



Making Sure the Senate's Access and Affordability Proposal Works

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One of the most consequential and possibly promising components of [the draft bill](#) being considered in the Senate Banking Committee is the way in which it reduces the cost of a mortgage for those who need it.¹ In the current system, Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs) deliver subsidy primarily through the level pricing of their guarantee fees, overcharging lower-risk borrowers in order to undercharge higher-risk borrowers. While providing support for homeownership through cross-subsidy makes good economic and social sense, there are a number of shortcomings to the way it is done in the current system.

First, it does not effectively target those who need the help. While Fannie Mae and Freddie Mac are both pushed to provide secondary market liquidity for the loans of low- and moderate-income (LMI) borrowers in order to comply with their affordable housing goals and duty to serve obligations, almost one in four beneficiaries of the subsidy are not LMI borrowers (Parrott et al. 2018). These borrowers receive the subsidy simply because their credit is poorer than the average GSE borrower and thus more costly than the average guarantee fee pricing covers. And LMI borrowers who pose less than average risk to the GSEs are picking up part of that tab, paying more in the average guarantee fee than their lower-than-average risk warrants.

Second, the subsidy is provided almost exclusively through lower mortgage rates, even though that is not the form of help all LMI borrowers need. For many, the size of their monthly mortgage is not the barrier to homeownership, but the lack of savings needed for a down payment and closing costs or to cover emergency expenses once the purchase is made. For those borrowers, the lower rate provided in the current system simply does not help.

And third, the opacity of the subsidy makes it difficult to determine who is benefiting, by how much, and whether it is actually helping. The GSEs are allocating more than \$4 billion a year in subsidy, yet policymakers cannot tell how it has affected the homeownership rate of those who receive it, much less

how the means of allocation compares with other means of support. We thus cannot adjust course to better allocate the support so that it provides more help those who need it.

The Senate proposal remedies each of these shortcomings, charging an explicit mortgage access fee to pay for the Housing Trust Fund, the Capital Magnet Fund, and a mortgage access fund that supports LMI borrowers, and *only* LMI borrowers, with one of five forms of subsidy: a mortgage rate buy-down, assistance with down payment and closing costs, funding for savings for housing-related expenses, housing counseling, and funding to offset the cost of servicing delinquent loans. Unlike the current system, the support is well targeted, helps address the entire range of impediments to homeownership, and is transparent. As a means of delivering subsidy to those who need it, the proposed system is likely to be more effective than what we have today.

If, that is, it can be designed in a way that overcomes two central challenges: determining who qualifies for the support and delivering the subsidy effectively to those who do.

Determining Who Gets Support

There are two questions in determining who should receive the subsidy: how, if at all, to limit the group of LMI borrowers who receive support and how to determine whether a borrower meets the income requirement in the proposal.

There are a number of judgment calls that policymakers will have to make about whether and how to limit the support that LMI borrowers might receive. For instance, while those who receive support from other sources, like state housing finance agencies, should likely not be excluded from receiving additional support here, if they receive the former subsidy in the form of down payment assistance, they should not be able to use that assistance to receive matching down payment assistance here, as part of the point of matching a borrower's down payment is to incentivize them to put skin in the game. There will be numerous questions like this for the Federal Housing Finance Agency (FHFA) to sort out, but the most consequential, and perhaps trickiest, will be determining whether to allow those refinancing to receive a subsidy.

The challenge with allowing the subsidy of refinancing is that it gives those who receive their first subsidy up front, through down payment assistance or help with their savings for emergency housing expenses, a strong reason to return for a second subsidy as soon as practicable, and then again for a third, and so on. The challenge with prohibiting it, on the other hand, is that LMI borrowers who have taken their support through a rate buy-down will be left unable to benefit as readily in a falling interest rate environment. This is not only bad for them, but it acts as a drag on the economy, as the benefit of lower interest rates will not be passed through as readily or effectively.

To thread this needle, the FHFA should only allow the subsidy of refinancing for those who have not already received a subsidy up front through this program, and it should only be received in the form of a rate buy-down. This will allow LMI borrowers whose mortgage rates are being subsidized in either the current or future system to transfer that subsidy from one loan to the next, so that they can participate

in falling rate environments like everyone else. It does mean that some of these borrowers will receive greater total subsidy over time, but the trade-off is worth it.

The issue of problematic incentives comes up again when determining who actually falls below 80 percent of the area median income (AMI), or 100 percent of the AMI as a first-time homebuyer, the maximum levels allowed for receiving the subsidy under the proposal. Borrowers who know they can qualify for a loan with less than all their income will have an incentive to underreport their income in order to qualify for the support and to qualify for deeper support if their subsidy will increase as their reported income decreases. This could lead to ignoring certain sources of income in their mortgage application or leaving one of those who will be on the title off of the mortgage if a single income is enough to qualify for the mortgage.

This is one area where the opacity of the subsidy's allocation in the current system actually helps. Borrowers who receive a subsidy typically are not even aware of it, much less are they aware that the support *might* have something to do with their income levels. They thus focus on maximizing the income they report so that they can qualify for a loan.

