Statement of
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before the

Subcommittee on Housing and Insurance,
Committee on Financial Services,
United States House of Representatives

SUSTAINABLE HOUSING FINANCE: PRIVATE-SECTOR PERSPECTIVES ON HOUSING FINANCE REFORM, PART III

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***The views expressed are her own and should not be attributed to the Urban Institute, its trustees or its funders.**

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Mr. Chairman, Ranking Member Cleaver, and members of the subcommittee, thank you very much for the opportunity to testify today. My name is Alanna McCargo, and I am the codirector of the Housing Finance Policy Center (HFPC) at the nonprofit Urban Institute, the United States' leading research organization dedicated to developing evidence-based insights that improve people's lives and strengthen communities. The Housing Finance Policy Center provides timely, impartial data and analysis on how the housing finance system affects households, communities, and the broader economy. I have seen how the housing market operates from many vantage points, having spent more than 20 years of my career in financial services and housing finance policy. A decade of that time, from 2002 to 2012, I was at Fannie Mae including when Fannie was first taken into conservatorship and the subsequent housing market boom, bust, and recovery.

The views I express today are my own and should not be attributed to the Urban Institute, its trustees, or its funders.

Almost 50 years ago, in 1968, President Lyndon B. Johnson founded the Urban Institute to help solve the problems that weighed heavily on the hearts and minds of America by bringing sound research, evidence, and perspective that could inform effective policymaking. At the time, the problem was the American city and its people, and the declaration of war on poverty. Johnson passed the Fair Housing Act that same year, making housing discrimination against blacks and other protected groups for renting and owning homes illegal. I mention this history as a reflection for this Congress as you consider the future, as we are facing some of the very same inequities that are plaguing not only our cities, but our suburbs and rural areas all over this country 50 years later.

In the 1992 Housing and Community Development Act, Congress called for a housing finance system that is **affordable, accessible, and stable**.[1] Such a system would provide access to sustainable financing options for all creditworthy borrowers from all communities in all economic conditions and business cycles. Unfortunately, we are far short of this goal even today. The country's housing finance system suffers from three interrelated and significant problems: **a growing wealth gap; a shortage of housing, particularly affordable housing;** and **a lack of access to mortgage financing for those who want to buy a home.**

The current housing finance system has remained in a state of uncertainty for far too long, and the work of this Congress to return confidence, trust, and stability to the system will go a long way in restoring housing credit markets, stabilizing regulation, and reestablishing a well-functioning housing finance system in the United States. One clear lesson from recent years is that the country needs one solid, interconnected housing finance system that serves all people and protects taxpayers.

Congress and the administration can address these critical issues by providing broad access to sustainable long-term, fixed-rate lending for all creditworthy borrowers who need it while protecting taxpayers, ensuring competitive private capital participation, and maintaining an explicit government guarantee. Housing finance reform must include improving the Federal Housing Administration (FHA), as FHA is essential to providing broad access to credit, especially for lower-income and first-time

[1] Pub. L. 102–550.

homebuyers. Finally, Congress should also focus on other issues in our housing system, including the lack of affordable housing for owners and renters that is significantly delaying homeownership.

Three Important Facts about Our Current System

It's been just over 10 years since the start of the US residential foreclosure crisis, during which more than 7.5 million families lost their homes and millions more lost equity and wealth.[2] A combination of poor underwriting standards (for both purchase and refinance lending), predatory lending practices, proliferation of exotic and risky mortgage products, lax regulatory oversight, and the disappearance of the private-label securities market led to the collapse of the housing market and one of the worst financial crises our country has seen.[3] The housing crisis left taxpayers in this country at great risk and exposed critical deficiencies in how the primary and secondary markets were functioning. Housing finance stakeholders have learned a tremendous amount by reflecting on the years before the Great Recession, and we must be sure to incorporate the facts and lessons learned in any future housing finance reform proposal.

Because of these systemic failures, three serious issues have emerged or worsened since the crisis.

1. *The wealth gap has widened, and it is hurting lower-income and middle-class families*

The wealth gap in our country is growing, both between races/ethnicities and between owner and renters. Research shows that homeownership creates wealth through equity and asset building, and continues to be the primary way many middle-class and working-class families become upwardly mobile and achieve economic stability. This is especially true for families of color, who hold most of their net worth in their home equity, and who are lagging in other savings and investments, creating financial insecurity. While some debate whether homeownership has caused the gap between owners and renters, I believe that people are better off when they own property and build assets. Homeownership is one of the best ways to achieve this.

In 2016, the net wealth of white families was seven times greater than the net wealth of black families.[4] White family wealth also was five times greater than Hispanic family wealth.[5] This gap is exacerbated by a dramatic difference in homeownership. For many families, their primary residence is an important component of their balance sheet. Close to three-quarters of white households are homeowners, compared with just under half of black and Hispanic households.[6] White households also

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[2] Molly Boesel, "Foreclosure Report Highlights: 10-Year Retrospect of the US Residential Foreclosure Crisis," Insights Blog, CoreLogic, March 14, 2017, http://www.corelogic.com/blog/authors/molly-boesel/2017/03/foreclosure-report-highlights-10-year-retrospect-of-the-us-residential-foreclosure-crisis.aspx#.Wf1KHGTythE.

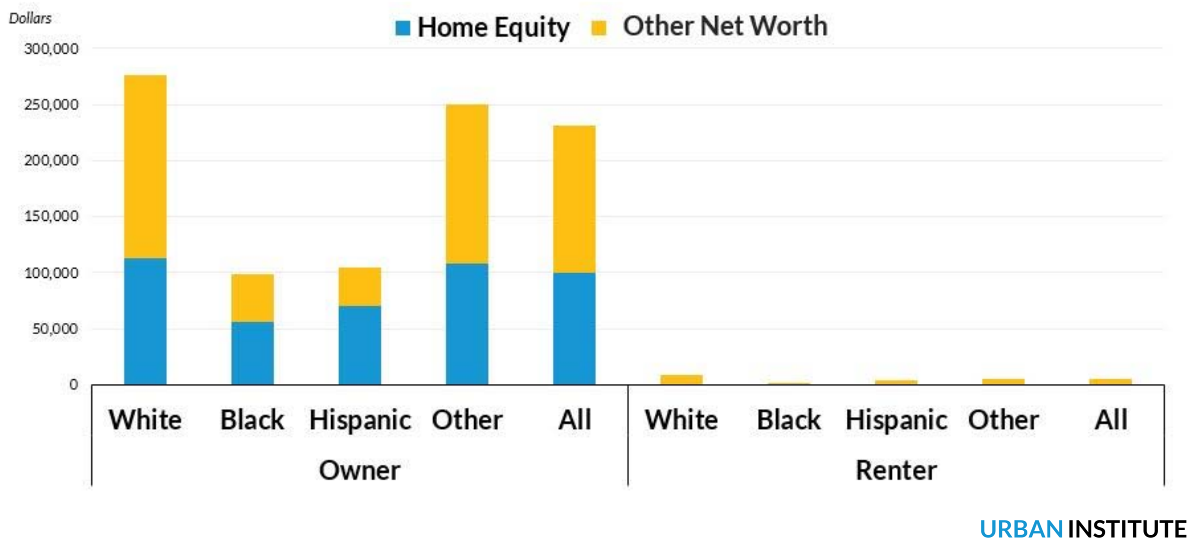
[3] "The Financial Crisis Inquiry Report," The Financial Crisis Inquiry Commission, January 2011, http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

[4] Signe-Mary McKernan, Caroline Ratcliffe, C. Eugene Steuerle, Caleb Quakenbush, and Emma Kalish, "Nine Charts about Wealth Inequality in America (Updated)," Urban Institute, October 5, 2017, http://apps.urban.org/features/wealth-inequality-charts/.

