicers are naturally concerned that the Fairbanks settlement reflects poorly on the entire industry.[36] Based on the interviews conducted for this study, industry perception of the predatory servicing issue can be summed up in four parts. First, while inappropriate practices have occurred, officials assert that they were never pervasive and are waning where they exist. Second, much of what is being labeled predatory servicing is, in fact, 'bad servicing,' as illustrated by the Fairbanks debacle, which occurred after its growth outpaced the ability of its internal systems and staff to manage. Third, where they do or did exist, problematic servicing practices are generally not nearly as severe or entrenched as those in originations. (One interviewee highlighted the qualitatively different financial impact of improper payment posting and equity stripping.) Finally, to the extent that problematic servicing practices are still occurring, they lend themselves to straightforward solutions, unlike problems on the origination side where disagreement still re-

[36] They also worry that state-level predatory servicing laws, such as those already enacted as part of anti–predatory-lending laws in New Jersey, New Mexico, and Illinois, will bring additional and unnecessary complexity to the servicing business.

mains as to what constitutes a bad loan or abusive practice, and the answer may in fact vary depending on the circumstances.

In an expression of the changing climate in the servicing industry, the general counsel for one company commented that “there is currently no tolerance for the servicer also providing ancillary services and charging for it,” noting that some third-party servicers had used this to increase revenues in the past “so now it’s under the microscope.” Some servicers continue to cross-sell ‘add-ons,’ claiming that because of their bulk purchasing power they can provide these additional services at a lower price than the customer could obtain on his or her own. Even so, this respondent explained that due to allegations about predatory servicing he forbids his company from providing any ancillary services even if they can do so at a cost savings to the borrower relative to other third-party vendors of the service.

Whatever the industry view, many groups that once focused exclusively on ‘predatory lenders’ have begun to focus on alleged ‘predatory servicing.’ These efforts are fueled by cases where homes have been lost not due to failure to pay principal and interest, but to an inability to keep up with fees charged by aggressive servicers. Alleging that Fairbanks had been misapplying fees, withholding payments, and charging unnecessary fees, National People’s Action (NPA), a grassroots coalition of community affiliates coordinated by NTIC, has mounted a multistate campaign to pressure Fairbanks to provide compensation to abused families. As part of this campaign, for example, the NPA Des Moines affiliate has enlisted the attorney general’s office to help in their efforts to get Fairbanks to compensate victims. In Syracuse, New York, the NPA affiliate recently mounted a campaign to persuade one bank to remove Fairbanks as its loan servicer. Undoubtedly, this coordinated advocacy campaign contributed to the willingness of Fairbanks to enter into the settlement with the FTC (see NTIC 2003).

4.2. SUBPRIME SERVICING: MARKET CHARACTERISTICS

As noted at several places in this report, mortgage servicing is a relatively consolidated industry. This subsection examines the pattern of consolidation, the factors driving the process, and compares the level of consolidation in servicing to that in originations.

Figure 10: Top 25 Subprime Servicers, 2002

Servicer	2002 Volume ($bill.)	Market Share (%)
Fairbanks Capital Corp	49.3	8.6
CitiFinancial Mortgage	47.3	8.2
Household Financial Services	46.3	8.1
Ocwen Financial Corp	30.4	5.3
Option One Mortgage	28.1	4.9
Homecomings (GMAC-RFC)	27.4	4.8
Countrywide Financial	25.2	4.4
Ameriquest Mortgage	17.0	3.0
HomEq Servcing Corp	16.7	2.9
Chase Home Finance	16.2	2.8
Washington Mutual	14.5	2.5
National City Home Loan Services	11.3	2.0
Litton Loan Services	10.8	1.9
American General Finance	9.5	1.7
Conseco Finance Corp	8.8	1.5
PCFS Financial Services	7.8	1.4
Saxon Mortgage	7.6	1.3
Wendover Financial Services Corp	6.3	1.1
Wells Fargo Home Mortgage	6.1	1.1
EMC Mortgage Corp	6.0	1.0
Centex Hoem Equity Corp	5.2	0.9
Key National Home Equity	5.1	0.9
IndyMac Bank	5.0	0.9
Equity One Mortgage	4.4	0.8
Wilshire Credit	3.7	0.6
Top 25 Total	**416.0**	**72.4**
Market Total	**574.2**	**100.0**

Source: Inside B&C Lending.

As shown in Figure 10, the top 25 mortgage subprime servicers account for nearly three-quarters of the market, up from less than one-third six years ago. Today's largest sub-prime servicers are a mixed bag of subsidiaries of major financial conglomerates, such as

Citigroup and HSBC, and firms specializing in subprime. Two of the largest, Ocwen Financial and Fairbanks Capital, are third-party servicers who neither originate their own loans nor hold a financial interest in the securities they service. Others are large subprime specialist firms such as Ameriquest, Option One, and New Century. The top 25 are listed with their portfolio volume and market share in Figure 10. Collectively, these organizations service 72 percent of the $574 billion in B and C loans outstanding (*Inside Mortgage Finance* 2003).

Few studies have examined the factors supporting consolidation in the servicing industry and none has looked at the subprime segment exclusively. More than a decade ago Follain and Zorn (1990) predicted that the unbundling of traditional thrift functions, including servicing, in response to regulatory changes in the 1980s would lead to increased 'specialization' of these functions in the overall mortgage market. They further noted that, after holding steady at around 11 percent between 1974 and 1979, the share of loans handled by the top 100 servicers had increased to 20 percent by 1988. The authors also commented on the "striking" level of consolidation apparent by 1989, when the top fifteen servicers handled 16 percent of the $2 billion outstanding.

Interestingly, Follain and Zorn (1990) were unsure about the impact of economies of scale on specialization or consolidation among servicers. This issue is addressed by Rossi (1998) in a study examining the costs structure of the mortgage banking industry designed to evaluate future consolidation trends in origination and servicing. He notes that an earlier study by the Mortgage Bankers Association showed servicing costs at mortgage banking operations with less than 5,000 loans were double those of mortgage banks with more than 70,000 loans. Using 1990 to 1992 balance sheet and income statement data from mortgage banks, Rossi finds that substantial economies of scale in servicing exist even at the highest output sizes. He claims that servicing is particularly amenable to scale economies because of the extent to which its requirements can be automated and involve information sharing. Rossi (1998) concludes that as of the early 1990s mortgage banking was an industry characterized not only by scale economies but also by declining costs due primarily to servicing.

Servicing has also been targeted as an industry destined for extreme consolidation due to technological advances that have unleashed economies of scale in a business based on information processing. In the mortgage market as a whole, the top five organizations now service almost 40 percent of all loans, compared to 10 percent a decade ago (Cutts and Green 2003). The subprime market has not reached this degree of consolidation, however. In part, this could reflect the fact that the subprime market itself is relatively young, and has yet to realize fully the potential cost reductions linked to scale economies. Alternatively, lack of consolidation could indicate a difference in borrower characteristics that make subprime servicing less conducive to consolidation. In the words of one servicing executive, "subprime servicing is not a scale business."

Going forward, industry is bracing for continued consolidation. One of the most widely quoted statements in the mortgage industry, made by both Angelo Mozillio and Kerry Killinger, who head two of the institutions expected to prevail in this battle (Countrywide and Washington Mutual, respectively), is that in five years' time only five major servicers will remain. Industry characteristics such as information intensiveness and the fact that technology can be applied to beneficial effect in nearly every aspect of the business seem to support such claims. The up-front costs of software systems and call centers each point to increasing inability of smaller players to compete. Further, competitive advantage is now and will increasingly be a function of having the most efficient cash management techniques, such as high-tech lock boxes that almost instantaneously deposit borrower funds.

4.3. ARE SUBPRIME BORROWERS DIFFERENT?

The subprime servicing is still in its infancy, with major players still competing for market dominance, and in doing so often employing fundamentally different business models to guide their efforts. One question that continues to divide the industry is whether there are meaningful differences between prime and subprime borrowers. While some industry experts interviewed for this report stressed that the differences were pronounced, others contend that the differences between subprime and prime borrowers were simply a matter

of degree. In any event, to the extent that such differences exist, they imply different levels of success for different servicing approaches in each market.

Evaluating evidence for the claim that prime and subprime borrowers are different reveals that prime borrowers, in addition to having superior credit backgrounds, tend to have larger cash reserves and more stable employment histories than subprime borrowers. They may also have greater sources of emergency cash, such as friends and relatives with funds available to help them overcome a temporary financial hardship. In combination, these features make prime borrowers unlikely to become delinquent or to default on their loans. As Figure 11 shows, serious delinquencies rise steadily as credit quality declines. The same is true for defaults.

Figure 11: Likelihood of Delinquency and Default by Credit Quality

	Prime			
	Conventional		FHA	*Total*
	Conforming	Jumbo		
Share of All Mortgages (%)	59.95	22.34	9.43	*91.75*
Serious Delinquency Rate (%)	0.94	5.31	6.40	*2.23*

	Subprime						
	AA+	AA	A	B	C	CC	*Total*
Share of All Mortgages (%)	0.47	3.42	1.94	0.87	0.66	0.89	*8.25*
Serious Delinquency Rate (%)	7.70	16.60	22.50	32.60	39.70	43.60	*23.80*

Notes: Share of mortgages based on 2001 dollar volume of originations. Serious delinquency rate based on Freddie Mac experience for loans originated in 2000; FHA serious delinquency rate from Feshbach (2002) for loans originated in 2000, Jumbo serious delinquency rates average over all current years and are from Loan Performance (2002); subprime performance from Option One Mortgage Corp (2002).
Source: Cutts and Van Order (2003).

Prime borrowers' more robust position vis-à-vis delinquency and default suggests that the appropriate servicing model for them is one in which the servicer initiates foreclose proceedings as quickly as possible once significant trouble is detected. Typically, prime borrowers are more likely to cure a delinquency if they have the desire to remain in the home because of additional resources available to them as compared to subprime borrowers. Therefore, loans that become severely delinquent are typically cases where the borrower has given up trying to save the loan. Following a divorce, for example, neither spouse

may have an interest in remaining in a home with little equity. In such a situation, accelerating the foreclosure process is the best option for the lender.

The extent to which prime and subprime loans differ with respect to market value of the homes that serve as collateral introduces another source of variation in servicing. Compared to prime loans, subprime loans are far more common in marginal neighborhood where foreclosing may not net the lender sufficient value to justify the cost of the process.

Those arguing that subprime borrowers are different also point out that thin cash cushions and more frequent employment gaps make delinquency a structural aspect of subprime payment streams. (One servicing manager estimated that one in four subprime borrowers becomes delinquent at some point.) Borrowers facing a three-month layoff may be unable to pay during that period but able and eager to begin paying again when they are rehired. At this point the loan is severely delinquent but, unlike in the prime market, the severe delinquency does not reflect the borrower's unwillingness to make the loan work, but rather the inability to pay off arrears.

An additional potential difference relates to the greater prevalence of inappropriately originated loans in the subprime market. To the extent that broker malfeasance produces loans for which borrowers are marginally qualified, delinquencies and defaults will also be higher, and servicing will be more challenging. A further source of difference is suggested by Cutts and Van Order (2003), who hypothesize that subprime borrowers may be more likely to 'borrow' from the noteholder by deliberately not paying their loan for a month or two in order to address other financial concerns. When they come current a few months later they take the penalty for doing so as an interest payment on what amounts to a short-term loan.

