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Residential mortgage lending for underserved communities: recent innovations

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Issue 1 2016

Our first edition of 2016 is our last to go to print. Henceforth, *ProfitWise News and Views* will be an e-publication. We sincerely hope our print-only subscribers will opt to receive *PNV* in its new format; please visit www.chicagofed.org/subscribe for subscription information.

We begin 2016 with a look at findings from the 'LMI (low- and moderate-income) Survey' summarized by business economist Emily Engel, who also administers the survey. Chicago is one of six Reserve Banks that participates in the survey. Our Seventh District respondents include approximately 150 individuals (of 1,500 surveyed) involved in some aspect of community development. Emily, Illinois economic development director Jason Keller, and a recent addition to Community Development and Policy Studies (CDPS), research analyst Taz George, explored five innovative products (at varying levels of development and scale) in the mortgage lending and housing sphere(s) in an article entitled, "Residential mortgage lending for underserved communities: Recent innovations."

The Federal Reserve Bank of Chicago

The Federal Reserve Bank of Chicago and its branch in Detroit serve the Seventh Federal Reserve District, which encompasses southern Wisconsin, Iowa, northern Illinois, northern Indiana, and southern Michigan. As a part of the Federal Reserve System, the Bank participates in setting national monetary policy, supervising banks and bank holding companies, and providing check processing and other services to depository institutions.

The low- and moderate-income conditions survey: A summary of Seventh Fed District community development practitioner responses

by Emily Engel

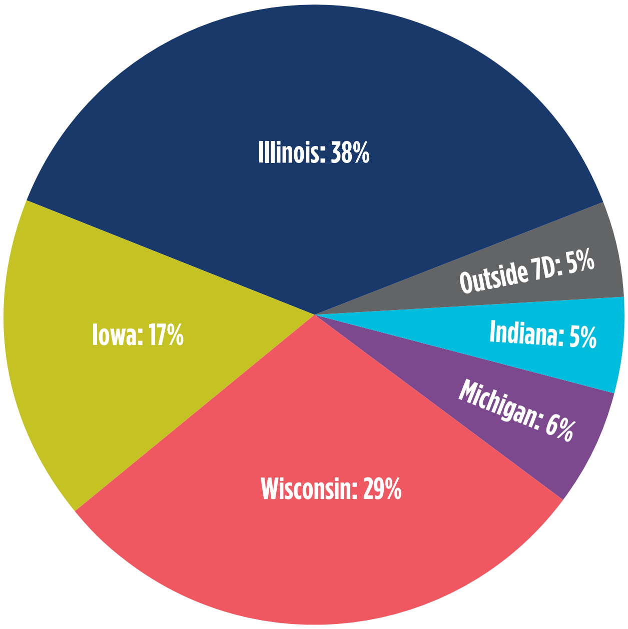
For the first time, the Federal Reserve Bank of Chicago participated in administering the Kansas City Fed's low- and moderate-income survey to respondents in the Seventh District. The survey is administered on line twice a year to measure "economic conditions of low- and moderate-income (LMI) populations and the organizations that serve them."[1] A key motivation for the survey is that compliance with the Community Reinvestment Act (CRA) entails banking institutions subject to CRA to provide credit, investment, and services, consistent with safe and sound banking practices, to LMI populations in their service areas. As a point of reference, LMI is the incomes of individuals below 80 percent of "median income" of an area, as defined by HUD. Median income, which varies by household size, is defined as "metropolitan median income for urban residents and state median income for rural residents."[2]

Rather than LMI households themselves, the survey is administered to community development organizations and people in related fields providing various services directly or indirectly to lower-income populations. Survey questions were emailed to approximately 1,500 contacts within the Chicago Fed District. Responses numbered 149, and accordingly there was sufficient participation to report the data as a non-scientific poll (approximately a 10 percent response rate). Respondents came from a wide variety of backgrounds, including real estate development, finance, financial counseling, economic development, banking, consumer advocacy, small business development, philanthropy, law, higher education, agriculture, manufacturing, and human services. Survey questions addressed (among other things) demand for services, jobs, affordable housing, financial well-being, and access to credit and capital. Additionally, in case respondents wanted to offer more nuance, the survey had an expository component where respondents could provide additional detail about their concerns.

As chart 1 indicates, a majority of the respondents were from Wisconsin and Illinois, but there was representation from all five Seventh District states, which also include Michigan, Iowa, and Indiana.[3]

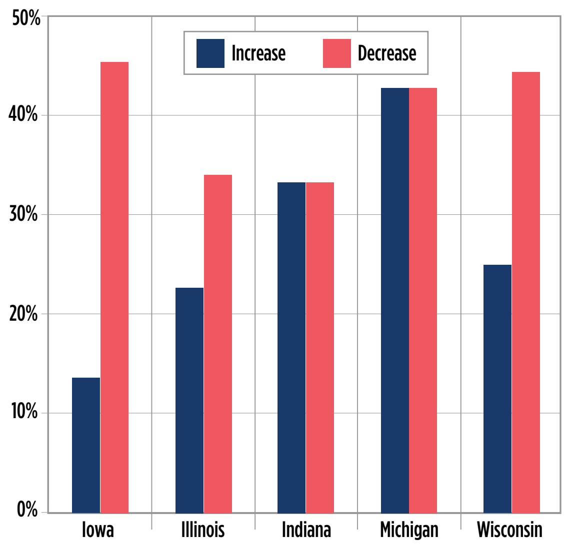
Two main themes from the responses stood out: 1) the shortage of affordable housing in various parts of the District; and 2) the distinction between increased employment and financial well-being. Various reports and studies reveal that these two issues, affordable

Chart 1. Respondents location



Source: Seventh District responses from the LMI survey.

Chart 2. Availability of affordable housing for low- and moderate-income people changed during the past quarter compared to same time last year



Source: Seventh District responses from the LMI survey.

(rental) housing shortages and the proliferation of low-wage jobs, impact most of the nation. Respondents also noted – in written responses – cuts in funding for social programs placing more stress on LMI households.

Shortage of affordable housing

Forty percent of respondents reported a decrease in affordable housing relative to last year, while few (23 percent) reported an increase. Decreases in affordable housing availability appear to be particularly pronounced in Iowa (45 percent) and Wisconsin (44 percent), as shown in chart 2.

