POLICY FOCUS

Enterprise

Housing Finance Reform

Creating a More Stable, Accessible and Affordable System of Mortgage Finance in the U.S.

By John Griffith and Andrew Jakabovics | July 2017

AT A GLANCE:

In the coming months, Congress will engage in a high-stakes debate over the future of Fannie Mae, Freddie Mac and the entire housing finance system. Enterprise believes that any housing finance reform effort must seek to: a) ensure stable access to affordable single-family and multifamily credit for all eligible borrowers, both across geographies and throughout the business cycle, b) promote broad access to sustainable homeownership for all creditworthy families, and c) expand support for rental housing that is affordable to low- and moderate-income households. This brief offers five policy recommendations for achieving those overarching goals:

1. Establish an explicit, limited and paid-for government guarantee on qualifying single-family and multifamily mortgage-backed securities, with private investors taking a loss before taxpayers.

2. Preserve the current multifamily businesses at Fannie and Freddie while ensuring that those businesses continue to focus on affordable rental housing.

3. Establish an annual assessment of at least 10 basis points on all government-insured, mortgage-backed securities to fund affordable housing activities.

4. Ensure broad access to the mortgage market for all eligible borrowers and support small lenders and small multifamily properties, particularly those in low-income urban and rural areas.

5. Preserve the dual mission of the Federal Housing Administration – promoting broad access to homeownership for low- and moderate-income families while providing countercyclical support to the market as needed – while taking steps to shore up the agency's long-term financial health.

THE NEED FOR HOUSING FINANCE REFORM

More than eight years ago, during the early days of the financial crisis, the federal government took control of the mortgage companies Fannie Mae and Freddie Mac through a legal process called conservatorship. Since then, Fannie and Freddie – collectively, the government-sponsored enterprises, or GSEs – have been at the center of a debate over the future of housing finance in the U.S. and the appropriate role of government in the housing market.

Any changes to our mortgage finance system will have a profound impact on the cost and availability of housing for homeowners and renters. Without access to safe and affordable mortgage credit – such as the 30-year, fixed-rate mortgage with a low down payment – it would be very difficult for low- and moderate-income families to achieve sustainable homeownership, which remains a key pathway to the middle class. This is particularly true for borrowers of color, who have historically been underserved by the private mortgage market, were disproportionally targeted by predatory subprime lenders in the run-up to the foreclosure crisis[1] and face a growing wealth gap that is largely attributed to lower rates of homeownership.[2]

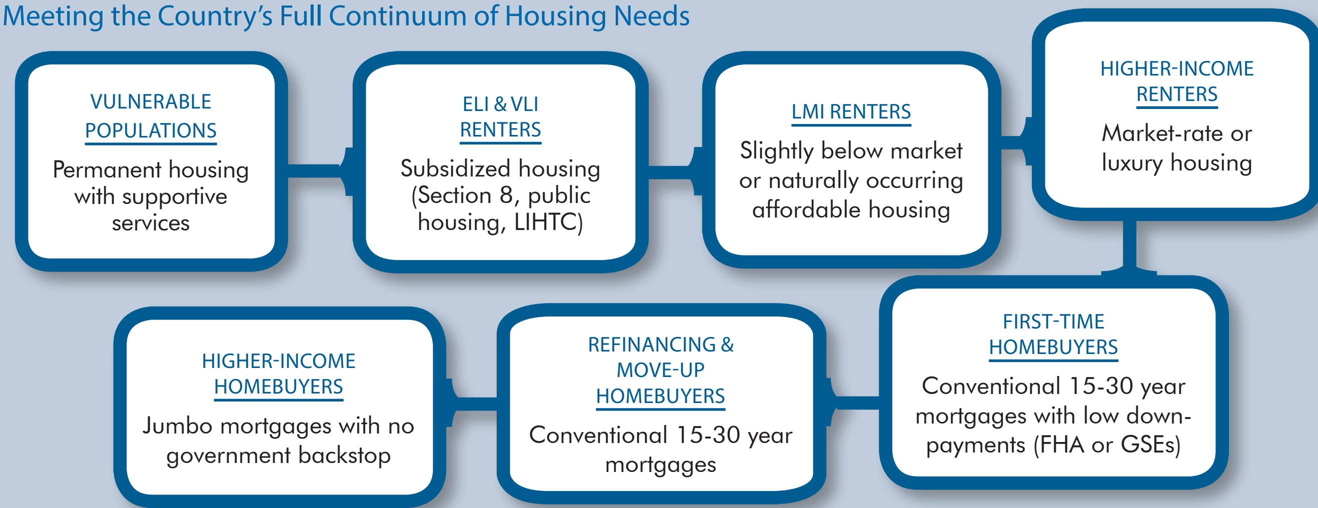
When homeownership is out of reach for families on the margins, competition increases for affordable rental options, which are already in short supply. Today an unprecedented 11 million renter households – more than one in four renters in the U.S. – are "housing insecure," spending at least half of their monthly income on rent and utilities.[3] Absent meaningful changes to public policy, the problem is only expected to get worse in the coming years. According to recent estimates from Enterprise and the Joint Center for Housing Studies, even if rent growth matches income growth, the number of housing insecure renters is expected to increase by more than 10 percent over the next decade.[4]