Extrapolating from these characteristics implies a very different and higher-cost servicing model that potentially requires increased human contact and hence reduced scope for economies of scale to operate. Subprime collateral is also likely to be weaker because it

tends more often to be located in marginal neighborhoods and because the subprime homeowner may have fewer resources available to maintain the home's quality. In addition, subprime loans tend to be smaller and the homes less expensive, meaning that less equity is typically available to reward the effort and expense of going through foreclosure. Further, as the preceding paragraph suggests, even fairly severe delinquencies are not necessarily indicative of the subprime borrower's lack of willingness to remain in the home. Given the high cost of foreclosure it is therefore almost always in the interest of the investor to employ a workout if the delinquent borrower has the ability and willingness to do so.

Another key issue is the servicer's differing incentive for pursuing loss mitigation in the prime and subprime markets. Cutts (2003a: 2) claims that servicers in the conforming market are very price-conscious because they are compensated by "a flat servicing fee with fee/bonus incentives from investors for achieving low incidences of default. Thus any change in practice that streamlines processes, reduces the incidence of foreclosure and REO, or increases the cure rate on delinquent loans will result in a direct increase in profitability for the servicer." In the subprime market, however, third-party servicing is less common and servicers are more often in line to take the first losses due to default and delinquency (referred to in the servicing industry as having 'skin in the game').

This investor/servicer role may provide stronger incentives to avoid foreclosures than do the bonus fees and provide the potential for obtaining superior results for other investors participating in the transaction. Said one official from a major subprime issuer/servicing organization "the fact that we have our own money on the line should a pool of subprime loans experience unexpectedly higher rates of foreclosure helps us to market our securities to other investors. We believe, and have put substantial amounts of our own money at risk in support of this proposition, that with greater attention to customer service, and our efforts to promote good customer relations, we can reach borrowers in distress sooner, and help them to get back on track and avoid costly foreclosures. Time will tell if we are right, but our growth in profitability and market share suggests that we are moving in the right direction."

Because risk levels are less well established in the subprime market and because the risk of credit losses is higher, potential returns to the residual-holder from minimizing credit losses are much larger on a subprime than a prime securities issue. Therefore, subprime servicers holding residual risk can devote additional effort to foreclosure avoidance and loss mitigation beyond what would be economic in the prime market, with the expectation of making it up via improved performance of the residual interest in the securities they hold. This is true even in comparison to a prime market servicer holding a residual interest in a loan pool because the payoff for success is larger in the subprime market to compensate for the demonstrably higher credit risk of the borrowers.

4.4 CONCLUSION

Servicing approaches in the subprime mortgage market are still being developed, tested, and perfected. Competing servicing models exist side by side in the marketplace, as the industry seeks to better understand what servicing best practices can be simply transferred from the prime mortgage sector, and what practices must be adapted to reflect the differences associated with subprime borrowers, subprime loan products, and the neighborhoods in which they are typically located. To date, while no approach is dominant, most industry participants recognize that the enormous opportunities for loss reduction exist during the servicing process. Sustained lower loss rates will translate directly into increased profitability for issuers by reducing credit enhancement requirements and/or by allowing securities constructed from the same pool of loans to be sold for higher price. Fortunately this market incentive should also work to improve outcomes for subprime borrowers. Lacking clear answers to many basic questions, now is the time for interested parties — industry, governments, and community-based players alike — to explore the potential for collaborative solutions to mitigate the substantial costs associated with the unexpectedly high level of foreclosures affecting many low-income communities.

Section 5: DISPOSITION OF FAILED LOANS: WORKOUTS, WRITE-OFFS, FORECLOSURE, AND REO

While innovative and appropriately aggressive servicing and collection efforts can help many borrowers avoid and recover from severe repayment problems, default and foreclosure are structural aspects of the mortgage market. Indeed, some level of foreclosure is unavoidable even in lending to the best credit risks. Because foreclosure is typically the worst outcome not just for borrowers but for investors as well, expanding credit access to less creditworthy borrowers has challenged the mortgage servicing industry to create new and enhanced foreclosure avoidance tools, with varying degrees of success. In the event that efforts to mitigate the financial impact of failed loans do not succeed, servicers often are left with the difficult task of disposing of the collateral backing the failed loans. Doing so in a manner that minimizes investor losses is far from an easy or straightforward process.

This section discusses this final stage of the servicing process, as well as the impact that the current structure of mortgage securitizations may have on the ability of servicers to engage in foreclosure avoidance and effective property disposition efforts that are consistent with limiting negative effects of foreclosure on the neighborhoods in which they occur.

5.1. ALTERNATIVES FOR BORROWERS IN TROUBLE

One of the most important functions performed by the servicer is to offer delinquent borrowers workout options that avoid foreclosure while also minimizing investor losses. A study of prime mortgage foreclosures by the Tower Group (Focardi 2002) highlights the fact that under most circumstance both sides have a strong incentive to avoid foreclosure if possible. The study finds that the average foreclosure takes eighteen months to complete at a cost of nearly $58,000. For the borrower, the obvious advantages of foreclosure avoidance include minimizing damage to credit histories and, in a surprising number of cases, the ability to remain in the home.

The term workout is often used to refer to any action by the servicer that sanctions a payment pattern different from that laid out in the original loan documents. Servicers speak of the difference between 'mods' (i.e., modifications) and 'plans,' with the former involving permanent legal changes to the terms of the loan and the latter being shorter-term solutions typically lasting less than one year.

While no strictly agreed upon typology of workouts exist, Cutts and Green (2003) offer a typology that divides them into home retention and voluntary title transfer alternatives. Home retention workout options include partial reinstatement, short-term forbearance, long-term forbearance, and loan modification. Partial reinstatement occurs when a borrower who has become delinquent begins paying again and agrees to a plan to repay arrears in twelve months or less. Forbearance refers to the servicer arranging for a period of less than six months (short term forbearance) or four to twelve months (long-term forbearance) during which payments will be reduced or suspended, followed by a repayment plan to make up monies not collected during the forbearance period. Bankruptcy is considered to be a workout by some servicers because, without changing original loan terms, it allows borrowers to remain in the home for several years while they attempt to pay back their loan.

Modifications ('mods') are generally any permanent changes to loan terms. These are usually a later effort to minimize the net present value of losses when earlier plans have not succeeded. In most cases modifications are used when the borrower has had a temporary financial hardship but cannot make up arrears on his own. In this case the arrearage is added to the principal balance and monthly payments recalculated (term extensions are usually prohibited). Less frequently modifications are used when the household has suffered a permanent loss of income (e.g., disability rendering one wage earner unable to work) but has demonstrated a commitment to remain in the home.

An example of the latter type of modification is presented in Figure 12. The household's monthly after-tax income has fallen by $300 (14 percent) and the modification lowers monthly mortgage payments by $170. The change reinstates the borrower and lowers

payments to a level that is affordable given the changed circumstances that led to the delinquency. The last row of the table reflects an aspect of workouts that is important to many lenders — keeping post-hardship debt-to-income ratios commensurate with those prior to the hardship. Mods have been become increasingly common over the past few years, in large measure because they have been shown to be successful in avoiding losses due to foreclosure.

Figure 12: Typical Pre- and Post-Hardship Ratios for Household with Modified Loan

	Pre-Hardship	Post-Hardship
Monthly Net Income	$2,200	$1,900
Mortgage Payment	$770	$600
Non-mortgage Recurring Monthly Obligations and Expenses	$1,080	$1,080
Total Monthly Expenses	$1,850	$1,680
Net Debt-to-Income Ratio	1.19	1.13

Voluntary title transfer workouts include deed-in-lieu of foreclosure, short sales, and mortgage assumption. In a deed-in-lieu of foreclosure transfer, the servicer determines that owning the home immediately — thereby avoiding the costs of the foreclosure process — is the cost-minimizing way out of the loan. A borrower accepting this workout option relinquishes any ownership interest in the home. A short sale is similar in that the borrower is allowed to pay less than what is owed, in this case by selling the home for less than this amount and turning the proceeds over to the servicer. Such sales are based on the servicer's determination that the difference between the short-sale selling price and the amount owed is greater than the cost of taking the borrower through the foreclosure process. A mortgage assumption occurs where a new party that has been approved by the lender assumes the original borrower's mortgage obligation. In the only published estimate of the savings associated with voluntary title transfer workouts for prime mortgages, Focardi (2002) found that, while costs are still high, they were roughly $14,000 lower and saved six months, relative to going through foreclosure.

5.2. DECIDING WHEN TO WORKOUT AND WHEN TO FORECLOSE

As noted in the previous section, loan servicers typically use complex mathematical models embedded in software programs ('scoring tools') to allocate collections resources relatively early in the default process. These scoring tools do not suggest who should get a workout, or what form workout options should take, however. This is the province of 'decisioning' tools which may or may not be combined with 'scripting' software that guides collections and default management counselors through a series of questions designed to gather the data necessary to determine whether a delinquent account is salvageable. The decisioning phase involves determining which route maximizes the present value of the loan given factors such as the stage of delinquency, borrower and loan characteristics, and applicable state laws governing the foreclosure process. An investors' list of acceptable modification alternatives and conditions can also be included in the software. Scripting is one way to ensure that all the information needed to compare workout alternatives is collected. As evidence of the diversity of industry practices, however, one of our interviewees from a major subprime outfit argued that these tools prevent the servicer from "listening to the borrower" and that the function is best left to well-trained specialists. Another noted that that automated decisioning tools often miss relevant components of a borrower's situation in the subprime market.

While decisioning tools can assess the financial ability of the borrower to continue paying the loan under various workout scenarios, they are not able to determine the borrower's level of commitment to doing so. This factor, called 'desire' or 'willingness' in the servicing industry, is the subject of behavioral models under development. Though in its infancy, these models are continually improving and may some day be as prevalent and effective in servicing as credit scoring has become in originations. In the meantime, servicers complement their effort to model desire by deploying their best and most experienced counselors on the toughest cases.

Cutts and Green (2003) point out that while on a case-by-case basis workouts are intended to (and presumably do) lessen losses relative to pursuing foreclosure, there is a

systemic concern that the increased availability of workout options will reduce the borrower's diligence and effort in meeting their payment obligations (i.e., a classic moral hazard problem). For this reason, lenders often mandate that to be eligible for a workout, borrowers must have gotten into trouble through an *involuntary* inability to pay such as a job loss, illness, or injury. (Others disagree, noting that the reason for default is not as important in determining which workout option minimizes loss severity.)

Cutts and Green (2003) also note that the state-level legal context, including provisions concerning payment of deficiency judgments (i.e., allowing other assets of borrowers whose homes are foreclosed upon to be claimed by the creditor) can influence borrower behavior. The influence of state laws on lenders' expectations about borrower behavior is supported by Pence (2003) who shows that, all else being equal, loan sizes in housing markets that span state borders are smaller in states that forbid deficiency judgments than on the other side of the border where they are permitted, a fact she attributes to lenders rationally limiting their exposure to risk under the differing legal regimes.

5.3 DOES SECURITIZATION LIMIT WORKOUTS?

Despite the appeal of workouts — when offered judiciously they are by most accounts better for the borrower, investor, and servicer — some claim their usage is limited by rules associated with the securitization process. To the extent that they exist, such rules could unnecessarily raise default and foreclosure levels. The issue receiving most attention is the alleged 'five-percent threshold' on loan modifications in pools whose cash flows have been securitized. In reality, the five percent figure does exist (since the spring of 2003) but only applies to mods where missed payments and penalties are capitalized, called 'capitalization mods.'[37] Further, while the bond rating agencies insist on the threshold, the language in the P&S is crafted in such a way that the restriction is not binding.

[37] Capitalization mods involve adding arrearage (delinquent principal and interest, escrow advances, and fees) to the principal balance of the loan and re-amortizing the loan over the remaining term. They are usually combined with a permanent reduction in interest rate or lengthening of the loan term in order to lower the borrower's monthly payment in response to a permanent reduction in income.

