



RESEARCH REPORT

Housing Finance Reform Incubator

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Laurie Goodman: A New Forum for Fresh Thinking on Housing Finance Reform

Eight years after Fannie Mae and Freddie Mac were placed into conservatorship, the conversation about their future is stuck. As we inch closer to electing a new president and to the start of a new Congress, it is time for an open-minded look at the housing finance system and what role, if any, today's government-sponsored enterprises might play in the future.

To help evaluate this critical issue, the Urban Institute's Housing Finance Policy Center is releasing a series of short essays about the future of housing finance reform.

Since the early days of conservatorship, home values have recovered in many communities, but others are still reeling from foreclosures. Speculation about the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act has shifted to understanding and observation. The private-label securities market remains stagnant, and portfolio lending's growth is limited. Early experiences with the government-sponsored enterprises' limited risk-sharing efforts raise new questions, even as they answer others. And perhaps most importantly, the shifting national demographics have broad implications for the nation's housing needs. Minority and senior households are on the rise, and the national homeownership rate is declining.

With all of these changes and uncertainties, one thing remains clear: perpetual conservatorship is not sustainable. Mel Watt, director of the agency overseeing the conservatorship, recently reminded policymakers of this and called on Congress to "engage in the work of thoughtful housing reform." While the Federal Housing Finance Agency has taken significant steps to keep the current system working and prepare for the future, we agree with Director Watt that the longer we remain in the current holding pattern, the greater the risk to taxpayers and the housing finance system.

Urban Institute researchers are not abandoning the discussion. We have offered our ideas about housing finance reform in the past and will continue to participate in the discussion. The Housing Finance Reform Incubator is a forum for thoughtful people outside of the Housing Finance Policy Center to join us in open dialogue and to learn from listening to each other.

About the Author

Laurie Goodman is codirector of the Housing Finance Policy Center at the Urban Institute. The center is dedicated to providing policymakers with data-driven analyses of housing finance policy issues that they can depend on for relevance, accuracy, and independence. Before joining Urban, Goodman spent 30 years as an analyst and research department manager at several Wall Street firms. From 2008 to 2013, she was a senior managing director at Amherst Securities Group LP, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of global fixed income research and manager of US securitized products research at UBS and predecessor firms, which were ranked number one by *Institutional Investor* for 11 straight years. Before that, she was a senior fixed income analyst, a mortgage portfolio manager, and a senior economist at the Federal Reserve Bank of New York. She was inducted into the Fixed Income Analysts Hall of Fame in 2009. Goodman is on the board of directors of MFA Financial, is an adviser to Amherst Capital Management, and is a member of the Bipartisan Policy Center's Housing Commission, the Federal Reserve Bank of New York's Financial Advisory Roundtable, and the New York State Mortgage Relief Incentive Fund Advisory Committee. She has published more than 200 journal articles and has coauthored and coedited five books. Goodman has a BA in mathematics from the University of Pennsylvania and an MA and PhD in economics from Stanford University.

Tim Howard: Fixing What Works

Serious proposals for housing finance reform must have clearly defined objectives against which they can be evaluated and must be derived from a clear-eyed analysis of the causes of the previous crisis so that by addressing and fixing those causes, we minimize the chance of a similar crisis happening again.

My proposed reform objective is the following: to create a capital markets-based secondary market mechanism capable of financing at least \$1 trillion of 30-year fixed-rate mortgages annually throughout the business cycle, at the lowest cost to homebuyers, consistent with an agreed-upon standard of taxpayer protection. The emphasis on homebuyer cost is deliberate. Low-, moderate-, and medium-income homebuyers suffered the most during the 2008 crisis and received no significant relief from the government. These same families have seen little growth in their incomes during the recovery, so it should be a policy priority to provide them with the greatest possible access to mortgage credit at the lowest possible cost.

Fixing the correct problem is the second essential element of mortgage reform. Immediately after the crisis, Fannie Mae and Freddie Mac were singled out as its primary cause. Based on indisputable data, however, we now know that this was not true. To the contrary, Fannie and Freddie were the most disciplined sources of mortgage finance in the years leading up to the crisis. During the summer of 2008, the serious delinquency rate on the single-family loans owned or guaranteed by the companies was about one-third the serious delinquency rate of other prime lenders, and less than one-tenth that of subprime lenders. The subsequent performance of Fannie's and Freddie's loans was equally superior: the loss rates on their single-family loans from 2008 to 2015 averaged less than 50 basis points per year—about one-third the average loss rate on comparable mortgages held by banks, and less than one-fifth the loss rates on loans financed with private-label securities.

We also now understand why Fannie and Freddie had to take \$187 billion in senior preferred stock from the Treasury Department. It was not because of operating losses. Through 2011, the companies' business revenues—net interest income, guaranty fees, and other income—exceeded their combined credit losses and administrative costs. Their draws of senior preferred stock were made necessary by \$151 billion in noncash expenses (plus \$36 billion in dividend payments) booked by their conservator, the Federal Housing Finance Agency (FHFA), based on highly pessimistic estimates of *future* losses. The large majority of those losses did not materialize, and as a consequence, Fannie and Freddie had enough income to pay Treasury \$158 billion—more than the \$151 billion in noncash expenses taken earlier—in

just 18 months, beginning in the fourth quarter of 2012. The companies never needed the \$187 billion “bailout” they received from the government.

When invented narrative is replaced with verifiable fact, Fannie and Freddie cease to be a “failed business model” that must be wound down and replaced; they instead become valuable resources that must be built upon and improved. My proposal—outlined below—does that. It makes fundamental changes to Fannie and Freddie in three key areas: relationship with the government, capital, and regulation. It also preserves the companies’ ability to support affordable housing and can be implemented administratively.

Relationship with the Government

Experts generally agree that the role of the government in the charters of Fannie and Freddie is too ambiguous and that the balance of benefits tilts too far in the direction of the companies. Moving to a “utility model,” with limited returns and a more focused business purpose, addresses both issues. In the model I propose, Fannie and Freddie would remain shareholder-owned but would agree to accept (1) a cap on the average return they could target in their guaranty fee pricing (I suggest 10 percent after-tax), (2) restrictions on the size and use of their portfolios (limited to 10 percent of outstanding credit guarantees and to purposes ancillary to the guaranty business), and (3) standards for minimum and risk-based capital determined by administration policymakers with percentages set and imposed by FHFA. In an “exchange for consideration,” the government would commit to provide temporary support to the companies should their capital ever prove insufficient (which by design would be highly unlikely).

Homeowners and the government each would benefit from this arrangement. The government backstop would produce the lowest possible yield on the companies’ mortgage-backed securities, benefiting homeowners, while the government would limit its risk—and control moral hazard—through rigorous capital standards, close regulation and supervision of Fannie and Freddie, and caps on their returns.

There are many advantages to the government’s supporting utility-like companies rather than the companies’ securities. Individual pools of securitized mortgages have limited diversification and can experience much higher loss rates than the companies that issue them. Even in normal times, guarantees on securities will require the government to make unrecoverable payments to investors. Worse, if the government guarantees only securities but not the issuing companies, in a crisis there may be no surviving entities to issue new securities and keep the system from collapsing. Having the

government stand behind companies keeps the system intact and allows the government to recover any outlays after the crisis has passed.

Capital

With strict limits on their portfolios, Fannie and Freddie will be taking one type of risk (credit) on one high-quality asset (residential mortgages) in one country and one currency. Proposals for Fannie and Freddie to adopt the Basel III bank capital standards therefore contradict the principle that capital must be related to risk. Large multinational banks can take many types of risks on many types of assets (including very risky ones) in countries and currencies around the world. Giving Fannie and Freddie bank-like capital requirements without bank-like asset powers would doom them to failure.

Fortunately, there is a proven way to set capital standards for a company that deals in a single, homogenous asset type: require that company to hold enough capital to withstand a defined, worst-case stress scenario. In my proposal, administration policymakers would pick that scenario. I recommend that they require Fannie and Freddie to hold sufficient capital to survive a 25 percent nationwide decline in home prices over five years. Even though such a price decline did happen between 2006 and 2011, both major factors that precipitated it—very risky mortgage types like no-documentation loans or interest-only ARMs with teaser rates now prohibited by the Consumer Financial Protection Bureau (CFPB) and the dominance of a financing method, private-label securitization, that placed few limits on the risks of the mortgages it accepted—will be absent in the future, making the chance of a repeat of the previous episode vanishingly small.

Fannie's prior experience suggests how it would have to capitalize against a future 25 percent home price decline. With the loans it had in 2008 and using its guaranty fees (but none of its portfolio or other income) to help absorb credit losses, Fannie would have needed less than 2 percent capital to survive the previous crisis. And if we remove from the data the loan types no longer permitted by CFPB regulations—which accounted for roughly half the company's postcrisis credit losses—it could have survived with only about 50 basis points of capital.

If FHFA confirms these results, it should set Fannie and Freddie's minimum capital ratio at 2 percent, and then specify a supplemental risk-based standard that imposes capital requirements by product type and risk category (defined at a minimum by paired combinations of loan-to-value ratios and credit scores). FHFA would grade the companies' business as it comes in and require them to hold

the greater of the risk-based or minimum capital amounts. All of the companies' capital would have to be retained earnings or common or preferred stock.

Fannie and Freddie could make their minimum standard binding by holding down the risk of the mix of business they acquire. With 2 percent capital and a 10 percent target return, Fannie and Freddie's average charged single-family guaranty fee would be about 40 basis points, which—after the 4.2 basis point affordable housing fee and the 10 basis point payroll tax fee (through October 2021)—would be a little over 50 basis points to the borrower. At this level, the companies could use cross-subsidization effectively to attract a broad range of business, including affordable housing loans. Should the risk mix of the companies' business rise, their risk-based standard would cause their capital and average guaranty fees to rise as well.

Regulation

After a stress standard for the companies has been chosen, FHFA will need to analyze Fannie and Freddie's credit performance during the prior housing market collapse to determine the percentage of minimum capital—for the types and characteristics of loans the companies are permitted to acquire today—that would allow them to comfortably withstand that stress. FHFA would use that same data to determine the stress capital percentages by product type and risk category used to calculate required risk-based capital.

Once the minimum standard and the risk-based requirements are in place, Fannie and Freddie would be permitted to price their business as they saw fit—including using cross-subsidization—as long as their guaranty fees in the aggregate were consistent with no more than a 10 percent return on capital. FHFA would monitor the companies' pricing, and if it found their average fees to be too high, it could take whatever remedial action it deemed appropriate. FHFA would track each company's business and calculate its required risk-based capital on a quarterly basis, with adjustments as warranted for any risk-sharing transactions they do.

Affordable Housing

Fannie and Freddie's role in supporting affordable housing is limited by the fact that they only can purchase or guarantee the loans lenders originate. Despite this, FHFA should set affordable housing goals for the companies. FHFA also should have the power to impose penalties for failing to meet those

goals, but only if the percentage of affordable business Fannie or Freddie does fall short of the percentage originated by lenders that year.

FHFA should not increase the amount it requires Fannie and Freddie to contribute to affording housing funds beyond the 4.2 basis points mandated by legislation. Fees for affordable housing imposed only on the companies are an excise tax on the secondary market. Should Congress wish to increase support for affordable housing through additional fees, it should levy them on all mortgages. This would raise more money—or raise the same amount at a lower fee rate—and not favor primary market over secondary market financing.

Implementation

The above changes could be effectuated through administrative action, as were the 2008 Preferred Stock Purchase Agreement and its amendments. With the written consent of the boards of directors of Fannie and Freddie, FHFA as conservator would make binding commitments on behalf of the companies, and Treasury and FHFA would make binding commitments on behalf of the government.

Before these reforms could take effect, the government would need to settle all of the lawsuits against it for its treatment of Fannie and Freddie before and during the conservatorships. It likely will take rulings adverse to the government's current position to trigger that settlement. Assuming such rulings are forthcoming, Treasury should cancel the warrants it holds for 79.9 percent of the companies' common stock, allow them to use proceeds from the reversal of the net worth sweep to repay their senior preferred stock, and retroactively replace the 10 percent dividend on that stock with a more reasonable 1 percent markup over the cost of the funds Treasury borrowed to give the companies the \$187 billion they did not need.

Treasury is prohibited by the "Jumpstart GSE" legislation from liquidating Fannie and Freddie's senior preferred stock before January 2018. Until then, FHFA should stop paying dividends on it, and notionally credit the companies with the amount of capital they will have when the stock is repaid, to assist them in planning for their recapitalization.

About the Author

Timothy Howard is former vice chairman and chief financial officer at Fannie Mae. After six years as senior financial economist for Wells Fargo Bank in San Francisco, Howard joined Fannie Mae as chief economist in 1982 and soon became involved with the financial management of the company. He was given responsibility for Fannie Mae's largest business in 1987 and became the company's chief financial officer in 1990. He became chief risk officer in 2000 and was named vice chairman of the board in 2003. When he left Fannie Mae in 2004, it was safely and profitably financing more than 25 percent of all US home loans. In 2013, Howard published *The Mortgage Wars*, a book on Fannie Mae and the financial crisis. He offers periodic commentary on mortgage-related issues on his website, Howard on Mortgage Finance. Howard owns common and preferred shares of Fannie Mae, which he addressed in a post on his website on February 15, 2016.

Jim Millstein: An Administrative Plan to Restructure and Reform the GSEs

“The housing system we have today is unhealthy and unsustainable, mortgage credit remains overly tight, taxpayers remain at risk, and the system lingers in a dysfunctional limbo” (Parrott et al. 2016). Why? Because in 2011, the executive branch decided to pass responsibility for government-sponsored enterprise (GSE) reform to Congress rather than use the powers given it under the Housing and Economic Reform Act of 2008 (HERA). In turn, major congressional reform efforts were based on “winding the current system down and starting largely from scratch” (Parrott et al. 2016). Ultimately, these efforts foundered on the fear that a “white board” approach to remaking an \$11 trillion credit market for single- and multifamily residences¹ would do more harm than good. In Congress’s hands, Fannie Mae and Freddie Mac proved not only too big to fail but also too important to kill. Hence our present state of “dysfunctional limbo.”

Worse, in 2012, the Treasury Department and the Federal Housing Finance Agency (FHFA) agreed to amend the Preferred Stock Purchase Agreements (PSPAs) to require that all of Fannie and Freddie’s profits be paid in perpetuity to the federal government (the Third Amendment). As a result of this amendment, \$246 billion of earnings have been siphoned out of the companies for use in the general fund, depriving the conservator of the means to resolve the GSEs’ undercapitalization, the fundamental problem that HERA directed the conservatorships to address. FHFA has since taken an indirect approach to solving this problem through so-called “risk-sharing” deals, but, as former Fannie chief financial officer Tim Howard recently noted, less risk has been shared than meets the eye.²

With legislative reform stalled and Treasury bound to the defense of its Third Amendment in court, we are left with the hope that a new administration will use HERA’s authority to fix the structural flaws in the GSEs that the crisis revealed. Most of this can be done administratively by FHFA. All it takes is political will.

First, FHFA as conservator needs to do what Congress expressly mandated it to do under HERA: “ensure that each regulated entity operates in a safe and sound manner, including maintenance of adequate capital.”³ To fulfill this mandate, until Treasury is willing to amend the PSPAs, FHFA should suspend payment of cash dividends on Treasury’s senior preferred stock to ensure that the GSEs have

the resources to build adequate levels of capital to protect taxpayers against loss on the GSE's trillions of dollars of mortgage guarantees. FHFA Director Melvin L. Watt recently stated that he "expects Freddie Mac and Fannie Mae to determine their pricing as though they were holding capital and seeking an appropriate economic return on this capital" (Watt 2016). This exercise should not be theoretical. FHFA should allow the GSEs to adjust pricing and build capital to levels adequate for the expected losses on their guaranty liabilities.

Second, in anticipation of corporate restructuring (described below), FHFA should promulgate new regulations to fix the structural flaws that the crisis revealed in Fannie and Freddie's corporate governance. There are three areas in which regulations need to be developed for the mortgage guaranty businesses: a new risk-based capital regime for different mortgage products, limits on leverage and on permitted equity rates of return, and business activity limitations.

Because the GSEs are private companies with public charters, there is an inherent conflict of interest between the GSEs' obligation to promote access and affordability and the private market's imperative to maximize shareholder value. Profit maximization clearly became paramount before the recent financial crisis. To retain market share and boost income, the GSEs chased an explosive market for private-label securities (PLS). They relaxed underwriting standards for conforming loans and used government-subsidized funding to purchase higher-yielding—and ultimately extremely risky—PLS. Although some of that activity expanded access and affordability, the imperative to maximize shareholder returns blinded managers to the credit risks they were taking. Weak capital regulation left them undercapitalized for the size of the levered portfolios and mortgage guarantees that their regulator permitted them to carry into the crisis. Meanwhile, the benefits of the funding subsidy from their implied government guaranty were pocketed at least as much by the companies' shareholders as the homeowners whose mortgages they guaranteed, transforming a subsidy for affordable housing into an invidious welfare program for corporate shareholders.

These structural flaws can be remedied by new regulations well within the authority conferred on FHFA under HERA. First, to address the conflict between their affordability mission and shareholder returns, the mortgage guaranty businesses should be subjected to utility-like regulation, with strict activity, leverage, and return on equity limitations. Limits on leverage and on the earned rate of return on capital should prevent the GSEs from repeating many of the mistakes of the past crisis. Second, with new statistical information from the crisis on loss frequency and severity across different classes of mortgage products, a more nuanced capital regime can be developed and refined for the guaranty businesses, similar to what federal banking regulators have developed for banks. Enforcing new capital requirements and strict limits on leverage and equity rates of return should prevent managers from

abusing their public charters for their shareholders' benefit and from taking on outsized risks. Third, the federal backstop for the GSEs' mortgage guaranty businesses should be made explicit and priced to reflect the government's risk of providing it and its cost of doing so.

This last "reform" will require congressional action. But the FHFA—with Treasury's consent under the PSPAs—can and should start the process now by restructuring the assets and liabilities of the GSEs to separate the explicit government guaranty the GSEs currently enjoy through the PSPAs from the mortgage guaranty businesses and then regulate by contract the pricing of the guaranty and the types of mortgage products to which it could attach. This administrative phase of reform would work as follows.

First, FHFA would cause each GSE to create a new wholly-owned subsidiary (Newco), transferring the assets of its mortgage guaranty business to Newco and having Newco assume the liabilities of each business. This could be done separately for the single-family and multifamily guarantee businesses. With this asset and liability transfer, Newco and the GSE would enter into a reinsurance contract, pursuant to which the GSE parent would "reinsure" Newco against any loss on its outstanding and future mortgage guarantees in exchange for a portion of the subsidiary's guaranty fees (a **reinsurance fee**). The GSE's liability for reinsurance to Newco would continue to be backstopped by Treasury's outstanding commitment to purchase additional preferred shares under the PSPAs to cover the GSE's losses. However, to protect itself against future calls on its backstop, Treasury could require that FHFA cause each GSE to use its reinsurance fees to build a mortgage insurance reserve fund (MIF) up to a certain level before "sweeping" any excess to Treasury as a dividend on its outstanding preferred stock.

Second, to protect the GSE against being called on its reinsurance of Newco's guaranty liabilities (and to protect Treasury against being called on its backstop of that reinsurance), the reinsurance contract between the GSE and Newco would require Newco to use its portion of guaranty fees—after operating expenses and reserves—to build capital to absorb potential future losses on its mortgage guaranty liabilities. The actual level of capital to be retained over time would be consistent with risk-based capital regulations for the mortgage guaranty businesses to be developed by the FHFA under HERA. Once each Newco has sufficient capital to be deemed "well capitalized" under FHFA's new capital regulations, FHFA would require that the reinsurance contract be amended so that reinsurance would not attach to future Newco guarantees unless Newco is in compliance with FHFA's new business activity, leverage, and return on equity capital regulations. Thereafter, FHFA would cause the GSE to sell its equity interests in each well-capitalized Newco in a series of public offerings until all shares had been sold, thereby privatizing the GSE's mortgage insurance businesses. The proceeds from those stock sales and the proceeds of the ongoing liquidation of the GSEs' portfolios would be applied as provided in

HERA, first to the GSEs' outstanding third-party debt obligations, and then to Treasury's senior preferred stock outstanding under the PSPAs, and then to each GSEs' other outstanding equity securities (including Treasury's warrants) in order of liquidation preference.

The result of this corporate restructuring will be four new private, well-capitalized, well-regulated "first-loss" insurers standing in front of the GSEs on their entire books of mortgage-backed securities (MBS), plus a new fully funded MIF at each GSE standing in front of Treasury on its backstop of the GSEs' solvency under the PSPAs. The GSEs, their charters, their MIFs, and their obligations under the reinsurance contracts with the newly privatized Newcos would remain in conservatorship backstopped by the PSPAs. MBS composed of "conforming" mortgages would be guaranteed by a combination of first-loss insurance provided by the Newcos in front of catastrophic risk insurance provided by the GSEs. The GSEs would continue to wrap the entire security so that the to-be-announced market continues to function. The reinsurance fees paid to the GSEs would fund the MIFs, pay for the operating expenses of the common securitization platform, fund the federal accounts created under HERA dedicated to affordable housing, and pay Treasury for its ongoing capital commitment under the PSPAs.

This would balance facilitating access and affordability with recapitalizing an undercapitalized system, tapping private investor demand for mortgage credit risk through the sale of the four Newcos' equity to the public, and protecting taxpayers against future losses by building layers of new capital at the Newcos and MIF reserves at the GSEs. These administrative actions, consistent with HERA's mandates, can charter a path to ending the longest-running conservatorships in American history without threatening the stability of the housing market or mortgage credit formation.

These administrative actions will also help Congress focus on the big picture: What support should the government provide, and how should the government regulate the conforming mortgage market? For example, the government guarantee currently extended by Treasury through the PSPAs to the GSEs could be restructured to operate outside of the conservatorships. One way would be to redefine the charter for one of the GSEs to reflect the utility-like model described above. That entity could either be sold out of conservatorship to private investors or be converted into a government corporation, as recently suggested by Parrott and colleagues (2016). Either way, it would have an explicit line of credit from Treasury for which it would pay a commitment fee. It would be regulated by FHFA with an appropriate risk-based capital regime and total leverage limitation. It would continue to have access and affordability goals. And it would continue to provide securitization services in conjunction with the common securitization platform and catastrophic risk insurance for an appropriate fee to private first-loss insurers, including the Newcos and other new entrants. The other GSE could either be put into

receivership and liquidated or merged into the other government corporation, or sold out of conservatorship if benefits from competition in a tightly regulated utility model would be material.

Creating a government- or highly regulated private corporation through which to funnel the government guaranty to the conforming mortgage market is not too far from the Federal Mortgage Insurance Corporation proposed by Senators Johnson and Crapo in bipartisan legislation that stalled in 2014. With such legislation, FHFA could also license and regulate private first-loss insurers directly, replacing the indirect influence exercised through the GSE-Newco reinsurance contracts effective during the conservatorships.

Alternatively, Congress could eliminate the government guarantee for the conforming mortgage market altogether. In that case, after provisioning for the GSEs' exposure on outstanding MBS, each GSE could be put into receivership and run off. Charters would be terminated. The grand experiment proposed by the Protecting Americans from Tax Hikes Act of 2015 could then be run with taxpayers out of harm's way.

The structure proposed in this essay would not alter the basic system used by the government today to facilitate access and affordability in housing. The 30-year, prepayable, conforming mortgage would survive. There would be no disruption in the MBS market and the funding it provides homebuyers. In the first phase, the GSE charters would survive and be imposed through reinsurance contracts on the newly privatized mortgage guaranty businesses during the remainder of the conservatorships. Various programs administered by the departments of Housing and Urban Development and Agriculture would continue to deliver federal support for housing and mortgage finance apart from the market for conforming loans.

Access should be improved in two ways. First, private first-loss insurers facing a risk-based capital regime can facilitate demand for riskier mortgage credit while holding an adequate buffer for that additional risk. To date, the FHFA has been reluctant to allow the GSEs to take on riskier credit given their exposure to expected losses, exposure that this proposal would shift to private first-loss insurers. Second, the proposed system would provide resources to fund the Housing Trust Fund, Capital Magnet Fund, and the HOPE Reserve Account.

Appropriate capital requirements and private rates of return mean that the price of a conforming loan will increase, all other things being equal. Guaranty fees charged by first-loss insurers can be regulated to some extent by the GSEs, whose necessary reinsurance provides significant bargaining power. But profits are necessary for private enterprise. There will be trade-offs among affordability, access, private risk taking, and taxpayer protection.

Notes

1. "Mortgage Debt Outstanding," Board of Governors of the Federal Reserve System, last updated March 11, 2016, <https://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm>.
2. Timothy Howard, "Risk Sharing, or Not," *Howard on Mortgage Finance* (blog), March 9, 2016, <https://howardonmortgagefinance.com/2016/03/09/risk-sharing-or-not/>.
3. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 (2008). <https://www.congress.gov/110/plaws/publ289/PLAW-110publ289.pdf>.

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About the Author

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Alex J. Pollock: Seven Steps to Housing Finance Reform

The giant American housing finance sector is as important politically as it is financially, which makes it hard to reform. From the 1980s on, it was unique in the world for its overreliance on the “government-sponsored enterprises” (“GSEs”), Fannie Mae and Freddie Mac—privately owned but privileged and with “implicit” government guarantees. According to Fannie and Freddie, their lobbyists, and members of Congress reading scripts from Fannie in its former days of power and glory, this made American housing finance “the envy of the world.” In fact it didn’t, and the rest of the world did not experience such envy. But Fannie and Freddie did attract investment from the rest of the world, which correctly saw them as U.S. government credit with a higher yield: this channeled the savings of thrifty Chinese and others into helping inflate American house prices into their historic bubble. Fannie and Freddie were a highly concentrated point of systemic vulnerability.

Needless to say, Fannie and Freddie, and American housing finance in general, then became “the scandal of the world” as they went broke. What *schadenfreude* my German housing finance colleagues enjoyed after years of being lectured by the GSEs on the superiority of the American system. Official bodies in the rest of the world pressured the U.S. Treasury to protect their investments in the insolvent Fannie and Freddie, which of course it did and does. The Treasury is also protecting the Federal Reserve, which in the meantime became the world’s biggest investor in Fannie and Freddie securities.

More than seven years later, America is still unique in the world for centering its housing finance sector on Fannie and Freddie, even though they have equity capital that rounds to zero. Now they are primarily government-owned and entirely government-controlled housing finance operations, completely dependent on the taxpayers. Nobody likes this situation, but it already outlasted numerous reform proposals.

Is there a way out that looks more like a market and less like a statist scheme? A way that reduces the distortions of excessive credit that inflates house prices, runs up leverage, and sets up both borrowers and lenders for failure—in other words, can we reduce the chance of repeating the mistakes of 1980 to 2006? I suggest seven steps to reform American housing finance:

1. Turn Fannie and Freddie into SIFIs at the “10% Moment”
2. Enforce the law on Fannie and Freddie’s guarantee fees
3. Encourage skin in the game from mortgage originators

4. Form a new joint FHLB mortgage subsidiary
5. Create countercyclical LTVs
6. Reconsider local mutual self-help mortgage lenders
7. Liquidate the Fed's MBS portfolio

Turn Fannie and Freddie into SIFIs at the “10% Moment”

The original bail out deal for Fannie and Freddie created a senior preferred stock with a 10% dividend. As everybody knows, the amended deal makes all their net profit a dividend, which means there will never be any reduction of the principal, no matter how much cash Fannie and Freddie send the Treasury. It is easy, however, to calculate the cash-on-cash internal rate of return (IRR) to the Treasury on its \$189.5 billion of senior preferred stock. So far this is about 7%-- positive, but short of the required 10%. But as Fannie and Freddie keep sending cash to the Treasury, the IRR will rise, and will reach a point when total cash paid is equivalent to a 10% compound return plus repayment of the entire principal. That is what I call the “10% Moment.” It provides a uniquely logical point for reform, and it is not far off, perhaps late 2017- early 2018.

At the 10% Moment, whenever it arrives, Congress should declare the senior preferred stock fully repaid and retired, as in financial substance it will have been. Simultaneously, Congress should formally designate Fannie and Freddie as Systemically Important Financial Institutions (SIFIs). That they are indeed SIFIs, able to put not only the entire financial system but also the finances of the U.S. government at risk, is beyond the slightest doubt.

As soon as Fannie and Freddie are officially, as well as in economic fact, SIFIs, they will get the same minimum capital requirement as bank SIFIs: 5% of total assets. At their current size, this would require about \$250 billion in equity. This is a long trip from zero, but they could start building capital, while of course being regulated as undercapitalized until they aren't. Among other things, this means no dividends on any class of stock until the capital requirement is met.

As SIFIs, Fannie and Freddie will get the Fed as their systemic risk regulator. In general, they should be treated just like big bank SIFIs. Just as national banks have the Fed as well as the Comptroller of the Currency, they will have the Fed as well as the FHFA.

Since it is impossible to take away Fannie and Freddie's too-big-to-fail status, they should pay the government for its ongoing credit guaranty, just as banks pay for theirs. I recommend a fee of 0.15% of total liabilities per year.

Fannie and Freddie will be able to compete in mortgage finance on a level basis with other SIFIs, and swim or sink according to their competence.

Enforce the Law on Fannie and Freddie's Guarantee Fees

In the Temporary Payroll Tax Cut Continuation Act of 2011, Title IV, Section 401, "Guarantee Fees," Congress has already decided how Fannie and Freddie's guarantee fees (g-fees) must set. Remarkably, the law is not being obeyed by their conservator, the Federal Housing Finance Agency.

The text of the statute says the guarantee fees must "appropriately reflect the risk of loss, as well the cost of capital allocated to similar assets held by other fully private regulated financial institutions." [italics mine]

This is unambiguous. The simple instruction is that Fannie and Freddie's g-fees must be set to reflect the capital that private banks would have to hold against the same risk, and also the return private banks would have to earn on that capital. The economic logic is clear: to get private capital into the secondary mortgage market, make Fannie and Freddie price to where private financial institutions can fairly compete.

This is in fact a "private sector adjustment factor," just as the Fed must use for its priced services. The difference is that the Fed obeys the law, and the FHFA doesn't.

Of course, the FHFA finds this legislative instruction highly inconvenient politically, so ignores it or dances around it. But Congress didn't write the act to ask the FHFA what it liked, but to tell it what to do. The FHFA needs to do it.

Encourage Skin in the Game for Mortgage Originators

A universally agreed-upon lesson from the American housing bubble was the need for more "skin in the game" of credit risk by those involved in mortgage securitization. But lost in most of the discussion was the optimal point at which to apply credit risk skin in the game. This point is the originator of the

mortgage loan, which should have a junior credit risk position for the life of the loan. The entity making the original mortgage is in the best position to know the most about the borrower and the credit risk of the borrower. It is the most important point at which to align incentives for creating sound credits.

The Mortgage Partnership Finance (MPF) program of the Federal Home Loan Banks was and is based on this principle. (I had the pleasure of leading the creation of this program.) The result was excellent credit performance of the MPF mortgage loans, including through the crisis. The principle is so obvious, isn't it?

I do not suggest making this a requirement for all originators, but to design rules and structures in mortgage finance to encourage this optimal credit strategy.

Form a New Joint FHLB Mortgage Subsidiary

Freddie Mac was originally a wholly-owned, joint subsidiary of the twelve Federal Home Loan Banks (FHLBs). Things might have turned out better if it had remained that way.

FHLBs (now there are eleven of them) are admirably placed to operate secondary markets with the thousands of smaller banks, thrifts and credit unions—and perhaps others-- that originate mortgages in their local markets. As lenders to these institutions, FHLBs know and have strong ability to enforce the obligations of the originators, both as credit enhancers and as servicers. But to be competitive, and for geographic diversification, they need a nation-wide scope.

The precedent for the FHLBs to form a nationally operating mortgage subsidiary is plain. They should do it again.

Create Countercyclical LTVs

As the famous investor, Benjamin Graham, pointed out long ago, price and value are not the same: “Price is what you pay, and value is what you get.” Likewise in mortgage finance, the price of the house being financed is not the same as its value, and in bubbles, prices greatly exceed the sustainable value of the house. Whenever house prices are in a boom, the ratio of the loan to the sound lendable value becomes something much bigger than the ratio of the loan to the inflated current price.

As the price of any asset, including houses, goes rapidly higher and further over its trend line, the riskiness of the future price behavior becomes greater--the probability that the price will fall a lot keeps increasing. Just when lenders and borrowers are feeling more confident because of high collateral "values" (really prices), their danger is in fact growing. Just when they are most tempted to lend and borrow more against the price of the asset, they should be lending and borrowing less.

A countercyclical LTV (loan-to-value ratio) regime would reduce the maximum loan size relative to current prices, in order to keep the maximum ratio of loan size to underlying lendable value more stable. The boom would thus induce smaller LTPs (loan-to-price ratios), steadier LTVs, and greater down payments in bubbly markets—thus providing an automatic dampening of the price inflation and a financial stabilizer.

Often discussed are countercyclical capital requirements for financial institutions, which reduce the leverage of those lending against riskier prices. The same logic applies to reducing the leverage of those who are borrowing against risky prices. We should do both.

Canada provides an interesting example of where countercyclical LTVs have actually been used.

Reconsider Local Mutual Self-Help Mortgage Lenders

In the long-forgotten history of mortgage lending, an important source of mortgage loans were small, mutual associations owned by their depositors and operating with an ethic that stressed saving, self-discipline, self-help, mutual support, and home ownership. Demonstrated savings behavior and character were key qualifications for borrowing. The idea of a mortgage was to pay it off.

In the Chicago of 1933, for example, the names of such associations included: Amerikan, Archer Avenue, Copernicus, First Croatian, Good Shepherd, Jugoslav, Kalifornie, Kosciuszko, Narodi, Novy Krok, Polonia, St. Paul, St. Wenceslaus, Slovak, and Zlata Hora...you get the idea.

