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Sustainable Housing Finance: Stakeholder Perspectives on Housing Finance Reform

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Good morning Chairman Duffy, Ranking Member Cleaver, and members of the House Committee on Financial Services' Subcommittee on Housing and Insurance. My name is Sarah Edelman and I am the director of housing policy at the Center for American Progress, an independent nonpartisan policy institute that is dedicated to improving the lives of all Americans, through bold, progressive ideas, as well as strong leadership and concerted action. Thank you for inviting me to testify today.

In today's testimony, I'll describe why the housing finance system matters to consumers, explore how the system failed consumers and taxpayers in 2008 and how to strengthen the housing finance system based on the lessons learned during the housing crisis.

## A Healthy Housing Finance System Supports the Growth of the Middle Class

Most American wealth is built through homeownership. Housing wealth accounts for about 60 percent of the typical white household's wealth and almost 70 percent of African American household wealth.[1] Even when controlling for income, homeowners have significantly more wealth than renters.[2] Absent federal intervention, it would be difficult for working families to own their homes. In the 1930s, before the federal government began playing a role in the housing finance system, long-term fixed rate mortgages were not available and only those who could afford to make a 40 or 50 percent down payment could buy a home.[3]

The housing finance system creates the conditions for mortgage lending in the United States – it helps to determine who can borrow money and what they will pay for the loan. The guidelines and preferences adopted by credit enhancers and institutions in the secondary market often determine mortgage availability and price for homebuyers or for owners of rental housing. When the housing finance market is working optimally, sustainable mortgage credit is broadly available, allowing qualified borrowers to buy homes and owners of rental housing to access the mortgage financing they need. However, when the housing finance system is not working well, qualified borrowers in many communities have trouble accessing sustainable mortgage credit. Or, as in the lead up to the housing crisis, the mortgage products that are available strip wealth from communities, instead of building wealth.

In the years following the Great Depression, when the private mortgage market was barely operating, the federal government stepped in with new resources to make homeownership possible for Americans. Congress created the Federal Housing Administration (FHA), which insured eligible mortgages.[4] This FHA insurance gave lenders the confidence to lend again, knowing that they would be protected if a homeowner defaulted. As servicemembers began returning home from World War II, the Veterans

Administration (VA) began offering mortgage insurance to returning servicemembers, enabling them to buy homes and begin to build wealth.[5]

Fannie Mae was created in 1938 and subsequently directed by Congress to, among other duties, "*promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing."*[6] Fannie Mae created a secondary market for government-insured mortgage loans as a government agency, and began purchasing mortgages insured by FHA and VA. In the 1970s Fannie Mae expanded its business to include conventional mortgages and Freddie Mac was chartered to purchase and securitize conventional mortgages.[7] Fannie Mae was privatized in 1968, Freddie Mac in 1989.[8]

These government interventions helped to increase access to homeownership. Mortgages became less expensive and their terms standardized across the country, and the 30 year fixed-rate mortgage became widely available. Between the 1940s and 1960s, the homeownership rate in the United States increased from 44 percent to 62 percent.[9]

While the FHA, VA and the GSEs paved the way for affordable, fixed-rate low down payment mortgages for white borrowers, borrowers of color were largely excluded from these wealth-building options. The FHA and VA engaged in redlining and promoted discriminatory lending patterns that drove racial segregation and limited homeownership opportunities for people of color.[10] The GSEs helped to reinforce these discriminatory patterns. The passage of the 1968 Fair Housing Act and the Community Reinvestment Act in 1977 helped to begin correcting federal policy and to promote access to credit in historically underserved communities.[11]

In the early 2000s, consumer advocates began to sound the alarm as lenders started peddling poorly-designed mortgage products in low and moderate-income communities.[12] With "teaser rates" followed by exploding interest rates, pre-payment penalties, and little to no underwriting, these mortgages were designed to fail.[13] With strong demand on Wall Street for mortgages to package and sell to investors, credit rating agencies blessing securities filled with toxic mortgages, and large commissions and fees for lenders, predatory mortgages flourished.[14] In 2007, when these mortgages began to default in large numbers, homeowners and taxpayers were left holding the bag.

