

Stabilize the housing market, ensure affordable rental housing, and help rebuild communities affected by the foreclosure crisis

While the American housing market is starting to recover from the bursting of the housing bubble, the housing market is in a significant hole. The housing crash resulted in approximately \$7 trillion in lost household wealth—causing deep harm to families, as housing has long been the largest source of wealth for the middle class.¹ In addition to almost 4 million completed foreclosures, the crash in housing prices has also resulted in millions of households owing more on their mortgage than the value of their home. These “underwater” homeowners have seen their largest source of wealth evaporate and are left struggling with the aftermath.

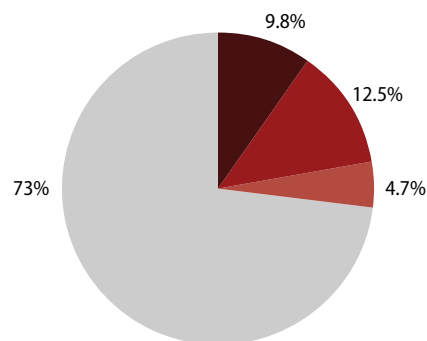
Homeowners aren’t the only Americans being squeezed by the housing market. Renters are paying an increasingly larger share of their income toward housing as rental prices have skyrocketed and earnings have stagnated. Fully 18 percent of all American households are severely burdened—paying more than 50 percent of their income—but 27 percent of renters are severely cost-burdened, which is more than twice the rate for homeowners.²

Policies are needed to deal not only with the aftermath of the housing bubble but also with long-term problems in the housing market, both for homeowners and renters. Reforming the housing market will require action at the federal level but state governments can help address current housing problems while building the foundation for a more sustainable housing market and rebuilding communities.

FIGURE 4
Nearly one in four U.S. homeowners is “underwater”

Percent of mortgages by equity level, second quarter 2012

- Severely underwater (by 25%+)
- Moderately underwater (by 0-25%)
- Nearly underwater (less than 5% equity)
- 5% equity or more



Source: CoreLogic, Second Quarter 2012

Prevent unnecessary foreclosures

Background

The foreclosure crisis has hit American homeowners hard: As of November 2012, banks and other financial institutions had completed approximately 4 million foreclosures since the financial crisis began in September 2008, with another 1.2 million home mortgage loans still in the foreclosure process.³ Earlier this year, Wall Street analysts predicted as many as 7.4 million to 9.3 million at-risk borrowers were yet to face foreclosure or liquidation.⁴

Moreover, the severe drop in home prices has placed between 22 percent⁵ and 28 percent⁶ of homeowners “underwater,” meaning they owe more on their homes than the homes are worth. These homeowners together owe approximately \$700 billion more than their homes are worth.⁷

Foreclosures are typically the least efficient economic outcome for homeowners and investors. The Department of Housing and Urban Development has estimated that median foreclosure “severities,” which is how much an investor loses, are more than \$75,000.⁸ Likewise, the typical foreclosure reduces the value of a house by 27 percent and costs borrowers up to \$7,000 in administrative costs alone.⁹ The costs of foreclosure also spill over into the local and state economies, reducing the value of neighboring houses, destroying consumer credit and purchasing power, and costing local governments billions of dollars in lost property taxes and increased expenses to fight crime and health hazards.¹⁰

For this reason, the prevention of unnecessary foreclosures—situations where the homeowner would like to stay in the home and has the capacity and willingness to continue to pay—is a critical goal for states.

Enact strong servicing standards

Mortgage servicers—companies that manage mortgages for the investors that own most loans in America and that process payments, handle modifications and foreclosures, and provide customer service to borrowers—have become notorious during the crisis for their incompetence and inability to handle the massive onslaught of delinquent borrowers. Servicers have not only failed to competently

serve borrowers but have also routinely falsified documentation about conducting reviews of the information used in foreclosure proceedings.¹¹ What's more, a misalignment of financial incentives means that when servicers act in their own interest, they are often working against the best interest of investors and homeowners. These problems and others have meant that servicers have failed to prevent a very large proportion of unnecessary foreclosures.¹²

