Armed against ARMs

Educating low-income borrowers may be an effective — if oft-overlooked — way to minimize mortgage losses

BY DOUG CAMPBELL

Back in October 2003, Donna Turner had her eye on a house. It was a modest house, priced to sell at $150,000. For the Raleigh market, that was something of a steal. But Turner had a few financial obstacles to overcome before she could live the American Dream. She was a single mother who worked as a certified nursing assistant, earning about $23,000 a year. Her credit report was pocked with poor choices and understandable setbacks, from delinquent cell phone payments to unwieldy medical bills.

It added up to a credit score in the mid-500s, putting her somewhere among the 15th percentile of the nation's debt seekers. By all definitions, Turner was a "subprime" borrower, a credit risk so great that mortgage lenders would charge her extra — if they chose to take her on at all — before putting up the funds necessary to close on her dream home.

Turner's story could have gone several different ways at that point. She might have been able to secure a subprime loan, perhaps one of those now much-maligned "adjustable rate mortgages" (ARMs), which would inevitably balloon in the years to come, making it impossible for her to keep up with payments. Turner would end up as another subject in a newspaper article about the hardships consumers face when taking deals from unscrupulous lenders. It's a familiar tale of late.

Or she could have somehow come up with the monthly payments, even after they increased with interest rates. It's less likely you've heard of that story, even though it's actually more commonplace than the first one. Remember: The majority of subprime loans are in fact being repaid on time.

Both interesting stories. But perhaps a better one is what actually happened. Turner didn't take out a home loan in 2003. Instead, she first walked into the Raleigh offices of Downtown Housing Improvement Corp., or DHIC. There she met Sheila Porter, who goes by the title of mortgage manager. Together they spent the next year and a half plotting a turnaround strategy. It entailed Turner taking a new job, lowering her expectations about how much of a home she could afford, and paying off her bills.

When she had done that, her credit score had risen about 100 points — right on the border between the ability to obtain a subprime or regular loan. With Porter's help, Turner found the latter, as well as downpayment assistance. She obtained a conventional, 30-year fixed-rate mortgage, originated by a reputable bank. Her monthly payment: $686, including insurance and property taxes. In March 2005, mortgage loan in tow, Turner closed on a brand-new, 1,500-square-foot, three-bed, two-bath home for $122,000.

More than anything, Turner says, she came away from her mortgage counseling experience with an appreciation for the commitment she was making. "I mapped out a plan, thought it through, and stayed the course," Turner says today. "I had to sit down and decide whether I wanted to do this. That sense of commitment is one of the best things I took away."

The focus on the role of mortgage brokers and Wall Street — and even on regulators in the recent decline of the subprime housing market — is richly deserved. But another player deserves attention: borrowers. The extent to which subprime borrowers were grossly misled, took calculated risks or simply didn't understand the details of the contracts they entered into, is unclear.

But if there is anything to be learned from Turner's experience, it is that financial education can make a difference. What if all subprime borrowers received the counseling that Turner did? Would we even be talking about the problems in the subprime market?

Subprime Primer

Though standards vary, in general a credit score of 660 (around the national average) or higher may qualify for a "prime" loan. There is also a near-prime, sometimes called "Alt-A," category of loans for borrowers with credit scores between 580 and 660. Subprime borrowers usually are those with credit scores lower than 580 (though by some

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measures, scores below 620 qualify). Federal regulators define such borrowers as those with records of delinquency or bankruptcy, and debt-to-income ratios of 50 percent or more.

As of this fall, prime loans were not showing signs of major trouble. The overall delinquency rate (between 30 and 90 days overdue) has stayed close to 4 percent since the early 1990s, according to a Chicago Fed paper, though rising to about 5 percent in the past year. Fixed-rate, 30-year mortgages in fact remain at historical low levels of delinquency, at around 2 percent. The problem has been in the subprime market.

