THE BORROWER'S MUTUAL INSURANCE FUND

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ABSTRACT

The US housing finance system is quite efficient but there is a gap that raises risk. The aftermath of the financial crisis has highlighted a long-standing problem that is reflected by lowered home-ownership rates and falling credit access among populations with lower income and wealth; especially people of color. Namely, the confluence of illiquid borrowers and the illiquidity of small downpayments. Downpayments reduce default rates and protect insurers, but provide no benefit to borrowers in times of financial stress because the funds are generally unavailable. This paper proposes a solution that is a Pareto improvement in financing efficiency and risk without subsidy.

The BMIF is a diversified escrow account funded by targeted borrowers in lieu of downpayments. It would entitle borrowers to cash for mortgage payments up to 3% of their original balance; around four months. The Fund would be administered to make payments when borrowers suffer qualified income interruptions or large uninsured housing expenses. This lowers risk in three ways:

- Makes funds otherwise used for downpayment much more liquid
- Diversifies otherwise separate funds into a more efficient insurance pool
- Reduces default rates because borrowers are the direct beneficiaries not insurers

FOUNDATION

It could be argued that liquidity is the most important attribute to financial well-being. The ability to generate funds from debt or assets can help produce more wealth or smooth out the effect of income fluctuations, so its unsurprising that a basic tenet of underwriting is adequate reserves. Significant reserves today are correlated with resilient mortgage performance tomorrow. However, the future availability of past reserves is not assured; the correlation to performance would presumably be even higher they were. Finally, among the consequences borrowers face from mortgage default is the damage to their liquidity by drastically limiting their ability to borrow for years.

It's widely viewed that financial commitments by borrowers align incentives with lenders. Borrowers making large downpayments are probably able to borrow against their equity if necessary and have other access to liquidity as well, so they are resilient to financial stress. However, it's very unlikely that equity in low downpayment loans could be tapped for short

term cash flow problems. So, especially for low-wealth first-time buyers, the short-term cash value of 3% downpayments is effectively zero. By contrast, if the funds were in escrow to make mortgage payments when qualified income interruptions or maintenance expenses occur, they could offset perhaps four months of delinquency.

Finally, a basic principal of insurance is the efficiency gain from pooling large but rare incidents like losses from mortgage defaults. Pooling mortgage insurance reduces risk to insurers and pricing for consumers but not the incidence of default. Individual escrows would reduce default, but pooling them would extend the ability to cover payments for those needing it because a large portion never would. Even without leverage, a mutual fund that is diversified across borrowers, geography and time could provide 3% reserve protection with perhaps a 2% borrower contribution.

TARGETED POPULATION

In principle, any borrower could participate in the BMIF, though as a practical matter it's probably better to focus on underserved and financially fragile borrowers.

- Owner-occupied
- Renters <= 120% area median income (or GSE expanding markets definition)
- BMIF members: Rate & Term refinances

HOW MUCH COULD THIS MATTER?

Research shows that borrowers who have three or four months of mortgage payment reserves cut defaults in half[1] compared with those without reserves. Low-wealth and lower-income first time buyers have much higher delinquency and default rates than average GSE borrowers, so cutting defaults in half would make a large difference losses, pricing, and access.

Programs might reasonably be designed that have expected default rates under 10% in benign environments; roughly typical FHA loans. Though in stress these default rates would rise to 25 or 30%. Cutting defaults in half for financially fragile borrowers could safely and meaningfully increase access and reduce risk.

HOW IS IT STRUCTURED?

- Borrowers contribute 2% - 3% reserves instead of 3% for down-payments into a fund that is diversified across borrowers, geography and time.

[1] Farrell, Diana, Kanav Bhagat, and Chen Zhao. 2018. "Falling Behind: Bank Data on the Role of Income and Savings in Mortgage Default" JPMorgan Chase Institute.

- The mutual insurance fund would be administered to make mortgage payments up to 3% - 5% of original balance triggered by qualified income interruptions and large maintenance expenses. This works out to four to eight months of payments including taxes and insurance.
- The Fund would be administered like auto or homeowner's insurance plans. Insurable events are submitted for claim and proceeds would be paid either directly to lenders or to certified housing contractors for repairs (furnace, plumbing, roof, etc.).
- Actuarial oversight to confirm that the Fund can pay out up to 3% per borrower, which probably holds provided less than half the borrowers make full claims.
- Participating borrowers may refinance (rate and term) their loans and seamlessly remain in the Fund. Payoffs receive the unused initial contribution plus interest, claims paid in excess of initial contribution plus interest would be repaid.
- Fund balances would be invested in Treasuries or MBS
- Probably needs a Fund administrator, an insurance process and coordination with servicers

CONCLUSION

Escrowed downpayment funds should unambiguously lower default rates for financially fragile borrowers in several ways. The BMIF increases the certainty that reserves will be available to cover mortgage payments during short-term financial distress and it increases the value of the borrower's own funds by making them much more liquid. Finally, combining individual funds into diversified pools raises the number of effective payments.

The key implementation issue will be to set insurance terms to make payments under appropriate conditions without leading to misuse. Reducing default rates would lower the cost for financially fragile borrowers and

Appendix

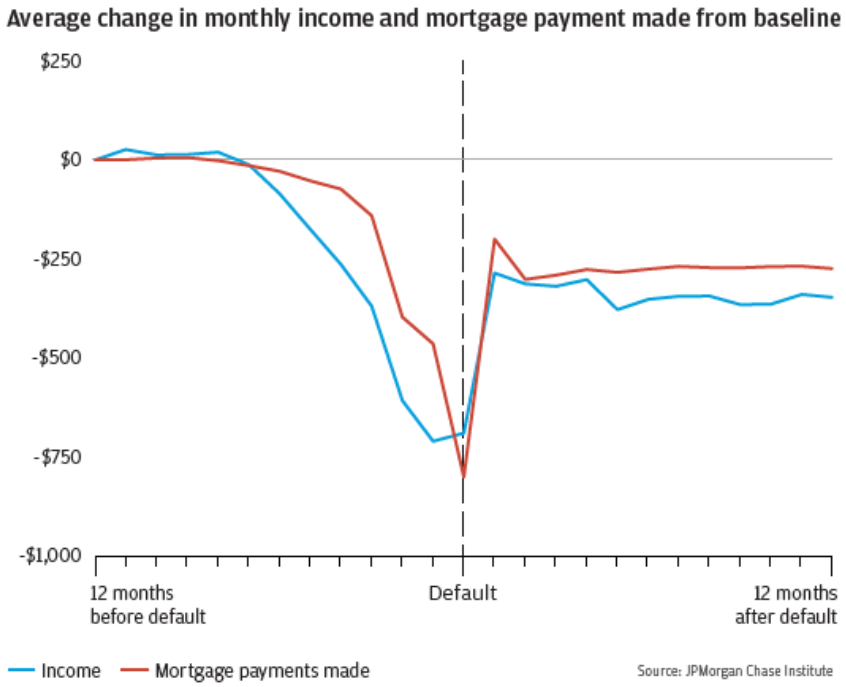

Figure 9: Default rates were higher for borrowers with lower levels of financial reserves regardless of total DTI, suggesting that default was likely determined more by the size of the borrower's financial buffer and less by their total DTI at origination.