The housing finance system broke down in the lead up to the housing crisis and has yet to fully recover. Americans lost $19.2 trillion in wealth between 2007 and 2009 when predatory lending caused a housing crisis, which triggered a global financial crisis and recession.[15] In the immediate aftermath of the crisis, private capital fled. The private label securities market collapsed.[16] Private mortgage insurance companies reduced their presence in the market dramatically and two failed entirely.[17] Were it not for the efforts of FHA and the GSEs to continue supporting the mortgage market during the crisis, the damage would have been even worse.

Today, the mortgage market is again functioning yet many prospective homebuyers remain on the sidelines. African American and Latino borrowers are severely underserved by the mortgage market when compared to their White counterparts.[18] Limited access to sustainable and affordable homeownership options has driven a racial wealth gap in the United States that continues to widen.[19]

**Lessons Learned from the Housing Crisis**

Building a stronger housing finance system for the future requires identifying the problems that caused the housing crisis and identifying the structural weaknesses that led Fannie Mae and Freddie Mac to stray from their mission in the years preceding the housing crisis.

Some conservatives have stated that the housing crisis was caused by policies at FHA and by Fannie Mae and Freddie Mac that encouraged lenders to expand lending to low and moderate-income consumers. There has been no credible research to support these claims. The share of the mortgage market backed by the GSEs or FHA was historically low in the years leading up to the crisis.[20] FHA-insured loans and GSE-backed loans had fair repayment terms and far lower default rates than the private market.[21] The predatory lending that destroyed the economy and housing market in 2008 was a product of loose regulatory oversight and a dysfunctional private securitization market.[22]

While Fannie Mae and Freddie Mac certainly did not cause the housing market, their behavior in the years leading up to the crisis brought them to the brink of bankruptcy and drove them into conservatorship. These weaknesses included prioritizing short-term profit over safety and soundness, weak oversight and regulation, insufficient capital, and an implicit government back stop that was not paid for.

As the private securitization market grew in the early 2000s, Fannie Mae and Freddie Mac lost market share and their incomes dropped.[23] Fannie Mae and Freddie Mac abandoned their historically high standards out of fear of losing more market share to the private securitization market. They began to fill their portfolios with toxic private label securities, which produced greater returns for shareholders in the near term.[24] To compete with the private market, the GSEs also began to lower their credit quality standards and purchased Alt-A mortgages, mortgages that typically had large down payments and very limited documentation. While Alt-A mortgages represented about 12 percent of the their single family portfolios, they represented between 40 and 50 percent of GSE defaults in 2008 and 2009.[25]

Fannie Mae and Freddie Mac made bad business decisions, in part, because they did not have a strong regulator. Regulatory responsibilities were divided between HUD and OFEO, and neither had enough authority to ensure proper conduct at the GSEs.

And, when the housing crisis hit, the GSEs did not have enough equity on hand to withstand all of the losses that were anticipated.

In 2008, the Treasury Department extended a line of credit to the GSEs and the GSEs have since tapped $187.5 billion of that line of credit to ensure that the Enterprises could meet their commitments to investors across the globe.[26] The Enterprises lost nearly $50 billion in 2008, alone.[27] For decades, investors operated under the assumption that the federal government would back Enterprise-issued securities in the event of a catastrophe. Indeed, the federal government had little choice but to step in because of the potential impact to the global economy. However, since this government guarantee was not explicit, the GSEs had not paid in advance for the ability to access the line of credit and needed to rely on taxpayers to step in.

**Strengthening the Housing Finance Market**

In the aftermath of the crisis, Congress took steps to help prevent another crisis from occurring in the future. Congress passed the Dodd Frank Wall Street Reform and Consumer Protection Act which established strong consumer protections for homebuyers, improved oversight of Wall Street, and created the Consumer Financial Protection Bureau to help spot predatory trends that could harm consumers and eventually pose a risk to the financial system. Congress also passed the Housing and Economic Recovery Act (HERA) which created a new regulator with the authority to properly regulate Fannie Mae and Freddie Mac.

As Congress seeks to take further steps to strengthen the housing finance system, its goal should be a system that makes sustainable, affordable mortgage credit available to all qualified borrowers during all credit cycles. This means building on aspects of the current housing finance system that have served Americans well, correcting weaknesses of the current structure that were exposed during the crisis, and addressing some of the affordable housing challenges that have emerged in recent years.