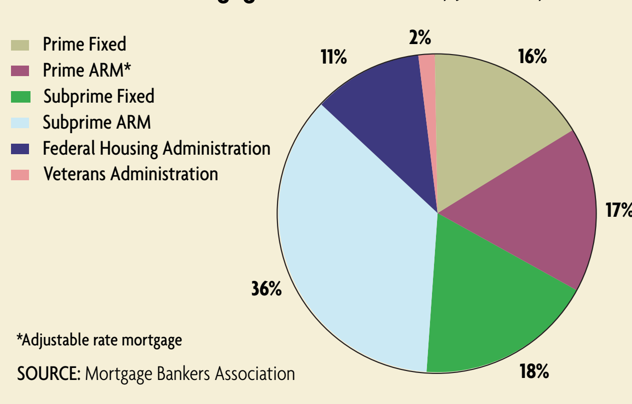
Subprime mortgages didn't gain much attention until recently, but their growth began in the early 1990s. Interest rates were declining, and some high-risk borrowers turned to them as a means to refinance existing mortgages. Meanwhile, technological improvements made it easier and cheaper to "score" borrowers' credit risks, helping to increase volume in the subprime category.

Subprime mortgages (defined here as loans obtained by borrowers with credit scores less than 620) have indeed seen a sharp increase in delinquencies, overall at more than 13 percent in early 2007, with ARMs leading the way at 14 percent. More to the point, the growth in subprime mortgages has been astonishing, rising from 6 percent of all loans as recently as 2002 to 20 percent at the end of 2006. (This 20 percent figure includes a 5 percentage point share for Alt-A loans.) The share of subprime loans that are ARMs — with the highest delinquency rates — stood at 50 percent (or about 7.5 percent of all mortgage loans) at the end of 2006. Not only are subprime loans risky, but half of them are the riskiest possible — ARMs. Meanwhile, the share of prime loans that are ARMs stood at 18.2 percent at the end of 2006.

Subprime borrowers of any type will pay between 2 and 3 percentage points more than the prevailing prime rates. For example, a hypothetical subprime loan originated this fall might carry an annual rate of 8.4 percent, compared with 6.4 percent for a prime borrower. (Historically, the subprime spread has been between 200 and 300 basis points, but in recent months has widened.) A 30-year, $250,000 loan at the subprime rate would require monthly payments of $1,904 compared with $1,563 for a prime loan — a difference of more than $4,000 a year. Economists with the St. Louis Fed put it this way: "At its simplest, subprime lending can be described as high-cost lending."

Many of the largest originators of subprime loans are not banks. New Century Financial Corp., for example, is a real estate investment trust and was the nation's second-largest subprime originator before seeking bankruptcy protection this spring. Other nonbanks are parts of bank or thrift holding companies. Also in the top 10 are banks like Wells Fargo and CitiFinancial, as well as thrifts like Countrywide Financial. But what distinguishes a subprime from a prime loan is the perceived credit risk of the borrower. A subprime loan may include features like interest-only payments or zero downpayment or adjustable rates, but it doesn't have to. All these features are also available to prime borrowers. So when we discuss subprime loans, we are generally considering mortgages to high-risk borrowers, or those who fail to provide adequate documentation on their income, or to those with high debt-to-income ratios.

Unquestionably, the subprime revolution extended credit to those who in previous decades were shut out of the homeownership market. On the other hand, it may seem like asking for trouble by charging the poorest, or the most debt-ridden borrowers extra. Or, as others have postulated, it may be perilous to offer complicated financial instruments to relatively unsophisticated consumers — and low-income borrowers tend to fall into that category.

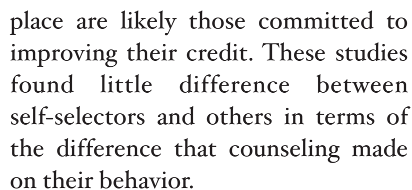


Does it Work?

Therein lies the motivation for thinking about the power of financial education. Reliable data are difficult to find on the impact of pre-homeownership counseling. With mortgage loans being sold to investors, tracking them over time is difficult. There are also many different forms of counseling (from workshops to intense, months-long individual programs), and a dearth of formal tests matching different programs with different outcomes.

