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# CASCADE

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## Principles of Sound Central Banking

*Editor's note: Community Affairs has received inquiries about the Federal Reserve System's response to problems in the credit markets. We think that Cascade readers will be interested in comments on these matters by Charles I. Plosser, Ph.D., president of the Federal Reserve Bank of Philadelphia. The following article is adapted from several of his recent speeches. For the full text of speeches by Dr. Plosser, go to [www.philadelphiafed.org/publications/speeches/plosser/](http://www.philadelphiafed.org/publications/speeches/plosser/).*

The current financial crisis and the actions by the Federal Reserve and Treasury to address it are leading to a restructuring of the financial services industry. We are already seeing major investment banks become bank holding companies, weaker financial institutions consolidate into healthier ones, and various types of non-bank financial firms substantially revising their business models.

The financial turmoil and the resulting restructuring in the marketplace have prompted calls for the Fed to assume expanded responsibilities. Some envision the Fed becoming the supervisor and regulator of a broad array of financial firms in order to ensure financial stability. Some want to expand the Federal Reserve's authority or give it a sweeping mandate to prevent systemic risk. Some want the Fed to lend to a wider range of financial institutions. Yet, before we seek to expand dramatically the Fed's responsibilities, I believe it is important to recognize the limits of what a central bank can and should do.

In general, we should avoid giving the Fed overly broad mandates, missions, or goals that conflict with the one goal that is uniquely the responsibility of a central bank – price stability. Instability in the

general level of prices – whether inflation or deflation – is itself a significant source of financial instability. Consequently, we must make sure that in trying to cure one source of financial instability we do not sow the seeds of another.

The Fed has learned much over the past two decades about how to conduct monetary policy more effectively by following four general principles:

- Clarity. Policymakers should set clear and explicit objectives. These

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Charles I. Plosser, Ph.D.,  
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## Message from the Community Affairs Officer

Who are subprime borrowers? What are subprime loans? Recently, researchers at the Fed published a paper that provides answers to these questions by looking at a national database of subprime loans.

Researchers Scott Frame, Andreas Lehnert, and Ned Prescott focus on the subprime portion of the market because it accounts for 53 percent of all loans in foreclosure, although it comprises only 12 percent of all first-lien mortgages. The paper, entitled "A Snapshot of Mortgage Conditions with an Emphasis on Subprime Mortgage Performance," looks at the size of the mortgage industry and how the subprime market is different from the prime market. The data are derived mostly from the Mortgage Bankers Association and a First American Loan-Performance database of securitized subprime loans.

If you haven't got the time to read the paper, let me help you with some of the pertinent points. The total mortgage market is estimated at 54.7 million first-lien mortgage loans with a combined value of \$10.1 trillion. There are about 42.7 million prime and near-prime loans totaling \$8.2 trillion and 6.7 million subprime loans totaling \$1.2 trillion. Government loans, which are not discussed in the paper, represent roughly 10 percent of the total mortgage market.

Despite their small number and value within the total market, subprime loans, particularly those with adjustable interest rates, are the most problematic. As of the first quarter of 2008, the serious delinquency rate (90 days or more past due or in the foreclosure stage) for subprime loans had increased to 24.11 percent for ARMs

and 8.73 percent for fixed-rate loans. These delinquency figures are more than four times higher than for prime ARMs and eight times higher than for fixed-rate prime loans.

Subprime borrowers and loans differ from their prime counterparts in a number of ways.

- The average FICO scores of prime loans in Fannie Mae and Freddie Mac portfolios are 721 and 723, respectively, but the average FICO score for subprime borrowers is 621, almost 100 points lower.
- More than three-quarters of prime and near-prime loans have fixed interest rates, but only 48 percent of subprime loans have fixed rates.
- Both Fannie Mae and Freddie Mac portfolios, which comprise mainly prime loans, have average loan to value ratios (LTVs) of 71 and 73 percent, respectively. However, almost 36 percent of subprime loans have LTVs greater than 90 percent and more than 43 percent of subprime ARMs have LTVs in excess of 90 percent.
- The average loan size is \$202,000 for prime and near-prime loans and \$177,000 for subprime loans, but for both subprime and prime loans, the average ARM is 50 to 80 percent larger, respectively, than for a fixed-rate loan.
- The data show that 22.3 percent of subprime borrowers have second liens, 72.6 percent have prepayment penalties, and the average length of the prepayment penalty term is 30 months.

The authors examine which factors played a role in the performance of

subprime mortgage loans. They argue that declining house prices affected the ability of homeowners to refinance or sell, particularly in geographies where there was a big increase followed by a drop in housing prices or where there were poor underlying economic conditions. The problem was made worse because loan-to-value ratios on these loans were higher than they were in the past. Furthermore, the inability to refinance or sell due to declining house prices was a particular problem for subprime ARMs that adjusted in 2007 because the index used to reset

subprime ARM rates was particularly high that year.

The authors close with a graph showing how the proportion of owner's equity as a percentage of household real estate has declined during the past 50 years.

I encourage you to take a look at this interesting study, which is available at [www.philadelphiafed.org/foreclosure](http://www.philadelphiafed.org/foreclosure).



## New Rules on Credit Card Practices and Disclosures

The Federal Reserve Board of Governors has issued final rules to protect credit card users. These rules prohibit certain unfair acts or practices and improve the disclosures received by consumers in connection with credit card accounts and other revolving credit plans.

Federal Reserve Chairman Ben S. Bernanke said: "The revised rules represent the most comprehensive and sweeping reforms ever adopted by the Board for credit card accounts. These protections will allow consumers to access credit on terms that are fair and more easily understood."