In my opinion, the ideals of these mutual associations are worth remembering and reconsideration; they might be encouraged (not required) again. We would have to make sure that current loads of regulatory compliance costs are not allowed to smother any such efforts at birth.

Liquidate the Fed's MBS Portfolio

What is the Fed, a central bank, doing holding \$1.7 trillion of mortgage-backed securities (MBS)? The founders of the Fed and generations of Fed officers since would have found that impossible to imagine. The MBS portfolio exists because the Fed was actively engaged in pushing up house prices, as part of its general scheme to create “wealth effects,” by allocating credit to the housing sector using its own balance sheet. It succeeded— house prices have not only risen rapidly, but are back over their trend line on a national average basis.

Why is the Fed *still* holding all these mortgages? For one thing, it doesn't want to recognize losses when selling its vastly outsized position would drive the market against it. Some economists argue that even big losses do not matter if you are a fiat currency central bank. Perhaps not, but they would be embarrassing and unseemly.

Whatever justification there may have been in the wake of the collapsed housing bubble, the Fed should now get out of the business of manipulating the mortgage market. It can avoid recognizing any losses by simply letting its mortgage portfolio steadily run off to zero over time through maturities and prepayments. It should do so, and cease acting as the world's biggest savings and loan.

Especially with the reforms to Fannie and Freddie discussed above, we would get closer to having a market price of mortgage credit. Imagine that!

Envoi

Will these seven steps solve all the problems of American mortgage finance and ensure that we will never have another crisis? Of course not. But they will set us on road more promising than sitting unhappily where we are at present.

About the Author

Alex J. Pollock is a distinguished senior fellow at the R Street Institute in Washington, DC. He was a resident fellow at the American Enterprise Institute from 2004 to 2015 and was president and chief executive officer of the Federal Home Loan Bank of Chicago from 1991 to 2004. Pollock focuses on financial policy issues, including financial cycles, government-sponsored enterprises, housing finance,

banking, central banking, uncertainty and risk, retirement finance, corporate governance, and financial crises with their ensuing political responses. He is the author of *Boom and Bust: Financial Cycles and Human Prosperity*, as well as numerous articles and congressional testimony. Pollock is a director of CME Group, Great Lakes Higher Education Corporation, and the Great Books Foundation—where he was chairman of the board from 2006 to 2014—and is a past president of the International Union for Housing Finance. He is a graduate of Williams College, the University of Chicago, and Princeton University. Pollock has no financial interest in Fannie Mae, Freddie Mac, or the Federal Home Loan Banks. As a taxpayer, he has a strong financial interest in the risks undertaken by the US Treasury and the Federal Reserve.

Mark Zandi: A More Promising Road to Reform

In today's housing finance system, two behemoth institutions, Fannie Mae and Freddie Mac, control most of the core infrastructure of the secondary market and take on most of its credit risk. While in many ways this system has served the nation well by providing a broad range of borrowers access to credit and a level playing field for lenders of all sizes, our reliance on this duopoly created perverse incentives that ultimately led to too much risk taking, forcing taxpayers to shoulder the resulting cost.

Repeated attempts to reform this system have failed, none able to strike an adequate balance between overhauling what hasn't worked and preserving what has. So we remain in a state of limbo that no one believes is sustainable, looking anxiously for a way out.

A group of us has thus put forward a reform proposal that addresses the system's structural problems and keeps what works. Our proposal moves the core infrastructure of the secondary market from Fannie and Freddie into a government corporation—the National Mortgage Reinsurance Corporation (NMRC)—and transfers all the noncatastrophic credit risk into the private market, where there is competition and innovation without risk to the taxpayer. In our proposal, no private institutions dominate the housing finance system by controlling its infrastructure or taking on the lion's share of its credit risk. The result is a system that will function like the current one for both borrowers and lenders, but without the underlying risk posed by a dependence on “too-big-to-fail” institutions.

Those who find this idea appealing should read “A More Promising Road to GSE Reform,” where the proposal is described in detail (Parrott et al. 2016). What follows here is a summary of some of our proposal's key features and comparisons with other reform proposals.

Ending Too-Big-to-Fail

Our proposal ends the housing finance system's reliance on too-big-to-fail financial institutions by putting the core infrastructure on which mortgage market participants depend into a government corporation and transferring the credit risk across a diverse range of private sector actors, including the capital markets, reinsurers, private mortgage insurers, lenders, and other private entities. No private

institution would be indispensable to a healthy, functioning secondary market; any institution could fail, and the system would not be affected.

Other reform proposals rely on too-big-to-fail private institutions in one form or another. Recapitalizing Fannie and Freddie and privatizing them would re-create this problem in the form we had before the crisis. Systems that replace Fannie and Freddie with a shareholder-owned utility or a mutually owned institution are a vast improvement, but those systems leave this critical flaw unaddressed. And while proposals that replace Fannie and Freddie with multiple private guarantors solve many of the challenges in today's system, these proposals are unlikely to establish enough guarantors that a regulator would ever let any of them fail. Each alternative proposal thus leaves in place some version of the incentives that led to the failure of the current system.

Maintaining Access for Borrowers and Lenders

By requiring the NMRC system to meet affordability and duty-to-serve goals defined by the Federal Housing Finance Agency (FHFA), we assure the same broad access for underserved communities that is required of Fannie and Freddie today. To achieve these goals, the NMRC would maintain the same underwriting standards and practices as Fannie and Freddie, and would price its guarantee fees in a manner that subsidizes lower-wealth borrowers who are creditworthy but may not be able to afford a mortgage loan otherwise.¹ In addition, an explicit affordability fee would fund initiatives to support access and affordability for homeownership and rental housing.

Community banks and small lenders would have the same access to the system they have today with Fannie and Freddie, namely through the NMRC's cash window. Moreover, the NMRC's mandate to provide broad, competitive access to the secondary market would ensure that lenders of all sizes have the same access to the market's infrastructure and benefit equally from the NMRC's credit-risk transfers.

Protecting Taxpayers

The NMRC would maintain the benefits of today's system at almost no risk to taxpayers. The private capital in the NMRC system would be on the hook for the first 3.5 percent of loss, consistent with the current implied capitalization of Fannie and Freddie and consistent with the losses suffered by the government-sponsored enterprises (GSEs) during the financial crisis. In case there is an even more

severe cataclysm in the future, a mortgage insurance fund would cover the next 2.5 percent of loss. And in case this doesn't cover it, the FHFA, the regulator in the NMRC system, would have the authority to claw back any losses taxpayers suffered by charging a higher insurance fee after the crisis passes and the economy normalizes. No other reform proposal offers more protection to taxpayers.

Providing Low and Less Cyclical Mortgage Rates

The NMRC system can provide this formidable taxpayer protection without driving up mortgage rates. There are some new costs in the NMRC system, including a fee for the government's explicit catastrophic reinsurance and an affordability fee for funding activities to support access for underserved communities. But these costs would be offset by lower yields on NMRC mortgage-backed securities (MBS). Unlike Fannie and Freddie's MBS, the NMRC's MBS would be explicitly backed by the full faith and credit of the US government and would thus trade more like Ginnie Mae's explicitly guaranteed MBS, which trade at a much lower yield than Fannie and Freddie's MBS.

Because there are no too-big-to-fail institutions in the NMRC system, the amount of capital required to support the system would be lower than in other systems. Less required capital means lower costs and thus lower mortgage rates. How much lower depends on what additional capital regulators would require the too-big-to fail institutions in the other systems to hold.

Moreover, despite the reliance on private capital in the NMRC system, mortgage rates may actually be less cyclical than in the current system. Guarantee fees would be more cyclical, as Fannie and Freddie's current guarantee fees rarely change in response to market conditions, but NMRC's guarantee fees would vary depending on the cost of private capital, which in turn would fluctuate with the perceived risk in the market. However, changes through the business cycle in other components of mortgage rates, such as the risk-free interest rate and lenders' margins, would likely offset the changes in guarantee fees. In good times (bad times), the cost of capital and guarantee fees would likely be lower (higher) in the NMRC system than in the current system, but the risk-free rate and lenders' margins would be higher (lower).

Even the cyclicity of the guarantee fees in the NMRC system would be mitigated by the use of multiple sources of capital. A critical feature of our system is that it gradually migrates toward a mix of risk-transfer structures shown to be resilient through the business cycle. We envisage, for instance, insurance companies and other entity-based sources of capital, who assume credit risk through good times and bad, to fully participate in the risk transfers. For how we think about this and other key

objectives of credit-risk transfers, see "Delivering on the Promise of Risk Sharing" (Goodman, Parrott, and Zandi 2015).

The NMRC would also have the authority to ease the impact on rates and liquidity during a financial crisis. In a time of acute stress, private investors would be unwilling to provide capital or require such a high return that it would cause guarantee fees and mortgage rates to spike, exacerbating the financial turmoil. To ensure that this does not happen, the NMRC could scale back its risk transfers when private capital's required return rises above a predefined crisis threshold.

Promoting Flexibility and Competition

As a government corporation, the NMRC would have considerable flexibility. It would not face the same constraints in rulemaking or employee compensation as a government agency, for instance, or depend on Congress for funding. This would allow the NMRC to function with more of the flexibility of a private entity, which would be critical in managing an infrastructure as complex and fluid as our housing finance system.

It is unlikely that systems based on a privately owned mutual or utility would be able to provide significantly more flexibility. The institution would be a heavily regulated monopoly whose range of business activities, rate of return, and market share would be closely prescribed by policymakers, removing many of the incentives and constraining much of the flexibility that drive the typical private company to be more innovative and efficient.

By putting the market's infrastructure into a government corporation, lenders of all sizes would have the same access. The system would not be beholden to larger institutions that gain an advantage by controlling access to the secondary market, as has previously occurred and would be repeated in many alternative proposals. There would thus be no barriers to entry into the primary market, leveling the playing field and increasing competition.

The NMRC system would also promote competition in providing private capital to the system by utilizing a wide range of sources, such as the capital markets, insurance companies, and other private entities. Moreover, the plethora of credit-risk transfer structures offered by Fannie and Freddie would eventually be rationalized into a mix of structures chosen to ensure a level playing field for all lenders, along with broad access and stable liquidity through the business cycle.

Easing the Transition

Finally, under our proposal, the transition from the current system to a much-improved one would occur with little disruption, uncertainty, or risk, and would build upon steps already under way. Fannie and Freddie would continue to build the common securitization platform, and the current effort to synchronize *some* of their processes would gradually be extended to *all* of them, from purchasing mortgages to securitizing them and overseeing their servicing. And Fannie and Freddie's current risk-transfer efforts would gradually be expanded from an effort to transfer *some* noncatastrophic risk to the private market to one in which they transfer *all* of it.

It is critical to move in this incremental fashion, as the structural reform called for here requires changes to a remarkably complex and important system. Rather than mandate today which capital structures should cover losses ahead of the taxpayer, for instance, it is better to mandate what they must achieve and allow the NMRC and the market enough flexibility to develop the mix of structures that is shown over time to best achieve it. With this in mind, Fannie and Freddie—and ultimately the NMRC—will gradually shift their risk-transfer efforts to the most effective mix of structures. Once Fannie and Freddie are issuing a single security from a single platform, operating under a single set of processes, and syndicating all of their noncatastrophic credit risk, their operational assets will be put into the newly formed NMRC.

In other proposals that offer the significant structural reforms required to improve the system, the transition process is inevitably much more daunting; they require creating privately held institutions that control the market's infrastructure and manage credit risk. Whether it's creating new too-big-to-fail guarantors, a mutual with thousands of members, or a single, privately owned utility, the new system's ability to bear the weight of the mortgage market in a way that achieves all of our objectives depends on whether policymakers appropriately gauge the market for investing in a complex, highly regulated system.

Like all reform proposals, ours ultimately requires legislation for the system to receive the full catastrophic backstop of the US government. But since our system sheds the problems and keeps the benefits of the current system in a way that minimizes the risk and uncertainty of transition, it should appeal to lawmakers on both sides of the aisle.

The Future is Now

The NMRC system is vastly preferable to the current system and offers important advantages over the alternatives. You may agree with us or, instead, prefer another path toward reform offered in this Urban Institute series, but it is critical that lawmakers reengage on this issue. The only question is whether we have the discussion now, in a moment of relative calm, or later, when a crisis forces our hand.

Note

1. One reviewer of our proposal appears to have misunderstood our limitation on the loans that the NMRC will buy, pool, and securitize to those that meet *the product features* of a “qualified mortgage,” as defined by the Consumer Finance Protection Bureau. With this limitation, we would only preclude loans with *the product features* prohibited in the rule, such as interest-only loans, negatively amortizing loans, and loans with balloon payments. We would *not* preclude loans on the basis of debt-to-income ratio. For more on this topic, see “What is a Qualified Mortgage,” Consumer Financial Protection Bureau, updated February 8, 2016, <http://www.consumerfinance.gov/askcfpb/1789/what-qualified-mortgage.html>.

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About the Author

Mark Zandi is chief economist of Moody’s Analytics, where he directs economic research. He is a cofounder of Economy.com, which Moody’s purchased in 2005. He is on the board of directors of Mortgage Guaranty Insurance Corporation, the nation’s largest private mortgage insurance company, and The Reinvestment Fund, a large community development financial institution that makes investments in disadvantaged neighborhoods. He is the author of *Paying the Price: Ending the Great Recession and Beginning a New American Century*, which assesses the monetary and fiscal policy response to the Great Recession. His other book, *Financial Shock: A 360° Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis*, is described by the *New York Times* as the “clearest guide” to

the financial crisis. He earned his BS from the Wharton School at the University of Pennsylvania and his PhD at the University of Pennsylvania.

James H. Carr: America Needs a 21st-Century Housing Finance System

As Jim Millstein states in his earlier essay in this series, the current housing finance system is in a state of “dysfunctional limbo.” Several policy briefs and data reports by the Urban Institute support that general observation based on many indicators (Goodman et al. 2016).¹ Not surprisingly, the system is most deficient in serving populations that have historically been precluded from fair and equal access to the housing finance system, namely, African Americans and Latinos. Ironically, net new household formation will be overwhelmingly nonwhite between now and 2030 (Goodman, Pendall, and Zhu 2015).

Yet the housing finance system is not only underperforming, but it is also outdated and in need of an overhaul in its mission, activities, products, and services. The basic pillars of our modern housing finance system were enacted in the 1930s during the Great Depression. Since then, there have been major shifts in the US economy, demographic composition, and spatial location of the population. These important reconfigurations in our economy and society demand greater intervention and bolder vision than simply attempting to better manage the risks posed by an underperforming and outdated system. This essay recommends transforming Fannie Mae and Freddie Mac into a new National Housing and Community Investment Corporation (NHCIC).

A Bolder Vision

Most housing finance reform proposals either ignore or only briefly mention rental housing financing. Yet, our nation is experiencing an affordable rental housing crisis. Failing to address this shortcoming of our housing finance infrastructure, while pursuing major housing finance reform, would be an important oversight.

The Housing Act of 1937 envisioned a nation in which families would pay no more than 30 percent of their income on housing (Schwartz and Wilson, n.d.). Today, nearly two-thirds of renter households pay more than 30 percent and nearly a quarter of African American and Latino renter households pay more than 50 percent of their income on shelter (Desmond 2015). In fact, the National Low Income Housing Coalition estimates “there is not a single state in the US where a minimum-wage

employee can reasonably afford a one-bedroom apartment at the fair market rent.”² A revamped housing finance system must address and solve this problem.

A severe shortage of affordable units is a key problem for the rental market. Yet, effectively addressing the rental housing supply challenge is not simple. It requires a keen understanding of housing supply-and-demand dynamics and insight into the influences of location, construction type, and available financing on rental prices because new construction can actually raise demand and further increase rents.³ Our future housing finance system must identify ways to leverage support for producing and preserving affordable rental units (Williams 2015). This would include innovative financing structures and working closely with state and local entities to remove regulatory barriers (Gibb, MacLennan, and Stephens 2015; Katz et al. 2003).

Further, over the past 80 years, the geographic preferences of American households have shifted dramatically. The current housing finance system was designed to support new construction in the suburbs. The system has few effective tools to address the challenges presented by inner-city development, particularly in older, industrial cities with large lower-income populations and many people of color.

Americans are increasingly rediscovering the attractiveness of cities, and because of that interest, many formally distressed cities are experiencing remarkable revitalization efforts. But just as the post-WWII movement of non-Hispanic white households to the suburbs excluded the equal participation of African Americans and Latinos, many impressive urban economic recoveries are, again, leaving people of color on the sidelines.

Segregationist housing policies have been replaced by discrimination based on economic capacity, which disproportionately favors non-Hispanic white households. Yet, the foundation of economic disparities by race and ethnicity have at their core decades of discriminatory federal housing policies (Carr and Anacker 2015). Today, black and Latino communities across the nation are not only struggling with weak labor markets and limited job opportunities, but they are also battling to recover from the recent foreclosure crisis.

Unregulated financial exploitation during the housing bubble inflation has left many inner-city communities of color in tatters, debris fields virtually littered with foreclosed and abandoned properties. These communities do not have access to the funding or tools to help them benefit from the return-to-the-cities movement. Further, many rural communities are struggling to adequately address economic and demographic shifts within their localities. Better meeting the community development needs of those jurisdictions is long overdue.

The new NHCIC would support the comprehensive community development that is essential to equitable urban revitalization and responsive rural investment needs. This would include comprehensive mixed-use redevelopment incorporating owner-occupied and rental housing, retail and commercial space, and the accompanying community infrastructure. This new function could be accomplished via a new generation of community-development tax credits or tax-preferred municipal bonds, direct federal loans or guarantees, or incorporating a fully developed infrastructure bank.

The ability to pursue broad-based community investment as part of its housing finance mission would enable the NHCIC to work with communities on long-term development strategies and near-term opportunities. The new community development infrastructure function would provide low-cost funding to developers who meet criteria related to local community benefits. There are many ways to design this financing vehicle, and adding this function within the new housing finance system would provide more integrated, long-term, and sustainable investments, as well as quality construction-related job growth, in many communities that need it the most. And having this function within the NHCIC is not completely new; for many years, Fannie Mae employed community-development experts who could perform many of these new functions.

Leveraging housing finance as a jobs creator is not new. The housing finance system of the past century was designed to create jobs and a nation of homeowners. The FHA and VA (Federal Housing Administration and the US Department of Veterans Affairs) housing programs helped build millions of homes and the infrastructure required by the burgeoning suburbs they created. Residents today in many of the nation's largest, older urban centers and distressed rural areas need good jobs that could be generated by the expanded development of decent, safe, and affordable housing and its accompanying infrastructure.

Fix the Basics

The NHCIC would have as its foundation an efficient, safe, and reliably self-sustaining mortgage finance system. Before the housing market's collapse, our housing finance system was plagued by five major deficiencies: (1) inadequate regulatory oversight, (2) misguided incentive structures, (3) inefficient leveraging of private capital and insufficient risk-sharing arrangements, (4) an unfunded explicit federal guarantee, and (5) inadequate service to diverse market segments. In addition to addressing those critical weaknesses, a further challenge going forward will be to design a new structure that ensures a

smooth transition from the current operation of Fannie Mae and Freddie Mac into a new government corporation.

The core framework for basic mortgage market operations for the NHCIC could be similar to that recommended by Mark Zandi in his contribution to this series. Zandi recommends establishing a new National Mortgage Reinsurance Corporation (NMRC), and his article draws on a more detailed proposal he coauthored with Jim Parrott, Lewis Ranieri, Gene Sperling, and Barry Zigas (Parrott et al. 2016). Their concept addresses the five challenges listed above and ease of implementation. As such, their framework could be the foundation for the basic mortgage market operations of the NHCIC.

Core features of the NHCIC that draw on the basic framework of the NMRC include merging Fannie Mae and Freddie Mac into a new government corporation (as opposed to a government agency) that would continue to perform all the basic mortgage market operations of the current government-sponsored enterprises with some key enhancements or modifications, including the following:

- Providing an explicit federal guarantee on mortgage-backed securities
- Maintaining catastrophic risk while transferring *all* noncatastrophic risk to the private sector
- Maintaining a portfolio for distressed loans and to aggregate single- and multifamily loans for securitization (but prohibiting the use of that portfolio for investment purposes)
- Ensuring equal access to lenders of all sizes
- Adjusting guarantee fees in a way that enables homeownership for creditworthy, lower-income households
- Collecting fees to support access and affordability for homeownership and rental housing
- Maintaining the Federal Housing Finance Agency as the new corporation's regulator

These key structural elements ensure a well-functioning mortgage market by more clearly defining the appropriate roles for private versus public capital, improving lender access to the new entity's securitization platform, shoring up the ability for duty-to-serve requirements to be met, continuing today's support for rental housing finance, and leveraging the best of the private sector and government with a government corporation structure.

The NHCIC would develop, pilot, and bring to scale innovative mortgage products and services. And it would have a portfolio sufficient for the corporation to pursue mortgage innovation. This expanded role for the housing finance system recognizes that all borrower groups should not be expected to

equally meet the underwriting criteria for standard mortgage products. The discriminatory practices of the government housing finance institutions of the 20th century are some of the most important contributors to the racial wealth gaps in America today (Kaplan and Valls 2007). The NHCIC's expanded role recognizes that, as the past decade proved, encouraging financially vulnerable households to rely exclusively on private-label securitized loans for mortgage innovation can be a recipe for future financial exploitation.⁴

Organizations such as Self Help Credit Union and Neighborhood Assistance Corporation of America have pioneered successful mortgage loan products. The new housing finance system should work with these and other nonprofit institutions to support and bring to scale (where possible) their innovative approaches. Innovative financing models should also explore the use of shared equity loans and shared equity ownership. Finding ways to enable investors to help borrowers own a home, rather than to compete against them in the market, would better align the interests of investors, families, and communities.

Further, the NHCIC would institutionalize borrower counseling (for those who need it) as a routine service funded by mortgage transactions (Spencer 2013). Counseling can better prepare borrowers to present higher-quality loan applications to lenders (Temkin et al. 2014). Also, accurate and reliable information is essential to making good housing finance choices. More robust borrower education might be particularly valuable to lower-income families and people of color because they are more likely to be vulnerable to financial predators and less likely to be familiar with the mortgage finance process. And given the challenges faced by young adults with low-wage jobs and high student debts, formalized borrower counseling might, nevertheless, help those households access homeownership.

The NHCIC would also be required to use the most up-to-date and predictive credit-scoring technologies. Using outdated credit-scoring models can unfairly deny households from homeownership to the extent that more accurate scoring models would have demonstrated a higher credit rating. Discussion about updating the credit-scoring models that lenders at Fannie Mae and Freddie Mac use have been under way for more than a year. There is no need to wait for the enactment of a new housing finance system for Fannie Mae and Freddie Mac to incorporate this recommendation.

This bolder vision for a 21st-century housing finance system that includes broader tools and expanded mission may, at first, seem unrealistic. But it's useful to remember that from 1934 to 1938, the federal government created the Federal Housing Administration, Home Owners' Loan Corporation, Federal Home Loan Bank System, and Fannie Mae. And that was in an era that predates supercomputers, data warehouses, sophisticated mathematical modeling, a wide range of risk-sharing

options, and access to global capital markets. It's inconceivable that we lack the expertise or knowledge to add a broader community infrastructure investment component to a system that has operated for more than 80 years.

Notes

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Andrew Davidson: Four Steps Forward: Streamline, Share Risk, Wrap, and Mutualize

September will mark eight years since Treasury Secretary Paulson announced the conservatorship of Fannie Mae and Freddie Mac and a brief “‘time out,’ where we have stabilized the GSEs (government-sponsored enterprises) while we decide their future role and structure.” During those eight years, there have been many proposals for GSE reform, but no resolution.

Much of this delay, I believe, is because of misinformation about the role the GSEs played in the financial crisis and flawed ideas about the economics of mortgage-backed securities (MBS). In particular, critics of the GSEs have suggested that the GSEs and their affordable housing goals were the primary cause of the financial crisis and that the mortgage market could function without a government guarantee.

The first claim, that the GSEs caused the financial crisis, has been widely debunked but continues to weigh heavily on GSE reform. Our analysis clearly shows that the problems in the mortgage market arose primarily from lax underwriting and high loan-to-value lending in the non-GSE mortgage market that was fueled by ratings arbitrage in the collateralized debt obligation market. For example, increases in home prices and subsequent declines were largely correlated with states that had a significant amount of option arms and high loan-to-value subprime loans. States without those products experienced much smaller home price bubbles and declines. While the GSEs contributed to these trends and had other severe flaws, they were the tail, not the dog. In fact, a substantial portion of the GSE losses can be traced to reduced-documentation high-loan-balance loans that did not qualify for the housing goals.

Because of this false narrative, congressional and administration reform proposals have focused on “winding down” the GSEs. This is difficult to do because the GSEs are essential to our housing finance system. Because the GSEs cannot be eliminated quickly, these proposals tend to have long timelines for implementing alternatives and phasing out the GSEs. Furthermore, proposals based on gradually eliminating the GSEs cannot assure that the proposed alternative arrangements can be established and achieve the necessary functional scale.

Because of the second claim, that a government guarantee is unnecessary, Congress considered proposals to fully eliminate the government guarantee and sought alternative methods to maintain the liquidity and functioning of the mortgage market and the TBA (to-be-announced) securities market. However, only a government guarantee fully separates the credit risk of mortgages from the interest-rate risk and prepayment risk of MBS. This allows an extremely liquid secondary market and an active forward market to function. Proposals to replicate this liquidity and functionality without a government guarantee are wishful thinking.

While the GSEs were not the fundamental cause of the housing finance crisis in 2007 and the more severe financial crisis in 2008, they contributed to the meltdown, and there were serious flaws in the structure of the GSEs that allowed private gain at public expense. The GSEs placed shareholder gain over risk management and were severely undercapitalized. GSE reform is needed to address the structural inadequacies of the pre-2007 system.

To eliminate the risk of the GSEs exercising monopolistic power and being too big to fail, several proposals (including the Johnson-Crapo reform bill) suggested creating a system of competitive guarantors. Unfortunately, it is unlikely that such a system would work. While many guarantors are needed to create competition, there are strong arguments for having fewer guarantors to promote standardization. If there are many guarantors, each guarantor would have slightly different guidelines for sellers and servicers which would lead to a race to the bottom as the players compete for market share or would require a government entity to establish rules. Such government-set rules would likely be static and could be gamed by unscrupulous originators. (The history of seller-financed down payments is a good lesson in the efficacy of the government setting the rules for loan programs.) Even if there is not a race to the bottom, it is very likely that a dominant player will emerge. The dominant guarantor would likely charge monopoly profits that would increase costs to borrowers and threaten the profitability of originators and servicers.

Instead of shutting down the GSEs, eliminating the guarantee, or creating new entities, a realistic approach to GSE reform would be to strip the GSEs down to the functions that are essential to promote standardization, liquidity, and access to credit, and adopt the best governance structures for those functions. This can be achieved in four steps: streamline, share risk, wrap, and mutualize. While some of these actions could be taken by the Federal Housing Finance Agency (FHFA) and the administration, the second, third, and fourth steps would require congressional action to fully implement.

I. Streamline

The GSEs should only perform functions related to their guarantee and securitization businesses. Their retained portfolio business should be substantially reduced or eliminated. This is already in progress. (Without having GSEs hold MBS, there could be greater volatility in pricing mortgages. This impact is currently mitigated by the large holdings of MBS by the Federal Reserve.)

Actions

- Reduce the retained MBS portfolios
- Allow GSE to maintain portfolios for cash window and repurchases of seriously delinquent loans
- Establish a plan to sell off nonperforming assets
- Securitize and sell reperforming assets in senior and subordinated transactions
- Recognize that such sales could produce losses
- Establish a common securitization platform or other shared functions, if it can be cost effective

II. Share Risk

The GSEs have demonstrated over the last two years that they can “reinsure” a significant portion of their credit risk into the market through several risk-sharing approaches, reducing taxpayer risk and the concentration of credit risk in the economy. For example, our analysis shows that Freddie Mac has shed approximately two-thirds of the risk on its target loans in its 2014 book of business. To continue this process, it is important to allow for the expansion of the investor base for credit risk transfer (CRT) products.

Actions

- Establish reinsurance and credit risk-sharing programs for up to 75 percent of risk on new GSE loans

- Develop risk retention and up-front risk sharing for originators on a pooled or specific basis
- Establish capital rules that encourage the use of risk sharing but adequately address counterparty risk
- Change Internal Revenue Service and Securities and Exchange Commission rules to establish risk-sharing transactions as real estate mortgage investment conduits and good assets for real estate investment trusts
- Address bank capital rules that reduce liquidity in secondary markets by requiring excessive amounts of capital to hold CRT bonds
- Address Commodity Futures Trading Commission rules that limit the use of credit-linked note structures

III. Wrap

The GSE MBS should receive an explicit government wrap like Government National Mortgage Association securities and should be closely regulated. In exchange for the government guarantee, the GSEs would pay a fee to the government that would defray the potential cost of the guarantee and fund affordable housing or other national housing goals.

Actions

- Establish a Government National Mortgage Association program to wrap GSE MBS or new government wrap
- Charge an explicit fee and housing affordability fee
- Hold the GSEs liable for losses up to a cap by cohort or vintage
- Government will establish eligible loan criteria, capital, and risk-sharing requirements to access wrap; Treasury will oversee this
- Establish a fund to cushion losses

- Maintain GSE access to agency market to maintain cash window and repurchases of delinquent loans from MBS pools

IV. Mutualize

Mutual ownership of the GSEs by mortgage originators offers the opportunity to align incentives and protect taxpayers from future losses while limiting the incentives to siphon the benefits of government guarantees to private shareholders. (If we need an acronym, we could call these NMMs, or national mortgage mutuals. The two entities could be named the Federal National Mortgage Mutual, or FNMM, and the Federal Home Loan Mortgage Mutual, or FHLMM.)

The mutuals would also implement the national duty-to-serve responsibilities of the secondary market. The regulator of the mutual can track the availability of credit to borrowers throughout the country and can require the mutual to have its members serve those communities. The mutual can decide what incentives would be necessary to achieve that goal, rather than having a government entity create incentives for private companies.

If the mutual is unable to raise capital in a stressed environment, Treasury could take on a portion of the risk-sharing role at a high (but not stifling) required return. This would ensure that the mutual would seek private capital first and that the government would earn an adequate return if and when it supports the market.

Actions

- Create a mutual structure, owned by originators, with activity-based funding
- Retain FHFA as regulator of the mutuals and the Home Loan Banks
- Require profits to be paid to members as dividends
- Require mutual to implement national duty-to-serve obligations, subject to regulatory oversight
- Allow Treasury to provide a backstop to risk sharing for new vintages (the target return on investment could be the 10-year Treasury rate plus 20 percent on a blended basis across the CRT stack)

There are three other possible governance structures for the streamlined entities: competitive private stock corporations, regulated utilities, and government corporations. Stock corporations are supported by those who favor “recap and release,” but this was the precrisis structure that led to private gain at public expense. The reason for using mutuals rather than stock companies is that the mortgage-guarantee business is likely a natural monopoly. This arises from the need for standardization and because of investor preferences for a large liquid issuer. A single security and government standards may create competition, but there is no assurance that they will succeed. The mutual structure accommodates a market structure of very few guarantors. A variant on this is to regulate the released entities as utilities. While this would be better than hoping for a competitive equilibrium, a privately owned utility would constantly seek to expand its footprint, reduce its capital, and increase its allowed return on equity. Government corporations would maintain the status quo, whereby taxpayers bear the risk of loss and mortgage availability would be subject to political winds swinging from excessively tight to excessively lax.

The transformation of Fannie and Freddie into issuer-owned mutual insurance companies also provides a clear and relatively simple transition plan. Table 1 compares the governance options.

TABLE 1
Comparison of Governance Structures

	Mutual	Stock	Utility	Government
Profits	Recycled into mortgage business	Extracted from mortgage business	Extracted from mortgage business	Used for other government purposes or allow noneconomic decisions
Innovation	Modest	Aggressive	Modest	Limited
Duty to serve	Enforced by members	Difficult to enforce	Enforced by regulator	Varies with political will
Precedent	Freddie Mac formerly operated as mutual largely funded by thrifts	Subprime originators or Fannie/Freddie pre-crisis	None in the mortgage market or similar financial institution	FHA/GNMA
Number of entities	Can maintain two, combine or add additional mutual	Need five or six to insure competition	Can maintain two, most likely reduce to one	Difficult to maintain more than one
Governance	Issues related to number and heterogeneity of members	Conflict between private profits and public goals	Conflict between shareholders and utility regulator	Political process affects management
Transition	Gradual	Need to raise capital in large IPO	Need to raise capital in large IPO	Difficult transition to single entity

While congressional action is needed to complete the transformation of the housing finance system, there is much that can be done under conservatorship. A primary goal of FHFA, Treasury, and the administration should be to establish and publish risk and capital guidelines for the GSEs. These guidelines should address

- the amount of risk in the loan portfolio;
- the value of future guarantee-fee income;
- reductions in risk because of risk sharing;
- counterparty risk, asset haircuts (e.g., mortgage-insurance, deferred taxes); and
- target returns, including cross-subsidization guidelines.

These capital guidelines would allow more consistent oversight of the GSEs and would provide legislators with a clearer picture of the risk remaining in the entities. They could also help evaluate the probability of exhausting the Preferred Stock Purchase Agreement credit line.

FHFA should also promote the creation and expansion of loan-originator risk-sharing programs. These programs could reflect originator-specific risk or pooled risk from several originators. Such programs could become the basis for originator activity-based capital requirements and impose the necessary skin-in-the-game discipline on the origination process. To some extent, the GSEs already have some of this via their claim on servicing rights and through representations and warranties. Originator risk sharing would not be a net cost to the originators, as it would provide originators another source of income or offset guarantee fees.

The congressional actions required to implement the plan do not need to be combined into a single GSE reform bill (although that would be nice) but could be implemented sequentially with the ability to adjust the plan as events unfold.

