5 Features of Successful Housing Finance Reform

By Sarah Edelman and Gregg Gelzinis December 14, 2017

In the coming weeks and months, Congress may again take up the question of how best to structure the housing finance system so that it serves families well during the coming decades. As soon as this week, Sen. Mike Crapo (R-ID), the chairman of the Senate Committee on Banking, Housing, and Urban Affairs, could release a new bill that is currently circulating among committee members.[1] The path that policymakers choose will affect both who can buy homes and at what price; the availability of affordable rental housing; and whether the housing system remains strong and secure in the event of a future economic downturn—without having to rely on help from taxpayers.

Nearly a decade ago, Fannie Mae and Freddie Mac, the government-sponsored enterprises (GSE) that promote liquidity and affordability in the housing market, teetered on the edge of bankruptcy. In 2008, Fannie Mae and Freddie Mac received a $187.5 billion capital infusion from the U.S. Department of the Treasury and were put into conservatorship by their newly created regulator, the Federal Housing Finance Agency (FHFA).[2]

Since the conservatorship, dozens of publications and several bills introduced in Congress have outlined options for strengthening the housing finance system. These plans have been diverse, ranging in focus from preserving the precrisis system in its entirety to fully privatizing and upending the current system.[3] In recent months, stakeholders have come closer to agreeing on important features of housing finance reform. However, significant differences persist.[4]

The Center for American Progress believes that policymakers should first build on the aspects of the housing finance system that have worked. For example, it has supported the growth of the middle class and helped produce much-needed affordable rental housing over the past decades. Policymakers also need to be clear-eyed about the history of the housing finance system if they want to address what went wrong in the lead-up to the crisis: a lack of consumer standards for mortgages; an unregulated private mortgage securitization system; and shareholder incentives that drove Fannie Mae and Freddie Mac to make risky business decisions. This issue brief first outlines the history of the housing finance system. It then details five features necessary for successful housing finance reform. The brief is based on testimony CAP provided to the House of Representatives Subcommittee on Housing and Insurance earlier this fall.[5]

The history of the housing finance system

Prior to government intervention in the housing market, which began in the aftermath of the Great Depression, homeownership was only an option for the wealthiest families. To buy a home, people often had to make down payments of 40 percent to 50 percent, and mortgages were often short term, requiring refinancing at potentially higher interest rates.[6] Fannie Mae, Freddie Mac, the Federal Housing Administration, the Department of Veterans Affairs, and the GI Bill all helped make homeownership accessible to America's middle class.[7] The affordable, 30-year fixed rate mortgage, which has helped millions of families build wealth and share wealth across generations, has been made possible by this federal support.

Starting in the late 1990s and early 2000s, risky mortgage loan products began to emerge. These predatory products—poorly underwritten loans with exploding interest rates and prepayment penalties—would eventually trigger the housing crisis.[8] These products became prevalent because there was growing demand from Wall Street firms to buy them from lenders.[9] Wall Street firms needed these loans to grow their securitization operations: They packaged high-risk loans into private mortgage-backed securities that they passed off to investors as high-quality assets.

As the private securitization market grew, Fannie Mae and Freddie Mac's share of the securitization market declined.[10] The enterprises faced growing pressure from shareholders as they lost market share to Wall Street firms and made bad business decisions, such as lowering underwriting standards to accept loans with high down payments but little documentation of income and filling their investment portfolios with Wall Street mortgage-backed securities.[11] Although the enterprises did not cause the housing crisis, they did put themselves in great financial danger in the pursuit of market share and shareholder returns.

