1

New Paths to Building Assets for the Poor

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Most poor people have no problem filling in the spaces on their balance sheets for income, debts, and expenses, but come up short in the space for assets. Apart from seniors who bought homes when their incomes were higher, few among the poor have many assets. In fact, when last measured in 2001, the median net wealth of renters with incomes of $20,000 or less was a low $900.

Indeed, assets for the poor among those who do not own homes seem an oxymoron. After all, low incomes coupled with high rents and other living expenses rule out savings. In some neighborhoods it is hard to find a bank branch, let alone one that offers accounts for those with minimal savings. Meanwhile, stocks and bonds are accessible to middle- to upper-income earners, as the other ephemera of wealth, like paintings and gold, are to high net worth households.

The Path More Traveled

Since poor people spend their money on daily living, how can they accumulate substantial wealth? In twenty-first century America, the answer is housing. People who buy homes are buying not just shelter, but also an asset, one in which they will build equity. Through the enforced savings of paying off a mortgage, homeownership can allow the poor to build assets even with little or no infla-

tion in a home's value. But housing usually appreciates over time, matching or beating inflation, especially if a property is held long enough.

Housing has not always been seen as a vehicle for generating financial wealth. Throughout history people have prized and exchanged salt, diamonds, and even tulips, converting these items into mediums of exchange that could rise or fall in value. But houses were not bought and sold. Instead, they were inherited or eventually collapsed from neglect. Even today, in much of the world homeownership is considered socially desirable, but it is not a vehicle for wealth accumulation. For instance, poor people in Mexico own their homes, but since those homes have limited exchange value they are not assets that can be borrowed against or sold to build wealth.

A home is most definitely an asset in the United States. Home equity ranks as Americans' chief source of wealth, even among the majority of households who own stock. And as home values have risen, homeowners have drawn on the equity in their homes through refinances and home equity loans, cashing out $333 billion in this way from 2001 to 2003. Both tax-advantaged and secured by real estate, borrowing against home equity is typically much less costly than consumer credit. Owning a home, therefore, can be a path both to wealth accumulation and cheaper borrowing.

Credit for All

Just as certainly as housing is an asset in this country, it is only recently that low-income households, especially those with a history of missed payments (or worse, default), have enjoyed widespread access to the mortgage credit needed to buy homes.

Mortgages themselves are relatively new. Until the mid-nineteenth century, most home buyers paid the full cost through accumulated savings, leaving homeownership to the ranks of the wealthy or families who pooled years of savings. By the mid-twentieth century, banks opened homeownership to the middle class, launching the now classic 20 percent down, thirty-year fixed-rate mortgage. After World War II, this classic mortgage propelled thousands of families to the suburbs where they purchased capes and split-levels. Yet many low-income families (as well as a lot of middle-income families) could not afford this classic mortgage. Either the down payment or monthly payment was too high.

Just as crucial, many would-be borrowers found that their race, ethnicity, or religion restricted their choices. Lenders said no to borrowers, even solvent ones, if their skin color was wrong. Real estate agents respected "gentlemen's agreements" that restricted some neighborhoods to Christian Caucasians. With red pens, bankers drew exclusionary lines around neighborhoods, barring African American buyers. Even the Federal Housing Administration spawned restrictive covenants and redlining. This barrier to homeownership stymied the creation of

wealth. Minorities and others could not buy homes and so could rarely build much wealth. It is largely due to this obstacle—as well as barriers to education, lower levels of pay for comparable levels of education, and labor-market discrimination—that the homeownership rate for minorities still stands more than 25 percentage points lower than that of whites.

Today nearly everybody, rich and poor, has access to mortgage and most other forms of credit. Now, even low-income Americans are able to buy homes with little money down, allowing them to capitalize on the substantial benefits of making a leveraged investment in an asset that is likely to appreciate in the long run. Another way to view it is that the alternative to making a 3 percent ($2,400) down payment on an $80,000 house is to invest it in stocks, bonds, or savings. Even if the home appreciates a mere 1 percent in value, in a single year the return on investment is 33 percent. And with programs now available that allow home buyers to pay only closing costs (which can be picked up by the seller), buyers can get an $800 return on no initial investment. While home buyers may be taking a risk that their house will go up in value between the time they buy and sell as well as if they can keep current on their loan, other paths to wealth accumulation are either blocked (minimum investment requirements), very risky (individual stocks whose values can rise and fall by large percentages in a single day), or very slow (low interest rates on savings accounts).

