

Restoring the American Dream Through Focused Housing Finance Reform

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The last remaining piece of financial services reform after the financial crisis and Great Recession is how to structure and reform the secondary mortgage market, including the role of Fannie Mae and Freddie Mac. While there is broad agreement that reform of these government sponsored enterprises (GSEs) is necessary to ensure a strong and stable housing economy, there continue to be fundamental disagreements on a range of key issues. With the Trump administration's recent focus on housing finance reform, there is an opportunity to complete GSE reform as well as maintain and enhance mortgage funding liquidity through a durable market structure that will support investments in mortgage financing through all business cycles, include an enforceable set of responsibilities to serve the entire market of renters and qualified home buyers while protecting the taxpayers' investment.

The National Housing Conference (NHC), America's oldest housing coalition, has led convenings and proposed solutions for policymakers dating back to its founding in 1931, including playing a critical role in the legislation that led to the creation of the Federal National Mortgage Association in 1938. Over the past year, we have convened a broad range of experts on housing finance to inform this paper. Any reform or restructuring of the secondary mortgage market system must focus on certain key objectives:

1. Maintain and enhance mortgage funding liquidity through a durable market structure that will support investments in long term, fixed-rate mortgage financing for both single family and multifamily housing through all business cycles, ensuring equitable access to safe, responsible and sustainable mortgage credit to the largest possible number of borrowers.
2. Ensure access to affordable and sustainable mortgage credit to broadly serve homeownership-ready borrowers through a variety of public and private channels, including addressing the minority homeownership gap. The GSEs should not withdraw from serving a portion of the continuum absent a high degree of confidence that those borrowers will be well-served through other market channels.
3. Maintain and enhance a broad commitment to access and affordability through measurable and enforceable standards, a Duty to Serve requirement in the secondary mortgage market and robust funding for the National Housing Trust Fund and the Capital Magnet Fund.
4. Replace implicit guarantees on debt and mortgage backed securities in the current system with a limited, explicit and appropriately compensated government role that retains a healthy "to be announced" (TBA) market, and encourages private capital participation to ensure reliable access to long-term fixed-rate single family and multifamily mortgages nationwide.
5. Sustain, strengthen and modernize the Federal Housing Administration's (FHA) capacity and flexibility to meet the nation's housing financing needs while protecting the taxpayer's investment.

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6. Protect taxpayers from risk in all but the most exigent circumstances through full engagement of the private sector in providing first loss coverage for conventional single family and multifamily mortgage assets.
7. Mitigate any adverse impacts on the marketplace and consumers, with a particular focus on a smooth transition. Any changes to the GSE footprint (or broader businesses) should be transparent and implemented steadily over a reasonable time horizon.

For most of the past ten years, GSE reform efforts focused on comprehensive reform of the entire housing finance model. This involved wholesale change to the nature, ownership and operational model of the secondary mortgage market in the United States. These efforts, while well intentioned, posed complex structural concerns and unacceptable transition risk, which made them politically unviable. In the past few years there has been growing consensus in support of a more direct course, working off the existing infrastructure of the current housing finance system.

This approach of building on the Housing and Economic Recovery Act of 2008 (HERA) makes the extraordinarily complex task of housing finance reform more manageable and more achievable. HERA's reforms were a bipartisan product that successfully created the Federal Housing Finance Agency (FHFA) and provided the statutory framework for the new regulator as well as the Treasury Departments of three administrations to place and manage the GSEs in conservatorship and move them out of insolvency. While some have suggested that they could remain in conservatorship indefinitely, we believe that providing reliable and durable countercyclical support for the housing market depends on the outcome of efforts to permanently address the structural problems in the secondary market that existed prior to the financial crisis, as the Dodd-Frank Act in 2010 did for the primary market.

A dual-track approach to administrative and statutory reform

The Trump administration and the new leadership of FHFA have indicated a dual-track approach of recapitalization, reform and release of the GSEs from conservatorship that if done right could make permanent some of the structural changes already undertaken under conservatorship, ensure safety and soundness, responsibly sustain access to mortgage credit and provide the certainty needed for private capital to establish a more reliable presence in single- and multi-family housing finance. Other key areas, like creating a limited, explicit and appropriately compensated government guarantee, or chartering additional enterprises with the same charter as Fannie Mae and Freddie Mac, can only be done by Congress. This is also the case with many of the indicia of the implicit guarantee that led investors to ignore the entreaty on every security and debt instrument issued by the GSEs, which clearly state that they are not guaranteed by the full faith and credit of the U.S. government. A limited and paid-for explicit guarantee cannot rely on implicit indicators that the limitations may be ignored. In both administrative and legislative approaches, there are changes that can improve the overall system, reduce risk to the taxpayer and expand responsible and sustainable mortgage credit for all qualified borrowers. However, some changes may also risk destabilizing the mortgage finance system over time, exposing borrowers and lenders to unreasonable credit or interest rate risk through a wide range of unintended consequences. Ultimately, the liquidity of the mortgage finance system can only be tested during periods of extreme market stress, so getting this balance right is critical.