Any legislation that seeks to build a stronger housing finance system and prevent history from repeating itself should include the following five features to be effective:

1. Preserving access to affordable, sustainable mortgages for all qualified borrowers in all areas of the country
2. Structuring the system in such a way as to prevent a race to the bottom on consumer standards and pricing
3. Ensuring mortgage guarantors are well-capitalized and well-regulated
4. Providing access to small lenders
5. Prioritizing America's renters

1. The system should preserve access to affordable, sustainable mortgages for all qualified borrowers in all areas of the country

Because Fannie Mae and Freddie Mac rely on support from taxpayers across the country, the enterprises are required by law to serve all markets in all economic conditions.[12] This means that the enterprises are required by their charters to serve the entire national market—they are not allowed to specialize in one region, for example, while refusing to do business in another. They are also required to serve low- and moderate-income borrowers, even if it means they earn less on these loans than they would on those made to higher-income borrowers.[13] These requirements are especially important for borrowers living in distressed rural and urban communities, which are often deprived of investments from financial institutions.

Congress ensures the enterprises are meeting their public purpose by requiring them to meet affordable housing goals and to comply with the duty to serve provisions contained in the 2008 Housing and Economic Recovery Act legislation.[14] While these measures are not perfect, they provide guidance to the enterprises; help ensure that they are serving qualified borrowers across the geographic and income spectrums; and help ensure that they are not hampering liquidity for loans originated by primary market lenders to these borrowers and communities.

Going forward, CAP believes that Congress should build upon these requirements. If the federal government is providing a government guarantee on mortgages issued through the new system, which nearly all stakeholders now support, we should ensure that all taxpayers have the opportunity to benefit from the system.

Critics of these rules say that they caused the housing crisis by encouraging the GSEs to buy risky loans that eventually triggered the crisis. But the evidence does not support this claim. GSE lending standards remained stronger than those in the private market in the lead-up to the crisis, resulting in far lower default rates on GSE-backed loans than on loans securitized by Wall Street firms.[15] Moreover, in the years leading up to the crisis, the GSE share of the mortgage market dropped significantly, limiting their ability to lead the market.[16] Postcrisis research has largely rebutted claims that the housing goals, or the GSEs for that matter, caused the housing crisis.[17]

Given the enormity of the affordable housing challenges facing U.S. communities, Fannie Mae and Freddie Mac—or their successors—should make a larger contribution to affordable housing than they do today. To improve upon the current system, CAP believes that the enterprises should use a 10 basis points annual fee on any government-insured securities issued in a new system to finance three funds dedicated to affordable homeownership and rental housing. These funds include the existing National Housing Trust Fund, Capital Magnet Fund, and a new Market Access Fund that the federal

guarantor should use to support market-expanding efforts. Today, the National Housing Trust Fund and Capital Magnet Fund are creating affordable housing options for low- and moderate-income households; 2016 recipients of Capital Magnet Fund awards are likely to develop 17,000 affordable housing units.[18] A 10 basis point fee directed toward these three funds could generate about $4.5 billion annually, according to the Urban Institute, which could help meet the demand for affordable housing.[19]

These funds are not a replacement for a requirement that enterprises, or their successors, serve the entire mortgage market or policies to enforce compliance with this requirement. On their own, the funds will not ensure that the housing finance system serves all qualified borrowers. Moreover, the political risk that Congress will not support these funds in the future, or will limit their effectiveness by making large cuts to critical housing programs the funds will then need to offset, makes them insufficient for guaranteeing access and affordability.

Congress should also ensure that any future system does not significantly raise the cost of taking out a mortgage. One way to ensure that costs remain manageable for all qualified borrowers is to require the enterprises or their successors, as much as possible, to price mortgages based on the total credit risk across their business instead of on an individual loan basis. Today, for instance, private mortgage insurance companies tend to charge middle- or low-income borrowers with average credit far more than higher-income borrowers with pristine credit.[20] Through their loan-level pricing adjustments, the enterprises, to a lesser extent, have also been pricing mortgages based on the loan-level risk since 2009, driving up the cost of their credit and contributing to a diminished share of financing for borrowers with low down payments and/or weaker credit scores.[21] This pricing structure puts a greater cost burden on the households that most need to reduce monthly expenses. Policymakers should be careful not to encourage pricing policies that would make mortgage credit more expensive for working families.