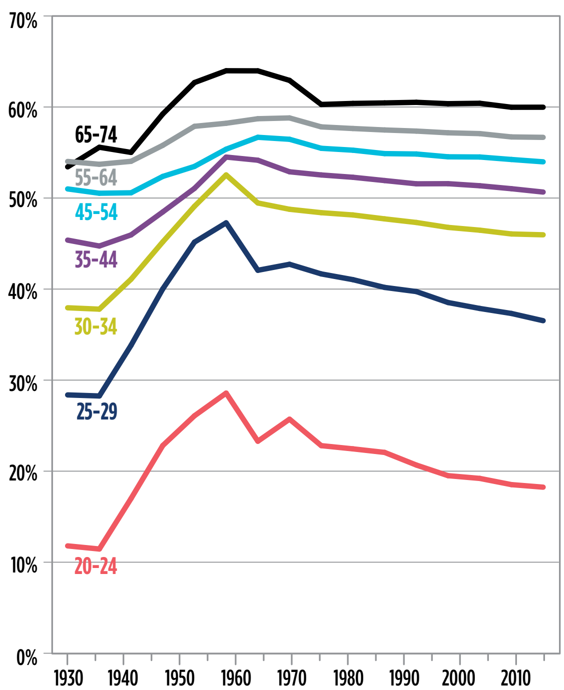
This finding is consistent with a RealtyTrac® study that found rents had increased faster than wages – a fact that underscores both the shortage of affordable housing and anxiety over financial well-being. Looking ahead this year, "Rents on three-bedroom properties will increase an average of 3.5 percent in 2016 compared to 2015 across all 504 counties analyzed, according to the HUD data. Meanwhile, average weekly wages in the second quarter of 2015 (the most recent wage data available) were up an average of 2.6 percent from a year ago and median home prices were up an average of 5.0 percent in the third quarter of 2015 compared to a year ago across all 504 counties."[4] The resulting increase in rents – combined with slow wage growth – may be straining the budgets of many Americans, and those of LMI populations in particular.

The State of the Nation's Housing 2015,[5] from the Joint Center for Housing Studies at Harvard, explores factors behind the affordable rental market shortage, which include (among other things) a drop in homeownership following the financial crisis, debt burdens (particularly among millennials who tend to have more student debt), and decreased household formation.

However, despite a continuing bleak picture for home sales and homeownership continuing to trend down, the Joint Center study provides some evidence that homeownership rates may *eventually* trend back toward pre-crisis levels. Immigration and headship rates – the number of households divided by the adult population – are "expected to be reasonably robust between 2010 and 2020 as the millennials form households."[6] Interestingly, these do not factor in current lower headship rates for young adults, which have generally trended lower since 1980. In fact the headship rate of people ages 20-24 has fallen to levels last seen in 1960, as shown in chart 3. This trend may be the result of many factors such as: student debt, increased housing cost, constrained credit access, and slow economic growth. "If rates of living independently among this age group do rebound, household growth will be even stronger in the decade ahead."[7] In theory, household growth underscores the need for more affordable housing.

In the meantime, however, nationally more than 80 percent of households with incomes under $15,000 were cost burdened (more than 30 percent of gross income spent on direct housing costs) in 2013. "Half of homeowners and three-quarters of renters with incomes between $15,000 and $29,999 were also housing cost burdened." Alarmingly, large cohorts of

Chart 3. Headship rate among U.S. adults, Ages 20-74, 1930-2013



Sources: Decennial Censuses 1930-2000 and American Community Survey 2007 through 2013, extracted from Steven Ruggles, J. Trent Alexander, Katie Genadek, Ronald Goeken, Matthew B. Schroeder, and Mattew Sobek. 2010. Integrated Public Use Microdata Series: Version 5.0 [Machine-readable database]. Minneapolis: University of Minnesota.

individuals who earn $30,000 to $44,990 a year are often housing cost burdened, regardless of whether they rent (45 percent) or own (37 percent).[8]

The Joint Center study notes that "an acute shortage of affordable housing for lowest-income renters is being felt everywhere."[9] This study further suggests that high quality affordable housing is a national priority in years to come.

In the Seventh District states, rent burden or median gross rent as a percentage of household income ranges from 27 percent in Iowa to 31.1 percent in Michigan. As indicated in chart 4 on the following page, rent burdens in all District states increased during the most recent recession (at the height, 33.3 percent in Michigan) and have since decreased.

One respondent explained their situation that highlights similar issues. "In the markets where we operate, rents are going up rapidly and vacancy rates are historically low. This is really pricing lower-income households out of the rental market, and yet they don't have access to homeownership. This is creating great instability for these households. Wages at the lower-income levels are not keeping up with rent increases."

Further, the Urban Institute's mapping tool, "Mapping America's Rental Housing Crisis," highlights populations of extremely low-income (ELI) renters, defined as households that earn 30 percent or less than the area median income or households whose income does not exceed the Federal Poverty Level. While this is not the same population as LMI, they also have lower incomes and face a severe shortage of rental housing. This population also experienced a trend with fewer and fewer affordable opportunities from 2000 to 2006 to 2012. For every 100 ELI renter households nationwide, there are only 29 vacant affordable rental units. As shown by the three maps on pages 8-9 (maps 1-3), the District states have also undergone the same trend toward greater shortage. Within our District, there are a few counties in Wisconsin that have the highest ratio of ELI housing for every ELI household, with 76 affordable units per 100 in 2012 and Hendricks county Iowa has the lowest ratio with only three affordable units per 100.

Disconnect between increased employment and financial well-being

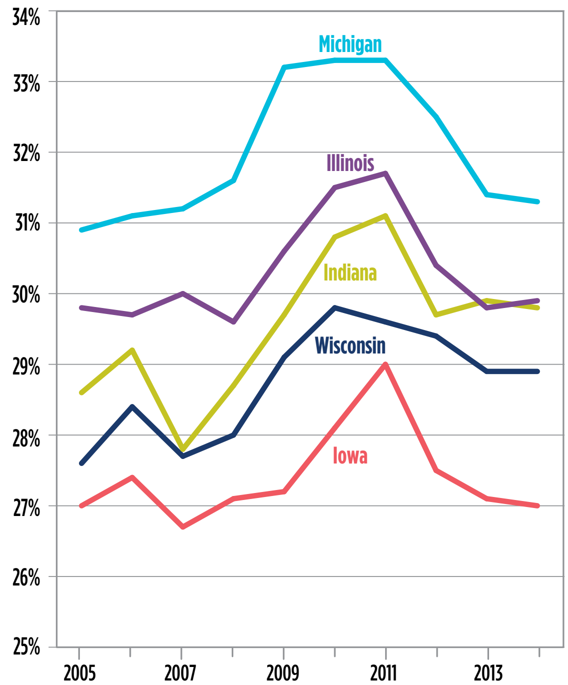
While most survey respondents (58 percent) indicated an improvement in the availability of jobs – and very few (10 percent) indicated a decrease – this trend has not resulted in an increase in financial well-being for LMI populations. In all, 41 percent of respondents indicated that financial well-being actually decreased since last year, supporting the assessment from various sources that job growth has been largely in low-wage work.

