Expanding Access Through Responsible Innovation: The Market Access Fund

By the Mortgage Finance Working Group January 8, 2014

An essential goal of a reformed housing finance system must be to serve all markets, including low- and moderate-income communities, communities of color, and other underserved or hard-to-serve markets. To help meet this goal, we recommend that the new system include a Market Access Fund, or MAF, which would enable private-sector participants in the new system—such as lenders, issuers, and guarantors—to safely and sustainably serve the broadest possible market. The MAF would provide grants and credit enhancement to support product research and development aimed at these markets. It would also encourage testing at a scale sufficient to enable commercial evaluation of new products and processes. Over time, private actors would adopt successful models without the need for further subsidy.

In this fact sheet, we will address common questions about the MAF and provide details about its many economic benefits.

Why is the Market Access Fund necessary?

Our mortgage market currently underserves many communities with creditworthy borrowers who can sustain homeownership but who may not be—or may not appear to be—as profitable for the financial system to serve as those in other communities or with other demographic characteristics. One of the reasons for this market failure is that it is sometimes challenging for market participants to invest in what is required to serve those markets, including:

- New products, services, and systems that serve a limited segment of the market, particularly segments that may be difficult to reach or evaluate using mainstream outreach and processes
- Products that have characteristics differing from standard, well-known products and that are not well understood or may appear to be riskier

- Innovations that require significant up-front investments in product development or system design

Only the secondary market has the reach, scale, and potential for standardization to develop and test the marketability and performance of such products. The MAF would provide resources to help the secondary market work with the primary market in developing responsible products, services, and system innovations.

What would the Market Access Fund do?

The MAF would make funds available on a competitive basis to research, pilot, and evaluate innovative programs to expand access to and address gaps in housing finance. It would use a prudent and experimental approach: If a product or process worked, it could be moved to commercial-level testing and eventually brought to the broader market, but if it failed—if, for example, it had excessive default rates or experienced a poor uptake rate—it would be abandoned or developed further based on initial experiences and tested again.

MAF funds could help defray some of the upfront costs that new products and process innovations entail. It is costly to develop and model new product structures, underwriting standards, counseling protocols, and specific servicing measures; establish specialized tracking systems and early warning indicators; do outreach to find originators to offer products; or prime the pump in other ways. The MAF could also offer credit enhancement for products with an uncertain risk profile, such as lending that supports newer or less-understood activities.

The following are some examples of innovations that the MAF could potentially support:

- **Reserve funds and homeownership success.** To make a down payment and pay closing costs, low-wealth households often use the bulk of their savings to acquire a home. But new homeowners with additional liquid reserves have lower default rates.[1] Using credit-enhancement funds from the MAF, grantees such as lenders, guarantors, and issuers could attract capital to buy loans from lenders who experiment with requiring smaller down payments from borrowers while also requiring them to contribute to a dedicated reserve fund. MAF funds also could defray lender costs of marketing and servicing this new product. Such experimentation could demonstrate whether participating borrowers experience lower default rates than similar borrowers who make somewhat higher down payments but have fewer reserves.

- **Energy efficiency and underwriting.** Household energy costs in this country are about $230 billion annually, making up 15 percent of the total cost of homeownership for average families and even more for lower-income families.[2] Research has found a clear association between home energy efficiency and loan performance, but more research is needed to quantify that link and incorporate it into the mortgage qualification process.[3] Lenders in markets with high energy costs could test using energy savings to adjust their loan underwriting, supported by secondary market institutions with MAF credit-enhancement or product-development funds.

- **Affordable housing preservation.** The cost of refinancing loans for affordable rental properties can make it difficult for owners to maintain their properties without setting rents prohibitively high. As a result, affordable units disappear from the market. Yet replacing these units is less efficient and more expensive than preserving them.[4] MAF resources could be used to explore whether loans with longer terms, lower costs, or lower levels of credit enhancement perform sufficiently well under different market conditions to win broader acceptance from commercial multifamily lenders. The MAF could also support exploring approaches to improve the sustainability of existing affordable rental properties by reducing utility costs.