Importantly, however, access to mortgage credit is no longer on equal terms. Indeed, the world of lending has changed fundamentally over the past thirty years. From a one-size-fits-all strategy of underwriting and pricing loans—in essence offering credit only to modest, credit-worthy borrowers at a uniform price—lenders increasingly base pricing on the risk profile of applicants and now reach out to borrowers once flatly denied. The change began in the credit card industry in the mid-1970s, branched to the auto and consumer loan industry in the 1980s, and began to transform the mortgage industry by the late 1990s. Two key developments have made this industry transformation possible: the ascendance of statistical measures of past credit history (known as credit scores) and the growth of capital markets.

Long Arm of Credit Scores and Histories

Credit scores—grades on how well individuals have met their past credit obligations—are the principal reason for the growth of risk-based pricing. These scores are highly predictive of the severity and incidence of defaults. Nearly every credit decision now involves a credit score, even subtle decisions, like allowing a customer to open a checking account, which could leave a lender responsible for bounced checks. Credit scores give lenders comfort that the magnitude of the risk they are assuming is well measured and justifies a particular yield. But these scores exact a price from borrowers who do not have the

established electronically documented credit histories that drive the scores. People who have not opened checking accounts, used credit cards, or obtained consumer loans are at a disadvantage in credit markets. Also at a disadvantage are those who borrow money from payday lenders or do not report to mainstream credit bureaus. And credit scores also exact a price from those who have had trouble making payments in the past.

Credit scoring relegates borrowers with tarnished credit histories to a subprime market where lenders charge higher rates to cover the added risk—and these rates are not published weekly in the newspaper, as are prime rates. Nor do disclosure regulations govern this market effectively. Only if combined rates and fees exceed a high threshold are special disclosures even required and very few practices are prohibited outright. Agents and brokers make commissions on the marketing of these mortgages and have no financial stake in the afterlife of these loans, so it does not matter if the buyer subsequently defaults. Poor people, especially minorities, often end up in the subprime market, paying more for the same mortgage than borrowers deemed more creditworthy. In low-income minority neighborhoods the subprime share of lending increased from only a few percentage points in 1993 to 13 percent of home purchase loans and 28 percent of refinanced loans in 2001.

The subprime market fills a niche, opening credit to people who might not get it otherwise. But an egregious offshoot of this market is the predatory lender, who issues mortgages at terms people cannot meet—indeed a lender who may profit when borrowers default. A foreclosure makes a mockery of the notion of a house as asset. When a lender forecloses, an owner loses any equity in the home. One particularly cruel scam depletes the equity a homeowner has amassed in the house: through home equity loans (again, available by phone), an owner ends up paying exorbitant fees and repeated refinances that escalate until the owner eventually loses the home to the lender.

Equally important, the centrality of credit scores to pricing decisions means that the long arc of past credit behavior governs access and pricing of mortgages. Hence a checking account or credit card, which electronically captures payment histories, can influence an individual's access to mortgage credit. Access is also influenced by how an individual handled past credit experiences. Therefore, success in building assets through homeownership starts long before a would-be home buyer walks in the door of a mortgage lender.

Two Faces of the Capital Markets

The second development that has transformed the world of credit is the ascendance of capital markets—markets where debts with maturities of a year or more are bought and sold. In the past, lenders held credit they extended in their own portfolios and serviced it as well. Over the past fifty years, loan originators

increasingly have become separated from those ultimately investing in loans. In addition, loans have been pooled to back securities that bring added liquidity to the market. The efficiency of capital markets in matching debtors with certain risk profiles to investors with certain risk tolerances is unparalleled. But this efficiency comes at a cost: it requires heavy reliance on third-party agents to connect investors and debtors. In theory, these intermediaries work on behalf of investors and in the interests of debtors, but in reality their incentives may not be aligned with either one.

Nevertheless, a powerful aspect of the global markets that dominate modern mortgage lending is that in many respects they are blind to race, ethnicity, and religion. A neighborhood banker often no longer makes a face-to-face decision on how much to lend an applicant. Instead, the financial history of the applicant is usually fed into a computer, which renders a score that is a financial calibration of risk. Each day lenders (no longer just banks, but mortgage brokers, too) issue thousands of mortgages, which are then sold on the secondary market. Indeed, the global markets care only about risk and return, not race and religion. To the degree that the scores and other information used to underwrite loans predict risk accurately, and arrive at an interest rate that compensates investors for the level of risk assumed, investors are satisfied.