The following two comments from respondents seems to sum up the disconnect between increased employment and financial well-being: 1) "Even as the traditional unemployment rate recedes and the job market has made modest recovery, the financial needs of low and moderate households have increased while their access to services and resources has declined." 2) "In the last quarter, there may have been more jobs for LMI individuals, because of the University of Iowa students leaving for the summer. Of course, these do not tend to be jobs that pay much more than minimum wage, which is not a wage that keeps pace with expenses in Johnson Co."

To make matters worse, decreases in funding are likely negatively impacting funding capacity for programs geared towards serving LMI populations. Forty-two percent of respondents reported a decrease in funding since a year ago. Poll results and commentary suggest cuts appear to be occurring in the public sphere: "The politics in Wisconsin from our Governor and the legislature has made our efforts very difficult with budget cuts and lack of support of the lower middle and lower [economic] class populations." Private philanthropy has changed course with respect to housing: "Decisions by foundations such as MacArthur and Grand Victoria to stop funding affordable housing and community economic development will decrease nonprofit and community-based organizations' ability to serve the needs of LMI people in the Chicago region and Illinois."

Among those respondents who experienced a decrease in funding, 58 percent reported a decrease in their capacity to serve the needs of their clients (vs. 25 percent who noted increased capacity and 10 percent among those whose funding did not change). Interestingly, Michigan respondents reported no decreases in funding. However, almost half (48 percent) of the Illinois respondents reported negative effects stemming from decreased funding.

Chart 4. Median gross rent as a percentage of household income



Source: Census Bureau/Haver Analytics.

Conclusion/implications

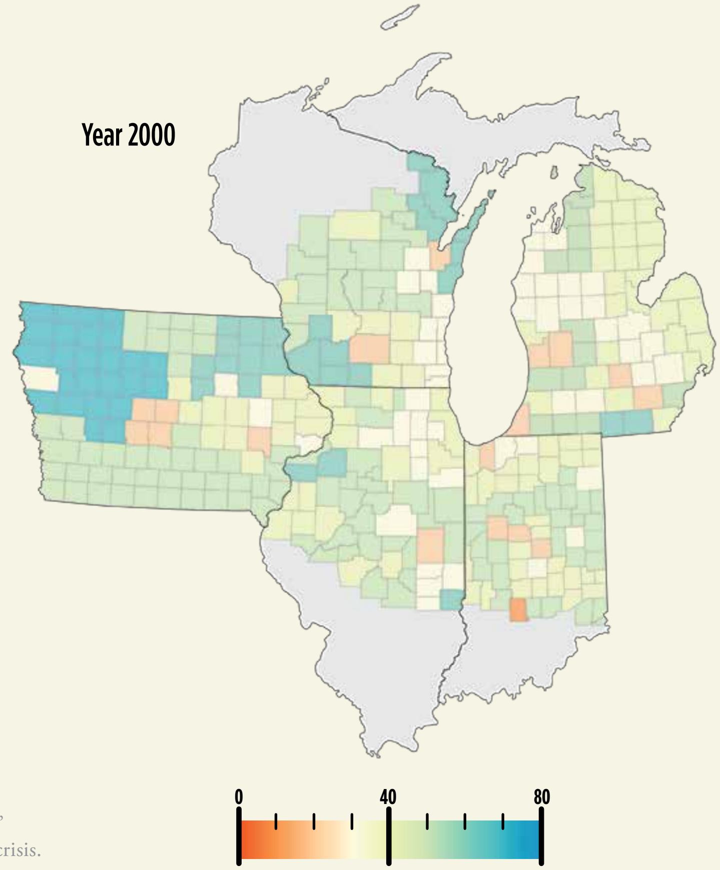
Increased employment, according to Seventh District survey respondents, hasn't translated into greater financial well-being among LMI populations. While surprising on its face, respondents offered three broad reasons for this seeming contradiction: a shortage of affordable housing has caused rent to increase faster than wages; job growth has hued to low-paying positions; and a decrease in funding for public and private programs targeted to LMI populations has further eroded the social safety net. The CDPS LMI poll reflected other reports sited, RealtyTrac's "Buying More Affordable Than Renting in 58 Percent of U.S. Markets According to 2016 Rental Affordability Analysis," and "The State of the Nation's Housing 2015," from the Joint Center for Housing Studies.

The Chicago Federal Reserve hopes to increase participation in this survey. If you work with LMI populations in the Seventh District and would be interested in participating in this survey, please reach out to Emily Engel at Emily.Engel@chi.frb.org.

Maps 1-3. Number of affordable and available units per 100 ELI renter households

Many Americans struggle to afford a decent, safe place to live in today's market. Over the past five years, rents have risen while the number of renters who need moderately priced housing has increased. These two pressures make finding affordable housing even tougher for very poor households in America. For every 100 extremely low-income (ELI) renter households in the country, there are only 29 affordable and available rental units.

As defined by the Department of Housing and Urban Development (HUD), extremely low-income households earn 30 percent or less of area median income.



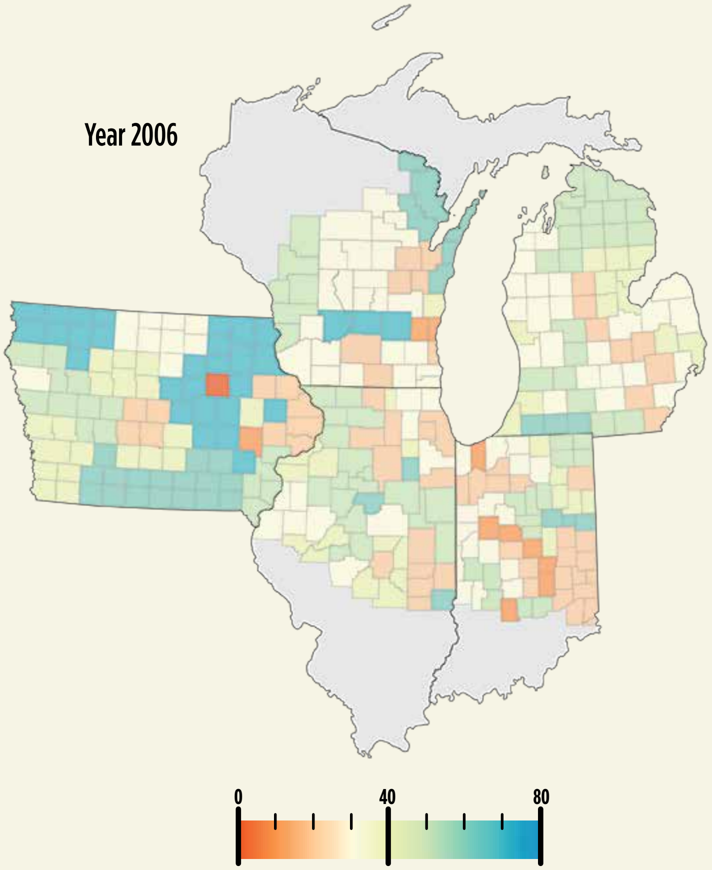
Source: Urban Institute, "Mapping America's Rental Housing Crisis," available at http://www.urban.org/mapping-americas-rental-housing-crisis.