In a survey of the literature on credit counseling, Richmond Fed economist Matthew Martin draws some conclusions that may be quite pertinent to the subprime market's decline. Based on his reading, Martin says it's clear that some households make mistakes in personal financial decisions, and that "mistakes are more common for low-income and less-educated households." As such, low-income households tend to benefit the most from financial education.

A widely discussed study found that, for low-income borrowers, there is a connection between prepurchase counseling and avoiding delinquency. In 2001, researchers with Freddie Mac showed that borrowers have a 19 percent lower delinquency rate after counseling. Of the different sorts of counseling, one-on-one was found to be most effective, with a 34 percent decrease in delinquency compared with 26 percent for group sessions and 21 percent for home study. Similar studies have tried to adjust for self-selection — the problem that results will be skewed because people who seek counseling in the first



place are likely those committed to improving their credit. These studies found little difference between self-selectors and others in terms of the difference that counseling made on their behavior.

In a 2006 paper, economists Valentina Hartarska of Auburn University and Claudio Gonzalez-Vega of Ohio State University found that counseling has a significant effect on borrowing behavior, as it makes low-income borrowers more aware of all their financial options — from refinancing to default. Counseled borrowers grow more "ruthless" in their decisionmaking, an outcome that may not always be so great for lenders. Borrowers, for example, would now understand that it might make more sense for them to default than to refinance.

Hartarska notes in an interview that her study was fairly limited. It drew from the experience of an Ohio bank that provided counseling services as part of its Community Reinvestment Act requirements from 1996 to 2000. The authors looked at a total of 1,338 loans over three papers, comparing those that occurred before counseling (1992 to 1995) and those in the post-1996 period. That said, Hartarska believes the results to be quite robust, and perhaps useful to lenders.

"It means that you can educate and then you can price your risk based on the experience that borrowers will behave slightly differently from what you would have expected of people with their income and credit score," she says. Hartarska also adds that much more study needs to take place, a process that could be aided if lenders made more data available to researchers.

It may help outcomes, but mortgage counseling isn't free. It is supported in part through government grants. NeighborWorks America is the main backer of local nonprofit housing organizations, with 240 members across the country. It distributes much of its $115 million annual (federally supported) budget to groups like DHIC in Raleigh. The local organizations can do a number of things with the money, from developing properties to hiring financial educators.

Most NeighborWorks-backed organizations offer some sort of prepurchase counseling, says Douglas Robinson, NeighborWorks spokesman. Perhaps because of that, local nonprofit housing groups see better results from their clients: The default rate on subprime mortgages taken out by their clients is less than 3 percent, Robinson says, compared with about 13 percent for all subprime loans.

"If more families and more households had taken advantage of prepurchase counseling, whether prime or subprime borrowers, they would have been better armed," says Robinson. "Mortgages can seem to be perfect that day but with any instant gratification, if you think about it, maybe it's not a good thing."

"Mortgage Ready"

The sort of homeownership counseling that Donna Turner received at DHIC is fairly rigorous — up close and personal, and not cheap to provide. In 2006, the center shuttled about 480 people through its program, and 210 ended up buying homes that year. A big chunk of DHIC's clientele exists because of lender requirements. The city of Raleigh, for example, offers some low-income residents up to $20,000 in downpayment assistance, but orders first that they complete a DHIC counseling program. Charlotte-based Bank of America instructed dozens of its clients in the past year to attend DHIC seminars as part of their mortgage qualification process.

Almost everyone who comes to DHIC, initially, would be considered a subprime borrowing candidate. The counselors here talk about getting clients "mortgage ready." The charge for this service is $25.

Like a lot of nonprofit housing organizations, DHIC derives most of its operating revenues from development projects, where it builds low-income housing. Grants provide cash for services that don't pay for themselves, including homeownership counseling. DHIC owns rental housing and in 2004 and 2005 sold 54 homes at its MeadowCreek subdivision, where Turner now lives.