The blindness of the capital markets to much of what goes into credit decisions cuts both ways, though, as it has both positive and negative aspects. On the plus side, with the protections of better colorblind risk assessment and management tools, lenders have abandoned near-exclusive reliance on the classic 20 percent down, fixed-rate mortgage. Today, lenders offer a remarkable array of products to borrowers with a wide range of past credit histories, and even offer products to borrowers without documented credit histories. These products include: low to no down payments; adjustable-rate loans; hybrid loans that fix a rate for a number of years and then reset to current market rate; loans that require low or no documentation of income and assets; and loans that allow for larger ratios of debt to income. As a result, people with low incomes (and minimal savings) can get mortgages. People with major blemishes on their credit records can get credit. Indeed, the poor no longer face a scarcity of credit; they face a surfeit of it. With a few clicks on the computer mouse, or calls to toll-free numbers, a person can take a first step toward homeownership. Easy mortgages have made many Americans homeowners. And for most of them, homeownership has been the first step in the accumulation of genuine equity, giving them an asset to list on their balance sheet.

On the minus side of the ledger are several items that, if not addressed, could diminish the potential value brought by the revolutions in information technology and capital markets. First, investors in mortgage-backed securities are remote from the lenders or brokers that initially underwrote the loans. Thus discrimination and fraud can plague the system if investors fail to

manage the risk that loan originators or servicers will not act in their interest. Second, investors do not care whether there might be better models that distinguish price risk more advantageously for low-income communities and minorities. Their main concern is whether borrowers are willing to pay mortgage interest rates that fairly compensate the investor. This can lead to charging borrowers for lax underwriting, servicing, and even fraud that suppliers may introduce into the system. As long as the borrowers are willing to cover the costs of those missteps or misdeeds in the form of interest rates and fees, investors are satisfied. Third, in a world in which mortgage products have proliferated to such a degree—and the price points for mortgages along with them—it becomes harder for consumers to know the best deal for which they qualify and easier for lenders to take advantage of this fact. Therefore, borrowers may be overcharged as a result of a lack of efficiency and accessible consumer information in the system. Furthermore, in a world in which loans have higher prices and fees than a conventional prime loan, opportunities to prey on hapless consumers mount.

As a result, not all homeowners have benefited equally (or at all) from opening the spigots of mortgage and other credit. Some owners have not been building wealth as much as they might because they are being overcharged. Others are getting credit even though they have high probabilities of missing payments and lack a safety net on which to fall back when they do. Other owners are building the asset-portfolios of an array of predatory lenders, brokers, and agents, rather than their own.

Regulation Matters

The world of lending has changed, but has the world of regulation changed with it? Without question, the legal and regulatory framework within which credit information is gathered and used, credit decisions are made, credit information is disclosed to the public, and capital flows are directed have all changed dramatically over the last half century. What is debatable is whether these regulatory changes have adequately protected consumers, educated and informed the public, and brought the greatest possible efficiency and fairness to the credit system.

Federal legislation, like the Fair Housing Act and Equal Credit Opportunity Act, barred discrimination in housing and mortgage markets. But barring discrimination by law is not the same thing as actually ending it. Signs that discrimination still exists in housing and mortgage markets are abundant. In fact, responsible banks themselves test for it in an effort to stamp it out. But some lenders, especially those not subjected to stiffer scrutiny by federal regulators, may tolerate it (or at worst, encourage it). The laws and their enforcement, though, have surely reduced discrimination. Some well-publicized lawsuits

against banks in the early 1990s made bank boards recognize that it was their responsibility to better police their own organizations.

Perhaps equally important on the regulatory side have been the Home Mortgage Disclosure Act (HMDA) and Community Reinvestment Act (CRA). Together these two acts have resulted in expansion of credit to low-income and minority borrowers and communities. HMDA has demanded increasingly revealing disclosure of mortgage information from more and more types of lenders. CRA has created an affirmative obligation—and public grading—on banks and thrifts to supply mortgage credit to low-income communities. These acts armed advocates for low-income borrowers with information they could use to highlight potential problem areas in the lending practices of particular institutions and provided powerful regulatory and public relations incentives to reach out to low-income and minority markets once weakly served. To this day, the two acts are bulwarks of the new path to asset accumulation for low-income Americans. They are joined by aggressive affordable, special needs, and underserved area regulatory goals imposed by Congress on secondary mortgage market giants Fannie Mae and Freddie Mac. These regulatory goals also keep the focus on the credit needs of those borrowers who were once denied. All these regulations have seen recent changes: goals set by HUD as the mission regulators for Fannie Mae and Freddie Mac keep getting ratcheted higher; interest rates and fees, if they are over specified threshold, must now be reported under HMDA; and CRA was recently amended.