Administrative Reforms

Protecting consumers from a mortgage market collapse were major priorities of HERA and the Dodd-Frank Act, as amended. However, there remains a significant concern that taxpayers were required to play a disproportionate role in averting a deeper crisis during the Great Recession. It is essential to remember that taxpayers and consumers of mortgage credit are one and the same. Taxpayers pay for the failure of the housing finance system to adequately supply housing that is affordable to all income cohorts, reducing savings and consumer spending, while increasing homelessness and the economic burden of underserved communities. Taxpayers are ultimately protected best by a careful balance of these priorities. Limiting access to mortgage credit and ultimately homeownership to responsible borrowers is no way to “protect” taxpayers from themselves.

The GSEs’ prudential regulator, FHFA and the Treasury Department have significant administrative powers under conservatorship and the Senior Preferred Stock Purchase Agreements (PSPAs), entered into in 2008. The PSPAs were designed to ensure Fannie Mae and Freddie Mac “be able to meet their outstanding obligations and to continue to provide liquidity to the mortgage market.”¹ They have been amended several times since, most recently on December 21, 2017², when Treasury agreed to reinstate a \$3 billion capital reserve for each Enterprise. In August 2012, Treasury and FHFA changed the PSPAs with Fannie Mae and Freddie Mac to require them to wind-down their portfolios at a faster pace and to suspend the existing 10 percent fixed-rate dividend with a quarterly net worth sweep.³ This change alone has contributed to a total repayment to the US Treasury of \$306 billion⁴ to date, far exceeding the original investments in the PSPAs of \$191.5 billion.⁵

Taken together, these statutory and regulatory powers authorize the Treasury Department and FHFA to take a range of actions, some of which risk an even wider array of consequences, including:

- Ending the net worth sweep and allowing the GSEs to use all their earnings to contribute to recapitalization,
- Raising or lowering guarantee fees, which could contract or potentially expand the mortgage market,
- Placing one or both GSEs into receivership and wiping out all shareholders⁶,
- Selling the newly developed Common Securitization Platform (CSP) jointly owned by Fannie and Freddie to private shareholders through an Initial Public Offering or converting the CSP into a publicly owned asset,

¹ Federal Register, Volume 83 Issue 137 (Tuesday, July 17, 2018)

² <https://www.fhfa.gov/Media/PublicAffairs/Documents/GSEletteragreementfnm12-21-2017.pdf>

³ https://www.fhfa.gov/Conservatorship/Documents/Senior-Preferred-Stock-Agree/2012-8-17_SPSA_FannieMae_Amendment3_508.pdf

⁴ https://www.fhfa.gov/DataTools/Downloads/Documents/Market-Data/Table_2.pdf

⁵ https://www.fhfa.gov/DataTools/Downloads/Documents/Market-Data/Table_1.pdf

⁶ This would have the effect of wiping out Treasury’s warrants to purchase up to 79.9 percent of the GSEs stock value and has the potential of disrupting mortgage markets depending on the approach taken by the bankruptcy court.

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- Selling the GSEs' multifamily business as well as other functions to fully private organizations,
- Further reducing the mortgage portfolios of the GSEs, selling the assets to raise additional capital,
- Reducing or suspending the affordable housing goals or trust funds based on specific conditions,
- Releasing the GSEs from conservatorship with or without conditions,
- Maintaining the PSPA indefinitely after release from conservatorship,
- Converting the remaining \$113.9 billion in loss support authority to capital through redirection of the net worth sweep to retiring the senior preferred stock, and/or
- Retaining the \$113.9 billion as part of an explicit back up authority in the absence of congressional action to make it explicit.

NHC is supportive of administrative policy reforms, so long as they avoid disruption to the flow of mortgage credit into the single-family and multifamily real estate markets and expand rather than contract access to credit for those underserved by the housing finance system, particularly people of color and low- and moderate-income people, who have lost historic levels of wealth and opportunity in the wake of the Great Recession.⁷ Exercising some of these powers could positively contribute to this effort if done right. However others, like selling off key functions of the GSEs, particularly their multifamily business, suspending the affordable housing goals or trust funds, or releasing them from conservatorship without bipartisan statutory reforms, would be widely opposed, deeply divisive and extremely risky.

