Developing the Blueprint for Viable Low-Down-Payment Lending

Highlights and Common Themes from an Invitation-only Roundtable Discussion
Hosted by the UNC Center for Community Capital

May 17, 2013
Chapel Hill, North Carolina

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The UNC Center for Community Capital at the University of North Carolina at Chapel Hill is the leading center for research and policy analysis on the transformative power of capital on households and communities in the United States.

The center’s in-depth analyses help policymakers, advocates and the private sector find sustainable ways to expand economic opportunity to more people, more effectively.

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Peter Zorn, Vice President of Housing Analysis and Research, Freddie Mac
Overview

In the wake of the financial crisis, we need to rebuild a mortgage market that is safer – for taxpayers, lenders, investors, insurers and households. A central but largely unresolved theme is how to lend to less-affluent borrowers, and in particular, those with lower down payments.

A thoughtful group of lenders, advocates, academics, policy influencers and government agencies convened in Chapel Hill, N.C. at the invitation of the UNC Center for Community Capital for a conversation to address this critical question.

We all recognized that generations of Americans took their first step up the ladder of homeownership – and toward all of the benefits homeownership offers – thanks to a low down payment and a high loan-to-value (LTV) mortgage. The vast majority of participants in our group recalled that they, too, received help closing the down payment gap to purchase their first home. That help took the form of low-down-payment Federal Housing Administration (FHA) and Department of Veterans Affairs (VA) loans, loans insured by private mortgage insurance companies, parental gifts and even advances on credit cards and student loans.

We also recognized that while homeownership remains the primary path to asset accumulation for middle- and lower-income households, small equity cushions put households at greater risk of default in the event of a financial setback. As a matter of policy, we could curtail high-LTV lending and limit homeownership to people who have enough assets to put at least 20 percent down (about $40,000 on the median home sold in 2013). Recent trends in policy and practice seem to be driving toward institutionalizing such a rigid, risk-averse system. But such strictness carries great costs.

Alternatively, we can figure out a way to allow families who have less wealth (the average renter household has net wealth of about $5,000), to achieve homeownership in a way that makes them and those who lend to them financially stronger, not more vulnerable.

This conference engaged a panel of experts to answer the question of what role high-LTV lending should play in the post-crisis mortgage market. Through presentations and panel discussions, experts sought to address three core questions:

- How important is high-LTV lending for the future housing market?
- How can it be done in a responsible manner?
- Who has responsibility for what roles in seeing that the market is served a way that absorbs risk safely while delivering affordable loans?

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1 According to estimates from the National Association of Realtors
PART I: Why Expanding Low-down-payment Lending is Essential

Conference participants began by identifying why it is crucial to design a housing finance system that is as inclusive as it is sustainable. The answer? Today, there is a mismatch between households who want to buy and those who are able to buy. The emerging housing market is characterized by lower-wealth, more-diverse, would-be borrowers (including debt-burdened young adults) who are unlikely to have adequate savings to comfortably afford a 20 percent down payment. Providing these households access to sustainable credit is the key to a vibrant housing market in the future.

Using traditional measures of house price and loan rates, affordability could be considered good, but as Andrew Davidson has pointed out, factoring in higher down payment requirements changes the picture dramatically.

We explored three important demographic drivers of future housing and mortgage demand:

The Traditional Homebuyer Segment is Aging Out

The traditional borrowers around whom the system was designed are aging. They tend to own their homes and are likely to begin looking to sell. These households cannot sustain the market by themselves and may instead create excess housing supply as they age and die.

On their heels are households aged 40-54, according to research from Harvard’s Joint Center for Housing Studies, who will experience negative household growth rates through at least 2020 as the baby bust generation (Gen X) begins to replace the baby boom generation.

The good news is that there is potential demand from the millennial, “echo boom,” generation as it reaches the years of household formation. But this market looks different than the ones that preceded it, with a greater share of minority and low-wealth borrowers. This change signals the need to redesign housing and lending policies that were largely developed for the boomer and older generations in the mid-twentieth century.

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A Growing Minority Population will Drive Household Formation and Housing Demand

Minorities will continue to make up a larger percentage of the population. The U.S. Census Bureau reports that the portion of the non-Hispanic white population in the United States will shrink from 63 percent in 2012 to 43 percent in 2060. Conversely, the minority population will grow from 36.5 percent in 2012 to about 54 percent in 2060. Figure 1 presents population projections by race from 2012 to 2060.

This change means that minority populations will contribute to an increasing percentage of household growth as the percentage of non-Hispanic white households declines over time.

Figure 2 presents findings from the Harvard University Joint Center for Housing Studies (JCHS) of the expected distribution of household growth through 2025 (using conservative estimates for immigration rates). The authors found that, by 2025, only 20 percent of new households will be non-Hispanic whites, while 80 percent will be minority households.

Shifts in the racial composition of household growth will have major implications for the housing and mortgage markets.

Households of color have the lowest level of access to mortgage credit and the lowest accumulated wealth available for down payments, according to data presented at the conference by JCHS Director Eric Belsky. This limit to access is evident when the U.S. homeownership rate is separated into “buckets.” In the race bucket, the black-white homeownership gap is 29.4 percent and the

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5 U.S. Census Bureau (2012). “U.S. Census Bureau Projections Show a Slower Growing, Older, More diverse Nation Half a Century from Now.”
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Hispanic-white gap is close behind at 27.1 percent.\(^6\)

Lack of access to mortgage credit, however, does not necessarily translate into a lack of desire to become homeowners. One group that has demonstrated a desire to become homeowners is the nation’s immigrant population. Homeownership rates among foreign-born immigrants rise dramatically the longer they live in the United States. Researchers found that recently arrived immigrants in 1990 had an overall homeownership rate of 9.3 percent, but that by 2008, the rate had grown to 58 percent for that cohort. This figure approaches the average homeownership rate of 66.6 percent for Non-Hispanic, native-born men.\(^7\)

Since minorities make up a growing share of the population and this trend is expected to continue into future generations, they could serve to reinvigorate the housing market. Conversely, if current racial and socioeconomic gaps in homeownership continue, a significant portion of these potential homeowners will be shut out of the mortgage market.