The Truth in Lending Act (TILA), Real Estate Settlements and Procedures Act (RESPA), and more recently passed Homeowners Equity Protection Act (HOEPA) are intended to provide important disclosures to borrowers in an effort to avert last-minute surprises and alert borrowers when they are getting especially high-cost mortgages. The disclosures signal greater need for caution on the part of the borrower. Of these, only HOEPA has been revised since the mid-1990s, but revisions to the others are under near-continual debate and review. The very recently revised Federal Credit Reporting Act (FCRA) is intended to ensure that credit information used to drive credit scores is accurately reported, though it does not mandate reporting by all creditors. This act has been both faulted and applauded for placing the onus on consumers for detecting and challenging credit reporting errors. Critics of the act charge it places a burden on consumers that is unfair and which they are ill-equipped to carry. Proponents counter that consumers are in the best position to judge whether credit information on them is accurate and that the system appropriately lowers costs of gathering literally billions of bits of information annually.

With predatory lending on the rise and even subprime lenders using practices that trouble many advocates, states have begun to take regulatory action in the absence of what some state legislators feel are adequate federal protections. States like North Carolina and cities like Chicago are stepping into the fray. As

these laws multiply, calls mount for federal law to regulate mortgage-lending tactics more aggressively and to preempt potentially more aggressive (and certainly disparate) state laws.

Taking Stock

Against this remarkable backdrop of sweeping changes to the mortgage finance system and surging homeownership, the Joint Center for Housing Studies of Harvard University convened a conference to present new research on building assets and building credit in low-income and minority communities and among low-income and minority individuals. Researchers from across the country gathered to present papers on the extension of basic banking services and mortgage credit to low-income and minority individuals and communities. In attendance were business, government, advocacy, and community leaders. Many of them participated on panels, sharing their reactions to the new findings being presented. The healthy dialogue that ensued and its implications for business, policy, regulation, and advocacy is summarized in a proceedings produced by the center (Joint Center for Housing Studies, 2004).

The most important of these findings are found on the pages that follow in this remarkable look at the path that leads from basic banking services, to creditmaking decisions, then to mortgage lending, and at last to the chance for low-income people and communities to build assets through credit. Here we note only a few.

On the one hand, the growth of the subprime market has propelled millions of Americans into homes, and those homes are an asset. On the other hand, there are ways to steer more Americans into the prime market, as well as ways to discourage the predatory lenders.

First, the mainstream financial institutions must reach beyond middle-class depositors and investors. In 2001 almost 30 percent of poor people did not have transaction accounts (savings or checking accounts), hence the profusion of check-cashing storefront operations. Accounts give people experience with mainstream banks, and vice versa. They also allow people to save safely and establish electronic records of their payments, records that fuel the fires that stoke the credit-scoring engine that now permeates our economic lives. As many as one-third of people who borrowed from subprime lenders may have been eligible for better rates from prime lenders, suggests a somewhat dated study from the late 1990s, but the borrowers erroneously assumed that certain banks would not lend to them, so instead went to the ever-willing lender who knocked on the door or called them on the phone or sent them a compelling letter.

Second, there should be more transparency in the subprime market. Just as prime lenders publish rates and terms, we can ask the same of subprime lenders, so that the borrower can make an informed decision. Lawmakers can require

brokers and agents to disclose their fees. Again, the predatory lenders are a subset of the subprime market. Transparency will highlight their scams.

Third, as a corollary to the transparency, policymakers can insist on and provide adequate funding for buyer education. There is evidence that such education, if done properly, can result in lower defaults. Yet right now the cost of providing that education is much higher than any lender has been willing to pay, even though it might ultimately pay for itself. And, the government has not helped much either. Funding for home buyer education is limited and the per-pupil amount offered is too low, even with counselors who themselves are often paid at or near a poverty wage.

Fourth, although our culture of ownership may encourage more and more Americans to trade their lease for a mortgage, without safeguards in place we may be saddling those people with more debt than they can handle. Instead of building assets, they will sink toward bankruptcy.

In sum, for most Americans homeownership constitutes a wealth-building strategy. For lower-income people, it is the only real wealth-building strategy. Right now, low-income Americans have unparalleled access to credit to buy a home. The challenge is to increase the chances that those homes become the new pathways to low-income asset building that everyone wants them to be. Low-income homeownership has been sold as a good thing to those putting their cash, homes, and credit records on the line. Let us all work to ensure that it succeeds for as many low-income Americans as possible.