First, Congress would need to facilitate the expansion of the risk-sharing investor base. There are several needs along this line, including changing Internal Revenue Service and Securities and Exchange Commission rules to facilitate CRT investment by mortgage real estate investment trusts. Commodity Futures Trading Commission rules also limit the use of credit-linked notes, which could further expand investor participation and protect taxpayer interests. Congress also needs to encourage and enable regulators to address bank capital rules that impose excessive capital requirements on CRT investment. Bonds created by the GSEs under the regulatory oversight of the FHFA should not be treated like the subprime and collateralized debt obligation investments that contributed to the crisis.

Second, Congress would need to make the implied guarantee of the GSEs explicit and establish a wrap fee and housing affordability fee structure associated with access to that guarantee. Treasury or another regulator such as FHFA or the Government National Mortgage Association would establish the loan eligibility and first-loss capital requirements to access the guarantee. Such a guarantee should lower mortgage rates without increasing the risk to taxpayers because the government has demonstrated that it would stand behind the GSE MBS. Such legislation would also allow the restructuring and eventual elimination of the Preferred Stock Purchase Agreements.

Third, Congress would need to authorize the establishment (or reestablishment, in the case of Freddie Mac) of a mutual structure for the GSEs. This legislation would need to include guidelines and authority for FHFA to oversee these institutions and enforce duty-to-serve requirements.

GSE reform may continue to languish until more of the public and Congress examine Fannie Mae and Freddie Mac objectively and practically rather than through philosophical and political prisms. An objective analysis would reveal that an effective housing finance system can be created from the existing flawed system with just a few steps that rely on economic structures with known features and manageable risks.

About the Author

Andrew Davidson is a financial innovator and leader in developing financial research and analytics. He has worked extensively on mortgage-backed securities product development, valuation, and hedging. He is the founder and president of Andrew Davidson & Co. Inc., a firm specializing in the application of analytical tools to investment management. He was instrumental in creating the Freddie Mac and Fannie Mae risk-sharing transactions STACR and CAS. These transactions allow Freddie and Fannie to attract private capital to bear credit risk, even as they remain in government conservatorship. Davidson is also active in other dimensions of GSE reform and has testified before the Senate Banking Committee several times. He also helped establish the Structured Finance Industry Group and served on the executive committee at its inception. Davidson is coauthor of several books including, most recently, *Mortgage Valuation Models: Embedded Options, Risk and Uncertainty*. He received a BA in mathematics and physics from Harvard University and an MBA in finance from the University of Chicago.

Mark Calabria: Coming Full Circle on Mortgage Finance

America's mortgage finance system was once called "the envy of the world," at least by Americans. Wisely, few other countries choose to emulate our system. The current limbo of Fannie Mae and Freddie Mac offers a once-in-a-generation opportunity to rethink our mortgage finance system. There is much we can learn from both our own history and that of other countries. We should return largely to an "originate-and-hold" model for mortgage finance. But as with any malady, the road to a cure begins with admitting you have a problem.

What are some of the problems with the current system? First, it is characterized by massive leverage on the part of financial institutions. My "back-of-the-envelope" calculation is that the ultimate holders of mortgage risk in the United States were leveraged almost 60-to-1 at the time of the crisis, based upon their minimum required capital standards. This requires a loss of only about 2 percent before the system becomes insolvent. Such leverage was largely the result of the interaction of the Basel III capital accords and mortgage securitization.

Despite oft-heard claims that the current system has largely worked fine for over 80 years, the truth is that our securitization-based system is relatively recent. Until the early 1980s and the implosion of the savings and loan industry, most mortgages were held as whole loans on the balance sheets of depositories. Insurance companies held most of the remaining loans. The securitized share did not even break double digits until around 1980. Our current system arose from the ashes of the savings and loan crisis. When the system was first tested in a housing downturn, it failed. It would be more accurate to say that the current securitization-based system has never survived a housing downturn, rather than to claim long-standing stability.

The recent crisis revealed that securitization has largely been a capital arbitrage that simply shuffled mortgages around from one balance sheet to another (Ambrose, LaCour-Little, and Sanders 2005). We should not forget that. Mortgages, under any system, have to rest on someone's balance sheet. Like water running downhill, the risk has flowed to the most leveraged sectors of our financial system. This is a recipe for instability.

Nor has the current system delivered gains in terms of homeownership. The homeownership rate today is lower than it was before the era of securitization. The racial homeownership gap is at a 100-year high. Interestingly enough, over the last century, the racial gap was smallest in 1980, at the

beginning of the securitization era. In fact, the growth of mortgage securitization coincided with an increase in the racial gap. So whatever the merits of our current system, it has not delivered on the American Dream.

The failure of our mortgage finance system to deliver broad-based gains in homeownership or even housing affordability should not come as a surprise, as the primary obstacles to achieving those goals are not related to mortgage finance. The primary barrier is the high price of housing relative to income. Rather than continuing to substitute easy credit for a lack of income growth, the better path would be to address both income growth (or lack thereof) and housing price growth directly. Our current system has left families drowning in debt, hardly the American Dream and completely unnecessary. As Elizabeth Warren recognized in her book *The Two-Income Trap*, additional easing of mortgage standards has only left families more indebted as they bid ever higher against each other for a limited supply of housing. The clear solution is to increase that supply of housing, not continue down the path of low down payments.

The most striking evidence of the need for an increased supply of housing can be found in California. Because of the legislated loan limits for Fannie Mae and Freddie Mac, their footprint in California was relatively constrained before 2008. Congress increased the loan limits for high-cost areas in July 2008. This change greatly expanded the footprint of the government-sponsored enterprises (GSEs) in California. Did California housing become more affordable? No, just the opposite. According to the California Association of Realtors, 38 percent of first-time buyers could afford a median-priced home in San Francisco just before the GSE loan limits were raised in 2008.¹ That number has dropped to 24 percent. Increasing the GSE footprint in San Francisco made housing less affordable, not more. That shouldn't be a surprise, as the housing affordability crisis in California has almost nothing to do with the mortgage market.

Who's Watching the Credit Risk?

Twenty years ago, Lew Ranieri (2000) succinctly laid out the goals of mortgage securitization:

“The goal was to create an investment vehicle to finance housing in which the investor did not have to become a home loan savant. He or she did not have to know very much, if anything, about the underlying mortgages.”

Mission accomplished. We have a system, as we did leading into the crisis, where investors did not either care or know about the underlying credit risk. While some might see that as a critical feature of

the system and one to be preserved, I believe it is the most fundamental flaw of our system. A system where investors do not care about credit risk is one where toxic mortgages are not only allowed but encouraged.

To substitute for investor due diligence, we have placed our faith regulators and politicians. The Dodd-Frank Wall Street Reform and Consumer Protection Act creates new standards for mortgages under the qualified mortgage and qualified residential mortgage rules. But, as I have detailed elsewhere, these new rules are unlikely to increase credit quality and may even increase delinquencies in the next downturn (Calabria 2014). Perhaps that should not be surprising. Our politicians have long been more interested in expanding ever cheaper credit than in promoting economic and financial stability. Any reformed mortgage finance system must align the incentives of investors, borrowers, lenders, and taxpayers. Insulating investors from credit risk fails to do so.

Broader Access Requires Local Knowledge

Even though the growth in securitization accompanied an expanded racial homeownership gap, many argue that securitization increases credit access. Associating securitization and greater credit access without qualification overlooks how lending decisions are made today. The expansion of automated credit scoring turned mortgage underwriting into an assembly line. This development reduced the cost of underwriting for standard borrowers, those with good credit and able to make a down payment.

The standard underwriting system relies heavily on hard, objective information, which is usually financial. Subjective, or soft, information is difficult, if not impossible to utilize in a securitization-based system. Expanding access responsibly requires gathering that subjective information. It also requires that mortgage lenders have appropriate incentives to review soft information and, when appropriate, extend credit based upon it. This is one reason why researchers have found that branch banking networks are critical for expanding access to low-income or thin credit-file borrowers (Ergunor 2010).

One could argue that those who pool mortgages, such as Fannie and Freddie, could rely on local originators to gather and base approval decisions on subjective knowledge. But as the recent crisis demonstrated, mortgage-pooling firms have no incentive to incorporate soft information. Going back to an originate-and-hold model is likely the best avenue for expanding access to borrowers who are truly “creditworthy.” The originate-and-hold model also helps at-risk borrowers avoid default by reducing barriers to modifying mortgages during downturns, because conflicts between investors, trustees, and servicers would be minimized.

Litigating Mortgage Out of Reach

The most critical elements of a functioning mortgage market are respect for property and contract. Mortgage providers are reluctant to extend credit if they do not believe their rights will be respected and protected. This includes the ability to foreclose on the underlying collateral. While every foreclosure is a tragedy, a system that did not allow foreclosures would be even worse. Unfortunately, we continue in the direction where consumer protection law makes legitimate foreclosure more and more difficult. If we wish to see mortgage credit widely available, litigation risk must be reduced. As researchers at the Federal Reserve Bank of Richmond have demonstrated, consumer “protection” policies that appear on the surface to help borrowers can actually leave those borrowers worse off (Athreya, Tam, and Young 2009).

Wrong Liquidity at the Wrong Time

Securitization is often defended as an important provider of “liquidity.” As the last decade demonstrated, however, securitization’s “liquidity effect” is procyclical, providing “too much” liquidity in good times and not enough in bad times. Looking at the jumbo mortgage market, Federal Reserve System researchers found that banks that were heavily dependent on secondary market activities cut back their lending during the crisis, while banks that engage more heavily in portfolio lending continued to extend credit (Calem, Covas, and Wu 2013).

Debt or Equity Funding

An oft-heard defense of the securitization model is that without it, there would not be sufficient funding for the US mortgage market. This claim ignores that funding for the secondary market must come from somewhere. For the most part, it has come from the institutions it was supposed to have replaced. Financial institutions and the Federal Reserve are the primary holders of agency securities. Instead of linking borrowers with retail investors, our current system shuffles around claims among financial institutions. If banks or insurance companies can hold a dollar’s worth of agency mortgage-backed securities, they can hold a dollar’s worth of whole mortgages. One might retort “but then they’d have to hold more capital,” but this claim only exposes the system for what it truly is: massive leverage. If we think increasing leverage is what the mortgage market needs, we could just as easily increase the

leverage of banks and insurance companies. That would end badly, but so does disguising that leverage via Fannie Mae and Freddie Mac.

Equally relevant is the division between debt and equity. Because of distortions such as the tax preference for debt, financial market participants prefer to fund investment via debt rather than equity. Yet, a dollar that goes into debt could just as easily fund equity, were we to reduce or remove those distortions. A far larger percentage of our mortgage finance system should be equity rather than debt. This should be true for lenders, investors, and borrowers.

Avoiding Another Savings and Loan Crisis

Why go back to an originate-and-hold model when, as demonstrated by the savings and loan crisis, it can fail, too? Because it wasn't the originate-and-hold characteristics of thrifts that caused the crisis. First, it was the lack of market discipline that resulted from the explicit guarantees of deposit insurance. Unfortunately, most reform plans move to an equally flawed explicit guarantee. While we must reform deposit insurance—including a roll-back of its extension under Dodd-Frank—a less leveraged portfolio-based system would rely more on equity and less on government guaranteed debt.

Second, the savings and loan crisis—and the banking crises of the Great Depression—were partly the result of a geographically fragmented system that lacked diversification. In fact, creating the GSEs was largely a Band-Aid to offset the flaws in our then predominately unit banking system. Fortunately, Congress and the states finally removed branching restrictions in the aftermath of the savings and loan crisis. Our largest banks can directly access the capital markets without Fannie, Freddie, or the Federal Home Loan Banks.

Countries such as Canada have managed to have similar rates of homeownership to the United States, with lower defaults and fewer crises, without relying upon securitization to fund the mortgage market (Bordo, Redish, and Rockoff 2015). Even the National Association of Home Builders recognized that among EU countries, those with higher homeownership rates actually had fewer owners with any mortgage debt.² We should recognize that encouraging more mortgage debt is not the same as encouraging homeownership. In fact, the result has generally been the opposite.

What to Do with Fannie and Freddie?

Because I am largely advocating a return to the originate-and-hold model, what should we do with the secondary market's biggest players? There may well be value in a smaller secondary market and in the current GSEs. To retain whatever value there is, the current GSE charters should be converted to national bank charters and the GSEs reorganized as bank holding companies (BHCs). Not only could the GSEs continue to pool and securitize mortgages as BHCs, but they could also originate, collect deposits, and engage in other bank activities.

Given the high concentration among the largest banks, adding two large BHCs would immediately bring increased competition to that market. It would level the playing field between the GSEs and the largest banks, in both directions. This would require that the GSEs operate under the same rules as other BHCs. Securities law exemptions and favorable tax treatment would disappear. But the goodwill and human capital within the GSEs would remain. Shareholders would also benefit to the extent that the companies had value. This would require the GSEs to meet bank capital levels. Selling off the government's preferred shares would assist in this regard.

It is worth noting that converting Fannie and Freddie to BHCs solves one problem while exacerbating another: the too-big-to-fail status of our largest banks. Ultimately all BHCs, including the newly created Fannie and Freddie BHCs, should hold substantially more capital. That capital should also largely be in the form of common equity and calculated on a non-risk-adjusted basis.

Conclusions

Securitization is a false god that failed us. While not without some value, its virtues have been exaggerated, if not illusory, while its costs have been hidden or ignored. The same holds for government guarantees of credit risk. Hiding costs rarely reduces them. Painful experience has continued to show the opposite. A more stable and affordable housing market would be best served by returning to an originate-and-hold model of mortgage finance. The past failures of that model—its fragmented nature and its extensive government guarantees—can be more easily addressed without a continued resort to massive leverage. We need not prohibit securitization or even mandate originate and hold; we simply need to remove the various subsidies and distortions that tilt the field toward securitization. While modest tweaks of the current system might be more politically palatable, such small tweaks will only push off the issue until the next downturn in the housing market (and yes, there

will be another housing downturn). The only responsible path is to fix the fundamental flaws in our current system.

Notes

1. "Housing Affordability Index," California Association of Realtors, accessed June 10, 2016, <http://www.car.org/marketdata/data/ftbhai/>.
2. Michael Neal, "A Cross-Country Comparison of Homeownership Rates," National Association of Home Builders, June 19, 2015, <http://eyeonhousing.org/2015/06/a-cross-country-comparison-of-homeownership-rates/>.

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About the Author

Mark Calabria is director of financial regulation studies at the Cato Institute. Before joining Cato in 2009, he spent seven years as a member of the senior staff of the US Senate Committee on Banking, Housing, and Urban Affairs. During his Senate service, Calabria drafted significant portions of the Housing and Economic Recovery Act of 2008, which established a new regulatory regime for the government-sponsored enterprises. Calabria was also deputy assistant secretary for regulatory affairs

at the US Department of Housing and Urban Development, and he has held several positions at Harvard University's Joint Center for Housing Studies, the National Association of Home Builders, and the National Association of Realtors. He has a PhD in economics from George Mason University.

Patricia Mosser: Principles—and a solution—for GSE reform

Replacing the housing securitization government-sponsored enterprises (GSEs)—Fannie Mae and Freddie Mac—is the biggest financial reform issue in the United States. It is a glaring gap compared with the extensive financial reforms in other parts of the financial system and seven-and-a-half years (and counting) of temporary government conservatorship. There have been many proposals to replace the activities of Fannie and Freddie, including a mutualized securitization utility that some of my colleagues and I outlined in two papers (Dechario et al. 2010; Mosser, Tracy, and Wright 2013). But more important than the details of our proposal to replace the GSEs are several key design principles—and a few hard-learned lessons—which need to guide reform.

Principles for Reform

First, **any replacement for Fannie and Freddie should be structured to reduce systemwide risk** by insuring that those who make decisions about housing risk appropriately price and bear those risks. Because securitization is atomistic, this incentive alignment needs to happen across the entire housing securitization chain (i.e., borrowers, lenders, securitizers, investors, and the government). The entities responsible for covering losses must have a stake in which loans to securitize, the risk monitoring of loans, and the amount of credit protection (capital) needed. The failure of private-label securitization in the financial crisis was partly because of the failure to align the incentives of lenders, securitizers, and investors in this dimension. Any proposal to replace GSE-type securitization should not be structured with the same flaws that destroyed the private-label market. Instead, it must ensure that the securitization entity has skin in the game and can monitor, price, and enforce credit standards.

One implication of this principle is that there needs to be greater capacity to absorb losses for core mortgages consistent with capital requirements for other financial institutions. Fannie Mae and Freddie Mac had skin in the game, just not enough. Another implication is that borrowers, lenders, and securitizers—all of whom influence lending decisions—should provide sufficient information to understand and monitor mortgage risks and have skin in the game. In other words, we need greater disclosure, meaningful household down payments (10 to 20 percent), close monitoring of credit quality, and risk retention.

Second, **the housing finance system structure must be more robust and provide access to mortgage credit through the housing cycle.** While this was an ostensible goal for the GSEs, they clearly could not do so without a government takeover. Moreover, this robustness cannot be achieved by merely spreading out or diversifying mortgage credit risk across many investors or financial companies. As the crisis proved, all boats rise and fall (or fail) together in a systemic real estate downturn.

Third, **governments own the tail risk in housing finance.** Across decades, countries and political regimes, and different types of financial systems, governments step in when house prices collapse and precipitate a financial crisis. While the form of government bailout can vary, there is no question that governments “reinsure” their housing finance systems in extremis (Laeven and Valencia 2010). Therefore, it is not credible (and not time-consistent policy) for the government to claim that it will not bail out the housing finance system. Moreover, if the government claims it will not provide a backstop, it is likely to provide incentives for more risk taking and leverage in the financial system through an unpriced implicit guarantee, making a housing-related boom-bust cycle more likely. Consistent with the first principle above, the government’s catastrophic reinsurance needs to be credible, explicit, and priced ex ante.

While governments must manage and price tail risk, they should not price and manage housing credit risk on a day-to-day basis. Setting standards and regulatory minimums is a government regulatory responsibility. Daily risk monitoring, repricing mortgage credit risk, and making monthly adjustments to issuer-specific fees are not. The history of government agencies and corporations has many examples of the private-sector actors “gaming” government entities, minimizing the costs and risks to the private sector and maximizing the risk taken by the government. In short, the government should price the (remote) tail risk it does face (already a difficult task) but not price normal mortgage credit risk.

Fourth, **the current high degree of standardization of mortgages (particularly for fixed-rate loans) and the associated market structures (particularly the agency mortgage-backed securities, or MBS, market) are worth preserving** if possible in a system consistent with the other design principles. Of course, the evolution of agency securitization reflects, in part, US homebuyers’ long-standing preference for long-term fixed-rate, fully amortizing loans with no prepayment penalties. Because such mortgages are a poor fit for most lender balance sheets, securitization and its associated market structures will be important for financing home mortgages.

Securitization of standardized mortgages has several benefits for borrowers, lenders, and investors. For borrowers, standardized fixed-rate mortgages provide some protection from interest rate

fluctuations and simplify comparison shopping across competing lenders. Because of their long history in the United States, they are consumer protection products in that their properties and risks are well understood by borrowers. Moreover, one reason that the current agency MBS market is so much more efficient than private securitization markets is because of the relatively standardized, homogenous underwriting process and the straight-through processing embedded in the GSE securitization structure.

The large size and deep liquidity of the agency MBS market mean that investors in agency MBS require lower yields because the bonds can be sold with lower transactions costs and without a long, uncertain wait for a buyer. These lower yields contribute to lower borrowing costs for households and to less risk (and thus lower costs) to lenders making loans. Similarly, the current agency MBS market is a hedging vehicle not only for investors but also for lenders who hedge their pipeline of originated mortgages and interest rate locks offered to borrowers. In addition, lenders use the MBS markets to hedge risks of all types of mortgages—even those not intended or eligible for GSE-type securitization—which likely lowers the cost of those mortgages as well.

Last, **standardized securitization is an infrastructure or a utility.** It is a high-volume, low-margin business, as demonstrated by the relatively flat profitability of the Fannie Mae and Freddie Mac securitization business lines over time. In other words, standardized securitization has relatively large fixed costs and low marginal costs (the characteristics of a natural monopoly), which suggests that there will be one or very few firms. An important implication of this principle is that there are no efficiencies or benefits for conducting nonstandard securitizations within such a utility. Securitization of idiosyncratic or bespoke loans—such as those included in commercial real estate or multifamily residential MBS—is the opposite of a utility business. Margin costs are high. Every security—compositionally and structurally—is different, and most involve few individual loans, so there is no “law of large numbers” to diversify idiosyncratic risk. In short, any replacement for Fannie and Freddie should not include such securitizations.

Our Proposal

What Do We Advocate?

My coauthors and I previously proposed a mutualized financial market utility (FMU) to replace Fannie and Freddie securitization. The proposed FMU is a regulated private firm mutually owned by lenders, focused exclusively on securitization of standardized residential mortgages.¹ The utility pools mortgages into pass-through MBS and provides a credit guarantee. It prices and manages credit risk of the mortgage pools it securitizes, subject to safety and soundness (capital) regulation, and it is required to buy catastrophic reinsurance from the government. It allows mortgage credit markets to function (or restart) even in times of market and economic distress by managing its capital waterfall on a vintage basis. Each vintage of mortgage risk (supporting multiple MBS) is separately capitalized and separately reinsured by the government, allowing for new capital (via a new vintage) to support origination of mortgage credit at the bottom of the cycle without additional government intervention.

How Is This Structure Consistent with the Principles Above?

The mutualized ownership and loss-sharing structure in our proposed utility are designed to address the first principle of incentive alignment. Our FMU creates incentives to adopt and maintain common underwriting and securitization standards and, more importantly, for owners to closely monitor the credit quality of each other's lending. Based on this monitoring, the utility can adjust pricing and guarantee fees of individual lender and member loans.

Appropriate incentive alignment also limits how much credit exposure the FMU can sell to other investors. This is important during housing booms, when it is easy for the utility to sell off all its credit risk. But without skin in the game, utility members would collectively ease credit standards, making the boom (and subsequent bust) worse. To avoid this outcome, the FMU must retain a portion of the mutual loss pool to insure appropriate risk management and ongoing monitoring of mortgage credit quality. Importantly, this also insures that the FMU has sufficient capital to fund new vintages, even in periods of market stress when external financing may not be available.

Moreover, characteristics of mutuals that may be seen as disadvantages for some types of financial companies are in fact advantages for our FMU proposal because they align the utility's incentives with other actors in the securitization chain. Creating a utility with a narrow focus, an emphasis on cost

control and efficiency, low risk taking, low return on equity, and low incentives for entrepreneurship and “mission creep”—all of which are characteristics of mutuals—is well aligned with the interests of owner/lenders and investors; with the government’s interest in insuring its backstop is sufficiently remote; and to offset monopolistic rent seeking. In practice, mutual ownership structures work well when they solve a principal agent problem—that is, when their business provides a service closely aligned to the needs of their owners and when owners are relatively homogeneous and knowledgeable (Hansmann 1999). All these characteristics fit our FMU.

The FMU’s vintage structure and government reinsurance are designed to address robustness. Vintages compartmentalize credit loss pools and capital so that losses on specific vintages of MBS are covered by the capital available for that pool. Excess profits or capital (as defined by the regulator) from older vintages may be used as capital for newer vintages but not vice versa. To ensure robustness, “new” capital may not be shifted to cover past losses. Securitization can restart with a clean slate with new mortgages from lenders and fresh capital and guarantee fees that can be used only for current and future vintages.

Government catastrophic reinsurance is purchased by vintage, so the government does not reinsure idiosyncratic tail losses on individual MBS but on extraordinarily large and widespread tail losses on an entire vintage. The government’s involvement naturally unwinds as the balance of the affected vintage pays down. Applying government reinsurance only after the FMU’s failure is not robust (because mortgage credit cannot be restarted) and risks repeating the conservatorship experience. Finally, by compartmentalizing risk (and tail risk insurance) in vintages, failure of the entire FMU is much less likely.

The FMU structure also reinforces secondary market liquidity and standardization of mortgages and is most likely to be used for fixed-rate loans. Our structure is consistent with recent efforts to create a single to-be-announced securities (TBA) market for delivery of mortgage pools and efforts by the Federal Housing Finance Agency on modernization and a new single securitization platform. In addition, mutualizing credit risk could facilitate creating larger and more diversified mortgage pools within the TBA market, which could improve liquidity, reduce market fragmentation, and lower mortgage costs.

Risks and Trade-offs

Like any proposal, our FMU is not without risks and challenges. Government reinsurance is notoriously hard to price. However, the previous price was zero (or negative because the government was subsidizing Fannie and Freddie's risk-taking behavior across several dimensions), so even an imperfectly calculated positive price would be a step in the right direction. Our proposal considers other key issues, such as retained portfolios (not allowed except for working out delinquencies), the amount of loss-absorbing capacity needed, and affordable housing programs (completely outside the FMU, perhaps funded by an addition to the guarantee fee).

Creating the mutual structure is challenging and reflects the large number of stakeholders in housing finance. From a governance perspective, the FMU would need to balance the needs of large and small members. This can be done several ways, including correspondent relationships akin to the arrangements used for other types of FMUs (e.g., clearinghouses). Even so, direct membership is likely to include small and large lenders, requiring a governance structure that encourages broad access for small lenders, but also risk-management oversight with sophisticated risk monitoring consistent with larger lenders.² Creating a robust mutual structure will involve consultation with mortgage lenders, borrowers, and investors; new legislation; and importantly, a knowledgeable, sophisticated regulator with the power to write rules that can carefully balance the needs of the various stakeholders. Like many other proposals, ours likely needs a long lead time and creation of administrative "bridges" to new corporate structures.³

Notes

1. Standardized mortgages need not necessarily be conforming, but those with common property, loan, and borrower characteristics. In practice and certainly at inception, most securitized mortgages are likely to be fixed rate.
2. See Mosser, Tracy, and Wright (2013) for several proposed governance structures.
3. Jim Millstein, "Jim Millstein: An Administrative Plan to Restructure and Reform the GSEs," Urban Institute, last updated March 29, 2016, <http://urbn.is/1ShTPiH>.

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About the Author

Patricia C. Mosser is a senior research scholar and senior fellow at Columbia University's School of International and Public Affairs and the director of a new initiative on central banking and financial policy. Previously, Mosser was head of research and analysis for the Office of Financial Research at the US Department of the Treasury. She spent over 20 years at the Federal Reserve Bank of New York as a researcher and monetary policy practitioner. She was a senior manager at the bank's open market desk, overseeing market analysis, foreign exchange operations, analysis of financial stability and reform, and monetary policy implementation, including many crisis-related facilities. Before that, she was an economist and manager in the New York Fed research department and an assistant professor in the economics department at Columbia. Mosser has written on monetary policy and financial stability topics, including crisis policy tools, the monetary transmission mechanism, and financial structure and reform. She has a BA from Wellesley College, an MSc with distinction from the London School of Economics, and a PhD from the Massachusetts Institute of Technology.

Marc Morial: The Homebuyers' Bill of Rights 2.0

In the aftermath of the Great Recession, the tragic loss of wealth, and the bailout of the big banks, our national government must continue to play a central role in the housing market to right previous wrongs, ensure access to all qualified borrowers, and keep the housing finance system afloat for future generations.

The National Urban League's Homebuyers' Bill of Rights 2.0, proposed below, is a road map to help all Americans—with a targeted emphasis on African Americans and people of color—live the American Dream and attain wealth through homeownership.

As president and CEO of the National Urban League, the nation's largest historic civil rights and urban advocacy organization focused on economic empowerment, I lead a dynamic team of economic first responders at more than 90 affiliates in 300 communities who provide direct services to over two million people annually.

As a leading housing counseling agency approved by the US Department of Housing and Urban Development (HUD), we operate housing programs at more than 40 of our Urban League affiliates. Since 2008, we have serviced nearly 200,000 clients.

We know and see it firsthand: African Americans lag behind whites in nearly every economic indicator. Higher unemployment, lower incomes, lower retirement savings, higher numbers of un- and underbanked, lower credit scores, lower homeownership, higher poverty, and less wealth than Whites—across the board—are the realities in life in black America.

I. Economic Disparities

Any effort to rebuild wealth through housing must confront the underlying realities of low wages, wage stagnation, income inequality, and declining disposable income for far too many Americans. A good-paying job is the difference between homelessness, living paycheck-to-paycheck, or struggling financially.

African Americans, who are typically the last hired and the first fired, were disproportionately slammed by the Great Recession and the ensuing financial crisis. According to the National Urban League's 2015 *State of Black America*® Unemployment Equality Index™, only two of the 70 major US cities surveyed had an African American unemployment rate lower than 10 percent. In addition to higher unemployment, many middle-class African American workers were forced to exchange the jobs that laid them off for low-skilled and part-time work, which paid much less. We must increase the minimum wage to \$15 an hour to address this and other pay disparities and ensure all Americans have access to living-wage jobs. We also must ensure all Americans have access to retirement plans through their employers. Currently, less than 50 percent of African Americans have access to an employer-sponsored retirement plan, and those who do have only 20 percent of the retirement income of whites. This is not enough on which to retire comfortably.

Poor credit scores and the absence of quality accessible banking resources in the community have led to an increasing reliance by un- and underbanked African Americans to use alternative financial services that strip wealth from consumers. Approximately two-thirds of African American small businesses are denied loans. African American small businesses start with less capital, use credit cards at a higher rate, and use loans with higher interest rates. Although they are one of the fastest-growing segments of the economy, the average African American small business grosses less than \$75,000 in annual revenue, and 95 percent do not have any paid employees. Small businesses are not the same engine for wealth for African Americans as they are for whites.

Homeownership is the primary means of building equity and passing on wealth from one generation to the next. This is especially true for African Americans. According to the Center for Global Policy Solutions, over 90 percent of African Americans' wealth is in their homes. Unfortunately, 25 percent of the homes that were in foreclosure or deeply underwater during and after the crisis were owned by African Americans. Fifty percent of African Americans' wealth was wiped out by the financial crisis, and a pernicious false narrative was promulgated by some to blame Fannie Mae and Freddie Mac's affordable housing goals for the Great Recession. In my testimony before the Senate Banking Committee in 2010, I referred to this egregious falsehood as a "weapon of mass deception."

African American homeowners were three times more likely to be steered into subprime products, even when they qualified for conventional mortgages. Over 50 percent of the subprime loans in 2005 and 2006 went to African American borrowers; the foreclosure rate for these loans was 10 times greater than conventional mortgages. Lenders steered African Americans into predatory products the lenders knew could not realistically be repaid.

African Americans have only 6 percent of the wealth of whites. This is unacceptable.

II. State of the Housing Market

While the African American homeownership rate peaked in 2004 at 50 percent, it is currently only 42 percent and is projected to decrease to 40 percent by 2030.

Unfortunately, owning or renting a home has become more expensive since the financial crisis, making it more difficult for African Americans and other people of color to access affordable housing in decent neighborhoods. Most people of color—a disproportionate share of African Americans, in particular—will continue to be renters unless meaningful policies address demographic shifts. Nearly 90 percent of the net new households formed between 2020 and 2030 will be headed by people of color. African Americans will make up nearly one-quarter of all new renters between 2010 and 2030, despite comprising only 14 percent of the population.

Over 25 percent of renters pay 50 percent or more of their income on rent-related costs; we can safely assume it is even worse for African Americans. People of color will continue to suffer the brunt of the current rental crisis, low homeownership rates, and the ills that accompany them without effective policy changes resulting from successful housing finance reform. It is essential for any effort to rebuild the housing finance system to be cognizant of this reality. To do otherwise is a formula for failure.

III. Homebuyers' Bill of Rights 2.0

The National Urban League's Homebuyers' Bill of Rights 2.0 includes the following recommendations:

1. Housing finance reform must include an explicit government guarantee and retain and strengthen affordable housing goals to ensure communities of color have access to affordable mortgages.

Reforms to the housing finance system should include an explicit government guarantee to keep the industry thriving, preserve the 30-year mortgage, and keep credit score and down payment requirements within reason. Our national government must continue to play a central role in backing the housing industry. The government has taken most of the credit risk on home mortgages since the

1930s. Even while in conservatorship, Fannie and Freddie have been the primary source of loans for most homebuyers. Fannie and Freddie hold \$5 trillion in mortgage-backed securities and back nearly 90 percent of the nation's housing market.

Fannie and Freddie's charters, which require them to provide liquidity to the secondary market, must continue to be included and strengthened in any new version of housing finance reform. Lenders should not have access to the government guarantee unless they actively originate loans for people of color in communities of color. "Fulfilling certain public mandates is a precondition of market participation and enjoyment of the federal government's support for the financial marketplace." The nation's civil rights community will not support—in good conscience—reform legislation that fails in this regard.

Experience has proven that just because lending in certain areas may be profitable, it does not mean lending in those areas will be pursued. To this end, the new housing finance system must not only retain, but also strengthen the affordable housing goals. The goals must "lead the market" to ensure underserved communities have representative access to affordable housing. Although vilified and scapegoated, the goals did not cause the foreclosure crisis, as the Fiscal Crisis Inquiry Commission made clear in its 2011 report. The goals helped qualified borrowers purchase homes.

We opposed Johnson-Crapo, namely, because the bill *terminated the goals*. The goals are not perfect, but they should remain in place until a viable replacement is offered.

2. Housing finance reform must include reform to the credit-scoring model and down payment requirements to ensure all qualified borrowers have access to affordable mortgages.

Almost everyone agrees credit score reform should be included in housing finance reform. According to the Urban Institute, "the market is taking less than half the credit risk it was taking in the precrisis period." Over five million Americans were locked out of the housing market between 2009 and 2014 because of unnecessarily high credit score requirements. Executives from FICO and Vantage Score agree that "lenders' credit score requirements for home purchasers are too high and out of sync with the actual risks of default presented by today's borrowers." This is unfortunate because most prospective borrowers barred from the market are people of color.