Can Millennials Pick Up the Slack?

Millennials, also known as Generation Y or the echo boom, are another source of potential future homebuyers. The millennial generation is the largest demographic cohort to come along since the baby boomers and are just entering the household formation years – suggesting they should be boosting the housing market. But millennials are entering peak buying years in a tough climate. Aside from more rigid credit approval requirements for mortgage loans, millennials face an economy marked by high unemployment and stagnant wages.\(^8\) To make matters worse, high levels of student debt make meeting the recent qualified mortgage (QM) debt-to-income (DTI) ratio cutoff of 43 percent unattainable for many millennials, even for those with higher-paying careers.

Further evidence from the Housing Vacancy Survey and researchers at JCHS shows that U.S. homeownership rates for persons ages 25-34 fell by 8 percent between 2004 and 2013.

In 2014, the homeownership rate for Americans under 35 years old age was 35.9 percent, which is the lowest recorded rate since the U.S. Census began

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\(^7\) Myers, D. and Pitkin, J. (2010). “Assimilation Today: new evidence shows the latest immigrants to America are following in our history’s footsteps.” Center for American Progress.

\(^8\) Masnick, McCue, and Belsky (2010).

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### Millennials and Debt-to-Income Requirements

A recent study from the National Association of Realtors found that the estimated DTI ratio for persons between the ages of 21 and 30 is 61 percent when accounting for student, auto, credit, and mortgage debt. They also estimated, using 2012 data, that with an assumed five percent increase in income per year it would take seven years (until 2020) for this age group to meet the DTI regulations required to originate a qualified mortgage. The study was based on a starter home price of $149,425 with a 10 percent down payment and a 30-year fixed-term mortgage. These figures imply that millennials will be postponing home purchases until later in life.

<table>
<thead>
<tr>
<th>Year</th>
<th>DTI Ratio</th>
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<tbody>
<tr>
<td>2012</td>
<td>61%</td>
</tr>
<tr>
<td>2013</td>
<td>58%</td>
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<tr>
<td>2014</td>
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<td>2018</td>
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<tr>
<td>2019</td>
<td>43%</td>
</tr>
<tr>
<td>2020</td>
<td>41%</td>
</tr>
</tbody>
</table>

tracking homeownership with its Housing Vacancy Survey in 1982. In addition to low homeownership rates among millennials, household formation rates have fallen from historic patterns. From 1997 to 2007, average household formation was about 1.2 million households per year; in the last five years, household formation has been half that rate, with about 600,000 new households forming each year.9

**Why We Need an Inclusive Housing Market**

Homeownership has been shown to offer many economic and social benefits. It is a crucial source of wealth accumulation, strengthening the homeowner family’s prospects for long-term well-being by promoting savings for retirement, entrepreneurship and education that carry over to the next generation.

Leaving minority and millennial buyers out of the market can have macro-economic ripple effects. Weakening the housing market could lower net wealth more broadly and lead to a stagnant economy.

In essence, the baby boomer generation is phasing out of the housing market and the millennial generation, which should be crossing the threshold into homeownership, is hindered by low wealth, high debt and other factors that are not well accommodated by the mainstream mortgage process. The approach must change to enable these prospective borrowers to obtain mortgage financing in a sustainable manner or the market risks shutting out the future drivers of U.S. homeownership.

Generally, our conference participants agreed that the current outlook for potential homeowners is bleaker than it was for homebuyers 20 or 30 years ago, especially for those who cannot look to their parents for help. A lender in the room reminded us, “Almost none of you would have gotten your first loan today.”

Low-down-payment lending can be used as a viable tool to open credit access to those who, while not traditional borrowers, have demonstrated a capability to repay a mortgage loan under the right conditions.

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Jim Carr, Senior Fellow, Center for American Progress
PART II: The Blueprint – How to Increase Credit Access While Managing Risk

Having reviewed why low-down-payment lending will be essential to the mortgage market in the future, conferees examined how to design a lending process that is more inclusive of low-wealth borrowers and supports the financial well-being of borrowers, lenders, communities and the economy.

High-LTV loans are riskier than low-LTV loans; this is well known and accepted throughout the mortgage finance community. However, there is ample evidence demonstrating that high-LTV loan programs can be managed successfully. A body of housing finance agencies, nonprofits and credit unions have and continue to run successful high-LTV lending programs. They include Self-Help’s Community Advantage Program and Navy Federal Credit Union’s zero-down payment option.

Successful programs such as these reveal elements to include in the blueprint and combine two key ways to manage risk: a process to reduce risk and capital to absorb it. Each are discussed below.

Note these practices are completely opposite of the risky lending that led to the foreclosure and financial crisis, which were marked by weak lending systems and excessive leverage among lenders.

Step 1. Transform the Lending Process

The lending process itself can reduce risk while facilitating access to responsible credit. The process of making and managing good low-down-payment loans is no mystery to mortgage financiers; the inputs: a prime, transparent, sustainable loan product, careful yet flexible underwriting, quality servicing and counseling and other borrower supports.