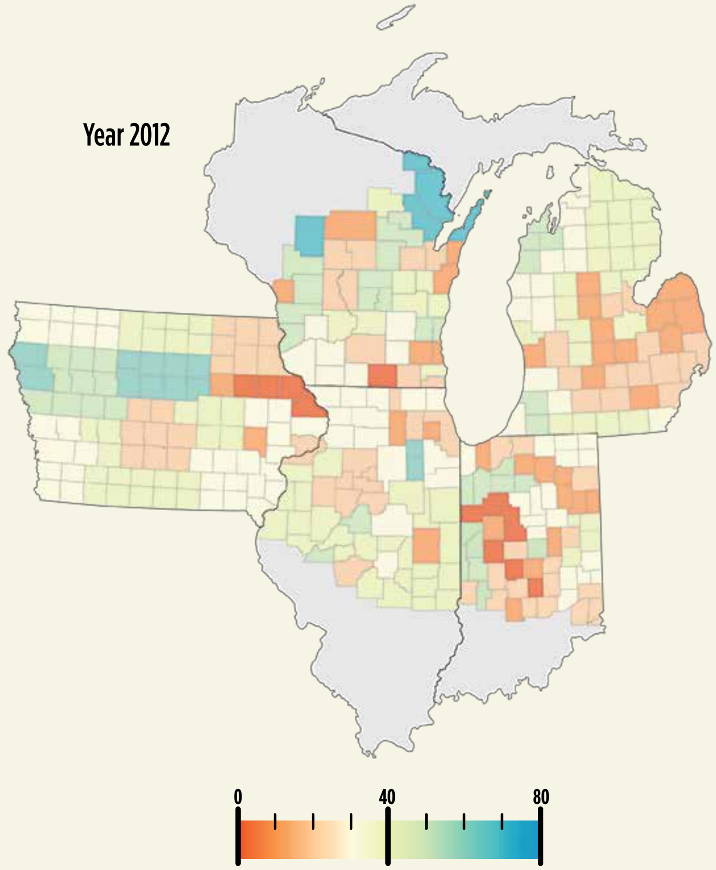
Notes

1. Federal Reserve Bank of Kansas City, Low- and Moderate-Income Survey, available at https://www.kansascityfed.org/research/indicatorsdata/lmi.
2. Ibid.
3. Since the exact location of respondents was not known, it's also possible that some participants may have technically been outside the District, but located in District states.
4. RealtyTrac, 2015, "Buying More Affordable than Renting in 58 Percent of U.S. Markets According to 2016 Rental Affordability Analysis," December 21, available at http://www.realtytrac.com/news/home-prices-and-sales/realtytrac-2016-rental-affordability-report.
5. Joint Center for Housing Studies of Harvard University, 2015, The State of the Nation's Housing, 2015, available at http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/jchs-sonhr-2015-full.pdf.
6. Goodman, Laurie, Rolf Pendall, and Jun Zhu, 2015, "Headship and Homeownership, What Does the Future Hold?," Urban Institute, June, available at http://www.urban.org/sites/default/files/2000257-headship-and-homeownership-what-does-the-future-hold.pdf.
7. Joint Center for Housing Studies of Harvard University, 2015, The State of the Nation's Housing 2015, available at http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/jchs-sonhr-2015-full.pdf.
8. Ibid.
9. Ibid.

Biography

Emily Engel is a business economist in the Community Development and Policy Studies Division at the Federal Reserve Bank of Chicago.


Year 2006
0
40
80


Year 2012
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Residential mortgage lending for underserved communities: recent innovations

by Emily Engel, Taz George, and Jason Keller

The authors would like to thank Eugene Amromin and Daniel Hartley of the Federal Reserve Bank of Chicago for reviewing this article, as well as Anne Cole of Neighborhood Housing Services (NHS) and Spencer Cowan of the Woodstock Institute for their comments on mortgage innovation, which we highlight in the pages that follow. Descriptions of products, innovations, and/or developments are not endorsements.

As the United States continues to recover from its worst financial crisis since the 1930s, housing finance leaders from both the public and private sectors have diligently worked to develop programs, products, and services to safely expand access to affordable homeownership. Despite persistently low interest rates, relatively modest growth in home prices, and a strengthening labor market, purchase mortgage volume remains low compared to the pre-crisis and pre-bubble years, and the homeownership rate continues to fall. Factors contributing to the homeownership decline include the still weakened credit profiles of the 7.9 million households who experienced a short sale or foreclosure during the downturn,[1] elevated lending standards due in large part to the mortgage industry's response to post-crisis regulatory measures, and reduced demand for homeownership among younger householders.[2] Meanwhile, low- and moderate- income (LMI) individuals struggle with access to affordable rentals due to severe shortages of housing supply, rental subsidies, and bank financing for smaller rental buildings in lower-income areas.

Some signs of distress from the downturn persist, with 8.1 percent of borrowers nationwide in negative equity and 3.6 percent seriously delinquent. In response, various attempts have been made to offer innovative products (to the benefit of lenders and borrowers), but these have proven difficult to scale. Among other hurdles, new and innovative mortgage products, designed to facilitate homeownership without a (necessarily) rigid payment structure, must do so in a way that is safe and sustainable for households, lenders, and investors.[3] Financial institutions participating in the mortgage market face an environment of evolving regulations, posing additional challenges to innovation. This article highlights a few of the emerging innovations and developments in mortgage finance that address, to varying degrees, affordability, equity growth (rate), credit risk (of borrowers), default risk (for lenders), and access to stable neighborhoods through specialized lease arrangements.

Community Development and Policy Studies' (CDPS) interest in mortgage innovation

CDPS is charged with engaging in research and outreach to help financial institutions, community-based organizations, and government entities understand and address issues impacting access to credit and financial services for LMI communities. When new financial products emerge that may offer benefits to LMI populations, CDPS explores that potential, as well as possible implications for Community Reinvestment Act (CRA) evaluations. For larger institutions,[4] CRA performance is measured in lending, service provision, and investment, with the lending test carrying the most weight. CRA incentivizes the use of innovative or flexible (but not unsafe or unsound) lending to address the credit needs of LMI communities. While innovation is rewarded, financial institutions are primarily judged on their responsiveness to market needs. New credit products and services should not be detrimental to consumers or divert resources from affordable housing, foreclosure prevention, and community development efforts. Lastly, financial institutions that choose not to offer new products or programs directly can still receive CRA credit for funding or servicing affiliates and/or third parties who do.