New York state has passed exemplary rules requiring all servicers to engage in loss mitigation prior to foreclosure.¹³ Additionally, all servicers are required to have adequate staffing, methods to make sure homeowners only need to submit one copy of documents, and procedures for handling homeowner complaints and inquiries. Servicers may not move toward foreclosure if a homeowner is being considered for, or participating in, a trial or permanent modification, and they must act in good faith and communicate clearly and accurately with homeowners. The state also prevents servicers from placing insurance on a property without informing the homeowner.¹⁴

States should also consider other means to create strong servicing standards. States, for example, can require servicers to have a “single point of contact” for all customer communications so that customers are not shuffled from employee to employee when they have questions or concerns. States can also require servicers to disclose the test used to decide whether to let a homeowner fall into foreclosure—the net present value test—and require that all denied loan modifications receive independent review. Likewise, states can classify a servicer's failure to act in good faith as a defense against foreclosure.

Assist local entities in purchasing nonperforming loans and keeping homes occupied through Hardest Hit Funds or other programs

State policymakers should create or fund programs that purchase distressed or nonperforming loans and aim to keep homes occupied. These programs will prevent stakeholders from incurring the large costs of foreclosure, prevent homes from becoming vacant and contributing to blight, and help homeowners who can be saved remain in their homes.

To do this, states can help fund local entities that purchase mortgages from financial institutions with the explicit intention of avoiding foreclosure and keeping these homes occupied. The local entities would purchase loans at the prevailing

market price for distressed notes. These local entities would use principal reduction and refinancing to make mortgages more affordable, keeping the homeowner in their home when possible. Alternatively, when homeowners cannot keep their homes, the entities would use alternative foreclosure prevention techniques such as short sales or deed-in-lieu of foreclosure and then keep the home occupied.

A good source of initial funding is the Hardest Hit Funds awarded to states by the federal government.¹⁵ Additionally, other Housing Finance Agency funding could be used. These initial funds will continue to have an impact because as assisted homeowners continue to make payments and these loans are sold into the secondary market for mortgages, funds can be recycled to make successive rounds of mortgage purchases.

This type of program is already operating in the Chicago area in the context of a partnership called the Mortgage Resolution Fund.¹⁶ Enabled by an initial infusion of \$100 million from Illinois's Hardest Hit Fund, the Mortgage Resolution Fund purchases distressed or nonperforming mortgages with the intention of reducing principal and performing other modifications to keep homeowners in their homes whenever possible.¹⁷

The Mortgage Resolution Fund targets homeowners who are earning documentable income, are still living in their homes, and want to remain in them.¹⁸ Homeowners who have their mortgage purchased not only receive a chance to reduce their monthly payments and stay in their homes but also receive comprehensive credit counseling that teaches them about developing a sustainable, long-term household budget.¹⁹ Once homeowners have successfully completed counseling and made payments on their modified mortgage for 9 to 10 months, the modification is made permanent and sold on the secondary market; the recycled funds are then used to purchase more distressed or nonperforming mortgages.²⁰ For mortgages that cannot be successfully modified to keep homeowners in their homes, the fund works with community nonprofits to place other occupants in the homes and educates current occupants about foreclosure alternatives and transitioning to more affordable housing.²¹

Besides aiming to keep homeowners in homes whenever possible, the Mortgage Resolution Fund also aims to stabilize neighborhoods by targeting its purchases. The fund purchases only within communities that are low income, have low vacancy rates, have received neighborhood stabilization funds, and are in need of stabilization efforts.²² Initial estimates suggest the Mortgage Resolution Fund is effective: It

expects to be able to modify 60 percent of mortgages purchased—a much higher rate than private equity funds that have made similar purchasing efforts and have kept only about 20 percent to 25 percent of homeowners in their homes.²³

Require servicers to enter into mediation with borrowers before foreclosure

Experience has shown that there are few opportunities for homeowners and mortgage servicers to communicate during the foreclosure process—as a result, servicers often proceed to foreclosure with little or no contact with the borrower. What’s more, these foreclosures are occurring despite the fact that they are economically inefficient, suggesting that both homeowners and those who own mortgages have an interest in preventing foreclosure. In order to combat this problem, state policymakers should require servicers to enter into mediation with borrowers before foreclosure.