[5] Ibid.

[6] Lisa J. Dettling, Joanne W. Hsu, Lindsay Jacobs, Kevin B. Moore and Jeffrey P. Thompson, "Recent Trends in Wealth-Holding by Race and Ethnicity: Evidence from the Survey of Consumer Finances," *FEDS Notes*, September

hold considerably more equity in their homes. Mean net housing wealth (the value of the home, less any debts on it) is $215,800 among white homeowners but only $94,400 among black homeowners and $129,800 among Hispanic homeowners.[7] White homeowners hold more home equity, yet housing accounts for only 32 percent of their total assets, compared with 37 to 39 percent for black and Hispanic homeowners.[8] The recent Survey of Consumer Finances shows the dramatic difference in wealth by owner and renter, and the vulnerabilities and inequity across race and ethnicity.



Sources: 2016 Federal Reserve Survey of Consumer Finances and Urban Institute calculations.

Notably, racial and economic inequality magnifies the critical issue that a growing wealth gap creates. The housing finance system is currently serving creditworthy families of color particularly poorly, with the homeownership rate among Hispanics at 45 percent and among African Americans at 43 percent, compared with 73 percent for whites—numbers particularly disconcerting given that families of color are gradually becoming the majority of new households formed in this country. Knowing how important homeownership and equity building are for family wealth, there is growing concern about how far the recent housing crisis and current instability of our housing finance system has set back families of color.

According to research conducted by my colleagues at Urban Institute, many of the gains minorities made in homeownership at the end of the 20th century have been lost. For blacks, the homeownership rate rose modestly after the Fair Housing Act was passed in 1968, but the rate is now back to levels we have not seen since the 1960s.[9] The projections suggest that absent major changes in housing policy,

27, 2017, https://www.federalreserve.gov/econres/notes/feds-notes/recent-trends-in-wealth-holding-by-race-and-ethnicity-evidence-from-the-survey-of-consumer-finances-20170927.htm.

[7] Ibid.

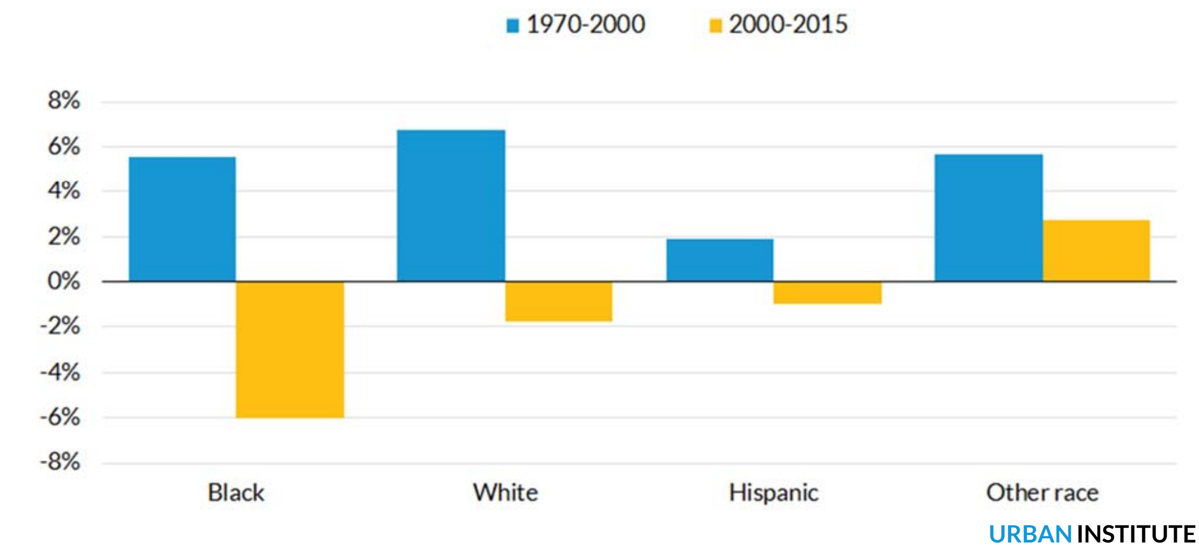
[8] Ibid.

[9] Laurie Goodman, Jun Zhu, and Rolf Pendall, "Are Gains in Black Homeownership History?" *Urban Wire*, Urban Institute, February 15, 2017, https://www.urban.org/urban-wire/are-gains-black-homeownership-history.

the black homeownership rate will continue to decline and have major consequences for the financial security and generational wealth prospects for the entire race.

All Gains in Black Homeownership since the Fair Housing Act Have Been Erased since 2000

Percentage-point change in homeownership by homeowner's race/ethnicity



2. *Affordable housing supply is inadequate for growing number of diverse household needs*

Over the next decade, an additional 13–16 million new households will be formed, the US population will get older and have different housing needs, and the housing needs of people of color will increase rapidly. This poses a significant problem: the national housing inventory is already deficient, continues to age, and is not being built to keep pace with the emerging demand for affordability. In 2015, while 1 million new households were created, only 620,000 new housing units were completed, creating a shortage of 430,000 units.[10] This leads to increases in home prices and rents, a trend that will continue for the foreseeable future, absent significant policy changes.

Between 2010 and 2030, household growth will be reasonably robust; and, notably, the overwhelming majority of that growth will be nonwhite: 77 percent between 2010 and 2020, and 88 percent between 2020 and 2030.[11] By 2030, Hispanic families will account for 56 percent of new homeowners.[12] Households headed by someone age 65 or older will also expand dramatically, by nearly 20 million between 2010 and 2030.[13]

[10] Laurie Goodman and Rolf Pendall, "Housing Supply Falls Short of Demand by 430,000 Units," *Urban Wire*, Urban Institute, June 21, 2016, https://www.urban.org/urban-wire/housing-supply-falls-short-demand-430000-units.