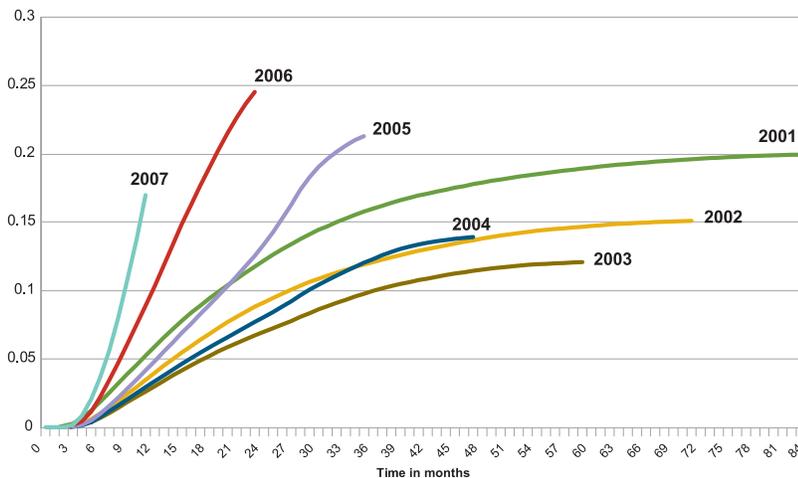
The new rules, which take effect on July 1, 2010, contain provisions that:

- Protect consumers from unexpected interest charges;
- Forbid banks from imposing interest charges using the "two-cycle" billing method;
- Require that consumers receive a reasonable amount of time to make their credit card payments;
- Prohibit the use of payment allocation methods that unfairly maximize interest charges; and
- Address subprime credit cards by limiting the fees that reduce the amount of available credit.\*

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\* The rules were adopted under the Federal Trade Commission Act and were issued concurrently with substantially similar final rules by the Office of Thrift Supervision and the National Credit Union Administration.

**Cumulative Default Rates on Subprime 2/28 ARMs by Origination Year: 2001-2007**



**Owner's Equity as a Proportion of Household Real Estate**



Note: These graphs are figures 8 and 15 in the study.

# Proposed Transfer of REO Properties to Local Partnerships

By Keith L. Rolland, Community Development Advisor

A new effort launched by four national community development intermediaries is attempting to expedite the transfer of real estate owned (REO) properties from financial institutions\* to local partnerships in order to bolster neighborhood stabilization.

The effort, the National Community Stabilization Trust (NCST), was launched as a nonprofit limited liability corporation on October 4, 2008, by Enterprise Community Partners, Housing Partnership Network, Local Initiatives Support Corporation, and NeighborWorks America.

Craig S. Nickerson, consultant during NCST's planning phase and currently its director, said he hoped that NCST's most important contribution in the first half of 2009 would be creating a cost-effective mechanism for transferring properties from REO departments to local collaborations of housing nonprofits and government agencies.

Local partnerships that will receive Neighborhood Stabilization Program



Craig S. Nickerson, Director,  
National Community Stabilization Trust

(NSP) funds from HUD face the formidable task of improving distressed neighborhoods through the purchase of properties from a wide array of prime and subprime lenders as well as Fannie Mae and Freddie Mac, he said.

Nickerson said that while the nearly \$4 billion in NSP funds will only begin to meet the need of acquiring properties and returning them to market, he hoped that NSP participants would seek to maximize leverage of NSP funds with other monies from lending institutions, housing finance agencies, and for-profit developers. The NSP funds, which will become available in early 2009, can be used for the acquisition of foreclosed and abandoned property, property renovation, demolition, new construction on vacant land, land banking, and similar activities.

Asked about the reaction of the financial institutions to NCST's efforts, Nickerson said that "last summer institutions had modest levels of interest in a broad execution, but now that NSP guidelines are clear, servicers are interested in streamlining the property transfer process and are looking for assistance from intermediaries." The servicers don't want to deal with hundreds of entities that want to purchase properties

using federal monies. Further, the REO departments are unfamiliar with HUD's NSP guidelines, he said. The NCST sees itself as "a bridge between the servicer and local housing worlds, helping to rebuild strong markets cost effectively," he added.

The NCST is currently establishing working relationships with six financial institutions – Bank of America, Citi, Fannie Mae, Freddie Mac, JPMorgan Chase, and Wells Fargo. Test runs are being conducted in the

NCST's most important contribution ... would be creating a cost-effective mechanism for transferring properties from REO departments to local collaborations of housing nonprofits and government agencies.

Minneapolis-St. Paul area, allowing the financial institutions to better understand the property transfer process and to work out process or technical glitches. Nickerson noted that not all properties in a locality would flow through the NCST to local housing providers; only properties in targeted areas would be transferred. For example, in Minneapolis, the NCST found that of 3,000 currently foreclosed properties, 2,360 could be sold without intervention in relatively healthy markets. Of the remaining 640 units, an estimated 400 would be acquired and renovated by for-profit developers, 100 might be demolished, and the remainder

\* The institutions are lenders, loan servicers, investors, and government-sponsored enterprises (GSEs).

would be rehabilitated by nonprofits using NSP funds.

The cities of Minneapolis and St. Paul said in a joint press release about the test program that “a key component of recovery efforts is to gain control of properties and then manage the disposition and redevelopment of those properties at a scale large enough to build confidence and stimulate investment.” The cities highlighted the importance of acquiring homes quickly, once the redemption period has passed and before they are listed for sale through traditional mechanisms. Participating financial institutions will provide an offer price and access to the properties for inspection, they said. The buyer of properties in the current test period will be the Greater Metropolitan Housing Corporation in Minneapolis and Dayton’s Bluff Neighborhood Housing Services in St. Paul.