To address this issue in the system proposed, the income that should be used to determine whether a borrower qualifies for a subsidy, and if so how much, should be the higher of the income reported to the IRS and the income reported on the mortgage application, and should include the income for all those who will be on the title of the house. The FHFA should also require that borrowers attest to the accuracy and comprehensiveness of the income reported on their mortgage application form, within some reasonable tolerance for error. With that attestation, lenders should be given safe harbor from liability for misinformation submitted by the borrower, so that they are not reticent to make the loans in the first place.

Delivering the Subsidy Effectively

To allocate the subsidy effectively, the FHFA will need to overcome both budgetary uncertainty and the inclination of intermediaries to capture some of the subsidy.

How many will qualify for a subsidy in a given year and how much money will be available to allocate will fluctuate somewhat unpredictably from one year to the next, making it difficult to operationalize the subsidy's allocation. If the FHFA either overestimates the volume of lending in the year to come or underestimates the number of borrowers who qualify for that subsidy, then it will overestimate the amount of subsidy available and allocate it too quickly. And if it underestimates the volume of lending or overestimates the number of borrowers who qualify for the subsidy, then it will not allocate enough of the subsidy, leaving money unspent.

The second challenge is making sure that all of the subsidy makes it to borrowers, as lenders and guarantors would naturally absorb some of the subsidy absent some protection. If the FHFA offers a rate buy-down, for instance, either lenders or guarantors or both are likely to capture some of that subsidy by offering those who receive the subsidy a slightly higher interest rate or guarantee fee.

Fortunately, both of these challenges could be addressed with a mechanism for delivering the subsidy that is automated, transparent, and adjustable through the course of the year. One way to do this would be for the FHFA to provide a quarterly subsidy sheet to lenders, in which lenders, qualifying borrowers, and guarantors can see precisely how much subsidy each borrower is qualified to receive on a loan that closes that quarter, and in what forms. It would lay out for each discrete AMI band how much subsidy a qualifying borrower can receive at the time of origination and how that subsidy would translate into a rate reduction, down payment assistance, and savings to cover housing expenses in times of economic stress.

Such a sheet might provide something like the following information:²

- Borrowers with greater than 70 percent of the AMI are qualified to receive \$2,000 in subsidy, which can be provided in one of three ways:
 - » A reduction in their interest rate equal to \$286 per year (\$2,000 divided by an average duration of seven years)³
 - » Up to \$2,000 in funding to be applied to their closing costs and down payment equal to the amount the borrower puts down in closing the loan
 - » \$2,000 in money deposited into a savings account to be used to cover housing-related expenses in a time of economic distress
- Borrowers with greater than 60 percent of the AMI but less than 70 percent are qualified to receive \$3,500 in subsidy, which can be provided in one of three ways:
 - » A reduction in their interest rate equal to \$500 per year
 - » Up to \$3,500 in funding to be applied to their closing costs and down payment equal to the amount the borrower puts down in closing the loan
 - » \$3,500 in money deposited into a savings account to be used to cover housing-related expenses in a time of economic distress
- Borrowers with greater than 50 percent of the AMI but less than 60 percent are qualified to receive \$5,000 in subsidy, which can be provided in one of three ways:
 - » A reduction in their interest rate equal to \$714 per year
 - » Up to \$5,000 in funding to be applied to their closing costs and down payment equal to the amount the borrower puts down in closing the loan
 - » \$5,000 in money deposited into a savings account to be used to cover housing-related expenses in a time of economic distress
- Borrowers with less than 50 percent of the AMI are qualified to receive \$6,500 in subsidy, which can be provided in one of three ways:
 - » A reduction in their interest rate equal to \$929 per year
 - » Up to \$6,500 in funding to be applied to their closing costs and down payment equal to the amount the borrower puts down in closing the loan

- » \$6,500 in money deposited into a savings account to be used to cover housing-related expenses in a time of economic distress

This would allow borrowers to choose the form of subsidy that would be most helpful to them, giving them the information they need at the time they need it, when trying to decide what kind of mortgage to take out. It would give lenders the information they need to make offers to qualifying borrowers that reflect these subsidies, in effect empowering those whose business is to present borrowers with their options to allocate the subsidy most efficiently. And it would allow the FHFA to adjust the amount of subsidy per borrower they are able to offer according to the flow of business guarantors are doing. While the FHFA will still have to estimate the flow of subsidy in a given quarter, this will be easier than estimating the flow over a given year and easier to adjust if they are off in their estimates. To help manage times when the supply or demand of subsidy varies from one year to the next by more than the FHFA can manage—and there will certainly be such years, particularly early on when neither the number of qualifying borrowers nor the total subsidy has reached an equilibrium—it will need the ability to carry both overages and shortfalls into the next year.

In order to ensure that neither lenders nor guarantors are able to absorb any portion of the subsidy, the FHFA should collect and publish enough information to compare compliance across lenders and guarantors, allowing lenders, guarantors, consumer advocates, and other third parties to assess whether a given lender or guarantor is offering LMI borrowers the same terms they offer similarly situated non-LMI borrowers, minus the rate reduction if that is how the subsidy is delivered.