***1. Establishing an explicit, paid-for, government guarantee is good for consumers and taxpayers:*** The 30-year fixed rate mortgage has helped to build the middle class in the United States yet it would not be broadly available without government intervention. Few lenders can afford to hold most of the mortgages they originate in portfolio throughout the life of the loan. They need to be able to sell many of the mortgages they originate on the secondary market to have enough capital on hand to make loans to more borrowers. Lenders need reliable secondary market partners who will buy plain vanilla mortgages during all economic cycles. This reliable secondary market only works when investors are confident that they'll receive timely payments when they purchase a mortgage backed security. In past decades, investors who purchased mortgage backed securities were confident that Enterprise-issued securities posed very minimal risk because they believed that the U.S. federal government would stand behind the securities in the case of an emergency. Future guarantors are also likely to benefit from the perception that the U.S. government will provide a bailout in an emergency. Fannie Mae, Freddie Mac or their successors should pay for the ability to offer to investors this assurance.

***2. Promoting access and affordability***: The housing finance system exists to serve America's housing needs. To build a strong housing finance market that serves the United States well in the decades to come, affordable mortgage credit needs to be available across geographies, and to lower-wealth families of all racial and ethnic backgrounds. This means that any new system must be able to provide liquidity for well underwritten loans with low down payments, and pricing should be averaged as much as possible across the portfolio and take into account the risk of mortgages' failure through a tough but reasonable stress test.

**Broad duty to serve**: Congress should build on the aspects of the current housing system that work for consumers. First, the GSEs are both chartered entities with a statutory duty to serve qualified borrowers across the entire United States.[28] This statutory requirement has helped to ensure the availability of mortgage credit among populations and geographic areas that might not otherwise be served by the private securitization market. Rural communities have benefited from this broad duty to serve with which the GSEs must comply.

**Affordable housing goals and the new duty to serve rule:** These are important tools that help to ensure that the GSEs are complying with their mission. Neither the affordable housing goals nor the broad mission of the GSEs caused their financial challenges during the housing crisis. Few of the toxic securities purchased by the GSEs or the Alt-A mortgages they backed to increase shareholder profits, counted toward the GSEs affordable housing goals. The mistakes Fannie Mae and Freddie Mac made were in service of satisfying their shareholders, not complying with their affordable housing mission or the housing goals.

**Affordability funds:** The National Housing Trust Fund and Capital Magnet Fund are both important for creating affordable rental and homeownership opportunities for families across the country. Affordable housing providers simply cannot afford to provide many low-income families with affordable options without the support of these funds. The market access fund, proposed by the Center for American Progress and the Consumer Federation of America is another important tool for creating access and opportunity. The market access fund would provide funding for pilots and new products so that more families can access affordable housing. All three of these funds should be expanded by a 10 basis point fee on all outstanding securities. This fee should generate about $4.5 billion annually for these affordable housing funds, according to the Urban Institute.[29]

***3. Managing mortgage costs for homebuyers***: Perhaps the most important factor that will determine access and affordability in the decades to come is the way in which mortgage credit is priced. A move toward more aggressive risk-based pricing, as might occur under some the housing finance reform proposals under consideration, could make it harder for low and moderate-income borrowers to buy a home using a conventional mortgage.

Pricing policies already appear to be keeping some homebuyers from accessing conventional mortgage credit. Traditionally, the GSEs have pooled risk, charging similar fees to all homebuyers to ensure that mortgage risk is managed across their book of business. Since the GSEs have entered conservatorship, they and their credit counterparties, the MIs, have shifted toward a more individualized approach. Borrowers at the lower end of the credit score spectrum are charged higher fees, up to 300 basis points more, than borrowers with pristine credit through loan level pricing adjustments and mortgage insurance costs.[30] With these pricing policies in place, it's no surprise that the average credit score on a loan purchased by Fannie Mae or Freddie Mac today is 740 for first time buyers and 756 for repeat buyers, both well above the credit score for the typical American.[31]

Some of the proposals under consideration could make pricing even more prohibitive for low and moderate-income borrowers by encouraging sources of private credit that may be more likely to price risk on an individual loan-by-loan basis. Going forward, the GSEs or any entities that replace them, should not engage in risk-based pricing. For the housing market to thrive in the decades to come, all qualified borrowers should have access to the conventional mortgage market, not just the highest earners or wealthiest individuals.