Mortgages are much safer now. While subprime loans still exist, they have a much smaller footprint than before the crisis. Qualified mortgages and qualified residential mortgages reformed the industry to

ensure borrowers now have the ability to repay their loans. The Consumer Financial Protection Bureau's mortgage servicing and "Know Before You Owe" rules, its updated Home Mortgage Disclosure Act disclosures, and the Supreme Court's affirmation of the use of the disparate impact theory in Fair Housing Act cases help limit the predatory and abusive practices that permeated the industry during the subprime boom. As a result of new regulations stabilizing the mortgage market and the Federal Housing Finance Agency's (FHFA) proposed duty-to-serve rule and the agency's recent clarification of its representations and warranties policies, we believe a 620 FICO score is an acceptable credit score to purchase a loan and to demonstrate a borrower's ability to repay the loan, if the current scoring system remains in place. This would not increase defaults; it would increase access to safe loans for people of color. Loans should be priced accordingly and should include lower guarantee fees. Rent and utility payments, among other recurring remittances that reflect creditworthiness that are not included in FICO 9 scores, should be factored into the new model if reform takes place.

Saving the necessary down payment to purchase a home is one of the major obstacles to attaining the American Dream. African Americans have lower incomes than whites, making it more challenging for them to save for a down payment for an affordable home in a decent neighborhood. Student loan debt, auto lending discrimination, rental car excise taxes, selective police enforcement, and other wealth-stripping efforts make it especially difficult for African Americans to save for a down payment. Moreover, African Americans are less likely than white borrowers to receive an inheritance or help from parents to buy their homes.

Large down payments are not indicators of a borrower's ability to repay a loan. There is no correlation between the ability to save a lump sum of money and the ability to pay a monthly mortgage. That is why we support a 3 percent down payment requirement. We urge FHFA Director Mel Watt to encourage and provide incentives for lenders to offer both Fannie and Freddie's 97 percent loan-to-value products more readily and to adjust the requirements to enable qualified borrowers the opportunity to access these loans. Historically, less than 5 percent of Fannie and Freddie's portfolio have down payments less than 5 percent. We also encourage elected officials and policymakers to provide innovative savings tools and policies, including individual and child savings accounts, to save for homeownership.

3. Housing finance reform must ensure housing counseling is part of the application process to educate borrowers and limit loan defaults.

Research shows that homebuyers who work with housing counselors have better outcomes than those who navigate the system on their own. Many consumers enter the mortgage application and homebuying process without full knowledge and understanding of how to obtain the best loan for their circumstances. According to Freddie Mac, face-to-face prepurchase education and counseling (similar to that provided by our affiliates) reduces loan delinquencies by as much as 34 percent. The evidence suggests that counseled buyers are not only less likely to end up with unfair loans, but are also better prepared for the responsibilities of homeownership.

Similar to private mortgage insurance, housing counseling should be used as a compensating or risk-mitigating factor, allowing borrowers who do not have the requisite credit score, down payment, or debt-to-income ratio to access the traditional housing market. A data field should be included on the mortgage application to give borrowers credit for receiving these services. “Integrating” housing counseling services into the mortgage application process benefits all parties involved (i.e., borrowers, lenders, and servicers) by educating homebuyers and preventing future delinquencies and foreclosures. This would not increase defaults; it would create responsible homeownership. We also support efforts similar to HUD’s Homeowners Armed With Knowledge, or HAWK, program, which provides incentives for borrowers to participate in HUD-approved housing counseling services.

Conclusion

In 2007, I released our Homebuyers’ Bill of Rights, highlighting the impending crisis in the housing market months before it was front-page news. We were ridiculed as “Chicken Little,” predicting a crash that would never come. The rest of the story is history.

Today, we have an obligation to rebuild the American Dream through homeownership for an emerging generation of Americans, and our recommendations, as embodied in our Homebuyers’ Bill of Rights 2.0, present a path toward this crucial 21st-century objective.

About the Author

Marc Morial, who has been described as one of the few national leaders to possess “street smarts” and “boardroom savvy,” is president and CEO of the National Urban League, the nation’s largest historic civil rights and urban advocacy organization. Previously, he was a highly successful and popular mayor of New Orleans and president of the US Conference of Mayors. He was also a Louisiana state senator and New Orleans lawyer. He is a leading voice on the national stage in the battle for jobs, education, housing, and voting rights equity. He has been recognized as one of the “100 Most Influential Black Americans” by *Ebony*, one of the “Top 50 Nonprofit Leaders” by the *NonProfit Times*, and one of the “100 Most Influential Black Lawyers in America,” and he has also been inducted into the International Civil Rights Walk of Fame in Atlanta. He holds degrees from the University of Pennsylvania and the Georgetown University Law Center.

Laurie Goodman: How Can We Keep Rent within Reach for Families?

When we launched our housing finance reform incubator, we wanted to offer a forum for thoughtful people outside of Urban's Housing Finance Policy Center to discuss the future of housing finance. The first nine essays primarily describe what a post-GSE conservatorship system might look like and how to structure it. But the discussion also brought to light two issues that call for further attention: How will the system address increasing rental housing demand? How can we assure that all creditworthy potential homeowners have access to affordable mortgage finance?

Why Is Rental Housing so Important?

Between now and 2030, this country will face an unprecedented surge in rental housing demand. Already, rents are skyrocketing out of the reach for many families, especially in places with job opportunities. New multifamily housing construction is at its highest level since the 1986 Tax Reform Act, but most of the units are high end, which limits affordability.

Some of the earlier essays in our incubator series discuss excessively tight access to credit for homeownership. The Great Recession hit minority families and communities hardest. Over the next 15 years, minority households will account for almost all new net homeownership demand, but these households have the least access to credit.

If these households, whose income and wealth are generally lower than white households', are locked out of homeownership, there will be significant social and economic consequences for the entire country.

Gary Acosta, Jim Park, and Joe Murin: The Future of the GSEs? The “Ginnie Mae 2.0” Solution

Now that the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac have been in federal conservatorship for over seven years, it is time to think about what happens next. GSE reform and its effect on future generations of homeowners requires careful consideration. Any outcome should aim to meet the *needs* of future homeowners, not the *wants* of political interests.

Recently, there has been a surprising amount of enthusiasm for “recap and release,” a catchy phrase that means allowing the GSEs to return to the precrisis days and operate under their old model, when private GSE shareholders profited when times were good and the taxpayers (most of whom are homeowners) picked up the tab when times were not so good. We do not think this is a sustainable or wise course of action. Nor do we think a fully privatized mortgage market without taxpayer support or a government catastrophic risk guarantee is prudent. As we have seen, foreign and domestic private capital markets show great reluctance to invest in US residential mortgage-backed securities (MBS) without an explicit federal guarantee, notwithstanding new laws that have substantially improved mortgage quality.

Fundamental change is necessary. We advocate for GSE reform that uses the “existing plumbing” of the mortgage market to develop a safer and more sustainable market bearing an explicit catastrophic-risk government guarantee that will serve each segment of the homebuying public.

The Harvard Joint Center for Housing has reported recently that as much as 85 percent of household formation in the next 20 years will be minorities and will represent the large majority of new homebuyers in the coming years. The changing demographics and its impact on the housing market cannot be ignored. Nor can the need of the explicit catastrophic-risk government guaranty requirement on conventional MBS. In this essay, we define fundamental principles to meet these two emerging needs and highlight our belief that meeting these needs is no longer optional.

These needs can be met only with a sustainable structure that provides consistent market execution, low down payment opportunity, and long-term fixed-rate mortgage finance, with the government taking as little risk as the market can bear to deliver this sustainable structure. Our proposal focuses on two goals:

1. Meeting the consumer need
2. Eliminating as much of the government risk exposure as possible

We propose a new Ginnie Mae 2.0 structure that utilizes the best of the GSEs' core capabilities and Ginnie Mae's functionality.

Key to our proposal is balancing the needs of future homebuyers and the demands of MBS buyers. MBS buyers are necessary to maintain the stability and liquidity of the housing finance market and meet the needs of future homebuyers. As a result, an explicit catastrophic-risk guarantee for the conventional mortgage market is necessary. Otherwise, the conventional mortgage market will not be a significant source of mortgage finance, and the needs of homebuyers will not be met with any reliable source of private capital. Instead, the mortgage market would be forced to rely almost entirely on the Federal Housing Administration (FHA), US Department of Agriculture (USDA), and Department of Veterans Affairs (VA) for mortgage loans. We cannot expect the FHA and other government-insured loan programs to meet America's vast needs, especially because government programs will always be at the mercy of political "trade winds."

To meet the critical needs of future homebuyers and MBS buyers, we've developed some principles that should guide the reform debate.

Overview of the Core Components and Principles of GSE Reform

- An explicit catastrophic-risk federal guarantee on conventional MBS paid for by the borrower and subject to federal oversight, similar to the current Ginnie Mae program
- Preservation of the affordable 30-year fixed-rate mortgage
- Entities issuing government-guaranteed MBS have a **duty to serve** low- and moderate-income homebuyers across all the markets they serve and through all economic cycles
- Support for continued availability of interest rate locks for mortgage applicants, currently provided through a "to-be-announced" (TBA) structure
- A requirement that private-credit enhancement attach to mortgages before they are delivered to any secondary market or government agency

- Transparency in the automated underwriting systems

A Model to Incorporate These Principles: Ginnie Mae 2.0

Ginnie Mae 2.0 retains the best functions currently supporting the conventional market at Fannie Mae and Freddie Mac and drops their more harmful aspects (e.g., large mortgage portfolios and expanded interest rate and credit risk). It requires the conservator to transfer the necessary components of the GSEs—such as the key employees, underwriting, and operating systems—to Ginnie Mae. With this new capacity, personnel, and expected volume, it would likely also require Ginnie Mae to become a “stand-alone” government corporation that is not part of the US Department of Housing and Urban Development. This is essential to attract and retain the leadership and personnel to run an enhanced Ginnie Mae.

The structure would allow the GSE “legacy” portfolios to retain the necessary support operations, the existing Treasury relationship, and employees to complete the run-off of their legacy obligations under conservatorship, while moving the necessary operating functions under Ginnie Mae to support the future needs of the conventional mortgage market.

Some other GSE reform models propose forming new government guarantors or other hybrid public-private corporations to perform this function. Ginnie Mae is the most viable solution with the least disruption because the US mortgage market is already familiar with Ginnie Mae, as are most domestic and foreign investors. We would not have to convince the investor market to buy Ginnie Mae MBS because they already purchase these instruments. Ginnie Mae 2.0 would allow the best of the needed GSE operations to continue (inside Ginnie Mae) with the least amount of market and operational disruption, while meeting the MBS buyer need of the explicit government guaranty. Other proposals seem too complicated or create unnecessary additional structures to meet the consumer and MBS buyer needs. Too many other proposals don’t seem sustainable or simply don’t remove the “private gain and public risk” that partly caused the housing crisis and continues to haunt us.

Undoubtedly, there will be nuanced demands coming from the high concentration of household formation in African American, Asian, and Hispanic communities. This made us focus on a conventional housing finance structure that brings as little disruption as possible, respecting the stated wishes of the presidential administration and Congress that there won’t be a “recap and release” outcome. Ginnie Mae 2.0 looks to be the safest way to build a sustainable platform to bring proven market stability to meet the needs of a materially changing demographic. Under Ginnie Mae 2.0, we have provided two

separate models for consideration. Both can meet the two goals stated above, but congressional appetite will determine which will be used.

The Ginnie Mae 2.0 Models

Model A

Under this model, the new Ginnie Mae 2.0 would collect a minimal, single guarantee fee for all conventional MBS just as Ginnie Mae charges today on securities backed by FHA and VA loans. The fee would cover the new cost of the explicit catastrophic-risk government guarantee on conventional loans, similar to the risk Ginnie Mae guarantees today on FHA and VA loans. The fees may be slightly higher than the cost of current Ginnie Mae guarantees on FHA and VA loans because the conventional loans would be credit-enhanced by private entities (such as private mortgage insurance) who bear some counterparty risk to Ginnie Mae that is not present in the government insurance programs. However, that cost is mostly mitigated because the Ginnie Mae guarantee is truly a remote loss; there would be virtually no taxpayer risk because the private-credit enhancement would cover typical and stress scenario frequency and severity of loss, and because Ginnie Mae operates on a “break-even” model, rather than the GSE model that strives for material shareholder profit.

While there would be numerous logistical details to complete this change and legislation giving Ginnie Mae this authority, this model could produce a competitive conventional mortgage market for future homebuyers, provide for a rational duty to serve for those issuing the new Ginnie Mae conventional MBS, and protect taxpayers by limiting the role of the government to a “catastrophic” MBS guarantor function, eliminating the need for the government to take any interest rate or credit risk. Investor markets would cheer this change because they would have many new Ginnie Mae MBS available, borrowers would likely see a better execution in loan pricing, policymakers would see value in shifting risk exposure to the private market, and consumer advocates would likely embrace the duty-to-serve requirements on the hundreds or thousands of new issuers of the Ginnie Mae 2.0 securities.

Legislation authorizing the changes to create Ginnie Mae 2.0 should include the following:

- Credit quality guidelines similar to those in the marketplace today (qualified mortgage loans)

- Flexibility to adapt and respond to borrower demand, such as allowing for updated and alternative credit-scoring models without additional legislation
- Small lender considerations, such as preserving the cash window through expanded membership in the Federal Home Loan Banks; this would not prevent a small lender from continuing to sell directly to another approved Ginnie Mae 2.0 issuer

Model B

Similar to model A, the core necessary functions, employees, and operations of the GSEs would be transferred to Ginnie Mae. Under model B, Ginnie Mae would be a purchaser of mortgages, an issuer of MBS securities, and a secondary markets maker (like the GSEs are today), with two major exceptions:

- All mortgages sold to Ginnie Mae 2.0 would require a private-credit enhancement attached to the loans *before* the Ginnie Mae 2.0 guarantee attaches, with coverage of no less than 50 percent of the underlying individual loan. This would allow the new Ginnie Mae 2.0 to function as Fannie Mae and Freddie Mac functioned, but with significantly reduced credit risk.
- At no time should mortgages be in the “warehouse” of Ginnie Mae 2.0 for more than 180 days, and at no time should Ginnie Mae 2.0 be allowed to make commitments to purchase mortgages without a similar commitment to sell them. This ensures the new Ginnie Mae 2.0 would always operate with a minimum “on-balance sheet” portfolio of mortgages. (Of course, Ginnie Mae 2.0 would need to plan for the remote possibility of absorbing defaulted mortgage loans and have a plan for disposing of them in the market.)

How Is This an Improvement for Potential Homeowners and Market Practitioners?

Ginnie Mae 2.0 would benefit consumers in the following ways:

- **Government corporation (break-even) profitability targets.** Conventional mortgage costs would probably go down because there would be no need for the new entity to achieve return thresholds historically targeted by the GSEs.

- **Competition.** As the vehicle to the secondary markets, Ginnie Mae 2.0 would ensure a constant “best-in-class” secondary market execution and constant competitive loan pricing. Additionally, ensuring that loan by loan, front-end private-credit enhancement is attached to the loans before they get to Ginnie Mae (or the secondary market) would ensure there is reasonably low-cost durable availability to financing, facilitated by private mortgage insurance or other forms of credit enhancement. Further, there would be a stronger appetite for alternative credit-scoring models to expand opportunity for creditworthy homebuyers.
- **Price reduction and transparency.** Repetitive Loan Level Price Adjustments currently charged by the GSEs could be eliminated if the credit risk is borne by quality-capitalized and regulated private entities.

Market practitioners would benefit in the following ways:

- **Stability.** As a government corporation providing “catastrophic risk” and “break-even” profit requirements, Ginnie Mae would have no incentive to pursue policies to enhance Ginnie Mae profitability or prioritize one marketplace participant over another.
- **No volume discounts.** The guaranty fee proposed would apply to all participants regardless of size.
- **Multiple points of access.** Because Ginnie Mae 2.0 preserves the Federal Home Loan Banks in the same role they have today but with expanded eligibility, there would be multiple points of access for lenders of all sizes.
- **Private capital.** Lenders could provide competitive conventional mortgage pricing for their customers and rely on the durability and consistency of front-end (deeper-cover) credit enhancement.

Regulatory Framework

Ginnie Mae 2.0 would be subject to significant oversight by the Federal Housing Finance Agency, which would continue to regulate the Federal Home Loan Banks and (hopefully) play a new liaison role in coordinating federal housing policy between the conventional market and the government insurance programs of the FHA, VA, and USDA. The state banking and insurance regulators would set the capital,

reserve, and leverage ratios for the private-credit enhancement providers upon which the new conventional market would rely.

Conclusion

Any solution for the future of the GSEs needs to be based on simple principles and meet the two goals we believe are strategic imperatives for America. **Ginnie Mae 2.0** could meet those goals and the needs of current and future homebuyers and MBS buyers in the least disruptive and most sustainable manner.

About the Authors

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Ethan Handelman and Shekar Narasimhan: Do No Harm: GSE Multifamily Works

The pillars of the housing finance system failed in the 2008 crash, but Fannie Mae and Freddie Mac's multifamily finance businesses did not. Policymakers too often overlook multifamily in discussions about housing finance reform, but multifamily provides housing for people at all income levels, especially lower-income households. Multifamily also has distinct needs for finance that can fit within many housing finance reform plans if we address it specifically, rather than tack it on as a placeholder page in a 200-page bill.

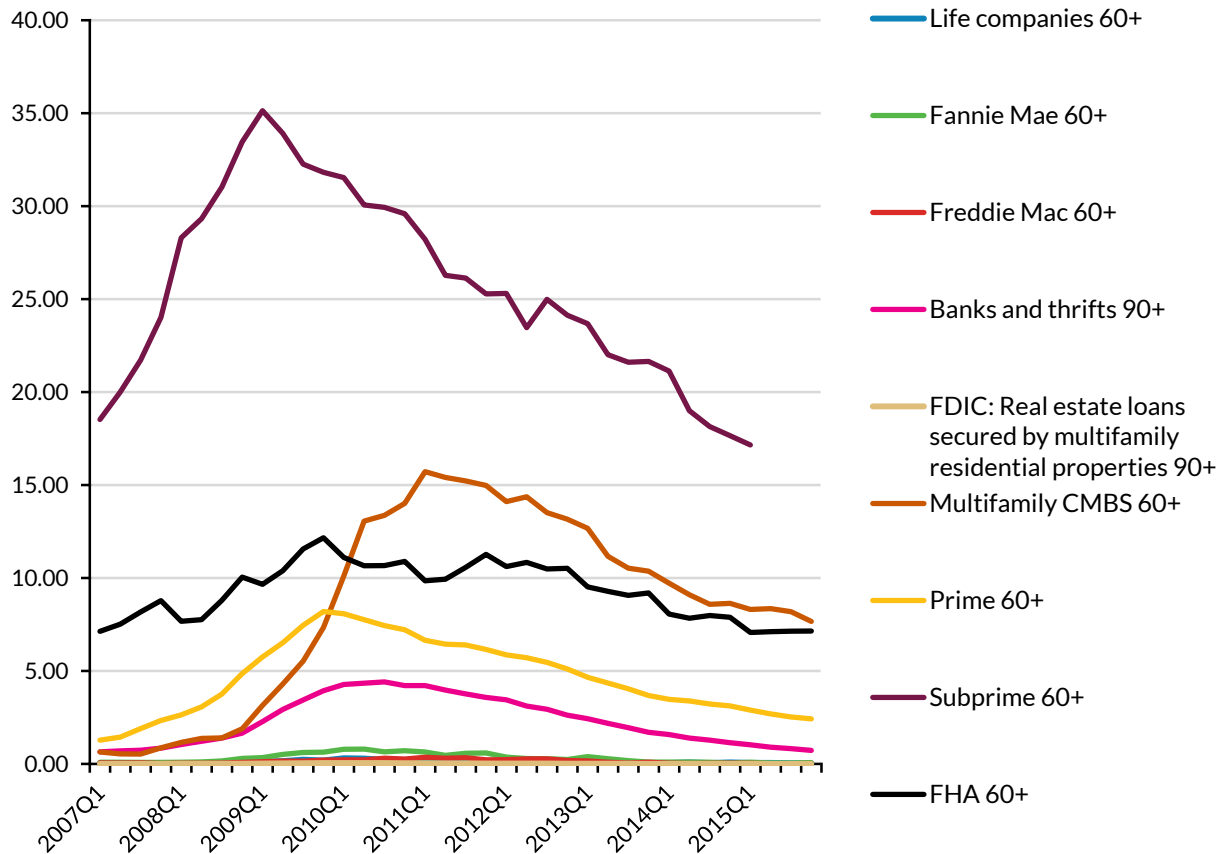
Permanent conservatorship was never the goal back when the crisis first hit, but rather a temporary solution until private capital could return to housing finance. Whether we end up with a public utility for securitization, a system of multiple chartered issuers, or some other form of deploying a government guarantee under regulatory oversight, the system can be compatible with multifamily mortgage finance using private capital to finance much-needed housing (Burke 2013; MFWG 2011; Parrott et al. 2016).

How Multifamily is Different

The multifamily businesses of Fannie Mae and Freddie Mac have put private risk-bearing capital ahead of government in two ways: one involves credible counterparty contingent risk sharing, and the other uses direct primary risk sharing by sophisticated B-piece buyers. Fannie Mae's Delegated Underwriting and Servicing model is 29 years old, and Freddie Mac's K-series securitization model is nine years old. The strength of these models, the effectiveness of their lending partners, and their culture of underwriting discipline are part of why their default rate has been much lower than many other mortgage segments. Multifamily underwriting is not immune to the animal spirits that at times lead to crises, as evidenced by Freddie Mac's underwriting failures in the early 1990s and the poor investment choices many institutions made leading up to the savings and loan bailout in the 1980s. But the track record of the current multifamily businesses warrants their preservation in a new housing finance system.

FIGURE 1

Comparison of Serious Delinquency Rates among Single-Family and Multifamily Mortgage Types



Sources: Mortgage Bankers Association National Delinquency Survey and commercial multifamily mortgage delinquency rates for major inventory groups; CMBS Delinquency Tracker from Moody's Analytics. Harvard University's Joint Center for Housing Studies compiled this chart.

Notes: CMBS=commercial mortgage-backed securities. FHA=Federal Housing Administration. Rates for different types of financial institutions show trends for that type but are not comparable between types. Single-family loans include loans for one-to four-unit properties. CMBS delinquencies include properties foreclosed but not yet sold.

In both economic upswings and downswings, there is strong underlying demand for multifamily, partly because of the need for affordable rental housing, as the more than 24 percent of renters paying more than half of their income for housing can attest.¹ Changing demographics, rising interest in

walkable urban neighborhoods, constrained access to mortgage credit, and expanding transit options also suggest that demand for multifamily housing will continue to grow (Goodman, Pendall, and Zhu 2015; Joint Center for Housing Studies 2015). Meeting this demand requires reliable access to credit throughout business cycles for creating and preserving multifamily housing (Handelman, Smith, and Trehubenko 2010).

What Multifamily Needs

To support the multifamily sector's ability to shelter people nationwide, the housing finance system needs a few features. Some of these are particular to multifamily, and others will be familiar to those following the mostly single-family debate.

1. **Stability and liquidity in the secondary market to purchase loans in all parts of the economic cycle**, which requires government backing against the catastrophic risk of systemwide failure buffered by private capital bearing credit and operating risks. Most participants in the housing finance reform debate recognize that a government wrap is essential. They also agree that the government's role should be explicit, priced, and limited.²
2. **Space for today's two proven, competitive models.** Fannie Mae uses its Delegated Underwriting and Servicing model to purchase loans from carefully overseen private originators who share risk with Fannie as it securitizes mortgages, usually loan by loan. Freddie Mac uses conduit securitization to share risk with private counterparties via pooled securitization.
3. **Ability to attract and retain talent.** Multifamily finance is complex and specialized, and the long conservatorship has taken a toll on Fannie Mae and Freddie Mac's ability to fully staff a business model that requires a relentless focus on monitoring and closing deals efficiently.
4. **Explicit support for affordable housing.** There is a public interest in ensuring that the secondary market serves all housing needs by enabling private market forces to reach as far as feasibly possible. Market participants benefiting from a government-backed secondary market will also have an obligation to support efforts to fill in the gaps where markets are failing or not reaching today.³

These are features to produce outcomes—not structures—because they can occur in several reform scenarios.

How to Fit Multifamily into Housing Finance Reform

Before trying to hammer the square peg of multifamily into a round hole in your single-family finance model of choice, remember that multifamily can be separate. As long as there is a mechanism to obtain an explicit, limited guarantee against catastrophic risk, Fannie Mae and Freddie Mac could spin off their multifamily businesses into separate entities that could continue supplying liquidity to multifamily housing finance. Indeed, one of us proposed this to the Senate Banking Committee to bipartisan approval (Narasimhan 2013).

As a simple example, we could use the existing Fannie Mae and Freddie Mac models to purchase multifamily housing loans or loan pools but apply a separate guarantee. Ginnie Mae could wrap the issuer's securities underwritten and insured by independent multifamily entities using the Fannie Mae or Freddie Mac model. The multifamily entities would pay a fee for the guarantee and bear risk ahead of the government, likely along with other private capital sources.

Separate multifamily issuers could work alongside a single government-owned issuer of mortgage-backed securities—as proposed by Parrott and colleagues (2016)—or a cooperative providing the same function. They could also operate in a system where several entities could purchase a government wrap, as proposed in various forms by the Center for American Progress's Mortgage Finance Working Group, the Mortgage Bankers Association, and others (Burke 2013; MFWG 2011).

If the secondary market system were privatized, private capital should take the first-loss position in front of a government guarantee against catastrophic risk. Private-sector conduits operating in such an environment should look to the two proven models for multifamily finance if they plan to use a government wrap.

Multifamily secondary market functions could also be part of larger entities, as long as there is enough flexibility to meet the core functions identified above. Having multifamily separate makes regulation easier because it would be easier to observe the financial performance of a business that will necessarily be much smaller and more specialized than its single-family counterpart. The most critical need for multifamily is simply that policymakers pay attention to it early and plan ahead.

Notes

1. Mindy Ault, "Housing Landscape 2016," National Housing Conference, accessed May 5, 2016, <http://www.nhc.org/#!/2016-housing-landscape/s06lv>.

2. A National Housing Conference Task Force representing for-profit, nonprofit, public sector, and private sector housing stakeholders agreed on this as a central principle; see “Housing Finance Principles,” National Housing Conference, last updated January 2014, http://media.wix.com/ugd/19cfbe_00e4fa741adb4fba853a8569124363c6.pdf. The Bipartisan Policy Center’s Housing Commission reached a similar conclusion; see “Housing America’s Future: New Directions for National Policy,” Bipartisan Policy Center, last updated February 25, 2013, <http://bipartisanpolicy.org/library/housing-americas-future-new-directions-national-policy/>.
3. The secondary market supports affordable housing with affordable housing goals, the National Housing Trust Fund, the Capital Magnet Fund, and the proposed duty-to-serve regulation. Other mechanisms could complement or replace the current options, but the core principles supporting affordable housing through market mechanisms and subsidies to address market failures remain the same. See Handelman (2013).

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Michael D. Berman and Mark A. Willis: Multifamily GSE Reform: A Different Road

While the recent proposal “A More Promising Road to GSE Reform” takes a fresh and well-conceived approach to restarting the conversation about government-sponsored enterprise (GSE) reform, the focus is on the single-family secondary market. Multifamily and its lending industry are different and should have a different reform approach that addresses the shortcomings of the GSE multifamily business model and meets the multifamily market needs for US renters. We propose a new organizational structure and legal ownership of these business units. (We do not intend to express any view as to the rights of the existing minority shareholders.)

The GSE multifamily business differs from the single-family business in five ways.

1. **Smaller market, larger loans.** The \$1.06 trillion debt market for multifamily loans is about one-tenth the size of the market for single-family loans, so its needs can be addressed with smaller institutions. This allows multifamily to avoid the pitfalls of too-big-to-fail and of satisfying the special needs for homogenous, liquid securities in the single-family space, as well as the impacts on capital flows and demands of any privatization. With larger loan sizes (average GSE loan size for multifamily is \$10 million versus less than \$250,000 for single-family), investors can underwrite each multifamily loan.
2. **No to-be-announced (TBA) market to enable rate locks.** The GSEs do not facilitate a market for the forward commitment of interest rates for multifamily mortgages as they do for single-family homebuyers. Accordingly, the multifamily arena does not have the same capital flow and liquidity needs.
3. **Risk sharing is already a reality.** The multifamily GSE business units for Fannie Mae and Freddie Mac have mature, time-tested risk-sharing models that were adopted voluntarily.
4. **Significant private competition exists.** Competition in the multifamily finance industry from the private sector (e.g., banks, life companies, and commercial mortgage-backed securities [CMBS]) has revived since the Great Recession, but on the single-family side, the private-label residential mortgage-backed securities market has not recovered, and no equivalent private competition has emerged in the conforming loan space.

5. **More resilience in economic stress.** Unlike the single-family arena, the GSEs' multifamily lending criteria combined with its loss-sharing programs results in exposure to the GSEs at or below 70 percent loan-to-value (LTV). Accordingly, in stressed economic cycles where values may drop 30 percent, for example, there is little or no exposure to substantial losses. Higher LTVs in subsidized and rent-restricted rental apartments has exhibited little default rate volatility in times of economic stress because of the rent restrictions and undersupply of this housing type for low, very low, and extremely low income households.

Importance of Multifamily Housing and the GSEs' Roles

Multifamily housing is an important source of rental housing. The number of American households that live in rental housing has grown from 34 million in 2005 to 43 million in 2016, and the percentage of households that rent has reached a recent high of 37 percent. Renters are usually lower income, earning less than 50 percent of what homeowners earn (\$32,466 versus \$67,298 per year, according the US Census Bureau). Half of all renters, or 21.3 million households, pay over 30 percent of their income to rent, and half of those households, or 11.4 million households, are paying over 50 percent, according to the Harvard Joint Center for Housing Studies. Accordingly, an adequate supply of quality and affordable rental housing is important, including middle-income workforce housing, affordable housing for low, very low, and extremely low income renters (including subsidized housing), housing for seniors, and manufactured housing. Consistent and affordable multifamily financing helps provide this housing stock.

Countercyclical support. The implicit government guarantee of the securities issued by the GSEs allowed them to finance multifamily properties when other private financing sources vanished during the Great Recession.

Long-term financing. The GSEs supply the long-term financing that provides a consistent, dependable takeout for construction and rehabilitation loans, which are essential for our aging multifamily housing stock.

Standardization and liquidity. The GSEs have enhanced the multifamily housing market by providing a benchmark for standardization of the secondary market and liquidity to ensure a sufficient supply of competitively priced capital to maintain the affordability of such financing.

Today's GSE Multifamily Business

The GSEs' multifamily and single-family businesses' approach to risk sharing and loan-level credit decisionmaking operate differently. Until the Federal Housing Finance Agency (FHFA) mandated the GSEs to sell and syndicate risk, the single-family businesses had no private capital other than private mortgage insurance on higher-leverage loans. In contrast, the multifamily business units had voluntarily decided to utilize risk-sharing lending mechanisms that put private capital in front of or in parri-passu position with the GSE guarantees: Fannie Mae's program started in 1988, while Freddie Mac programmatically adopted risk sharing in 2009, although Freddie Mac has required that each individual loan be prereviewed and preapproved by its underwriting staff since 1993.

The GSE multifamily risk-sharing mechanisms are as follows:

- Freddie Mac uses the K Series Program to purchase multifamily loans, aggregates those loans into pools for securitization, and sells off the top 15 percent of loss to private bond investors, while providing the Freddie Mac guarantee wrap on the remaining 85 percent of the pool (equivalent to a AAA tranche).
- Fannie Mae has a Delegated Underwriting and Servicing (DUS) Program, which employs counterparty risk mechanisms with its licensed lenders contracting to absorb either 33 percent loss sharing or 5 percent top loss plus additional loss sharing up to nearly 20 percent through the capital stack.

While both GSEs have established similar underwriting and eligibility criteria, the differences between these two risk-sharing programs are significant. The Fannie Mae DUS Program focuses on the motivation and discipline of the lenders who make each loan and retain risk for the life of each loan. Fannie Mae shares in the first dollar of that risk on most loans. In contrast, the Freddie Mac K Series Program requires that Freddie Mac prereview and preapprove each loan and is subject to the discipline of third parties who buy the riskiest tranches of each pool of loans. Freddie Mac takes no first-loss position post-securitization for the first 15 percent of losses. The implications for times of economic stress are also significant, as the pricing of the Freddie Mac K Series subordinate tranches is subject to pricing spikes, while Fannie Mae has some first-dollar loss exposure. Both GSE multifamily business units performed well during the Great Recession. The differences in these models and the innovative approach of each business unit have resulted in competition between the GSEs, providing a healthy diversity of mortgage products for the multifamily industry.

From 2003 to 2007, the GSEs became more aggressive to keep up with the competition but maintained sufficient underwriting discipline to avoid losses because of their approaches to risk sharing and underwriting. Freddie Mac's multifamily loss experience from 1989 to 1993—when its underwriting system was weak—has not been repeated in the last 20 years. The combined GSE book of guarantee and portfolio multifamily business of \$367 billion (a 34.6 percent share of total outstanding multifamily debt) has experienced cumulative losses of less than 0.8 percent of outstanding balances over the last 10 years. In contrast, other sources of multifamily finance experienced significant losses—particularly CMBS lenders and some banks—during the Great Recession as multifamily market vacancies increased and net operating incomes declined.

In addition, the GSEs played a countercyclical role in the Great Recession as they maintained a steady stream of mortgage purchases. As a result, the GSE market share increased from about 30 percent in 2004 to 2006 to over 80 percent in 2009. And as liquidity in the private capital markets increased from 2011 to 2014 through life companies, CMBS, and banks, the GSE market share gradually retreated to under 40 percent, partly because of a cap imposed by FHFA, the GSE regulator, in 2013. However, most experts believe that based on competition from banks, life insurance companies, and CMBS lenders, the GSE market share would have been under 40 percent in 2013 and 2014 even without the loan volume restrictions imposed by FHFA. The FHFA volume cap is now \$70 billion, with caveats for affordable housing with a goal of less than a 40 percent market share.