Use low-risk products

The lending industry knows what a responsible mortgage loan looks like: 30-year, fully amortizing and fixed-rate. When these standards are upheld, borrowers of any background are less likely to default. In reviewing data from Self-Help’s Community Advantage Program (CAP), researchers at the UNC Center for Community Capital found that, although the median CAP borrower makes less than $30,800 per year (or 60 percent of area median income), the program’s delinquency rates during the crisis looked a lot more like those of traditional prime loans than of subprime loans. In fact, subprime loans were three to five times more likely to default than CAP loans. Details about

High-LTV Lending Programs Done Right

Self-Help’s Community Advantage Program (CAP)
- 50,000 loans to low- and moderate income families in 15 years
- Fixed-rate, 30-year mortgages
- Average 22 percent return-on-equity
- High LTV (most at 95 percent)
- No private-mortgage insurance (PMI) required

Massachusetts Housing Partnership’s ONE Mortgage Program
- Fixed-rate, 30-year mortgages
- Up to 97 percent LTV
- No PMI required
- Subsidy available for qualifying households

VA Loan Program
- Mortgage loans to 20 million veterans and service members
- 100 percent financing
- No PMI required
- Partially guaranteed by the VA

State Housing Finance Agencies
- N.C. HFA provides down payment assistance through the N.C. Home Advantage Mortgage Program (on 30-year fixed-rate loans through FHA, VA or USDA)
- 69 percent of NCHFA mortgages since 2009 have LTVs of 95 or higher

NASA Federal Credit Union
- Fixed-rate, 30-year mortgages
- 100 percent financing
- No PMI required

Navy Federal Credit Union’s HomeBuyers Choice Mortgage:
- Fixed-rate mortgages
- 100 percent financing
- No PMI required

Source: UNC Center for Community Capital, N.C. Housing Finance Agency website, NASA Federal Credit Union website, Navy Federal Credit Union website
this program and similar ones can be found in the box titled High-LTV Lending Programs Done Right.

A specialized product for low-wealth borrowers is down payment assistance (DPA). It typically is provided at closing in the form of grants or forgivable, low-cost loans (“soft seconds”) via public or nonprofit agencies to offset a qualified homebuyers’ outlay, leaving them with more reserves and usually making the financing more affordable. Program features and eligibility requirements vary greatly from provider to provider, with any given metropolitan statistical area having a variety of DPA programs available. Often these programs result in combined LTVs of 100 percent. By providing a small amount of gap financing, these programs put homeownership within reach for many households and qualify them for affordable mainstream first mortgages. Including additional specialized features can further reduce risk. A model product proposed by Mark Goldhaber, principal of Goldhaber Policy Services, for instance, offers mortgage payment due dates that match the borrower’s pay cycles.

**Encourage Sensible Underwriting**

High-LTV loans are not inherently risky; rather, it is the failure to balance different layers of risk that can increase the likelihood of default. This combination includes such factors as credit history, debt-to-income, job security and the risk embedded in the mortgage product itself. During underwriting, the balance of these inputs has to be correct, which in the case of the more complex picture of a lower-wealth borrower often requires nonstandard documentation and judgment. Finding an equilibrium to minimize risk for high-LTV borrowers can be achieved through diligent, cautious underwriting.

The problem? Efficiency and limited resources.

In a period where automated underwriting is the norm and strict documentation guidelines have already increased the time needed to underwrite a loan, large lenders are not enthusiastic about programs that require time- and labor-intensive processes, particularly if lenders can survive making low-risk loans using automated underwriting. Data presented by Mike Fratantoni, vice president of research and economics for the Mortgage Bankers Association, (See Figure 3) demonstrated that, for lenders large and small, a single underwriter could handle about 200 loans per month in 2002 but only about 60, or one-third the load, in 2011.

What is particularly startling about Figure 3 is that today’s loans are of extremely high credit quality and should be easy to process with heavy
reliance on automated underwriting systems (AUS). Loans to lower-income, lower-wealth borrowers are more likely to fall outside the framework of AUS and require more hands-on underwriting, thus requiring even more underwriting resources. Participants felt that the extra effort required to process and underwrite loans not easily evaluated by AUS is a key factor that is keeping lenders away.

On a hopeful note, Peter Zorn, vice president of Housing Analysis and Research at Freddie Mac, shared research indicating that AUS could be formulated to work better for at least a portion of target borrowers – those with low incomes, high LTV or below-average credit – providing better underwriting risk management at scale.\(^\text{10}\)

Models require data to get better at evaluating more complex applicants at the margins. If such loans are not getting made, as in today’s market, these models will never develop the learning needed to better serve this segment and distinguish the less-risky borrowers in the higher-risk cohort. Or, if unobserved factors related to success or failure that manual underwriters are often able to consider are not fed into the computer, then the AUS cannot learn how to distinguish lower-risk borrowers within broader high-risk categories.

Even if AUS is improved to serve the target market more efficiently and effectively, participants noted that they will always leave some people out who might be good risks, and the required manual review will never fully lend itself to automation and scale.

### Manage loan performance with preventive servicing

Servicing matters. Proactive servicing can help keep people in their homes during periods of personal and macro-economic hardship. During

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the housing crisis, government implemented programs, such as the Home Affordable Modification Program (HAMP), standardized and incentivized provisions for servicers to make home loan modifications. Applying these types of proven high-touch servicing techniques could help steer low-equity borrowers through bumps in the road while reducing losses. New servicing standards are a first step in this direction.

On the downside, servicing distressed loans has proven very costly. The traditional financial model of servicing distressed loans failed under the wave of foreclosures. In response, many banks have shed distressed servicing. Specialized servicers have proven to be a good solution for risky borrowers in distress, participants suggested, but it costs more.

How can high-touch servicing be made to work at scale? And can the economics work for the servicers? Likely the key lies in recognizing that servicing is really two different models: a collection model and a loss mitigation model. The collection model is a steady business and pays well enough to support a minimal amount of distressed loan management, whereas the loss mitigation aspect is cyclical, like many other facets of the mortgage business, calling for substantially greater capacity and average per loan costs during times of macro-economic stress.