[11] Laurie Goodman, Rolf Pendall, and Jun Zhu, *Headship and Homeownership: What Does the Future Hold?* (Washington, DC: Urban Institute, 2015).

[12] Goodman, Pendall, and Zhu, *Headship and Homeownership*.

[13] Goodman, Pendall, and Zhu, *Headship and Homeownership*.

Housing finance reform is happening amid a serious challenge for the housing market: a critical shortage of housing, particularly affordable housing. This affordability shortage has many causes, well beyond housing finance. But housing finance needs to do its part to mitigate the problem, and certainly not to exacerbate it. The housing goals and duty to serve mandate for the government-sponsored enterprises (GSEs) direct housing finance supported by the government to be part of the supply solution. As noted in a recent publication by my Urban Institute colleagues:

> Our existing housing system has a set of rules, regulations, and incentives that fail to motivate market actors to produce and preserve affordable, inclusive, and sustainable housing and communities in sufficient volume to meet current and future demand. The risks and costs associated with developing or preserving housing, especially housing affordable to low- and moderate-income households, can negatively affect the risk-return calculus and reduce private investors' interest in these deals.[14]

There are many causes for this, including the pent-up demand created by the lack of household formation during the recession, the lack of construction during the recession, the millions of families who lost their homes during the recession, and failure to preserve the housing we have. The problem is particularly acute for affordable housing, especially rental housing.

As Congress considers tax reform, I want to note that tax policy can play a key role in affordable housing with tax credits and incentives for more affordable housing production. The primary source of development funding is the Low-Income Housing Tax Credit (LIHTC), a federal tax credit administered by state agencies. I encourage the Committee to take a serious look at how tax reforms can continue to support and fuel the necessary tax credits needed for affordable sustainable housing development

3. *Consumers have insufficient access to credit, hampering homeownership opportunity*

As a result of the default and foreclosure crisis in 2008, and the instability and uncertainty in parts of the system (including the GSEs and the FHA), access to credit is too tight. Several factors contributing to the tight credit box include the high costs of servicing delinquent loans, along with lender concerns of litigation and other enforcement risks associated with making imperfect FHA loans.[15]

According to Urban research, roughly **6.3 million** mortgage loans are completely missing from the market since 2009 for borrowers who are creditworthy based on reasonable lending standards.[16] These tight standards mean that fewer families will become homeowners, depriving them of a critical wealth-

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[14] Maya Brennan, Pam Blumenthal, Laurie Goodman, Ellen Seidman, and Brady Meixell, *Housing as an Asset Class* (Washington, DC: Urban Institute, 2017), p. 1.

[15] Urban researchers also note that many credit box constraints disproportionately hurt purchase money mortgages, when problems during the housing crisis were largely driven by cash-out refinances. For more discussion, see Laurie Goodman, "Using Homes as ATMs, Not Homebuying Fervor, Was More to Blame for the Housing Crisis," *Urban Wire*, Urban Institute, May 11, 2017, https://www.urban.org/urban-wire/using-homes-atms-not-homebuying-fervor-was-more-blame-housing-crisis.

[16] Laurie Goodman, Jun Zhu, and Bing Bai, "Overly Tight Credit Killed 1.1 Million Mortgages in 2015," *Urban Wire*, Urban Institute, November 21, 2016, https://www.urban.org/urban-wire/overly-tight-credit-killed-11-million-mortgages-2015.

building opportunity. Limiting the pool of potential borrowers is also slowing the housing market recovery.

In 2014 HFPC researchers released the Housing Credit Availability Index (HCAI), which has since illuminated a serious problem in the housing finance system that must be addressed with reforms. The HCAI, which measures how much product and borrower risk lenders are taking in the market, clearly demonstrates that risky products and lending practices, not risky borrowers, caused the housing crisis. There is virtually no product risk in the system today, given the regulatory reforms enacted under Dodd-Frank and the lending rules of the Consumer Financial Protection Bureau, such as the qualified mortgage rule or QM. These important consumer protections have eliminated risky and unsafe products. In fact, HFPC research finds that the rule has had little impact on the availability of mortgage credit, largely because the market eliminated these products before the rule took effect. Borrowers are just as creditworthy today as they were before the foreclosure crisis, yet few financing options are available to those who have anything less than perfect credit.

The HCAI calculates the share of owner-occupied purchase loans/home purchase loans that are likely to default—that is, go unpaid for more than 90 days past their due date. A lower HCAI indicates that lenders are unwilling to tolerate defaults and are imposing tighter lending standards, making it harder to get a loan. A higher HCAI indicates that lenders are willing to tolerate defaults and are taking more risks, making it easier to get a loan. The latest data show that credit availability decreased slightly in the second quarter of 2017, down from the first quarter of the year, which was the highest level since 2016.[17] This decline was driven largely by a shift in market composition from the first quarter of 2017 to the second quarter of 2017. During that period, mortgage loans backed by the government (e.g., FHA and Veterans Administration loans) lost market share to the conventional loans held by banks and other lenders, where lending standards are tighter. Lenders are taking less than half the credit risk they were taking in 2001—a period of reasonable credit standards—and less than one-third the credit risk they were taking in 2005–06, when credit standards were too loose.[18]

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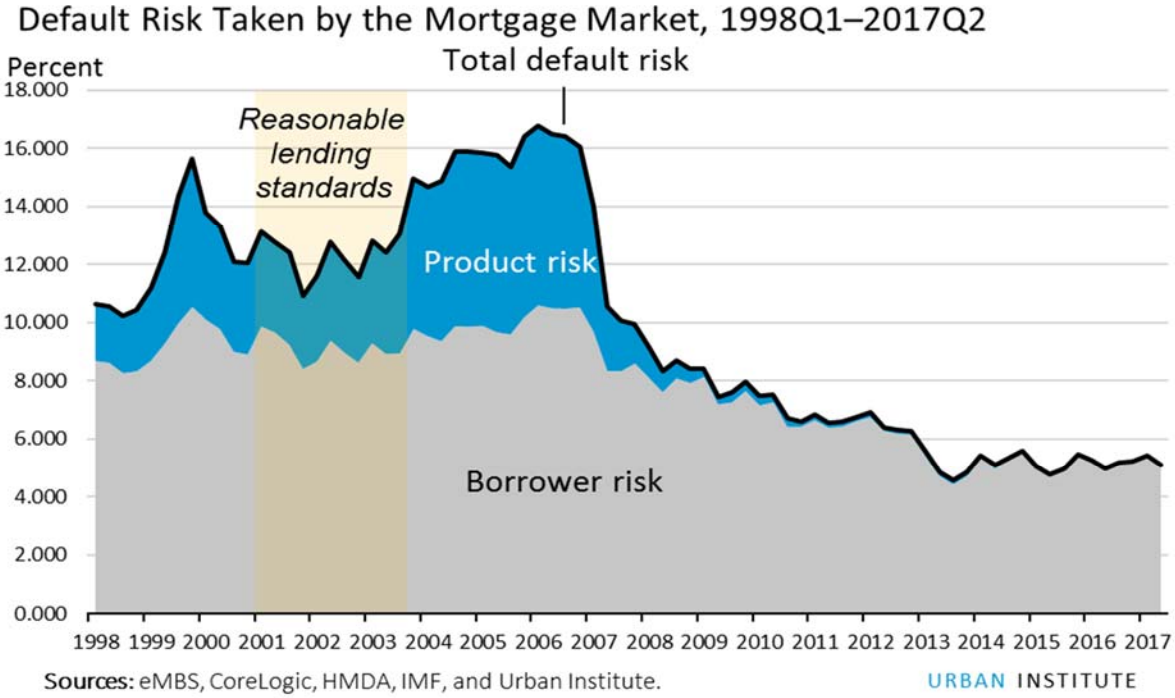
[17] Housing Finance Policy Center, *Housing Finance at a Glance: A Monthly Chartbook* (Washington, DC: Urban Institute, October 2017).