Within each of the GSEs, the relationship between the single-family and multifamily business units is independent, with many parallel functions in each unit. This is especially evident in the key functions of loan production and acquisition, underwriting and credit, asset management, and increasingly in securitization. Various infrastructure-sharing functions (e.g., accounting, information technology, human resources, reporting, and legal) have become more independent over the past few years, with an increasing focus on securitization functionality independence. Over the past 10 years, the strong domestic and global markets for single-family GSE securities has helped the multifamily units sell their securities, especially in the international market. If they were spun out from their minority position within the GSEs, they would face new challenges, such as raising their own corporate debt and equity.

Flaws in the Current System

The current GSE model, however, could be improved in the following areas:

- Increase competition in the multifamily mortgage market by

- » opening up the duopoly of Fannie Mae and Freddie Mac to competition by providing other entities access to the government guarantee; and
 - » expanding the number and breadth of lenders that can access the government-guaranteed secondary mortgage market to include more community banks and lenders focused on secondary and tertiary housing markets, including those in rural areas (currently, only about 40 lenders are authorized to sell multifamily loans to the GSEs).
- Increase access to the GSEs' long-term fixed-rate credit products by
 - » offering special programs for smaller loans through more lenders that serve the owners of properties with 5 to 50 units (their current average loan is about \$10 million);
 - » offering special programs for loans to rehabilitate the older properties that make up a large share of the stock of multifamily properties; and
 - » offering programs through more lenders tailored to needs of affordable housing for low, very low, and extremely low income renters; while the GSEs' books of business include a significant portion of workforce housing, the GSEs should focus on financing housing that serves not just those with incomes at or below 120 percent of the area median income (AMI) but also those with incomes at or below 80 percent of AMI and those with incomes at or below 60 percent of AMI, with consideration toward limiting loans on luxury rental housing (i.e., properties with average rents affordable at over, say, 200 to 250 percent of AMI).

Design Features of a Reformed Multifamily Finance System

Private capital should be at the core of the system and in a first-loss position, as is the case with Fannie Mae and Freddie Mac's multifamily risk-sharing business models. Any new system for multifamily housing finance should include the following 13 design features, many of which were included in the bipartisan Johnson-Crapo Bill:

1. **Separate the multifamily and single-family businesses.** The new system should create new regulated bond *guarantors*, two of which would be created by spinning out and grandfathering Fannie Mae's and Freddie Mac's multifamily business units.

- Each new spinout guarantor could be owned by the private sector (through a public offering of its stock) or in a mutual structure, provided that no lender to the multifamily sector controls more than 10 to 15 percent of these entities to avoid vertical integration.
 - FHFA would regulate the guarantors and treat the guarantors in many respects as utilities.
 - FHFA should license up to three additional guarantors and license at least one in addition to the two GSE spinouts to ensure competition but not oversaturate the market. All guarantors must be required to oversee their multifamily servicers and special servicers of defaulted loans and oversee counterparties in credit risk-sharing transactions. (The vertical integration restriction from above would apply to investors in the new guarantors.)
 - Each guarantor, as a mono-line business, should have a minimum capitalization of 2 to 4 percent of outstanding multifamily loan guarantees plus defaulted loans that have been foreclosed plus any portfolio loans. At 2 percent, this is over two-and-a-half times the cumulative losses experienced by the GSE multifamily business units in the last 10 years, including the Great Recession.
2. **Minimum loan standards.** Eligibility of loans for the guarantee should be limited and prescribed by FHFA and the government insurer (see item 3 below) to limit the guarantors' and taxpayers' credit-risk exposure. Such loan-eligibility standards should require full documentation, the use of in-place cash flows (or other adequate security for rehabilitation loans), a maximum LTV, and a minimum of debt service coverage ratio. Examples of FHFA criteria could include an LTV limit of, say, 75 to 80 percent, with interest-only features prohibited on all loans over 65 percent LTV, and a debt service coverage ratio limit of, say, 125 percent, except for affordable housing loans for properties with tenants with incomes under 60 percent AMI where there are local, state, or federal restrictions or subsidies that mitigate the additional credit risk.
 3. **Government insurance for catastrophic loss.** The government should provide an explicit guarantee to insure investors in multifamily mortgage-backed securities against any loss of principal and interest for these guarantor-issued securities. This would ensure the liquidity of these mortgage-backed securities and maximize the potential for mortgage financing to be available to property owners throughout the economic cycle, particularly in times of moderate and severe economic stress. There would be no government guarantee of the debt or equity invested in each guarantor. A possible entity to provide the catastrophic insurance is the Government National Mortgage Association (GNMA), which confirms appropriate counterparty risk for issuing its securities and the servicing of loans collateralizing these

securities backed by Federal Housing Administration and US Department of Veterans Affairs mortgages. (GNMA would need to adjust its processes to account for the lack of government insurance on these mortgages.) In this role, GNMA would approve any guarantors licensed by FHFA and would have its own counterparty oversight.

4. **Third parties hold top loss.** Third parties should hold a percentage of the top-loss risk of all securities issued by the guarantors at levels set by FHFA. For standard loans of up to 75 percent LTV, that top loss could be mandated by FHFA at 15 percent. The percentage may be adjusted for various loan types depending on the risk characteristics of each type (e.g., a lesser top-loss sharing would be permitted for loans that don't exceed 55 percent LTV). The Fannie Mae DUS Program should be grandfathered but might need to meet a higher capital requirement or require a sale of a portion of its top-loss exposure to account for its sharing of the top-loss risk. (The quality track record of losses of the DUS Program should be used in determining treatment of the top loss for capitalization purposes.)
 5. **Protect taxpayers from losses.** A guarantee fee should be charged for the explicit government backstop to create a reserve fund that will protect taxpayers from losses. This fund should be a reserve of 1 percent of the outstanding covered securities to be built up over, say, 7 to 10 years. A portion of the guarantee fee should defray the operating expenses of running an insurance program and managing the fund. This reserve of 1 percent, in combination with the 2 percent minimum equity capital for the guarantors, would create a buffer more than three-and-a-half times the cumulative losses over the last 10 years. Accordingly, the taxpayer is protected by (1) strict loan eligibility criteria (including minimum borrower equity requirements), (2) the guarantors' 15 percent top-loss risk-sharing requirements, (3) the guarantors' 2 percent minimum equity capital (with their history of less than 0.8 percent cumulative losses over the past 10 years), and (4) this additional reserve of 1 percent. This should protect the taxpayer in times of severe economic stress, when multifamily values drop by 30 percent or more.
 6. **Broader access for lenders.** Mandate that the guarantors provide access to lenders of all sizes in a competitive landscape, including small community banks and credit unions. FHFA should eliminate the duopoly of the GSEs by licensing up to three guarantors in addition to the two GSE spinouts (if market conditions allow).
 7. **Underserved markets.** FHFA should impose duty-to-serve mandates (subject to revision every three years) for the guarantors to provide access to underserved communities, such as rural and inner-city markets, affordable housing, housing for seniors, and manufactured housing.
- Each year, the covered securities issued by each multifamily guarantor for the rolling previous 24 months (**rolling book**) must meet the following tests: 60 percent of the rental units financed

must be affordable to tenants whose incomes are at 80 percent of AMI (60 at 80 test), and 10 to 15 percentage points of this cohort should be affordable to tenants at or below 60 percent of AMI. These affordability tests should be based on the rent roll (or pro-forma for new construction) at the time of loan commitment using US Department of Housing and Urban Development standards for units with different numbers of bedrooms.

- Guarantors should be restricted to 10 percent of their rolling book for higher-end rental properties (where average rents are over 120 percent of AMI) and should be further restricted to 5 percent of their rolling book of guarantees for luxury rental property loans (where average rents are affordable at or above, say, 200 percent of AMI).
8. **Affordable housing fund.** Provide funding of 10 basis points on each loan in a guaranteed security for the National Housing Trust Fund and the Capital Magnet Fund created by the 2008 Housing and Economic Recovery Act legislation to assist low and extremely low income households with rental housing.
 9. **Funding for a limited mortgage portfolio.** The guarantors should retain only a very limited mortgage portfolio to aggregate loans for securitization, implement FHFA-approved pilot loan programs and other risk-sharing transactions, finance rent-restricted housing subject to a regulatory agreement, and buy back defaulted loans. Guarantors should seek warehouse lines and other forms of credit and equity to fund these portfolios, their aggregation functions, and their ability to buy back defaulted loans for loan modifications. The old business of creating arbitrage profits by holding loans in portfolio and issuing cheap corporate debt should be prohibited.
 10. **Size and activity limits.** FHFA should maintain its current goal of a 40 percent market share limit for the guarantors in the aggregate, except during times of economic stress. The guarantors should be mono-line entities; there should be no guarantor activities other than those required to issue the securities and to carry out their responsibilities under the terms of the securities (e.g., dealing with defaults and the underlying collateral).
 11. **Flexibility in times of economic stress.** Under “unusual and exigent circumstances of economic stress,” FHFA, with approval from the Federal Reserve, can reduce the capital standards for guarantors and the top-loss risk-sharing requirements, help insure warehouse lines and other sources of liquidity for daily operations, and modify rolling book and market share restrictions.
 12. **Resolution authority.** For failing guarantors, the resolution authority of FHFA should be based on standards and processes in the same manner as the Federal Deposit Insurance Corporation with respect to institutions which are “critically undercapitalized.” FHFA would take over

failing guarantors and continue operations and could wipe out the old shareholders of the failed guarantor and recapitalize these failed companies when the economic stress dissipates and liquidity returns to the markets.

13. **Transition.** When the two GSE multifamily business units are spun out, their books of business can be held in the new entities and capitalized by the new shareholders. Alternatively, each legacy book can be retained in the old GSE with an asset-management contract to each spun-out entity to reduce the necessary capital raised in the spinouts while maintaining consistent asset-management oversight.

Conclusion

This proposal preserves the successful features of the GSEs' multifamily business units while reforming the system to mitigate some of the system's flaws. This proposed system ends the conservatorship and reduces the government role by returning the multifamily secondary market's functionality to the private sector with proper regulatory oversight, the ability to operate throughout the economic cycle, and a focus on affordable and workforce housing. The system protects the taxpayer with restrictions on activities to secondary-market guarantees of eligible loans with sound underwriting characteristics, loss sharing and risk allocation to the private-sector participants, adequate capital for guarantor entities, and a catastrophic backstop loan-loss reserve. We look forward to a further dialogue to move quickly to a final resolution of the current conservatorship.

About the Authors

Michael Berman established Michael Berman Consulting LLC in 2014 to provide advisory services to best-in-class enterprises in the real estate finance industry. Drawing from his extensive experience in the industry, Berman provides strategic and tactical advice in business and policy. From 2012 to 2014, Berman served in the Obama administration as senior adviser of housing finance for Shaun Donovan, secretary of the US Department of Housing and Urban Development. Berman also served on the senior administration housing policy team focused on developing policies for reforming the government role in housing finance for both single-family and multifamily lending. Until September 2012, Berman was president and chief executive officer of CWC Capital. Berman was chairman of the Mortgage Bankers Association (MBA) from 2010 to 2011. He also chaired MBA task force committees on the future of the GSEs. He served on the board of directors of the Real Estate Roundtable (2011–12) and the executive

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Doug Bibby and Bob DeWitt: Rebuilding Housing Finance on a Strong Foundation

September marks eight years since the federal government placed Fannie Mae and Freddie Mac in conservatorship. It was an aggressive and controversial move predicated by fear that the magnitude of the economic catastrophe would grow if the two mortgage giants fully collapsed.

The conservatorship used taxpayer money to shore up these part-public, part-private entities, which accounted for roughly two-thirds of both single-family and multifamily mortgage markets. Desperate times called for drastic measures.

But it was designed to be a temporary solution, an interim fix to prevent economic Armageddon while a more lasting prescription for the nation's housing finance system could be determined. Since then, we've worked with lawmakers, regulators, and administration officials on a broad range of solutions that could ensure liquidity, stability, and affordability in the housing market—especially for multifamily, which has been a growth engine for the housing market during the economic recovery.

Without reliable financing sources for multifamily properties, our industry cannot serve the 38 million people who currently live in apartments, much less provide new housing options for the estimated 4.4 million additional renter households that are expected to form in the next decade (JCHS 2015).

We are not advocating for the status quo or a return to the past. However, it is important to recognize the structures that work in practice, as they can provide core principles for lawmakers and stakeholders as they craft a long-term solution for today's challenged housing finance system.

Financing That Performs

There's broad consensus that the next iteration of the housing finance system must protect taxpayers, emphasize the private markets, support a broad variety of housing options, and remain liquid throughout ebbs and flows of an economic cycle.

But what's been surprising as we've struggled through the fits and starts of housing finance reform is how few people recognize that a proven model already exists that meets those objectives: Fannie and Freddie's multifamily programs.

Largely overshadowed by the significant losses coming from their single-family portfolios, Fannie and Freddie's multifamily programs performed remarkably well during and after the housing crash. Loan performance remained strong, with delinquency and default rates at less than 1 percent—a mere fraction of the defaults that plagued single-family at the bottom of the cycle.

Moreover, the government-sponsored enterprises' (GSEs') multifamily businesses have continued to be profitable on balance, with the GSEs' combined multifamily comprehensive income reaching \$30 billion from 2008 through the second quarter of 2015 (Division of Housing Mission and Goals 2015).

These positive performance metrics are because of the GSE multifamily programs' adherence to prudent underwriting standards, sound credit policy, effective third-party assessment procedures, conservative loan portfolio management, and, most importantly, risk-sharing and retention strategies that place private capital ahead of taxpayers.

Each GSE utilizes its own risk-sharing models that protect it from losses. These models worked effectively through the economic downturn.

Fannie Mae employs a delegated originator and servicer model (the Delegated Underwriting and Servicing program, or DUS), where risk is shared between Fannie Mae and the DUS lender. Each loan purchased is securitized, and the resulting mortgage-backed security sold to investors carries a full guarantee of Fannie Mae in the event of default. Their two risk-sharing models protect Fannie Mae in the event of default. These models are as follows:

- **Pari Passu:** Fannie Mae and the lender share losses on a pro rata basis, with one-third borne by the lender and two-thirds borne by Fannie Mae.
- **Standard:** The lender bears a share of losses, calculated using a tiered loss-sharing formula (generally involving a first-loss position and a cap at 20 percent of original loan amount) based on established risk factors, such as loan-to-value and debt-service coverage ratios.

Freddie Mac employs Program Plus, a prior approval business model wherein it underwrites each loan purchased from its network of sellers, creates a multiloan, multiclass security, and sells that security to investors. The repayment of the senior-most security is guaranteed by Freddie Mac, while

the bottom 10 to 15 percent of first-loss securities are sold to qualified investors, protecting Freddie Mac from all but the most extreme losses associated with a loan default.

Filling the Gaps in the Private Market

The GSEs' multifamily programs address a market failure in the housing finance system that results in an abundance of capital for high-end properties in top-tier markets but largely ignores middle market and affordable housing needs in urban cores and leaves secondary and tertiary markets underserved.

The GSEs ensured that multifamily capital was available in all markets at all times so the apartment industry could serve the broad range of America's housing needs from coast to coast and everywhere in between. A reformed system must continue to fill this important public policy need.

We share the collective desire to have a marketplace where private capital dominates, and that's been the case in our markets, save for periods of market dislocation. The apartment industry relies on many private capital sources to meet its financing needs, including banks, life insurance companies, the commercial mortgage-backed securities market, and, to a lesser extent, pension funds and private mortgage companies.

However, even during healthy times, the private market has been unwilling or unable to meet the totality of the rental housing industry's capital needs. For example, banks are limited by capital requirements and have rarely been a source of long-term financing. Life insurance companies typically make up less than 10 percent of the market, lend primarily to newer and high-end properties, and enter and exit the multifamily market based on their investment needs. And a stricter regulatory environment post-financial crisis will likely keep the private-label commercial mortgage-backed securities market from returning to previous volumes.

These private market constraints are why government-backed capital sources like Fannie, Freddie, and the Federal Housing Administration have a place in the market today. Moreover, there is no evidence to suggest that the situation will be much different going forward.

Financing for All Economic Cycles

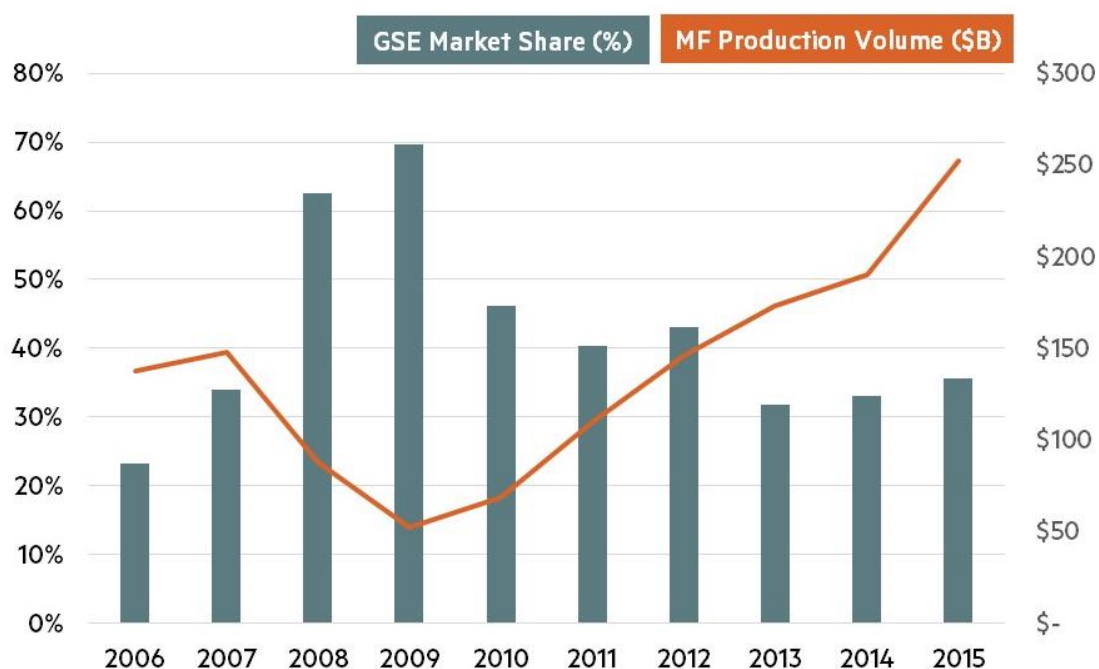
Aside from being a key source of long-term multifamily mortgage financing that supports underserved geographic markets and an array of apartment products, the GSEs' multifamily programs ensured liquidity in the multifamily market throughout the economy's ebbs and flows.

In times of economic growth, private capital becomes active in the multifamily market alongside the GSEs and the Federal Housing Administration. That's what we're seeing today as the economic recovery continues. However, there's a historical pattern of private capital pulling back or exiting the market entirely when the economy slows and then reentering the market after these periods of disruption.

We saw this during the 1997–98 Russian financial crisis, the post-9/11 recession of 2001, and again in 2008, when private capital sources left the housing finance market in droves while Fannie, Freddie, the Federal Housing Administration, and Ginnie Mae remained active, accounting for the bulk of the multifamily mortgage market (figure 1).

FIGURE 1

GSEs Step Up Role in the Multifamily Mortgage Market When Private Capital Retreats



Source: Fannie Mae and Freddie Mac 10-Ks; FHFA Performance Report on the Housing GSEs; Mortgage Bankers Association.

In fact, between 2008 and 2010, the GSEs supplied \$123 billion in mortgage capital to the apartment industry, making up 59 percent of the total multifamily mortgage production. As private capital reentered the market, the GSEs' share dropped to 36 percent by the end of 2015.¹ But without that critical backstop, thousands of otherwise performing multifamily mortgages would have gone into default because there were no private capital sources willing to refinance maturing loans. This could have disrupted millions of renter households.

Different Asset Classes Require Different Solutions

It is tempting to believe a single solution will solve all that ails our housing finance system. Unfortunately, that is not the case because multifamily finance and single-family finance systems operate differently.

Not only are multifamily loans not as easily commoditized, but the multifamily financing process, mortgage instruments, legal framework, loan terms and requirements, origination, secondary market investors, underlying assets, business expertise, and systems for multifamily are separate and unique from single-family home mortgage activities.

Housing finance reform must take different approaches for multifamily and single-family to recognize each sector's needs and public policy goals.

As we show renewed urgency to devise a stronger housing finance system, we acknowledge the proven elements in the current system that supported liquidity in the multifamily market, served public policy goals, and protected taxpayers from unnecessary risk.

We offer these seven principles to help shape reform efforts.

1. **Provide Access to an Explicit Government-Guaranteed Backstop.** Given the market failure of the private sector to meet the apartment industry's broad capital needs, an explicit federal "backstop" guarantee for multifamily-backed mortgage securities should be available in all markets at all times.
2. **Provide Broad Liquidity Support, Not Just "Stop-Gap" or Emergency Financing.** Any federal credit facility should be available to the entire apartment sector and not be restricted to specific housing types or renter populations. Moreover, it would be impossible to turn on and off a government-backed facility without seriously jeopardizing capital flows.

3. **Protect Taxpayers.** Retain the GSEs' multifamily first-loss risk-sharing models, which put private capital ahead of taxpayers.
4. **Restrict Federal Credit Support to the Security Level.** The benefit of any federal guarantee should only accrue to the investors of multifamily mortgage-backed securities; it should not apply to the underlying multifamily mortgages or the entities issuing the securities.
5. **Support Private Capital Participation and Protect Taxpayers through Effective Guarantee Structure and Pricing.** Borrowers should pay for the guarantee through an appropriately priced credit enhancement fee that insures taxpayers against future losses. The fee should not be low enough to crowd out private capital.
6. **Empower a Strong Regulator.** The regulator must have independence and deep multifamily experience.
7. **Retain Limited Portfolio Lending Without a Federal Guarantee.** This will allow for loan aggregation, pilot programs, and targeted transactions.

The Vexing Affordability Challenge

As housing finance reform efforts gain momentum, we anticipate that housing and rental affordability will increasingly be part of the discussion.

Housing development and operation costs are rising while income growth has stalled; inflation-adjusted median renter household income today remains virtually unchanged since 1981.² More people are spending greater percentages of their incomes on housing. At the same time, growing rental demand continues to outpace supply, even as the apartment industry has ramped up construction activity.

It is tempting to believe that more can be done to address affordability through housing finance reform, namely through imposing limitations on federal guarantees or other mandated benchmarks. We caution policymakers not to overreach, as such well-intended moves, if overly prescriptive, could have adverse consequences.

Housing finance reform cannot address all affordability concerns, as there are factors beyond the reach of the finance system that contribute to housing expense and limit new supply. Aggressive labor, environmental, and building code requirements and regulations can hamper new apartment production while local policies governing entitlements, zoning rules, impact fees, and mandates such as inclusionary zoning or rent control add to rising housing costs.

While there's a clear need for more public-private partnerships to drive creative solutions to the nation's affordability challenges, housing finance reform efforts' primary focus should remain on ensuring liquidity in the multifamily market. Multifamily housing remains inherently affordable housing. Fannie and Freddie report that approximately 85 percent of their multifamily loans serve households earning 100 percent of area median income or less.

Providing financing options that support the long-term ownership and operation of multifamily properties while developing loan products that meet underserved markets is the most effective way a housing finance system can meet our nation's housing affordability challenges.

The Stakes Are High

Communities are more dynamic and stronger economically when there is a healthy mix of both for-sale and rental housing options across a variety of price points. While homeownership remains a financial goal for many Americans, demand for rental housing, including apartments, is growing significantly.

To provide additional rental housing that fulfills various family, lifestyle, and economic needs, it's crucial that a reformed housing finance system provides reliable long-term financing for multifamily properties, filling in gaps in private capital lending and maintaining liquidity during economic fluctuations.

Many of the conservative operating principles governing Fannie and Freddie's multifamily businesses offer a solid framework for housing finance reform efforts, especially because they promote risk sharing that puts private capital before the taxpayer.

While challenges exist for development, preservation, and affordability, ensuring constant mortgage market liquidity is the foundation for future solutions. A housing finance system in flux jeopardizes the ability of a growing population of people—including young professionals just starting out, empty nesters looking to downsize, workers wanting to live near their jobs, married couples without children, and families building better lives—to live in homes that are right for them, within their budgets, and without the burden of the debt that comes with a mortgage.

Notes

1. National Multifamily Housing Council analysis of Fannie Mae and Freddie Mac 10-Ks (2006–15), data from the Mortgage Bankers Association, and Division of Housing Mission and Goals (2015).
2. National Multifamily Housing Council tabulations of Current Population Survey Annual Social and Economic Supplement, US Census Bureau.

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Robert E. DeWitt is president and CEO of GID, where he oversees corporate strategy development, new client and equity partner sourcing and procurement, property acquisitions and dispositions, client relations, and overall management of the company. He is chairman of the board of directors of the National Multifamily Housing Council. He is a member of the Pension Real Estate Association and the Multifamily Silver Council of the Urban Land Institute, and he is past chairman of the Multifamily Gold Council. DeWitt graduated cum laude with a BA from Middlebury College and received an MBA from the Amos Tuck School of Business at Dartmouth College.

Barry Zigas: Achieving Access and Affordability in Mortgage Finance

Desirable objectives worth pursuing when designing a durable mortgage finance system include liquidity through all business cycles, long-term fixed-rate financing for consumers who want it, transparency in pricing, security for investors, and access to capital markets funding for lenders of all sizes and types. But none of these objectives justifies federal involvement without assuring access to sustainable mortgage financing for as many creditworthy borrowers as possible in the least costly way. A balance must be found among these sometimes competing objectives that is economically sound and socially just.

Moreover, as other authors in this series have pointed out, the country's shifting demographics will put greater pressure on the mortgage finance system to effectively serve diverse markets. Meeting this challenge is a matter of social equity and economic consequence.

Consumers will have the greatest access to credit when there is a strong, stable economy producing jobs at good wages. But the housing finance system can make a difference in such access in any economy. And no aspect of housing finance reform has proven more vexing. Over the past eight years, debates about mortgage finance reform have focused only on the market space and activities of Fannie Mae and Freddie Mac, forcing us to address this systemwide problem of access within one narrow channel.

Taking a broader view that encompasses all federal housing credit supports in the primary and secondary markets, especially Federal Housing Administration (FHA) mortgage insurance, would make this goal more manageable, reduce inconsistencies in how consumers are served, and end decades of confusing and contradictory federal policies. FHA insurance, with its existing trillion-dollar book of business and historical social mission, can break the logjam over how mortgage finance reform can most fully meet access and affordability aspirations. We should be thinking of a more fundamental shift in how to restructure mortgage finance.

A proposal I coauthored in March, which was discussed earlier in this series by Mark Zandi, allows us to break out of this unnecessarily narrow frame for tackling the issue, so that we can utilize *all* the federal instruments designed to assure access to affordable credit to build a system that increases access and affordability.

Our proposal would merge Fannie and Freddie into a new government-owned corporation that would share risk with private capital and provide a government guarantee of a single class of mortgage-backed securities supporting a well-defined market. This corporation would keep the 2008 Housing and Economic Recovery Act requirements of annual percent of business housing goals. It also would retain the duty-to-serve requirement for underserved markets and a 10 basis point annual fee on the guaranteed securities to finance affordable housing and community development efforts through the Housing Trust Fund, Capital Magnet Fund, and other means. The proposal would avoid private profit–public mission conflicts that existed preconservatorship and in most other proposals. It would retain strong regulatory oversight over the new merged system and allow lenders of all sizes access to it.

It would also open the door to better integrate other critical tools for expanding access to credit—such as the FHA—into a single, coherent, and effective mortgage finance system. Access to credit in the government-sponsored enterprise (GSE) market is tight, as documented by the Urban Institute’s Housing Credit Availability Index and other metrics.¹ Any reform, including our proposal, would be less than a full success if it didn’t produce a better outcome. Our proposal offers an opportunity to significantly broaden how the system serves the market. Like many of the proposals suggested in this series, our proposal would require legislation. But that is part of why it can significantly improve credit accessibility.

The Old Model

Ensuring access to credit requires attention to several issues. Household formation in coming decades will be driven by a diverse population that will need measures of credit history that are more responsive to them than current measures. Lenders in the primary market must have similar incentives to serve these new households. Those incentives must be aligned with the secondary market and include requirements to offer the broadest range of products. Biases and barriers against loans with smaller balances must be addressed. Latent demand among diverse households must be stimulated, and lenders must have products and a workforce that can respond. The secondary market must provide liquidity for these products.²

But discussions of access and affordability ultimately hinge on the size of the credit box, which is governed by the credit costs of lending. High-risk assets will bring either higher fees for borrowers or lower returns for credit providers. This drives up the cost of credit, constrains access for some

borrowers, and eventually closes off credit altogether. For decades, federal policy has tried to moderate this dynamic.

The GSE model has accomplished this moderation in part by taking advantage of the widely dispersed risk in the GSEs' large risk pools in a well-defined market to use a cross-subsidy in which the best credit risks are charged a fee that helps cover the costs of high-risk loans. The potential lender or investor costs of the higher-risk loans are further mitigated through risk sharing with private mortgage insurers.

Access has also been promoted through a requirement for Fannie and Freddie to accept lower returns for products serving targeted households and meet annual housing goals determined by the Federal Housing Finance Agency. Encouraging these lower returns expands cross-subsidization's reach, and the housing goals ensure that secondary market policies do not constrain and, importantly, encourage primary market lenders to serve creditworthy borrowers. These requirements increased Fannie and Freddie's service to low- and moderate-income borrowers, especially in the early years after their adoption. At some point, however, the value of the cross-subsidy and coinsurance is overtaken by the costs of riskier credit and access is closed off.

Lastly, the GSEs must serve historically underserved or poorly served markets, though the requirement has not yet been put into effect. The Federal Housing Finance Agency's recently proposed rule to implement this duty-to-serve requirement will further shape the GSEs' approach to markets and consumers.³

But focusing on only Fannie and Freddie to increase access fails when the cross-subsidy and coinsurance reach their limit. Tremendous energy is spent debating how to move that limit some amount with higher housing goals or limits on credit insurers' returns, but many borrowers affected by this limit move to another credit risk system and obtain a mortgage through the FHA insurance program. A debate that focuses only on outcomes in the GSE system ignores this. A consumer who shifts from GSE credit insurance to FHA credit insurance is considered a "system fail."⁴

A New Paradigm

FHA loans are securitized primarily through Ginnie Mae and over time have come to be viewed as "second-class" mortgages, somehow inferior to conventional loans. Decades of mismanagement, explicitly racist policies (abandoned decades ago), and scandals and corruption in its mortgage

programs in past decades tainted FHA and contributed to its second-class reputation. In its present state, weakened by underfunding and political interference, and struggling to restore lender confidence in it as a business partner, FHA does not seem like an obvious solution.

But FHA insurance can break the logjam over how mortgage finance reform can meet access and affordability aspirations. To be sure, mortgage finance reform should not be designed around a substandard FHA. Comprehensive reform should address and fix the FHA's flaws and strengthen its role in a cohesive system. Mortgage finance reform that focuses only on overhauling conventional market tools will miss a critical opportunity to overhaul a valuable and powerful tool for access: FHA. Our proposal suggests that the system we proposed could integrate the government's other mortgage finance supports, including FHA and Ginnie Mae.

Whether rechartering FHA as a separate government-owned corporation, incorporating it into the unified entity we propose, or tackling some of the FHA's features that most constrain its market responsiveness, mortgage finance reform that does not consider all federal tools will miss the mark. FHA insurance and other federal mortgage credit insurance could be an acceptable form of credit insurance for mortgage-backed securities guaranteed through the structure we propose. But our proposal also creates a larger opportunity to modernize and reform FHA and Ginnie Mae as part of a commitment to a comprehensive, stable, open, and accessible mortgage finance system, and to remove some of the operational barriers that have stopped lenders from using FHA. Without such change, FHA's use is likely to remain constrained, its efficacy in supporting responsible credit hampered, and frustration over the conventional market's obligations continue.

Credit access would be greatly enhanced by reducing the distinction between FHA and GSE mortgages and providing a continuum of credit insurance based on loan risk. Integrating loan underwriting and pricing in our proposed model with that of FHA would enable risk factors to be priced along a continuum within the same secondary market model.⁵ Many if not most loans would be backed by private capital, as is the case now. Loans for which that alone would be too costly, or for which there would be no risk takers could shift to FHA seamlessly. Primary market lenders could offer credit through the secondary market covering many factors without having to distinguish among credit insurers or securities guarantors. Borrowers could get loans with features for which they qualify and at the best price through one secondary market channel. Loan originators and brokers in the current fragmented system sometimes steer borrowers to the insurance or security combination they think will get an approval most quickly, even if it is not the best choice for the borrower. Lenders also have conscious and unconscious biases that can influence which credit insurance option they recommend

and leave borrowers with mortgages less appropriate than those for which they qualify. Reducing the importance of these market actors' influence in this area would be a welcome reform outcome.

This integration will require close attention to how to price both private and FHA mortgage insurance and to clarify intentional distinctions between them, but the system we propose would help reduce some of the distinctions that drive execution and pricing differences today.⁶ Other forms of credit enhancement could and should be incorporated into an integrated system where they add value, such as lender recourse on loans they originate and securitize, innovative models through community development financial institutions, and state and local housing finance agency programs. Having one secondary market path to liquidity for all these options would make assuring broad access more efficient.

Not every applicant can or should qualify for a mortgage in any system.⁷ Though more expansive than the current GSE model, our approach would also have boundaries, and some borrowers would not obtain a loan. But more borrowers would get a mortgage through the new system if comprehensive reform eliminated the dual credit market.

