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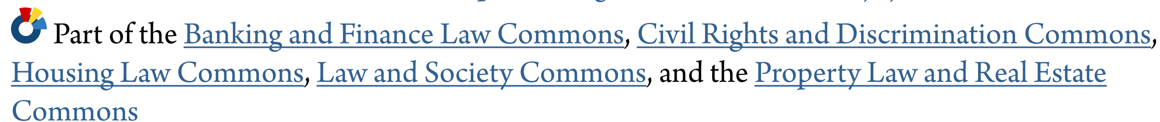
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MORTGAGE SUPPLY CHAIN FAILURE AND INNOVATION

LISA DAVIS*

Abstract: The standard mortgage supply chain is so costly and inefficient that large national banks have dramatically scaled back their provision of mortgages to low- and moderate-income households. Absent regulatory requirements, subsidy, improvement in the way the mortgage supply chain works, or maybe all three, low- and moderate-income households will continue to be underserved by those banks with the largest share of the mortgage market. A number of factors contribute to this problem, including expensive marketing costs and commissions, as well as the obsolete, paper-based technology for loan production. Arguably, the national banking system has never excelled at providing fairly priced mortgages to low- and moderate-income borrowers or in low- and moderate-income communities without external motivation, and furthermore, has still not dealt with a history of discrimination that underlies this lack of capacity. While community development organizations, local and regional banks, and credit unions have developed small local capacity to address these credit gaps, we need a system for scaling up and integrating the ability to serve this sector of the market. For example, we need a method for integrating the housing counseling system and the risk mitigation benefits it provides into the loan origination process and secondary market pricing.

This Article envisions a new way of organizing the community development sector in order to expand sustainable credit to qualified low- and moderate-income borrowers. To reduce costs, the existing housing counseling system would be tapped to provide outreach and marketing in place of the marketing structure used by mortgage brokers and banks. In this new supply chain, housing counseling agencies would refer loan applicants to community development financial institutions (CDFIs) or credit unions, which would originate mortgages at reduced cost. To further limit costs, marketing would be shifted to a technology platform that would allow applicants to apply online and connect housing counseling agencies to CDFIs and secondary market buyers. CDFIs would be con-

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nected to one another and able to share, standardize and manufacture not only loan products but also efficient systems for delivering them both to consumers and the secondary market. The Article closes by describing two initiatives that are seeking to create a national marketplace of CDFIs, linked to the housing counseling system, to create a wholesale conduit for home loans.

Introduction

According to recent Urban Institute estimates, 6.3 million more mortgage loans might have been made between 2009 and 2015 if underwriting standards prevailing in 2001, when lending was relatively safe, had been used. (Goodman, Zhu & Bai 2016, 1). This credit contraction post-2008 disproportionately affected lower-income and minority households. (Goodman 2017, 235, 250). There are perhaps many reasons for the insufficient amount of mortgage lending to low- and moderate-income households and to communities of color, but one that is perhaps overlooked is that the big banks have decided not to do it because they don't have a workable business model for it. (Andriotis 2016, 1; McCoy & Wachter 2017, 4). The decisions by big banks to refuse to lend to this population of homeowners is not because of regulation and not because of credit scores. It is because the business model of lending to low- and moderate-income (LMI) borrowers and people of color does not work for the big banks. So if the big banks are pulling out of lending, what do we do to make sure that average Americans can get home mortgages?

This in turn raises the question, why do we care about ensuring a sufficient provision of LMI mortgages? The first reason is access. Residential mortgages are the primary way that people get access to the middle class in this country. Disparities in access to credit also represent a huge aspect of inequality, which is the racial wealth gap. This shortage of adequate mortgage credit in our communities produces a disparate racial impact, both in terms of wealth and income, which drives inequality. Although the U.S. Supreme Court recently upheld the disparate impact theory in housing discrimination cases (Texas Department of Housing and Community Affairs v. The Inclusive Communities Project, Inc. 2015, 2525–26), proving disparate impact remains difficult. Disparate treatment of individuals is easier to establish. However, proving disparate impact and proving it in a way that actually drives towards a solution and an agreement that is going to ameliorate the problem is much more difficult.