Provide borrowers the tools for success via counseling

Another factor that can impact performance is counseling. This term is broad and covers homebuyer preparation, pre-purchase counseling, post-purchase counseling and default counseling. At the conference, this concept was well-agreed upon by the experts present: homeowners are generally more willing to speak with an independent counselor than with a bank when repayment issues arise and counseling can assist homeowners to better manage their financial capital. One expert stressed the potential value of comprehensive financial counseling with more stakeholders and good metrics.

The consensus on counseling diverges when asked who should pay for it. In 2011, funding for homeownership counseling in the federal budget declined, leaving more counseling costs to either the lender or the potential buyer. A large but unsung part of the value of up-front counseling is sorting borrowers: identifying mortgage-ready borrowers, making a longer-term investment in preparing less-ready borrowers and letting go of other borrowers who are simply not ready. Janis Bowdler from the National Council of La Raza

estimated that 80 percent of people coming through counseling are not ready for homeownership.

Most everyone in the mortgage chain is paid when a loan gets made. Building counseling expenses into the cost of the broader lending system is one avenue that holds promise. For this to occur, a publicly facilitated subsidy is needed. Mark Goldhaber suggested taking five basis points on all mortgages to create a pool of funds, and some felt confident the capital markets would pay if the value could be proven.

But others called into question the true scalability of effective counseling. If it can be brought to scale, how can the quality of the process be monitored, especially if there is no legal backing to ensure standards are met. The answer lies in making it scalable and better integrated into the system. Participants suggested a fuller discussion is needed on this challenge.

As the discussion and examples of successful programs show, good products, flexible but responsible underwriting, proactive servicing and quality counseling result in performing loans to less-wealthy borrowers – the borrowers of the future. These risk-reduction tools may limit access to credit in varying degrees, but the blueprint must include ways to foster and implement these product and process improvements as dials to optimize risk and access.

**Step 2: Manage Capital to Absorb Risk**

Another crucial dial involves economic and actuarial measures to absorb risks – essentially insurance – that enable the system to tolerate some level of risk.

Insurance has taken many forms, including public and private mortgage insurance (PMI), Fannie Mae and Freddie Mac guarantees, bank balance sheets backed by deposit insurance and risk-absorbing tranches of securities.

Effective insurance mechanisms operate under two principals: 1) pooled, diversified risks and 2) adequate capitalization. Important considerations in designing risk absorbers for the entire system, as well as component parts, are:

1. How much risk should it be geared to absorb?
2. How should the costs be allocated?
3. What is the best form and structure?

**How Much Risk?**

Mechanisms can be built to absorb a range of risks, from routine risks (at the micro level – the isolated risk that an individual borrower will default) to
macro and correlated risks as a result of regional downturns or widespread economic crises (the risk that many borrowers will default at the same time, accompanied by greater loss severities that often trigger further defaults). The mortgage industry faces both types of risk but is more prone than many other forms of insurance to correlated, systemic risks that arise in cycles and result in tremendous losses relative to “normal” experiences.\textsuperscript{12}

A low down payment has long been an actuarially identified risk factor. The good news is that the risks are fairly predictable, which helps make them insurable. The extent to which lower amounts of equity increase risk of loss over loans with high equity has been tracked and quantified over decades of experience. It has also been well understood that cyclical downturns significantly amplify losses on low-equity loans, and the recent foreclosure crisis presents another in a series of stress case scenarios for which to plan.

Ken Bjurstrom, principal at Milliman Inc., demonstrated the interplay of the ordinary and cyclical risks in the high-LTV lending arena. Seven percent is the norm, as shown in Figure 4, based on data from the Federal Housing Administration’s Mutual Mortgage Fund of the historical distribution of annual books of business by default rate (claims rates). However, outlier claims rates, or “tail risk,” occur in a high number of years. The largest outliers are from the most recent crisis – 2006, 2007 and 2008 – with claim rates between 20-30 percent. Bjurstrom contends two factors drove these exceptional default rates – poor underwriting and macro-level economic crisis. Together, these two elements were responsible for creating the high tail risk we saw in the recent crisis.

Meanwhile, analysts found that Fannie and Freddie could have avoided conservatorship if they had been prepared to cover a loss rate of only four to five percent.\textsuperscript{13}

Bjurstrom’s analysis begs the question: how much tail risk should the

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\caption{High LTV Lending Performance, presented by Ken Bjurstrom}
\end{figure}

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Year & Default Rate & Claim Rate \\
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\caption{High LTV Lending Performance}
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system be structured to absorb? Should all of the potential tail risk costs be built into the pricing, and what would be the implications?

Bjurstrom presented evidence on the cost-prohibitive nature of fully pricing and capitalizing for worst-case scenarios for every book of business. Using the private mortgage insurance capitalization metric of risk-to-capital (RTC)\(^{14}\), he asks: what RTC ratio is acceptable? A standard of 25:1 RTC will capture about 98 percent of risk scenarios and require about $13 million in capital. The amount of capital necessary to cover 99.9 percent of losses is 3.8 times higher than that required for the 98 percent confidence level.\(^{15}\) In short, it is a huge additional amount of capital to protect against a statistically small likelihood of catastrophic loss.

Such high capitalization requirements might not offer sufficient returns to attract adequate private capital. They are likely to become cost prohibitive, especially when multiple participants are all preparing for the worst case scenario. The end result may be that the government has to step in to fill the void.

Bjurstrom went on to illustrate how this scenario is currently playing out. Efforts to achieve stability through pricing mechanisms have become redundant, with government-sponsored enterprises (GSEs) using increased fees and loan-level price adjustments, private mortgage insurers charging premium rates and lenders using loan-loss reserve funds – all charging for the same risk. The result is that costs of obtaining a low-down-payment loan through conventional conforming channels is so high that few loans are being made.