2. The system's structure should help prevent a race to the bottom on consumer standards and pricing

The structure of the housing finance system—in particular, the number of entities permitted to issue mortgage-backed securities with government backing—will determine whether the system is easy to regulate and whether consumers are well-served. Two proposals that have drawn significant attention over the past year envision a new system with many entities that provide the services currently provided by Fannie Mae and Freddie Mac.[22]

While consumers benefit tremendously from competition among primary market lenders, they are unlikely to benefit much from significant competition among mortgage guarantors. In fact, in the lead-up to the housing crisis, too much competition in the secondary market triggered a race to the bottom on consumer standards and pricing. Firms lowered standards to increase their share of the mortgage market.

While it can be argued that this competition did encourage lenders to open the credit box, allowing borrowers with average and lower credit scores and down payments to qualify for mortgages, few would argue that the predatory lending facilitated by this competition was sustainable or desirable.

It is true that there are some downsides to having fewer entities, including the likelihood that the federal government would need to provide financial support if the entities ran into trouble during a crisis. However, CAP believes that through well-aligned incentives, strong capital standards, and regulation, policymakers can ensure entities' safety and soundness through a downturn. Moreover, a system with many guarantors does not safeguard the system from bailouts. As leading mortgage analyst Andrew Davidson put it in a recent report, "Even if there are multiple guarantor entities, it is likely that if one is failing the others are likely to be under pressure. Government might still need to intervene. Further, the risk isn't just that they fail, but the damage that is done as they race toward the bottom."[23]

3. The system should be well-capitalized and well-regulated

America needs a strong, sustainable housing finance system for the decades to come. Strong regulation and adequate capital standards are needed to ensure the system's long-term health.

In 2008, Congress created a new regulator to oversee Fannie Mae and Freddie Mac called the Federal Housing Finance Agency. Prior to the crisis, regulation of Fannie Mae and Freddie Mac was split between the U.S. Department of Housing and Urban Development and the Office of Federal Housing Enterprise Oversight, neither of which had sufficient regulatory authority.[24] Today, FHFA can set capital standards, set executive compensation, and approve new products, in addition to other important authorities.[25] This regulatory structure is appropriate and should be preserved or built upon in any new system.

During the housing crisis, Fannie Mae and Freddie Mac did not have sufficient equity to withstand their mounting losses.[26] The federal government stepped in and provided an infusion of capital to put them on solid ground. In the future, the enterprises or their successors should have enough equity to withstand losses and continue to do business in a crisis scenario.

Credit risk transfers should be treated with caution

With that in mind, Congress should be careful not to create a system that is overly reliant on credit risk transfer (CRT) transactions as a primary source of capital, as some have proposed.[27] CRTs are financial transactions, insurance, and reinsurance agreements that the enterprises use to transfer credit risk from their books to the private sector.

First, back-end CRT structures are no substitute for equity for protecting a company against losses—nor are they intended to be. Congress and regulators should not treat them like equity when considering capital requirements for the enterprises or their successors. Strong prudential regulations, including robust equity capital requirements, liquidity rules, counterparty credit limits, and rigorous stress testing remain the best way to ensure that taxpayers are not on the hook for future losses. Congress and regulators should not put CRTs on par with equity when considering capital requirements for the enterprises or their successors.

If counterparties are unable to meet the terms of the CRT, especially in a time of broader stress in the mortgage market, that credit risk may return to the balance sheet of the enterprises. To the extent that the enterprises or their successors continue to pursue these transactions, Congress and regulators should require capital to be held against CRT structures—depending on the quality and quantity of collateral in the transaction—to protect taxpayers against the risk that the enterprises or their successors may have to absorb losses on the CRT transactions. Beyond the counterparty risk associated with these transactions, the FHFA has outlined additional risks that the enterprises retain when transferring credit risk through CRT transactions.[28] These risks must be considered when factoring capital and collateral requirements associated with these transactions.