***4. Preventing profit-seeking at the expense of consumers and taxpayers****:* As Fannie Mae and Freddie Mac competed with the private securitization market and sought to increase returns for shareholders, they strayed from historically strong standards and practices. Moving forward, these incentives need to be addressed so that guarantors do not put the short-term interests of shareholders ahead of taxpayers and consumers.

***5. Protecting taxpayers through appropriate capital standards*****:** In the lead up to the crisis, Fannie Mae and Freddie Mac were not holding sufficient equity and relied on an implicit government guarantee. And like the big banks, Fannie Mae and Freddie Mac were supported by the federal government as they teetered on the edge of bankruptcy. To safeguard taxpayers against needing to step in again, Fannie Mae, Freddie Mac or the new entities should be required to hold sufficient equity to ensure they can weather tough times.

***6. Strong regulatory oversight to protect the housing finance system:*** There should also be a strong regulator in place to ensure safety and soundness. In the lead up to the crisis, Fannie Mae and Freddie Mac were poorly regulated. Responsibilities for regulating the Enterprises were split between HUD and OFEO and neither was particularly effective. Congress created a new regulator, the Federal Housing Finance Agency (FHFA), through the HERA Act in 2008 and gave it far more regulatory authority than the prior regulators. FHFA can set capital standards, set prudential management standards, remove officers and directors, put the regulated entity into receivership, and review and approve new product offerings.[32] The housing finance system needs a strong, empowered regulator like FHFA for the decades to come.

Moreover, consumers, investors and taxpayers all benefit from strong consumer protection. The rules put in place after the crisis to prevent a return to predatory lending are crucial to the long-term health of the housing finance system and the housing market. Regulators and Congress should defend these important rules of the road. If they deteriorate, the housing finance system will be put at risk.

***7. Easy access to the secondary market for small lenders*:** Small lenders serve the credit needs of their communities and need a secondary market execution that is easy to access and does not favor larger lenders. Today, small lenders can sell loans to directly to Fannie Mae and Freddie Mac through the cash window and obtain a price like what the Enterprises offer larger banks selling larger pools of loans. Small lenders can also maintain the servicing rights for the loans they sell which strengthens customer relationships and provides a reliable income stream. As the Center for Responsible Lending noted in its recent testimony, several housing finance reform proposals include a cash window but few of these proposed cash windows provide all the benefits and access of today's cash window.[33] Moreover, while a well-functioning cash window is important for small lender access, it is not sufficient to guarantee a level playing field for small and large lenders. It there are other aspects of the housing finance system that give a cost-advantage to larger banks, small banks could also be disadvantaged.

***8. The housing finance system must meet the needs of America's renters:*** The number of households that cannot afford their monthly rent is growing. According to an analysis by the Joint Center on Housing Studies of Harvard University and Enterprise Community Partners, there could be nearly 15 million cost-burdened renters by 2025, a 25 percent increase from 2015.[34] Supply has been slow to meet an increase in demand for rental housing. As rents have increased and incomes have remained relatively stagnant, more families are having difficulty affording rent each month. Our communities need more affordable rental housing.

The housing finance system helps to determine the availability of affordable rental housing. For a new multifamily building to open its doors to renters, the building owner needs to be able to acquire permanent mortgage financing after the building is constructed. Periodically, building owners need to make renovations to keep rental units habitable and attractive. The Enterprises play an important role in the rental market, making financing for acquisition, refinancing and rehabilitation more easily accessible. The majority of the rental units financed by the Enterprises are affordable to low and moderate-income households.[35]

Going forward, the Enterprises, or their successors, should increase focus on affordable rental housing. Recognizing the persistent affordability challenges in the rental market, it may be necessary to set higher thresholds for affordability than are in place today.

**Assessment of Current Housing Finance Reform Proposals**

CAP believes that there are several structures that could accomplish these goals and serve the housing finance system well. A government corporation, private utility, or mutually-owned cooperative if structured right, could deliver well-priced, sustainable mortgage credit to qualified borrowers across markets and economic cycles.

