A More Promising Road to GSE Reform: Access and Affordability

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A key test of any proposal to reform the housing finance system is how broadly it provides sustainable, affordable credit to those in a financial position to become homeowners. In this paper, we discuss the economic and social challenges that policymakers face in maintaining broad access to credit for creditworthy borrowers, how the challenges are met in the current system, and, finally, how they would be met in our recent proposal to combine Fannie Mae and Freddie Mac into a single government corporation required to sell all noncatastrophic credit risk to the private market.

In our proposal, the government corporation would retain the affordable housing goals and duty to serve obligations that currently guide Fannie and Freddie. Although this regime can be improved, it is an important foundation on which to build over time. It is well understood by policymakers, stakeholders, and the Federal Housing Finance Agency, and it combines helpful quantitative and qualitative tools to promote broad credit access in both the rental and homeownership finance markets. The government corporation would be in a strong position to meet these obligations under the system proposed, given its ability to cross-subsidize among larger pools and the elimination of conflicts between private shareholder interests and public mission. And, with an increased affordability fee to support affordable housing and community development efforts, the FHFA and government corporation together would be in a strong position to address the range of broader housing affordability challenges.

By bringing the securitization infrastructure currently managed by Fannie and Freddie into the government, our proposal would also create an opportunity to unify all the government-backed channels of support for the mortgage market in a way that would improve the country's approach to ensuring broad access to affordable mortgage credit. The government corporation could eventually create a single channel through which all government-supported lending would flow, whether it is credit enhanced by the private sector or by one of the mission-focused agencies such as the Federal Housing Administration or the Department of Veterans Affairs. This system would be more efficient in allocating the subsidies needed to maintain broad access to credit. It also would allow the government corporation and the FHFA to ensure that the market as a whole is providing adequate access to credit. This more integrated system will lead to more seamless credit access for all creditworthy potential homebuyers.

To be clear, the goal here is not to stretch the mortgage market to serve those who are not creditworthy and not prepared to be homeowners, but to ensure that all families that *are* creditworthy and *are* prepared at least have the chance, no matter where they live.

The role of policy in maintaining broad access to credit

A host of economic and social issues would likely render many communities across the country credit deserts absent some kind of policy intervention, and indeed ***have*** on many occasions throughout our nation's history. It is not always in the economic interest of lenders to fully serve communities without a large number of potential homeowners, particularly where the lending is often in the form of small loan balances. The costs are often perceived as simply too high relative to the revenues. Absent something to change these incentives, then, many of these communities would be left with no lending at all, or only lending at a prohibitively high cost. Non-economic factors also compound the problem. Many minority families have historically relied on nontraditional sources of credit or count on multiple sources of income, leaving them poorly served by today's underwriting and credit scoring systems. Indeed, there is mounting evidence that the credit scoring model used most widely today is unable to even score a significant number of these families. And implicit and explicit racial bias, while much less prevalent than in past decades, has not disappeared.

Congress passed the Home Mortgage Disclosure Act in 1975 and the Community Reinvestment Act in 1977 in response to many of these challenges. The HMDA requires lenders to provide the data necessary for policymakers to assess their lending practices, and the CRA requires federally regulated banks and savings and loans to fully serve their communities. The two together provided early tools to overcome restrictive lending practices that had left communities without access to mortgage and other forms of credit.

Focusing on the primary market alone was found insufficient, however, as lenders unable to sell loans from underserved communities were less likely to make them. So when Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act in 1992, it included new requirements that a specified percentage of the mortgage loans backed by Fannie and Freddie go to low- and moderate-income households and communities, and directed the Department of Housing and Urban Development to ensure that the government-sponsored enterprises were "leading the market" in providing access to credit. FHEFSSA also amended the GSEs' charters to require them to accept lower but still-profitable returns on loans serving low- and moderate-income consumers where necessary, making it easier for them to meet their new obligations under the statute. In addition to assuring liquidity for an expanded primary market, Congress was requiring something more in return for the implicit guarantee that it was providing Fannie and Freddie.