[18] Laurie Goodman and Alanna McCargo, "Increasing Access to Mortgages for Minorities," *Urban Wire*, Urban Institute, December 1, 2016, https://www.urban.org/urban-wire/increasing-access-mortgages-minorities.



The data also show that access to credit has become extremely tight, especially for borrowers with lower credit scores, for both GSE and FHA channels. The mean and median credit scores on new purchase loans have increased 21 and 20 basis points over the past 10 years, respectively. As of July 2017, a borrower needed a credit score of more than 649 to qualify for a mortgage. Before the housing crisis, a borrower could qualify for a mortgage with a credit score in the low 600s. For context, here is the latest borrower composition for first-time and repeat homebuyers in both GSE and FHA origination channels. Note the average loan amounts, which are far higher than they have been, and the average credit scores, which are well over 670—even for FHA.

Comparison of First-Time and Repeat Homebuyers, GSE and FHA Originations

	GSEs		FHA		GSEs and FHA	
Characteristics	First-time	Repeat	First-time	Repeat	First-time	Repeat
Loan Amount ($)	227,341	253,197	201,672	224,438	215,898	248,166
Credit Score	739.9	755.6	676.6	684.3	711.7	743.1
LTV (%)	87.0	78.8	95.5	94.1	90.8	81.5
DTI (%)	34.3	34.8	42.2	43.3	37.8	36.3
Loan Rate (%)	4.19	4.05	4.2	4.1	4.19	4.06

Sources: eMBS and Urban Institute.
Note: Based on owner-occupied purchase mortgages originated in July 2017.

Certain thresholds in underwriting have a detrimental impact on creditworthy borrowers, especially minorities. Changes in debt-to-income (DTI) ratios are an example. Studies have shown that DTI ratios are less powerful predictors of default than loan-to-value (LTV) ratios or FICO scores.[19] Recently, Fannie Mae announced it would consider mortgage applications with a DTI ratio of up to 50 percent, up from 45 percent. HFPC researchers estimate that this change could result in 95,000 new mortgage loans approved annually.[20] Research also estimates that the probability of default on a mortgage with a DTI ratio between 45 and 50 percent is 31 percent greater than a mortgage with similar characteristics and a DTI of 35 percent. Assuming default costs are approximately 5 basis points a year, the extra cost on loans with a 50 percent DTI would be approximately 1.5 basis points a year. In other words, the increase to 50 percent DTI was an important step to opening the credit box without appreciably increasing the cost to Fannie Mae. If Fannie Mae were to increase the limit further to 55 percent DTI, HFPC researchers estimate that would result in about 120,000 new mortgages per year. Underwriting thresholds and caps, such as DTI ratios, restrain affordable access to credit for creditworthy borrowers.

Housing Finance Reform

The United States needs a housing finance system that serves the people and communities needing investment and that provides access to sustainable and affordable credit for all creditworthy borrowers across all ethnicities and socioeconomic levels. Toward that end, housing finance reform should **(1) ensure that consumers have access to sustainable, affordable mortgages; (2) protect taxpayers by having private capital share the risk; and (3) reform the FHA so it can fulfill its mission and be a healthy part of a unified system**.

The core takeaway is that we have **one** housing market and should have one housing finance system that safely supports all communities and all demographics, and that is available at all times.

As of the second quarter of 2017, the housing market had reached $25.1 trillion in value, surpassing the pre-crisis peak of $23.9 trillion in 2006, with total debt and mortgages stable at $10.4 trillion and household equity reaching a new high of $23.9 trillion. Agency mortgage-backed securities make up 59.6 percent of the total mortgage market today, 30.1 percent is unsecuritized GSE first liens and portfolio loans, and 4.7 percent is private-label securities. The majority of new mortgages originated in the US are backed by a government guarantee or insurance program. Most of the rest are issued by private banks, credit unions, and other entities which make loans and hold them in their portfolio.

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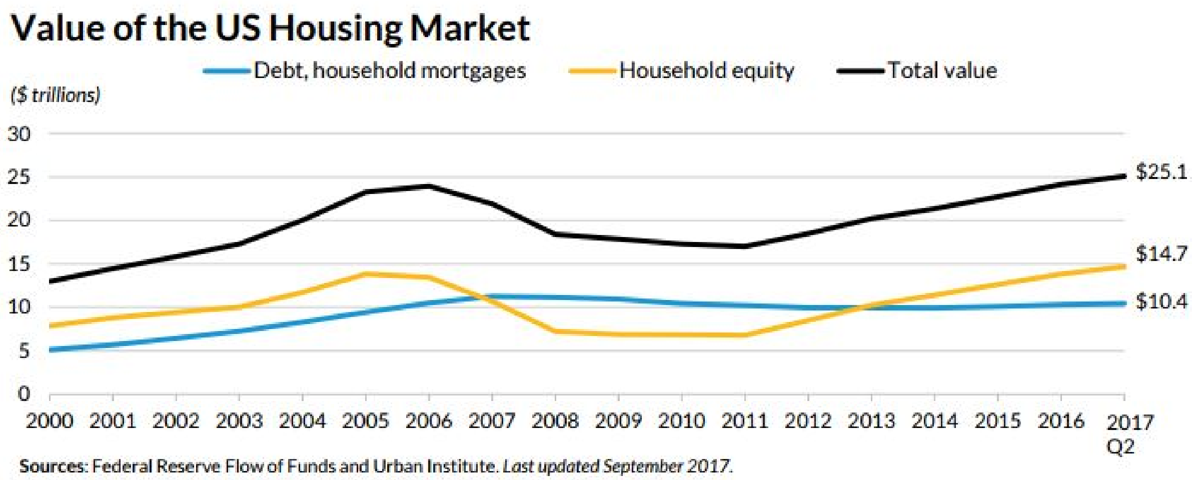
[19] For example, Richard Green, "The Trouble with DTI as an Underwriting Variable--and as an Overlay," *Richard's Real Estate and Urban Economics Blog*, December 7, 2016, http://real-estate-and-urban.blogspot.com/2016/12/the-trouble-with-dti-as-underwriting.html.