We are also concerned that the shift to requiring loan-level risk-based pricing for single family lending reduces the GSEs' exposure by undermining their statutory obligation to support the market, shifting those loans with higher risk profiles to FHA, where they would have a 100 percent government guarantee. This has a disproportionate impact on borrowers of color, who suffered the worst equity losses in the Great Recession and were prime targets for unscrupulous subprime lending outside of the GSE system before the financial crisis.⁸ Shifting to loan-level risk-based pricing abandons the social and financial benefits of a book of business with a broadly diversified mix of risks and borrower types and undermines the Enterprises' charter obligation to provide credit broadly and with a mix of economic returns.

Policymakers must fully assess and consider the impact of the extent to which single family loans "cut" from the GSE footprint would shift to FHA, the Department of Veterans Affairs (VA), the Rural Housing Service (RHS), bank and institutional balance sheets—or not be made at all. Moving risk from the private market to the taxpayer in the name of "privatization" does not make sense and reinforces a separate but unequal mortgage finance system which is neither fair nor sustainable. If

⁷ <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4200506/>;
https://www.aclu.org/sites/default/files/field_document/discrimlend_final.pdf

⁸ <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4193596/>;
<https://www.ncbi.nlm.nih.gov/pmc/articles/PMC6084476/>; <https://www.responsiblelending.org/mortgage-lending/research-analysis/Lost-Ground-exec-summary.pdf>;
<https://jointcenter.org/sites/default/files/OFFICIALHomeownershipPaperBrief2.pdf>;
<https://www.tandfonline.com/doi/full/10.1080/10511482.2013.771788?scroll=top&needAccess=true>;
<https://www.nber.org/papers/w22004>

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those loans flow to other financing channels, policymakers must understand the impact on consumer costs and access to credit. Furthermore, moving interest rate risk onto bank and institutional balance sheets in a rising interest rate environment could destabilize a broader market, as long term, low interest rate fixed assets are marked to market. A reformed system must recognize that private capital within the GSEs may prove more resilient and diverse than under a purely private system.

Any administrative reforms to the GSEs have the potential to bring about significant changes in consumer access to credit. Therefore, they must contain safeguards against higher costs, reduced access, or other disruptions in both the single-family and multifamily markets. They must also include enforceable mechanisms to ensure the GSEs serve the entire market of potential renters and qualified homebuyers, including underserved consumers and communities, as well as responsible manufactured housing. This is not a unique concept, as federally-chartered institutions across a spectrum of industries and market sectors typically carry an obligation for related public service. The GSEs should not be any different in this regard.

Efforts to reduce the GSEs' single family footprint through increases in guarantee fees (g-fees) should not move forward unless there is compelling and widely-accepted evidence that the private market is able and willing to assume an expanded role in all economic conditions and that the root causes of the housing crisis that derived in part from the failure of the private label securitization market have been fully addressed. We remain skeptical that this is realistic, particularly in light of the inability of both the Obama and Trump to resuscitate the PLS market. While regulatory issues are certainly components of this failure, the inability to reform the legal structure of PLS is likely to make any regulatory changes largely inadequate. Any changes in guarantee fees should in any case be based on a transparent and relevant capital structure that takes account of changing market conditions, the need to retain countercyclical liquidity and the specific nature of the GSEs' mortgage credit portfolios.

Furthermore, any potential administrative reforms to the GSEs that would meaningfully alter their market presence—single-family or multifamily—must seek to improve and enhance the stability, liquidity and accessibility of the housing finance system. It is essential to recognize that despite significant increases in the cost of obtaining a GSE loan through higher g-fees and loan-level price adjustments, the mortgage market for loans backed solely by private capital remains a minor participant in the housing sector. Private-label securitization was an experiment in the American mortgage finance system that failed and has not been successfully reformed. While the private market may choose to make this kind of investment again in the future, it is not the role of government to make a new market at the expense of the one that exists and performs well today.

Statutory Reform

Several areas of reform can only be accomplished through statutory change, which requires bipartisan agreement. These include an end to the implicit government guarantee and adoption of a limited, explicit and appropriately compensated government guarantee; the elimination of the indicia of the implicit guarantee that are not material to the preservation of the GSEs' mission; revision of the affordable housing requirements, including dedicated funding of affordable housing

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and community development programs; alterations to the GSEs' ownership structure; and the enhancement of FHFA's regulatory powers currently available only under conservatorship. Statutory reform is critical for a variety of reasons. It is essential to ensuring that FHFA's administrative reforms have bi-partisan support. It is the only way to move from an implicit to an explicit and paid-for guarantee, and it is crucial to ensuring that broadly acceptable reforms are sustainable through a full range of leadership at FHFA.