Over the past several years, there have been dozens of proposals published about how to best structure the housing finance system. There are areas where the conversation has progressed significantly and positively. First, there appears to be widespread agreement about the need for a paid-for, government guarantee for mortgage backed securities issued by Fannie Mae and Freddie Mac and/or their successors. There also appears to be consensus forming about the need for expanded affordable housing funds. Finally, more stakeholders and experts are supportive of keeping the current affordable housing goals, the new duty to serve rule and the broad duty to serve requirement currently in place.

However, important differences persist among the proposals that are significant for the consumers and the health of the housing finances system. Some experts believe that competition in the secondary market is a primary goal of housing finance reform which we believe may not be a sustainable approach. Some experts also envision a system that relies heavily on credit risk transfer structures, both pre and post loan origination and securitization, which we believe need to be developed further before assuming a larger role in the housing finance system.

**Competition in the secondary market does not always yield benefits for consumers or taxpayers**

CAP believes that competition in the primary market is very desirable. Consumers do better when they shop around for a mortgage, and lenders push one another to offer better terms to consumers. CAP also agrees that some competition in the secondary market is preferable. Fannie Mae and Freddie Mac, for instance, often drive one another to offer more innovative products and compete to offer lenders the easiest execution, which delivers benefits to consumers.

However, it is important to consider whether much more competition in the secondary market is a desirable goal. In the lead up to the housing crisis, there was significant competition in the private market. The private label securitization market was robust and private mortgage insurers were very competitive. This competition did not lead to better terms for consumers nor did it protect taxpayers. In fact, competition among secondary market participants drove a race to the bottom, with each jockeying for market share.

Several of the housing finance reform proposals under consideration make the mistake of setting secondary market competition as a goal of housing finance reform. Both the Milken Institute and the Mortgage Bankers Association (MBA) proposals envision a system in which many entities could issue mortgage backed securities that are guaranteed by the federal government.[36] Their theory is that more competition will deliver better priced mortgage credit and greater efficiencies to the consumer while also protecting taxpayers by diversifying risk.

History tells a different story. When the housing market collapsed and the global finance system teetered on the edge of collapse, many firms with connections to the private label securities market needed bailouts. Competition among secondary market participants or among private mortgage insurance companies did not protect taxpayers or consumers during the crisis.

Some of the largest issuers of private label securities – Goldman Sachs, Bank of America, GMAC, and Wells Fargo – all needed support from the federal government to keep their doors open.[37] They also withdrew from the private label securitization market. Private mortgage insurance companies also withdrew from the housing market – their market share decreased from 74 percent at the onset of the crisis in 2007 to 14 percent during the depths of the foreclosure crisis in 2010.[38] Had FHA and the GSEs not continued to do business during the crisis, the impact of the crisis would have been even more severe and more homeowners would still be underwater on their mortgages today.

The models proposed by Milken and the MBA envision a competitive marketplace of many companies that can offer mortgage backed securities that are backed by the federal government.[39] Our concern is that these proposed structures may create the conditions for the bad behavior we saw in the private label securitization market in the lead up to the financial crisis – this time, however, with the securities guaranteed by the federal government.

In a new report, Andy Davidson, an expert in mortgage backed securities and a designer of Fannie Mae and Freddie Mac's new credit-risk sharing instruments explains how competition in the secondary market can lead to a race to the bottom that does not help consumers or taxpayers.

"Even if there are multiple guarantor entities, it is likely that if one is failing the others are likely to be under pressure. Government might still need to intervene. Further, the risk isn't just that they fail, but that the damage that is done as they race toward the bottom. We have seen the impact of poor underwriting and lax standards on the broader financial system when competition to feed the machine led to a severe decline in underwriting discipline in the subprime market."[40]

In a market with many guarantors, it may also be harder for a regulator to ensure safety and soundness and that the system is serving all qualified borrowers, including those who do not live in the nation's most desirable markets. Moreover, it is questionable whether a system of many guarantors would be sustainable over the long term. The secondary market business model is based on aggregating large numbers of loans into securities, with relatively low margins.