[20] Edward Golding, Laurie Goodman and Jun Zhu, "Fannie Mae Raises the DTI Limit" (Washington, DC: Urban Institute, 2017). As detailed in that analysis, an estimated 16.5 percent, or 16,000, of the 95,000 new mortgages will be to black or Latino families.



Sources: Federal Reserve Flow of Funds and Urban Institute. *Last updated September 2017.*

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The private-label securities market, where the risky players and products that lead to the housing boom and bust arose, is no longer originating mortgages to any significant degree. While having a safely-operating private market adds liquidity and competition, we cannot allow unregulated chaos to ensue again. Housing finance reform legislation must explicitly include this critical area, and regulators must ensure that new private-market entrants taking on credit risk are adequately capitalized, stress tested, and able to sustain market shocks.

When considering reforms to the housing finance system, I encourage building on the aspects of the system that are working, emphasize correcting what went wrong during the crisis, and be careful not to exacerbate existing problems. There have been a number of reform proposals introduced, and a great number of ideas put forth about how to ensure a stable system for the future.

Last year, the Housing Finance Policy Center hosted the Housing Finance Reform Incubator, a series of essays from a cross section of stakeholders and experts on what a post-conservatorship housing finance system should look like and ideas about how to move the system forward. I encourage Members of Congress to review these proposals, several of which have emerged in plans (such as the promising road proposal, which incorporates ideas from Mark Zandi and my colleague Jim Parrott and others.) I am not an architect of nor do I endorse any particular housing reform plan. My goal is to ensure that whatever plan Congress moves forward on creates a system that ensures equity of opportunity at reasonable costs for consumers. I also believe the major plans that this committee has been reviewing, including the MBA plan and the Milken plan, have more in common than not; perhaps, with compromise, such plans can be the starting point for the future.

Access to Sustainable, Affordable Mortgages

American homeowners need access to long-term, self-amortizing, level-payment, prepayable mortgages at reasonable prices. Long-term fixed-rate products have been helpful in the past because they allow access to credit repaid over a longer period that makes the monthly payment affordable. Fixed-rate mortgage products help remove risk of interest rate volatility from consumers' list of things to worry about, and they allow for affordability of payment. Fixed-rate loans over time have also shown better default performance and provide certainty of cost for homeowners. The standard fixed-rate long-term mortgage product, most notably the 30-year fixed-rate mortgage, must be preserved. Not all homeowners will choose a 30-year fixed-rate mortgage; a shorter-term self-amortizing mortgage with higher payments may be more appropriate for consumers who can afford it. However, the opportunity for long-term stable housing payments is an essential element of the stability of the market, and it gives homeowners the ability to build equity over time.

The downside to 30-year fixed-rate mortgages for lenders it that they carry significant credit and interest rate risk for long durations. Thus, ensuring the availability of these mortgages requires backing by the federal government, and mitigation of risk through credit risk sharing with mortgage insurers and others. By removing the credit risk from mortgage-backed securities through the government guarantee, more investors will invest in long-term mortgages, and that investment will lower the cost of mortgages and provide widespread access to long-term, fixed-rate lending. Without an explicit government guarantee, the costs of mortgages will increase and the availability of long-term fixed-rate mortgage loans will be severely limited, hurting access to mortgages for most Americans.

A liquid mortgage market is needed to provide sustainable, affordable mortgages. Despite the flaws in their design, the GSEs have facilitated a highly liquid housing finance market, which relies on the standardization of products, documentation, and processes. Liquidity increases the amount of capital available for mortgage loans and decreases the price of those loans. It also reduces the geographic differences in the availability and price of mortgages. The ability to sell mortgages forward into the To Be Announced market also enables borrowers to lock in interest in rates, and it helps provide certainty for all parties involved.

A liquid market also should facilitate some cross-subsidization to ensure access to reasonably priced mortgage credit for lower income borrowers. Pure risk-based pricing can have destabilizing effects on regional and national housing markets, as well as on the lives of individual households. Some level of cross-subsidization permits more uniform pricing across the housing cycle and in different markets. The reforms to the US housing finance system should accommodate this as it will improve access to credit. *A note on risk-based pricing*: the current model has several pricing layers built in that are ultimately impacting cost to homebuyers. The path forward cannot put the burden of systemic risk into consumers' mortgage payments. As the HCAI shows (see pages 6–7), very little borrower risk is being taken in the market today, and most of the defaults of the past came from risky products that are no longer available. Ultimately, the reformed system must carefully balance subsidy and risk sharing.

Other improvements to increase access to sustainable, affordable mortgages include the following:

- <u>Improving credit scoring systems and including additional credit indicators:</u> Outdated credit scoring systems keep some creditworthy borrowers from having mortgage applications considered or even from applying. Millions of renters in America are creditworthy and would qualify for mortgages, but they are unable to become first-time homebuyers based on lack of payment history information. Most landlords do not report rents to major credit bureaus, nor do utility companies, cell phone companies, and others. The tools and methods used to extend credit must be brought up to modern times. Americans are being poorly served by the traditional credit bureau reporting and scoring. Broader payment habits need to be brought into view to assess creditworthiness of consumers, and credit should not be restricted because borrowers are unable to report their pay history. Several bills from this Congress have tried to address this and need consideration. For example, the Credit Score Competition Act of 2017 (H.R. 898/S. 1685), introduced by Representatives Royce and Sewell and Senators Scott and Warner, would require the GSEs to consider alternative credit scoring in order to promote more lending to creditworthy consumers.[21] The Federal Housing Finance Agency is continuing to explore the GSEs' ability to use alternative credit scores, although this issue is complicated.[22] Such activities related to the underwriting of mortgage credit should be seriously considered in a reform package.