We also need to care about access to mortgage credit because everybody is affected. Ultimately, that includes the big banks. At some point the banking system will need to realize that there will not be the same base of retail customers that the banks are used to without the wealth-building potential that home ownership represents. There will be fewer and fewer people who can afford to buy consumer goods and services on the scale they could ten years

ago. For these reasons, an efficient mortgage system is critical to the economic future that we would all like to see.

I. The Mortgage Supply Chain

The mortgage supply chain is a critical component of an efficient mortgage system. The supply chain refers to the operational system both for delivering mortgages to borrowers and financing those mortgages. This is not as much about policy as it is about the business practices and the institutions that allow for the provision of mortgages in the private sector.

To illustrate the complications in the mortgage supply chain, I have broken that chain down into two parts: an origination part and a secondary market and servicing part. Figures 1 and 2 demonstrate that there are different actors at each step of the way that are not interconnected. Consider housing counseling agencies, which may interact with borrowers at points during the home-buying process. Studies have shown that counseling provided by these agencies can mitigate risk and thus loan losses on the back end. (*See, e.g.*, Brown 2016, 167–68; Quercia & Riley 2017, 328–29). Indeed, housing counseling can mitigate risk to such an extent that if we had a better supply chain, secondary market buyers of those mortgages would price them more efficiently. But currently, we do not have a mortgage supply chain system that actually establishes communication between the risk mitigation that happens on the front end through counseling, all the way into pricing in the secondary market.

There are other failures along the way. Of these, the main failure is that the supply chain is very expensive. The cost of producing a mortgage loan is more than double on average what it was in 2009. (Cosgrove 2015, 8). The Mortgage Bankers Association reports that in first quarter 2016, it cost $7,845 on average for non-depository mortgage lenders to manufacture a loan. (Mortgage Bankers Association 2016, 2). If bank origination costs are comparable to those of non-depository lenders, no wonder banks are not extending mortgage loans of $100,000 or less. In order to have a business model that works for low-value loans, loan manufacturing costs need to come down. Thus, we must come up with a way to improve the supply chain so we can manufacture low-value loans more efficiently. If you look at mortgage loan production costs, a substantial amount goes for marketing and sales. (*Id.*). These are costs to both the brokers and the banks. In contrast, if the housing counseling system was at scale and connected to a mortgage delivery system using technology-based underwriting and manufacturing, it could actually be an effective outreach and marketing arm at a much lower cost.

We also lack an integrated supply chain that is connected to a technology platform for mortgages in the way that, for example, travel companies or tax returns or car buying are connected. We have the tools and knowledge to create

such a technology platform, but are not currently doing it for the typical low- and moderate-income (LMI) borrower. Quicken and like platforms exist for borrowers that fit both the conforming mortgage box and lender overlay standards for higher credit scores for these loans. We could lower the manufacturing cost per loan, especially non-conforming loans, if we migrated the marketing of mortgages to a technology platform where customers could apply successfully online. Furthermore, the different disconnected actors in today's mortgage supply chain are not there to actually deliver an efficient, well-priced high-quality low-risk mortgage to customers outside of a very small credit and underwriting box. Instead, those actors are there to make their fees or to pursue some other agenda that is not related to borrower needs.

If the big banks are not going to provide high-quality mortgages to underserved borrowers, who will? We have now reached a point where we can scale up a community lending system built on standardized products and operations, and housing counseling agencies. This type of system would route the mortgage manufacturing process through a network of community development financial institutions (CDFIs) or credit unions, resulting in more choices for people and a lower cost basis.

Such a system would require a community lending infrastructure that was different in a couple of ways. Currently, the community development industry remains a cottage industry. It does not offer a high degree of standardization or transactional performance. CDFIs often have highly localized loan products, making it difficult both to manufacture loans at scale and to sell them into the secondary market. They often focus on one type of loan or borrower because that's the type of subsidy or access to capital they have at the moment, to the detriment of serving a broader LMI market. Likewise, housing counselors are often more focused on social outcomes and are not driving towards a loan at the end of the day. These other outcomes are important, but they do not help people achieve homeownership at scale.