Because CRA performance evaluations are made public, lenders that do not lead or foster innovation run a risk of losing at least some customer base to institutions perceived to be more on the "cutting edge," and could also face increased regulatory scrutiny in subsequent CRA examinations for failing to meet market needs of those not able to access mainstream credit. In sum, community development lending, qualified investments, and services that are responsive to local needs and have not been routinely provided by other private institutions can be heavily weighted – both positively and negatively during examinations. The products and strategies discussed in this article, while not (yet) marketed or proven at scale (with one exception), may represent opportunities for banks to meet CRA obligations in the communities they serve, as well as important innovations to reduce defaults.

Overview

We first highlight three emerging mortgage lending products developed by private sector actors, each offering a nontraditional pathway to homeownership that may benefit underserved communities. Home Partners of America (HPA) provides credit-constrained households in 18 states the opportunity to rent single-family homes in primarily established, predominantly owner-occupied neighborhoods, with an option to purchase the home within a fixed term. The Wealth Building Home Loan (WBHL℠) gives prospective homeowners the ability to accrue equity more quickly than with a typical purchase loan, in exchange for a higher monthly payment. The Shared Responsibility Mortgage (SRM℠), developed by mortgage lending startup PartnerOwn, but not yet on the market, gives borrowers downside protection from the risk of a home price decline in the form of monthly payment relief, in exchange for a stake in the future appreciation of the home.

We then describe two ongoing policy developments with potential implications for mortgage credit access and affordability. Regulators and industry participants are working to advance alternative credit scoring models, which may expand access to mortgage credit for individuals without traditional credit accounts or extensive credit history, and those who score poorly under traditional models. Finally, pending changes in the manufactured housing loan market proposed by the Federal Housing Finance Agency have the potential to boost the supply of credit for manufactured housing, which typically is far more affordable than site-built housing. We conclude the article with some thoughts on both benefits and risks associated with innovation, as well as ideas for additional research.

Finally, CDPS asked two long-time partners to weigh in on current issues and trends related to this discussion. The Woodstock Institute is a nonprofit research and policy organization whose mission is to create a just financial system in which lower-wealth persons and communities, and people and communities of color, can achieve economic security and community prosperity. Neighborhood Housing Services (NHS) is a nonprofit neighborhood revitalization organization and lender whose mission is to create opportunities for people to live in affordable homes, improve their lives, and strengthen their neighborhoods. We have lightly edited their contributions and inserted them in relevant sections of this article.

Home Partners of America: A New Path to Homeownership

With persistently tight mortgage lending standards in the post-crisis period, many creditworthy families that may have qualified for a loan prior to the housing bust have been locked out of credit markets in recent years.[5] Besides preventing many households from accruing equity via a mortgage, tight credit might be keeping prospective first-time buyers from accessing desirable neighborhoods with limited rental stock. These problems are especially prevalent among households that experienced a short sale or foreclosure – which severely impact credit scores for up to seven years – during the downturn.

Innovations to improve the consumer experience

Changing demographics and consumer preferences have led NHS and its affiliated nonprofit mortgage lending entity, Neighborhood Lending Services (NLS), to think of new ways to meet the needs of a growing, younger client base. For example, in July of 2015, NLS launched its online mortgage application. Existing demand for this technology has driven increased application volume, with nearly 200 submitted online in the first six months of operation. In addition to providing the opportunities to submit online mortgage applications, many lenders are implementing new technology to allow borrowers to upload loan documentation directly from their phone. NHS is also exploring technology that allows for more streamlined and transparent client engagement throughout the education and counseling process.

— **Anne Cole**
manager of Impact Evaluation and Policy, Neighborhood Housing Services of Chicago

Active in 18 states – two of which are in the Seventh District (Illinois and Indiana), HPA offers an innovative program that gives people a different path to homeownership through its "Lease with a Right to Purchase Program." Distinct from past attempts at lease-to-purchase programs, which have had mixed results, HPA's program includes a comprehensive household balance sheet and financial counseling component, and makes an affirmative effort to direct participants to established neighborhoods. Participants first undergo an underwriting process which incorporates evaluation of the applicant's credit history, income,[6] job history, and public records such as eviction and criminal history. Once approved, participants work with a real estate agent to select a desired property from homes available for sale that meet certain criteria within HPA-approved communities. According to HPA, the criteria for selecting neighborhoods include public school performance and high owner-occupancy rates. HPA purchases the property the participant selects, subject to their underwriting requirements. The average acquisition price per home is approximately $280,000. While this average price exceeds the national median home sales price of $219,000 as of October 2015, according to CoreLogic, HPA nonetheless offers an opportunity for underserved borrowers in that many participants are unable to meet the credit requirements for a traditional loan given current elevated lending standards.

For up to five years (three in Texas), the household then has the right to purchase the home at a fixed premium over HPA's cost (including any expenses made to rehabilitate the property and certain closing costs), currently set between approximately 3.5 and 5 percent per year. Annual rent escalations are currently set at approximately 3.75 percent. For markets with significant housing price growth, HPA's pricing terms may be competitive or even better than the market. If the borrower prefers to rent or buy another property instead (perhaps because market prices have not increased at the HPA's fixed rate), they have the right to do so without penalty, provided they obey the terms of their lease, including 60 days' notice of nonrenewal. HPA determines rental rates based on home prices, taxes, homeowners' association fees, local school quality, and local market rents. For homes that participants choose not to purchase, HPA generally rents the property to a new resident.

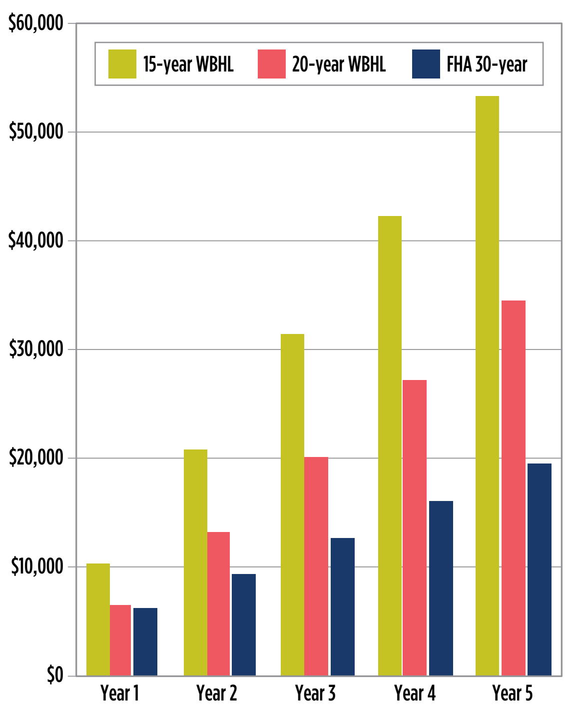
In February 2016, HPA closed its first securitization transaction, backed by 2,232 renter-occupied properties. While other market participants have produced rental securitizations in recent years, HPA's is unique given the right-to-purchase feature of the properties in the pool. When a property is purchased, it is released from the security at a premium, which Moody's noted as a "credit positive" in their ratings rationale.[7] The secondary market for HPA's properties may help the company expand their reach in existing markets and enter new ones by providing liquidity for additional home purchases.