- <u>Low–down payment lending options:</u> Access to sustainable mortgage credit is often only possible with options for lower–down payment loans. In addition, borrower's need to be able to access down payment assistance, beyond government guaranteed loans. HFPC is studying the availability of down payment assistance for conventional as well as government-guaranteed loans across the nation, and how to better match those needing such assistance with available funds, education, and access. There are down payment assistance programs, particularly through most state housing finance agencies, that are healthy and viable. Few data have been collected about historical use and types of programs, but looking at borrower loan data, it appears consumers are not taking advantage of the programs, essentially leaving money on the table. This is because these programs are not being aggressively sought out, referred, and communicated to potential homebuyers. There is a need to increase the visibility of these programs, and to ensure borrowers in every mortgage transaction know about what assistance they could be getting. Not all down payment assistance programs are created equal, and they come in different forms. Homebuyers need to be educated and made aware that funds are available. It could be the difference maker for a first-time homebuyer in a higher-cost city, for example, who really needs the assistance to bring their payment down even more. The GSEs could play a bigger role in first-time homebuyer access to credit as they work to make low–down payment lending programs more widely accessible.
- <u>Modernize underwriting standards and models:</u> Underwriting models should be improved to recognize changes in households and job employment trends. The GSEs are exploring some ideas in this area, such as considering income of nonborrower household members. Similar initiatives need to be undertaken recognizing income variability, and recognizing that freelance, part-time, and self-employment work are increasingly important sources of incomes for individuals and families. Removal of certain thresholds and caps in underwriting standards would help address some of these issues and would improve accessibility to sustainable mortgages for creditworthy people (see page 8). Reevaluating the right levels for debt to income, opening credit scoring alternatives, including different forms of credit history,

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[21] In March 2017, Urban Institute held a data event, "Can New and Alternative Credit-Scoring Tools Mean Greater Access to Credit?" Information about the event can be found here: https://www.urban.org/events/can-new-and-alternative-credit-scoring-tools-mean-greater-access-credit.

[22] For a discussion of that issue, see Prepared Remarks of Melvin L. Watt, Director of FHFA, at Mortgage Bankers Association Annual Convention and Expo 2017, October 23, 2017, https://www.fhfa.gov/Media/PublicAffairs/Pages/Prepared-Remarks-of-Melvin-L-Watt-Director-of-FHFA-at-Mortgage-Bankers-Association-Annual-Convention-and-Expo-2017.aspx.

determining what the right level of savings and assets needs to be. These are all ways in which underwriting can be modernized to meet the needs of current and future consumers.

- Encourage well-funded, high-quality homeownership counseling: Homebuyer counseling, financial coaching, and literacy programs also have an important place in ensuring access to sustainable mortgage credit. Such programs help to ensure that borrowers understand the mortgage loan process and fully appreciate the relationship between homeownership and their finances. This is critical in every stage of homeownership—pre-purchase and post-purchase, as well as during financial and retirement planning. The Urban Institute has researched the impact of homeownership counseling.[23] In one study, researchers found that those who received pre-purchase counseling were more likely to be African American, Hispanic, low income, and female than the general population of home purchase borrowers.[24] Additionally, the research found that, holding all other factors equal, delinquency rates for borrowers that received pre-purchase counseling were 16 percent lower than for borrowers who did not receive such counseling.[25] Housing finance reform should encourage well-funded and high-quality financial counseling and coaching programs. The housing finance system of the future should ensure that there is a healthy network of informed housing counselors who can work on the ground in communities. In the years before the crisis, the GSEs played a significant role in counseling, with resources in states and in offices with a local reach. The GSEs have moved away from that in conservatorship. Part of reform should be rethinking how the GSEs can be most effective working in communities, partnering with local nonprofits, lenders, community development block grants, housing finance agencies, and others.
- Increasing the availability of other programs: There should be better access to quality mortgages for manufactured and modular housing. In addition, there is a dearth of small-dollar mortgage lending in lower-cost rural communities which stymies homeownership in these areas. The work that the FHFA has directed the GSEs to do under the duty-to-serve rule is a critical step in expanding affordable housing. We need to scale new ideas and bring more liquidity into the markets that need it most, to increase affordable housing and preservation.

Protecting Taxpayers

The housing finance system should have an appropriate sharing of risk among parties, with private capital taking first loss credit risk and operational risk before the federal government. My colleagues at the Urban Institute, Laurie Goodman and Jim Parrott, have written extensively on how much private capital should be required to guard against all but catastrophic risk.[26] No matter what the amount,

[23] See, for example, Kenneth M. Temkin, Neil S. Mayer, Charles A. Calhoun and Peter A. Tatian, "National Foreclosure Mitigation Counseling Program Evaluation: Final Report, Rounds 3 through 5" (Washington, DC: NeighborWorks America, 2014); and Brett Theodos and Ellen Seidman, "Housing Counseling Should Help with More Than Just Homebuying," *Urban Wire*, Urban Institute, August 1, 2016, https://www.urban.org/urban-wire/housing-counseling-should-help-more-just-homebuying.

[24] Wei Li, Bing Bai, Laurie Goodman and Jun Zhu, *NeighborWorks America's Homeownership Education and Counseling: Who Receives It and Is It Effective?* (Washington, DC: Urban Institute, 2016).

[25] Ibid.

[26] Laurie Goodman and Jun Zhu, "The GSE Reform Debate: How Much Capital Is Enough?" (Washington, DC: Urban Institute, 2013); and Jim Parrott, Lewis Ranieri, Gene Sperling, Mark M. Zandi and Barry Zigas, "A More Promising Road to GSE Reform: Governance and Capital" (Washington, DC: Urban Institute, 2016).

however, private capital needs to be in a first-loss position and needs to be stable. Placing layers of private capital, such as through credit enhancements, risk transfers, and a mortgage insurance fund, ahead of the taxpayer's risk will protect the taxpayer without undermining access to credit for creditworthy borrowers and access to the secondary market for lenders of all sizes. There must be a mechanism to ensure capital is available throughout the business cycle. The GSEs' current experiments with credit risk sharing are useful in understanding the availability and pricing of capital in the current housing market, but these models have not been tested in periods of stress.

FHA Reform

Most discussions about housing reform since 2008 have focused on the GSEs. This moment is an opportunity for us to think differently about the future, and take a broader view of housing reform that includes all the federal housing programs involved in supporting primary and secondary markets. One system that serves all people. A national housing policy. The FHA and other federal housing guarantee programs also should be a key part of housing finance reform. In today's disjointed structure, FHA and government programs are operating one way and GSEs are operating another, and an entire system of lenders, servicers, and investors must adapt to all the differences. It is highly inefficient, incredibly costly, more opaque than it could be, and unfair to consumers. The United States cannot rely on the private mortgage market to keep the housing finance system robust for first-time homebuyers or seniors who want to downsize or age in place. The FHA, as well as the USDA and the Department of Veterans Affairs, are particularly critical for the first-time homebuyers, minority borrowers, veterans and military families, and lower-income borrowers with limited wealth for a down payment.

As a threshold matter, the FHA needs increased appropriations to improve its 30-year old technology. The current underinvestment and inept systems are costly, and they cannot keep pace with the rapidly changing lending environment. Other FHA reforms can be dealt with administratively—and the FHA leadership has indicated they are starting to do just that. Today, I want to highlight two key aspects that would strengthen the agency.