In foreclosure mediation, a neutral third-party mediator assists servicers and borrowers to reach a voluntary settlement in their foreclosure proceedings.²⁴ Mediation creates an opportunity for the parties to negotiate an outcome that is superior to foreclosure. It also provides a clear venue for borrowers and servicers to interact—a key step to combating the failings of many servicers in dealing with borrower requests.

Voluntary settlements can take the form of short sales, deed-in-lieu of foreclosures, cash for keys, negotiated departure date, or, commonly, loan modification. Not all voluntary settlements lead to borrowers staying in their homes but these settlements allow the parties to avoid evictions and lengthy foreclosure proceedings.

It is particularly important that states make foreclosure mediation mandatory, meaning that foreclosure mediations are automatically scheduled by a program administrator when the foreclosure process is initiated. The benefits of mandatory mediation are illustrated by Connecticut’s foreclosure mediation program. The Connecticut program initially required homeowners to opt in. Under this policy, approximately 20 percent of homeowners facing foreclosure participated. Since the end of 2009, however, participation has been automatic—homeowners now have to opt out if they do not want to participate. As a result of the change, nearly 75 percent of troubled homeowners have participated.²⁵

Furthermore, the mandatory program has proven remarkably successful at keeping homeowners in their homes. In the opt-in program, 12 percent of all home-

owners facing foreclosure were able to stay in their homes.²⁶ In contrast, with the mandatory program, 67 percent of mediations resulted in the homeowner staying in their homes, meaning about half of homeowners facing foreclosure were able to stay in their homes.²⁷

Expand the supply of affordable and sustainable housing

Background

Middle-class and low-income Americans face an affordability crisis when it comes to housing their families. According to the latest American Community Survey, 42 million households (37 percent of Americans) pay more than 30 percent of income for housing (moderate cost burden), while 20.2 million (18 percent) pay more than half (severe cost burden).²⁸ This problem is only getting worse: Between 2001 and 2010 the number of severely cost-burdened households climbed by 6.4 million.²⁹

The problem is even more severe for low- and moderate-income families who rent. Twenty-seven percent of renters are severely cost-burdened—more than twice the rate for homeowners—and only about a quarter of cost-burdened renters receive federal housing assistance.³⁰ Today there are 5.1 million more low-income renters than there are affordable rental units—more than double the shortfall observed in 2001. Of the affordable units that are available, more than 40 percent are occupied by higher-income renters.³¹ Nor are we creating more affordable housing: Nearly 3 of 10 units renting for less than \$400 in 1999 were lost from the stock a decade later.³² The problem has gotten so severe that in no state can a minimum-wage worker working a standard 40-hour work week afford a two-bedroom unit at fair market rent.³³

The crisis also has implications beyond the housing market. Unaffordable rents are depressing demand for goods and services. Lower-income families in unaffordable housing units spend 50 percent less on clothes and health care, 40 percent less on food, and 30 percent less on insurance and pensions compared to families in affordable units.³⁴

At the same time, there is an urgent need to increase the energy efficiency of our affordable housing stock, much of which was built in the late 1960s and early 1980s with only limited energy efficiency considerations in mind. Not only will

this benefit the planet but lower energy costs will also help lower-income tenants make ends meet or make owners of affordable housing more likely to preserve the units as affordable.

Given these challenges, state policymakers have an opportunity to create a housing market that works for low- and middle-income Americans by expanding our supply of affordable and sustainable housing.

Encourage the rehabilitation of vacant homes and land through land banking

Vacant and foreclosed properties have disastrous effects on neighborhoods, not only depressing property values but also fostering crime and creating health hazards. Moreover, leaving land and homes vacant misses an opportunity to collect property taxes and to put these resources to more productive use, such as in creating affordable housing.

In order to combat neighborhood blight and create more affordable, sustainable communities, states should pass laws to enable land banking and then fund land-banking projects.

Land banks are nonprofits or public authorities that acquire, manage, and develop vacant land and homes. Land banks are enabled by state laws that typically prescribe the forms that land banks take and the means through which land banks are funded and can acquire properties. Land banks typically focus on short-term ownership of land and homes, aiming to demolish homes or remediate these properties before they are sold to private developers for redevelopment.