Limiting modifications to a share of the pool is a somewhat coarse solution to address the fact that some servicers had previously abused the ability to modify loans. According to one industry insider, such abuses included making modifications that were not in the borrower's best interest, merely postponing inevitable losses. Servicers might be motivated to do this because servicing contracts have triggers built in that, for example, forbid release of overcollateralization to residual holders if the share of nonperforming loans is too high. In order to ensure that poolwide defaults remain low enough not to hit this trigger, these lenders would modify loans (thereby reclassifying them as current or performing), thus avoiding making the marketplace aware of the fact that they were not able to pay a class of bondholders (as well as avoiding angering the actual bondholder). Using modifications could also improve trading of securities, benefiting the issuer's reputation by managing the share of performing loans. Finally, the five-percent threshold is intended to impose some discipline on lenders who modify too frequently simply because they are not adept at determining which borrowers should be offered a mod and which should not.

As noted above, however, the five-percent threshold is not firm.[38] The P&S typically refers to exceeding the five-percent threshold on mods 'pending rating agency approval.' In theory (since the practice of including the five-percent language is so new no one has reached the threshold yet), lenders who hit the five-percent ceiling can go to the rating agency and present their case. By showing that their modifications have been effective in mitigating losses and explaining their reasons for wanting to do more, servicers feel that they will be allowed to exceed the five-percent threshold without triggering a ratings action on the securities. However, a large degree of uncertainty remains as to whether securities contracts do in fact limit a servicer's flexibility in the pursuit of realistic workout options. The ratings agencies may need to better understand mitigation efforts so that innovative efforts by servicers can be more strongly encouraged.

[38] In practice, the five-percent limit is not overly restrictive either, because it is based on the original pool balance at the time securitization. Since this balance begins shrinking immediately as borrowers prepay, the pool of potentially modified loans declines over time, making reaching the cap a larger challenge than it might initially appear.

Other aspects of the argument that 'securitization limits foreclosure avoidance options' are less well specified than the one dealing with the five-percent capitalization modification threshold. Some observers contend, for example, that enabling the sale of servicing rights has resulted in the emergence of a class of servicers whose financial interests are not aligned with those of either the borrower or the investor. As discussed earlier, however, the relative effectiveness of different servicing models has not been definitively established in the marketplace, an event that may only occur in the face of a true housing market downturn.

5.4. FAILED LOANS: REO AND WALKAWAYS/WRITE-OFFS

When workout plans and modifications are unsuccessful, or when servicers determine that a workout is no longer an economical choice, there are two routes a failed loan can take: REO and write-offs. Servicers take property into REO (real estate owned) portfolios when they determine that doing so will minimize investor losses. Since a prerequisite for such determinations is that the property has sufficient value to justify the expenditures associated with the foreclosure process, they tend to be relatively higher-quality homes. For very low-value homes or those properties associated with other negative characteristics (e.g., court cases, code violations, liability issues), the lender simply writes off the loan to avoid compounding investor losses with expenses such as property taxes, insurance, and a variety of maintenance costs, including city ordinance requirements. In this case, title legally remains with the borrower (although the borrower is often unaware of this and has vacated the home), making it difficult later for municipal authorities or neighborhood groups to deal effectively with the vacant property.

One REO specialist interviewed for this report described the process through which loans reach REO as follows. At ninety days past due (DPD) the company conducts an initial evaluation to determine whether there is sufficient value in the home to initiate foreclosure proceedings. (At most institutions foreclosure proceedings and workout efforts proceed simultaneously due to the length of the foreclosure process and the imperative to

foreclose as quickly as possible when the loan cannot be saved).[39] In rare cases where value is insufficient at this early stage, the company ceases further recovery efforts, in some cases releasing the lien but leaving the borrower in title. This value estimation is repeated periodically as the foreclosure process unfolds (with the same possible outcomes as at 90 DPD) and a final time prior to the foreclosure sale. If a determination is made not to take the property to REO, the company can avoid assuming title by writing off the asset and not bidding at the sale.

REO is costly because it requires servicers to arrange for the repair, maintenance and resale of the property. They must also stay current on property taxes. This requires that large national servicing firms maintain a large network of vendors to perform these services. The challenge and cost of assembling and policing these networks is substantial and is one reason why servicing is amenable to economies of scale.

It is worth remembering that the loan and the servicer typically have been bleeding cash on behalf of the trust for months, if not longer, by the time properties enter the REO portfolio. In addition, the fact that a vacant property may continue to lose value can add further costs until the property is sold. In addition to cost to investors, there can also be negative impacts for vulnerable neighborhoods. Servicers often have little incentive to engage in the time-consuming and costly process of conducting a thorough rehabilitation, especially since housing markets in the neighborhoods where foreclosures concentrate are often weak. Though some do so in cases where the costs are offset by anticipated higher sales value of the rehabbed unit, many rationally 'paint and patch' in order to turn the property around as quickly as possible.

This has several neighborhood impacts. First, the failure to fully rehab a home may pose problems to the new owners, especially lower-income borrowers who may lack the re-

[39] Moody's (2001) servicer evaluations describe this process as follows: "Moody's believes that better servicers pursue both early settlements and foreclosures simultaneously. That way, if early settlement efforts are unsuccessful, the foreclosure process is already underway and costly delays may be minimized. Additionally, many servicers incorporate the foreclosure process into their efforts as a way of impressing the seriousness of the situation on a borrower."

sources to address any needed structural repairs. Second, since potential owner-occupiers may shy away entirely from purchasing an REO property in poor repair, many are sold to investors who rent them in a shabby state to tenants at whatever rate the market will bear. In either of these scenarios, the property can and often does deteriorate further, and in doing so drags down property values in the rest of the neighborhood as well.

If anything, the neighborhood impact of write-offs is worse and the legal issues associated with intervention even more complex. When a loan is written off, in some cases the borrower remains in the home. In such cases the home is already in poor and potentially unsafe condition as evidenced by the fact that the servicer determined that the interest of the trust is best served by relinquishing claim to it. Often, however, the borrower has already left the home and is unaware (and most likely not interested in the fact that) he or she holds title. The home, now a 'walkaway,' does not go through the foreclosure process and hence sits in limbo, deteriorating. Those agents interested in ameliorating its negative impact on the neighborhood (community groups, municipalities, and others with properties in the area) have no way to take control of the property, since state laws governing title transfer and foreclosure procedures were not designed to handle cases such as these. In some cases municipal ordinances permit or mandate the demolition of such buildings, but otherwise it is difficult to do anything about them.

In order to take control of the 'walkaway' problem, some community-based organizations and cities are exploring legislation allowing the creation of nonprofit corporations formed especially to take these properties through foreclosure in order to free up title. These entities would then hold title to the unit, which they could transfer to existing CBOs who would then take responsibility for rehabbing the properties and ensuring that they reenter the housing stock in a structurally robust state and with a capable owner-occupier.

The complexity of issues involved in the foreclosure/REO/write-off process is central to the impact of failed loans on vulnerable neighborhoods and industry bottom lines. Problem properties are not only sources of large losses to investors but are also magnates for illicit behavior that depress surrounding property values. Streamlining and rationalizing

these processes is essential in order to shorten the period of deterioration and vacancy and make it easier to transfer these properties into the hands of actors seeking to improve or remove them for the sake of the neighborhoods of which they are part.

5.5. WHAT PREVENTS BETTER OUTCOMES?

Servicers interviewed for this study were unanimous in claiming that foreclosure was not only an undesirable outcome for borrowers, it was bad for business as well. Given the general alignment of incentives, how then do foreclosures come about? One respondent developed a loose, four-class foreclosure typology comprised of two borrower-induced problems and two industry-induced problems: (1) borrowers who refuse to contact or be contacted by the servicer; (2) borrowers who remain unrealistic about their ability to meet payment obligations following a permanent income shock (i.e., divorce, disability, or death of an earner); (3) victimization by fraudulent or abusive origination practices; and (4) servicing by firms lacking the resources and, in some cases, technological sophistication to meet the challenges of servicing in the subprime market.[40]

In addition to these paths to foreclosure, the industry is also plagued by borrower fraud. There are a variety of permutations, often involving some combination of brokers, appraisers, and borrowers. These scams have a large enough impact on losses that servicers and issuers have invested heavily in fraud detection systems that evaluate loan applications for suspect characteristics and patterns. One firm reported on their special 12-point ‘purchase money checklist’ that subjects nonrefinance loans to additional scrutiny. To illustrate the nature of such fraud, several servicers told of a scheme in which the fraud purveyor will arrange to have a low-value building appraised for well above its market value. This individual then finds a presumably financially unsophisticated collaborator with a clean but undeveloped credit history to apply for a subprime loan on the property. Assuming the loan is approved, the fraud purveyor pays a modest sum (often just $5,000) to the collaborator and walks away with the balance of the loan funds. The individual in

[40] This respondent also noted that a small minority of borrowers appear to lose their homes as a result of substance abuse or gambling problems. As evidence, the interviewee referred specifically to cases where the financial documentation available to the servicer indicate substantial capacity to meet payment obligations but the borrower consistently failed to do so.

whose name the loan was made disappears and no payment is ever made on the loan. One interviewee called this "renting out someone's credit history."

In addition to these more direct avenues, some foreclosures result from the fact that subprime servicing models are still works in progress. In general, there is insufficient data to calibrate models predicting subprime loan-repayment behavior. Both servicers and the rating agencies are collecting and tracking this data with the goal of improving current credit-risk assessment capabilities, but the industry as a whole is not there yet. A related issue is the attempt to recalibrate models established for the prime market for the subprime market. Simply having enough years of data is one problem, but getting relationships between variables properly established is another. At this time it is an open question whether relationships are consistent across the two markets. As evidence of this point, several servicers interviewed for this report claimed that Freddie Mac's Early*Indicator*, a scoring tool widely utilized in the prime market, is not as effective as similar tools developed especially for the subprime market.

Others argue that the rise of subprime foreclosures reflects the structure of the marketplace, and the fact that task segmentation limits the ability of the industry to self-correct. According to this view, elevated foreclosure rates are in part the combined effect of the origination issues detailed earlier and the fact that securitization renders most of the funds invested in a pool of loans immune from credit risk (Taff 2003). Servicers report, for example, that residual and mezzanine investors are more vigilant and attentive to servicing performance than holders of investment-grade tranches. While these investors might also be expected to have spent more time assessing the originators of loans in the pool and, where possible, avoiding those with a history of poor performance, in practice it is often difficult to gain useful information below the issuer level.

Under most circumstances, therefore, only a small minority of investors has an incentive to examine and track originator performance and to a great extent these investors cannot observe it anyway. In this context the feedback that investor decisions would ordinarily supply to improve origination practices is substantially attenuated and, in combination

with the fact that securitization makes it easy to price away the additional risk produced by flawed origination practices, does little to purge these practices. Though enhanced due diligence and increased familiarity with the market are helping lenders and servicers better understand risks and borrower fraud, the upshot may well be persistence of foreclosure-related issues stemming from subprime lending.

It is also clear that borrowers bear some of the blame for foreclosures. First, a substantial minority simply refuse all contact from the servicer. Possible explanations include that they think the servicer is the enemy; they do not want to remain in the home; they may have stretched the truth in their mortgage application and are worried about being caught; or their approach to dealing with mortgage problems is what one interviewee called "sticking their head in the sand." One servicing executive estimates that, despite repeated attempts, the firm is unable to establish contact with the borrower on fully half of the loans it refers to foreclosure. As evidence of the challenge of simply reaching the borrower to discuss the loan, one can look at the rating agencies' servicer evaluations showing 'right party contact rates' during collections, a measure of the frequency with which servicers are able to reach borrowers to initiate a discussion of payment interruptions. As figure 13 indicates, even the largest and most highly rated subprime servicers have trouble reaching borrowers. A servicing technology expert at Freddie Mac referred to steps to educate borrowers that currently "just disappear" as the "missing element … in borrower education" (Cordell 2001).