The HPA program also presents unique challenges for prospective participants. Compared to the closing of a typical rental contract, it may take participants more time to complete the HPA process, select a property, have HPA complete the purchase, and make ready before move-in. The HPA designated communities may not meet the desires of prospective households. Furthermore, in a market where home prices or rents are flat or slowly appreciating, HPA's fixed price increases may be uncompetitive. On the other hand, in markets with volatile home prices, aspiring homeowners may find that the costs of renting an HPA property are worthwhile given the option to purchase at a known price.

Wealth Building Home Loan (WBHL℠)

A key benefit of homeownership for low- and moderate-income (and in fact most) households is the opportunity to build wealth. But for a typical affordable mortgage product such as a Federal Housing Administration (FHA) loan, less than a quarter of the borrower's monthly payments (including mortgage insurance, taxes, and principal and interest) from the first three years go towards reducing the principal of the mortgage. An innovative mortgage product aims to help traditionally underserved borrowers build equity faster. The WBHL℠, formulated by the American Enterprise Institute (AEI), is a 15- to 20-year loan with a few unique features that may benefit certain borrowers. There are some variations in the terms of the product among the approximately 15 lenders offering it, according to AEI. Generally, it is a fixed-rate loan except for one step up occurring in the sixth, seventh, or eighth year of the term, with a modest payment increase. Rather than requiring a down payment, the borrower may make an upfront payment of up to 6 percent of the size of loan that pays for some of the interest owed on the mortgage and allows the lender to reduce the borrower's interest rate (though at least one lender does not offer this interest rate buy-down in their version of the WBHL℠).

Chart 1. Equity on a $175,000 home at end of years shown



Source: Illustration and underlying calculations provided by the American Enterprise Institute. **Note:** A 15-year WBHL℠ has an interest rate of 1.75% for the first 7 years and 5% for the remaining 8 years, no down payment, and 3 buy-down points. A 20-year WBHL℠ has an interest rate of 2.99% for the first 7 years and 5.25% for the remaining 13 years, no down payment, and no buy-down points. FHA 30-year loan has a 4% interest rate, 3.5% down payment, and a 1.75% upfront mortgage insurance premium rolled into the loan amount, for an effective initial LTV of 98.19%. Nominal house price is assumed to be unchanged.

Changing demographics of potential home buyers

Millennials have seen the collapse of a housing bubble and the ensuing foreclosure crisis, and so they may not be as anxious to become homeowners as earlier generations. They also seem to be adapting to the changes in the labor market and the rise of the "gig economy" (i.e., high ratio of short-term jobs) by avoiding the commitment to one location that buying real estate entails. They seem to prefer renting, which allows them greater flexibility to relocate. Growing student debt is another possible factor delaying young households from becoming first-time home buyers. Whether millennials change their preferences when they start to have children entering the public school system, a factor that motivated many people in earlier generations to move to suburbs with strong school systems, remains to be seen.

People of color are predicted to constitute a growing percentage of new households formed in the coming years, and many of them will lack the wealth to make the large down payments required for conventional mortgages, which means that many of those new households will have to start as renters. With rents rising faster than incomes, those new renter households may have a harder time accumulating funds for a down payment, while QM standards limit the flexibility that lenders have to create new products to serve low-wealth households. As a result, the pool of potential first-time buyers may be reduced, especially at the lower end of the market.

— **Spencer Cowan**
senior vice president of research, Woodstock

The buy-down, combined with the lower cost of credit enhancement necessary for this product, means the borrower makes a modestly larger monthly payment on the mortgage, but with a much higher share going to the equity portion than a comparable product. In the hypothetical example in chart 1, which assumes no house price appreciation,[8] three identical borrowers each purchase a $175,000 home with a 15-year WBHL℠, 20-year WBHL℠, and 30-year FHA loan, respectively. Compared to the FHA borrower, who would pay about $942 each month in the first year of the loan, the 15-year WBHL℠ borrower would pay about 17 percent more, or $1,106. In return, after one year, the 15-year WBHL℠ borrower will have accrued $10,293 in home equity via their monthly payments, 66 percent more than the $6,196 in equity for the FHA borrower. By the end of year three, the difference is even more striking: the 15-year WBHL℠ borrower will have accrued $31,427 in equity, compared to the FHA borrower's $12,623, a 149 percent advantage. For the 20-year WBHL℠ product, the equity gap with the FHA product at three years is a more modest 59 percent ($20,072 vs. $12,623), but in exchange for a monthly payment that is just 3 percent higher than the FHA payment.

There are three factors that contribute to accelerated equity accumulation of the loan while delivering comparable buying power to a 30-year FHA loan. First, shorter-term mortgages have lower interest rates than the standard 30-year fixed-rate mortgage and, by their nature, a shorter amortization schedule. Second, the underwriting process for the loan includes a residual income test, which has been credited as key feature of prudent high LTV lending in other programs.[9] Third, the upfront interest rate buy-down reduces the interest rate substantially, especially for WBHL℠ products with a rate step-up, as the buy-down only applies to the initial rate for those versions of the loan.[10] Altogether, these factors allow the WBHL℠ to achieve a lower interest rate and higher equity contribution with each payment than that possible with a comparable mortgage product.

AEI estimates that roughly half of FHA's market of first-time buyers could qualify for WBHL℠ programs, as the credit requirements are modestly higher than FHA (a minimum FICO of 660 or 680, depending on the lender, is required for the WBHL℠; roughly 55 percent of new FHA borrowers in 2015, including purchases and refinances, had a FICO score of less than 680).[11] Prospective homeowners on the higher end of FHA's credit score range who can handle slightly higher payments and the prospect of a known future payment increase, and who hope to accrue equity faster, may find the product attractive. Lenders, meanwhile, may benefit from the upfront interest payment and from an additional product offering for traditionally underserved communities and first-time home buyers, allowing them to potentially reach new markets or expand existing ones while earning CRA credit by serving an unmet need.

The WBHL℠ program also faces challenges, including barriers to scaling, a unique repayment structure that may not satisfy some low- and moderate-income borrowers, and the tradeoff of higher monthly payments in exchange for faster equity accrual. For at least the foreseeable future, lenders participating in the program would need to keep WBHL℠ loans in portfolio, as there is no secondary market for the product. Some borrowers may prefer to make an initial, traditional down payment rather than an interest buy-down to lock in their equity in the home upfront. Finally, the initial monthly payment of the WBHL℠ is, for the examples of the product described in figure 1, between 3 percent and 17 percent higher than that of an FHA loan even before a potential rate step-up, meaning the program is best fit for borrowers willing to either spend more in housing costs or purchase a less expensive home, in exchange for significantly faster growth in equity.