First, remove the cloud of uncertainty created by the False Claims Act (FCA). Currently, if a lender submits a claim on an FHA-insured loan that is found to have an underwriting defect, the lender can be sued by the Department of Justice for submitting a "false claim" under the FCA. The FCA provides for a penalty of three times the size of the loan. The federal government's use of the FCA has led to well-capitalized lenders pulling back dramatically, constraining FHA lending and increasing taxpayers' exposure. Lenders need greater certainty that minor mistakes will not lead to suits under the FCA. To resolve these issues, the FHA should use its defect taxonomy to clarify that minor and nonmaterial mistakes in loan underwriting standards will not lead to suits under the FCA. Research suggests this will help bring well-capitalized lenders back to the FHA program, strengthening the FHA and increasing the number of loans it originates.[27]

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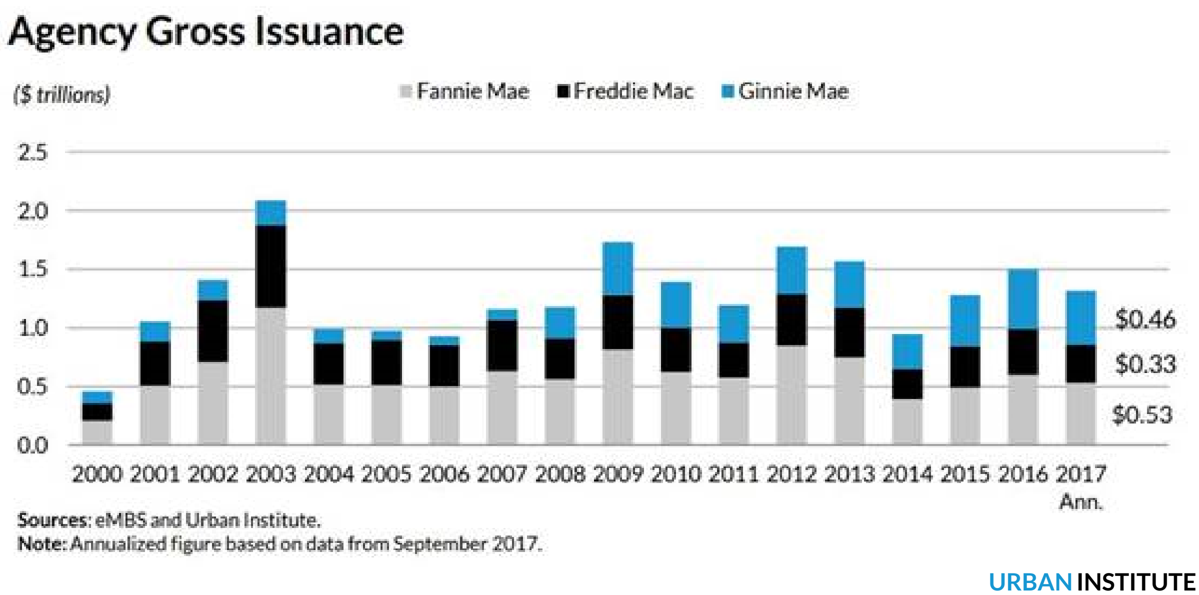
[27] For additional discussion on FHA and FCA, see Laurie Goodman, "Fannie and Freddie Eased Access to Credit. Now It's the FHA's Turn," *Urban Wire*, Urban Institute, March 24, 2017, https://www.urban.org/urban-wire/fannie-and-freddie-eased-access-credit-now-its-fhas-turn; and Laurie Goodman and Jim Parrott, "To the Next HUD Secretary: Two Steps to Strengthen the FHA," Urban Institute, December 6, 2016, https://www.urban.org/2016-analysis/next-hud-secretary-two-steps-strengthen-fha.

Second, fix the serious problems in the FHA's rules for servicing delinquent loans. The current servicing rules for FHA loans are inadequate, costly, and risky, and they are inhibiting access to credit for potential FHA borrowers as a result. FHA must improve its processes for servicing for delinquent loans, enhance its loss mitigation toolkit, and overhaul the property conveyance for foreclosed properties. FHA servicing rules are so burdensome that the costs of servicing FHA loans in default have become uneconomical, which, again, is pushing well-capitalized lenders from originating FHA products. The FHA needs to be more clear about the servicing of delinquent loans, make deadlines more realistic without requiring special waivers, and, ideally, conform to prevalent industry standards, such as GSE conveyance standards, where appropriate. For example, instead of requiring servicers to keep foreclosed properties in their name until the properties are conveyed to the FHA (a process that takes one year on average), servicers should be allowed to transfer the property to the FHA immediately upon foreclosure. Immediate transfers will reduce significant expenses for managing and maintaining foreclosed properties and result in properties being resold more quickly. Additionally, the FHA requires the servicer to put the home into conveyable condition before transferring it to the FHA. While the FHA provides a budget for repairs, the amount typically is well short of what is needed, leaving servicers to cover the difference. The FHA should raise these repair budgets to levels consistent with what is needed to repair badly damaged homes to the levels required for FHA conveyance. Finally, the FHA's timelines for loss mitigation are unnecessarily tight, leaving servicers unable to comply without harming the borrower or running afoul of other requirements, such as those imposed by the Consumer Financial Protection Bureau. To avoid penalties for delays, servicers must go through a cumbersome and expensive process for special dispensation on a loan by loan basis. The FHA should allow for more servicer discretion and an expanded timeline.[28]

To some extent, similar issues affect USDA and VA. The processes and systems of all these agencies should be robust, transparent, and, to the maximum extent possible, consistent. Again, much of this work will require improved systems and additional staff.

Standing behind the government insured housing finance channels is a woefully underresourced Ginnie Mae, which is now supporting more of the market than Freddie Mac. Ginnie Mae and its issuers play a critical role in providing capital and liquidity through the global capital markets. Ginnie Mae enables government lending is available so millions of households can purchase, refinance, and rent homes.

[28] For additional discussion on FHA servicing, see Goodman and Parrott, "To the Next HUD Secretary: Two Steps to Strengthen the FHA"; and Laurie Goodman, "FHA's Proposed Servicing Reforms Need More Thought" (Washington, DC: Urban Institute, 2015).



Other Issues for Congress to Consider

Beyond housing finance reform, other significant problems are contributing to the wealth gap, affordability crisis, and access to credit issues in our current system. As the committee works on Housing Finance reform, it may also want to consider the following issues.

Rental Housing

Almost 40 million Americans live in housing they cannot afford, and more than half of all renters are experiencing cost burdens due to high rents. My colleagues at the Urban institute have done extensive work to map America's rental housing crisis, and across the entire country we find communities without enough affordable rental housing. Almost everyone rents at the start of their household experience. Without affordable rentals, it is hard to save for a down payment and build a savings cushion to deal with emergencies.