Nickerson explained that the NCST seeks to obtain “a first look at properties when they first come into REO.” Financial institution REO properties typically do not sell quickly in struggling markets coping with many abandoned and foreclosed properties. In such neighborhoods, properties may sit in the servicer’s inventory for many months, resulting in high costs for maintenance, security, and taxes and insurance. By obtaining property from financial institutions quickly, Nickerson said, the NCST can help reduce costs to financial institutions while conveying property to local housing providers at a below-market purchase price.

Nickerson said he expects the NCST to work in 40 to 50 localities in 2009,

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The Greater Metropolitan Housing Corporation (GMHC) in Minneapolis, Minn., has purchased and rehabilitated foreclosed homes such as the ones shown above and sold them to low- and moderate-income buyers. It is one of the organizations expected to acquire, rehab, and sell similar properties under the NCST test program. (Photos provided by GMHC)

# Recent Study Examines Poverty in Atlantic City

By Harriet Newburger, Ph.D., Community Development Research Advisor

Community Affairs departments in the Federal Reserve System across the country, including the Reserve Bank in Philadelphia, recently undertook a joint research project with the Brookings Institution's Metropolitan Policy Program that examined 16 American communities characterized by extreme poverty. An "extreme poverty" community is typically defined as one whose

Most previous research on concentrated poverty has focused on neighborhoods in large central cities. By design, this project studied concentrated poverty in a broader range of settings, encompassing not only this type of city but also smaller cities, rural areas, and Native American reservations. Statistical data from sources such as the U.S. census and interview data collected from residents, service providers, and other stakeholders were used in drawing a picture of the 16 communities and the issues they face.

The research conducted by the Philadelphia team sheds light on the workforce paradox of plentiful jobs co-existing with high rates of poverty and unemployment.

The Community Affairs research team at the Philadelphia Fed studied an area within Atlantic City, New Jersey. This city

poverty rate is 40 percent or higher. Research suggests that communities where poverty is so highly concentrated are associated with disadvantages for households living there over and above those disadvantages that might be expected because of the households' limited resources.<sup>1</sup> Negative effects might be transmitted via a number of avenues. For example, children who grow up in high poverty neighborhoods may have few positive role models, or the quality of public services that a jurisdiction provides may be lower in high poverty neighborhoods than in more affluent areas.

provides a particularly interesting context for examining concentrated poverty. Economic activity in Atlantic City is today dominated by the casino industry. In 2005, for example, the casinos provided almost 44,000 jobs in a city whose total population was only about 40,000; these jobs represented about 78 percent of the city's private-sector jobs.<sup>2</sup> A high proportion of casino jobs are open to low-skill workers, and on any given day, many go unfilled. Yet in 1999 the city's poverty rate was 23.6 percent, while the national rate was 11.3 percent; unemployment stood

at 12.9 percent in 2000, compared to 5.8 percent in the nation.<sup>3</sup> The city's poverty rate is actually a bit higher than before the beginning of legalized gambling in 1978, when the city was in sharp economic decline, following its loss in popularity as a beach resort in the mid-twentieth century.<sup>4</sup> The research conducted by the Philadelphia team sheds light on the workforce paradox of plentiful jobs co-existing with high rates of poverty and unemployment. It also identified concerns that residents have about their neighborhoods and about their future status in Atlantic City.

The geographic area on which the research team focused was made up of three contiguous census tracts in the central to northeastern section of the city, each with a poverty rate above 40 percent in 1999. The tracts, located in an area that has historically been African American, are home to a series of distinct neighborhoods, such as Bungalow Park, a neighborhood of single-family dwellings with many elderly homeowners, and Back Maryland, characterized by a number of HUD-subsidized privately owned housing projects. In 2000, the area contained 7,771 residents, 19 percent of Atlantic City's population.

Socioeconomic data on the study area's residents for 2000 show that unemployment levels were higher

<sup>1</sup> See, for example, Ingrid Gould Ellen and Margery A. Turner, "Does Neighborhood Matter? Assessing Recent Evidence," *Housing Policy Debate* 8 (1997), pp. 833-66, and Christopher Jencks and Susan Mayer, "The Social Consequences of Growing Up in a Poor Neighborhood," in *Inner-City Poverty in the United States*, ed. Laurence E. Lynn Jr. and Michael G. H. McGeary (Washington, D.C.: National Academy Press, 1990).

<sup>2</sup> Data on employment in Atlantic City are available on the New Jersey Department of Labor and Workforce Development's website, [lwd.dol.state.nj.us/](http://lwd.dol.state.nj.us/).

<sup>3</sup> 2000 census. Unless otherwise noted, other statistics for the city and the study area also come from that source.

<sup>4</sup> Data from the 1970 U.S. census, the last decennial census before the advent of gambling, show a poverty rate of 22.5 percent in 1969.

than in the city as a whole, particularly for males (male and female rates were 25.3 percent and 12.8 percent respectively). About 45 percent of family households were headed by females with one or more children under 18, compared to about 26 percent for Atlantic City as a whole. About 44 percent of residents over age 25 lacked a high school diploma, and only 7 percent of this group had completed college.<sup>5</sup>

Eighty-four percent of occupied housing units in the study area were renter-occupied, compared with 71 percent for the city as a whole.<sup>6</sup> About 53 percent of all occupied units in the area were in public housing projects or in HUD-subsidized privately owned housing.<sup>7</sup>

The study area's concentration of poverty would be expected simply based on the concentration of subsidized housing, since it is provided by design for low-income households. The blocks in and around some of this housing have a reputation for criminal and gang activity; residents stressed the need for more free youth activities and school-related programs, particularly within their neighborhoods, to provide



Atlantic City, N.J., looking west from the Absecon Lighthouse. The Borgata Casino is in the background. (Photo: iirraa@flickr)

alternatives to gang membership and drug use. More generally, they noted the lack of physical and social investment in their neighborhoods.