Shared Responsibility Mortgages

In Chicago, PartnerOwn, is promoting Shared Responsibility Mortgages℠ (SRM℠), a product that is not on the market yet, but would offer some protections to borrowers in the case of a home price decline in exchange for sharing future appreciation with the lender. The concept of SRMs℠ was described in the book, *House of Debt: How They (and You) Caused the Great Recession, and How We Can Prevent It from Happening Again*, by Atif Mian and Amir Sufi. The authors address the concern that mortgages with fixed amortization schedules make it difficult for borrowers to keep up with payments in an economic downturn, and may even incent borrowers to default. PartnerOwn's proposed program would track house prices in each borrower's zip code using the CoreLogic/Case-Shiller home price index, and in case of declining prices, would reduce a borrower's monthly mortgage payments proportionally to the declines in the local

Negative equity and distressed housing markets

The recovery in the housing market has been uneven, and the neighborhoods hardest hit by the collapse of the housing bubble and the foreclosure crisis seem to be lagging the most. Many neighborhoods have not seen prices recover to pre-crash levels, leaving millions of homeowners who bought during the bubble with negative equity. Not only does negative equity discourage homeowners from investing in their properties, causing visible blight that has negative spillover effects on nearby properties, it leaves the owners without the option of downsizing if they suffer an economic setback, increasing the likelihood that properties will go into foreclosure. This means that many disadvantaged neighborhoods that suffered the most during the foreclosure crisis will continue to have to deal with negative equity and the refusal of the Federal Housing Finance Agency to allow principal reduction.

— **Spencer Cowan**
senior vice president of research, Woodstock

market. In exchange, the lender is owed 10 percent of gains in the value of the home when the home is sold or the mortgage is refinanced. Monthly payments would never exceed the loan's first payment.

If SRMs℠ are used in the future, Mian and Sufi argue, future housing market crises may be mitigated. Participating borrowers who fall into negative equity due to declining home prices would experience some payment relief,[12] and lenders would be better incentivized to have 'underwater' borrowers recover as they would benefit from future capital gains, and avert costly foreclosure expenses.

SRMs℠ would also provide benefits to the bank or institution that holds the mortgage, such as helping expand lending to new potential borrowers who are concerned about house price volatility, and potentially helping lenders earn CRA credit for serving LMI communities. PartnerOwn has also designed a warranty product that could be wrapped around any individual mortgage to offer the same payment protection as their proposed mortgage product based on neighborhood home prices. The warranty would cost borrowers 5-15 basis points on an ongoing basis (rather than an equity share upon property sale or refinance).

Challenges to the PartnerOwn program include the logistical and legal barriers to implementation. Indexing borrower payments to zip code-level home prices could be impractical in areas with few home sales (such as rural areas, or primarily renter-occupied neighborhoods), and would not reflect differences in market activity within a zip-code. The lender and servicer of the loan would likely face additional costs dealing with the payment adjustments (and the potential for reduced cash flow in times of a downturn), monitoring home prices, and handling the additional complexities of home purchases and sales. Past attempts at shared equity mortgages have gained little traction in stronger housing markets, as borrowers are wary of the equity/payment adjustment trade-off [see Shiller paper for example].[13]

Alternative credit scoring

Millions of individuals do not have traditional credit scores as they lack mainstream credit lines, and are unmeasurable by established credit scoring methods, effectively locking them out of the mortgage market. Promising new efforts by policymakers and industry participants are building momentum for innovation to allow many (new) prospective borrowers to be considered by lenders, who universally require home loan applicants to have a credit score.

For decades, the FICO score has served as the standard for mortgage. Consumer credit reporting agencies, also known as credit bureaus, gather data on individuals' outstanding debt and repayment behavior, and use the FICO model to compute a score ranging from 300 to 850 that reflects an individual's creditworthiness. While FICO scores are generally an effective predictor of loan performance,[14] they fall short in other respects. Fifty-three million Americans, according to FICO, cannot be scored due to limited credit history, with recent immigrants, young adults, and households using alternative financial products frequently among those left out. Compounding the problem even further, individuals without a score face major barriers in accessing standard products, such as a credit card, needed to build up their credit history in the

Alternative credit scores

The dominance of the older version of FICO excludes millions of potential home buyers with thin credit files and does not adjust scores to reflect the disproportionate impact that medical debt can have. Newer models from FICO and VantageScore, a competing provider of credit scores, incorporate a wider range of indicators, such as rent and utility payments, and discount the impact of medical debt, allowing as many as 35 million more people to receive qualifying credit scores than the older FICO model. Banks and credit card companies are already using the newer credit scoring models in making decisions for non-mortgage extensions of credit, but Fannie Mae and Freddie Mac are not.

— **Spencer Cowan**
senior vice president of research, Woodstock

first place, and often are at a disadvantage when seeking rental housing, employment, and insurance.

Policymakers and industry participants have taken notice. In April 2015, FICO announced[15] the piloting of a new score that covers as many as 15 million additional individuals by incorporating new data to measure borrowers' repayment ability, such as utility, cable, and cell phone bills. About 5 million of these individuals have a score of 620 or greater, making them potentially eligible for a mortgage loan if this score were widely adopted by lenders (about 51 percent of FHA originations[16] in fiscal year 2015 had a borrower FICO score of 620-680, and another 5 percent of less than 620). FICO's own research[17] suggests the new method drawing on alternative data is producing reliable scoring results for previously unscored individuals.

Meanwhile, emerging competitors to FICO have advanced their own approaches to scoring previously unscored individuals. VantageScore Solutions, one such competitor, offers a scoring technique that assigns as many as 40 million new consumers with a score. A number of startups[18] have entered the market, as well. Policymakers in a number of arenas have shown interest in the potential benefits of new approaches to credit scoring. The Federal Housing Finance Agency directed Fannie Mae and Freddie Mac (collectively referred to as the GSEs[19]) to "assess the feasibility of alternate credit score models and credit history in loan-decision models" via a directive in its 2015 Scorecard, and the 2016 Scorecard asks the GSEs to continue the assessment and plan for implementation, as appropriate. Later, in December 2015, members of the House Financial Services Committee introduced a bill with bipartisan support allowing the GSEs to use models other than the standard FICO score to make mortgage purchasing decisions.

Alternative credit scoring techniques could yield benefits to currently unscored individuals and to the broader economy by increasing the number of consumers with access to traditional lending tools, but policymakers and industry leaders must proceed with caution. New scoring methodologies and data sources must be carefully tested and validated to ensure that lenders can safely underwrite and that secondary market participants can adequately measure and price the risk of mortgages underwritten with alternative scores.