Figure 13: Servicer Ratings and Contact Rates

Servicer	2002 B&C Servicing Rank	2002 B&C Servicing Volume (bil.$)	Moody's Residential Primary Servicer	Right Party Contact Rate
Ocwen Federal Bank	4	30.4	SQ1	29
Option One Mortgage	5	28.1	SQ1	25
Homecomings Financial Network (GMAC-RFC)	6	27.4	SQ1	29
Ameriquest Mortgage Company	8	17.0	SQ2	30
Litton Loan Servcing (C-BASS)	13	10.8	SQ1	22
Saxon Mortgage Services	17	17.6	SQ2	36
EMC Mortgage	20	6.0	SQ1	17

Note: SQ1 is the highest rating on a scale of SQ1-SQ5.

Source: Moody's Servicer Reports and Inside B&C Lending.

A final concern in the foreclosure arena is the possibility that the 'headline risk' of being a foreclosing agent will drive larger and better capitalized organizations out of subprime servicing. As one servicer told us, "no matter how hard we push loss mitigation and foreclosure avoidance, we are still going to have to foreclose on ten thousand borrowers every year." Playing this role in the system makes a forecloser vulnerable to targeting and pressure from advocacy groups and the press. If large firms judge this risk to be too high, it is possible that the market will be left to less well-known firms with reduced reputational incentive to avoid foreclosures and lesser willingness to work with community groups to develop better foreclosure avoidance strategies. To some extent reputational concerns were behind Bank of America's sale of its subprime servicing portfolio to Fairbanks. To the extent that Fairbanks lacked the capacity to be an effective servicer of subprime loans, arguably borrowers would have been better served if Bank of America had remained in the business.

5.6 CONCLUSION

In the end, not all loans can be saved. All servicers mentioned a core of borrowers who are simply not interested in saving the home. For the rest, however, the ability to find ways to keep them in their homes if possible, and ease them out in ways that result in as little psychological, financial, and credit damage as possible are largely consistent with efforts to mitigate both investor losses and neighborhood-level negative externalities. The final section of the report examines proposals for making more of these win-win solutions a reality.

Section 6: PROPOSED SOLUTIONS: THE ROLE OF BUSINESS, GOVERNMENT AND COMMUNITY-BASED ORGANIZATIONS IN FORECLOSURE AVOIDANCE

The preceding sections of this report have documented the adverse impacts that rising foreclosures have on low-income and low-wealth households forced out of their homes and on bottom lines of businesses and investors incurring foreclosure-induced losses, as well as the less obvious adverse impacts that foreclosures have on affected neighborhoods. Concentrated foreclosures in fact threaten to reverse several decades of effort by local governments, community-based organizations, and the mortgage industry to revitalize distressed urban neighborhoods. This final section presents a series of proposals to address these issues. The proposals are organized into five broad classes.

The first approach involves efforts to better detect, monitor, and avoid foreclosures. The second set of proposals concerns ways to help borrowers in distress to avoid ending up in foreclosure. The third grouping suggests ways to minimize the impact of unavoidable foreclosures in economically distressed communities where they occur. The fourth approach examines potential industry responses to the current foreclosure situation. The fifth section considers ways to better prepare borrowers to participate in the subprime mortgage market. The report concludes with an examination of the social tolerance for risk and its role in motivating public policy.

6.1. IMPROVED DATA COLLECTION TO SUPPORT FORECLOSURE MONITORING AND AVOIDANCE EFFORTS

The rapid rise of subprime lending and associated rise in foreclosures has caught many — from industry and policy analysts to government officials and community activists — off guard.[41] This is due in no small part to the fact that there is little data available to government agencies charged with tracking the mortgage sector of the economy or to the general public. Although information on individual foreclosures is generally on file at

[41] One of a group of senior community-development officials interviewed for this report lamented that, “we just didn’t see this coming.” He went on to note that his organization now focuses almost exclusively on assisting individuals facing foreclosure and working to mitigate the negative impact that foreclosures are having on already struggling neighborhoods.

courthouses or land registry offices, there has been surprisingly little effort to systematically collect these records. Where available, data from foreclosure documents often fail to identify key characteristics of the mortgage loan or the identity of the originator, funder, or servicer — information essential to illuminating the factors that precipitate foreclosures.

To the extent that there is a growing understanding of the determinants of loan performance, it is largely in private hands and not readily available even to those entities charged with monitoring the activities of mortgage sector of the economy, including the U.S. Department of Treasury, HUD, the Federal Reserve Board of Governors, or other bank regulators. In light of this situation, the report presents three proposals to better monitor, assess, and respond to the challenges posed by rising foreclosures.

Data Proposal 1: Create a National Loan Performance, Default, and Foreclosure Data Base. Federal regulators should collect default (90 DPD) and foreclosure (starts and completions) data and make it available to the public for analysis. Clearly a national electronic database on loan performance is needed to support policy development and evaluation, to detect and react to foreclosure hot spots, and to identify the number of borrowers at risk of falling prey to predatory mortgage lenders. Ideally such a database would include data on loan, lender, servicer, property, and borrower characteristics sufficient to track foreclosures and ultimately to assess the key determinants of serious mortgage delinquency and default. Such research is already underway in the private sector as firms attempt to enhance development and underwriting of loan products and to streamline servicing of problem loans. Due to the significant external costs associated with mortgage foreclosures, government agencies and the interested public must have this data as well to support efforts to ensure that the public interest is being protected and public costs kept to a minimum.

Lack of data is an even greater problem in the area of mortgage servicing, where aggregate-level information is limited and there are no readily available public sources of micro-level data. Recall that servicing rights are bought and sold regularly, and various as-

pects of servicing a single loan may be handled by different entities. As a result, should a problem arise, borrowers and their advocates often encounter obstacles simply talking to a person who has the capacity to investigate and resolve the problem. The lack of data on servicers also can be a problem for lenders. For example, the lack of a comprehensive repository of consumer complaints against particular servicers, not to mention the lack of a comprehensive database of court cases either completed or pending against servicers, limits the ability of lenders and issuers to appropriately select and monitor the entities that service their loans.

The additional benefits of enhanced, nationally available data on servicing practices and foreclosures are numerous. At the federal level, such data would support detailed analysis of the determinants of the foreclosure process, shape more effective legislation and regulations to mitigate individual and public-sector foreclosure costs, and assist in the design of enhanced regulations to minimize the extent of abusive lending and servicing practices that are linked to an unknown share of the current foreclosure wave. More importantly, better data would enable local officials to identify current foreclosure hot spots and move to take remedial action. Lacking data, federal agencies are currently in a reactive mode on the foreclosure issue.

As evidence of what might be achieved, HMDA and CRA are illustrative. More than 25 years ago these acts initiated a data-gathering and monitoring effort that led to a greater understanding of how best to expand access to mortgage credit. A similar data collection effort on a national scale for loan performance, delinquency, and default is now needed. Lacking specific legal authority to mandate the collection of these data, the Federal Reserve Board of Governors could work in cooperation with HUD and other federal regulators to develop a data collection protocol and seek voluntary compliance.[42] Another approach would be for the Fed to use existing authority and make participation in a national

[42] Currently, the largest repositories of these data include the GSEs, financial services conglomerates, and the rating agencies. In the face of rising subprime losses these firms began amassing loan performance data and now possess sizeable databases. For obvious reasons no single firm that has incurred the expense of constructing such a database is willing to simply turn it over to the public in the micro-data format that would support serious assessment of the determinants of foreclosures.

loan-performance data collection effort eligible for CRA service test credit for regulated entities. By adding a data-sharing component to CRA evaluations, the Fed could increase the pressure on major banking organizations to contribute to the creation of better data, without the need for new legislative authority that would be required to make the submission of these data mandatory.

Data Proposal 2: Identify and Respond to Potential Foreclosure Hot Spots. Enhanced foreclosure data would also enable local officials to better gear up to meet the challenges of foreclosure and do so earlier in the process. Availability of detailed data on loan origination, foreclosure, and loan performance at the local level could enable identification of emerging foreclosure 'hot spots.' While such a hot spot detection system could be a by-product of the creation of a national database, local officials could aid such efforts by automating and making more widely available existing 'courthouse' data. Having a database capable of identifying areas with elevated rates of foreclosure filings would enable local officials — working in partnership with local community-based organizations as well as interested mortgage servicers — to take appropriate action.

The National Training and Information Center and affiliates have worked to combat rising foreclosures in the Federal Housing Administration program that result from extensive fraud by both appraisers and lenders involved in the program. As a result, NTIC and HUD created the Credit Watch and Appraiser Watch programs. Based on analysis of FHA default data, lenders and appraisers associated with a high number of defaults had their authority to make FHA loans terminated. For example, any lender with a default rate more than twice that of the average regional and national default rates is cut from the program, and prohibited from making FHA loans. In addition to monitoring and sanctioning abusive lenders and appraisers, these same FHA data could be utilized to identify FHA foreclosure hot spots.

Recognizing the complexity of the mortgage foreclosure process, it would also be useful for local governments to create a 'foreclosure hot spot protocol,' or a plan formulated in advance of problem detection that describes specific actions designed to minimize the

adverse consequences of extreme foreclosure levels. For example, municipal tax collection agencies could exercise temporary restraint in collecting funds from owner occupants residing in foreclosure hot spots if such efforts would allow the homeowners to remain in their homes. By helping individual owners avoid foreclosure, such forbearance activities could help to stabilize a local market and in doing so actually increase the amount of taxes collected in the area over the longer run. Moreover, to the extent that a municipality has access to resources to support loss mitigation efforts or to avoid foreclosure, it may choose to devote these resources to solve problems in specially identified 'hot spots.' In addition, the city could strive to weave the efforts of the community-based organizations and mortgage lenders and servicers pursuing their own foreclosure avoidance programs in the area into its protocol.

Data Proposal 3: Assess the Neighborhood Impact of Foreclosures. The allegation that subprime foreclosures cluster and that rising foreclosures can generate additional foreclosures and destabilize entire neighborhoods is a persistent one. This suggests the need for several studies. The first such study would examine the extent to which clustering of foreclosures increases the likelihood of foreclosure in neighboring properties — an empirical examination of the so-called 'foreclosure contagion effect.' One possible explanation for such an effect is the negative impact that foreclosures have on house price values and trends, which in turn leave other borrowers less willing to meet their mortgage payments on an asset of declining value. Industry experts interviewed for this study acknowledged that a potential 'contagion effect' would be relevant to the correct evaluation of mortgage risk and in subsequent pricing.

The second study would seek to understand the full cost of foreclosures, that is, to estimate the size of the direct 'externality effects' of foreclosure.[43] Doing so would involve not only tallying the additional drain on municipal services but also require careful

[43] In principal, a default, foreclosure, and subsequent resale of a property should have no more impact on a community than any other real estate transaction. But in fact foreclosed properties pose special issues. For example, to the extent that foreclosed properties are 'boarded up' or otherwise not well maintained during the foreclosure process, they may undermine the appeal, and ultimately the market value, of other properties in the neighborhood.

econometric estimates of the impact of concentrated foreclosure on changes in house prices. Such a study could help focus attention on public costs of foreclosure that extend beyond those suffered by the borrower and investor.

6.2. HELPING BORROWERS IN DISTRESS

Dramatic increases in foreclosure rates attending the rise of subprime lending have highlighted the need to help borrowers in distress. Such help not only improves the situation of individual families and creditors, but ultimately the neighborhoods in which they reside. This section discusses five ways to aid borrowers, all involving collaboration between industry, CBOs, and government.