One of the most critical components of statutory reform is the need to address regulatory weaknesses that led to the "race to the bottom" in single family lending between Fannie Mae and Freddie Mac as their market share shrank and competition between the GSEs and the PLS market became increasingly toxic. "Competitive mortgage securitization has been tried three times in U.S. history," notes legal scholar Michael Simkovic, "during the 1880s, the 1920s and the 2000s—and every time it has collapsed. Most recently, competition between mortgage securitizers led to a race to the bottom on mortgage underwriting standards that ended in the late 2000s financial crisis."⁹ There were two key drivers of the GSEs' market share losses: lender consolidation and the rapid rise of PLS. Lender consolidation significantly reduced the GSEs' customer base, giving lenders selling loans to Fannie Mae enough influence to dictate terms on credit quality (underwriting), counterparty risk management (loan repurchases) and pricing (g-fees).

The growing PLS market gave lenders their own channel for securitizing mortgages, driving the total GSE single family market share down from 57 percent of all mortgages purchased in 2003 to 47 percent in 2004 and down to 37 percent by 2006. Fannie Mae and Freddie Mac were in a fight with each other over a rapidly declining share of the total mortgage market.

By the early 2000s, competition over market share between the GSEs resulted in g-fees reaching deminimis levels, some as low as 6 basis points. These low g-fees allowed the largest lenders to become aggregators of loans sold by lenders with much higher g-fees, which were then passed through the GSEs at the lower rate. As a result, market share of the largest lenders ballooned even further. In its September 6, 2008 memo¹⁰ recommending Fannie Mae be placed into conservatorship, the Office of Federal Housing Enterprise Oversight (OFHEO) expressly cited this practice as unsafe and unsound.

By 2005, g-fees were so low that some lenders negotiated for increasingly reckless underwriting, permitting multiple layers of product risk by combining interest-only adjustable rate mortgages, teaser rates with huge payment shocks after just two or three years and few if any requirements for verification of a borrower's ability to repay. When in internal debates, the question of how consumers could possibly repay these loans was raised, the response was that mortgage brokers would refinance them before they reset¹¹. With that, the loans were no longer backed by solid underwriting or appropriate capital reserves, but by equity stripping and a permanent gamble on forever-increasing property values. Fannie Mae and Freddie Mac could have said no, as some of

⁹ Simkovic, Michael; Competition and Crisis in Mortgage Securitization; 2013; Indiana Law Journal

¹⁰ https://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-09-06%20FHFA%20Freddie%20Mac%20Conservatorship%20Memo.PDF

¹¹ Housing finance reform should fix what's broken; What does housing finance reform look like? by David M. Dworkin, July 17, 2018. Housing Wire. <https://www.housingwire.com/blogs/1-rewired/post/46096-housing-finance-reform-should-fix-whats-broken>

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their officers argued, but they did not because they were afraid of losing so much market share that their stock price would plummet and they would become irrelevant, possibly even insolvent. It was a choice between drinking the poison or jumping off the ledge. Drinking the poison seemed like the better choice.

Today, lenders have learned important lessons from the subprime debacle, but in time, as the current generation of mortgage leaders retire, the same pressures for market share will emerge and lenders will press for lower fees and more permissive underwriting. Any new system has to recognize this basic dynamic of competition and FHFA must be required to manage guarantee fees within a narrow enough range so the GSEs' lender-customers cannot arbitrage competition. The GSEs should compete against each other on performance, not on price.

Access to the federal guarantee on qualifying securities should be open to any future issuers under the same financial, capital, oversight, transparency and reporting and public purpose requirements imposed on the GSEs. These conditions include appropriate capitalization at the corporate level to back the guarantees they are providing, balanced with the need for affordability, national coverage and countercyclical liquidity. A portion of the guarantee fee should flow into an insurance fund to be drawn down as needed after an issuer's capital is depleted. Like the Federal Deposit Insurance Corporation's (FDIC) insurance fund, the Mortgage Backed Security (MBS) insurance fund should also have the ability to be post-funded; that is, in the event the guarantee fund goes into the red, the g-fees on future issuances would pay back any Treasury draws.

We also support ongoing efforts by the GSEs to transfer (credit) risk to other private parties as a way to reduce their exposure to losses. These efforts should not, however, encourage adverse selection at the borrower or portfolio level. Similarly, increased capacity and authority to manage and mitigate counterparty risk at Ginnie Mae and those agencies with access to the federal guarantee is a critical aspect of reform that will directly reduce taxpayer risk and almost certainly will require congressional action in order to be successful.