- **Process innovation.** In the market for smaller apartment buildings, it would be useful to develop new forms of appraisal and building quality studies that can reduce the cost of underwriting while yielding better information about the profitability and risk related to these buildings.

Who would run the MAF?

A dedicated office at the public guarantor would run the MAF. Locating it there would be efficient, as most parties will already deal with the guarantor in their core business activities. It would also ensure strong coordination between the public guarantor's safety and soundness activities—which would be concerned with the prudent use of any government funds—and the MAF's purpose. Both the grant and the credit-enhancement parts of the MAF would be run as competitive rather than formula-based programs.

Who would be eligible to apply for MAF awards?

The MAF staff would establish criteria for allocations of direct subsidy and credit enhancement. Applications for research and development funds for initial product development would likely come from single entities, but applications for credit subsidy and larger awards should require a team that can demonstrate a mechanism for both primary market origination and delivery into the secondary market. Such teams could include many different partnerships of nonprofit and for-profit financial institution lenders; Community Development Financial Institutions, or CFDIs; state and local housing finance agencies; private mortgage insurers; mortgage-backed securities, or MBS, issuers; and MBS guarantors. Applications should be rewarded for risk sharing and for leveraging MAF funds with other capital sources.

How would the MAF be funded?

A modest fee of 10 basis points—or 0.01 percent—on all mortgage-backed securities, including those using the government guarantee and securitizations that are entirely private, would fund the MAF, as well as the previously established National Housing Trust Fund and Capital Magnet Fund. The fee would be structured as a "strip," like the monthly servicing fee, meaning that it is assessed periodically for the life of the loan. The funds would accumulate as mortgages are securitized under the new system, and after five years, the annual contribution to all three funds combined would be in the range of $2.5 billion to $8 billion.[5] The size of the MAF matters because without very significant dollars available, it is unlikely that primary lenders or secondary market entities would have sufficient incentive to compete for its grants and credit enhancements.

How would the MAF differ from the National Housing Trust Fund and Capital Magnet Fund?

These three funds support different parts of the market through very different mechanisms. The National Housing Trust Fund is a formula grant program in which the Department of Housing and Urban Development, or HUD, gives states grants to support rental housing for extremely low- and very low-income families. The Capital Magnet Fund, administered by the Community Development Financial Institutions, or CDFI, Fund at the U.S. Treasury, provides grants to CDFIs and other nonprofits to support rental housing for low-income families.

Can the MAF also support rental-housing innovation?

Yes. Many rental properties need attention from the private secondary market but are unlikely to get it without some incentive, particularly rural rental housing, small properties, and rental housing that serves low-income seniors. Financial product and process innovation to serve these segments would be eligible for MAF funding.

Would the MAF completely replace Fannie Mae and Freddie Mac's "housing goals" and "duty to serve"?

No. The MAF is a critical piece of a new approach to housing finance that would provide a form of direct and transparent subsidy to support innovation that expands access and reaches underserved markets. The "housing goals" and "duty to serve" rule encourage Fannie Mae and Freddie Mac to support lending to certain underserved communities and housing types.

The MAF and an affirmative charge to serve all markets are crucial elements of a well-functioning housing finance system. But other elements must be part of reform legislation as well, in order to ensure that the system can serve all markets at all times. For example, the system will need to take a comprehensive approach to data collection, analysis, and evaluation to ensure that all qualified borrowers have affordable and safe access to mortgage credit regardless of geography, population demographic, or housing type.

Won't the MAF encourage risky lending?

No. On the contrary, the MAF encourages—through carefully designed and monitored experimentation—the development and testing of responsible lending products to serve the changing demographics of the United States in all markets at all times. This approach contrasts with the so-called innovation of the mid-2000s, during which time untested products, such as hybrid adjustable-rate mortgages, negatively amortizing loans, and no-documentation loans, were rapidly and inappropriately mainstreamed with no regulatory oversight.

Would the MAF become a permanent subsidy program like HUD programs?