Aiding Distressed Borrowers Proposal 1: Partnering to Increase Contact Rates. Servicers interviewed for this study repeatedly bemoaned the fact that many loans fail without contact ever being established with the borrower, or when the first contact occurs after problems have become too severe to rectify. In response, the most proactive servicers have impressive programs to establish and maintain contact with their clients. These efforts are driven by concern for the bottom line, but can nonetheless improve outcomes for borrowers who would otherwise have avoided all contact with the servicer when they encountered payment problems. A first step to increasing contact rates at the industry level would involve disseminating best practices from those organizations that excel in this area.[44] Because contact rates even for the leaders remain fairly low, however, a strategy is needed that goes beyond what industry has been able to achieve on its own to date.

The pilot partnership between Homecomings Financial Network[45] and Neighborhood Housing Services of Chicago (NHS) is a promising way forward. Homecomings is betting that some borrowers who are unwilling to talk to the company directly will talk first to NHS instead. Upon contacting NHS, these borrowers are offered the option of independent credit counseling (see discussion later in this section) or speaking with a Home-

[44] Of course such a program threatens to benefit less innovative servicers along with borrowers and neighborhoods, so any such proposal must be done in a way to protect the competitive advantage of the leaders in effective servicing in order to maintain their incentive to innovate.
[45] The servicing arm of GMAC-RFC.

comings representative *based in the NHS office*. The partnership allows the organizations to work together to arrive at appropriate workouts, and provides borrowers with a trusted advisor to guide them in what can be an intimidating process. Homecomings has stationed servicing staff in the NHS office in order to facilitate this contact, increase its local presence, and provide learning opportunities for both organizations on the resources available and potential workout solutions.

Initial results of this approach point to success. Between April 1 and September 30, 2003, NHS counseled 372 clients at risk of foreclosure. Although it was not possible to avoid foreclosure in every instance, the program was able to achieve 186 'successful outcomes' (defined as any resolution of the situation that did not result in the property becoming vacant and abandoned). These successes resulted from NHS staff interventions with lenders, accessing private and public loan and grant resources (such as the Neighborhood Lending Program or Homeless Prevention Fund), or refinancing through NHS or a partner lender in order to achieve a more sustainable mortgage for the owner. This includes 47 loans to prevent foreclosures on $2.3 million in loan balances.

In addition, in November 2003 NHS and Homecomings partnered to invite 1,000 Homecomings borrowers — ranging from those current on their loans to those in foreclosure — to a financial education workshop. The homeowners were provided with a free dinner and a gift certificate. The invited homeowners lived in four NHS neighborhoods, Chicago Lawn, Auburn Gresham, West Englewood, and Back of the Yards, all of which have been hard-hit by foreclosures. Forty-five homeowners attended and were educated about refinancing opportunities, how to finance home improvements, and default and foreclosure avoidance.

Aiding Distressed Borrowers Proposal 2: Restructure Regulations that Limit Servicers' Ability to Help Borrowers. Another concern among servicers stems from the rules of the Fair Credit Reporting Act (FCRA) and Fair Debt Collection Act (FDCA) that limit the ways in which servicers can contact mortgage borrowers. For example, under FDCA servicers cannot mention the mortgage delinquency (and hence the fact that they might be

proposing a workout) on recorded messages left during collections calls. Essentially all contacts termed aggressive are prohibited even if they are for the borrower's own good. Moreover, privacy rules also limit servicers' capacity to provide information to others concerning borrowers in distress, even if such dissemination of information is done to determine whether the borrower is eligible for a city- or CBO-sponsored foreclosure avoidance program. Finally FCRA mandates that servicers providing information to non-profit credit counselors for the purpose of contacting borrowers must become registered credit reporting bureaus. The regulatory burden associated with doing so is, to say the least, prohibitive.

While consumers must be shielded from egregious credit collection practices, in many instances existing regulations have the unintended consequence of limiting the options of servicers trying to arrange early workout options for borrowers in danger of losing their homes. One alternative approach would be to keep the current framework in place, but carve out exceptions to the basic rules in which the public benefits associated with avoiding foreclosures outweigh the private benefits of protecting consumer privacy. Such reforms could be linked to the 'hot spot' protocols discussed earlier. In situations where a local government identifies the existence of a concentration of foreclosures, servicers would be given greater leeway to work cooperatively with city government and local CBOs to pursue a strategy of foreclosure avoidance and customer outreach.

Aiding Distressed Borrowers Proposal 3: Connecting Borrowers to Existing Sources of Assistance. In addition to efforts involving servicers directly, municipal resources can be used to overcome information bottlenecks. Several cities, including Chicago, have begun providing foreclosure-avoidance information through 311 systems, a non-emergency city call center equipped to receive inquiries about city services and direct callers to appropriate city agencies or delegate agencies. Chicago's program offers borrowers the chance to speak to a person who can help them take the next step in addressing the problems they are facing. Callers to the system are directed to counseling agencies or participating loan servicers for help in finding the best way out of temporary financial crises and mitigating the downside effects of permanent income reductions.

As discussed throughout this report, servicing firms have elaborate systems of people and software to manage the delinquency, default and foreclosure process. The goal of these systems is basically to determine the loss-minimizing route to cure the default. In virtually all cases, however, these systems ignore information that could change this calculation because they do not have access to a detailed menu of municipal, state, and federal programs that supply funding and other forms of assistance to borrowers in trouble. Because most borrowers are also unaware of these alternatives, many families lose their home to foreclosure even though they could have been saved if they could have accessed these existing sources of assistance.

The most obvious way to illustrate this point is to imagine those servicers that use software tools to gather information that allows them to calculate the expected net present value of various workout options for delinquent borrowers. For example, the evaluation tools may suggest that foreclosure is the best option for the investor, even in situations where home retention options would become viable with the addition of a modest public subsidy. One specialist in distressed assets interviewed for this study estimated that in roughly one-third of foreclosure cases there is some public money available, but that it is rarely accessed because state and municipal level programs are idiosyncratic and there is no systematic method of making borrowers or servicers aware of these programs. This problem could best be rectified by centralizing program information and integrating it into software systems used to analyze foreclosure avoidance and loss mitigation options.

Aiding Distressed Borrowers Proposal 4: Integrate Effective Credit Counseling into Loss Mitigation Strategies. For borrowers in trouble on their mortgage, credit counseling offers both promise and risks. When done by skilled counselors with the borrower's interests at heart, counseling can help borrowers chart the best course for navigating their financial difficulties. Credit counseling can literally be the difference between saving and losing a home. When done poorly, however, counseling is a waste of time and money. When done unscrupulously, it makes a bad situation worse. As industry and government

become increasingly supportive of these efforts, the pressure for counseling to be done effectively should increase.[46]

As it moves toward greater interaction with credit counseling agencies, however, the mortgage industry must address several issues. First, a more effective method must be devised to separate legitimate, effective agencies from others. Many consumers currently rely on the IRS's 'nonprofit' designation as evidence that the agency will act in their best interests, but this is by no means the case. Second, even among agencies that are not out to take advantage of borrowers through excessive fees and referrals for costly ancillary services, not all have the skills to counsel borrowers facing mortgage-related problems. Third, the effectiveness of various counseling methods has been subject to little empirical scrutiny. Different methods and programs must be evaluated and results disseminated so that more effective approaches supplant others.

Finally, in a world in which many legitimate nonprofit counseling agencies continue to struggle for survival, the mortgage industry offers them little financial sustenance. The 'debt management plans' (DMPs) through which these agencies earn fees historically have not included secured debt (a key reason why many agencies are not knowledgeable about mortgage issues). A new approach rewards counseling agencies for devising 'action plans' for their clients that may or may not include an official DMP. This approach is more mortgage-focused and integrates secured and unsecured debt into financial advice for borrowers in trouble on their loan.

Aiding Distressed Borrowers Proposal 5: Designing Additional Subsidies for Foreclosure Avoidance. While the magnitude of the costs is unknown, foreclosures, especially those in distressed neighborhoods, are widely thought to trigger enormous local, state, and federal government expenditures on things such as crime prevention. Consequently,

[46] For several years, GMAC-RFC has paid for counseling and has formed an alliance with three credit counseling agencies called the Credit Counseling Resource Center (CCRC) to "help borrowers restore financial balance to their lives." Ameriquest's Best Practices, for example, include provisions for free credit counseling by a nonaffiliated, nonprofit third party.

efforts to reduce the number of foreclosures or to limit the degree of financial distress suffered by the homeowner and damage or deterioration of the property can save money that government would have been forced to spend later on cleaning up the mess. To the extent that neighboring home values and foreclosure probabilities are affected by foreclosure events, municipalities may also have a responsibility to help protect neighboring owners from their ripple effects.

Determining how government money could best be deployed is a challenge, however. One promising option is to make funds available to enhance loss mitigation and foreclosure avoidance efforts already employed by servicers. This would essentially extend the margin of borrowers who would be able to remain in their homes based on their financial ability and 'desire' alone. Since resources are likely to be limited, localities must create clear borrower and neighborhood eligibility standards to ensure that limited public funds target those situations most deserving of assistance and/or produce the greatest public benefit. Further, avoiding a situation where government money substitutes for funds, forbearance, and forgiveness that lenders would have offered on their own is challenging.

Rather than directly administer the foreclosure avoidance funds, it may be better to involve qualified CBOs to help establish and monitor the use of clear guidelines under which participating private servicers determine whether a borrower meets the criteria established for public assistance, and, if the borrower is eligible for assistance, complete the transaction. In any event, even though more work is needed to develop the delivery vehicle for federal, state, or local foreclosure avoidance assistance, there is broad agreement among individuals interviewed for this study that if injected at the right point, such a subsidy could reduce foreclosures substantially.

Aiding Distressed Borrowers Proposal 6: Helping Victims Refinance Out of Predatory Loans. Another way to help victims of abusive predatory loans is to support the creation of targeted refinance loan pools to assist borrows at risk of losing their home to foreclosure. Lenders and servicers could help fund such loan pools, and the resulting loans could allow for qualified homeowners to refinance into a more affordable loan administered by

a nonprofit or intermediary lender. NHS of Chicago developed such a fund and it has proven to be an innovative strategy for keeping families in their homes. To date, 33 homeowners at risk of foreclosure have refinanced with NHS through this special fund. Of course not all nonprofits have the capacity or lending experience to create such a fund, but where it exists, this strategy provides a good alternative to foreclosure.

6.3. MAKING FORECLOSURE LESS DAMAGING TO NEIGHBORHOODS

When foreclosure is unavoidable, lenders, municipalities, and community-based organizations must focus efforts on preserving the properties for affordable homeownership. In many cases, the properties have been vacant for anywhere from six months to over a year and require substantial rehabilitation. In their deteriorated state, the properties are not marketable to owner occupants who lack financing, technical expertise or wherewithal to take on a purchase-rehab project. Thus, these properties are often purchased by investors who cosmetically rehab them and rent or sell them to unprepared families. Inadequately rehabbed properties often set the next owner up for failure due to overwhelming maintenance costs in the early years of the loan. Too often, the cycle of foreclosure then continues, and the block and neighborhood suffer the impact of yet another foreclosure. This section discusses strategies to mitigate the effects of foreclosed properties on neighborhoods. First, the foreclosure process could be shortened to avoid the drawn-out process that leads to property deterioration. Further, strategic partnerships between financial institutions and nonprofit developers can lead to the rehabilitation of key neighborhood properties and sale to owner occupants.