**Ways to Insure Risk**

Again, here we can draw on decades of experience by looking at mortgage insurance models that have been used in the past. Do they work? Can they be improved or should they be overhauled? We looked closely at two models: PMI and FHA

**PMI**

According to Rohit Gupta, president & CEO of Genworth Mortgage Insurance Co., in “normal” times, 30-35 percent of the market cannot afford

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\(^{14}\) Risk-to-capital (RTC) represents the monetary ratio of risk insured to capital retained. This means that for every $25 of risk that a PMI company insures, it must reserve $1 of capital - Baker, P. S. & Baker, J.K. (2011). “Private Mortgage Insurance Essential Link in the Financial Services Institution Audit Chain.”

\(^{15}\) These figures were calculated based on an LTV of 95 and a FICO score between 680 and 719.
What is the Role of PMI in the Housing Market?

Mortgage insurance is a tool used to protect lenders in the case of borrower default, especially in high-LTV lending. It is required on all mortgage loans with an LTV higher than 80, and is either government-sponsored through the FHA or the Veteran’s Affairs Department, or provided by private mortgage insurance (PMI). Mortgage insurance allows loans to be purchased by GSEs and sold on the secondary market as mortgage-backed securities.

The origins of the PMI industry date back to the nineteenth century in New York State, but all companies providing PMI were wiped out during the Great Depression. The modern PMI industry began in 1957.


As with most forms of insurance, solvency within PMI companies is maintained by pooling the individual risk of each borrower and sharing the costs. This mechanism is effective in safeguarding against particular (or individual) risk, but is less effective at guarding against fundamental risks, such as macro-level economic shocks. For this reason, modern PMI companies are required to hold a contingency reserve of 50 percent of premiums for 10 years. Overall, PMI companies adopt a portion of the risk associated with high-LTV loans from lenders, purchasers, and investors.


a 20 percent down payment. PMI help borrowers who pay less than 20 percent down obtain a mortgage loan.

The crisis caused significant losses for PMI companies. As a result, capital levels fell below the levels required by state regulators and by GSE counterparty risk criteria. State regulators and the GSEs reacted by waiving the RTC requirements. This action may not have followed the safety and soundness rules but it allowed the companies to stay open to write new, stronger business and keep collecting premiums so they could continue paying claims.

The industry came through the crisis but not unscathed. Two companies stopped writing new business and went into runoff mode while continuing to pay claims. One company failed to pay some claims.

The industry also suffered reputational damage. As claims mounted, the companies denied many of them. Between the claims denials and company failures, many questioned the dependability of the model and the strength of the insurance.

Laurie Goodman, senior managing director at Amherst Securities Group LP, opened a discussion with Gupta about the weaknesses, strengths and outlook for the PMI industry. Goodman raised concerns about the lack of investment-grade MI companies. She also noted that the remaining legacy MI companies are still in business because of waivers.

16 Capital waivers allow PMI companies to continuing selling mortgage insurance coverage when their RTC ratio surpasses the 25:1 standard, and is no longer in compliance with regulations. Waivers can be granted by state insurance regulators and GSEs.
FHA vs. PMI – Which is a Better Deal for Borrowers?

What is the best option for a homeowner in need of a high-LTV loan – an FHA loan or a conventional loan backed by PMI? Research from the Urban Institute indicates that the better choice comes down to credit score. Buyers seeking a conventional loan with an LTV higher than 80 will need to purchase private mortgage insurance (PMI) to enable the loan to be sold to GSEs like Fannie Mae and Freddie Mac.

In a comparison of interest rates and premiums, researchers at the Urban Institute studied the monthly payments required for a loan with an LTV of 95 for a property worth $250,000. They found that borrowers with FICO scores between 620 and 680 would pay more per month using PMI than they would pay through an FHA loan. Alternately, they found that borrowers with credit scores greater than 680 paid more through an FHA loan than through a conventional loan using PMI.

One of the reasons for these findings is that FHA premiums do not change based on FICO score, but PMI premiums and GSE loan-level-price-adjustments drop as credit scores improve. In addition, homeowners with conventional loans can drop PMI coverage when their LTV reaches 78, whereas borrowers with FHA loans.


Gupta presented private mortgage insurance data from the Great Recession showing that PMIs paid out $43 billion in claims from 2005-2012 while taking in $37 billion in premiums and raising $9 billion in new capital. He pointed out that two new entrants have emerged and that seven companies currently exist, as before the crisis. He showed that Genworth’s claims denials were driven by nontraditional loans and delegated underwriting, with less than five percent involving traditional loans in which Genworth performed an underwriting review (where any rescissions would have been strictly due to clear fraud).

Gupta also acknowledged the need for transparency and certainty about willingness-to-pay (contractual clarity about rules for rescinding claims) and ability-to-pay (better, stress-tested capital requirements). For the former, he pointed out that the implementation of the QM rule will play a role, and laid out several options for increasing contractual certainty, including less delegation of underwriting.

For the latter, ability-to-pay, he described a new claims-paying capital model being developed by the industry. The proposed model, an update to the “Model MI Act” would provide third parties with an objective measure of a PMI’s solvency through quarterly stress-testing. The proposed model is based on tested risk-based MI models in use in Canada and Australia.

In response, Goodman stressed the importance of getting to a better capital model as proposed and of having certainty that the rules would be adhered to by PMI companies. One issue raised by participants was competitive pressure; for example, MIs choosing to compete for market share by agreeing to insure risky loans. Gupta explained that state and federal regulation is required to institute and enforce the rules in order to bring all the MI companies into the standards. In closing, Gupta noted that the
more capital required, the more expensive the insurance, while Goodman emphasized the primacy of the solvency issue.

