Proposal: The Borrower's Mutual Escrow Fund

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Home-ownership rates and credit access are falling among populations with lower income and wealth, especially people of color. Insurers and advocates alike worry about financially fragile borrowers staying in their homes. Down-payments reduce default rates and protect insurers, but they're not liquid and they don't help borrowers in times of financial stress.

WHAT IS THE BORROWER'S MUTUAL ESCROW FUND (BMEF)?

- Escrowed funds available for short-term income interruptions and major maintenance
- Aggregated across targeted borrowers and time to gain diversification

WHO IS IT FOR?

- Under-served populations and markets

WHY IS IT NEEDED?

- To keep those with fragile liquidity in their homes and reduce credit risk

WHAT PROBLEMS DOES IT SOLVE?

- Transforms illiquid down-payments into targeted, liquid reserves to prevent delinquencies
- Diversifies individual borrower funds into an escrow pool
- Prevents defaults with several months of mortgage payment reserves

HOW IS IT STRUCTURED?

- Borrowers contribute 2% to escrowed reserves instead of 3% for down-payments
- GSEs or others could contribute 10 bps on outstanding balance of BMEF loans
- Aggregating across borrowers allows individual withdrawal limits above 2.5%
- Targeted and escrowed funds allow guarantors to rely on the Fund when assessing risk

WHERE IS IT ADMINISTERED?

- A Board of housing advocates, guarantors and insurers (mortgage and home), lenders and others
- Servicers and potentially, a Trustee

Program Details

TARGETED POPULATION

- Owner-occupied
- Lower area income and/or minority
- BMEF members: Rate & Term refinances

TERMS

BORROWERS/LENDERS

- Underwrite and price using terms for 97% LTV loans: GSE, FHA, VA
- Borrow up to 100% of the purchase price and place 2% into BMEF escrow
- GSE could contribute 5-10 bps annualized on outstanding unpaid principal balance (UPB) into fund
- Borrowers pay typical closing expenses including certified inspection and receive homeowner counseling
- For loan payoffs, borrowers either
  - Receive unused escrow (2% - usage) plus interest, or
  - Reimburse funds used in excess of 2.5%
- Escrow balance unaffected by R&T refi for BMEF members

FUND/MANAGER

- Fund balances invested in short-term similar
- Payouts range from 2.5% - 4% of original UPB when approved by Fund Administrator
  - The highest FHA vintage delinquency rate ever recorded is about 30%. although a Fund diversified by vintage and borrowers would have lower stress delinquencies. Nevertheless, this maximum delinquency rate implies that the maximum payout could be three times borrower contributions. However, we recommend not levering more than 1:1.
  - For Fund access borrowers apply for unemployment escrow, *or*
  - Provide an estimate from an approved contractor for repairs not covered by homeowner's escrow
  - Payouts exceeding 2.5% depend on Administrator assessment of Fund's actuarial soundness
    - Fund must have at least 1000 participants
    - Funding ratio (available funds / 2.5% of UPB) exceeds 75%

ADMINISTRATION

INSTITUTIONAL COMPOSITION (DO WE NEED A BOARD?)

- GSE, Mortgage Insurer (MI), lenders, servicer(s), administrator/trustee, home insurer, counseling agency, NFHA/local HFA, Urban Institute, AD&Co, other
- Pilot program ($1B or 10,000 loans quarterly)

STARTUP

- Gain agreement for pilot from GSE, MI and FHFA
- Establish BMEF entity and select qualified administrators (servicer, MI, GSE, HFA, home insurer)
- Establish policy and operational capability, marketing
- Execute

AREAS FOR FURTHER RESEARCH (COINCIDENT WITH PILOT, NOT PRECEDENT)

- Impact of reserves on delinquency performance for targeted population (including race?)
- Impact of a diversified pool of escrows on delinquency rates compared with individual small down-payments
- Rate of short-term unemployment in targeted population
- Rate of significant housing maintenance occurrences for targeted population
- Reasons for delinquencies in targeted population outside of periods of general economic stress
- Monthly performance reporting against benchmark **->** otherwise comparable 97% LTV loans
- Towards rational pricing between FHA, VA and GSEs
    - Resolve the problem that FHA underprices this risk while GSEs are trying to fairly price it
    - A quantified, intentional subsidy is fine

Appendix

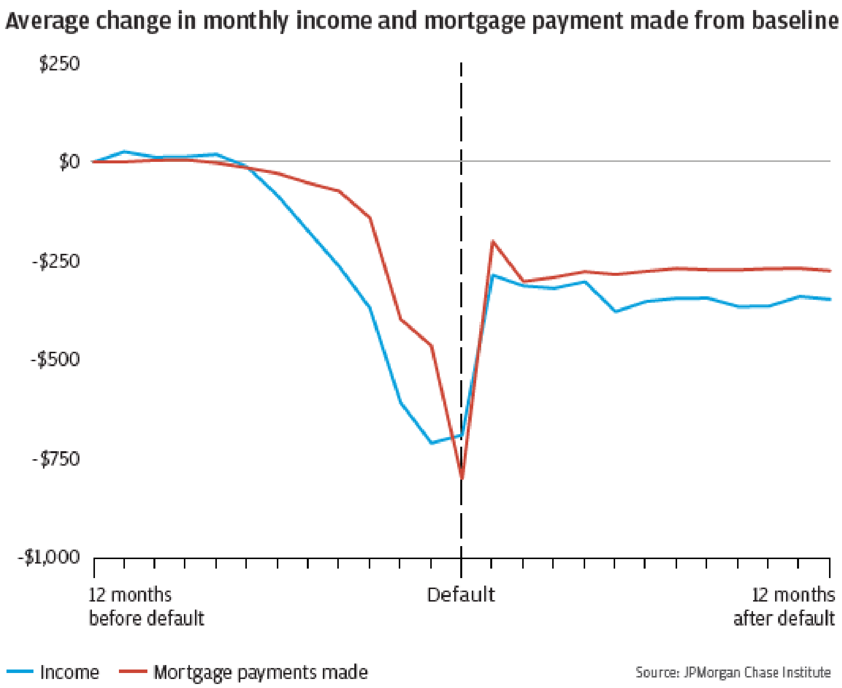

Figure 9: Default rates were higher for borrowers with lower levels of financial reserves regardless of total DTI, suggesting that default was likely determined more by the size of the borrower's financial buffer and less by their total DTI at origination.