Reducing Neighborhood Impact Proposal 1: Eliminate Counterproductive Regulation. In light of the dramatic rise in the number of foreclosures, now would be a good time to assess and potentially streamline and standardize state and local laws and regulation governing the foreclosure process. In addition to the challenges that heterogeneous foreclosure regimes pose to servicers, many of these laws are outdated. Foreclosure legislation designed to slow the process down used to make sense, but now this is changing — especially to the extent that servicers adhere to emerging best practices that reflect the fact

that foreclosure is undesirable for borrowers and investors and, less obviously but no less significantly, for neighborhoods as well.

While it remains important to offer a homeowner every reasonable effort to cure a default situation, foreclosure statutes have to recognize that the overall good is best served when the neighborhood-level benefit of a speedy and predictable foreclosure process is seen to outweigh the advantages to individual borrowers of a sluggish process. Standardizing and updating foreclosure law with an eye to eliminating provisions that simply delay inevitable foreclosures while worsening their adverse impact on neighborhoods is an important element of regulatory reform.

Reducing Neighborhood Impact Proposal 2: Create Programs to Transfer Properties to Community-Based Developers. As noted above, foreclosed homes are likely to have experienced deferred maintenance and deterioration, especially those located in distressed urban neighborhoods. After foreclosure — and prior to sale to a new owner occupant — is an ideal time to rehab the properties to a standard that addresses all health and safety issues as well as functional obsolescence of key structural elements of the home. Community-based developers with strategies of building long-term, sustainable homeownership are often in the best position to manage the extensive rehabilitation process, and to then market and sell the homes to owner occupants who have access to solid financing and are prepared to take on the responsibilities of homeownership. In order to make high-quality rehabilitation financially feasible, nonprofit organizations must be able to acquire the property for low or no cost. In the past, when the majority of foreclosures were FHA-insured and sold by HUD, nonprofits were able to obtain across-the-board, significant discounts on acquisition. In this new environment of subprime foreclosure with multiple actors involved, nonprofit organizations must develop relationships with a variety of institutions to structure programs to offer deep discounts or property donations.

Successful deep discount or property donation programs can be created with cooperation from three main actors: financial institutions with a high loan volume that care about protecting the property values of the neighborhoods in which they do business: nonprofit or-

ganizations with financial and technical capacity to rehab the properties; and city government that can provide subsidies to the buyer or developer to offset 'appraisal gaps' — the difference between the total cost of developing the property and the amount it can be sold for after rehab.

Broadly, there are two options for properties backed by failed loans that do not get worked out: some become real estate owned (REO) and others are written off. REO properties are those that the servicer determines have sufficient economic value to make taking through the foreclosure process worthwhile. Write-offs are those that do not meet this standard. As the name suggests, walkaways are abandoned by both the borrower and the servicer/investor, who never takes title to the home to avoid incurring additional expenses on a property with very low value. Walkaways are particularly likely to become sites for drug use and other crime, and at minimum are eyesores blighting neighborhoods as they decline.

Nonprofit organizations can begin the dialogue by identifying target geographies in which they want to strategically acquire properties. Financial institutions are often willing to identify REO properties in those geographies that would make sense to discount or donate to nonprofit organizations. In many cases, servicers take into account the increased cost they would incur by holding and marketing the property for a higher price as opposed to a quick but deeply discounted sale to a credible community-based developer. By showing success on a few properties — a thorough rehab and a timely sale to an owner occupant — nonprofit organizations can set the stage for an ongoing REO discount or donation program.

Community-based developers and municipalities can also explore opportunities on 'write-off' properties. These properties are determined to be of such low value that the cost of foreclosure exceeds any potential recoveries by the servicer. The servicer has made a well-researched decision to write off the loan rather than pursue foreclosure and subsequent title to the property. Because the financial institution has not completed the foreclosure, title cannot be transferred directly to the nonprofit. However, the interested

parties can explore partnerships in which the senior lien is assigned over to the nonprofit or municipality. This entity can pursue clear title by either initiating or completing the foreclosure action, or pursuing title through forfeiture or nuisance proceedings, according to the local ordinances of the municipality. These cases present a win for all involved: the servicer loses nothing, as the write-off strategy has already been determined as the best outcome; the nonprofit organization acquires a property for little or no money and can dedicate resources to substantial rehabilitation; and the municipality gets a code-compliant building that remains on the tax rolls, rather than having to demolish the property and pursue a re-use strategy for the vacant lot. Strategies around the transfer of written-off properties should be explored and pursued as a way to deal with the most seriously deteriorated properties.

The Homeownership Preservation Initiative (HOPI) in Chicago is demonstrating that such a strategy can work. With a goal of reclaiming 300 vacant and foreclosed properties, Neighborhood Housing Services of Chicago, working in cooperation with lender partners and the city of Chicago Department of Housing, will acquire 100 foreclosed single-family buildings per year over three years, rehab them to safe and habitable condition, and sell the homes to low- and moderate-income families. Already, NHS has reclaimed 39 properties through direct development or purchase-rehab lending from April 1 to September 30, 2003. NHS acquired 12 formerly vacant buildings for rehabilitation and sale, through donations or deep discounts from HUD as well as from Bank One, Citigroup, Chase, Household, and Washington Mutual. In addition, NHS and HUD are close to a final contract which will begin the second phase of the 'Asset Control Area' program, in which NHS will acquire all HUD properties at a substantial discount within a targeted area, rehab and sell them to owner occupants. This builds on the successful acquisition and sale of 100 vacant buildings through the first phase of the program.

The efforts of NHS of Chicago demonstrate that rehabilitation funds coupled with lender/servicer discount or donation of properties can turn problem properties into community assets, but also indicates that doing so requires substantial capacity and commitment of resources from public and private sources. For example, in 2001, the Los Ange-

les City Council appropriated nearly $6 million to assist a major national nonprofit intermediary in purchasing, rehabbing and selling a large portfolio of HUD-foreclosed properties. Given the many claims on public and philanthropic funds, such efforts must include clearly articulated rules governing the program criteria, including neighborhood and property characteristics as well as nonprofit status and capacity to ensure that these funds are targeted appropriately. Industry funds may also be available, either based on the charitable inclinations of mortgage companies, or the fact that helping to improve the disposition of foreclosed assets will forestall additional losses linked to the 'contagion effect.'

Reducing Neighborhood Impact Proposal 3: Develop a Queue of Loan-Ready Borrowers. Unfortunately, many community-based organizations lack the needed rehabilitation resources to operate a HOPI-type initiative at any significant scale. In these circumstances, it may make sense to try to focus on homes that are less in need of major rehabilitation but that would still provide a good first-time buyer opportunity. Key here is to minimize the period in which homes are vacant and/or occupied by owners who no longer have an interest in preserving the home's quality. Industry losses escalate dramatically during the time when a borrower loses the capacity to save the loan and the date the servicer actually takes title to the home.

Working cooperatively with concerned servicers, it would be possible to identify homes that are in reasonably good repair, but nevertheless are moving toward foreclosure. Rather than pursue the expensive foreclosure process, the servicers could offer the current owner an opportunity for a preforeclosure sale to a loan-ready borrower identified by a neighborhood-based organization. One approach is for the servicer to offer a cash-for-keys type of settlement that leaves the borrower something with which to start over, and then quickly resell the property to the loan-ready borrower. By minimizing the costs associated with foreclosure, such an approach could be beneficial to the servicer/investor, not to mention both the former and new homeowners.

Responsibility for producing and managing the borrower queue would lie with municipalities and counseling agencies. The city could maintain the lists from its CBO partners and handle arrangements between borrowers, servicers, and lenders. This oversight is intended to make sure that the terms of the agreement to vacate the loan and those of the new loan are fair and consistent with city goals of fortifying neighborhoods against future decline. This could also include a requirement that homes sold through this process only go to prospective owner occupants.

Such an approach could be particularly helpful in areas of rising — or even high but stable — property values where affordable homeownership opportunities are limited. In these situations, even potential homebuyers with access to subsidized financing may have difficulty finding an affordable property to purchase. By working closely with servicers, city and community groups help to make available for sale to lower-income borrowers at least a portion of the homes about to enter into foreclosure. Of course, extreme care must be exercised to insure that the new homeowner has the financial capacity to pay the mortgage as well as cover the costs of any subsequent rehabilitation issues that may arise. Similarly, it is important to make sure that these transactions are not completed at an inflated price that would inappropriately enrich the servicer or investor in the initial mortgage. Yet subject to these safeguards, such a program could add a useful new tool, especially in areas where homes are in better shape and property values are stable or on the rise.

6.4 ENHANCING INDUSTRY RESPONSE CAPACITY

The rise of subprime delinquencies and foreclosures has surprised many in the private sector, including investors, servicers, and the rating agencies. While investors and servicers obviously were aware of the potential for higher losses in the subprime sector, the magnitude of these potential losses was arguably not fully appreciated. Although credit enhancement shielded many investors from losses associated with faulty estimates of credit risks, even these investors may have suffered as unexpectedly high foreclosure rates have boosted prepayment speeds, exposing them to interest-rate risk, and under-

mined their efforts to time income and liabilities. Moreover, credit enhancement does not fully shield investors from potential reputational damage associated with being the ultimate (though distant) funder of a process in which low-income households are all too frequently overcharged or otherwise taken advantage of. The subprime industry and its investor base therefore have an incentive to improve understanding of default and loan failure from both a bottom-line perspective and reputational perspective.

Industry Response Proposal 1: Summit on Foreclosure Avoidance. As noted throughout this report, there are a number of reasons why foreclosures are damaging to various industry players. Most obviously, some investors in mortgage securities incur losses directly and/or may have to deal with investment issues caused by accelerated prepayments. Foreclosure also costs servicers dearly through the additional cost of taking loans through the foreclosure process.[47] All legitimate subprime industry participants are vulnerable to negative publicity and perceptions of the industry.

As a result, market participants could benefit from a series of 'summits' to discuss issues and outline workable solutions from an industry perspective. These summits would aid in information dispersal and work to overcome collective action problems. A first meeting would involve servicers and be designed to accelerate the dispersal of best practices and design strategies for mitigating the impact of 'foreclosure contagion.' A second meeting would educate investors about the process through which their insulation through credit enhancement allows origination problems to flourish and would motivate increased attention in the investor community to the monitoring and performance of originations, and the need for innovative strategies for reducing the number of foreclosures through loss-mitigation efforts.

These forums could be hosted by the Federal Reserve and SEC, perhaps in conjunction with Wall Street mortgage securities underwriters. Absent such collective action on the part of industry leaders, the existing allocational inefficiency that results from misaligned

[47] In some cases, depending on the nature of the servicing contract, the servicer might be paid more for dealing with problem loans, in which case losses to the trust are compounded.

incentives will persist, as will the inability of the industry to develop and implement a universal set of best practices for servicing, foreclosure avoidance, and neighborhood-sensitive REO disposition.

Industry Response Proposal 2: Increase Investor Accountability. Under today's rules, investor responsibility for the actions of the various parties in the mortgage delivery chain is limited largely by the extent of their investment. In cases of outright fraud and abuse on the part of the mortgage broker or servicer, investors are shielded by the claim that they relied on the actions of others, and hence are not responsible for the actions of their agents. In such situations, this paper argues that by detaching investors from the consequences of important aspects of the mortgage system, an important feedback loop is broken, making the industry slow to route out abusive practices or respond to unexpected problems.

Some have proposed shocking the system into change by altering the current environment with respect to assignee liability. As industry argues, making investors more accountable for the loans that they purchase would, in the short run, almost certainly make them less willing to participate in the market for subprime securities. Any decision on this issue should, however, also consider medium- and longer-term effects. While the flow of capital might initially slow down in some markets, the process could also drive the less efficient and especially the less reputable players from the business, to the advantage of borrowers and legitimate lenders alike. Enhanced investor accountability would ramp up demand for securities backed by loans originated using advanced risk-management tools and according to methods and systems that are more nearly immune to the still prevalent abuses of today.