Residents and service providers cited a number of factors that contributed to Atlantic City's workforce paradox. A lack of critical skills necessary for employment – a problem linked to limited educational achievement – was cited in a number of interviews.<sup>8</sup>

New Jersey laws barring individuals with criminal records from many casino jobs limit work opportunities for some residents. The round-the-clock nature of casino work, coupled with a lack of enough safe, affordable child care, affects the ability of employees with children, particularly single parents, to maintain their jobs. Finally, the low-skill service jobs available in casinos or other

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<sup>5</sup> In general, education levels in Atlantic City are low, with 38 percent of city residents over 25 lacking a high school diploma in 2000. The comparable figure for New Jersey in that year was 18 percent.

<sup>6</sup> These numbers stand in sharp contrast to the state, where only 34.4 percent of households are renters.

<sup>7</sup> Data for 2000 are taken from the U.S. Department of Housing and Urban Development and from the 2000 U.S. census.

<sup>8</sup> Atlantic City's graduation rate is about 16 percentage points lower than the state average, despite per pupil spending that is about \$1,500 higher than the state average. Reasons cited for low graduation rates included tensions among different factions of young people in Atlantic City, the lure of selling drugs, and the stigmatization that sometimes occurs for high-achieving students in low-income areas. In addition, one service provider commented that area students, who come directly from their neighborhood elementary schools to a high school shared with students from more affluent communities outside Atlantic City, were unprepared for the competition they faced. (Data on Atlantic City schools are available at the New Jersey Department of Education's website, [www.state.nj.us/njded/](http://www.state.nj.us/njded/).)



## “Juvenile Delinquency” in Nonprime Mortgages

The recent crisis in the housing market has policymakers scrambling to craft programs to deal with its continuing fallout. Much of the effort has been focused on “nonprime” mortgages, which comprise subprime and Alt-A loans. The former are mortgages made to borrowers with some flaws in their credit history, while the latter are generally larger loans made to those who are more creditworthy but choose not to provide the income or asset verification necessary to attain a prime mortgage. Both types of mortgages are typically higher cost than prime loans.

While the dramatic rise in the default of nonprime mortgages has been documented, the cause of the defaults, especially early in the loan, remains a subject of investigation. Such an understanding will assist in crafting measures that address the situation in the short term and help in the structuring of long-term solutions that prevent its reoccurrence. Andrew Haughwout, Richard Peach,

and Joseph Tracy weigh in with a recent study that centers on two possible explanations: relaxation of underwriting standards and changes in economic forces. The following is a summary of their study.<sup>1</sup>

### Background

The authors note that traditionally there are several risk factors (or underwriting criteria) relied upon to gauge the probability that an individual will default on a mortgage. Those factors include the loan-to-value ratio (LTV),<sup>2</sup> the debt-service-to-income ratio (DTI),<sup>3</sup> the borrower’s credit score,<sup>4</sup> and the degree to which a borrower’s income and assets are verified independently through sources such as employers, tax returns, and bank account statements. They further point out that in an effort “to expand the potential pool of borrowers, nonprime (subprime and Alt-A) mortgages by design relaxed one or more of these underwriting criteria beyond the margins required for prime mortgage loans.” As a con-



Marvin M. Smith, Ph.D.,  
Community Development Research Advisor

sequence, the authors indicate that we would expect the default experience of nonprime loans to be worse than that of prime mortgages. The authors report that “industry data confirm that the performance of the very first vintages of nonprime loans was significantly worse than that of prime loans.”<sup>5</sup> They reveal that, starting with the 2005 vintage, the performance of nonprime mortgage loans became markedly worse than

<sup>1</sup> Andrew Haughwout, Richard Peach, and Joseph Tracy, “Juvenile Delinquent Mortgages: Bad Credit or Bad Economy?” Federal Reserve Bank of New York Staff Report 341. It should be noted that the findings reported here are preliminary. To see the report, go to [www.newyorkfed.org/research/staff\\_reports/sr341.html](http://www.newyorkfed.org/research/staff_reports/sr341.html).

<sup>2</sup> The LTV is the ratio of the mortgage balance to the value of the house. Typically, the LTV is represented as a number from 0 to 100 or higher. If the mortgage balance is greater than the value of the house, the borrower has “negative equity” and the LTV will exceed 100.

<sup>3</sup> Similar to the LTV, the DTI is expressed as a number in the study with a range from less than 30 to 40 or higher.

<sup>4</sup> The authors use Fair Isaac Corporation’s FICO score in their analysis. They use the following categories: <600, 600-619, 620-659, and ≥660.

<sup>5</sup> The primary source of data was the National Delinquency Survey published by the Mortgage Bankers Association of America.

prior vintages. “By 12 months following origination, the 2005 vintage had a 90 day or more delinquency rate that was not reached by the 2003 vintage for 20 months, and the 2006 vintage at 12 months had a rate that was not reached by the 2003 vintage even by 30 months.” According to the authors, this precipitous decline in loan performance was puzzling to investors in these mortgages, since the observed risk factors failed to fully explain the trend.

The authors focus their attention on mortgages that exhibit defaults *very* early in the life of the loans, which they characterize as “juvenile delinquents.”<sup>6</sup> In addition, they define an “early default” as a mortgage that is 90 days or more past due during the first year following origination. The authors investigate how much of the sharp rise in early defaults of the 2005 through 2007 vintages of nonprime mortgages can be explained by changing underwriting standards over time (i.e., “bad credit”). They further note that many housing markets experienced a peak in housing sales in late 2005, which was eventually followed by a decline in housing prices. Thus, the authors “also explore the extent to which house price dynamics over the housing cycle as well as other economic factors help explain the early default behavior of the more recent vintages of nonprime mortgages (i.e., ‘bad economy’).”