Congress put the final piece of the current regime to support access and affordability into place in 2008, with the Housing and Economic Recovery Act. HERA included changes to how the annual housing goals were tracked and calculated, and established a new "duty to serve" requirement to supplement the goals. Fannie and Freddie would now have a duty to increase liquidity for mortgages for very low-, low-, and moderate-income families in three markets deemed underserved: manufactured housing, affordable housing preservation, and rural markets.[1] The FHFA finalized regulations implementing this requirement in December 2016. HERA also imposes a 4.2-basis point "affordability fee" on the GSEs' loan purchases, the revenues from which go to the National Housing Trust Fund, which finances the construction of affordable rental housing primarily for very low-income households, and the Capital Magnet Fund, which supports the lending activities of community development financial institutions, or CDFIs.[2]

These four legislative steps—the HMDA, the CRA, the FHEFSSA and HERA—together created a multifaceted legislative approach to overcoming the various impediments to mortgage lending in underserved communities.

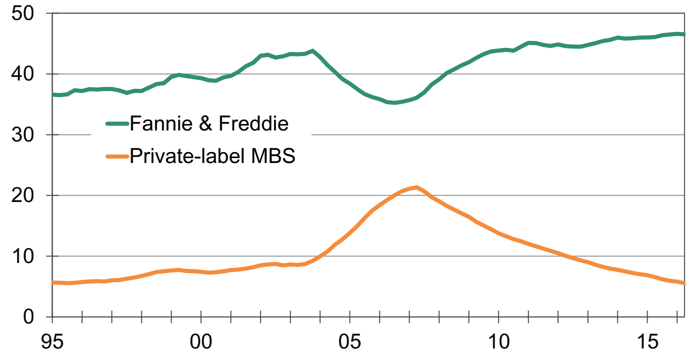
Affordable goals and the financial crisis

It is worth noting that some have argued that the GSEs' affordability goals were a principal cause of the financial crisis. These critics contend that, by forcing the GSEs to lower their underwriting standards, the goals fueled the rise of irresponsible lending that came to a head with the financial crisis in the mid-2000s.

This narrative is not supported by the facts, however. If it were true that the private-label securities market chased the GSEs in loosening credit standards, for instance, we would have seen the GSEs' market share expand in the early stages of the bubble, as it took

GSEs Lost Share to Private MBS in the Bubble

Share of mortgage debt outstanding, %



Sources: Federal Reserve Board, Moody's Analytics

market share from the private market by loosening standards. Instead, we saw exactly the reverse. Between 2003 and 2006, the period when the market began to move aggressively into lower credit quality mortgages, GSE share of mortgage debt outstanding actually *fell* an unprecedented 10 percentage points, as a rapidly expanding private-label mortgage-backed securities market moved in to take share from the GSEs (see Chart).[3]

More fundamentally, it is hard to square the losses that the GSEs actually suffered with the view that the GSEs' affordability goals undermined their underwriting, much less led to the crisis. The GSEs' rate of realized losses on their mortgage exposure during the crisis was approximately one-fifth of loans not backed by the GSEs, including FHA loans, and close to one-eighth that of private-label MBS. This is not consistent with the view that the GSEs' goals and underwriting led the rest of the market in its reckless expansion.

It is also worth noting that housing bubbles during this period plagued countries all over the world, most notably Ireland, Spain, and the United Kingdom. What these countries had in common was of course not government-sponsored enterprises, but well-developed private mortgage securities markets that expanded rapidly into higher-risk mortgages.

Citing these and other factors, academic research since the crisis is largely (if not entirely) consistent in the view that the GSEs' goals should not be blamed for the crisis. See, for instance, work done by the Financial Crisis Inquiry Commission, the Office of Financial Stability and Research at the Board of Governors of the Federal Reserve, or researchers from any number of Federal Reserve banks or universities. In language that could have come from these or many other researchers who have weighed in on the question in recent years, the St. Louis Federal Reserve offered the following:

"We find no evidence that lenders increased subprime originations or altered loan pricing around the discrete eligibility cutoffs for the Government-Sponsored Enterprises' (GSEs) affordable housing goals or the Community Reinvestment Act. Although we find evidence that the GSEs bought significant quantities of subprime securities, our results indicate that these purchases were not directly related to affordable housing mandates."