Second, the enterprises or their successors should continue to develop the CRT market at their own discretion. Congress should not require them or their successors to use these transactions. According to University of Pennsylvania Wharton School Professor Susan Wachter, requiring mortgage guarantors to commit to a certain volume of CRT is inefficient. Such a policy "encourages transactions where the cost of risk transfer is greater than the cost of the GSE retaining the risk and thereby raises the cost of mortgage lending."[29]

Third, the CRT market is unlikely to function well during weak economic times. Mortgage guarantors should be encouraged to build equity that they can draw on during a housing downturn. This is important not only for their ability to withstand credit losses but also so that they can continue to do business in weak economic conditions. In terms of CRT transactions, it is also unclear whether mortgage guarantors would force losses on CRT counterparties during a time of stress in the mortgage market if those losses would result in the failure of one or more institutions. Furthermore, if the CRT market dried up during weak economic times, there may be significant risk that the enterprises must unexpectedly retain the credit risk of purchased and securitized mortgages that they were planning to but can no longer transfer through CRT transactions. In weak economic times, guarantors may not have high enough capital levels to take on this unexpected credit risk, and it may be difficult and costly to raise additional capital.

Fourth, as the enterprises continue to move from fully collateralized CRT deals toward partially collateralized ones, it may become harder to ensure that the respective CRT counterparties will be able to provide coverage when needed. The enterprises or their successors must ensure that CRT transactions are conducted with quality counterparties to limit counterparty risk.

Finally, front-end CRT transactions, which take place at the time a mortgage is originated, could drive up prices for consumers unless they are well-structured and regulated. As described earlier, private mortgage insurance companies tend to price based on the individual risk of a loan instead of spreading the cost of the risk across their business to all borrowers. Unless the mortgage insurance companies agree to level price mortgage risk or the guarantors commit to offsetting the cost, middle- and lower-income borrowers will likely pay higher rates.

4. The system should provide access for small lenders

For decades, the number of community banks has continued to dwindle at a steady pace.[30] It can be difficult for these institutions to compete against larger financial institutions, particularly when it comes to accessing the secondary market. Any housing finance reform legislation should help level the playing field between small and large lenders rather than exacerbate the advantages already available to larger lenders.

Furthermore, any legislation should ensure that small lenders can continue to sell loans to the enterprises or their successors directly through the cash window, as they can today. It should also preserve changes put in place since the crisis that prohibit the enterprises from giving special deals to firms that sell more loans to them.[31] These preferential rates put smaller firms, which make and sell fewer loans, at a disadvantage.

Additionally, a requirement that the enterprises or their successors serve all markets across the country is especially important for small lenders. There is not always a business advantage to serving small lenders and smaller, rural communities; a mortgage guarantor can be profitable by focusing on larger lenders in wealthier markets where larger home loans are originated. Small lenders in rural areas, however, need access to the secondary market in order to continue to offer mortgages throughout all market conditions.

5. The system should prioritize America's renters

One in 4 renting households cannot afford their monthly rent.[32] This challenge is not limited to families living in high-cost cities; rather, it is spread out across the nation. A worker earning a minimum wage cannot afford a two-bedroom apartment in any U.S. state, according to the National Low Income Housing Coalition, as two-bedroom monthly rental prices exceed 30 percent of a minimum wage earner's monthly income across the country.[33]

These headwinds do not appear to be letting up anytime soon. By 2025, 15 million households could be unable afford their rent, a 25 percent increase over 10 years, according to Enterprise Community Partners and the Joint Center for Housing Studies.[34] When

a family stretches to pay rent each month, they are likely forgoing important investments in retirement, education, and health care. For many families, this rental burden also means they are one paycheck or rent increase away from being out on the street.

Fannie Mae and Freddie Mac make it possible for building owners to make renovations to keep their units habitable. They also pave the way for the construction of rental housing—most of the mortgages financed through the enterprises are for rental units that are affordable to households earning less than the local-area median income.[35] Going forward, the enterprises or their successors should continue to play this role, and their regulator should consider more ambitious affordability targets.

Conclusion

Over the past nine years, members of Congress have spent many hours debating the future of the housing finance system. As they prepare to resume this work, they should focus on how any proposed changes will affect borrowers and the long-term health of the housing finance system. They should be guided by a clear account of history to preserve aspects of the system that have served America well and effectively address system weaknesses.

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