No. Although it would serve as an ongoing mechanism for research and development, the MAF would not permanently support products. It would instead focus on innovation, design, and testing, with the intention of creating products and programs that could either become mainstream offerings of the conventional market or become eligible for ongoing subsidy from other programs. Some of the projects would be of longer terms than others, and credit enhancement would need to remain in place for the term of the loans made during the trial period. Once created and tested, some processes and products will be proven feasible. These can be adopted by lenders without further support and become regular features of the primary and secondary markets. Some will fail and will not be offered beyond the proof-of-concept stage, while others may prove useful for state Housing Finance Agencies or government agencies but not for the broader secondary market. In some cases, it may become clear that permanent subsidies are needed, and the MAF results will help enable policymakers to consider such needs based on empirical data and market-tested approaches.

Why should private securitizations also pay the fee that finances the MAF and other funds?

The market as a whole benefits from greater liquidity, stability, and access to credit, and it thrives when the first rungs on the homeownership ladder are accessible and stable. With shifting demographics, homeowners of the future are more likely to be minorities, younger, and less wealthy.[6] Figuring out safe and sustainable ways to enable these families to develop stability and build savings through affordable, quality rental housing—and to acquire an affordable mortgage for their first homes—benefits the whole market. Furthermore, as stable, affordable housing provides a basis for economic opportunity, the ripple effects for the rest of the economy will go well beyond the housing market.

The government's longstanding support of the mortgage market has provided a framework that benefits all mortgage lending, even those loans made without explicit government involvement. For example, the jumbo market—the market for loans that are larger than those eligible for Fannie Mae and Freddie Mac to purchase—is modeled on standards and processes established by Fannie and Freddie. Looking to the future, government-sponsored enterprises are building a common securitization infrastructure—a platform for issuing mortgage-backed securities that would also serve non-guaranteed transactions. Additionally, products developed and tested in the government-supported market could ultimately be adopted by other segments of the market, and the oversight and macrostability framework maintained by the government enables all segments to function better.

Conclusion

Creating a Market Access Fund would help our mortgage market responsibly innovate and therefore better serve all communities and creditworthy borrowers. It would do this by providing grants and credit enhancement to support responsible innovations that reach hard-to-serve markets. After these innovations are piloted, the broader market could adapt those that prove successful, allowing more and more communities access to safe and sustainable mortgage credit. The MAF is an important part of a reformed housing finance system that supports the housing needs of all communities and families.

The Mortgage Finance Working Group is a group of housing finance experts, affordable housing advocates, and leading academics who started meeting in 2008 to better understand the causes of the mortgage crisis and to discuss policies that will shape the future U.S. mortgage market.

***Correction, January 8, 2014:** The original version of this issue brief contained ambiguous language about how the Market Access Fund would be funded. The current version has been corrected to clarify the source of funding.*

Endnotes

1 See, for example, Stephen L Ross, "Mortgage Lending, Sample Selection and Default," *Real Estate Economics* 28 (4) (2000): 581–621; James A. Berkovec and others, "Race, redlining, and residential mortgage loan performance," *The Journal of Real Estate Finance and Economics* 9 (3) (1994): 263–294.

2 Bob Sahadi and others, "Home Energy Efficiency and Mortgage Risks" (UNC Center for Community Capital and Institute for Market Transformation, 2013), available at http://www.imt.org/uploads/resources/files/IMT_UNC_HomeEEMortgageRisksfinal.pdf; UNC Center for Community Capital analysis based on data from the Bureau of Labor Statistics' Consumer Expenditure Survey.

3 Ibid.

4 U.S. Department of Housing and Urban Development, "Preserving Affordable Rental Housing: A Snapshot of Growing Need, Current Threats, and Innovative Solutions," *Evidence Matters* (2013), available at http://www.huduser.org/portal/periodicals/em/summer13/highlight1.html#title.

5 Mortgage Finance Working Group calculation.

6 George S. Masnick, Daniel McCue, and Eric S. Belsky, "Updated 2010-2020 Household and New Home Demand Projections." Working Paper 10-9 (Harvard University Joint Center for Housing Studies, 2010), available at http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/w10-9_masnick_mccue_belsky.pdf.