Rental housing serves millions of households, who are disproportionately young, lower income, or minority. Additionally, an increasing percentage of the senior population will be renters. An estimated 22 million new households will form between 2010 and 2030, and 59 percent of these hew households will be renters.[29] Renters ages 55 and older accounted for over 40 percent of the growth in renters between 2004 and 2014, and the share of older Americans who own a home is projected to decrease

[29] Martha Galvez, Maya Brennan, Brady Meixell, and Rolf Pendall, *Housing as a Safety Net: Ensuring Housing Security for the Most Vulnerable* (Washington, DC: Urban Institute, 2017), p. 6.

from 80 percent to 74 percent by 2065.[30] These trends in rental housing have big implications for the growing affordable housing crisis.[31]

A mobile labor market requires a significant supply of rental housing at all price points. However, availability of affordable rental housing is limited. In 2016, rental vacancy rates nationally hit their lowest point in three decades at 6.9 percent.[32] In 2014, none of the nation's 100 largest counties had sufficient rental housing to meet the needs of the lowest-income families.[33] One-quarter of renters, or 11.1 million households, are spending at least half their income on rental housing. Workers earning the federal minimum wage would need to work 117 hours a week to earn enough income to afford the average rent for a two-bedroom apartment.[34]

The GSEs' multifamily lines of business weathered the recession well, and in fact provided critical support to financing of multifamily housing during that period. These businesses, with the guidance and direction provided by the housing goals and duty to serve rules, need to continue.

Given the demographics of the renter population, federally subsidized rental programs are essential to affordable rental housing. In 2014, more than half of units affordable to extremely low–income households were federally subsidized.[35] While these federal programs, whether through HUD, US Department of Agriculture, the Treasury's Capital Magnet Fund, or the LIHTC, have worked well, these programs need continued and increased support. As of 2016, about 5.2 million households lived in federally assisted housing, about three quarters of whom were extremely low income. But over 19 million households are eligible for assistance based on their income.[36]

Mortgage Servicing

Sustainable homeownership also requires changes in the mortgage servicing system. One critical thing we learned in the crisis is that we had an entire system that was ill prepared to take on the sheer volume of defaults that happened and be responsive to the needs of millions of consumers who found themselves unable to pay their mortgages. The lessons learned from the default crisis clearly point to a need for us to standardize mortgage servicing rules, loss mitigation processes, and foreclosure processes. Fixing mortgage servicing can have a direct impact on making access to credit available.[37] The costs involved in servicing a loan that goes delinquent are prohibitively high, and that fear of default risk is finding its way into the system. The Housing Finance Policy Center is hosting a multiyear

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[30] Ibid.

[31] Alanna McCargo, "These Four Trends in Rental Housing Have Big Implications for the Growing Affordable Housing Crisis," *Urban Wire*, Urban Institute, July 27, 2017, https://www.urban.org/urban-wire/these-four-trends-rental-housing-have-big-implications-growing-affordable-housing-crisis.

[32] Galvez et al., *Housing as a Safety Net*, p. 5.

[33] Ibid.

[34] Galvez et al., *Housing as a Safety Net*, p. 6.

[35] Galvez et al., *Housing as a Safety Net*, p. 7.

[36] Ibid.

[37] Alanna McCargo and Laurie Goodman, "Updating Mortgage Servicing Now Will Ensure the Mortgage Market Better Serves All Americans," *Urban Wire*, Urban Institute, February 2, 2017, https://www.urban.org/urban-wire/updating-mortgage-servicing-now-will-ensure-mortgage-market-better-serves-all-americans.

Mortgage Servicing Collaborative to identify improvements in mortgage servicing.[38] That effort includes stakeholders from all parts of the servicing system, including lenders, servicers, academics, civil rights and consumer groups. We are gathering evidence that will support policy recommendations for improvements that can be implemented by servicers, the GSEs, and the government agencies. I look forward to sharing this work with the Committee as it is published.

It will be critical that servicing be a key consideration for reforms, because mortgage servicing is the critical part of the housing system that must create stability through any crisis. Servicers are critical points in the system in times of crisis, whether it's an economic crisis or a natural disaster. When homeowners are in distress, the system they rely on and the options that they have need to be clear and responsive. There is a real opportunity to take the entire default servicing mechanism today, especially with the diversity of different servicing models and regulations in place, and standardize and eliminate risks, inefficiency and costs in the mortgage servicing system. Mortgage servicers have long term responsibility for the life of the loan, and ensuring payments to all parties to the loan. The long-term risk inherent in servicing requires a rethinking of the way it works, and a clear set of standards that work for borrowers across the board, regardless of who the investor or insurer of their loan is. I urge us to continue to keep mortgage servicing in the reform conversations, to ensure stability in times of distress. This is where the greatest vulnerabilities of the system be in the future, and where we can apply lessons from failures of the past.

A Note on Data Transparency and Standardization

The ability for the Urban Institute, or any policy and economic research organization, to understand the state of the mortgage market, how the system is servicing consumers and how programs are servicing the American public have been enhanced over the last four decades, as more data about the housing market has moved into the public domain. Data made available under the Home Mortgage Disclosure Act (HMDA) and the Community Reinvestment Act, and public data released by the GSEs and the FHA in recent years, including data on new credit risk transfer structures, offer a transparent comprehensive view of the housing market and communities across America. The Housing Finance Policy Center has developed important tools that offer evidence of lending progress across the country.[39] That is possible because of transparency of government and public datasets such as these.

Yet, greater transparency into the housing market is needed to support evidence-based policy making. Much of the critical data, especially portfolio performance data and servicing data remains in private hands and is available only at substantial cost, if at all. Additionally, the GSEs, the FHA, and the VA could make more data available to the public as part of their missions. Continuing to improve this data, and gain as much participation as possible in reporting would help Congress, regulators, market participants, and the public better understand the housing market and helps ensure evidence is

[38] For more information, see https://www.urban.org/policy-centers/housing-finance-policy-center/projects/mortgage-servicing-collaborative.

[39] For more information, see https://www.urban.org/policy-centers/housing-finance-policy-center/projects/home-mortgage-disclosure-act-data.

available to support changes in law, new regulations, and industry practices that facilitate a housing finance system that is affordable, accessible, and stable.

Conclusion

We are at a pivotal moment to make significant changes that can positively impact millions of Americans. There is significant evidence regarding the causes of the housing crisis and flaws in our system. We have an opportunity to help solve the three challenges that persist in our housing system—the wealth gap, the housing affordability challenge, and the lack of access to credit.

Our country has changed. The path ahead needs to begin, and during a time when housing is finding some solid footing, yet still fragile. Neither the status quo nor the way we used to do things is the answer. The demographic shifts in age, race, income, and education are all significant drivers of what our future housing system needs to be able to meet the diverse needs of the market.

This is a unique time because there is more agreement and in common on the path forward for housing reform than ever before. We cannot continue to let the GSEs linger in uncertainty. Clarity is key to moving forward with a healthy housing market. We must stabilize and bring more certainty to FHA and other government lending programs. It is critical that our future housing finance system provide sustainable access to affordable credit for all creditworthy borrowers across all demographics and communities, at all times.