**FHA**

The Federal Housing Administration is the other key actor in the provision of mortgage insurance. Traditionally, the FHA provides mortgage insurance for underserved markets via a 100 percent guaranty of typically high-LTV loans. At the start of the foreclosure crisis, when the mortgage market threatened to freeze up, FHA loan limits were raised and its market share jumped. Within the mortgage insurance sector, FHA’s share went from 17 percent in 2007 to 71 percent during 2008. This figure is decreasing with the economic recovery currently under way, but there is still sentiment that the FHA is operating outside of its “normal” playing field.

At the same time, as Ken Bjurstrom’s figures already suggested, the FHA's 2005-2009 books of business have performed poorly, putting a big dent into the insurance fund.

In a discussion facilitated by Ann Schnare, principal at AB Schnare Associates LLC, FHA’s Frank Vetrano, chief credit officer, discussed steps his agency has taken to strengthen the fund and keep FHA on mission, including making adjustments to programs, positioning FHA to prudently phase out of its crisis role and establishing clarity around FHA's risk appetite.

Vetrano stressed that, under current pricing, every FHA loan is priced to cover expected loss and contribute to the reserve fund, even those with lower credit scores. FHA has also established “risk-based underwriting” through their TOTAL scorecard or manual underwriting rules. This approach assesses both loan-level and portfolio-wide loss expectations, taking into account compensating factors, instead of using hard cutoffs on single factors. Applying the risk threshold is likely to reduce losses through a reduction in the relatively small share of FHA loans that present the highest risk and should shift the overall portfolio to better performance.

At the same time, FHA’s new higher pricing is driving lower-risk business to other channels where risk-based pricing is better for them. Already, PMI has seen substantial share recovery since 2009 as FHA’s share has declined. FHA’s current pricing structure anticipates this shift in risk.

Discussion ensued over the risk that FHA would be adversely selected by PMI, which could ultimately be destabilizing. Since a stated policy objective is to bring in more private capital, the implication is that a lower performance at FHA should be tolerated or access to credit be withdrawn from underserved but creditworthy segments.
How to Allocate Costs and Account for Risk

Much of the discussion on managing capital comes down to pricing. How do we price for risk in a fair and transparent way? It may seem fair for those who have more risk to pay higher prices. The problem is that paying higher premiums for mortgage insurance can further weaken a “risky” borrower’s ability to make a mortgage payment.

For perspective, we can compare auto insurance to mortgage insurance; the difference is that instituting higher auto insurance premiums for accident-prone drivers does not affect a driver’s risk of having an accident. With mortgage risk, a low-wealth borrower using limited monetary resources to pay a higher cost leaves less income available to make a mortgage payment. Alternatively, it may lead them to rely on FHA or just keep those borrowers out of the market altogether, putting a long-term damper on the housing market.

In effectively managing capital for high-LTV lending, it is important to consider how we want to price for risk. Should we be pricing based on a “business-as usual” model or based on a worst-case scenario? And what is the role of the government guaranty? Investors have made it clear that without some sort of backstop by the government, there is very limited appetite to fund mortgages and none to fund affordable, long-term fixed-rate mortgages for more marginal borrowers.

Looming GSE reform presents a prime opportunity to build low-down-payment lending into the system the right way. However, the way forward is not at all clear. Andrew Davidson\(^1\) discussed the pricing implications for GSE reform proposals currently in favor that have a large role for private capital in the first-loss position, with government taking tail risk. His report estimated that the annual credit cost plus government wrap would be around 45 to 81 basis points. This level sounds reasonably affordable, but it also predicted that the cost for high-LTV loans with a FICO of around 660 would be more than 10 times higher than that for a loan with 750 FICO and LTV below 80 percent and would add 2.5 percentage points or more on top of the cost of funds and servicing, even when using a baseline assumption of modest home price appreciation and long-term income growth.

Alternatively, a market where all the risk is pooled and costs are shared reduces risk while allowing marginal borrowers to participate in homeownership in a manner that is safe and affordable. Pooling risk allows for more uniform pricing across different housing markets and cycles.\(^2\)

\(^1\) Davidson, Andrew, and Levin, Alexander (2012).
PART III: Who Can Serve This Market

We Know How to Do It.

The preceding discussions confirm that access to credit can be safely provided through process improvements and insurance backed by capital, both of which mitigate loan level and macroeconomic risks, in different degrees. As one participant noted: “It isn’t a secret sauce per se. We know how to do it.”

However, the reality is, these tools carry costs. In fact, there is a fairly straightforward tradeoff: costs stemming from credit risks are reduced by process improvements, which also have costs. If these costs are all borne by the target borrowers, they will become prohibitive. As we discussed, there are societal benefits (“positive externalities”) from providing high-quality credit to borrowers starting their journey up the homeownership ladder. Today, we have the odd combination that credit risk costs are high and redundant while underwriting risk is being kept low through tight regulations. Public policy is pushing both of these elements in the same direction – against high-LTV lending.

We explored how various stakeholders and institutions are positioned to serve this market and to implement the ideas discussed in this forum:

The PLS Sector: Not Open for [This] Business

Purely private lending channels have existed in the jumbo niche for a long time, as did a steady niche in subprime, low-LTV lending. The intemperance of the mid 2000s and the subsequent collapse of this sector make it unlikely that it will play a significant role in lending at the margins any time soon, especially given new lending rules. Currently, ratings agencies and investors are likely to require high and costly levels of credit protection. A review of the risk profile of PLS issuances of the last two years confirms that this much-curtailed channel, once a source of flexible but risky credit, has been securitizing only the safest of loans.