II. The Emergence of Integrated Supply Chains

New conceptions of the community development industry, however, are starting to emerge. National community lending networks are starting to think about the mortgage supply chain holistically and how it could connect across networks. Figure 3 shows a schematic design for the NeighborWorks Organization Shop Program, which seeks to connect housing counseling through the loan manufacturing process to a secondary market vehicle, and all the way back into evaluation. NeighborWorks has about 240 members around the country. They range from very small nonprofits to mid-sized regional nonprofits and many of them do some mortgage lending, although it is not their main activity. These member organizations are not very efficient and most of them are

not self-sufficient through their lending operations. In addition, most of them operate as mortgage lending operates—paper-based and disconnected from capital providers. But they are making attempts to unite that system more carefully.

Another emerging national community lending network is The National Mortgage Collaborative, which is funded by the Ford Foundation. The National Mortgage Collaborative is based in a community development financial institution (CDFI) in Riverside, California, named Springboard. When I was at the Ford Foundation, I convened a group of the highest-performing single-family mortgage CDFIs in the country and asked them the following: Can we solve the low- and moderate-income (LMI) credit gap problem? Can we look at the supply chain? Can we make it more efficient? Can we establish a technology platform? Can we connect counselors to secondary market performance? How do we do this? The challenge was to break through the cottage industry mentality.

A breakthrough came in the form of the California Road Home Program (the "Program"), which was a Home Affordable Refinance Program (HARP) initiative doing mortgage refinances and loan write-downs. The Program had developed a consumer-facing technology platform and a back office manufacturing hundreds of loans a week that were designed to keep people in their homes. The operation was relatively high-touch, compared with much of the industry, and was built with a $13 million investment from the U.S. Department of the Treasury. When the HARP program was nearing its end, that investment was due to sunset, and the National Mortgage Collaborative at Springboard proposed repurposing the Program's technology platform to serve a national marketplace of CDFIs to create a wholesale channel for loan originations. The technology platform would also connect housing counselors all the way through to secondary market buyers. This proposal got underway and the Program launched the technology platform that was repurposed from the HARP program to originate loans in September 2016.

Figure 4 depicts Springboard's mortgage delivery system. At the center of operations is the technology platform, which connects housing counseling agencies to CDFIs and eventually to the capital market. Figure 5 provides an illustration of two screenshots from the app. It looks like Quicken Rocket or any other interface where customers can plug in their data and get loans at the end of the day. It is very customer-friendly.

In a next step, the National Mortgage Collaborative began to offer private-label products and private-label web portals for all of their collaboration members. The leadership council that helped them to develop this product—and that will continue to help develop the capital market component—includes some of the largest and highest-performing single-family CDFIs in the country, as well as organizations such as the Massachusetts Affordable Housing Alli-

ance (MAHA). The National Federation of Community Development Credit Unions is working on something similar.

Another important opportunity is an initiative by the national network of HUD housing counseling agencies. For years we have been trying to figure out how to pay HUD counselors for counseling. The banks are not going to pay for it. They did a little bit in the glory days but not so much and not consistently. Springboard and the National Mortgage Collaborative have committed to paying these housing counselors for any loans that they manufacture. Thus, in contrast with the banks, the National Mortgage Collaborative model provides a way for housing counselors to get paid consistently. The model also treats counseling as a throughput for an actual mortgage over time.

Partner organizations in this housing counselor pilot project benefit in numerous ways. They can earn income while delivering enhanced value to their clients through increased product offerings and better transparency. In addition, they can originate mortgage loans wholesale for licensed lenders and CDFI partners. Other benefits include counseling agreements for groups performing homebuyer education and pre-purchase counseling, additional homebuyer education tools, enhanced collateral, and assistance in deploying local down payment assistance funds. One question is how to fund a startup like the National Mortgage Collaborative, and how to fund the operational capacity to deliver at the national scale? By scale, we are not talking about thirty-two mortgages per organization per year; we are aiming for an aggregate of tens of thousands of mortgages around the country in this space per year.