#### Data and Methodology

The authors draw their mortgage data from LoanPerformance, a San Francisco company. The data provide loan-level information (on a monthly basis) on roughly

7 million active, securitized subprime and Alt-A loans. They use a 1 percent random sample of first-lien nonprime loans, which yields 115,000 loans for analysis. They also add other economic data, such as measures of house price appreciation and labor market conditions.

First the authors examine tabulations on nonprime mortgages, with special attention paid to the early defaults in the mortgages as they relate to the various risk factors mentioned above. Then they use regression analysis to explore the determinants of early default.

#### Results<sup>7</sup>

The authors considered the distribution of early defaults by initial LTV ratio and year for subprime and Alt-A mortgages. They observed that the incidence of early defaults more than quadrupled for both types of mortgages from 2003 to 2007. Also, “for any given range of LTV the early default rate for subprime mortgages tended to be higher than for Alt-A mortgages.”

Likewise, a distribution of early defaults by the DTI ratio from the sample data over the same period showed an increase in the incidence of early defaults for both subprime and Alt-A mortgages but with a relatively common change across DTI intervals.

The distribution of early default rates by FICO scores overtime revealed that early defaults in each

year typically decline as FICO scores increase. Moreover, except for subprime mortgagors in 2006 and 2007, “borrowers with a FICO score of less than 600 are at least three times more likely to experience an early default as borrowers with a FICO score of over 660.”

Finally, the authors classified the underwriting of the nonprime mortgages in the sample as full documentation, low documentation (‘limited-doc’), and no documen-

Fully documented subprime mortgages fell from 77.8 percent in 2001 to 61.7 percent in 2006, while fully documented Alt-A mortgages declined from 36.8 to 18.9 percent over the same period.

tation (“no-doc”). The resulting distribution over time revealed three noteworthy findings. “Despite the focus in the press made on no-doc mortgages, in each year the incidence of no-doc mortgages was in single digits, and was declining over the sample period.” But the authors thought that an even more notable discovery was the shift in underwriting from fully documented to limited documented. The tabulations showed that the share of fully documented subprime mortgages fell from 77.8 percent in 2001 to 61.7 percent in 2006, while fully documented Alt-A mortgages declined from 36.8 to 18.9 percent over the same period. The distributions also revealed that “in each year for subprime

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<sup>6</sup> They point out that “in the case of nonprime adjustable rate mortgages (ARMs), defaults often occurred well before the first rate reset while the initial ‘teaser’ rate was still in effect.”

<sup>7</sup> The authors discuss many findings in their study, but only a few are highlighted here.

# Principles of Sound Central Banking continued from page 1

objectives must be realistic and feasible, and not just what might be desirable.

- **Commitment.** Policymakers must commit to conducting policy in a systematic way over time, even when it seems expedient to abandon it.
- **Transparency.** Policymakers must be as transparent as possible in communicating their policies and actions to the public.
- **Independence.** Experience has shown that monetary policy yields better outcomes when it operates independently of fiscal and political influence.

I believe that these four principles also apply broadly to other central bank roles, including our role in promoting financial stability.

With these guiding principles in mind, I want to mention three areas I believe will be crucial as we move forward: Specifying the objectives for regulatory reform, establishing resolution mechanisms for failing financial firms, and defining the scope and scale of the Fed's role as lender of last resort.

## **A Systematic Approach To Regulatory Reform**

History tells us that financial crises invariably lead to regulatory reforms. Yet, there are risks in rushing into regulatory reforms unless legislators and policymakers establish in advance the guiding principles and objectives for such regulations.

For example, we should aim to lower the chances of financial crisis in the first place by setting capital and

liquidity standards that encourage firms to manage risk appropriately. We also should think about ways to strengthen market discipline, market infrastructures, clearing mechanisms, and resolution procedures that will make our financial system more resilient to shocks.

In addition, rather than focusing on more regulation, we should focus on better regulation. In particular, we should avoid regulatory reforms that stifle innovation. For example, despite the problems with subprime mortgages, the majority of homeowners who financed their homes with these new instruments are meeting their obligations. Indeed, these new types of mortgage products have given many families an opportunity they might never have had before – to live in their own home.

**Rather than focusing on more regulation, we should focus on better regulation. In particular, we should avoid regulatory reforms that stifle innovation.**

We must be careful that heavy-handed regulation does not discourage the kinds of innovations that make such progress possible.

We also should concentrate on financial markets that are critical to the efficient functioning of the payment system, rather than focusing on individual firms. Indeed, it would

be desirable to be in an environment where no firm was too big, or too interconnected, to fail.

Even so, we must be realistic and recognize that no system of financial regulation and supervision can prevent all types of financial instability. Instead, our goal should be to lower the probability of a financial crisis and the costs imposed from any troubled financial institution.

## **Resolution Mechanisms For Failing Financial Firms**

The rationale for banking regulation stems, in large part, from the dangers posed by systemic risk. Systemic risk generally refers to the risk that problems at one financial institution will spill over to a broad set of otherwise healthy institutions, thereby posing a threat to the integrity of the financial system as a whole. This spillover can occur because of linkages among financial institutions through counterparty borrowing and lending arrangements or through payment and settlement systems. Lack of transparency, imperfect or asymmetric information, and uncertainty about exposures can all give rise to such financial contagion.

One of the lessons from the current financial crisis is that, for policymakers, bankruptcy is not an attractive option for a failing financial institution that poses systemic risk. Therefore, policymakers are often left with one of two unappealing outcomes: (1) very costly failures; or (2) very costly bailouts to avoid the failure.

Since normal bankruptcy proceedings make no provision for sys-

temic concerns, we have long had a specialized regime for dealing with bank failures. However, there is no similar mechanism for the orderly liquidation of most nonbank financial firms. So legislators and policy-makers should consider establishing alternative resolution mechanisms for nonbank firms that pose systemic risk as one way to improve our ability to ensure financial stability in the future.