At present, industry representatives and community advocates are far apart on how best to balance consumer protection with industry interests.[48] The OCC recently entered the

[48] Industry argues that such prohibitions reverberate through fragile neighborhoods in the form of diminished credit access (cf. Cowan 2003, Green 2003, Nadon 2003). Researchers and borrower advocates have responded with studies showing that in North Carolina, where anti–predatory-lending law has been on the books longest, there is little evidence of diminished access to legitimate nonprime mortgage credit and

fray, issuing a ruling that preempts the application of a wide range of state-level consumer protection statutes for national banks (more than half of the U.S. banking industry). This action has been controversial, however, and Senator Larry Craig, an Idaho Republican, has taken the lead in challenging the validity OCC preemption of state statutes. At the time of this writing the likely solution to the preemption issue is unclear.

Recognizing the complexity of this situation, additional research needs to be done on how to establish the proper balance between consumer protection and assignee liability. Moreover, there must be a concerted effort to push Congress to settle this dispute. In the end, it is the responsibility of Congress — not Wall Street or even federal regulators — to clearly articulate how best to balance the interest of consumers with the need to establish clear and enforceable accountability for abusive practices that harm low-income borrowers and communities alike.

Industry Response Proposal 3: Work with Rating Agencies to Improve Ratings Rationale. Absent a more substantial shift in rules governing investor accountability, rating agencies will continue to hold one of the most import 'sticks' with which to influence servicing practices via their published mortgage servicer ratings. Because these ratings ostensibly measure capacity to maintain cash flows smoothly when borrowers are paying on time and limit investor losses by helping borrowers out of trouble where possible, the rating of the servicer is one aspect that determines pricing and execution of a securities issue. All else being equal, lower servicer ratings translate into requirements for higher credit enhancement for a given pool (a factor that reduces issuer profitability) and/or into reduced liquidity of the issue. As a result, servicers work to maintain their ratings by demonstrating their innovativeness and effectiveness in loss mitigation and avoidance of costly foreclosures.

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strong indications that predatory lending has been curtailed (Quercia, Stegman, and Davis 2003; Ernst, Farris, and Stein 2002). Federal Reserve Board Governor Gramlich (2003) argued recently that subprime lending growth in North Carolina was slower than that of its neighbors following passage of the law, but noted that the there is no evidence on whether the difference between lending growth in North Carolina and its neighbors represents predatory lending that was stopped before it started or a diminution of access to legitimate subprime credit.

In spite of these incentives, subprime servicer ratings have been correlated somewhat loosely with actual ability to sustain cash flows or with servicing acumen. The Fairbanks case, where servicing efforts collapsed while the company enjoyed a top servicer rating, is the most obvious example. Since Fairbanks' problems became public, the each of three major rating agencies (Fitch, Moody's and S&P) have taken pains to more accurately reflect the likely performance of individual servicer entities.

Admittedly, this is a difficult task. In a major difference with rating the quality of servicing in the prime market, there is limited historical data on the impact of alternative servicing approaches on the overall performance of subprime loans. Simply stated, industry experts interviewed for this project differ on what constitutes the best approach to subprime servicing, if only because they disagree on the extent to which subprime borrowers differ from prime borrowers other than in obvious differences in income, wealth, and credit history. As a result, today there is no agreement as to whether a servicer that owns the entire residual interest in a securities issue is likely to be more effective than one holding only a portion of the risk, or no stake at all. Overall, ratings remain coarse, no doubt reflecting the fact that rating agencies recognize that differing approaches currently coexist in the marketplace and that no one has yet established a basis for determining which methods work best.

In order to rectify this situation, the rating agencies must continue their efforts to gather data on loan performance and servicing activities. These data are essential for conducting rigorous tests of alternative servicing approaches and their impact on loss mitigation and foreclosure avoidance. Relatedly, the SEC has a role to play through its mandate to protect the interests of investors and ensure the proper functioning of the mortgage market. Absent the development of more sophisticated efforts to understand the effectiveness of alternative servicing strategies, the SEC must push the rating agencies to enhance their assessments, while at the same time helping them to assemble the data needed to accomplish this task.

Industry Response Proposal 4: Disseminate Best Practices in Servicing. A new foreclosure model should also prioritize best practices in servicing and loss mitigation generally. Relative to the current situation, improvements could be made by expanding the share of companies committed to practices such as those published by Ameriquest (2003). In essence, these guidelines are a combination of two elements: proper operation of a servicing business and good corporate citizenship. Few, for instance, would mourn the loss of a business whose model was based in part on delaying the posting of payments in order to reap late fees from subprime borrowers. Similarly, while hazard insurance is necessary, force-placing inappropriate policies and collecting a fee from the insurer for doing so is the wrong way to go about it. Leaders in the industry may need to come together to develop best practices in order to place pressure on others by setting the standard for good practices.

An additional and more challenging effort would see leading servicers participate in efforts to help raise operational quality at companies that currently lag behind as a result of lack of resources or commitment. The market incentive for more technologically sophisticated lenders to aide stragglers depends on if and how closely geographically concentrated foreclosures are causally linked. If it is true that foreclosure on a property reduces the salability of other homes and hence house-price appreciation on a block, neighboring borrowers will rationally place less stock in the importance of continuing to repay their loans. This downward spiral puts at risk even loans originated and serviced by forthright and reputable market participants.

6.5 ENGINEERING FORECLOSURES OUT OF THE SYSTEM

As discussed throughout this report, the subprime mortgage market is flawed in ways that do not appear amenable to self-correction. First, the market does not allocate credit efficiently as defined by the criterion that equally qualified borrowers should pay the same price for credit. Second, it is characterized by principal-agent issues that impose unnecessary costs and/or siphon off surpluses that would normally accrue to borrowers or investors. Finally, the inability on the part of consumers to effectively shop the market pre-

vents market forces from acting to drive prices lower in response to competitive pressures. Fortunately, there is a growing awareness of the importance of providing better pricing information to potential borrowers.

Virtually all of the interviewees mentioned the need for increased transparency. In its strategic plan for 2003 to 2007, Neighborhood Reinvestment Corporation's NeighborWorks® Campaign for Home Ownership emphasizes assisting borrowers to obtain better information on loan terms and prices. Improved transparency in the origination process would also help lower loan losses and reduce foreclosures. This would include increased efforts to help borrowers understand the risks of the mortgage up front. Though, as with all consumer purchases, the buyer must beware, in today's market buyers are not able to be fully cognizant of the relevant product characteristics when the product is one as complex and infrequently purchased as a mortgage. A first step would be to limit a borrower's ability to obtain a loan that he or she has no reasonable expectation of being able to repay, as attempted in several state-level anti–predatory-lending initiatives. A second step would be to help the borrower get the best loan terms for which he or she qualifies. Finally, escrowing of tax and insurance funds needs to become standard in the subprime market.

Engineering Foreclosures Out Proposal 1: Enhance Consumers' Capacity to Protect Themselves. One approach is to expand the capacity of CBOs to work with buyers individually to search for the best mortgages.[49] Of course, for such a service to be helpful, CBOs must have the track record and capacity to keep abreast of mortgage market trends for credit, and to be recognized by potential borrowers as a trusted source of information. 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

[49] Community-based organizations have to be mindful of the real or 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 lending institution, it may feel pressured to recommend this institution's products even in situations where more advantageous products exist in the marketplace. Needless to say, a CBO's failure to provide proper safeguards to avoid conflicts of interest would quickly erode the trust that community residents have placed in the organization.

'buyer's broker,' while at the same time earning a small fee for offering this service. Like the trusted advisors available to many higher-income borrowers, a buyer's broker would provide lower-income or less knowledgeable borrowers access to information on available mortgage terms and pricing. Like mortgage brokers, these buyer's brokers would help borrowers qualify for and procure a loan but, unlike mortgage brokers, would work entirely on behalf of the borrower.

To do this efficiently CBOs will need to acquire automated tools to evaluate the risk profile of individual borrowers, and develop the capacity to identify the best products available in the market. Again, this goal is achievable, but challenging. 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 address the current complexity that now works to the detriment of many borrowers.

Fortunately, there are other ways, short of opening a full-scale mortgage brokerage operation, that CBOs can help borrowers search for better mortgages. Borrowing from the automobile blue books, CBOs could make 'rate sheets' available to recent graduates of homebuying courses or fairs. Armed with knowledge of their credit score, income, and other characteristics, these rate sheets could guide borrower efforts to shop for the most appropriate mortgage product and help them better evaluate unsolicited offers.

Guttentag (2001) envisions another version of the buyer's broker system in which for-profit mortgage brokers agree to a fixed, up-front fee for using their expertise to shop for the best mortgage on the borrower's behalf. Rather than have consumers rely on current mortgage brokers to provide them with accurate information, for a fee consumers could secure the services of a market professional who would be contractually and legally accountable for finding them a loan on the best terms available in the marketplace. Such brokers are contractually bound to forfeit to the borrower any fees earned from the

lender, so the usual disincentive (i.e., principal-agent problem) to finding the borrower the best loan terms that he or she qualifies for does not apply.

Finally, the potential importance of RESPA reform in simplifying the mortgage origination process cannot be overstated. Despite years of negotiating, today RESPA reform remains controversial, and the recently proposed HUD RESPA regulation faces an uncertain future. The question remains whether Congress, the Administration, the mortgage banking industry and other interested parties are willing to do the hard work needed to fashion a consensus proposal that will generate meaningful RESPA reform.

Engineering Foreclosures Out Proposal 2: Provide Consumers with Better Information. Basic economic theory suggests that markets work best when consumers make informed choices concerning the goods and services they consume. Due to the complexity of the product and the difficulties inherent in shopping the marketplace, the subprime mortgage market is not characterized by these idealized competitive market conditions. In economic terms, there is an 'information asymmetry' between buyers and sellers, particularly with respect to the price of mortgage credit. Mortgage industry professionals participate in numerous transactions over the course of weeks and months and have ready access to information on the set of fees, rates, and terms that collectively determine 'price of mortgage credit.' In contrast, consumers only occasionally search for a loan to purchase or refinance a home, and hence begin shopping for a loan with limited prior experience and equally limited access to the information needed to make an informed choice.

Consumers, of course, could spend more time and money to better educate themselves about the price and terms of alternative mortgage products, but from the perspective of the efficient use of societal resources, it is probably not efficient for individual consumers to devote considerable resources to ferreting out information that is already known by mortgage originators. Yet as previously noted, often these originators have little incentive to provide detailed pricing information, particularly information that would enable a consumer to compare prices of alternative products to determine whether they were being offered a loan on the best available terms.

These comments suggest that mortgage pricing information is in effect a public good, and that therefore there is a role for government in providing or encouraging the private provision of price information necessary to support the efficient operation of the mortgage market. While improved disclosure of the terms of the particular loan being offered to the consumer would help, as would continued consumer education efforts, these steps are not sufficient to achieve desired results. Federal regulators operating under applicable Fair Lending and Fair Trade authorities must expand their efforts to ensure that consumers obtain sufficient pricing information to make informed choices. This could take the form of a national registry of best available mortgage products, or other efforts to assist local government and community-based organizations help families to better understand the pricing of mortgage products as they relate to borrower income, credit score, and ability to meet down-payment and closing-cost requirements. Such readily available information — equivalent to the 'blue books' or consumer reports that have successfully guided shoppers for automobiles and other consumer durables — will both help consumers find the best available deal and better protect themselves from the adverse consequences of aggressive and/or deceptive marketing practices. Working to enable borrowers or their trusted advisors to be better shoppers and resist such marketing practices would go a long way not only in reducing the incidence of predatory lending, but also in stemming the growth of foreclosures that inevitably follows in the wake of these same predatory-lending practices.