Reforms should be mindful of countercyclical liquidity needs across the system and recognize that while FHA and the GSEs have often been responsible for ensuring continued availability of mortgages even in downturns, greater capacity across the system to play a countercyclical role would help mitigate steep price declines. Indeed, FHA and the GSEs did so in earlier downturns such as the oil patch recession and the 2002 recession that followed the 9/11 attacks. During times of expansion, however, private capital should be expected to take a growing share of the market in a variety of forms, including direct securitization of mortgage assets and risk sharing with Fannie and Freddie to reduce government risk exposure. To ensure countercyclical liquidity, the GSEs' debt issuances should also carry a paid-for, explicit guarantee that matches the guarantee on MBS, backed by an initial capital contribution of the \$113.9 billion remaining under the PSPA with the Treasury Department.¹² To ensure long-term stability of GSE debt, this backstop should be made permanent in legislation.

Lenders of all sizes and business models must have reasonable and dependable access to the secondary market for the loans they originate, including providing liquidity for new and seasoned loans eligible for Community Reinvestment Act (CRA) credit and for loans supported by state and

¹² Title III of the National Housing Act, 12 U.S.C. 1716 §301

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local housing finance agencies and other governmental and qualified nonprofit entities. This will require careful consideration of each of the indicia of the implicit guarantee in the current model. Taken together, five indicia of the implicit government guarantee have worked together to convince investors to ignore the statutorily required language on the cover of every Fannie Mae and Freddie Mac debt instrument and mortgage-backed security.¹³ Restating that language, which is already perfectly clear, will not end the implicit guarantee.

Since the separation from the government of the Federal National Mortgage Association (Fannie Mae) in 1968 and the chartering of the Federal Home Loan Mortgage Corporation (Freddie Mac) in 1970, these indicia have contributed to the widely held perception of government backing of the corporations. The statutory indicia of the implicit guarantee are:

1. Congressional Charter and Public Purpose. The GSEs' charter requires them to provide stability in the secondary market for residential mortgages, increase the liquidity of mortgage investments, improve the distribution of investment capital for housing finance and promote access to mortgage credit throughout the nation. Under the current law, the GSEs are chartered to:
 - provide stability in the secondary market for residential mortgages,
 - respond appropriately to the private capital market,
 - provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing, and
 - promote access to mortgage credit throughout the nation (including central cities, rural areas and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.
2. State and Local Tax and Regulatory Exemptions. The GSEs are exempt from taxation by states or local governments, with the exception of property taxes.¹⁴ They are also exempt from local regulations and legal actions.¹⁵
3. SEC exemptions. The GSEs are legally exempt from registration of their equities, however, they have voluntarily agreed to register their stock with the Securities and Exchange

¹³ "The corporation shall insert appropriate language in all of its obligations issued under this subsection clearly indicating that such obligations, together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality thereof other than the corporation."

¹⁴ Title III of the National Housing Act, 12 U.S.C. 1723 §309(c)(2)

¹⁵ Title III of the National Housing Act, 12 U.S.C. 1723 §309(a)

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Commission (SEC).¹⁶ The GSEs are also exempt from the registration of their securities¹⁷ to the same extent as securities which are direct obligations of or obligations guaranteed to principal and interest by the United States. This exemption relates to MBS and has implications on the liquidity of the TBA market.

The GSEs' debt obligations¹⁸ are exempt and required to be treated to the same extent as securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, be deemed to be exempt securities within the meaning of laws administered by the Securities and Exchange Commission. This exemption relates to debt obligations and has implications on the pricing and liquidity of the Enterprises' debt issuance.

4. Access to Federal Reserve. The Federal Reserve Banks are authorized to act as depositories, custodians and fiscal agents for the GSEs;¹⁹ and
5. Treasury Line of Credit. The Secretary of the Treasury is authorized to buy GSE debt obligations at his/her discretion up to \$2.25 billion.²⁰

Unwinding these indicia must be done with great care. The congressional charter responsibilities and restrictions, remain important to ensuring the GSEs have and maintain focus on a clear mission. Likewise, access to the Federal Reserve as a fiscal agent is an important component of ensuring the reliability of the secondary mortgage market. The SEC exemptions, however, must be examined individually and carefully considered in context.