There is a class on adjustable rates. The counselors walk their clients through "good-faith" estimates point by point, highlighting potential trouble spots like high upfront fees or the possibility of ballooning rates down the road. For many, there is subsequent one-on-one counseling to improve credit scores before even trying to secure a loan.

Are some brokers trying to sell products that borrowers probably can't handle? Probably, DHIC counselors say. "A lot of our clients are told, 'Do it now and then you can refinance in a year,'" says Porter, who was Turner's main mortgage counselor. "But they probably have to come up with more out-of-pocket money to do that because they won't have enough equity built up to cover all the costs. I've had clients come in with a good-faith estimate, and with their credit score, and I'm thinking, 'Why are you being offered this?'"

And yet, some borrowers simply act on what they want to hear, ignoring what they know is true.

"It's more complicated now," says Saundra Harper, a sales manager and counselor at DHIC. "You've got so many different products that have come on board, like interest-only loans. I've seen lenders come up with some unbelievable things."

DHIC does not keep track of its clients in a systematic way after they complete their counseling, so there is no way to say how effective the programs have been. Anecdotally, DHIC staffers offer up evidence like Turner. And they wonder why there isn't a bigger push to support pre-homeownership counseling for low-income borrowers. "We've been asking that question for a long time," says Gregg Warren, DHIC president. He attributes some of the lack of motivation to the way mortgages are sold to investors, seemingly reducing the risk that lenders carry, and thus

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the white diaspora," writes Gregory. "Fewer than half of the nearly 20 million whites who left the South actually left for good. That means that the white diaspora is best understood as a circulation, not as a one-way population transfer."

But black return migration was only about a third of the rate of white migration during most decades. Some did come back even as others departed. For instance, in 1949, some 43,000 black Southerners returned, about 1.7 percent of all Southern-born blacks living in the North and West.

Still, in the 1970s, the return flow of blacks to the South was evident — more moving in than moving out. Between 1975 and 1980, Virginia, the Carolinas, and Maryland were among the states gaining the most black in-migrants, according to demographer William Frey.

Frey analyzed migration data from four decennial censuses. Among other findings, the South netted black migrants from all other U.S. regions during the 1990s, completely reversing the migration stream. Charlotte, Norfolk-Virginia Beach, Raleigh-Durham, and Washington-Baltimore were among the 10 most-preferred destinations during that time. Atlanta, however, was the strongest magnet. New York, Chicago, Los Angeles, and San Francisco lost blacks during the same period. Also noteworthy: Blacks were more likely than whites to pick Southern destinations. Maryland, North Carolina, and Virginia were among the 10 states that gained the most black college graduates during the late 1990s.

Black reverse migration reflects economic growth, improved race relations, "and the long-standing cultural and kinship ties it holds for black families," according to Frey.

James Macbeth, who is 71 and beginning to think about retirement, may move back to Charleston. His parents, both dead, are buried in South Carolina, and his siblings have scattered throughout Southern cities in a return migration of their own.

Over his lifetime, Macbeth witnessed the chain of events that people like his father set in motion. The migratory tide, once it began going out, forced change as it rearranged population, employment, education, attitudes, art, music, sports, transportation, recreation, housing, and more. The Great Migration was driven by more than the opportunity to improve working conditions — at least for blacks. James Macbeth's father didn't leave Charleston just for a good job in New York at the post office. "He just couldn't get along with segregation in the South." **RF**

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causing them to lack incentive to ensure that borrowers are "mortgage ready." (It should be pointed out that lenders do carry risk even when they sell their mortgages because over the long term, if defaults are widespread, then they are certainly worse off in terms of their future ability to originate loans and sell them.) "Are we going to expect Wall Street investors to support homeownership counseling?" he asks rhetorically.

Almost three years after her purchase, Donna Turner is keeping up with her monthly payments and tending a small garden out back. She is the very picture of a happy, responsible homeowner. "I had always lived with somebody. And after you pay your part of the bills, they say get out," Turner says. "So I was determined to get to the point where nobody could ever tell me to get out again."

Turner did it. Economic research suggests that, while it won't come close to working for everyone, she needn't be the only exception. **RF**

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