States should focus on passing or modifying land bank legislation that enables flexible financing of land banks, and enables land banks to acquire properties in innovative ways.

To finance these efforts, state law should give land banks a stable source of financing, permit land banks to raise money on their own, and allow land banks to accept fees from banks and other entities to contribute to costs such as demolition and for upkeep and maintenance on properties the land banks do not formally own.

To facilitate acquisitions, state law should enable land banks to acquire properties through purchase; through transfers from banks, nonprofits, and other govern-

ment agencies; and through an expedited foreclosure process through which land banks can receive properties without sheriff's auctions.

Whenever possible, land banks should cooperate and coordinate with partners in the private sector and at all levels of government. Land banks should also have clear goals, including, whenever possible, a requirement that land be dedicated to affordable housing and in line with other planning priorities, such as sustainable urban planning and economic development.

Policymakers looking for an example of innovation in land banking can turn to Ohio and the experience of the Cuyahoga County Land Reutilization Corporation, or CCLRC. In 2009 Ohio updated its previous laws on land banks. The bill tasked land banks to work on a regional scale, gave land banks the ability to acquire foreclosed properties without appraisal or sale, and enabled land banks to fund themselves in the innovative ways mentioned above.³⁵

The Cuyahoga County Land Reutilization Corporation was able to take advantage of two rounds of federal Neighborhood Stabilization Funds and issue a \$9 million bond.³⁶ Likewise, the organization signed memoranda of understanding with municipalities within its jurisdiction to spell out the land bank's powers and priorities. Finally, the Cuyahoga County Land Reutilization Corporation entered into innovative partnerships with Fannie Mae, which sold low-value foreclosed properties to the organization and worked with banks, which not only donated foreclosed properties but also contributed to demolition costs.

Encourage affordable housing through inclusionary municipal zoning laws

States should pass laws that encourage municipalities and localities to zone a certain percentage of their residential units for affordable housing.

Today there are 5.1 million more low-income renters than there are affordable rental units—more than double the shortfall observed in 2001. And of the affordable units that are available, more than 40 percent are occupied by higher-income renters.³⁷

Given the high and rising cost of housing in many parts of the United States, governments have an interest in promoting affordable housing for working families who can't afford housing at the market rate. Many localities have implemented successful "inclusive zoning" laws that require a certain percentage of new housing

units to be rented or sold at an affordable rate or price. The vast majority of communities, however, have zoning laws that exclude or greatly inhibit the creation of rental housing affordable to the great majority of average working families.

State governments should encourage and even require inclusionary zoning in local communities. Massachusetts has been a leader in this area. Under chapter 40b of Massachusetts state statutes, local communities are required to have at least 10 percent of their housing stock meet affordability standards.³⁸ If communities do not meet this requirement, affordable housing developers can obtain a permit to build affordable housing through an override of local zoning laws, with an appeal before the state zoning board.³⁹ This provision allows developers to build affordable housing in areas previously zoned off limits by local governments. New Jersey also requires municipalities to provide a certain percentage of affordable housing, but the localities only have to submit a plan and the enforcement mechanism has weakened over time.⁴⁰

States should enact legislation similar to the Massachusetts model requiring communities to set aside, or allow, a certain portion of housing units for affordable housing. Under this model localities can adopt local zoning that encourages rental development in areas the municipality has determined are best suited. If a municipality continues to have exclusionary zoning, then the requirement would be enforced by developers who can override local zoning barriers, with appeals to a state-run zoning board.

Provide tax incentives to encourage the development of affordable housing units

States should target tax incentives to increase the development of affordable housing units.

Governments have an interest in encouraging the private sector to supply and operate affordable housing. Experience over decades has demonstrated that in many communities, without some sort of assistance from the public sector, private developers are unlikely to produce enough rental housing to meet demand.⁴¹ In order to be affordable to working families, rents need to be at levels generally below the rates charged by private, for-profit developers given the cost of producing and financing housing.