The exemption relating to equity securities of the enterprises was voluntarily suspended in an agreement with the SEC and Fannie Mae on March 31, 2003 and with Freddie Mac on July 18, 2008. As a result of HERA and the subsequent execution of conservatorship, the implied guarantee on the GSEs' equities has been eliminated. The exemption from registration of their MBS is critically important to the functioning of the TBA market. But the registration exemption for debt instruments is equally important. An explicit, paid-for guarantee of GSE debt is necessary to ensure that they can maintain their countercyclical role so that every recession doesn't automatically become a housing recession as well. This could easily become the case if the GSEs were unable to go to the debt markets to temporarily support mortgage purchases when investors are less sanguine about mortgage market investments. FHFA raised this important concern in January 2018 supporting a robust and stable housing finance market requires guaranteeing debt funding for a core set of well-defined, related secondary market activities, similar to the FDIC deposit insurance

¹⁶ Under their current charters, "all stock, obligations, securities, participations, or other instruments issued pursuant to this title shall, to the same extent as securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, be deemed to be exempt securities within the meaning of laws administered by the Securities and Exchange Commission." This exemption relates to equity securities of the enterprises and was voluntarily suspended in an agreement with the Securities and Exchange Commission and Fannie Mae on March 31, 2003 and with Freddie Mac on July 18, 2008. As a result of HERA and the subsequent execution of conservatorship, the implied guarantee on the GSEs' equities has been eliminated.

¹⁷ Title III of the National Housing Act, 12 U.S.C. 1719 §304(d)

¹⁸ Title III of the National Housing Act, 12 U.S.C. 1719 §304(e)

¹⁹ Title III of the National Housing Act, 12 U.S.C. 1723 §309(g)

²⁰ Title III of the National Housing Act, 12 U.S.C. 1719 §304 (c)

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fund, which also guarantees core defined liabilities.²¹ The regulator should oversee and limit these eligible activities to the following cash window and loan aggregation operations, loss mitigation efforts for delinquent loans, and affordable loans serving underserved markets.

The GSE cash window, where smaller lenders often sell individual loans to the GSEs, allows originators to sell loans without having to rely on larger competitors to gain access to the secondary market, which would also likely result in them having to give up their servicing rights in the process. To facilitate loss mitigation programs for delinquent loans, the GSEs need the ability to buy defaulted mortgages out of government-guaranteed securities and hold those loans on their balance sheet. MBS contracts require the GSEs to buy loans delinquent more than 120 days out of the security, an essential component of MBS liquidity. Further, loss mitigation efforts often include loan modifications that have a track record of restoring delinquent loans to performing loans, avoiding unnecessary foreclosures. The failure of the PLS market to develop a similar universal model has been a key element of its inability to reclaim a meaningful share of the mortgage market. Finally, FHFA noted that “limited and regulator-approved purchase of certain affordable mortgages that are not immediately able to be securitized and regulator-approved investments” would allow the GSEs to explore new ways of providing housing finance market liquidity for underserved housing markets. Such loan purchases or investments can be critical to meeting duty-to-serve obligations to support rural communities, responsible manufactured housing and preservation of affordable housing.

Affordable Housing Responsibilities

While FHFA has the power to curtail the affordable housing goals, or suspend payments to the trust funds in specific circumstances, Director Mark Calabria has rightly reassured a wide range of stakeholders as well as members of Congress that he “will not take such action so long as the GSEs are not failing.”

Reform to the existing framework for affordable housing goals must be done by legislation, which given the political division of the House and Senate, requires broad bipartisan agreement. While not perfect, the existing framework enacted under HERA in 2008 made significant progress for reform including:

- De-politicizing the affordable housing goals by removing them from the Department of Housing and Urban Development (HUD) and placing them under the prudential regulator,
- Prioritizing safety and soundness in goals application and enforcement, and
- Funding critically needed affordable housing production through the Capital Magnet Fund and Housing Trust Fund.

There remains room for additional improvements. As has been done with the GSE Report Card under conservatorship, linking GSE executive compensation to attainment of these housing market objectives could be impactful and effective. Support for the Capital Magnet Fund and the Housing

²¹ Federal Housing Finance Agency Perspectives on Housing Finance Reform, January 16, 2018.

<https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/FHFA-Perspectives-on-Housing-Finance-Reform.pdf>

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Trust Fund should be expanded to address the growing challenges of housing affordability by increasing the fee from its current de minimis 4.5 basis points (4.5 hundredths of one percent) on new business to a 10 basis point strip on outstanding securities.

Across the spectrum of industries and activities, a grant of a federal privilege usually comes with a requirement for related public service. On the most basic level is the exchange of government services like national defense and infrastructure in return for taxes. Private companies often receive government benefits like deposit insurance and have a related obligation to reinvest in their communities. Historically, radio and television broadcasters were required to operate in the public interest and were expected to provide free public service announcements in return for access to radio and television broadcast bands. The GSEs should not be any different, especially under any model that relies on federal guarantees to support broad mortgage liquidity.