**Credit risk transfer program needs more development**

Credit risk transfer is playing an increasingly significant role in our housing finance system and several of the prominent housing finance reform proposals envision a system where credit risk transfer is a primary means of shifting mortgage risk from taxpayers to the private market.[41]

CAP believes that credit risk transfer structures are important tools that the GSEs should continue to develop. However, it is not yet clear whether the credit risk transfer program will be sustainable over the long term or whether credit risk transfer instruments will raise costs for consumers. These issues need to be taken into consideration before Congress considers any legislation that requires mortgage guarantors to share credit risk with the private market through these instruments or considers a broader role for credit risk transfer.

Since 2013, the GSEs have made progress toward creating a back-end credit risk transfer marketplace. They have transferred about $54.2 billion of credit risk to the private market on a $1.6 trillion of unpaid principal balance, or 3.4 percent of outstanding UPB.[42] To date, about 80 percent of credit risk has been transferred through fully collateralized derivative instruments – Fannie Mae has transferred risk through its Connecticut Avenue Securities (CAS) and Freddie Mac through its Structured Agency Credit Risk transactions (STACR). [43]

The credit risk transfer marketplace needs significant oversight to reduce taxpayer risk and to promote stability through economic housing cycles, objectives established by the FHFA. [44] Credit risk transfer transactions should also make sense for consumers – they should not raise the cost of borrowing for working families.

Credit risk transfer instruments only protect taxpayers if the credit risk is permanently transferred. If a counterparty fails or is unable to provide promised reinsurance, taxpayers are not protected. While this is less of a concern with fully collateralized transactions, regulators will need to closely monitor newer partially collateralized structures. In Quarter 1 of 2017, about 20 percent of the risk transferred through the CRT program was transferred through insurance and reinsurance transactions, which are not fully collateralized.[45] More research may be needed on the state of supervision and risks within the reinsurance industry. While it is generally assumed that reinsurance companies present minimal correlation risk to the GSEs because of their highly diversified lines of business, there may be other risks to manage. For instance, AIG was believed to be a strong counterparty with limited correlation risk in the run up to the crisis. These transactions may need to be fully collateralized, as was recommended by the authors of A More Promising Road proposal.[46]

There are still remaining questions about the future of the credit risk transfer market. First, Enterprises' credit risk transfer offerings have been piloted during a time of economic expansion. Many experts have expressed concern that it could become prohibitively expensive to transfer risk to the private market during an economic downturn when mortgage defaults increase. Moreover, the future of the credit risk transfer market depends largely on the structure of the housing finance system. In a forthcoming paper, Susan Wachter explains that a robust CRT market may not flourish in a system with multiple guarantors because it will be harder to maintain standardization, transparency and liquidity.[47]

Finally, any use of deeper mortgage insurance to transfer credit risk needs to be carefully considered. As CRL explained in its recent testimony, overreliance on the private mortgage insurance market could lead to more differential pricing, which raises borrowing costs for working families. It may be possible to limit cost increases to low and moderate-income consumers by requiring private mortgage insurance counterparties to price based on the risk of the entire pool and not on a loan-by-loan basis. Guarantee fees could also be lowered to offset any increases for borrowers, as recommended by the authors of A More Promising Road.[48]

## Moving Forward

As policymakers consider ways to strengthen the housing finance system, it is critical that they preserve what's working, build on the reforms underway, and carefully consider additional reforms to ensure a sustainable system. The Center for American Progress supports housing finance reform, but only if the reforms make the system stronger.

Fannie Mae and Freddie Mac have served the American mortgage market well over the decades. Even today, while in conservatorship, they are meeting the mortgage market's credit needs, although they should be doing more to reach low and moderate-income borrowers and renters. Their mission, and the tools that Congress has helped to develop, including the affordable housing goals and the duty to serve rule, help to strengthen the mortgage market and should be preserved in the system moving forward. The new regulatory structure provided by HERA and the new mortgage protections outlined by the Dodd Frank Act are critical for the future health of the housing finance system.

The most important remaining work that requires new policy solutions includes addressing the misaligned incentives that led Fannie Mae and Freddie Mac to prioritize short-term shareholder profits over the long-term sustainability of their businesses. Also needed is an explicit government guarantee for mortgage-backed securities that is paid for the entities guaranteeing the mortgages. As policymakers weigh policy options to address these outstanding issues, they should evaluate how each proposed structure affects prices for consumers and whether they are sustainable over the long run. We look forward to continued discussions about how to best address these remaining challenges.

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