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Here's one idea to spark loans to low-income homebuyers

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WASHINGTON — When a Boston community development group needed money to expand an innovative lending program that fights area foreclosures, it had high hopes.

In less than a year, the Stabilizing Urban Neighborhoods program at Boston Community Capital had purchased or financed $11 million in properties that were facing foreclosure. The effort kept 100 low-income families in their homes and cut their housing costs by an average of 50 percent. Even better, none of the new loans was in default.

But when the group tried to raise money by selling the loans on a secondary mortgage market — in which mortgages are pooled together, or "securitized," then sold as bonds to investors — it had no luck, because the collapse of the housing sector has virtually frozen that secondary market.

In this skittish environment, Boston Community Capital's loans looked even more risky to investors because the borrowers were fresh out of foreclosure proceedings, said Elyse Cherry, the group's CEO. Even Fannie Mae and Freddie Mac, the mortgage-finance giants that securitize about 90 percent of U.S. home mortgages, wouldn't touch the group's loans, she said.

"If you look at these folks' credit ratings, they're in the toilet," Cherry said of her borrowers. "It's a tough thing to sell."

So Cherry's goal of taking her program nationwide remains on hold, along with scores of low-income borrowers who could benefit from it.

But what if the federal government could guarantee payments to investors on the first 25 to 50 percent of losses that Boston Community Capital's securitized loans might incur? Would that kind of risk sharing, or "government wrap," make investors more willing to purchase these and other innovative loan products for low- and moderate income borrowers?

The Center for American Progress thinks it would. A partial government guarantee is a major component of the liberal research center's broad proposal to resuscitate the moribund secondary mortgage market.

Its plan, which has caught the attention of lawmakers, regulators and housing advocates, comes as Congress and the Obama administration open discussions on how to fix the secondary market.

Their ultimate solution will determine the fate of Fannie Mae and Freddie Mac. Chartered by Congress and subject to federal oversight, Fannie and Freddie have been in government conservatorship since the peak of the global financial panic in September 2008.

Republicans generally want the government to get out of the mortgage lending business, while Democrats want to retain government support, but overhaul it. The Obama administration is expected to release a white paper Friday that discusses various options for Fannie and Freddie's future.

David Min, a senior fellow at the Center for American Progress, said sharing the risk of loss on loans for underserved areas and borrowers would do what whole-loan insurance provided by the Federal Housing Administration did now: make it more attractive for private lenders to serve lower-income areas, where loans were seen as riskier.

"The idea is to basically put training wheels on certain types of (loan) products and eventually take them off so they can be self-standing in the secondary market," Min said. "After three or five years, or some period of time, you'd have sufficient loan performance data and other research information that might make it viable for these loans to be securitized without that government wrap."

While it offers solutions, the proposal also has raised many questions. Cherry said it was unclear how much the partial government guarantee would cost. This backstop and additional fees the measure proposes could force lenders to increase interest rates on loans, which could make them unaffordable for low-income borrowers. Cherry also questioned whether the financing mechanism for the government guarantee would generate enough money to meet its obligations.

Janis Bowdler, who directs the Wealth-Building Policy Project for the National Council of La Raza, a Hispanic advocacy organization, said she worried that the government guarantee and other credit enhancements in the proposal could become lenders' sole method of reaching underserved customers.

"We have to make sure it's not used to alleviate the primary responsibility of mainstream lenders to serve all qualified borrowers," Bowdler said. "This can't be a replacement."

Cherry's group buys homes facing foreclosure at distressed prices before the owners have been kicked out. The group then finances the homes at a standard 30-year, 6-percent fixed rate and sells them back to the original owners.

Cherry said many of her borrowers originally faced foreclosure because they were in homes they couldn't afford, due to exotic, unsustainable loans with rates that started low and grew progressively higher. On average, families see their housing costs decline from $3,100 to $1,600 per month under the new loan terms, Cherry said.

At one time, Wall Street firms specialized in securitizing subprime loans to borrowers with poor credit histories, like those in Cherry's program. But after issuing a record $1.2 trillion in residential mortgage-backed securities in 2005, Wall Street firms securitized only $63.6 billion in home loans last year, said Guy Cecala, the publisher of the newsletter Inside Mortgage Finance.

"Investors have been burned so badly by the subprime meltdown, they don't want to touch a mortgage security unless it has a government guarantee. And that's the way it's going to be for a while," Cecala said.

The Center for American Progress' proposal calls for the partial government guarantee to be provided on a competitive basis through a new entity called a Market Access Fund. The fund would support housing finance efforts in troubled areas such as isolated rural communities and places with high foreclosure rates.

Min envisions the Market Access Fund being administered through a new government agency or one such as the Department of Housing and Urban Development or the FHA.

In addition to guaranteeing loans, the fund would provide grants and direct loans to help government agencies, nonprofits and other groups serve borrowers who don't meet the standard 20-percent down, 660 credit-score profile. The fund would be financed by a fee on all mortgage bonds.

Without these kinds of credit enhancements, some fear that FHA mortgage insurance could become the main vehicle for lending in underserved areas.

In that scenario, civil rights advocates worry, a "two-tier" housing finance system could emerge, with taxpayers — through the FHA — taking all the risk for lending in underserved areas while private capital goes mainly to higher-income areas, where the risk isn't as great.

In a recent letter to HUD Secretary Shaun Donovan and Treasury Secretary Tim Geithner, more than a dozen civil rights and housing advocates made that very case.

Unless new, flexible underwriting standards are adopted as part of any overhaul of the secondary mortgage market, Cherry said, millions of borrowers with foreclosures in their past won't ever be able to buy homes.

"If we don't solve the problem for this whole cohort of potential buyers, who is actually going to buy homes in low and moderate income neighborhoods?" she asked. "Speculators?"

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