Property tax abatements are one way to potentially help alleviate these problems. While state governments should be careful to ensure that property tax abatements are not allowed to undermine the tax base, state leaders should consider allowing cities to use property tax abatements to reward developers that provide affordable housing—either by improving the targeting of existing tax incentives or by creating new ones.

Several states have programs that reduce tax burdens for affordable housing developments. Illinois, for example, provides for a reduction in property taxes depending upon the number of renters who use federal Section 8 housing vouchers. The program reduces the assessed value of the units leased to voucher holders by 19 percent therefore decreasing the landlord's taxes.⁴²

And New York state's 421a property tax abatement program—originally designed to spur all housing development—has recently been adjusted to encourage affordable housing development in high-cost areas as well. The program identifies high-cost zones in which private developers must construct at least 20 percent of new units as affordable to low-income households in order to qualify for the property tax abatement.⁴³ Reforms to the 421a program also added several requirements to the program including provisions requiring that affordable housing be built on-site and a prevailing wage be paid to workers who provide care or maintenance for buildings receiving benefits.⁴⁴ These tax abatements can last between 10 years and 25 years depending upon the location of the building and the number of affordable units.⁴⁵

Finance energy-efficient retrofits of multifamily properties

Roughly 6 million apartments, representing approximately 17 percent of the nation's stock of rental housing, are subsidized to serve low-income families. Most of this affordable rental housing was built with only limited energy efficiency considerations in mind. Energy retrofits of existing apartments can increase energy efficiency by 25 percent to 40 percent, leading to substantial savings in the affordable housing system—and in those cases where tenants are paying energy costs, more disposable income for lower-income families.⁴⁶ Moreover, these retrofits cost just \$2,000 to \$5,000 per unit.⁴⁷

There are, however, multiple barriers to such retrofits, particularly in the lack of targeted, efficient capital through loans, grants, or rebates that work with existing subsidized finance.⁴⁸ Consequently, some states are addressing the need for such financing with innovative programs such as Pennsylvania's Smart Rehab, which

has combined federal weatherization program funds with other grant and loan sources to retrofit multifamily housing developments that house lower-income individuals and families.⁴⁹ The Smart Rehab program has taken other innovative steps, such as securing foundation funding to train energy auditors. Current estimates suggest that the program will achieve an average reduction in energy costs of 25 percent to 30 percent and preserve 10,000 units of affordable housing over the next three years.⁵⁰

Help families access homeownership

Background

The foreclosure crisis and resulting credit crunch has hit middle-class and low-income homeowners hard. With so many families losing their homes, the U.S. homeownership rate has fallen from 69.2 percent in 2004 to 65.4 percent in the first quarter of 2012—the lowest level in 15 years.⁵¹ Creditworthy borrowers who want to buy a home face a difficult environment due to the lack of availability of credit: Lenders originated about \$505 billion in home purchase loans in 2011, compared to a peak of \$1.5 trillion in 2005.⁵²

Moreover, credit standards have gotten much tighter since the crisis began. In 2007 the average Fannie Mae-backed loan covered 75 percent of the home's value—meaning the borrower covered the other 25 percent through down payments and mortgage insurance—and went to a household with a credit score of 716. Last year's average loan covered just 69 percent of the home's value and the average borrower had a credit score of 762.⁵³

Expand down-payment and closing-cost assistance programs

Lack of savings for down payment has long been recognized as a key barrier to homeownership for lower-wealth families.⁵⁴ Similarly, a lack of savings makes it difficult to pay the costs of closing on a house—costs that can run from 3 percent to 6 percent of the home purchase price.⁵⁵

Fortunately, state policymakers can rely on a proven method for helping families achieve homeownership: down-payment and closing-cost assistance programs.

These programs assist borrowers with down payment and closing costs either through grants or loans. Typically, borrowers do not need to repay unless they rent or sell their home within a relatively short period of time or stop using it as their principal residence. Additionally, borrowers may be required to attend housing counseling classes to ensure they are educated about the responsibilities and risks of homeownership.

When designing or expanding down-payment and closing-cost assistance programs, policymakers should ensure the programs can only be used to offer safe mortgage products and explicitly forbid predatory loan features such as negative amortization, balloon payments, and seller-financed down payment assistance.⁵⁶ Additionally, in order to use public funds most efficiently, these programs should be targeted to low- and moderate-income borrowers.