None of this is to say that the GSEs did not play an important role in contributing to the financial crisis. They did. They were undercapitalized relative to the risk they were taking, particularly as they followed private-label securities issuers into increasingly risky territory in the peak of the bubble, primarily in the Alt-A market, and remained there even after other actors faltered and pulled out. The GSEs' failure then sent tremors throughout the financial system, confirming the system's unhealthy overreliance on institutions that were, literally, too big to fail. As *this* is how the GSEs contributed to the crisis, *this* should be the focus of reform. Focusing instead on the GSEs' affordability goals is simply a distraction.

How Fannie and Freddie currently provide access

Fannie and Freddie currently use several policy levers to meet their access and affordability mandate. Most important is their use of cross-subsidies to lower the cost of a mortgage for those who might otherwise be priced out of the market. Their guarantee fees are averaged across many loans of varying credit risk, rather than set at a loan level. This enables them to charge higher-risk borrowers less than the economic cost of their credit risk, by spreading the costs among borrowers with higher credit quality. Although the cross-subsidization provided in the GSE system is substantial, it has declined in recent years with the imposition of loan-level price adjustments, or LLPAs, by the GSEs. LLPAs are added to the GSEs' guarantee fee for higher-risk borrowers, reducing the subsidy they are receiving (see Table). Private mortgage insurers also have increased the granularity of their pricing given changes to their capital requirements, which results in a heavier load on the very borrowers most impacted by these LLPAs.[4]

Under the direction of the FHFA, GSE guarantee-fee pricing assumes a level of capital that is higher than before conservatorship. But their cost of capital is still lower than that of private credit insurers, which allows them to charge lenders, and thus borrowers, less than they would otherwise. This taxpayer subsidy is meaningful, lowering mortgage rates for borrowers across the entire credit box.

Fannie and Freddie also have a range of more targeted tools to reach underserved borrowers. They have crafted partnerships with state housing finance agencies and CDFIs, for instance, to reach hard-to-serve borrowers. They have created a variety of innovative mortgage products designed to increase access, as we have seen most recently in their creative use of the Home Ready and Home Possible programs. And their cash windows give them the ability to buy whole loans for their own portfolio with nonstandard features or pricing, much like other balance sheet lenders in the primary market.

The GSEs deploy this mix of tools to meet the mandates established through the goals and are expected to do so to meet the duty to serve requirements. This regime has undoubtedly increased GSE lending to underserved groups over time, but it is far from perfect. The affordability goals rely on forecasts of market conditions several years into the future, which become less reliable the more granular the goals become.[5] Timing differences between origination and delivery into the secondary market can distort both the estimates and actual performance of the market on a year-to-year basis. Regulatory incentives in the primary market are not fully aligned with the secondary market goals. And most important, the calculation of primary market lending that determines the goals ignores loans made through government loan insurance programs even though these channels reach more deeply into low-wealth households and borrowers of color. Moreover, the duty-to-serve obligation remains untested, and the 4.2-basis point affordability fee, while a welcome supplement to other appropriated funds, is still only a modest contribution to the supply of affordable housing subsidies.

There is also the hard reality that access to credit under this regime is particularly constrained today. The Urban Institute estimates that 5 million fewer loans have been made between 2009 and 2014 because of lenders' extraordinary constraints, which have been put into place not as a matter of restoring sound underwriting, but as a response to the rise in the regulatory and legal risks associated with originating and servicing loans that fail. The system is serving creditworthy families of color particularly poorly, with the homeownership rate among Hispanics at 45% and among African Americans at 43%, compared with 72% for whites—numbers particularly disconcerting given that families of color are gradually becoming the majority of new households formed in this country.