The challenge comes in how we measure and enforce that public service obligation in the future so meaningful market participation and responsible innovation are sustained without encouraging inappropriate risk-taking or market-chilling activities. Business planning requires predictability around regulatory requirements. Where regulatory requirements are too static, the GSEs are not incentivized to support innovation in the primary market. Despite these challenges, there is broad consensus that the function the Enterprises fill in providing liquidity, stability and broad support to the primary market is critical. A modernized approach to ensuring that any new system fulfills the goal of broad access would require the designated regulator to establish standards, reviews, incentives, penalties and transparent data sharing in the following areas:

- Single-family and multifamily loan purchases, measured by the volume and composition of the guarantors' acquisitions and securitizations compared with the primary market's generation of loans, especially to reach underserved markets and communities,
- Identifying, testing, adopting and scaling products and services that sustain and expand consumer participation in the mortgage market and advance sustainable rental housing finance, and
- Investing directly and indirectly in activities and partnerships that expand sustainable mortgage and rental housing credit that are designed to increase secondary market liquidity for underserved markets and communities, as proposed by the Mortgage Bankers Association (MBA) in April 2017,²²

Affordable housing performance should be tied to a material portion of executive bonuses. The operating principle of this approach should be to ensure that secondary market government guarantees actively support and do not unreasonably restrict innovation and loan production in the primary market. Consideration should also be given to reform of the FHA multifamily insurance program to more clearly define its mission to support affordable housing, including the possible adoption of specific affordable housing goals to govern their allocation of FHA insurance

²² "The secondary market must therefore seek new ways to evaluate and underwrite borrowers and develop innovative products, partnerships and programs to respond to changing demographics and reach underserved groups and communities." GSE Reform: Creating a Sustainable, More Vibrant Secondary Mortgage Market, Mortgage Bankers Association, April 2017.

https://www.mba.org/assets/Documents/Policy/17305_MBA_GSE_Reform_Paper.pdf

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commitment authority. Since FHA does not price loans for risk and its loans are fully guaranteed by the federal government without transferring or sharing credit risk with private investors, it should be narrowly focused on supporting affordable housing and underserved market segments; not duplicating the liquidity support already provided to market rate borrowers by the GSEs, except during times of broad market distress.

Priorities for a Reformed Multifamily Housing Finance System

Much of the housing finance discussion about the GSEs focuses on the single-family mortgage market. It is critical to keep in mind the important role the GSEs can play in expanding the supply of rental housing affordable to low- and moderate-income tenants. Few have found fault with the way the GSEs managed their multifamily business during the housing crisis. We believe there is more need than ever for the kind of financing the GSEs can bring to support affordable housing development and preservation. Both Fannie Mae and Freddie Mac should be allowed and encouraged to again make forward commitments to enable locking in an interest rate on multifamily mortgages, a move likely to attract additional private capital for rental housing development. They should also be allowed to invest in affordable rental housing equity funds only to support properties in underserved market segments and geographic areas that are not already adequately supported by private equity investors.

During a time when the need for new housing units is reaching unprecedented levels, our housing production is barely keeping up with new household formations. Exacerbating the affordability crisis is the fact that the rental housing units being built are predominately higher-end and more expensive units. According to the Harvard Joint Center for Housing Studies report on the State of the Nation's Housing for 2019²³, the supply of low-cost rental units has decreased 17 percent since 2011, resulting in a 3.6 percent increase in rental costs in 2018 alone. The report notes that most new multifamily housing development continues to be geared toward high-income renters. As a result, nearly half of renter households (47.4 percent) are cost-burdened.²⁴

The business models of Fannie Mae and Freddie Mac engage private capital to share credit risk on the loans they buy, which are widely shared policy reform priorities since it puts private capital at risk ahead of the government guarantee. However, as noted above, since the FHA insurance programs are 100 percent government-guaranteed, they should be more focused on financing properties that fulfill FHA's public mission and not on market rate or luxury properties for which ample liquidity support is already provided by the GSEs and private lenders. Although some of the Fannie Mae, Freddie Mac and FHA loan programs overlap, all are needed to assure sufficient liquidity in the affordable housing finance market. Together, they provide debt financing options for subsidized properties with varied and complex financing structures and for market rate properties with affordable rents. In fact, Freddie Mac and Fannie Mae have developed unique and competing multifamily products. Merging or selling off these well-functioning enterprises is not warranted and would likely result in unintended consequences that could worsen the growing affordability crisis.

²³ https://www.jchs.harvard.edu/sites/default/files/Harvard_JCHS_State_of_the_Nations_Housing_2019.pdf

²⁴ Ibid.