Mortgage finance reform discussions have failed to generate consensus assuring the widest possible access to sustainable mortgage credit at the lowest practical cost. We can resolve this impasse if we integrate all federal supports for mortgage finance into one cohesive whole.

Notes

1. Housing Finance Policy Center, "Housing Credit Availability Index: Index for April 12, 2016," Urban Institute, last updated April 12, 2016, <http://www.urban.org/policy-centers/housing-finance-policy-center/projects/housing-credit-availability-index>.
2. Another barrier to access beyond the scope of this essay is rising rental housing costs that consume increasing amounts of household income. These high rent burdens sap households' ability to save for a down payment and may contribute to credit problems, especially for low- and moderate-income renters. According to a recent study, "rental housing is home to a growing share of the nation's increasingly diverse households. But even with the strong rebound in multifamily construction, tight rental markets make it difficult for low- and moderate-income renters to find housing they can afford. As a result, the number of cost-burdened renters set another record last year" (JCHS 2015).
3. Federal Housing Finance Agency, "FHFA Issues Proposed Rule on Fannie Mae and Freddie Mac Duty to Serve Underserved Markets," press release, December 15, 2015, <http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Issues-Proposed-Rule-on-Fannie-Mae-and-Freddie-Mac-Duty-to-Serve-Underserved-Markets.aspx>.
4. For research on the interactive relationship between FHA and GSE lending, see An and Bostic (2006).

5. This also could mitigate concerns over the procyclical nature of private-credit insurance and how relying on it in a new system could constrain credit when it is most needed. By integrating FHA into the same system, its use could be easily expanded when private credit is too expensive or not available. This happened in the mortgage crisis when FHA's market share swelled, but not in a coordinated or integrated way.
6. See Bing Bai and Laurie Goodman, "The private mortgage insurance price reduction will pull high-quality borrowers from FHA," *Urban Wire* (blog) Urban Institute, May 2, 2016, <http://www.urban.org/urban-wire/private-mortgage-insurance-price-reduction-will-pull-high-quality-borrowers-fha>.
7. Homeownership education and counseling can help borrowers who do not qualify for a loan get on a path to do so. Any future system should incorporate such support in as integrated a way as possible.

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About the Author

Barry Zigas is director of housing policy at the Consumer Federation of America. He also provides strategic planning and facilitation services to nonprofit and for-profit entities through his consulting firm Zigas and Associates LLC. He worked at Fannie Mae from 1993 to 2006 as vice president and senior vice president for community lending, through which he receives retirement benefits. His responsibilities included reporting corporate and regulatory housing goals. Zigas was president of the National Low Income Housing Coalition from 1984 to 1993, where he helped develop the 1992 legislation that first established GSE housing goals and other legislation that established the HOME program and the Low Income Housing Tax Credit. He is chair of Mercy Housing Inc. and has served on the boards of the Low Income Investment Fund, Enterprise Community Partners, National Housing Trust, and the National Housing Conference. He is a member of the consumer advisory councils at Bank of America, Ocwen Financial, Chase, and the Mortgage Bankers Association. Zigas is a Phi Beta Kappa graduate of Grinnell College and a graduate of the advanced management program at the Wharton School of the University of Pennsylvania. The views in this essay are the author's sole responsibility.

Edward J. Pinto: It's Time to Put the Market Back in Housing Finance

Today's government-centric housing finance system is an "economics free zone" indifferent to supply and demand. Composed of an alphabet soup of agencies, this system has fostered a massive liberalization of mortgage terms and provided countless trillions of dollars in lending in up and down markets. At the same time, other government policies constrain supply. As a result, housing has become less, not more affordable or accessible. Here's why.

[In a seller's market] it is more likely that the liberalization of mortgage terms will increase both price and the amount of the debt, with debt service remaining approximately unchanged. ... Thus, the liberalization of terms easily becomes capitalized in higher prices. (Fisher 1951)

Because of a reliance on excessive leverage, US homeownership policy has failed to broaden homeownership access, failed to achieve wealth accumulation for low- and middle-income homeowners, and led to 11 to 12 million foreclosures since 1973.

US multifamily policy failed to promote plentiful rental housing opportunities at rents accessible to low- and moderate-income tenants (Fisher 1975; Jakabovics et al. 2014). With the supply of unsubsidized, economical, workforce housing stagnating, there are calls for large expansions in subsidies.¹ Building hundreds of thousands of high-cost apartment units—with inflated costs because of federal, state, and local regulations as well as layers of subsidies to lease to extremely low and very low income households—is not viable (Fisher 1975).

The Case against Current US Homeownership Policy

For 60 years, policymakers have loosened mortgage lending standards ostensibly to promote broader homeownership and wealth accumulation, particularly for low- and moderate-income households.

- In 1954, Federal Housing Administration (FHA) borrowers had an average loan-to-value of 79.9 percent, an average loan term of 21.4 years, and an average housing debt-to-income ratio of 15 percent.

- By 1964, these metrics had risen to 92.8 percent, 29.9 years, and 16.5 percent, respectively.
- Today, the average figures are 96 percent, 29.5 years, and 28 percent, respectively.

Today's FHA borrowers spend nearly twice as much of their income—2.15 times the debt, for a home at 1.79 times the price, with 6 times the default risk under stress—compared with typical 1954 FHA borrowers with the same nominal income.

It's not surprising that the FHA has experienced 3.4 million foreclosures from 1973 to 2014 (one in eight purchase borrowers) compared with a near-zero rate in its first 25 years.² For the 25 percent of FHA borrowers living in the highest default rate zip codes, an estimated one in five lost their homes, with untold neighborhood devastation (Pinto 2012).

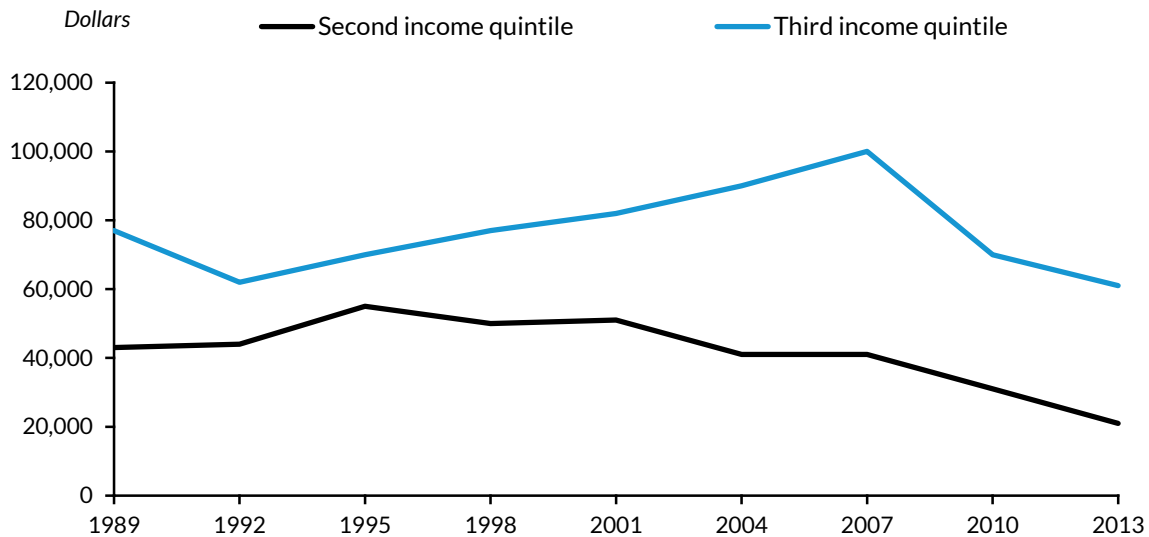
Fact 1: The US homeownership rate is no higher today than in the early 1960s and is only marginally higher than in 1956, before FHA loans with low down payments or 30-year terms became broadly available.³

Fact 2: Homes are less affordable today, standing at a multiple of 3.32 times median home price and median income compared with 2.95 times in 1979 or 2.86 times in 1992. A new round of increasing loan leverage began after 1992, the year Congress imposed government-sponsored enterprise (GSE) affordable housing mandates. This helped drive home prices to unsustainable levels (4.05 times in 2006). After hitting a trough of 3.03 times in 2012, the ratio now stands at 3.32 times.⁴

Fact 3: Low- and middle-income households have lost wealth since 1989.

FIGURE 1

Median Household Income



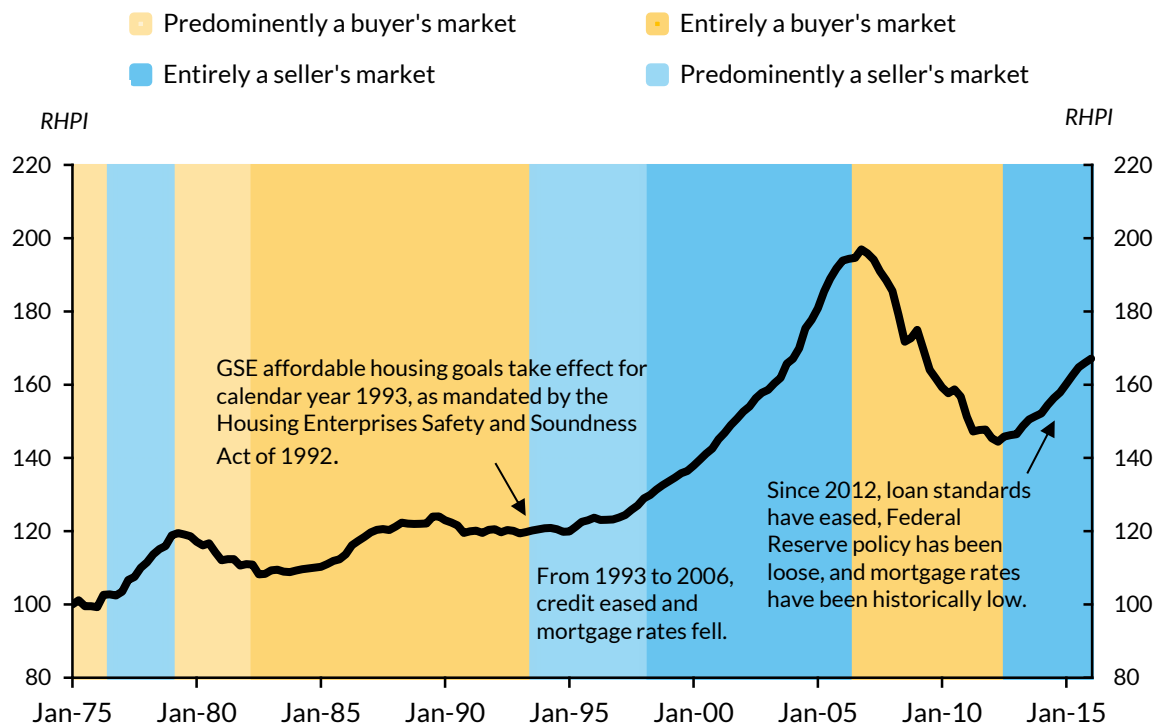
Source: Federal Reserve Survey of Consumer Finances.

Fact 4: Liberalizing credit terms during a seller's market inflates home prices and sets up future price volatility and higher default rates under stress.⁵ Extended periods of increasing leverage fuel a price boom that makes homes unaffordable, promotes price volatility, and leads to unforgiving mean reversion.⁶

Figure 2 confirms FHA's first chief economist Ernest M. Fisher's 1951 prediction that in a seller's market, liberalized credit terms easily translate into higher prices. During the current up cycle, real home prices are up 16 percent.

FIGURE 2

Real Home Price Index



Source: US Census Bureau for new home inventories used before June 1982.

Notes: RHPI = Real Home Price Index. January 1975 = 100, which is calculated as the Federal Housing Finance Agency's all-transaction house price index divided by the Bureau of Economic Analysis's price index for personal consumption expenditures. The National Association of Realtors defines a seller's market as inventory that is less than or equal to six months of sales. National Association of Realtors data pertain to existing homes and are not available before June 1982.

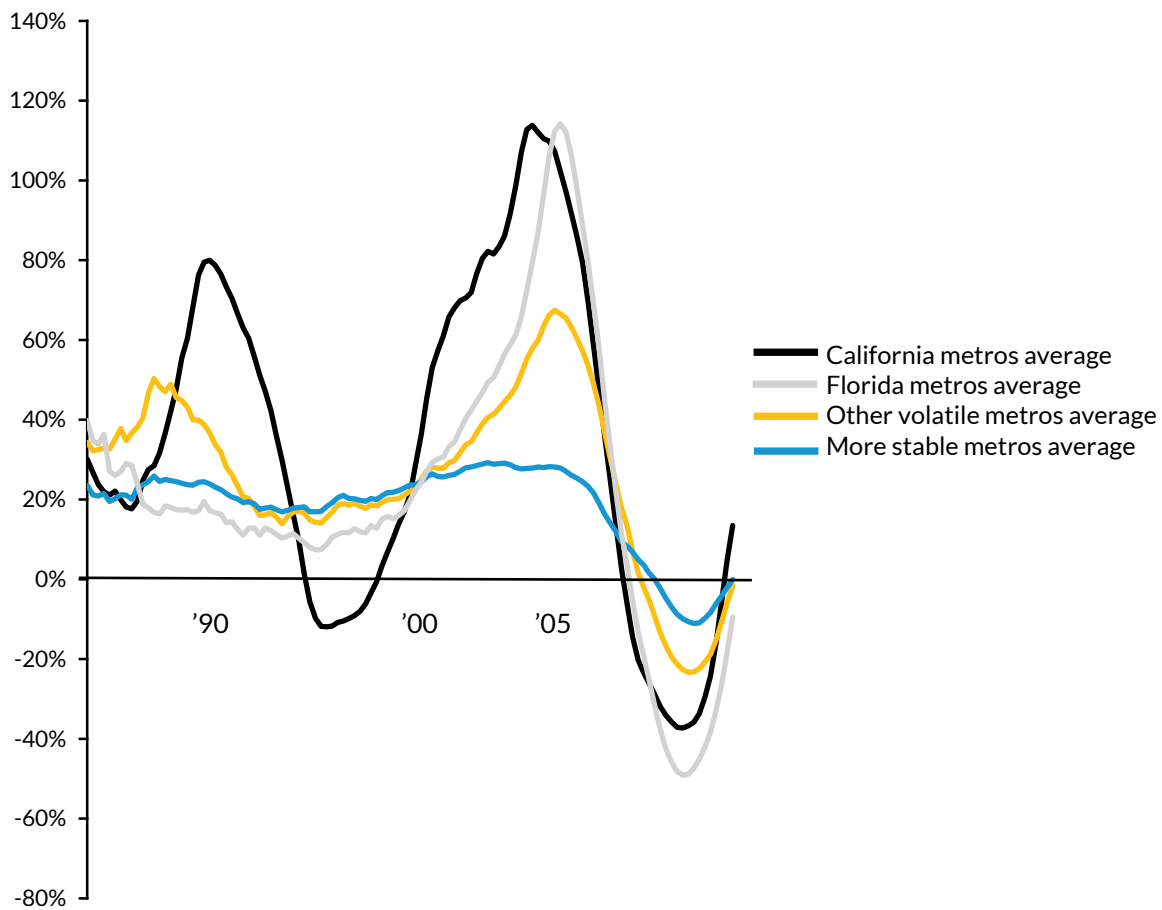
In January 2015, the FHA announced a mortgage insurance premium cut during a seller's market. It had the effect predicted by Fisher: nearly three-quarters of the additional buying power was absorbed by price (18 percent) and quality/quantity (55 percent) effects.⁷ Because the price effect increased the cost for all FHA buyers, the marginal cost of attracting each new first-time buyer was high (\$82,000).⁸

Fact 5: Averages are misleading, and home prices are volatile.

National averages are misleading because they mask price volatility (figure 3) and price dispersion at the metro, zip code, and neighborhood levels (figures 4 and 5).

FIGURE 3

House Price Volatility in the 51 Largest US Metropolitan Areas from 1984 to 2011

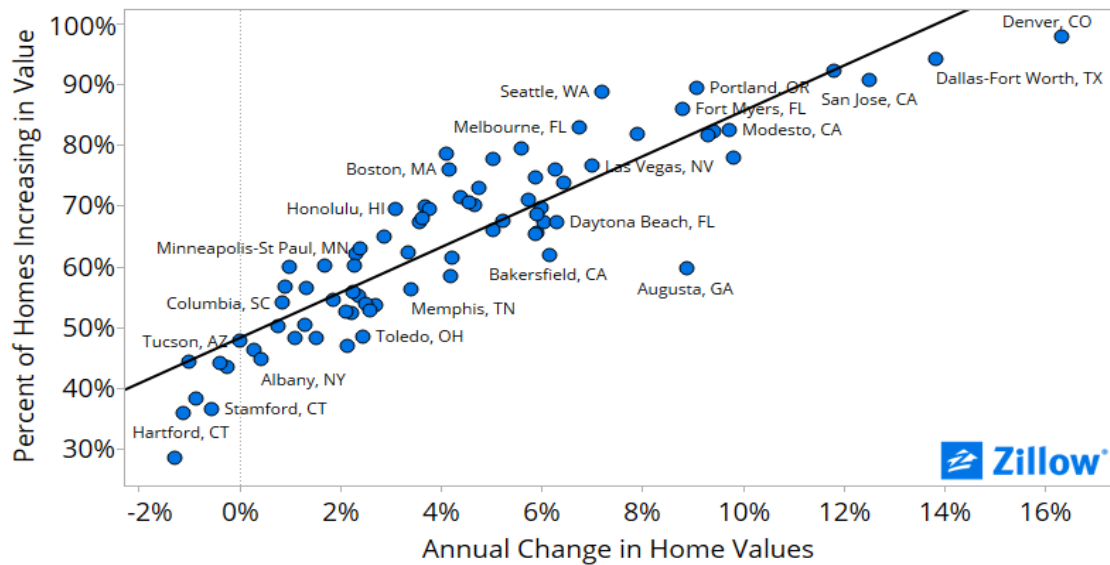


Source: Zillow.

Notes: Volatile metros are those for which the difference between the highest and lowest annual percentage changes is greater than 30 percentage points. House prices are most volatile in the six California metros and the four Florida metros. Twenty-three metros make up the “other volatile metros,” and 18 metros make are considered “more stable metros.” Each series shows the percentage change from five years earlier.

FIGURE 4

Home Value Increases versus Annual Change in Median Home Value, August 2015

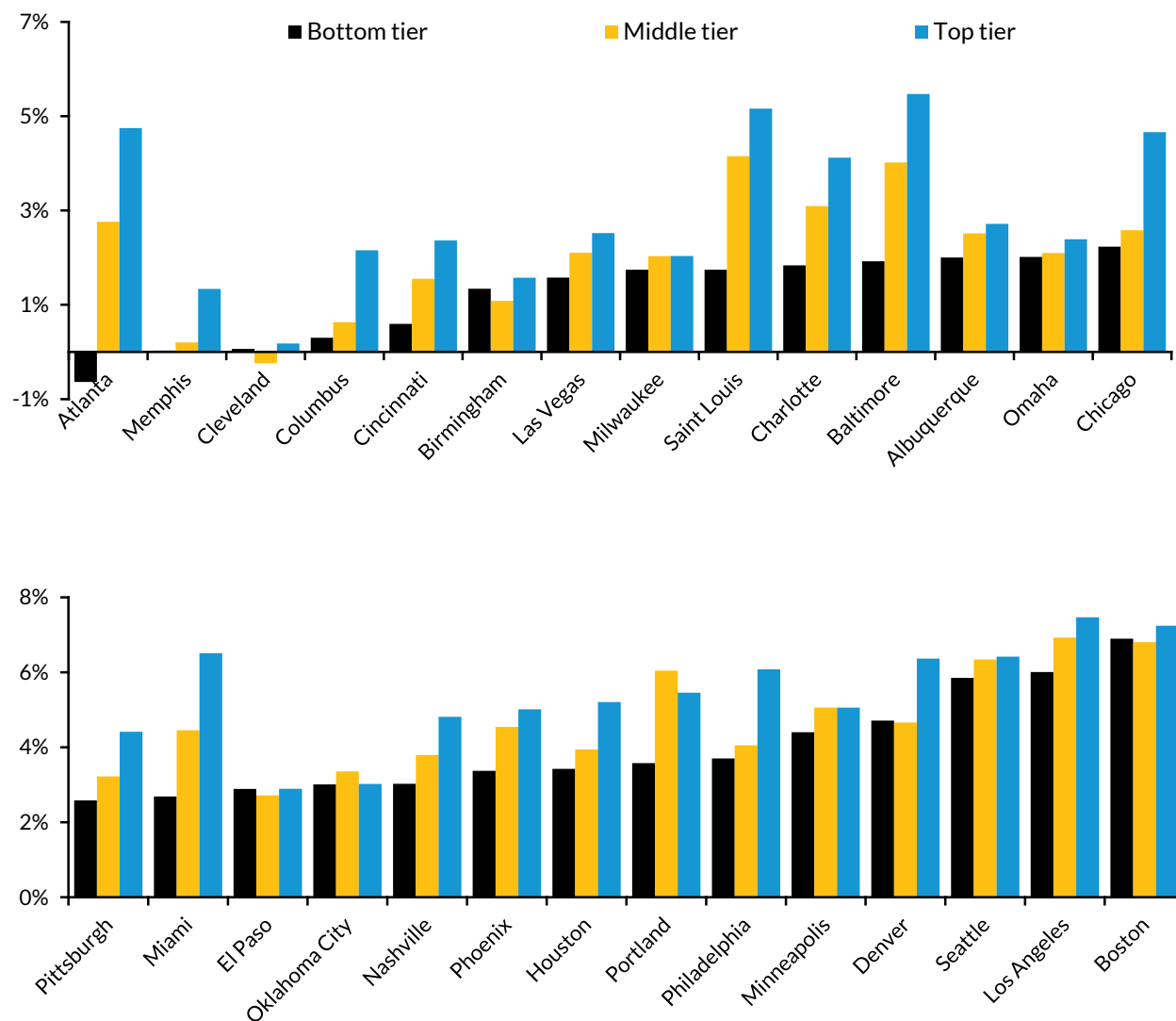


Source: Zillow.

Lower-priced homes, generally owned by low-income and minority households, experience higher price volatility and lower nominal gains. In figure 5, the bottom price tier of all 28 cities had a lower nominal price increase per year than the top tier (computed over 18 years). These borrowers also experience higher default rates because of the higher leverage.⁹

FIGURE 5

Nominal Percentage Increases in House Prices per Year for 28 Cities from April 1996 to May 2014



Source: Zillow.

Notes: Figure shows weighted average across zip codes, with weights based on the number of owner-occupied housing units in the zip code. Each zip code is divided into three price tiers based on median home prices in the zip code. Only zip codes in the city proper were used.

Fact 6: Postcrisis credit is not tight;¹⁰ underwriting and regulatory changes promote rather than constrain a boom.¹¹ Whether leverage is exotic is less relevant than the relative change in buying power generated by increasing leverage, which drives deviation from the price mean.

Fact 7: Federal, state, and local policies increase home-building costs (Jakabovics et al. 2014). The 10 metros with the lowest multiples of 2013 median home price and 2013 median household income had less restrictive land-use regulations. The 15 metros with the highest multiples had more restrictive land-use regulations.¹² Even California has recognized that public policies are largely responsible for it being the most expensive housing market in the country (Taylor 2015). Burgeoning impact fees have a disproportionate impact by constraining the construction of entry-level homes.¹³

The Case against Current US Multifamily Policy

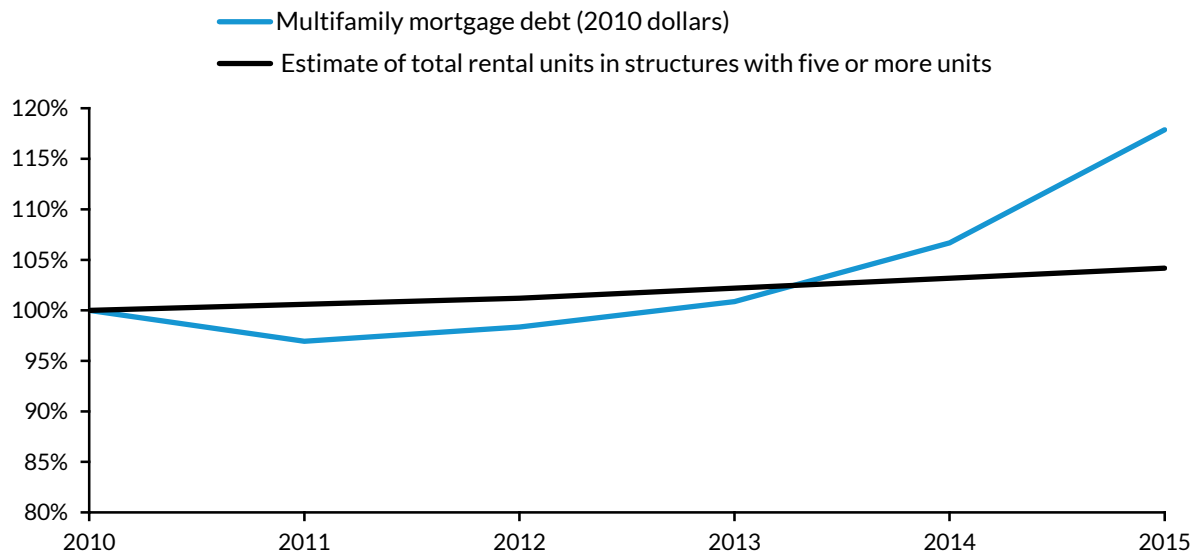
Fact 1: Rents are increasingly less affordable. In 1979 (earliest Zillow data available), median rents nationally stood at 24 percent of median incomes (Los Angeles rents stood at 30 percent of median incomes). Today, the national rate stands at 30 percent with Los Angeles at 49 percent.

Fact 2: Federal, state, and local policies increase apartment construction costs. Eight of the 10 metros with the lowest multiples of 2015 median rent and median household income had less restrictive land-use regulations. Thirteen of the 15 metros with the highest multiples of 2015 median rent and median household income had more restrictive land-use regulations.¹⁴

Fact 3: Multifamily debt (in 2010 dollars) is rising much faster than the number of total units because of liberal financing from Fannie Mae, Freddie Mac, FHA, and Ginnie Mae, as well as highly accommodative monetary policy.¹⁵

FIGURE 6

Multifamily Mortgage Debt and Total Multifamily Rental Units from 2010 to 2015



Note: Author's calculations using data from the Federal Reserve and the Census Bureau.

Fact 4: While the Low-Income Housing Tax Credit (LIHTC) is the primary means of promoting the construction of “affordable” apartments, it’s expensive and opaque.

New LIHTC credits total \$10 billion annually, funding about 100,000 LIHTC units.

- These units have high construction costs (estimated \$175,000 to \$200,000 per unit).
- These units serve few low-income tenants; 80 percent are either extremely low income (area median income less than or equal to 30 percent) or very low income (area median income from 31 to 50 percent); only 7 percent have an area median income greater than 60 percent but less than or equal to 80 percent (Furman Center 2012).
- These units benefit from layers of subsidies, driving subsidy costs to \$12,000 per unit, raising questions about unfair distribution of scarce resources. These subsidies include government-aided financing, state and local subsidies, and rental assistance (e.g., Section 8 and Housing Choice Vouchers) targeted to very low and extremely low income households.
- This tax credit risks repeating same errors as previous housing subsidy programs.

- » Tenants are overwhelmingly minority households (61 percent), and nonelderly units are concentrated in metropolitan statistical area census tracts with high minority concentrations (Office of Policy Development and Research 2016).
- » Many developments face fiscal challenges to avoid blight that sets in after 16 to 20 years.

Market-Based Solutions to Bring Home Prices Back in Line with Median Incomes and Improve Accessibility

Objective: A more stable housing finance market that provides a reliable path to wealth building and broader low- and middle-income access to homeownership.

- Repeal Title XIV (qualified mortgage) and section 941 (qualified residential mortgage) provisions of Dodd-Frank (Pinto 2016) (legislative action needed)
- Require the FHA and GSEs to adopt sound underwriting, pricing, and capital standards (legislative and administrative action needed)
- Repeal the GSE affordable housing goals (see replacement Low-Income First-Time Buyer tax credit below) to end destabilizing competition between the FHA and the GSEs (legislative action needed)
- Adopt policies to support market stability by ensuring a high preponderance of good-quality mortgages (administrative action needed)
- Help low- and middle-income families with wealth-building strategies
 - » The American Enterprise Institute's Wealth Building Home Loan offers such a path, but the 30-year mortgage does not.¹⁶ (administrative action needed)
- Enact the Low-Income First Time Homebuyer (LIFT Home) tax credit (legislative action needed)
 - » This credit would allow low-income,¹⁷ first-time buyers to forgo the interest deduction and receive a one-time refundable tax credit.
 - » This credit is equal to 4 percent of the mortgage loan (\$10,000 maximum) and can be used to buy down the loan's interest rate for at least seven years on loans with terms of 20 years or less.

- » The legislation would funnel \$4.5 billion per year to fund 500,000 LIFT Home buyers, 250,000 of whom would be incremental low-income, first-time buyers. This assumes that 150,000 live in apartments (freed-up units would be a bonus).
- » Funding LIFT Home would require the following:
 - Reductions in the US Department of Housing and Urban Development's budget
 - Repurposing other budgeted amounts that support affordable housing to push tax dollars directly to homebuyers instead of having the money siphoned off by bureaucracies and advocacy groups
 - Restructuring home mortgage interest deductions to promote wealth, not debt accumulation
 - For future homebuyers, this restructuring would
 - limit interest deductions to purchase loans and exclude second mortgages and cash-out refinances (also for existing homeowners) and
 - cap mortgage interest deductions to amounts payable on a loan with a 20-year amortization term.
 - For existing home loan borrowers, the restructuring would
 - grandfather current interest deductions, ameliorating impact of change on current home prices; and
 - direct any interest savings (from refinancing an existing loan at a lower rate) toward shortening the loan term.

Over 10 years, these solutions would reduce capital needs by 60 percent and allow weaning off the federal government's overwhelming loan guarantee role. Outstanding debt would be reduced by approximately 20 percent, and risk-absorbing capital per loan would be reduced by 50 percent.

- With less interest rate risk and lower capital requirements, these loans would be safer and easier for depository institutions to hold in portfolio. Today, these institutions hold about 50 percent of total single-family mortgage debt.

Market-Based Rental Housing Solutions to Bring Rents Back in Line with Median Incomes and Improve Accessibility: The “Blight Preventer” Loan

Objectives: Shift from the current debt- and government-centric finance system to a rental housing market where supply is permitted and encouraged to meet demand; establish life cycle underwriting¹⁸ and the “Blight Preventer” Loan as best practices in financing subsidized multifamily housing.

- Repeal GSE affordable housing policies and the Community Reinvestment Act
- Increase supply of unsubsidized economical workforce and entry-level apartments
- Use life cycle underwriting and 15- and 20-year self-amortizing first mortgage—the “Blight Preventer” Loan (White and Wilkins 2016):
 - » Excessively long loan terms used to finance affordable multifamily properties leave many properties unable to fulfill affordability commitments without additional public subsidies and leaves those properties poorly maintained, leading to blight and urban decay.
 - » Most affordable multifamily housing is located in lower-income neighborhoods, leaving public funders to accept blight or throw good money at bad investments.

Bending the Cost Curve to Increase the Supply of Unsubsidized Economical Workforce and Entry-Level Houses and Apartments

- Local and state governments should
 - » authorize expedited permitting and “just-in-time” building inspections;
 - » identify building code interpretations to reduce cost impact;
 - » review and amend density and parking requirements, height maximums, size minimums, and other provisions that increase barriers and raise costs;
 - » expand permitted uses in a zoning district that are not subject to special review and approval by local government;

- » review and amend building codes that dictate costs and amenities that put economical workforce developments at a disadvantage;
 - » reduce regulatory complexity and include staff flexibility in applying and interpreting burdensome requirements (direct staff to be as flexible as possible);
 - » adjust impact and permitting fees to reflect any reduced impact of such housing;
 - » establish a “good enough to be economical” standard; and
 - » reduce the expenses calculated as a percentage of costs.
- Designers and builders should implement innovative and economical techniques for
 - » design and construction,
 - » sustainability,
 - » utilizing existing infrastructure,
 - » repurposing existing structures, and
 - » management.

Notes

1. “Cantwell Launches National Campaign to Increase Federal Resources for Affordable Housing,” press release, March 24, 2016, <https://www.cantwell.senate.gov/news/press-releases/cantwell-launches-national-campaign-to-increase-federal-resources-for-affordable-housing>; Peter Dreier, “How to House the Working Poor,” *How Housing Matters*, last updated April 7, 2016, <http://howhousingmatters.org/articles/house-working-poor/>.
2. FHA Actuarial Studies and author. See Pinto (2012).
3. Edward J. Pinto, “Housing finance fact or fiction? FHA pioneered the 30-year fixed rate mortgage during the Great Depression?” *AEIdeas* (blog) American Enterprise Institute, June 24, 2015, <http://www.aei.org/publication/housing-finance-fact-or-fiction-fha-pioneered-the-30-year-fixed-rate-mortgage-during-the-great-depression/>.
4. Zillow and author.
5. Liberalization of credit terms takes many forms, including smaller down payments, higher debt-to-income ratios, longer loan terms, lower interest rates, quantitative easing, and reduced mortgage insurance premium.
6. Mean reversion is a theory suggesting prices and returns eventually move back toward the mean.
7. The 0.5 percent decrease in premium increased buying power by 6.0 percent. This could be “spent” in three ways: price effect (seller raises price), quality/quantity effect (buyer purchases larger or better-quality home), or expanded access (attracts new buyers).
8. Forthcoming research to be published by Stephen Oliner, Edward Pinto, and Tobias Peter.
9. Default risk increased in zip codes where median family income and median home prices are low. See Pinto (2012).