Manufactured housing

A small but promising source of affordable housing may receive a big boost in 2016. Manufactured homes, a form of factory-built housing that meets specific construction and installation standards,[20] are typically far less expensive than site built homes, yet they comprise only 6 percent of all occupied housing. Newly proposed rules[21] by the Federal Housing Finance Agency (FHFA) could jumpstart a more robust financing system for this kind of housing and spur lenders to launch innovative affordable programs, with protections in place to ensure affordability and fairness to consumers.

The Housing and Economic Recovery Act of 2008 established a duty for Fannie Mae and Freddie Mac (the GSEs) to support underserved markets including manufactured housing, and the law directed FHFA to issue specific goals and evaluate whether they were met. Following a stalled attempt at establishing this 'Duty to Serve' rule in 2010, FHFA unveiled a new proposal in December 2015 with clear emphasis on strengthening the manufactured housing market, a low-volume market that can carry significant risks for consumers and lenders.

Manufactured home buyers face challenges in finding adequately priced loans, with many states treating these homes as non-real estate property – even for buyers who own the underlying land, a common combination in rural areas (real estate loans have better pricing for borrowers and lower default rates relative to non-real estate loans, known as chattel loans, according to the CFPB[22]). Manufactured home owners who don't own their underlying land face additional challenges. In many states, FHFA noted in their proposed rule, these households are entitled to minimum protections in the case of default, allowing lenders to repossess homes without prior notice. Communities that offer pads to install modular housing typically require short-term leases that give residents little stability, and these communities often restrict residents from selling their unit without first moving it off the property.

With challenges for consumers and an insufficient stream of affordable financing, manufactured housing accounts for a small share of households despite averaging less than half the cost[23] per square foot of site-built housing. The FHFA's new rules could go a long way towards mainstreaming manufactured housing. Under the proposal, the GSEs must facilitate a secondary market for two forms of manufactured home loans: those made to individual households whose manufactured home is titled as real estate rather than chattel, and blanket loans made to manufactured housing communities that meet certain criteria. By developing lending products and standards for individual real estate-titled manufactured homes, FHFA hopes to boost the supply of credit for affordable housing in states where real estate titling is already common, and to incentivize reforms that make real estate titling more viable in states where chattel financing is the current most common practice. Blanket loan financing, meanwhile, should help manufactured housing occupants who do not own underlying land to have more options of affordable communities with basic tenant protections by providing financing for new properties.

Under the new rules, to receive credit for blanket loan purchases, the GSEs must target properties with 150 or less pads, properties owned and operated by nonprofits or government organizations, or other properties that ensure occupants' rights to sell or sublease their unit on its existing pad, have advance notice of rent increases or sale of the property, have a minimum one-year lease, and be given basic protection in case of missed rent payments to the property. Blanket loans for manufactured housing in census tracts with greater median income than the surrounding area will earn the GSEs less credit than loans in LMI areas. After devising written plans to achieve these goals and taking public comments, the GSEs will eventually be scored by FHFA based on the degree to which their activities and purchases foster a secondary market for affordable manufactured housing loans.

It remains to be seen whether states will institute reforms to make real estate titling easier for manufactured homeowners who own their underlying land, as the rule is designed to incentivize. Lenders may face challenges in underwriting blanket loans to meet the criteria specified in the rule and to ensure compliance with the consumer protections, as applicable. And there are no assurances as to the final details of the rule or the timing of when the GSEs would begin to implement their new lending practices, as much of 2016 will be spent seeking public comment and revisions on follow-up proposals from FHFA and the GSEs. Nevertheless, it is promising to see innovation from regulators designed to boost the supply of sustainable credit for affordable housing.

Barriers to affordable homeownership

In Chicago, just over half of all renters pay more than 30 percent of their income for rent expenses, preventing potential homeowners from saving for a down payment and closing costs. In order to allow many qualified, creditworthy LMI families to enter the housing market, which ultimately moves forward neighborhood revitalization, new closing costs and down payment resources are needed. In 2013, NHS served as a partner organization for the Wells Fargo CityLIFT program, a program resulting from a $175 million fair lending settlement between the U.S. Department of Justice and Wells Fargo that included $50 million for community improvement programs nationwide. The Chicago region's CityLIFT program provided $8.2 million in down payment assistance grants, and NHS helped to create over 540 new homeowners in Chicago and additional Cook County municipalities. This innovative source of grant funds provided the small "nudge" necessary for otherwise qualified borrowers to enter the housing market, and made a significant impact towards neighborhood recovery in our communities and across the region.

— **Anne Cole**
manager of Impact Evaluation and Policy, Neighborhood Housing Services of Chicago

Conclusion

This article describes five innovations in the residential mortgage marketplace – some already in place, others in progress. Given changing regulatory and market factors in mortgage finance, the time is ripe for innovation, and it behooves policymakers, business leaders, and communities to consider potential alternatives to traditional mortgages. CDPS reached out to over 20 internal and external constituents with expertise in housing issues in underserved areas to gain insight on recent or contemplated new products. Our conversations raised five key questions, which may ultimately determine whether innovation in the mortgage market improves access and affordability for underserved communities:

1. Can innovations be brought to scale broadly to serve the populations that need them most?
2. How can lenders and regulators ensure the safety and soundness of new and emerging products, especially amidst regulatory uncertainty, while continuing to encourage potentially beneficial innovations?
3. Will additional housing counseling and other supportive services be needed to assist borrowers who face a new array of complex products and services?
4. Will these develop and enact innovations that make housing and mortgage markets more sustainable?
5. As the key intermediaries in opening markets to promising new products, how can policymakers strengthen the incentives, including CRA, for financial institutions to implement innovative programs and services that benefit LMI communities?

To foster these and other innovations, we believe policymakers must encourage further dialogue with community groups, action coalitions, and financial institutions active in the mortgage market. Both the needs of underserved communities and the market and regulatory constraints facing lenders must be central to this dialogue. CDPS is committed to researching and understanding new innovations as they emerge, and to encouraging the necessary dialogue to improve access to residential mortgage credit. Promoting innovation is a critical component of our effort to foster community and economic development in the Seventh District and across the nation.

Notes

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8. With the assumption of no appreciation, the equity comparison counts only equity accrued via the borrower's down payment (pertains to FHA loan only) and monthly payments on the mortgage. Assuming growth in the value of the home over time, the borrower would benefit from higher equity across all three mortgage products. The gap between FHA and WBHL℠ products in total equity would be the same in absolute dollars, but less in percentage terms.
9. The residual income test ensures borrowers have a sufficient amount of income to cover unanticipated expenses, while still making timely payments. Unlike traditional debt-to-income tests, a residual income test uses an absolute dollar threshold of income remaining after mortgage expenses, rather than a ratio alone. Available at http://www.urban.org/research/publication/va-loans-outperform-fha-loans-why-and-what-can-we-learn.
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