### **The Scope and Scale of the Fed's Role as Lender of Last Resort**

As policymakers and legislators consider regulatory reform, they also will need to define the scope and scale of the Fed's role as lender of last resort. By any measure, we have expanded this role of the Fed to historic proportions to deal with the current financial crisis and to help funding markets function more effectively.

Perhaps the expansion of the scope and scale of Fed lending might not have been so large had we had better resolution mechanisms to deal with such failing firms as Bear Stearns and AIG. And our lending might not have become so wide-ranging had there been better regulations, including more transparency about the markets for mortgage-backed securities and credit default swaps.

Eventually we must consider how to wind down some of these facilities as "unusual and exigent circumstances" abate. We then must consider a systematic approach to how we should operate the discount window in "normal" times, and how we should proceed the next time a crisis arises. Intervening too often or expanding

too broadly the set of institutions that have access to the central bank's credit facilities can create moral hazard, distort the market mechanism for allocating credit, and thereby increase the probability and severity of a future financial crisis.

It can also undermine central bank independence. Just as we know that independence leads to more effective monetary policy, free from fiscal and political influence, I believe independence is vital to a more effective lending policy.

To protect that independence, the central bank's lending policies should avoid straying into the realm of allocating credit across firms or sectors of the economy, which I believe is appropriately the purview of the market. If government must intervene in allocating credit, the fiscal authority should do so rather than the central bank.

### **Conclusion**

To sum up, the past year has been a challenging time for the U.S. economy and for policymakers. The Fed responded to the deteriorating economic outlook and ongoing stresses in financial markets with monetary policy and extraordinary actions to ensure financial stability.

Because of the financial crisis and the response by the Treasury and the Fed, restructuring is occurring in

the financial services industry, and it is clear that when some normality returns to the markets – which eventually it surely will – some type of regulatory reform will be needed.

Some people may think expanding the Federal Reserve's regulatory and

**Setting up expectations that the Fed will surely be unable to fulfill would undermine our ability to achieve our primary monetary policy and financial stability objectives.**

supervisory authority would prevent the types of financial crises we have been experiencing this year. Yet, I believe it is important to be realistic about recognizing the limits of what a central bank can and should do. A modern financial system will never be immune to all financial stress. Setting up expectations that the Fed will surely be unable to fulfill would undermine our ability to achieve our primary monetary policy and financial stability objectives.

As legislators consider regulatory reforms, they should avoid giving the Fed new missions or goals that conflict with the one goal that is uniquely the responsibility of a central bank – price stability – the one objective that cannot be delegated to an agency other than the central bank.

# Proposed Transfer of REO Properties to Local Partnerships

continued from page 5

offering properties from 15 to 20 participating financial institution REO departments. He said geographic areas would be selected based on the presence of a strong degree of collaboration in which a city or county has decided on its use of NSP funds and identified roles; targeting of properties in a concentrated area; a comprehensive strategy in which the partners have identified which properties, if rehabilitated, would have a positive impact; capacity to restore a substantial number of properties; and the ability to leverage capital from NSP funds.

The NCST is housed within NeighborWorks and is expected to have a staff of six by the end of January. Development funding for the NCST has been provided by the Ford and MacArthur foundations and the four national sponsoring organizations.

Nickerson was vice president of expanding markets for Freddie Mac from 1997 to 2008. Previously, he coordinated the National Partners in Homeownership program for HUD Secretary Henry Cisneros. In addition to serving as director of the NCST, he is president of the Nickerson Group, a housing and community development consultant firm in the Washington, D.C., area.

*For information, contact [info@stabilizationtrust.com](mailto:info@stabilizationtrust.com). Related topics may be viewed at [www.stablecommunities.org](http://www.stablecommunities.org).*

## Curriculum on REO Properties

NeighborWorks America (NWA) has developed a new curriculum called "REO Solutions." There are sessions on property assessment, acquisition and financing, approaches to efficiently rehabilitating REO properties, and strategies for selling or leasing REO rehabilitated properties.

NWA will introduce the curriculum at its National Training Institute in Atlanta on February 16 to 20, 2009. Participants can register for individual parts of the course. To register, go to [www.nw.org/](http://www.nw.org/).

NWA trainers will also use the curriculum when sponsoring organizations host training at other locations. For information, contact [sgreenberg@nw.org](mailto:sgreenberg@nw.org).

The curriculum was developed as part of an NWA-Federal Reserve System partnership on efforts to stabilize neighborhoods that have experienced high foreclosure rates.

## N.J. Nonprofit Signs Deal for Mortgages

HANDS, a nonprofit housing developer in Orange, N.J., has embarked on a pilot program to acquire the mortgages of 47 properties (91 units) in New Jersey from one lender. HANDS signed a mortgage loan purchase agreement with the lender in December 2008.

HANDS is raising \$6.5 million for the 91-unit purchase and carrying costs from New Jersey Community Capital (NJCC) and other organizations. Most of the properties are vacant and are located in Essex County. HANDS plans to acquire title to the properties and sell them to community development corpo-

rations for rehabilitation and sale to first-time homebuyers. A major goal is neighborhood stabilization.

Based on the pilot program, HANDS, NJCC, and other participants are attempting to create a public purpose entity that would acquire between 1,000 and 1,500 properties in northern New Jersey. The entity is known as the Community Asset Preservation Company (CAPC).

HANDS and the lender signed a memorandum of understanding in March 2008. The lender agreed not to market the mortgages and to provide information to enable HANDS to assess the properties; HANDS agreed

to a 60-day due diligence period that enabled it to enter into the December 2008 agreement.