GSE Loan-Level Pricing Adjustments on All Eligible Mortgages

By credit score and LTV ratio, as of 10/25/2016

	0-60	60.01-70	70.01-75	75.01-80	80.01-85	85.01-90	90.01-95	95.01-97
>740	0.00%	0.25%	0.25%	0.50%	0.25%	0.25%	0.25%	0.75%
720-739	0.00%	0.25%	0.50%	0.75%	0.50%	0.50%	0.50%	1.00%
700-719	0.00%	0.50%	1.00%	1.25%	0.10%	1.00%	1.00%	1.50%
680-699	0.00%	0.50%	1.25%	1.75%	1.50%	1.25%	1.25%	1.50%
660-679	0.00%	1.00%	2.25%	2.75%	2.75%	2.25%	2.25%	2.25%
640-659	0.00%	1.25%	2.75%	3.00%	3.25%	2.75%	2.75%	2.75%
620-639	0.00%	1.50%	3.00%	3.00%	3.25%	3.25%	3.25%	3.50%
>620	0.00%	1.50%	3.00%	3.00%	3.25%	3.25%	3.25%	3.75%

Sources: FHFA, Moody's Analytics

Nonetheless, we believe that the access and affordability regime now in place is worth building upon and improving rather than discarding, because it addresses the incentive challenges faced in both the primary and secondary markets, and supplements those efforts with a host of useful tools worth retaining.

How our proposal maintains broad access to credit

The government corporation system that we have proposed will have the same mandate and range of tools to ensure broad and affordable access as Fannie and Freddie have today. These tools will be more effective in the proposed system, however, given the expanded reach and resources of the government corporation. With a much larger flow of loans than either of the GSEs alone have today, the corporation will be able to create larger pools and thus provide greater cross-subsidization. The higher 10-basis point affordability fee we have proposed will also generate significantly more funding to support direct subsidies for affordable housing for very low-income households and community development.

The government corporation will engage in only those risk transfer structures that are conducive to cross-subsidization. This is relatively straightforward in back-end transfers to capital markets and insurers, as the corporation will be able to structure the deals so that private sources of capital bear the credit risk on pools sufficiently large to ensure the necessary cross-subsidization. Ensuring access is less straightforward with front-end risk transfers, such as lender recourse deals and deep-cover mortgage insurance, but it can be readily accomplished by requiring average pricing across a wide range of credit risks. Mortgage insurers competing to provide deep-cover MI, for example, could be required to charge premiums for insuring a representative pool of loans on a forward basis. The pool would be designed to ensure an appropriate amount of cross-subsidization. The MIs' Private Mortgage Insurance Eligibility Requirements capital standards could also be set sufficiently broadly across borrower credit characteristics to provide an economic incentive to cross-subsidize.[6] And given the government corporation's mandate to maintain broad borrower access to credit and broad secondary market access for small lenders, it would prohibit pricing differentiation by private insurers to the degree that it undermines either.

The current onetime 4.2-basis point affordability fee on GSE loan purchases will be increased to an annual 10-basis point market access fee on all outstanding loans, increasing that funding source from an estimated $200 million per annum currently to $4.5 billion. This much larger funding stream will fund the Housing Trust Fund and the Capital Magnet Fund, as well as a new Market Access Fund, which would be focused on increasing the number of families in a position to afford homeownership and ensuring that the mortgage market is inclusive enough to ensure that *all* who are in such a position can get access to a loan. The MAF will do this by funding and incentivizing efforts in both the primary and secondary markets to create a more inclusive mortgage market.

As it does today, the FHFA would use the affordability goals to size the market's potential and to monitor the government corporation's success at filling it. It would also ensure that the corporation is fulfilling its duty to serve the market in the broadest possible way through innovation, product development and targeted outreach, as it has done in the regulations implementing the GSE duty to serve. The FHFA would have many tools at its disposal to ensure that the government corporation meets the objectives of access and affordability, with broad discretion and authority over both. For example, it could require the corporation to use average pricing across large pools of loans to facilitate greater cross-subsidization, or change the capital requirements for those taking risk ahead of the corporation to ensure prices are set across broad credit categories.