Conclusion

The goal of the integrated supply chain is to make a dent in the 6.3 million person mortgage gap (Goodman, Zhu & Bai 2016, 1), not to think about it in little individual chunks. It offers great promise for large national banks to meet their Community Reinvestment Act and duty to serve obligations. They can either fund a functional supply chain for low- and moderate-income (LMI) borrowers or become integrated into directly. Some of them are starting to step up. But the way the integrated supply chain gets paid for is to recognize that this is a critical part of the banking system. One way or another, banks are responsible for the provision of these mortgages as part of their charters and as a part of national policy of a duty to serve. Nonprofits also have to focus on performance, and performance at scale and delivering loans that allow them to be self-sufficient over time. This system will require an initial operating subsidy and upfront capital infusion, but hopefully over time it will become an independent, self-sufficient system.

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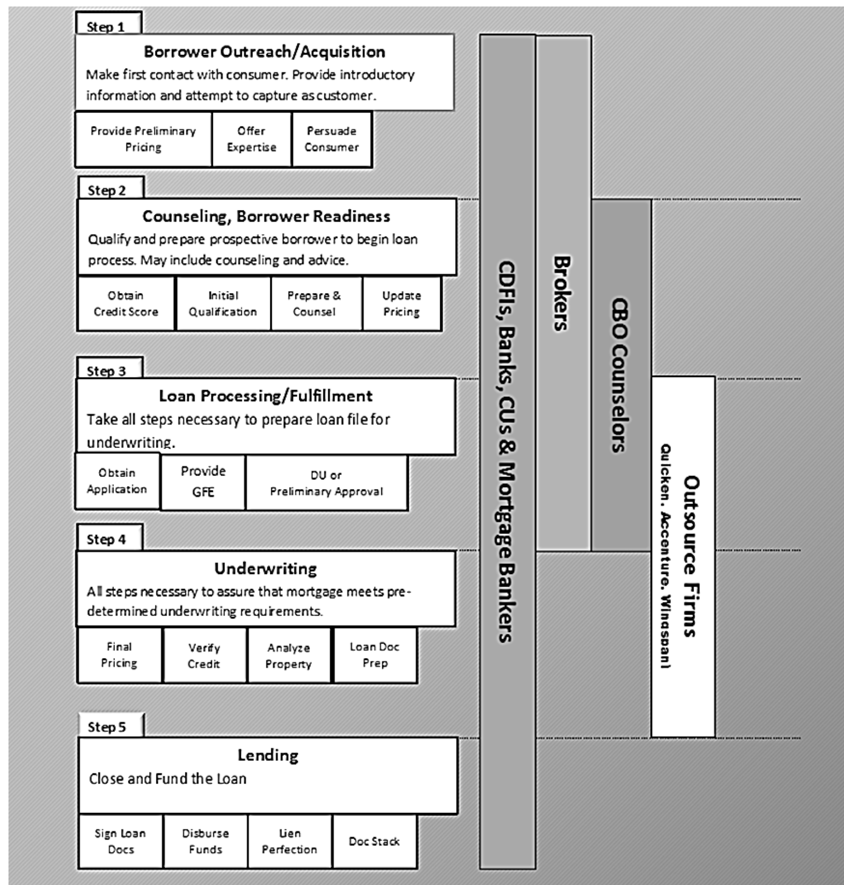
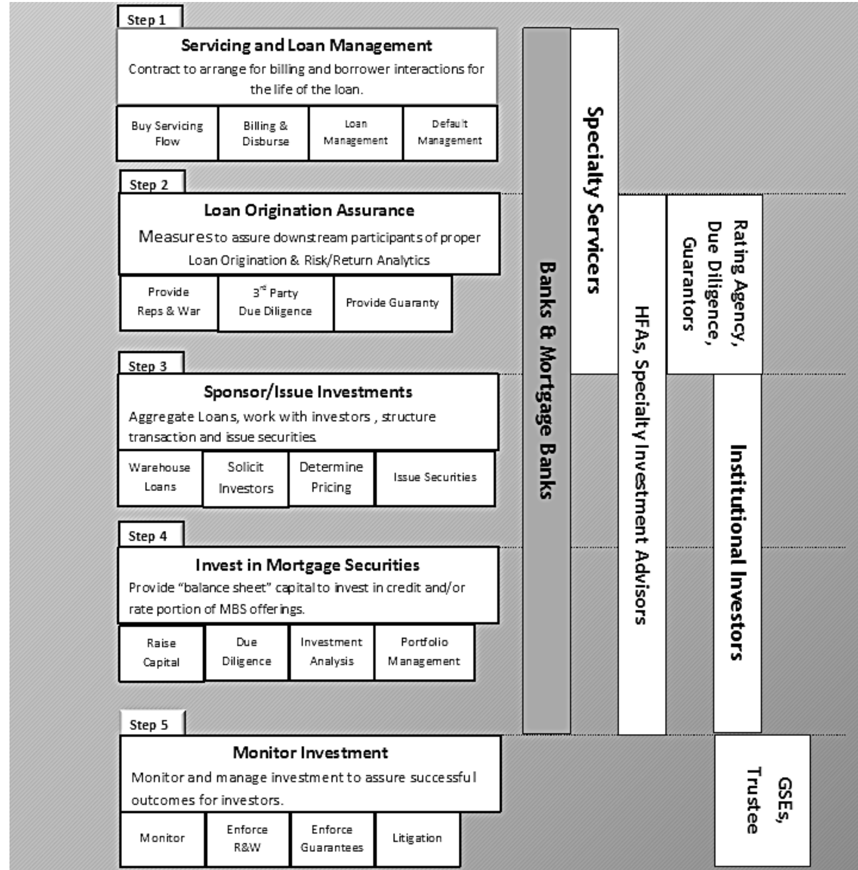
Figure 1. Mortgage Supply Chain Phase 1: Origination