Robert Zdenek, president of NJCC, said that some properties will be sold at market rate, while others will be using limited subsidy funds. Zdenek said that to his knowledge HANDS's purchase of mortgages would be the first portfolio purchase of distressed properties by a CDC or CDFI in the U.S.

*For information, contact [robin@handsinc.org](mailto:robin@handsinc.org); [www.handsinc.org/](http://www.handsinc.org/).*

## “Juvenile Delinquency” in Nonprime Mortgages continued from page 9

mortgages, early defaults are more prevalent for limited as compared to fully-documented mortgages,” while the incidence of early defaults in each year for Alt-A mortgages “generally increases as one moves from fully-documented to limited doc mortgages, and from limited doc to no-doc mortgages.”

The regression results yielded valuable insights on the effects of key variables on the probability of an early default (ED) for nonprime mortgages. These are some of the findings:

- As the LTV increases, the likelihood of an ED rises by a similar amount for both kinds of nonprime mortgages.

- Among borrowers with negative equity, investors are more likely to default than owners.<sup>8</sup>
- Borrowers with DTI above 50 (financially stretched) have an ED rate 1.3 percentage points higher than those with DTI below 40.
- The likelihood of an ED rises for subprime loans as FICO scores fall below 680.
- Low-doc underwriting is associated with a higher ED rate: three percentage points higher for subprime loans; 1.3 percentage points higher for Alt-A loans.
- When house prices rise by 10 percentage points, EDs are reduced 1.4 percentage points for subprime owners.

Further statistical analysis centered on examining “the question of the relative importance of credit effects versus economy effects in explaining the sharp rise in early defaults.” Their “results suggest that while both of these factors—bad credit and bad economy—played a role in increasing early defaults starting in 2005, changes to the economy appear to have played the larger role.” However, the authors hasten to add that their estimating model “predicts at most 43 percent of the annual increase in subprime early defaults during the 2005-2007 period.” While the authors have added considerably to our understanding, much is left unexplained—something they are currently working to rectify.

<sup>8</sup>This is consistent with findings in the literature that indicate defaults have transaction costs that can range from 15 to 30 percent of the house’s value. Thus, owner occupants tend to underutilize the default option relative to the prediction of some models. But the authors point out that “investors face fewer of these transaction costs and therefore may be more likely to default for a given LTV level.”

## New Rules on Credit Card Practices and Disclosures continued from page 3

### Disclosures

In addition, the Board adopted final rules that revise the disclosures received by consumers in connection with credit card accounts and other revolving credit plans, ensuring that information is provided in a timely manner and in a readily understandable form. The rules, which amend Regulation Z (Truth in Lending), require changes to the format, timing, and content of credit card applications and solicitations and the disclosures received by consumers throughout the life of an open-end account. The rules follow a comprehensive review of open-end credit

rules. Many of the changes reflect the results of consumer testing conducted on behalf of the Board during its review. These rules also take effect on July 1, 2010.

### Electronic Fund Transfers

Separately, the Board issued for public comment proposed amendments to Regulation E, which concerns electronic fund transfers, to provide consumers with a choice regarding their institution’s payment of overdrafts for automated teller machine withdrawals and one-time debit card transactions. Two alternative approaches are proposed. The

comment period ends 60 days after publication in the *Federal Register*.

### Disclosure Practices Regarding Overdraft Services

Finally, the Board adopted final amendments to Regulation DD (Truth in Savings) to address disclosure practices related to overdraft services of depository institutions. The rules take effect on January 1, 2010.

*For the December 18, 2008, press release, go to [www.federalreserve.gov](http://www.federalreserve.gov), and select news and events.*

# Recent Study Examines Poverty in Atlantic City continued from page 7

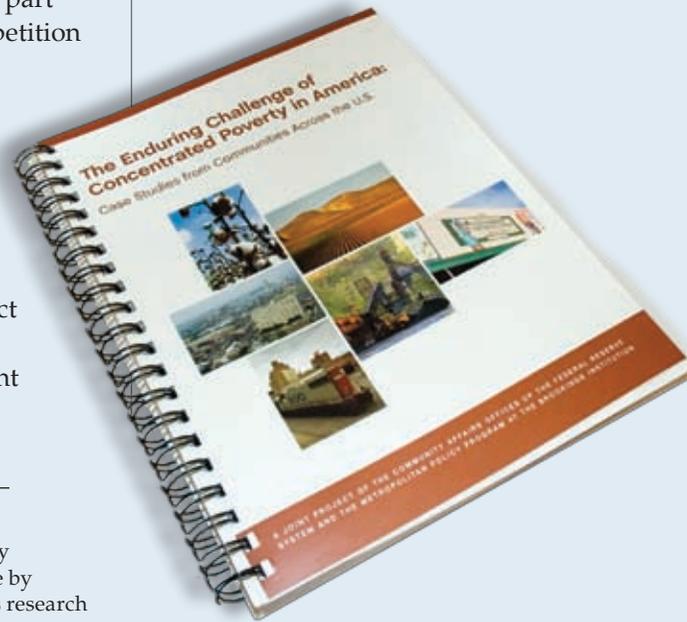
industries may not provide enough income to escape poverty. Residents often noted that they or someone they knew held two or three casino jobs in order to make ends meet.

In addition to concerns about the current quality of life in their neighborhoods, area residents frequently expressed deep concern about their ability to continue to live in Atlantic City in the face of casino-related development. Their fears stemmed from a number of different sources. In one part of the study area dominated by HUD-subsidized but privately owned housing developments, there is some concern that owners will find it profitable to sell their properties once HUD obligations to maintain low-income occupancy expire in the near future. Rapid house-price appreciation in Atlantic City in recent years has also

contributed to residents' fears that affordable housing will become increasingly scarce. Homeowners, particularly elderly residents on fixed incomes, expressed concern that an upcoming property tax revaluation mandated by the state would raise taxes to the point that they would no longer be able to live in the city.<sup>9</sup>

Despite plans for new upscale casinos and retail districts as part of a strategy to counter competition from new gambling venues in nearby states, Atlantic City's actual development path cannot yet be known with certainty. But in a city where the casino industry is so dominant, that path can be expected to have an impact on the well-being of a large part of Atlantic City's resident population.