Engineering Foreclosures Out Proposal 3: Make Escrow Standard. Although subprime borrowers are generally less equipped to withstand the 'payment' shock of lumpy annual payments such as property taxes or insurance, subprime mortgage contracts are far less likely to include provisions for escrow accounts than conforming mortgages. This is problematic because the fact that many borrowers are ill-prepared for these large payments when they arise can be the start of a steady slide into loan failure. Though escrows are common in the prime market, perversely, in subprime lending *not* including escrow provisions can be a source of competitive advantage as it makes monthly payment burdens appear lower. Because most legitimate lenders have incentives to worry about performance of the loan beyond the origination period, few object in principal to applying

escrow requirements broadly in order to eliminate any advantage to not including such provisions and to reduce the likelihood of loan failures.

Engineering Foreclosures Out Proposal 4: Establish a National Center to Focus Attention on Foreclosure Avoidance. As noted throughout this report, there are numerous things that business, government, and the nonprofit sector can do to reduce both the incidence of foreclosures and the costs associated with those foreclosures that do occur. Today, there are numerous national efforts to promote homebuyer education and to develop new mortgage products that better enable low-income and low-wealth borrowers to become homeowners, and in doing so create a storehouse of equity that over the years can help them meet other financial needs. While these efforts, in combination with a rapidly changing mortgage market, have expanded access to credit to millions, they have also left a growing number of foreclosures in their wake. Having worked so hard to get families and individuals into homeownership in the first place, now would be a good time to launch an equally vigorous effort to preserve the homeownership gains that have been achieved. This could be accomplished by the creation of a new national foreclosure avoidance center to coordinate research, policy development, and implementation of a series of efforts to address the mounting foreclosure problem.

Of course no single center working in isolation can address the totality of the growing foreclosure problem. But working in cooperation with other interested parties, this new foreclosure avoidance center could do much to focus attention on the problem and help to develop and disseminate creative solutions. For example, a national foreclosure avoidance center could help build the national database needed to better understand the foreclosure process. In addition, it could work with mortgage industry leaders to enhance the monitoring of those who continue to 'push market' borrowers into high-priced mortgages they can not afford and may not even need. It could also work with local governments and community-based organizations to create and disseminate best practices in foreclosure avoidance. Finally it could work with federal, state, and local entities to create new and more effective laws and regulations concerning the mortgage industry in general, and foreclosure avoidance efforts in particular. Absence such an effort, for all too many

homeowners the dream of homeownership will deteriorate into the nightmare of foreclosure.

6.6 CONCLUSION

Perhaps the most fundamental public-policy issue raised by the rise of foreclosures is whether, given their impact on borrowers, bottom lines, and neighborhoods, there is a socially unacceptable level of risk of mortgage failure and, if so, what that level is in different types of neighborhoods. The motivation for such policies would be twofold. First, from a 'paternalistic' perspective government may be justified in helping citizens avoid bad choices. This position underlies much of consumer protection law, for instance in the medical field where the FDA determines socially acceptable levels of risks associated with new medications. The second motivation for a policy circumscribing the ability to originate some types of loans is the negative external effects of foreclosures on everything from neighbors to municipal budgets. Because the loan terms do not reflect the full social cost of foreclosure, very-high-risk subprime mortgages are underpriced. Either or both of these justifications could be used to support a federal determination of maximum failure tolerance standards in mortgage lending.

Once appropriate thresholds were agreed upon (admittedly the hard part), implementing such a policy is relatively straightforward. If approved automated underwriting systems predicted a probability of failure for a given borrower that exceeded the threshold, the loan could not be made, even if it could be done 'economically' from the lender's perspective. Short of such an outright ban, lenders might be required to identify all consumers that presented foreclosure risks above the threshold, and refer them to certified credit counseling agencies in order to ensure that they fully understand the risks they confront and their loan alternatives. Before the borrower could be approved for the loan, the counseling agency would have to certify that the consumer understood the extent of the risks associated with loan, had agreed to participate in regular postpurchase counseling sessions, and that the loan reflected the best rates and terms available in the marketplace.

Going forward, the public policy challenge posed by the subprime mortgage industry is how to balance the need to continue to expand access to capital without exposing consumers, neighborhoods, and investors to unacceptably high levels of risk. Any intervention in the complex mortgage process must be mindful that well-intentioned but poorly executed interventions will needlessly circumscribe access to capital to many deserving borrowers. Achieving such a balance will not be easy. But whatever regulations emerge, it is important to bear in mind that the goal of expanding access to capital for low-income and low-wealth communities is not simply getting people into a home, but keeping them there. Helping them purchase a home that they can afford will not only improve their housing situation but will be key to building long-term assets in the process. A foreclosed home is the American Dream shattered. Now is the time to rethink how best to make homebuying a long-term benefit for individual consumers and communities alike, and not just the start of another costly cycle of deterioration and decline.

APPENDIX A: Homeownership Preservation Initiative Update on Accomplishments

December 15, 2003

Background

The Homeownership Preservation Initiative (HOPI) is a partnership between the city of Chicago, Neighborhood Housing Services of Chicago, and key lending, investment and servicing institutions doing business in Chicago. The partnership seeks to preserve homeownership whenever possible and keep families in their homes through counseling, loss mitigation and loan workouts. When foreclosure is unavoidable, the partners seek to preserve the vacant properties as neighborhood assets.

Three-Year Goals

Homeownership Preservation: Help 1,500 homeowners avoid foreclosure

- Help 500 homeowners per year avoid foreclosure through loss mitigation efforts, including loan workouts, refinancing, loan modifications, repayment plans and small loans to bring homeowners current on mortgage payments.

Property Preservation: Reclaim 300 vacant, foreclosed properties

- NHS, through cooperation with lender partners and the Chicago Department of Housing, will acquire 100 foreclosed single-family buildings per year over three years, rehabilitate them to safe and habitable condition, and sell the homes to low- and moderate-income families.

Homeownership Preservation

The Department of Housing, NHS and HOPI partners are aggressively working to send the message to homeowners to seek help at the first sign of trouble, rather than waiting until foreclosure is a foregone conclusion. This message is being delivered through neighborhood-based outreach strategies and workshops, a new citywide 311 campaign, and postpurchase education.

Neighborhood-based Outreach Strategies

NHS, in partnership with HOPI lenders, continues to successfully implement its neighborhood-based outreach and counseling efforts to help homeowners in trouble, including regular mailings to homeowners on the foreclosure lists provided by the National Training and Information Center (NTIC). Between April and September 2003, NHS counseled 372 clients at risk of foreclosure and was able to

achieve 186 successful outcomes — defined as any resolution of the situation that did not result in the property becoming vacant and abandoned. These successful outcomes resulted from NHS staff interventions with lenders, accessing private and public loan and grant resources (such as the Neighborhood Lending Program or Homeless Prevention Fund), or refinancing through NHS or a partner lender. This includes 47 loans to prevent foreclosure totaling $2.3 million.

NHS, through its partnership with GMAC-RFC's Homecomings Financial loan servicing unit, has enhanced its efforts to educate homeowners through a new "Homeowner's Workshop." In November 2003, NHS invited 1,000 Homecomings Financial borrowers — ranging from current to in foreclosure — to a financial education workshop. The homeowners were provided with a free dinner and a gift certificate. They all lived in four NHS neighborhoods — Chicago Lawn, Auburn Gresham, West Englewood, and Back of the Yards — that have been hard-hit by foreclosures. Forty-five homeowners learned about refinancing, financing home improvements, and how to avoid foreclosure.

Homeowners in attendance who were having trouble with mortgage payments were encouraged to follow up with Homecomings Financial or NHS to work toward a solution. Homecomings Financial plans to monitor these borrowers to determine what impact the workshop has on loan performance. NHS and Homecomings plan to host more workshops and will be seeking participation from other HOPI lenders. This type of hands-on activity at the local level has helped Homecomings Financial exceed its best-case business plan by 50 percent in NHS neighborhoods during the first six months of establishing a local presence to keep more families in their homes.

311 Homeownership Preservation Campaign

The partners seek to expand efforts to reach homeowners at risk of foreclosure. The 311 Campaign will encourage homeowners to call the city's non-emergency 311 line at the first sign of mortgage delinquency. Callers will be connected with one of three credit counseling agencies affiliated with the Credit Counseling Resource Center for a free one-hour counseling session. The counseling agency will:

- Provide an in-depth assessment of the homeowner's financial situation and an individual action plan;
- Serve as a liaison between the homeowner and the mortgage company, where appropriate, to advocate for a repayment plan, loan modification or other loss-mitigation strategy that will help the homeowner avoid foreclosure; and

- Provide referrals to NHS where the in-depth housing preservation, rehabilitation, and community-based services and resources can make a difference and to other local resources, where appropriate, for job training, tax assistance, and foreclosure-prevention classes.

A pilot campaign will begin in late January 2004, with targeted mailings to homeowners in zip codes with high rates of foreclosure. The pilot campaign will provide the opportunity to assess the response rate and ensure that referrals are operating smoothly. A more broad-based outreach strategy through local alderman's offices, schools, churches, libraries and community-based institutions is planned for late February.

Postpurchase Education

The Department of Housing will be working with NHS and other housing counseling agencies to deliver a Postpurchase Education Curriculum. The series of classes will focus on a variety of postpurchase issues, including home maintenance, taxes and insurance, budgeting and credit, home improvement, and refinancing. A key message will be how to avoid getting into financial trouble that could lead to foreclosure, and what to do if you are behind in your mortgage. Classes will be offered in various communities throughout the city.

Reclaiming Vacant Buildings

When foreclosure is unavoidable, the partnership seeks to reclaim the building for affordable homeownership. NHS, DOH and HOPI partners have been working on innovative ways to transfer ownership of troubled, single-family buildings to NHS or other responsible developers.

Acquisition and Rehabilitation of Vacant Buildings

NHS reclaimed 39 properties through direct development or purchase-rehab lending during April 1 to September 30, 2003. NHS acquired 12 formerly vacant buildings for rehabilitation and sale, through donations or deep discounts from financial partners or through HUD. To date, NHS has received donations or deep discounts of properties from Bank One, Citigroup, Chase, Household, and Washington Mutual.

HUD Asset Control Area Program

NHS and HUD are close to a final contract which will begin the second phase of the "Asset Control Area" program, in which NHS will acquire all HUD properties at a substantial discount within a targeted area, and will rehab and sell them to owner occupants. This builds on the successful acquisition and sale of 100 vacant buildings through the first phase of the HUD ACA program.

Appraisal Gap Subsidy

The Department of Housing has included funding in its 2004 budget to assist NHS and other nonprofits in rehabbing vacant buildings. This subsidy ensures that vacant, deteriorated properties can be rehabbed to safe and marketable condition for homeownership.

Community Development Best Practices

As a result of the Homeownership Preservation Initiative, Chicago is the subject of a national research project sponsored by Neighborhood Reinvestment Corporation and NHS of Chicago and conducted by independent consultant Mark Duda and William Apgar, Senior Scholar at Harvard's Joint Center for Housing Studies. The objectives of the research are:

- To better understand investment securities, servicing agreements and other financial structures;
- To better understand the industry's assumptions, chart the institutional and legal relationships, and test how each stakeholder in the process operates and how this affects low- and moderate-income markets;
- To diagnose issues and create innovative partnership solutions around tools, strategies, and business models that serve to better manage the mortgage delinquencies and foreclosures experienced by low- and moderate-income neighborhoods.

The report is expected to be complete in March 2004.

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