Credit Unions: Balance Sheet Community Lending Marginalized by National Lending Policy

This channel has traditionally served community needs and has advantages that can make them more flexible, as participants explained. As vertically integrated, locally focused, member-owned cooperatives (in the case of credit unions), who can hold their own loans, they are free to make locally based judgments and be patient lenders. Jim Blaine, president of
North Carolina’s State Employees Credit Union (SECU), one of the nation’s largest, pointed out his organization has been making mortgages for many decades, with LTVs of up to 100 percent. SECU has a 0.29 percent default rate and a 2 percent delinquency rate and has never had a buyback. The problem? Credit unions represent at most about 7 percent of the market. Adding in community banks would still only make up a small share.

Blaine stressed the need for local loans to sustain local institutions. However, current low lending rates, securitization and the 30-year fixed-rate mortgage available through Fannie and Freddie have removed the local lender from the equation to the detriment of borrowers who require more personalized lending. Blaine pointed out that adjustable-rate mortgages can be offered in a low-risk format, such as two-year adjustables with a 1 percent cap, or even five-year adjustables. These could be held on credit union and community bank balance sheets, providing those institutions with a good source of loan revenue and a bigger role in the market.

Unless dramatic changes are made, however, the credit union channel is not going to be a scale solution for flexible lending. Credit unions have to deal with the reality of the secondary market. Those selling loans to the GSEs, while not worried about QM, do have to worry about lack of clarity regarding GSE putbacks, “impossible execution,” and the lack of grey areas, despite their demonstrated track record of making flexible, safe, well-underwritten loans.

**Banks & CRA Lending: Is Scale Incompatible with High-touch Lending?**

For banks, it gets back to capital and costs, participants said. For scale programs, many use FHA, Fannie and Freddie. For niche lending, they can use their balance sheets. For example, Barbara Kelly described a new Citibank program using down payment assistance to deliver low-down-payment loans with intense underwriting and virtually no defaults to date. To put things in perspective, a large bank that does FHA lending and then manages a number of niche, portfolio products can make “as many loans to LMI borrowers at scale” as many numerous small and nonprofit lenders combined.

Nevertheless, there is an inherent tension between operating at scale and really serving communities (one-at-a-time decisions and localized programs). The high touch model is incompatible with scale. The question: how to deliver small pieces of capital to lots of small local programs?

Furthermore, FHA is often cheaper. A portfolio loan where capital carry is higher may make the loan ineligible for QM, which increases litigation risk,
which further raises costs. Servicing has gotten much more costly as well, especially for marginal loans with smaller balances and greater likelihood of needing attention.

To suggestions that banks charge more for such loans, they point to fair lending risk, not to mention Community Reinvestment Act (CRA) and reputational risk. Recent U.S. Department of Housing and Urban Development actions on fair lending are described by the agency and advocates as simply codifying long-standing rules, but the industry is reacting as though it is a new day. It remains to be seen how this will affect high-LTV lending. To the extent that the GSEs are charging higher and higher fees, banks may decide to put the lowest risk loans on their own balance sheets instead.

Mark Willis, resident research fellow at NYU Furman Center for Real Estate and Urban Policy, explained that instead of charging more, banks often absorb the additional costs. For CRA loans, this lower profit is acceptable to some extent. However, if CRA programs are pressed for mainstream return levels, they have to charge more. They run the risk of being adversely selected or running a fair lending risk or may simply choose not to compete for the business.

**State Housing Finance Agencies: High Quality Loans, Heavy Reliance on Funding**

Since 1974, state housing finance agencies have been providing affordable mortgages to low-down-payment borrowers up to 100 percent. The loans are typically made and serviced by mainstream mortgage lenders and funded through tax-exempt bond financing issued by the agencies. They often feature subsidized down payment assistance. Recent studies have confirmed good performance of these loans. But as reported by participants, the funding for mortgage revenue bonds (MRBs) has waned, and spreads are less available to support the accumulation of down payment assistance dollars.

The New Issue Bond program provided a temporary flow of funds for HFA MRBs, but the permanent, post-crisis value proposition for these agencies is still developing. Fannie Mae has recognized the high quality of these loans by offering special terms through HFAs, including higher loan-to-value ratios for My Community Mortgage than for other channels, as well as no loan-level price adjusters, low or no mortgage insurance requirements and

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other special features in exchange for a degree of risk sharing. Whether this channel falls into the niche category or the scalable category was debated, but certainly it holds the potential to be an important component of high-LTV financing going forward.

**FHA: Refocusing**

FHA’s market share peaked in Q3’08; though it has been on a steady decline since, it still remains elevated relative to the previous few decades. Over the crisis it has been tasked to perform a dual mission of providing counter-cyclical stability, while still promoting access to credit for low-wealth borrowers. The risk profile of FHA has tightened considerably while its costs have increased. Since FHA loan limits were raised to record levels in the wake of the mortgage market collapse, it seems to have shifted to serving a more affluent borrower.

One issue is whether these higher loan limits and its counter-cyclical role are drawing FHA away from its mission to serve the underserved. Ann Schnare shared an analysis showing that in 2011, 90 percent of FHA-insured mortgages were still below the $271,000 lowest loan limit, with only 1 percent above $600,000 and less than 4 percent above the GSE limit. She showed that the share of First Time Home Buyer (FTHB) loans has remained in the 70-80 percent range, nearly flat since 2007. She also showed that FHA has provided some 60 percent of all the owner-occupied purchase money mortgages to Black and Hispanic borrowers from 2009-2011 and had maintained its deepest penetration in the lowest income categories. She projected the impacts on FHA’s share and mission focus of reducing FHA loan limits, concluding that such changes would most likely fall hardest on the FHA’s base borrowers, minorities and first-time homebuyers, unless undertaken gradually and predicated on the continued availability of alternate mortgage credit.