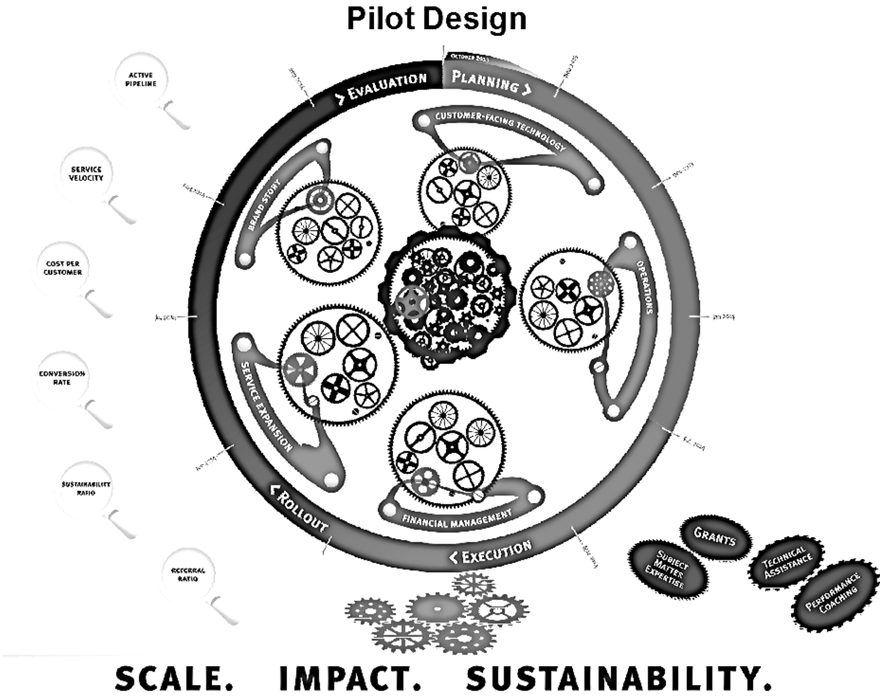
Source: Tim Duncan

Figure 2. Mortgage Supply Chain Phase 2: Secondary Market and Servicing



Source: Tim Duncan

Figure 3. Schematic Design of NeighborWorks Organization Shop Program



Source: NeighborWorks America

Figure 4. Springboard Mortgage Delivery System

National
Mortgage
Collaborative

A New Mortgage Delivery System

Connecting the people, products, and process at scale, the National Mortgage Collaborative approach combines the efficiency of **technology and centralized services**, with deep local connections and vital services provided by **partner HUD Orgs & other CDFIs**; with access to a **marketplace of affordable mortgage products** from investors at partner banks, GSEs, Credit Unions, and other capital providers, in conjunction **with down-payment assistance** where available.

SPRINGBOARD.ORG

Figure 5. Two Screenshots from Springboard App