10. First-time buyer credit metrics are as follows: 69 percent of buyers have a combined loan-to-value ratio less than or equal to 95 percent, 97 percent have a 30-year loan, 29 percent have a debt-to-income ratio less than 43 percent, and 22 percent have a FICO score below 660. See “Mortgage Risk Index Release of March 2016 Data,” American Enterprise Institute’s International Center on Housing Risk, last updated April 26, 2016. As an up real estate cycle ages, credit maximums usually become minimums, thus leading to calls for even more liberal credit terms, including less traditional ones. See Fisher (1951).
11. For example, income leverage (measured by borrower debt-to-income ratio) is largely unconstrained by Dodd-Frank’s qualified mortgage regulation. Its 43 percent limit is swallowed by agency exemptions (Fannie, Freddie, FHA, the US Department of Veterans Affairs, and the Rural Housing Service guarantee some 85 percent of all primary home purchase loans). An effective income leverage limitation operates to “take the punch bowl away” before a leverage-fueled price boom goes too far.
12. Demographia.com and author; “Regulations Add a Whopping \$84,671 to New Home Prices,” *NAHBNow* (blog) National Association of Home Builders, May 9, 2016, <http://nahbnow.com/2016/05/regulations-add-a-whopping-84671-to-new-home-prices/>.
13. Nick Timiraos, “How City Hall Exacerbates the Entry-Level Housing Squeeze,” *The Wall Street Journal*, May 5, 2016, <http://blogs.wsj.com/economics/2016/05/05/how-city-hall-exacerbates-the-entry-level-housing-squeeze/>.
14. Demographia.com and author.
15. Paul Bubny, “CRE Debt Increase Hits 8-Year High,” *Law.com*, March 15, 2016, <http://www.law.com/sites/paulbubny/2016/03/15/cre-debt-increase-hits-8-year-high/?sreturn=20160419120431>.
16. Edward Pinto and Stephen Oliner, “WBHL,” American Enterprise Institute’s International Center on Housing Risk, accessed May 19, 2016, <http://www.housingrisk.org/category/wealth-building-home-loan/>.
17. Incomes below 80 percent of the area median income.
18. Lifecycle underwriting considers a property’s ability to cover its long-term capital needs (e.g., replacing worn-out roofs, air conditioners, and appliances) over the property’s life cycle. See Brennan and colleagues (2013).

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About the Author

Edward J. Pinto is an American Enterprise Institute (AEI) resident fellow and codirector of AEI’s International Center on Housing Risk. Pinto is cocreator and developer of the AEI Pinto-Oliner Mortgage Risk and Collateral Risk Indexes. He is also the cocreator of the Wealth Building Home Mortgage, a new approach to home finance designed to serve the twin goals of providing a broad range of homebuyers—including low-income, minority, and first-time buyers—a more reliable and effective means of building wealth than currently available under existing policies, while maintaining buying power similar to a 30-year loan. Active in single- and multifamily housing finance for 42 years, he was an executive vice president and chief credit officer for Fannie Mae until the late 1980s. Pinto has done groundbreaking research on the role of federal housing policy in the 2008 mortgage and financial crisis. He has no financial interest in Fannie Mae, Freddie Mac, or the Federal Home Loan Banks. As a taxpayer, he has a strong financial interest in the risks undertaken by the US Treasury and the Federal Reserve.

John Taylor: Improving Our Mortgage Finance System Shouldn't Require a Total Reinvention

Let's consider what's at stake in the housing finance reform debate. It's a big deal. It will have enormous consequences for Main Street. If we get it wrong, many hardworking, creditworthy families will be shut out of homeownership, and their efforts to climb the economic ladder will be stymied. Much of the conversation on Capitol Hill and among policy thinkers has pushed affordability and access to the back burner. We need to bring it to the forefront of the conversation. The shape and quality of housing finance reform will have repercussions in every neighborhood and community and for our national economy.

Homeownership is the best vehicle for low- and moderate-income families and people of color to build wealth and enter the middle class. African American and Hispanic families hold most of their wealth in the form of home equity (Kochhar, Fry, and Taylor 2011).¹ This is also true for working-class whites. A home purchased using the leverage of a responsible mortgage beats any other investment option in terms of return on investment. Homeownership is a mechanism that is unmatched in providing economic opportunity to working families.

Homeownership also offers community, economic, and social benefits, including better health outcomes, less crime, and better academic achievement (National Association of Realtors 2012). Homeownership also drives economic growth, benefiting the whole economy. For decades, a strong network of US policies supported responsible homeownership and the creation of affordable and safe mortgages, which had vast benefits for our economy and bolstered the growth of the middle class. Fannie Mae and Freddie Mac are a cornerstone of this success, providing a deep, liquid market for US mortgage debt. The shift toward securitization by Fannie Mae and Freddie Mac signaled the start of a long, stable, and gradual rise in homeownership and home values. This ended with the rise of the private-label securities market in the early 2000s, and we see a sharp rise in prices that coincides with the growth of private-label securities market share.

In the 1990s, affordable housing goals were put into effect for the government-sponsored enterprises (GSEs). The housing goals offered regulators a method to ensure that Fannie Mae and Freddie Mac led the market, increasing credit access for blue-collar, working-class Americans in

underserved communities, while ensuring the long-term stability of the GSEs. Decades of lending discrimination and redlining left these communities with severe financial disparities. Without laws and rules such as the Community Reinvestment Act and the affordable housing goals, underserved communities could be blocked altogether from affordable credit.

Almost all authors on this forum have acknowledged how large a role Fannie Mae and Freddie Mac have played since the 2008 financial crisis and the preeminence of agency mortgage securitization as a source for mortgage capital since the savings and loan crisis in the 1980s. But the major proposals considered by Congress to reform housing finance have eliminated Fannie Mae and Freddie Mac and eliminated their affordable housing goals. And there is scant evidence that any of the alternative models that have been postulated would do as good a job as Fannie Mae and Freddie Mac did for most of their history. So why reinvent the wheel?

Market Uncertainty and Insufficient Private Capital in Alternative Models

There may not be enough private capital to replace the \$5 trillion in mortgage credit made possible by the GSEs' role in the secondary market. All the reform models proposed to date have significant flaws regarding this issue and whether they could provide stable financing in all markets at all times. It's unclear whether guarantors could raise sufficient capital to support reform models that require a 10 percent capitalization like the one proposed by Alex Pollock, not to mention whether that type of capitalization requirement and the guarantee fees it implies would simply price many low- and moderate-income borrowers out of the conventional market altogether.

Other proposals, such as those proposed by Mark Zandi as well as Gary Acosta, Jim Park, and Joe Murin rely heavily on transferring far more credit risk and GSE revenue into the private market (e.g., private mortgage insurers, capital markets, reinsurers, and lenders). They seem to require a much greater shift in the focus and resources of the GSEs away from their primary role of ensuring liquidity, stability, and affordability in the housing market for new mortgage credit to much more of a credit risk-sharing mechanism. Based on Fannie Mae and Freddie Mac deal documents, the first-loss securities sold by the GSEs under Fannie's Connecticut Avenue Securities (CAS) and Freddie's Structured Agency Credit Risk (STACR) is still under \$1 billion. And overall, private capital has been sharing first-loss and mezzanine risk on mortgage pools that had the most pristine credit, with average FICO scores of 758.²

In reviewing the housing finance reform legislation by US senators Tim Johnson and Mike Crapo, Freddie Mac approximated that to attract enough private capital to insure only the top 10 percent of the GSEs' \$5 trillion mortgage credit book of business, the industry would need to attract close to \$500 billion of capital—16 times what the entire mortgage insurance companies and financial guarantors had. The combined capital for the three largest banks (JP Morgan, Bank of America, and Citi) was approximately \$650 billion at the end of 2013.

The Johnson-Crapo model suffered from both flaws: requiring substantial capital for guarantors while permitting the sale of credit risk into the securities market. Legitimate questions have been raised about whether the coexistence of such securities- and guarantor-based models can provide stable financing. It seems implausible that these reform proposals will yield enough private capital, mitigate taxpayer risk, and facilitate financing at comparable or better levels of affordable housing for low- and moderate-income borrowers.

Most reform proposals rely on private-label securitization and portfolio lending to provide most of the nation's credit needs. There is little evidence that the private-label securities market and balance sheet lending, for example, can step up to the GSEs' mortgage credit book of business, and most acknowledge that the private sector lacks the willingness or capacity to take risks in an economic downturn. Based on history, the sufficiency-of-private-capital question is a reasonable one to ask before we upend the current system in favor of a new one. Many proposals appear to imply reforming to a much smaller mortgage market with less available and more expensive credit. As a result, many creditworthy borrowers of modest means in working-class communities will get squeezed out of a market that offers fewer options. A smaller market will also negatively affect older Americans seeking to downsize and sell their homes.

The Necessity of a Strong Affirmative Obligation and Measurable Affordable Housing Goals

None of the legislation that has gained serious consideration so far has included affordable housing goals. This omission is highly problematic. The GSEs' affordable housing goals—loan purchase targets that have provided conventional mortgage credit to low- and moderate-income borrowers and traditionally underserved—must be included in any new model. A stronger version of the existing goals should be the objective. The affordable housing goals have increased access to responsible mortgage credit in underserved communities.

Unfortunately, some experts have persisted in repeating falsehoods about the affordable housing goals, blaming them for the crisis. These claims are without merit. The US Financial Crisis Inquiry Commission examined the housing bubble and found that neither the Community Reinvestment Act nor the affordable housing goals was a significant factor in the financial crisis. Other researchers have reached the same conclusion, including economists at the Federal Reserve Bank of St. Louis, Federal Reserve economist Neil Bhutta, and researchers at the Center for American Progress.

The major housing finance reform proposals considered by Congress did not re-create Fannie and Freddie's statutory "affirmative obligation to facilitate the financing of affordable housing for low- and moderate-income families...at a reasonable economic return" or include affordable housing goals. Instead, they have included a nebulous "duty to serve" and a weak financial incentive model. None of these measures are a satisfactory replacement for a strong affirmative obligation in statute and measurable affordable housing goals setting clear benchmarks. Two contributors to this forum, Marc Morial and Tim Howard, have joined the National Community Reinvestment Coalition's clarion call for strong affordable housing goals that "lead the market" and are enforceable. Blue-collar Americans are served by the affirmative obligation in Fannie and Freddie's statutes and the affordable housing goals that apply to both entities. The affirmative obligation and the affordable housing goals are current law, giving those working up the economic ladder a fair chance at owning a home via a responsible and sustainable loan. Most Americans got a loan precisely through this mechanism, in which Fannie, Freddie, the Federal Housing Administration, the US Department of Veterans Affairs, or the Rural Housing Service guaranteed or securitized their loan. Any future law must match and exceed these measures in strength.

The Virtues of Preserving the Existing System

Despite the efforts to contrive a new model for housing finance, it is unnecessary to dismantle Fannie Mae and Freddie Mac and replace them with an untested new system. The US banking system—and the housing finance system within it—is far more safe and sound today than it was before the financial crisis. Global banking regulators, Congress, and the nation's new and existing regulators have enacted reforms in response to the 2007 financial crisis that have strengthened the requirements for regulated financial institutions with regard to capital adequacy, liquidity, disclosure, risk retention, and consumer protections. The nation could simply build upon the regulation, transparency, and capital provisions enacted for the GSEs by the Housing and Economic Recovery Act of 2008 and improve the

accountability of the enterprises. Fannie Mae and Freddie Mac should be put back to work doing the job they have done well for most of their existence.

Much of the resistance to this course of action originates from entities who have long been clamoring for Fannie and Freddie's business: Wall Street banks and insurance companies. Not coincidentally, these institutions are the primary beneficiaries of some of the alternate models that have been put forth.

Political and Policy Uncertainty Create the Need for Immediate Action

As this housing forum demonstrates, there are a lot of ideas about how to reform the secondary mortgage market. But comprehensive housing finance reform is at an impasse in Congress, with no legislative consensus on the horizon. Various piecemeal legislative and administrative approaches to a new housing finance system continue to take shape while the future of Fannie Mae and Freddie Mac hangs in the balance as their capital buffers dwindle to zero and their investment portfolios decline.

The Federal Housing Finance Agency inspector general has found that the future profitability of the GSEs is not assured. Recent statements by Director Mel Watt on the impacts of a protracted conservatorship and declining capital, the earnings volatility and net income losses at Freddie Mac in the third quarter of 2015 and the first quarter of 2016, and recent tepid profitability at Fannie Mae are all bringing into sharper focus the stakes for the nation's mortgage market. Yet Fannie Mae and Freddie Mac have paid the US Treasury over \$50 billion more than they withdrew on their line of credit with Treasury. It appears that efforts by the Obama administration to continually sweep profits from the GSEs may be to keep them in a precarious financial state and prevent them from ever coming out of conservatorship, thereby making a comprehensive reform bill necessary.

In addition, there is the political uncertainty about the policy approaches the next president and his or her appointees will take on the GSEs, their conservatorship, and their affirmative obligation and affordable housing mandates, including the affordable housing goals, the forthcoming duty-to-serve rule, and the National Housing Trust Fund and Capital Magnet Fund.

Because of the important role Fannie Mae and Freddie Mac continue to play in providing access to all creditworthy borrowers, including those in low- and moderate-income, minority, rural and other traditionally underserved markets, the National Community Reinvestment Coalition has urged that it is

time to recapitalize the GSEs, institute a capital restoration plan, end the conservatorship, and build on the reforms of strong supervision, oversight, and increased transparency started as part of the Housing and Economic Recovery Act of 2008. Recapitalizing the enterprises does not mean that reforms to governance stop. Building the capital reserves that the GSEs have already calculated into their guarantee fees and charging the market to build is a responsible and prudent step that protects taxpayers and the GSEs' affordability mission.

Holding these enterprises in conservatorship has not been beneficial for working-class Americans. While in conservatorship, Fannie and Freddie have reduced securitization of low- and moderate-income loans to a near 10-year low. And for most of the time in conservatorship, they have essentially securitized loans for people with high down payments and extremely high credit scores. What's the point of Veterans Affairs loans, Rural Housing, the Federal Housing Administration, Fannie Mae, Freddie Mac, or any government guarantee if not to assist those whom the market chooses to ignore?

Everyone talks about the growing wealth inequality in the United States, but there are scant offerings on how to narrow that wealth gap. The working poor are already paying rent. Having that portion of their income go toward a mortgage is the greatest tool used by working people to build wealth. But the bar has been raised for homeownership disproportionately for working-class whites, African Americans, Hispanics, Asian Americans, and others. Let's get back to what builds economic opportunities and strengthens the middle class: responsible homeownership opportunities for all creditworthy borrowers. Let's ensure that homeownership does not fall victim to political shenanigans and market greed.

Notes

1. Editorial Board, "Homeownership and Wealth Creation," *New York Times*, November 29, 2014, http://www.nytimes.com/2014/11/30/opinion/sunday/homeownership-and-wealth-creation.html?_r=1.
2. Ben Lane, "Fitch: Fannie, Freddie risk-sharing deals will become more common," *HousingWire*, July 15, 2015, <http://www.housingwire.com/articles/34488-fitch-fannie-freddie-risk-sharing-deals-will-become-more-common>.

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John Taylor is president and CEO of the National Community Reinvestment Coalition. Raised in the housing projects of Boston and trained as an attorney, he has dedicated his life to economic justice. With over 25 years in the field, he has received numerous local, state, and national awards, including the Martin Luther King Jr. Peace Award, two United States Congressional Citation Awards, the State of Massachusetts Award for Excellence in Community Economic Development, and a presidential appointment to the Community Development Financial Institutions Fund. He has served on many national boards, including the Consumer Advisory Council of the Federal Reserve Board, the Fannie Mae Housing Impact Division, the Freddie Mac Housing Advisory Board, and the boards of the Rainbow/PUSH Coalition and the Leadership Conference on Civil Rights. He has appeared on ABC's *Nightline*, CBS, Fox News, CNN, C-SPAN, in the *New York Times*, *Washington Post*, *Chicago Tribune*, and hundreds of other print, television, and radio media. Taylor has testified before numerous congressional committees in the US Senate and the House of Representatives.

Mike Calhoun and Sarah Wolff: Who Will Receive Home Loans, and How Much Will They Pay?

Any housing finance system's ability to provide broad access and affordability is predicated on two factors: how prices are set and, equally importantly, how costs are distributed. Price is important to focus on for many reasons; chief among them is because price is a barrier to accessing mortgage credit. One way to see this operating is to look at the difference between what kinds of loans the government-sponsored enterprises (GSEs) say they will purchase based on their guidelines and the loans they actually purchased. GSE guidelines allow borrower FICO scores as low as 620 and loan-to-value (LTV) ratios up to 97 percent. However, the loans actually purchased by the GSEs have much tighter underwriting than the guidelines allow. Why don't qualified buyers receive loans? One reason is that the price is too high to make them practically available even though they are technically available. The GSEs have made greater use of loan-level price adjustment and risk-based capital requirements, creating large differences between the prices different borrowers pay, with prices much higher for certain borrowers. Assessing housing finance reform proposals must involve an analysis of pricing that recognizes what different borrowers will pay. This is true for today's system and for proposed alternative systems.

Estimates of how structural changes will affect mortgage costs (i.e., the rates consumers pay on their mortgage) use several approaches, but nearly all provide a combined estimate or estimate costs for a "typical" borrower.¹ What is lacking is analysis of how costs will be **distributed**. Average price estimates mask huge variations in prices for borrowers with different risk profiles. The biggest drivers of credit risk pricing (rate of return and capital requirements) affect borrowers differently. Finally, different structures provide incentives for either finer distribution or greater sharing of costs, which affects who pays and how much.

Much of the interest rate borrowers pay goes to market participants that insure borrower credit risk. In today's system and in proposed systems, different actors (e.g., GSEs, private mortgage insurers, lenders, and guarantors) can take on borrower credit risk. To assess the likely impact of future systems on borrower prices, we move some of the levers that most affect prices: the required rate of return on capital, overall capital requirements, and the degree to which costs are either distributed or pooled for guaranteed mortgages. Our estimates for four borrower profiles show how these levers independently

and in combination affect prices for different kinds of borrowers. We use data made public by the Federal Housing Finance Agency (FHFA),² private mortgage insurers,³ and the Urban Institute⁴ to estimate the price borrowers pay to cover credit risk.⁵

Lever 1: Risk-Based Pricing

To determine the amount of capital required and the fee to be charged for that capital, a credit guarantor must assess risk and decide to what degree risk will be segmented or pooled, which is not as easy as it sounds. Should we assume future loans will behave like those originated in the past? Having recently experienced a major crisis, what time period should be used to predict future losses?

In its request for comment materials, FHFA described the process of setting guarantee fees (g-fees) and explained how current g-fees are, among other things, a function of historic loan performance and the rate of return FHFA is willing to accept on loans across a FICO/LTV matrix. These important decisions affect the prices new homebuyers pay. Less than a decade ago, the GSEs did not charge loan-level pricing adjustments, and the mortgage insurance (MI) pricing was largely the same across FICO scores (differing only by LTV), spreading costs among a large pool of loans. In 2014, FHFA decided to increase variation in pricing by risk but accept a lower rate of return on some loans (table 1). The effect of a greater reliance on risk-based pricing is evident when we look at how recent g-fees compare with those calculated based on historical loan performance with a consistent rate of return for all borrowers.⁶ Neither of these includes fees paid for private mortgage insurance (PMI), which further exacerbates the disparities in pricing.

TABLE 1

Effect of Increased Risk-Based Pricing on Borrowers with Different Credit Profiles

	2014 GSE g-fees ^a	Full risk-based pricing ^b (10% rate of return)
Credit score >740		
LTV 60–80	57	37
Credit score 700–740		
LTV 80–97	64	62
Credit score 620–700		
LTV 80–97	80	92
Credit score 620–700		
LTV >97	Not available	136

Note: LTV = loan-to-value ratio.

^a Estimated g-fees by risk bucket are from figure 3 in FHFA (2014). The estimates include up-front fees (loan-level pricing adjustments and delivery fees) and ongoing fees (g-fees) but do not include fees for PMI.

^b These estimates include risk-based calculations for expected and stressed losses and assume credit for g-fees, as described in Goodman and colleagues (2014). The estimate includes 10 basis points for administrative costs. They do not include fees for PMI.

A core policy question is: are we going to maximize the benefits of pooling risk, or are we going to customize mortgages based on the profile of the individual borrower? In a future system, different structures are likely to decide differently. For example, private insurers and guarantors in competition with each other on price will be incented to finely price credit. If the systems structure has the pricing decision made by these entities on a loan-by-loan basis, pooling risk will be nearly impossible. These decisions increase or reduce prices for certain borrowers, ultimately affecting the degree of affordability and access to mortgage credit.

Credit guarantors could distribute costs even more finely, and they may be under competitive pressure to do so. Recent PMI pricing changes provide an example of such decisionmaking. In April, private mortgage insurers updated their pricing in response to finalized regulations called Private Mortgage Insurer Eligibility Requirements, which directed MI companies to hold more capital and to calculate capital based on credit quality of individual loans. In response, MI companies raised prices and increased the granularity of risk categorization use to determine prices. For example, considering 35 percent coverage on a loan with LTV from 95 to 97 percent before the changes, borrowers with credit scores from 620 to 679 paid 148 basis points. After the changes, borrowers in this range fall into three different categories, all paying different and higher amounts: borrowers with scores from 620 to 639 pay 225 basis points, borrowers with scores from 640 to 659 pay 205 basis points, and borrowers with scores from 660 to 679 pay 190 basis points. At the same time, prices fell for borrowers with higher credit scores; borrowers with credit scores above 760 paid 105 basis points before the changes and only 55 basis points after the changes.

Lever 2: Who Provides the Capital and at What Cost?

One key part of calculating the cost of capital and the resulting credit risk fee is the after-tax rate of return on capital. While other components of pricing calculations (e.g., administrative expenses, expected losses, and stressed losses) are fairly constant regardless of what entity takes on the risk, the required after-tax return on capital is likely to vary as different amounts of private capital are used to cover the same projected expenses. Researchers at the Urban Institute argue that the GSEs in conservatorship might require only a 5 percent after-tax return on capital (Goodman et al. 2014). In contrast, a privately held company might be held to a much higher standard by its investors. Various reform proposals bring in different amounts of private capital in several ways: in the form of equity investors (if the GSEs were released from conservatorship as private entities), through greater use of private mortgage insurers (as proposed in the 2016 appropriations bill), or by having private actors act as securitizers and guarantors (as proposed in the Protecting Americans from Tax Hikes Act of 2015). We varied this input at 5 percent, 10 percent, 20 percent, and 25 percent to test how isolating and varying this assumption affects the estimated g-fee when calculated to fully risk-base price on each product (table 2).⁷ We assume a 10 basis points cost for administrative expenses in each case.

TABLE 2

Effect of Changing Rate-of-Return Assumptions on Borrowers with Different Credit Profiles

	Rate of Return			
	5%	10%	20%	25%
Credit score >740				
LTV 60–80	26	37	48	52
Credit score 700–740				
LTV 80–97	43	62	85	92
Credit score 620–700				
LTV 80–97	65	92	126	136
Credit score 620–700				
LTV >97	96	136	184	200

Note: LTV = loan-to-value ratio.

Increasing the required after-tax return on capital assumption increases the credit-risk fee for each combination of FICO score and LTV. For borrowers with higher credit scores, the estimated fee is similar to other published estimates. However, assuming a lower return (5 percent) results in a lower g-fee than other estimates, and assuming a higher return (25 percent) results in a higher fee. These capital changes unevenly affect prices for borrowers with different risk profiles; increasing the return assumption from 5 percent to 25 percent increases the estimated g-fee by 26 basis points for the borrowers with the highest credit scores and the lowest LTV loans (from 26 to 52 basis points), but by

104 basis points for the borrowers with lower scores and higher LTV loans (from 96 to 200 basis points).

Lever 3: Capital Requirements

FHFA calculated required capital based on predicted losses, but another system might have a different method of setting capital requirements. A future housing finance system might involve entities deemed to be systemically important financial institutions (SIFIs), subject to an overall capital requirement. In such cases, the amount of capital would not only be calculated from loss projections but also include a capital cushion. Assuming a loan portfolio similar to recent originations, the total calculated capital needed for stressed losses is less than what the cushion approach would yield.

Consider a 4 percent capital requirement and a 10 percent after-tax return on capital for a portfolio of loans that looks like the 2012 Fannie portfolio. The amount of capital for stressed losses totals 292 basis points (Goodman et al. 2014; see table 3, panel A). This is 108 basis points less than needed to meet a 4 percent capital requirement (400 basis points). Evenly distributed, this adds about 14 basis points to the costs of each loan. The cost increases for higher assumed capital requirements and after-tax return on capital assumptions, as a fully private guarantor might be subject to. A 10 percent capital requirement and a 20 percent rate of return results in 708 basis points in additional costs, not 108 basis points. Adding this assumption can more than double the fee calculated without this component. Like the costs of stressed losses, market participants could choose to pool or distribute this cost as well.

Why Does This Matter?

Finer and finer risk-based pricing structures shoulder the costs of systemic risk on borrowers who are classified as risky but who successfully pay their mortgages. While many more borrowers with higher-risk profiles defaulted on their loans during the crisis, the majority with responsible loans did not.⁸ Furthermore, the crisis triggered a recession that cost jobs and depressed home values, setting off further defaults. In the crash, we saw borrowers fall behind on their loans because they lost their jobs in the recession, not because of personal financial failure. Changes such as the qualified mortgage requirements make today's market stronger and decrease the likelihood of a repeat event. Future pricing should not punish today's higher-risk profile borrowers for yesterday's macroeconomic events, such as weak lender regulation preceding the Great Recession.

The housing finance system provides credit insurance. Higher-risk profiles can be seen as a type of “preexisting” condition that profit-maximizing guarantors and insurers aim to minimize in the pool of loans they insure. Price and underwriting standards are the mechanisms these actors use to adjust their portfolios to minimize risk. Allowed to operate unchecked, market incentives can result in only a select type of borrower having access to home loans.

This is what has happened in the postcrisis period. The average credit score on new originations has risen to over 750, up more than 40 points in the last decade (Goodman et al. 2016, 14). The Urban Institute’s Housing Credit Availability Index has fallen to 5.6, less than half of where it stood in the late 1990s and early 2000s.⁹ Borrowers of color have become a smaller share of mortgage borrowers even as their share of the population has risen; only 2.6 percent and 5.0 percent of conventional loans in 2014 were made to black and Hispanic borrowers, respectively (CRL 2015).

The demographics of which homebuyers have lower credit scores and lower wealth for a down payment identify who is most likely to pay even more. Unfortunately, data that combine race and ethnicity, LTV, and FICO scores are rare.¹⁰ Using our “merged dataset,”¹¹ we estimated the average credit risk fee paid by borrowers in different racial and ethnic groups. The results show that borrowers of color are likely to pay substantially more than white borrowers. On average, black borrowers would pay approximately 1.5 times the fee paid by white borrowers, even under modest assumptions (a 10 percent after-tax return on capital and no capital cushion).¹²

What Does This Mean for Reform?

Today’s system does not provide broad access and affordability, which is troubling because future homebuyers will be more diverse than today’s homebuyers; 30 percent of millennials are black or Hispanic (JCHS 2015). Unfortunately, the housing finance reform proposals that have gained political traction are unlikely to reverse these affordability trends and may exacerbate them. The Johnson-Crapo model, for example, would likely demand high rates of return and did not include an enforceable duty-to-serve requirement to exert pressure to spread costs across borrowers. To evaluate a proposal’s effect on access and affordability, we need to consider how each proposal pulls the levers that we know affect prices: the rate of return on capital, the amount of capital required, and the incentives the structures create to more and more finely price mortgages.

Average price estimates obscure significant variation. To assess access and affordability, we need to look closely at differential prices, not just overall prices or prices for low-credit risk profiles. The

variation documented here exists because the levers that drive costs operate through and on risk assessment. A higher required rate of return on capital will cause higher prices for some borrowers compared with others. Our estimates indicate that these differences are significant, increasing costs two to four times average estimates. In addition to affecting the amount and cost of capital, different proposals incorporate different sets of incentives that push actors to spread costs to greater or lesser degrees. For example, the Private Mortgage Insurer Eligibility Requirements framework resulted in higher costs for borrowers with lower credit scores and lower costs for borrowers with higher scores.

Housing finance reform proposals should estimate costs not just for borrowers with higher credit scores or borrowers like those getting loans today, but also for loans that might be made to a broader set of potential borrowers. Each proposal should be evaluated on how the structure is likely to distribute costs. Only through such an assessment can we truly consider the impact of any proposal on access and affordability.

Notes

1. In “Modeling the Impact of Housing Finance Reform on Mortgage Rates,” the authors use two methods of estimating the costs on a pool of Freddie loans of comparatively high credit quality (Andrew Davidson 2013). “A More Promising Road to GSE Reform” presents an average cost estimate for all borrowers, assuming a distribution like Fannie and Freddie’s current portfolio (Parrott et al. 2016). Other recent estimates, including those found in “Privatizing Fannie and Freddie: Be Careful What you Ask For” and “Cost of Housing Finance Reform,” are based on a borrower credit score of 750 and an LTV less than 80 percent (Parrott and Zandi 2015; Zandi and deRitis 2013).
2. FHFA undertook a public process in 2014 to reassess the guarantee fees (g-fees) charged by the GSEs, providing data by which we can decompose their credit risk pricing process. See FHFA (2014).
3. Private mortgage insurance (PMI) pricing comes from the published rates of Genworth and Radian.
4. The loan default rates on which these calculations are based are from Goodman and colleagues (2014).
5. Unless noted, we include only the credit risk fee that is not covered by PMI. Borrowers with loans that have LTV over 80 percent will pay a higher price than we estimate when that cost is added in.
6. The loss rates are based on 2001 and 2007 originations.
7. The calculation uses the risk-based pricing structure described in Goodman and colleagues (2014) and varies only the rate of return on capital component of the calculation. The estimates in figure 2, column 2 are the same as those in figure 1, column 2.
8. See appendix A in Li and Goodman (2014) for default rates by loan type, FICO scores, and LTV for loans originated from 2001 to 2002 and from 2005 to 2006.
9. Housing Finance Policy Center, “Housing Credit Availability Index,” Urban Institute, April 12, 2016, <http://www.urban.org/policy-centers/housing-finance-policy-center/projects/housing-credit-availability-index>.

10. Recently finalized changes to the Home Mortgage Disclosure Act will eventually make this combination of data publicly available.
11. We used this dataset to estimate how many borrowers of each race and ethnicity fall in each risk bucket. The dataset is more fully explained in Bocian and colleagues (2011).
12. These assumptions are consistent with those made in Parrott and colleagues (2016).

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About the Authors

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Rodrigo Lopez and Debra Still: Affordable Housing and Access to Credit: Critical Objectives for a New Secondary Mortgage Market

Affordable rental housing and access to credit for *all* qualified homebuyers are the cornerstones of housing in America, and these two commitments must be present in any dialogue about housing finance reform. The policy questions are complex and the politics equally so. Yet, unless these fundamental challenges are resolved in a balanced and effective way, housing finance reform will be incomplete. Moreover, it is time that lenders join in the dialogue with an appropriate level of commitment to these noble aspirations.

To this end, the Mortgage Bankers Association (MBA) recently convened a task force of its members to once again address housing finance reform. Two groups of senior executives, representing a cross-section of single- and multifamily lenders of varying sizes and business models, are meeting to develop both an end-state model and a road map to ensure affordable housing and access to credit issues are sufficiently addressed. Through our discussions with various public interest groups, consumer advocates, and industry experts, we have developed what we believe is a holistic framework for addressing these issues and have outlined some potential solutions.

Housing in America: Mission Critical

A centerpiece of most housing finance reform plans, and consistent with MBA's reform principles, is the attachment of an explicit federal government guarantee to mortgage-backed securities backed by a limited, defined class of well-underwritten loans. In exchange for this guarantee, secondary market entities should have a corresponding duty to provide access to credit for prospective homebuyers and financing for affordable rental housing. The challenge is how to define and fulfill this obligation in ways that balance the public purposes of the government guarantee with the need to protect taxpayers.

While certain structural and socioeconomic barriers limit the scope and effectiveness of the secondary market in serving affordable housing needs, we believe that a well-designed end state can

and must do its part to advance solutions and partner with other stakeholders. Here are our thoughts on some potential approaches.