**GSEs: Not competing today**

Fannie Mae and Freddie Mac are required to serve the entire eligible market, even those segments which are not as profitable as others (though still safe and sound business), and have long operated under housing goals for serving lower income borrowers and underserved areas.

More recently, the Housing and Economic Recovery Act (HERA) called for a duty to serve select underserved segments: rural, manufactured and affordable housing preservation. But the duty to serve rule is not yet implemented and the goals have been set at levels well below historical levels
and even at levels below recent historic performance. With high general guarantee fees coupled with loan-level price adjustments, which discourage loans at the risk margins, and aggressive use of putbacks, the GSEs are seen as not competing for this business.

Should the GSEs compete for this high-LTV market? We have recognized that the risk is quite insurable as long as house prices are stable. It is also recognized that their lack of appetite for high-LTV loans simply drives loans away from the GSE/private MI sector to the FHA, where the loans are 100 percent government backed, so it doesn’t protect the taxpayers.
Discussion Highlights and Conclusions

If the future of homeownership depends on broadly available, affordable and sustainable low-down-payment lending, then the responsibility cannot be left to credit unions, community banks and nonprofits. One proposed solution is to get large lenders more engaged. While the big box lender model does not lend itself to high-touch, special programs, big box lenders could be encouraged to sponsor programs run through small lenders.

Meanwhile, the reality is there is not enough capital on bank balance sheets to cover mortgage demand. Holding the GSEs more accountable to serving this market would also be a positive change.

GSE reform, which is currently under way, provides an excellent opportunity to strike the right balance between these channels that would provide access and affordability with stability. Prospects for workable GSE reform are dim. Nevertheless, it is critical that GSE reform be undertaken for the purpose of meeting its public mission and ensuring a liquid, resilient mortgage market that serves as many borrowers and communities as it prudently can.

In sum, participants predicted very limited balance sheet lending with some boutique lending by nonprofits, specialized community lenders and HFAs. To the extent the GSE sector fails to pick up the slack, the FHA seems the likely place where first-time, low-down-payment borrowers of the future will be served.

As an example, the initial proposed QRM rule sought to require risk retention on all loans with down payments less than 20 percent, even those with mortgage insurance, and the Basel III proposal would have increased capital requirements for many low-down-payment loans. Both lenders and advocates for affordable homeownership opposed these measures, arguing that it would leave too many potential homeowners out of the market, and that low-down-payment lending could be done in a safe and sound manner. Ultimately, neither the QM nor QRM guidelines included any specific loan-to-value (LTV) requirements and the capital requirements for higher-LTV lending remained unchanged from Basel II.

Nevertheless, there remains an atmosphere of trepidation among lenders in serving borrowers with less wealth. This outlook is worsened by fear of buybacks (where defaulted loans are closely scrutinized for defects that would require the originating lender to buy the loan back) and by the perceived risk of being sued by the borrower for violation of the Ability-to-Repay rule, which went into effect in early 2014. Though these factors do not have down payment provisions, they may reduce the willingness of lenders to serve
Developing the Blueprint for Viable Low-Down-Payment Lending

low-down-payment borrowers because they potentially raise the costs of any failed loans and lower down payments are correlated with higher default rates. Moreover, lower-down-payment borrowers are also often those requiring greater flexibility and due diligence in evaluating credit and income.

Likewise, policymakers and regulators will play an important role in redesigning the mortgage secondary market and the provisions affecting the future of traditional sources of high-LTV lending, such as the Federal Housing Administration, state housing finance agencies, private mortgage insurance companies and second liens. Even though there is widespread evidence that high-LTV lending did not cause the crisis, the minimal amount of equity high-LTV borrowers had in their homes can be considered an exacerbating factor. There is widespread recognition that institutional leverage, rather than borrower leverage, destabilized the market; yet borrowers, particularly those of low wealth, have been left to bear the consequences of housing market failure.

No Home, No Wealth

Concluding Remarks George McCarthy, Director, Ford Foundation

We gathered here today in recognition that we are on the precipice of casting a long-term definition of the housing finance system, of who should have access to homeownership and what that implies for “what kind of country” we are.

We met in Chapel Hill, North Carolina – not Washington D.C., not New York City – bankers, advocates, academics, etc., and shared facts and real-world understanding from many perspectives. We converged on the point that the system can and should better meet the credit needs of low-wealth borrowers while managing risk, based on several consensus conclusions:

Given political realities, if people who understand this issue do not make a conscientious effort, policy and competitive dynamics will lead us to the wrong place and leave a huge part of the market unserved by the mainstream, exactly where we most want it served. Some 75 percent of forecasted new household formation will go unserved. This is bad for households and it is bad for the economy.

For economic stability, a path to the middle class and a chance to build long-term assets, the reality remains that this is it for lower- and moderate-income households in this country. No home, no wealth.

We have strong research and analysis quantifying the risks and clear proof that high-LTV lending can be done safely. It is critical to unbundle the borrower-level risks from the systemic, economic risks.

It is about underwriting, but even more, it is about the economy. In a stable system, with stable mortgage products, you can lend more safely to more borrowers at the margin. Volatility in the housing market and in products creates default risk. This is a circular condition: lack of a first-time homebuyer market will hamper the economy.

Getting it right, even though we know the required elements, is easier said than done. The tension between “big box” and “high touch” came up again and again. Continued consolidation is working against the high-touch lending that this market segment needs. At one time, CRA helped balance that, but today it is out of date, while consolidation is here to stay.

Some ideas: many of the tools and devices discussed have tremendous potential value for the whole market, but they are not easily supported by the economics of the business.

Government policy has an important role to play in balancing the scales between risk, access and profitability. We need to find ways to empower high-touch channels and mechanisms in partnership with scale capital.