Studies and experience have shown that down-payment assistance is an effective and safe tool to encourage low- and moderate-income borrowers to become sustainable homeowners. Research by the Federal Reserve Bank of Cleveland, for example, has shown that down-payment assistance is more cost effective at creating new homeowners than interest-rate subsidies.⁵⁷ Moreover, state policymakers have a model of an especially effective down-payment and closing-cost assistance program in Massachusetts' SecondSoft Program.⁵⁸

In the SecondSoft Program, borrowers receive financing for up to 97 percent of the first home's price; a 3 percent down payment is required, but only half must come from the borrower.⁵⁹ The home is paid for with two loans: The first loan is a conventional, 30-year, fixed-rate, fully amortizing loan. The second loan, which finances 20 percent of the price, is a fixed loan and carries a fixed rate but only requires interest payments for the first 10 years, keeping the costs to the borrower down while the borrower builds equity in the home through the first mortgage. Borrowers must have low or moderate income and must also complete a pre-purchase education class.

In its two decades of existence, the SecondSoft program has used a small public subsidy to finance \$2.5 billion in lending and help more than 15,000 borrowers buy their first home—between 10 percent to 20 percent of all eligible households statewide.⁶⁰ Furthermore, the SecondSoft program has done nothing to increase the likelihood of default: SecondSoft loans have a serious delinquency rate (90-plus days delinquent or in foreclosure) below that of prime loans in Massachusetts, and as of fiscal year 2010, the program had a default rate of just 3.4 percent since its inception.⁶¹

Protect tenants during foreclosure

Background

The foreclosure crisis has not exclusively affected homeowners: Tenants living in rental properties also face eviction when their building goes through foreclosure. In an effort to protect the rights of tenants, Congress passed the Protecting Tenants at Foreclosure Act of 2009. The act states that new owners of a property cannot require tenants to vacate until the conclusion of their prior lease, or for at least 90 days after they are notified—whichever is later.⁶²

While the Protecting Tenants at Foreclosure Act is an important step toward safeguarding tenants during foreclosures, numerous problems remain:

- The tenant protection act has no regulatory mechanism at the federal level, and enforcement at the state level has not been consistent.⁶³
- Despite the fact that renters have very different rights in a foreclosure than homeowners, few advocates are aware of local laws in these situations.⁶⁴
- The act will expire on December 31, 2014, and few states have enshrined the protections in the act in their state law.⁶⁵
- The act fails to address many abuses tenants face during foreclosure—for example, it does not prohibit eviction of some or all tenants without “good cause” or require that tenants be notified about their rights before foreclosure occurs.

By taking proactive steps detailed below, however, states can address these problems.

Enforcement of the protections in the Protecting Tenants at Foreclosure Act has not been consistent or strong. Many “notices to vacate” violate the law; tenants are sometimes given misleading “cash for keys” offers, in which tenants accept a payment to vacate quickly without being told they have the right to stay; and some owners make no effort to communicate with tenants or determine whether the properties are occupied.⁶⁶

Enforce, strengthen, and make permanent the Protecting Tenants at Foreclosure Act

Because the Protecting Tenants at Foreclosure Act expires in 2014, states should adopt its protections into state law. Maryland has incorporated these tenant protections into state law without a sunset date.⁶⁷ If necessary, a state should include provisions permitting enforcement by state agencies. Maryland's other efforts worth replicating include requiring that tenants be notified before foreclosure occurs about their rights, and that their property may fall into foreclosure.⁶⁸ Additionally, Maryland requires that tenants receive timely notice of who owns their rental property after foreclosure and how to pay rent.⁶⁹

Another exemplary state when it comes to tenant protection is Connecticut. Its Office of the Attorney General worked with legal service attorneys to send “cease and desist” letters to more than 30 violators of the law’s protections.⁷⁰ Connecticut also prohibits eviction of elderly or disabled tenants living in multifamily properties without “good cause” such as failure to pay rent or violation of rent terms, meaning that foreclosure is not sufficient cause for eviction.⁷¹

Finally, states should pursue public education and outreach efforts to ensure that tenants understand their rights.