Lastly, as we described in an earlier paper, the benefits of the capital structure and lower yield on its mortgage securities provide the government corporation the flexibility to maintain current mortgage rates through the business cycle and across the credit distribution. Thus, the introduction of more private capital and greater taxpayer protection in this system will not come at the expense of access and affordability.

Integrating the government-supported channels to improve access

In any insurance model, there is a tension between maximizing access to that insurance and managing its costs. Forcing consumers who present higher risk to bear the entirety of the higher cost of covering that risk will render the insurance unaffordable for many. So, to maximize access to their insurance, most insurers spread that higher cost across a broad pool of lower-risk consumers. As explained above, Fannie and Freddie do this to some degree today, thereby expanding the number of those who can afford to get a mortgage backed by the enterprises.

Cross-subsidization does have its limits, however, as passing on too much cost to lower-risk consumers will drive them to more affordable options elsewhere in the market. This natural ceiling on the amount of cross-subsidy that can be provided creates a limit on the level of risk an insurer can take on through higher-risk consumers without added costs. Fortunately, in the mortgage market borrowers that present too much risk to Fannie and Freddie often have another option: the directly subsidized government agencies of the FHA, the Department of Agriculture, and the VA, whose mission it is to serve many of these very borrowers.

Yet, for various historical and other reasons, policymakers rarely if ever consider this complete range of insurers—Fannie, Freddie, the FHA, the USDA and the VA—when assessing whether and how to ensure the broadest possible access to sustainable mortgage credit. This not only makes it difficult to adequately understand how well the system as a whole is performing, but, more importantly, makes it difficult to ensure that it *does* perform well, because the system is not being managed as a single, coherent system with a common set of objectives. By putting the key secondary market functions in a single government-owned corporation, our proposal offers a way to begin to overcome this structural challenge. In a second stage of reform, policymakers could create a single channel through which all government-supported lending would flow, including both that of the new government corporation and that of the mission-focused agencies of the FHA, the USDA and the VA.

Policymakers would create a single channel by allowing the government corporation to use FHA and other government insurance to back loans in its pools. Ginnie Mae would initially continue to back the bulk of the production of the mission-oriented agencies, but over time the activity of the agencies would transition to the government corporation. The move away from Ginnie securities to those of the corporation would occur much like the current shift to a single Fannie and Freddie security. The scale of the move would be comparable given the comparable amount of Freddie and Ginnie securities outstanding.

Integrating FHA, USDA and VA lending into the government corporation would allow the government corporation and the FHFA to step back and assess whether, as a whole, the market is providing adequate access to credit and, if not, how it can help across any of the various government-backed channels. This would provide for a more integrated approach to ensuring affordable access to the mortgage market than exists today, yielding more seamless access and lower mortgage rates for underserved communities. A creditworthy borrower who requires either no subsidy or a modest one would receive a loan that is credit-enhanced by the private market. Those who require a deeper subsidy would receive a loan credit-enhanced by one of the mission-focused agencies.

The current separation between the GSEs, which are subject to the housing goals, and the mission-focused agencies, which are not, complicates the policy challenge of providing appropriate mortgage access. With this next step of reform, all of the loans backed by the government corporation would be counted in both the market estimates of primary market production and the housing goals scoring for the corporation. Success at reaching those borrowers that the private market typically does not serve well would be measured by the *entire* set of government credit supports. FHA and other government insurance would be valued as part of this effort and would significantly amplify what can be accomplished through the maximization of cross-subsidies in the government model.

This should also increase competition for credit enhancement and create more choices with better economics for borrowers. The government corporation would be agnostic from an economic perspective about whether credit enhancement is provided by private risk sharing partners or the FHA, the USDA or the VA, as long as they can meet the capital, liquidity and other standards promulgated by the corporation. It should also help unify underwriting and servicing practices across the government channels, assuring consistent credit analysis across loans, providing borrowers with more transparent loan terms, and helping to address any potential bias that exists in the primary lending market.