Two of the five forms of support allowed under the proposal—housing counseling and support for the servicing of delinquent loans—do not fit neatly into this solution for several reasons. Both require an intermediary to provide a service for which they will need to be compensated, making it difficult to monitor intermediary capture of the subsidy. The intermediaries will also need to be compensated a specific sum, making it impossible to allocate variable amounts depending on the size of the subsidy available to the borrower. And, more fundamentally, neither works as a borrower-driven choice at the time of origination. Support for servicing a delinquent loan cannot be allocated at the point of origination, and it is likely that few borrowers would choose to allocate their subsidy toward counseling even if they could. The FHFA will thus need a different approach for these two forms of support.

Supporting housing counseling is nonetheless relatively straightforward. The FHFA should set up a fund with a finite amount of annual resources and allocate sums based on its estimates of annual need, adjusting the amounts offered through the course of the year as its estimates change, much as it adjusts the rate sheet suggested above. In order to help with oversight and guard against intermediary capture of the subsidy, the fund should only be available for counseling through US Department of Housing and Urban Development–approved counselors.

Delivering support for servicing delinquent loans is more challenging, as it raises a host of difficult questions over when the payments should be made and what exactly they should cover. What this provision is attempting to do is overcome the incentive that lenders have to avoid making loans to LMI borrowers in the first place, because of the lower profits at the point of origination and the higher rate

of delinquencies. As a general matter, lenders tend to charge roughly the same percentage for originating and servicing all of the loans they handle. Yet on average, LMI borrowers take out smaller loans and are more likely to go into default, making them less profitable to originate and service. Lenders are thus less inclined to make or service these loans absent some other financial or legal incentive. This could be particularly problematic in the system proposed, which, without the affordability goals, does not require guarantors to provide secondary market liquidity for such loans. With less regulatory pressure, the economic incentives for supporting LMI loans become all the more important.

The proposal addresses this by giving the FHFA the authority to offset the higher servicing cost of delinquent loans, taking a large part of the disincentive off the table. A simpler and more direct way to address the problem would be to pay lenders for each LMI loan made and serviced. The FHFA could set the per loan incentive at the beginning of each quarter, paying each lender the incentive at the time of origination and adjusting the sums offered quarterly as it adjusts the other subsidies provided. This would get at the problem more directly, avoiding the difficult questions associated with focusing on the cost of loans as they go delinquent.

Even with this modification, it is still the least direct form of support allowed in the bill. Unlike the other forms, it will not be driven by borrower choice, and it will not go directly to reducing an impediment to homeownership. Moreover, addressing the challenge of lender incentives meaningfully may well take an overwhelming portion of the subsidy, leaving the FHFA with a bleak choice: pay lenders some portion of the subsidy to little effect or shift the lion's share of the subsidy to address this one issue. With these challenges in mind, the proposal would be better served dropping this form of subsidy altogether. While it is undoubtedly attempting to address an important issue, this is not the best way to address it and not the best use of the subsidy.

Conclusion

Putting affordable homeownership within reach for more households of modest means is a critical function of the housing finance system. But the system we have in place to do this today is opaque, inefficient, and of uncertain effectiveness. The proposal on the table in the Senate Banking Committee offers what could be a very helpful restructuring of how we provide that support, but some critical design challenges must be addressed to ensure that it lives up to that potential.

Notes

1. A copy of the draft bill as of February 20, 2018, is available at <https://assets.bwbx.io/documents/users/iqjWHBFdfxIU/r8xUN8jPpe5c/v0>.
2. The FHFA will likely want to provide a more granular, and thus gradual, slope of subsidy to avoid the cliff effect of differences in AMI. It may also want to consider varying the allocation according to area median home prices to account for the significant difference in effect of a subsidy between, say, San Francisco and Detroit.
3. Giving everyone the same reduction in terms of rate would lead to larger loans receiving a larger subsidy.

Reference

Parrott, Jim, Michael Stegman, Phillip Swagel, and Mark Zandi. 2018. “[Access and Affordability in the New Housing Finance System](#).” Washington, DC: Urban Institute.

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Jim Parrott is a nonresident fellow at the Urban Institute and owner of Falling Creek Advisors, which provides financial institutions with strategic advice on housing finance issues. Before joining Urban in 2013, Parrott spent several years in the Obama White House as a senior adviser at the National Economic Council, where he led the team of advisers 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. Before his time in the White House, Parrott was counsel to Secretary Donovan at the US Department of Housing and Urban Development. Before that, he was a litigator, first in New York with Sullivan and Cromwell, and later in North Carolina with Smith Anderson. Parrott serves on the advisory board of the J. Ronald Terwilliger Foundation for Housing America's Families and the Ackland Museum of Art. He also served in Sri Lanka with the Peace Corps. Parrott has a BA in philosophy from the University of North Carolina, an MA in philosophy from the University of Washington, and a JD from Columbia Law School.

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