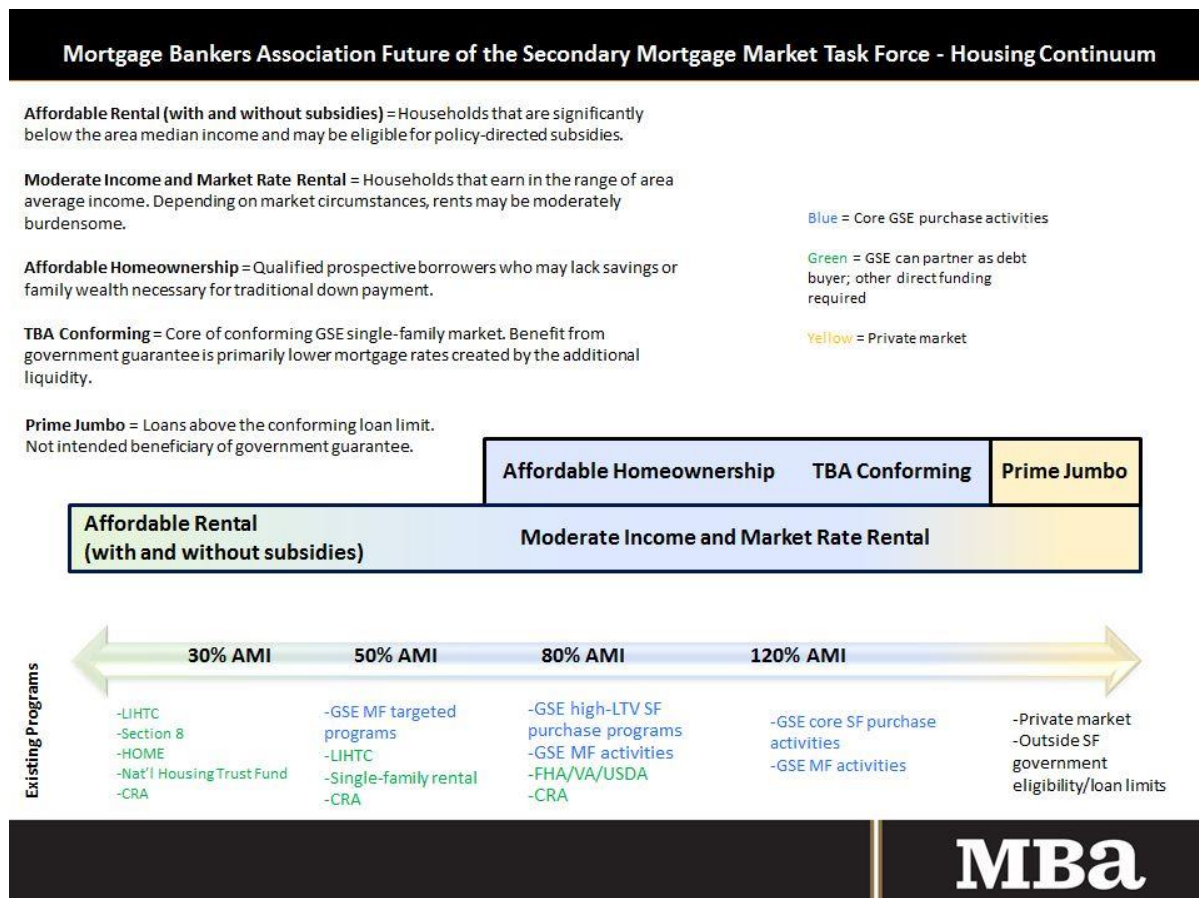
Framing the Housing Continuum

America's housing finance system should address the full continuum of households. We believe that all housing needs, from the most directly subsidized, affordable rental housing to the prime jumbo single-family lending market, lie along a single continuum. This housing continuum can be best served only by addressing single-family and multifamily, rental and homeownership, and government and private capital as parts of a holistic strategy.

Research shows that in the United States, there will be demand for 1.4 to 1.6 million additional housing units each year for the next 10 years (Fisher and Woodwell 2015). Demand for housing will come from households that are increasingly diverse across dimensions such as age, race and ethnicity, and geography. The government-backed secondary mortgage market must be able to provide liquidity to facilitate the development, preservation, or purchase of all types of housing for both owner-occupants and renters. Moreover, government policy should reflect a unified, holistic approach toward addressing the full scope of housing needs along the continuum.

Our continuum framework (figure 1) was developed to provide a single context for integrating the roles of single-family, multifamily, and other programs in serving the housing market writ large. The framework identifies five broad housing market segments across the homeownership and rental markets that policymakers should consider in crafting a holistic housing strategy to meet consumers' needs. It also identifies some of the federal programs that directly or indirectly affect consumers within the various segments along the continuum.

FIGURE 1



Notes: AMI = area median income. CRA = Community Reinvestment Act. FHA = Federal Housing Administration. GSE = government-sponsored enterprise. HOME = HOME Investment Partnerships Program. LIHTC = Low-Income Housing Tax Credit. LTV = loan-to-value ratio. MF = multifamily. SF = single-family. TBA = to-be-announced. USDA = US Department of Agriculture. VA = US Department of Veterans Affairs.

The government-guaranteed secondary mortgage market cannot serve the entire continuum by itself. On the affordable rental housing end, the government-guaranteed market can help facilitate financing for the development and preservation of good-quality, affordable rental housing. At the same time, the role of equity investment is also critical, and in some cases, the secondary mortgage market will require partnership with other programs, such as Low Income Housing Tax Credits, Section 8, or the National Housing Trust Fund to serve America's affordable housing needs.

On the other end of the continuum, the highest-income and highest-credit-quality borrowers are adequately served by the private mortgage sector and do not require the support of a government guarantee.

Importantly, along this continuum lie racial and geographic dimensions, challenges which warrant special consideration. Some of these factors can be addressed through frameworks such as the Community Reinvestment Act or the Federal Housing Finance Agency's proposed Duty to Serve rule. Others may require collaboration and information-sharing between primary and secondary market participants (including nonprofit organizations), while others bear mentioning but are best addressed in the context of income equality or jobs and economic growth policies.

Serving the Full Continuum

A core objective underlying our support for a government guarantee in the housing finance market is to ensure broad liquidity in all markets and through all economic cycles. The importance of liquidity throughout cycles is common to both the single-family and multifamily mortgage markets. Affordable rental and homeownership policies could be viewed as a means to direct this liquidity toward particular market segments along the continuum. However, to do so, government policy must be crafted as a single, holistic strategy to ensure that programs operate effectively in service to the overall policy. With a unified approach, policymakers can best develop and utilize programs and products to address discrete segments in a unified housing policy.

Preserve and enhance what works. Policymakers' approach to affordable housing should take into account the differences between, and respective advantages of, the multifamily and single-family markets. The current government-sponsored enterprise (GSE) multifamily businesses should be considered a policy and economic success. Both GSEs' multifamily businesses have experienced very low default rates, even during the financial crisis, and their predominant business executions have incorporated significant private capital (Mortgage Bankers Association 2015). In addition, because the GSEs do not play the same dominant role in multifamily finance as in single-family finance, there is strong competition among capital sources in apartment finance between banks, life insurance companies, commercial mortgage-backed securities, and other market participants.

Multifamily rental housing tends to be affordable, with rents predominantly affordable to households at or below area median income. The vast majority of the two GSEs' multifamily business is within this range. We believe that the future housing finance system should be focused on ensuring liquidity to the multifamily housing market broadly, with a particular focus on moderate-income and affordable rental housing. Most of the annual cohort of government-backed multifamily activities should finance properties with units affordable to households at or below area median income or some

similar standard. We believe that any affordability standards imposed in the context of GSE reform should advance policy objectives to support moderate-income and affordable rental housing and provide flexibility during periods of market disruption and illiquidity.

In the single-family market, the GSEs are, and have been, the dominant liquidity providers, particularly for longer-term (terms of 20 years or more) fixed-rate mortgages. Borrowers currently benefit from this role in two primary ways: first, the GSEs are perceived as being backstopped by the federal government, allowing them to broadly serve the nation's home purchase needs even through economic downturns; and second, the availability of the TBA (to-be-announced) market for the core of the GSE single-family businesses allows a broad segment of borrowers who obtain financing through conforming loans to receive modestly lower interest rates, saving them money over time. An explicit government guarantee would enhance these benefits and eliminate the risk of market disruption during a regional or national downturn.

As noted above, however, secondary market activities that support the affordable rental housing end of the continuum will need to be complemented by other market mechanisms and clear housing policy. In particular, policies aimed at facilitating development, rehabilitation, and preservation of affordability in the existing housing stock are increasingly important. Adequate quality housing for the lowest-income households and other groups with special needs will require direct-income or place-based support. Such alternative support should work in partnership with flexible debt financing, as in the case of Low Income Housing Tax Credits or the use of Section 8 vouchers to occupants. Such programs should be fully appropriated and funded to meet the needs of households.

Align federal housing regulations and policy missions. To fully serve the needs of the housing market across the entire continuum, federal housing policy should be harmonized into a single, holistic strategy. The at-times competing missions of the Federal Housing Administration, US Department of Veterans Affairs, US Department of Agriculture, Rural Housing Service, Ginnie Mae, and the GSEs should be complementary and coordinated. One approach would be to create or empower a single body to coordinate and manage the various roles and targeted missions. Combining our fragmented housing policy into a single, unified strategy would allow for greater coordination, more dynamic program development, and clear communication with market participants and stakeholders. Moreover, it would help prevent discrete segments of consumers from falling through the cracks as specific policies are developed and executed.

Utilize transparent, pooled pricing and underwriting, where possible. Pricing single-family loan risk at the pool level provides a cross-subsidy that can result in some savings for qualified borrowers

while maximizing access to credit. The application of this cross-subsidy and consideration of compensating factors utilized in the underwriting process across various programs and markets should be as transparent as possible to ensure eligibility, qualification, and pricing information can be clearly communicated to the market to improve service.

To protect taxpayers, MBA and its members support additional transparency in the transfer of credit risk to private capital sources. Transparency in the forms and cost at which this risk is transferred to the private sector will help the government manage risk and identify where additional support or research may be necessary. Importantly, risk-based pricing of credit risk by private investors through risk-sharing structures does not preclude the use of pooled pricing of government guarantee fees for borrowers.

Subsidy contributions. The government guarantee of a well-defined class of single-family and multifamily mortgage-backed securities should be explicitly priced and paid for. This price should include a fee dedicated to funding certain affordable housing-targeted funds, such as the Affordable Housing Trust Fund or Capital Magnet Fund. Entities empowered to grant the government guarantee could also use this fee to work through mortgage originators and other primary market participants (e.g., mortgage insurers or nonprofits) to expand the role of consumer education and mortgage counseling in the housing finance system. These activities are particularly important to assist minority and immigrant households, those burdened by high rents and student debt, and first-time homebuyers so that they may gain from the wealth-building opportunity provided by sustainable homeownership. Additionally, support for affordable housing programs, such as those referenced above, could be supplemented by the fee.

Conclusion

MBA and its members believe that housing finance reform must address and support affordable rental housing, broad access to credit for qualified borrowers, and a commitment to supporting underserved markets. Viewing our national housing needs along a single continuum provides a framework that we believe allows policymakers, industry, and stakeholders to partner together to address our affordable housing objectives in a strategic and sustainable way. The success of housing finance reform will depend on it.

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About the Authors

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Janet Murguía: Updating Our Housing Finance System to Reflect a Changing America

Between 2010 and 2020, minorities will account for 70 percent of new household formation, and by 2020, half of all first-time homebuyers will be Latino (Becerra 2014; JCHS 2012).¹ Without affordable access to credit for these prospective buyers, the housing market will decline, with harmful consequences on the larger economy. While there is much to consider regarding the future of housing finance—with many solid proposals emanating from this incubator’s authors—our country’s changing demographics require access and affordability to be at the center of the solution.

At the helm of NCLR (National Council of La Raza), the nation’s largest Latino civil rights and advocacy organization, I have the honor of working with a network of nearly 300 Hispanic community-based organizations who annually serve more than seven million Latino families. Creating homeownership opportunities in low- and moderate-income Hispanic communities has been an NCLR priority for more than two decades. NCLR has worked to preserve and strengthen the Community Reinvestment Act, support strong fair-housing and fair-lending laws, and increase access to financial services for low-income Hispanic families. We also provide housing counseling services to more than 50,000 families annually as a US Department of Housing and Urban Development–certified housing counseling intermediary; in the last 12 years, the 51 community-based organizations in our network have nurtured more than 30,000 first-time homebuyers.

Our work could not be more critical during this time of substantial demographic change. Latinos have become the largest and fastest-growing racial or ethnic minority in the United States:

- Between 2000 and 2012, the US Hispanic population increased by 50 percent to reach 53 million. By 2060, Latinos are projected to represent nearly 30 percent of the country’s population.
- One in six Americans are Hispanic, and one in four children under age 18 are Hispanic.
- We are the fastest-growing group of American workers, with the highest labor force participation rate of any population.

- With nearly one million young Latinos turning 18 each year, we are also the youngest and fastest-growing group of potential voters in the nation.

Home Equity Is Key to Latino Wealth

While Hispanics make up more than 18 percent of the US population, we have only 2 percent of its wealth. In 2013, the wealth of white households was 10 times that of Latino households. While there are many economic factors at play, wealth disparities between whites and communities of color are heavily affected by disproportionate rates of homeownership.² The Latino homeownership rate in the first quarter of 2016 was 45.3 percent, while the white homeownership rate was 72.1 percent. Homeownership remains a cornerstone of the American Dream and is one of the most effective wealth-building tools available to Hispanic families. In 2010, home equity accounted for 67 percent of net wealth for the median Latino homeowner, compared with 38 percent for the median white homeowner (Rockey Moore and Guzman 2014).

In addition, homeownership can provide financial and social stability. Homeowners can establish and maintain a known monthly cost for shelter, enjoy a stable residence and stable schools for their kids without worrying about arbitrary eviction, and devote a portion of the monthly housing cost to building equity by paying down a mortgage. Homeownership is also correlated with better health outcomes, improved educational opportunities, and higher incomes in the next generation. Owning a home also provides an opportunity to transfer assets from one generation to the next.

Yet, the benefits of homeownership have not always been available to everyone equally. Our nation has a long history of discrimination and segregation that has limited access to credit for communities of color. Throughout the 20th century, skin color, national origin, and neighborhood demographics have been better determinants of credit availability than one's ability to pay. Although we've come a long way thanks to laws such as the Fair Housing Act and the Equal Credit Opportunity Act, the housing crisis and Great Recession demonstrated how the nation's mortgage lending system failed people of color. Latino borrowers were disproportionately steered toward subprime loans even when they had good credit, and compared with whites, Latinos were 30 percent more likely to receive high-cost loans at the height of the housing bubble (Bocian, Ernst, and Li 2006).³

Latinos suffered some of the most devastating losses as housing prices collapsed. By 2009, the median Hispanic homeowner had just under \$50,000 in home equity, while black homeowners had nearly \$60,000 and white homeowners had about \$95,000. As a group, Hispanic homeowners lost

about \$655 billion in home equity between 2005 and 2009. The Financial Crisis Inquiry Commission spent more than a year evaluating the crisis and its potential causes (FCIC 2011). They concluded the crisis was attributable to several factors, including failures in financial regulation, an explosive mix of excessive borrowing by individuals and Wall Street, widespread predatory lending practices, and ill-prepared policymakers who didn't fully understand the system they oversaw.

Where We Are Today

Unfortunately, today's housing market remains broken and is not serving communities of color significantly better. Housing prices in many urban markets with heavy minority populations are once again rising faster than income. Overcorrection in today's credit market means that low-income families have more trouble accessing credit, and it is more difficult to obtain mortgages for homes less than \$100,000. The Urban Institute estimates that "four million more loans would have been made between 2009 and 2013 if credit standards had been similar to 2001 levels."⁴ Latinos may have missed out on loans because they did not fit the imposed credit standards; they are less likely to have a traditional credit history and more likely to have credit scores damaged by unemployment or underemployment during the recession. Hispanic borrowers are also left out of the credit box even when their incomes could support sustainable homeownership, because they are more likely than others to have a cash income, multiple sources of income, or a family structure with multiple co-borrowers on the same loan.

As the conventional market has turned away from the Latino community, the Federal Housing Administration share of lending to Hispanics increased from 6 percent in 2005 to 55 percent in 2012 (Bostic 2013). While Federal Housing Administration lending has provided an important backstop for creditworthy Latino borrowers during this period, high insurance premiums often make these mortgages more expensive than a conventional loan. When Hispanics are paying more to borrow money, it takes longer for them to build home equity and wealth.

Ensuring Access and Affordability

The government must have a role in the housing finance system, and there are many compelling proposals for how to structure a more effective system. An explicit duty to serve all communities across the country is essential in a future structure. The price of admission for any government backstop is a

duty to serve all markets with affordable mortgage credit. In addition, a new structure must encourage innovation around new products or processes that can expand homeownership safely and profitably.

We do not have to start from scratch to find models that promote access and affordability. With programs such as the Community Home Buyers Program in the 1990s, lenders exercised intense scrutiny to ensure that borrowers were prepared for their mortgage obligations through a combination of low down payments and homeownership counseling. Research shows that between 1997 and 2002, the government-sponsored enterprises' affordability goals helped expand mortgage credit to underserved populations—including communities of color and low-income borrowers—by standardizing eligibility criteria and underwriting factors that enabled more households to obtain loans. During this same period, rates of Hispanic homeownership increased from 43.3 percent to 48.2 percent.

If we are to regain the ground we lost during the Great Recession, effective future housing finance should incorporate some of these lessons and must include the following principles.

1. **Increase access to affordable homeownership.** A redesigned housing finance system must be based on creating affordable and sustainable credit to the broadest possible range of creditworthy borrowers. The system must include an explicit “duty to serve” to ensure communities of color and low- and moderate-income people gain needed access to quality loan products, including 30-year fixed-rate mortgages that do not mandate down payment requirements in underwriting standards. Further, effective enforcement tools must be available to render a duty-to-serve provision meaningful in the primary and secondary markets.
2. **Uphold fair and nondiscriminatory lending practices.** The federal government should monitor the market for discrimination, with a zero-tolerance policy on unethical lending. Any housing finance system must include a clear obligation to serve all qualified borrowers and an entity that will approve originators. Consistent with existing civil rights statutes including the Fair Housing Act and Equal Credit Opportunity Act, no homebuyer should be subject to discrimination based on race, sex, religion, age, or any other protected class. Not only is discrimination illegal, but according to former Federal Reserve chairman Alan Greenspan, it also drags down the economy because it delays wealth accumulation among much of the population.
3. **Recognize the value of pre- and postpurchase housing counseling.** Loan performance is greater when a family has housing counseling support. Housing counseling supports safety and soundness and should be more fully integrated into the credit process. Prepurchase counseling should be encouraged with pricing discounts or as a compensating factor to reduce down payment or credit score requirements, as appropriate. Not only are housing counseling services

beneficial to the homebuyer but the lender and investor also benefit from having a more informed consumer. Additionally, postpurchase counseling can help families manage their obligations and remain in their homes. The value of housing counseling has been proven many times, and the integration of housing counseling into housing finance reform was a key feature of a 2013 report from the Bipartisan Policy Center's Housing Commission, where I was a commissioner (Bipartisan Policy Center Housing Commission 2013).

4. **Expand the role of lenders that deliver innovative and responsible lending models.** Credit unions, community development financial institutions, and community lenders have provided safe and affordable mortgages to underserved communities for years. Regardless of size, these lenders should have access to the secondary market to bring their products to scale without suffering from volume-based pricing, for example.
5. **Find balance among the multiple market players.** The Federal Housing Administration plays a critical role by making credit available to people with modest incomes who have the ability to repay a mortgage but have limited resources to cover a down payment or closing costs. However, the Federal Housing Administration will work best in a competitive market where it is one of many options. If the secondary market structure is too narrow, we risk perpetuating a two-tiered lending system where white borrowers and communities of color are treated differently and are funneled into separate channels with different fees.

Our nation is dynamic and diverse, and the Latino community is one of the driving forces behind much of the demographic change. By 2044, people of color will account for more than half the population. For our country to have a well-functioning economy that works for Americans of all income brackets, we need a safe and sustainable housing finance system. This system should encourage and promote homeownership opportunities that allow parents to have financial stability, build a nest egg, and send their kids to college. More Hispanic homeowners make for stronger families, more stable communities, and a healthier economy.

Notes

1. The terms "Hispanic" and "Latino" are used interchangeably by the US Census Bureau and throughout this document to refer to persons of Mexican, Puerto Rican, Cuban, Central American, Dominican, Spanish, and other Hispanic descent; they may be of any race.
2. Robert R. Callis and Melissa Kresin, "Residential Vacancies and Homeownership in the First Quarter 2016," press release, April 28, 2016, <http://www.census.gov/housing/hvs/files/currenthvspress.pdf>.

3. "Justice Department Reaches \$335 Million Settlement to Resolve Allegations of Lending Discrimination by Countrywide Financial Corporation," US Attorney's Office, Central District of California, last updated June 22, 2015, <https://www.justice.gov/usao-cdca/dojcountrywide-settlement-information>.
4. Laurie Goodman, Jun Zhu, and Taz George, "Four million mortgage loans missing from 2009 to 2013 due to tight credit standards," *Urban Wire* (blog) Urban Institute, April 2, 2015, <http://www.urban.org/urban-wire/four-million-mortgage-loans-missing-2009-2013-due-tight-credit-standards>.

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About the Author

Janet Murguía is president and CEO of the National Council of La Raza (NCLR), the largest national Hispanic civil rights and advocacy organization in the United States. As someone who has experienced the promise of the American Dream, Murguía has devoted her public service career to opening the door to that dream to millions of American families. Since 2005, Murguía has strengthened NCLR's work and enhanced its record of impact as a vital American institution. Murguía has also amplified the Latino voice on issues affecting the Hispanic community such as education, health care, immigration, civil rights, and the economy. Murguía has been selected twice as one of *Washingtonian's* "100 Most Powerful Women in Washington" and as one of the *NonProfit Times'* "Power and Influence Top 50" leaders. Before joining NCLR, she worked at the White House, ultimately serving as deputy assistant to President Clinton, and as executive vice chancellor for university relations at the University of Kansas.

Murguía received a BS in journalism, a BA in Spanish, and a JD from the University of Kansas. She also received an honorary doctorate from California State University, Dominguez Hills.

Concluding Remarks

Tim Howard

The large majority of the Urban Institute essays focus on fixing what their authors call the “perverse incentives” of Fannie and Freddie’s business structure. That’s the wrong problem. The companies’ incentive structure was good enough to enable them to produce and maintain a level of credit quality that was far higher than all other sources of mortgages before the crisis. Their real problem was insufficient capital. In a postcrisis world, credit guarantors should be required to hold enough capital that they will have only a miniscule chance of failure (or of triggering the government’s catastrophic risk guaranty), but not so much that the fees they have to charge are so high that the guarantors are unable to provide an acceptable amount of affordable financing for the low- and moderate-income homebuyers Fannie and Freddie were chartered to serve.

Only a few essayists—myself, John Taylor, and Mike Calhoun and Sarah Wolff—addressed this balance between capital and affordability. Most authors either were silent on the amount of capital their proposed systems would require, or gave a capital percentage with no explanation of its derivation. And no author addressed how the capital requirements and structure of their proposed credit guaranty system would affect the mortgage rates quoted to different classes of borrower; in fact, most did no more than state that their proposed systems would be good for affordable housing because the guarantors would be given housing goals. But housing goals will not have much effect if guarantors have no practical way to turn them into business they actually can finance.

The essayists have done the easy part of their task—coming up with ideas for the guarantor’s business structure. Now they must do the hard part: determine how much capital credit guarantors should hold and why that’s the right amount, devise a guaranty mechanism that is the best way to provide financing to as wide a range of borrowers at as low a cost as possible, and, if there is a significant transition from the current system to the envisioned one, explain how that would work in practice.

Tim Howard’s essay can be found on page 8.

Alex J. Pollock

Housing Finance: Two Strikes, and Now?

Memories fade, so while trying to draw conclusions about going forward, we should also do our best to remember our past expensive lessons in politicized housing finance.

It should be most sobering to Americans engaged in mortgage lending that the U.S. housing finance sector collapsed twice in three decades—a pretty dismal record. There was first the collapse of the savings and loan-based system in the 1980s, then again that of the Fannie Mae and Freddie Mac-based system in the 2000s. The first also caused the failure of the government’s Federal Savings and Loan Insurance Corporation; the second forced the government to admit that the U.S. Treasury really was on the hook for the massive debt of Fannie and Freddie, frequent protestations to the contrary notwithstanding. The first generated a taxpayer bailout of \$150 billion; the second a taxpayer bailout of \$187 billion. That’s two strikes. Are we naturally incompetent at housing finance?

In both cases, the principal housing finance actors had tight political ties to the government, which allowed them to run up risk while claiming a sacred housing mission. The old U.S. League for Savings, the trade association for savings and loans, was in its day a serious political force and closely linked with the Federal Home Loan Bank Board. In their glory days, in turn, Fannie and Freddie bestrode the Washington and the housing worlds like a hyper-leveraged colossus. In retrospect, these were warning signs.

The savings and loans did what the regulators told them to do: make long-term, fixed rate mortgage loans financed short. Fannie and Freddie were viewed as a solution to this interest rate risk problem, then had a credit risk disaster instead. They, too, did what the regulators told them to do: acquire a lot of lower credit quality loans. Thinking that regulators know what risks will come home to roost in the future is another warning sign.

We need to eschew all politicized schemes and move to something more like a real housing finance market, if we want to avoid strike three.

Alex J. Pollock’s essay can be found on page 20.

Mark Calabria

Mark Twain is credited with saying, “It ain’t what you don’t know that gets you into trouble. It’s what you know for sure that just ain’t so.” He could easily have been talking about the American mortgage finance system. Current debates are heavily focused on who can build the better mouse trap, without asking whether we should be catching this particular mouse or not. Many commentators assert we cannot have a functioning mortgage system without extensive government guarantees, despite the evidence to the contrary. Many assume our current securitization-based system has delivered broad gains in homeownership and affordability, again despite the evidence otherwise.

The single biggest problem confronting mortgage finance reform is that the consensus assumptions simply are not supported by the objective evidence. While I can sympathize with the desire to “get back to business,” pretending the crisis didn’t happen or that Dodd-Frank actually fixed the flaws, is just kicking the can down the road. The business cycle in American history has long been driven by the housing cycle. Attempts after each bust to renew the boom with increased leverage and weaken underwriting have occasionally brought short-term relief but at great long-term cost. One reason this bust was so bad was we finally reached the limits of increased leverage; it’s difficult to reduce down payments below zero.

If we hope to build a sustainable, affordable, and reliable mortgage finance system, then we must recognize that a few tweaks will not do. We must also recognize that the greatest drivers of housing unaffordability have little to do with the mortgage market. In fact, by increasing housing demand without increasing supply, mortgage subsidies actually make housing more expensive, not less. What is keeping homeownership out of reach for low-income and poor-credit families is not the mortgage market; it’s high home prices and low incomes. Those are the issues we should be addressing.

Mark Calabria’s essay can be found on page 49.

Ethan Handelman and Shekar Narasimhan

Putting Affordability at the Center of Housing Finance

Incubator authors apparently agree America needs a stable and liquid housing finance system and that a government catastrophic backstop is necessary, but many disagree about mechanisms and which

participants should play the largest role. Only by focusing on housing affordability can we create the housing finance system to serve renters and homeowners at all times nationwide.

From a multifamily perspective, we observe:

1. **Multifamily needs a separate solution from single-family.** An explicit, priced, and limited federal guarantee is essential for well-functioning multifamily and single-family secondary markets. The implementation of the guarantee should be different for the two sectors, because multifamily's proven models rely on distinct securities from different issuers. Spinning off multifamily, leaving room for new entrants, and putting private capital ahead of government can work, as Berman and Willis detail.
2. **Multifamily should welcome more lenders and reach underserved communities.** There are only 29 multifamily lenders fully approved to work with Fannie Mae and Freddie Mac. From our observations, none is a minority- or women-owned business or a community-based bank. These lenders generally do an excellent job, so the system would benefit from more competition. We should lower barriers to entry to encourage the primary market to reach more underserved and new American communities, while maintaining credit quality.
3. **The secondary market should support affordability.** That is the quid pro quo for the government guaranty. There was a near consensus that those who benefit from the secondary market should contribute to affordable housing solutions. Dissenting opinions did not convince us: neither Bibby and DeWitt nor Pollock mention targeted affordability, while Pinto sketches a radical and unworkable restructuring of all housing finance and development.

We care about housing finance reform to ensure everyone can afford a place to call home. Providing a stable, well-functioning system for profitable businesses run by skilled professionals is essential, but not an end in itself. Our housing finance system should help markets reach as many people as possible and provide resources to address needs where the market underperforms.

Ethan Handelman and Shekar Narasimhan's essay can be found on page 80.

Michael D. Berman and Mark A. Willis

Multifamily GSE Reform

Of the three essays exclusively focused on reform of the GSE multifamily businesses, ours was the most granular (the other two were authored by Narasimhan and Handelman and by Bibby and DeWitt). Nevertheless, there is general agreement that multifamily lending is different from single-family and should have a different reform approach that retains the successful features of the multifamily business units of Fannie Mae and Freddie Mac while mitigating flaws. We agree that the new system should preserve the strengths of the existing risk-sharing models, promote competition, protect taxpayers, retain the features that maintain market liquidity through the economic cycle, and strengthen regulatory oversight, including support for creating and maintaining affordable and workforce housing.

1. We appear to agree to creation of **new regulated bond guarantors**, two of which would be spun out and grandfathered from Fannie Mae and Freddie Mac's multifamily businesses.
 - » Ownership of guarantors by the **private sector**
 - » FHFA to **regulate** the guarantors as mono-line businesses
 - » **Explicit government guarantee** (e.g., GNMA) only for MBS investors' principal and interest
2. We appear to agree to **strong protection for taxpayers**
 - » **Strict loan eligibility criteria** prescribed by FHFA
 - » **Sale of top-loss risk** to third parties (including Fannie Mae DUS lenders)
 - » Minimum **capital requirements for guarantors**
 - » Government to charge guarantee fee **for a reserve fund**
3. We appear to agree on **setting standards** for
 - » annual production percentage for units renting at different levels of affordability to focus activity of guarantors on affordable and workforce housing,
 - » limiting **portfolio size**, and
 - » overall **market share** for the guarantors.

There is a strong basis for building consensus among these authors. However, more detail is needed to determine the extent of agreement on minimum level of capitalization of guarantors, broad access of small banks to the system, specific duty-to-serve mandates, the level of a market share cap, funding of the HERA affordable housing funds with a fee charged on all loans in the system, transition to the new

system regarding the old book of business, and how to handle capital requirements in times of extreme economic stress.

Michael D. Berman and **Mark A. Willis's** essay can be found on page 86.

Doug Bibby and Bob DeWitt

Our Take-away: Everyone Agrees Multifamily Works

All of us recognize that Fannie Mae and Freddie Mac's multifamily programs maintained solid underwriting standards and strong credit performance even during the global financial crisis and, importantly, kept capital flowing to our sector even in the depths of that crisis. Moreover, the GSEs' multifamily programs today feature characteristics that advocates of reform are seeking, including robust taxpayer protections, increased private capital participation, risk sharing, a limited government role, and a mandate to serve all markets at all times.

While their programs continue to operate soundly and provide much-needed capital to our industry as we try and meet the gap between historic apartment demand and the existing apartment supply, we cannot take it for granted that that will continue to be the case. The inability of the GSEs to build capital reserves as required in the Senior Preferred Stock Purchase Agreement may trigger a rush to reform them in 2018 when their reserves are exhausted.

The greatest current threat to the multifamily industry is poorly designed and executed GSE reform. The fact is that Fannie Mae and Freddie Mac's multifamily programs are a critical capital provider and participate alongside private capital sources to support a well-functioning marketplace for multifamily borrowers. GSE reform that destabilizes the presently healthy market must be avoided. We support GSE reform that builds on the proven, successful elements of today's system and promotes rental housing for all Americans.

Doug Bibby and **Bob DeWitt's** essay can be found on page 96.

Barry Zigas

The collected essays make it both easier and harder to understand eight years of gridlock on reform. Harder because the essays show so much alignment around core principles. Easier because some outliers either reject or significantly reduce a federal role in broad housing finance, or will not venture beyond the current model that has little political support. These persistent voices encourage political resistance to any change, making finding a way forward more difficult despite consensus on important issues from diverse quarters.

Several essays effectively laid out the critical reasons for making broad consumer mortgage credit access a key outcome, but mostly offered no way to do so besides retaining the current housing goals model. But focusing only on “fixing” the GSE model in isolation would waste the rare opportunity to erase artificial distinctions between different existing supports that could enable an integrated model of federal engagement in housing finance to more effectively assure broad credit access, as a few of the essays described.

Within the mix of recommended organizational models—utility, mutual, regulated shareholder, or government-owned corporation—lie consensus on key issues:

1. A federal role to insure liquidity in the secondary market for mortgage credit availability throughout business cycles
2. Limiting this role to providing paid-for, explicit guarantee on securities
3. Leaving the majority of credit risk to private capital through one means or another and avoiding the creation or resurrection of “too-big-to-fail” institutions
4. Insulating the goals of public benefits from the pressures of profit-seeking private ownership of the mortgage system’s critical infrastructure
5. Eliminating Fannie and Freddie’s large portfolios in any new structure
6. Considering a separate approach for necessary support for multifamily finance
7. Equal access to the market for lenders of all sizes and types under any organizational model

These essays show we can take the GSEs another step on their long evolutionary journey. Building on this consensus to integrate their most important features and outcomes with other federal tools including regulation of primary market lenders would make real change and create more opportunity to fulfill access objectives more effectively.

Barry Zigas’s essay can be found on page 104.

John Taylor

It is encouraging to see almost universal consensus in this forum around the importance of affordable housing requirements, with several essays reaffirming a central role for one or all of the following: affordable housing goals, a duty to serve, the National Housing Trust Fund, and the Capital Magnet Fund. All of these elements must be in place, including strengthened affordable housing goals. There was also broad acknowledgement that today's credit standards and the substantial increase in the cost of credit postcrisis are undermining access for many qualified LMI and minority borrowers. I believe that today's credit access conditions for LMI communities and communities of color reflect a weakening of the nation's commitment to affordable housing and affirmative obligations on financial institutions to serve these communities. While some proposals are stronger than others, this incubator reflects a watershed in the conversation around housing finance reform in that so many saw affordable housing mandates as of central importance.

The spectrum of structural reforms to the housing finance system proposed in this forum magnifies how great the disagreement is over next steps: eliminate the GSEs and return to the "originate-and-hold" model; merge the GSEs into one government corporation or transfer them to Ginnie Mae; reconstitute the GSEs as a mutual-owned or shareholder-owned utility; or recapitalize the GSEs and continue reforming them—the best approach in our view. These wide policy differences also reflect the current political reality—there is not consensus. More political and policy uncertainty is ahead about what approach a new administration will take and how the protracted conservatorship will affect the GSEs' future earnings, their ability to carry out their affordable housing mission—lackluster currently, by all estimations—and the secondary mortgage market overall.

With regards to homeownership, the proposals and analysis offered by Marc Morial, Mike Calhoun and Sarah Wolff, and Janet Murguía most closely dovetail with NCRC's, and Tim Howard's proposal also reflects a lot of wisdom and is worthy of further review and consideration. Overall, I am encouraged by the movement of so many on the necessity of clear and strong affordable housing mandates.

John Taylor's essay can be found on page 125.

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