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Competition between the GSEs has resulted in lower borrowing costs, faster loan product innovation and greater transaction efficiency. The GSEs' share of the multifamily finance market has grown significantly during conservatorship, with GSE financing now representing more than half the total market despite the very strong interest in this asset class from private investors and lenders. It appears that FHFA's multifamily scorecard, which attempts to cap the GSEs' loan volume and market share, has been ineffective. A better means of constraining the GSEs' growth and leaving room for private capital would be to adjust their pricing models to reflect the public purpose of the property financed, with lower pricing for affordable housing (as is already offered by the GSEs) and a premium added to the price for properties with high market rents. In this way, the price of GSE financing for market rate properties would be equivalent to that of private lending sources, and the GSEs' and private lenders would compete based on loan product innovation, flexibility and transaction execution rather than price.

The GSEs and FHA play a critical role in preservation of existing affordable housing. The features and terms of their loan programs should facilitate preservation of affordable rents and incent borrowers to maintain the affordable rents that were in place at loan acquisition and for which the GSEs received regulatory credit. This is particularly true for Naturally Occurring Affordable Housing (NOAH) and workforce housing, where rents are not controlled and where greater focus should be placed on properties with rents that will continue to be affordable during the loan term. The GSEs' regulator should require ongoing monitoring of the NOAH properties they have financed to be sure that the GSEs' loan programs and lending terms assure preservation of the existing affordable market rents.

There are clear distinctions between the risk profiles of the FHA and GSE programs, with FHA willing to take greater risk on its affiliated HUD programs as well as its critical ability to assume construction risk, which are essential for affordable housing development and should be continued. However, the federal government takes significant risk in the FHA construction loan program, since these loans are nonrecourse, have very low equity requirements, do not require a property to have stabilized occupancy before the FHA construction loan converts to a permanent mortgage and have no Loan to Value limits. As a result, FHA multifamily insured construction loans should only be available for construction of new affordable housing, or for new market rate housing with affordable rents located in distressed areas. In times of economic distress, FHA multifamily programs should be able to be used for any rental housing since these programs serve as a countercyclical liquidity source during economic downturns. The GSEs typically offer quicker and more flexible programs since they take less credit risk – thereby serving a different market segment. As with the single-family market, some overlap between the GSEs and FHA promotes competition, program innovation, cost reduction, and greater efficiency, so long as they do not lead to counterproductive adverse selection.

The GSEs and FHA should prioritize creating the most effective and efficient products for subsidized and market rate affordable rental housing and for underserved market segments, such as for housing in rural locations, financing for small properties and smaller balance loans. FHA's programs play an important role in affordable housing finance – providing for new construction, effective substantial rehab and leveraging rental assistance and Rental Assistance Demonstration (RAD). FHA has significantly improved its flexibilities, processing speeds and capacity to work with other affordable housing finance sources and should continue to invest in the systems, training and

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policies that support timely and cost effective executions of complex, layered financings. For the GSEs and FHA to better serve all geographic areas, they should also consider adding more lending partners to their networks to ensure that GSE finance activity is not concentrated in only the largest urban population centers.

Conclusion

A well-functioning housing finance system should provide consistent, affordable credit to borrowers across the nation and through all parts of the credit cycle, minimizing the risk of another taxpayer-funded bailout. Lenders and other market participants should have confidence that they can access the secondary market on a level playing field with their competitors, through clear and transparent standards that do not discriminate based on charter type, asset size or loan volume; while investors should feel confident that channeling long-term capital into the housing market is sustainable. Furthermore, any approach to GSE reform that does not provide for an enforceable set of responsibilities to serve the entire market of renters and qualified home buyers is not politically viable, nor should it be. Thus, we are hopeful that the approach we have set out will have broad bipartisan support in Congress, the administration and stakeholders in housing finance reform. Housing finance reform does not require the invention of an entirely new mortgage finance system. Much of the needed reforms have been achieved in HERA and the Dodd Frank Act. Finishing this work with the least disruption to housing markets should be a high priority across the political spectrum.

This paper was prepared in consultation with a diverse group of NHC members representing a broad range of housing advocates, lenders and both for-profit and nonprofit housing developers, among others. However, it represents solely the views of the NHC and does not seek to speak on behalf of our individual members. Those participating in these discussions included staff from Chris Tawa Consulting, Enterprise Community Partners, Federal Home Loan Bank of Chicago, LISC, Mortgage Bankers Association, National Association of Affordable Housing Lenders, National Association of REALTORS, National Community Reinvestment Coalition, National Council of State Housing Agencies, National Low Income Housing Coalition, NeighborWorks America, New York University Furman Center, Opportunity Finance Network, SKA Marin, Stewards of Affordable Housing for the Future, Tennessee Housing Development Authority, ULI Terwilliger Center for Housing, Quicken Loans and Zigas and Associates, LLC. We are grateful for their time and deep expertise.

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