Use National Mortgage Settlement Funds to support housing

Background

In February 2012 federal prosecutors and 49 state attorneys general finalized the National Mortgage Settlement with the nation’s five largest mortgage servicers. In addition to other payments, \$2.5 billion of the settlement involves direct payments to states, which states can decide how to spend.⁷² The settlement agreement specifies that this portion of the settlement (\$2.5 billion) is intended to “compensate the States for costs resulting from the alleged unlawful conduct of the Defendants”⁷³ by giving them funds for “purposes intended to avoid preventable foreclosures, to ameliorate the effects of the foreclosure crisis, (and) to enhance law enforcement efforts to prevent and prosecute financial fraud.”⁷⁴

Yet many states are using their settlement money to fill their budget gaps rather than to revive ailing communities and support the housing recovery. So far, only 23 states are using substantially all of the money on housing-related initiatives, while five are using none of their award on housing. States have announced plans to spend \$977 million on activities related to housing and foreclosure prevention. They will divert \$989 million to states' general funds for nonhousing initiatives,⁷⁵ and \$588 million of settlement money is still uncommitted.⁷⁶

State policymakers should use as much of the settlement money as possible on housing-related issues. And while it may not be possible to recover the money that has been diverted for other uses, states should at a minimum use the remainder of the state's uncommitted money to revive the housing market, prevent unnecessary foreclosures, and help struggling communities. Below are some suggestions for how states can use the settlement money.

Provide housing counseling

Housing counselors provide education, training, and technical assistance to prospective and current homeowners and renters. Research shows that housing counseling benefits both homeowners and lenders. Prepurchase housing counseling can reduce delinquency by 19 percent up to 50 percent,⁷⁷ and postpurchase counseling not only doubles the likelihood that homeowners will get a loan modification but also improves the terms they get on that modification.⁷⁸ Given its effects in reducing defaults and preventing foreclosures, housing counseling is important both for our economy's recovery and for a future sustainable housing market.

Typically, the cost of housing counseling ranges from \$500 to \$1,500.⁷⁹ Given the magnitude of funds from the settlement, states have an opportunity to provide counseling to many prospective homeowners.

Fund legal aid

Nonprofit legal aid groups are increasingly strapped for cash at a time when they are needed most. The Brennan Center for Justice reports that fewer than 15 percent of borrowers in foreclosure in some communities had any legal counsel.⁸⁰ Legal aid is an often underfunded and ignored piece of the housing puzzle that is essential for helping underprivileged communities deal with the housing crisis.

While the services offered are often similar to housing counseling, legal aid advocates see a different community of clients, and they can also help clients pay for their mortgages by ensuring that the homeowner is paid wages appropriately and can access any public benefits for which they are eligible.

Encourage principal reduction

State policymakers have an opportunity to devote settlement funds to a proven technique to reduce defaults and prevent unnecessary foreclosures: principal reduction. Principal reduction lowers the amount of the loan in exchange for a greatly increased chance of repayment.⁸¹ Recent research suggests that loan modifications that include principal reduction not only maximize value for lenders⁸² but also lead to far lower rates of default.⁸³

Two good examples of using state funds for principal reduction are the Nevada and California Hardest Hit Fund programs. In California the Housing Finance Agency is using those funds to target delinquent homeowners. The program reduces principal on Fannie Mae and Freddie Mac loans, after which the borrower's loan is recast at the lower principal balance, making the monthly payments much more affordable and restoring homeowner equity.⁸⁴ Nevada's Housing Division is using those funds to assist deeply underwater homeowners who have remained current on their mortgage payments. In that program the state's housing division reduces principal balances for homeowners with Fannie and Freddie loans who qualify for the Home Affordable Refinance Program, or HARP, thereby enabling them to refinance into a loan that has both a lower interest rate and a lower principal balance.⁸⁵

Principal reduction, as one of the most effective ways to prevent default and right-size underwater mortgages, should be a centerpiece of any housing plan for National Mortgage Settlement funds. Unfortunately, only four states have reported plans to use settlement money for loan modification programs.⁸⁶

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