Of course, integrating the government-backed channels presents clear challenges. The current market for Ginnie Mae securities is large, liquid and international, so it is extremely important to transition these securities into the government corporation's channel carefully, much as the FHFA is doing today in unifying those of Fannie and Freddie. Equally important and even more complicated is overhauling the mission agencies so that they can be integrated into the unified system. To function well in that system they will need to be reformed to be much more sensitive than they are today to market demands and risks. This likely means giving them more independence from many of the bureaucratic constraints that have long made them much less efficient and effective than they could be. Determining precisely how to do this raises many challenging questions, but they are questions that need to be answered even absent broader reform.

Conclusion

Ensuring broad and stable access to mortgage credit must be a central tenet of any proposal to reform the housing finance system. In our proposal, we take all of the pieces of the access and affordability regime in place now and put them together into a more unified system that is much better positioned to deliver on the promise of a fair and open mortgage market for all communities. We impose the housing goals and duty to serve obligations that we have today onto a government corporation that has even stronger policy levers to meet them. And we open the way to integrating the FHA, the USDA and the VA into a single system that is more coherent, efficient and effective for both the market and the borrower. This results in a housing finance system that provides consistent access to affordable mortgage credit to *all* communities through all economic cycles.

Endnotes

1 Federal Housing Finance Agency, notice of proposed rulemaking.
2 The fee was suspended when the GSEs were taken into conservatorship in 2008, and collected for the first time in 2016.
3 This is based on data from the Federal Reserve Board's Financial Accounts.
4 For example, in an illustrative example provided by the Mortgage Bankers Association, the all-in cost on a standard 97 loan to value 740 credit score loan would be 4.59%, compared with 6.04% for a 97 LTV with a 660 credit score, when the base guarantee fee, LLPAs, and MI premiums are included. Both Fannie and Freddie have limited special low down payment products that have lower coupons.
5 Changes to HMDA reporting in Dodd-Frank and work at the FHFA suggest that these market estimates can become more accurate than in the past, which would make the goals themselves more useful.
6 PMIERS is scheduled to be updated in 2017. This update could address any FHFA and GSE concerns with their counterparty risk to the MIs.

About the Authors

Jim Parrott is a senior fellow at the Urban Institute and owner of Falling Creek Advisors, which provides financial institutions with strategic advice on housing finance issues. Jim spent several years in the White House as a senior advisor on the National Economic Council, where he led the team of advisors charged with counseling the cabinet and president on housing issues. He was on point for developing the administration's major housing policy positions; articulating and defending those positions with Congress, the press and public; and counseling White House leadership on related communications and legislative strategy. Prior to his time with the NEC, Jim was counsel to Secretary Shaun Donovan at the Department of Housing and Urban Development. He has a JD from Columbia University School of Law, an MA from the University of Washington, and a BA from the University of North Carolina. Jim also served with the Peace Corps in Sri Lanka from 1994-1996.

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Gene Sperling was National Economic Advisor and Director of the National Economic Council for President Obama (2011-2014) and President Clinton (1996-2001). He was also Counselor to Secretary of Treasury Tim Geithner (2009-2010), Deputy National Economic Advisor (1993-1996) and Economic Advisor to Governor Mario Cuomo (1990-1992). He currently heads Sperling Economic Strategies, which provides advice to several companies, start-ups as well as foundations and philanthropies. Sperling is also the founder, former Executive Director (2002-2008) and Advisory Board Chair of the Center of Universal Education (Brookings Institution), which focuses on policies for education in low-income nations, with a special focus on girls education and children in conflict, and a former Senior Fellow at Center for American Progress and Council on Foreign Relations. Sperling was a consultant and part-time writer for the television show West Wing (Season 3-6) and the author of two books: The Pro-Growth Progressive (2006), and What Works in Girls Education: Evidence on the World's Best Investment (2004, 2015).

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