*The full report on the Federal Reserve's concentrated poverty project, The Enduring Challenge of Concentrated Poverty in America: Case Studies from Communities Across the U.S., can be seen at [www.frbsf.org/cpreport/](http://www.frbsf.org/cpreport/). Single copies are available from: Publications, Mail Stop 127, Federal Reserve Board of Governors, 20th and C Streets, N.W., Washington, DC 20551; (202) 452-3245.*



<sup>9</sup> The revaluation was completed in early 2008. While New Jersey has programs that may assist elderly and low-income homeowners affected by the revaluation, comments made by interviewees suggest that they were largely unaware of the programs in 2007, when this research was conducted.

## Policy Forum on Concentrated Poverty

The Federal Reserve Board of Governors hosted a policy forum on December 3, 2008, to discuss the findings of the report issued recently by the Federal Reserve Community Affairs Offices and the Brookings Institution's Metropolitan Policy Program. (See the accompanying article in this issue that begins on page 6.)

Panel discussions focused on tackling concentrated poverty with human and physical capital investments. Some presentations may be viewed at [www.frbsf.org/cpreport/policy\\_forum.html](http://www.frbsf.org/cpreport/policy_forum.html).



## News and Events

A **Federal Reserve System (FRS) research conference** examining the causes and consequences of changes in housing and mortgage markets and possible policy responses was held December 4 and 5, 2008, at the Board of Governors. The conference was part of the FRS's Homeownership and Mortgage Initiative. To see papers and presentations, go to [www.richmondfed.org](http://www.richmondfed.org) and select conferences and events, and the December conference.

Also as part of its Homeownership and Mortgage Initiative, the FRS has sponsored a series of forums on foreclosure-related subjects. The forums, entitled **Recovery, Renewal, Rebuilding**, have been held on Research and Policy on Vacancy and Abandonment; Strengthening Neighborhoods in Weak Markets; and Confronting the Neighborhood Impacts of Foreclosure. Presentations can be viewed at [www.stlouisfed.org/rrrseries/](http://www.stlouisfed.org/rrrseries/).

The Federal Reserve Bank of Boston has published a discussion paper entitled "**Foreclosure's Price-Depressing Spillover Effects on Local Properties: A Literature Review.**" It may be seen by going to [www.bos.frb.org/](http://www.bos.frb.org/) and selecting community development.

The Greater Philadelphia Urban Affairs Coalition (GPUAC) has issued a winter 2008 edition of its **Foreclosure Prevention Resource Guide**. GPUAC revises the guide quarterly. To access the guide, go to [www.gpuac.org/foreclosurehelp.htm](http://www.gpuac.org/foreclosurehelp.htm).

The Federal Reserve Bank of Chicago invites the submission of research- and policy-oriented papers for the 45th annual Conference on Bank Structure and Competition, which will be held May 6-8, 2009, at the InterContinental Hotel in Chicago. Submissions of high-quality research on all topics related to **financial services, their regulation, and industry structure** are welcome. For information, contact conference chairman Douglas Evanoff at (312) 322-5814 or go to [www.chicagofed.org/index.cfm](http://www.chicagofed.org/index.cfm) and select conferences and events.

"**Economic Development Incentives: Research Approaches and Current Views**" has been published in the *Federal Reserve Bulletin*. The author finds that enhanced incentive disclosures, greater access to local economic data, and stronger methodologies enable researchers to better assess the effectiveness of state and local incentives. Go to [www.federalreserve.gov](http://www.federalreserve.gov) and click on community development.

The FRS conducts a semi-annual **survey of the terms of credit card plans** offered by financial institutions and publishes a report of the findings. Historical data from past surveys are available from 1990. To see the reports, go to [www.federalreserve.gov/pubs/shop/survey.htm](http://www.federalreserve.gov/pubs/shop/survey.htm).

**Joseph Firschein** has been appointed community affairs officer in the Department of Consumer and Community Affairs (DCCA) at the FRS Board of Governors in Washington, D.C. He most recently served as director of REO disposition strategy at Fannie Mae, where he was responsible for creating and implementing strategy for selling Fannie Mae's inventory of single-family homes acquired through foreclosure.

**Allen Fishbein** has joined DCCA as an advisor. He previously served as director of housing and credit policy for the Consumer Federation of America, general counsel with the Center for Community Change, and senior advisor for government-sponsored enterprises at HUD. He has written reports on subprime lending, CRA lending, and other housing topics and serves on a number of advisory councils, including those of NeighborWorks and the Center for Responsible Lending. He can be reached at [allen.j.fishbein@frb.gov](mailto:allen.j.fishbein@frb.gov).

**John Blake** has been appointed acting secretary of the Pennsylvania Department of Community and Economic Development (DCED). He had been executive deputy secretary of DCED and earlier served as vice president and senior development advisor for PNC Bank's northeast and central Pennsylvania markets. He can be reached at [johnpblake@state.pa.us](mailto:johnpblake@state.pa.us).

**Kevin Dow** has become deputy director of commerce for neighborhood and business services with responsibility for the city of Philadelphia's services to small businesses. He previously worked at Wachovia Bank, where he was responsible for the bank's corporate, philanthropic, and employee engagement strategies for the northern region. He can be reached at (215) 683-2018 or [kevin.dow@phila.gov](mailto:kevin.dow@phila.gov).

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