In addition, access to long-term, fixed-rate debt is essential for owners and developers of rental housing to keep costs low and rents affordable. That's especially true for owners of subsidized rental housing – such as properties financed with Low-Income Housing Tax Credits or Section 8 rental assistance – who often rely on long-term, low-cost financing to make a project financially viable.

The debate over GSE reform gained significant momentum in the 113th Congress, with four competing bills introduced between 2013 and 2014.[5] After two years of relative silence, the issue has re-emerged in the 115th Congress, with senior leadership in both Congress and the White House identifying housing finance reform as a top legislative priority for 2017. Notably, members of the Senate Banking Committee recently hosted a series of "listening sessions" on key components of housing finance reform.[6]

To help guide that debate in the coming months, this issue brief provides historical context and lays out Enterprise's recommendations for systemic reform. Given the county's urgent needs for affordable rental housing, our recommendations focus primarily on Fannie's and Freddie's multifamily businesses, but it is critical for America's housing finance system to serve the full range of renters and homeowners.

Meeting the Country's Full Continuum of Housing Needs



FOUR BASIC OPTIONS FOR HOUSING FINANCE REFORM

Housing finance reform is considered one of the last remaining pieces of unfinished business from the financial crisis. Since conservatorship began in 2008, the GSEs have required roughly $188 billion in taxpayer support to stay solvent, and the companies have so far returned $266 billion to the U.S. Treasury. Under current rules, the Treasury Department sweeps all quarterly GSE profits, leaving the companies with dangerously low capital reserves. Analysts project that, unless the terms of conservatorship are reformed, even a modest downturn in the market could trigger another government bailout.[7]

Over the past eight years, dozens of advocates, industry groups, researchers and academics have offered competing plans for reforming Fannie, Freddie and the rest of the housing finance system.[8] While each proposal is unique, they generally fall into four broad categories of structural reform:

- Recapitalize and Release: Allow the GSEs to begin building capital reserves, with the goal of releasing the companies from government conservatorship.[9] This is often considered a "light-touch" approach to reform that would not require congressional action; however, it would leave in place many of the inherent flaws in the GSE model exposed during the financial crisis.[10]

- Full Privatization: Gradually wind down the GSEs, resulting in a fully private mortgage market with no explicit guarantee from the federal government on mortgage-backed securities (except those backed by Ginnie Mae). This is the general approach taken by the Republican-led Protecting American Taxpayers and Homeowners Act (PATH Act), which passed the House Financial Services Committee in 2013 through a party-line vote. This model would make it very difficult to provide liquidity during market downturns, which could hinder efforts to correct the problem.

- Full Nationalization: Transform Fannie and Freddie into government entities – either as federal agencies or government-owned corporations – that are backed by the full faith and credit of the U.S. government. This is the general approach taken by the Democratic-led Housing Opportunities Move the Economy Forward Act (HOME Forward Act) which was introduced in the House Financial Services Committee in March 2014. Such an approach would largely replicate the role that the Federal Housing Administration (FHA) and other public entities play in the mortgage market.

- Privatization with a Limited Government Guarantee: Re-establish Fannie and Freddie as private entities – either by releasing them from conservatorship or selling off their assets – and provide a new explicit, paid-for and limited government guarantee on eligible securities they issue. Under this arrangement, only the securities would be guaranteed, not the entities that issue them. This is the general approach taken by the bipartisan Housing Finance Reform and Taxpayer Protection Act (Johnson-Crapo) which passed the Senate Banking Committee in May 2014,[11] as well as recent proposals from the Urban Institute[12] and the Mortgage Bankers Association.[13]

While there are upsides and downsides to each approach, Enterprise strongly supports the fourth option as the best way to ensure: a) stable access to affordable single-family and multifamily credit for all eligible borrowers, both across geographies and throughout the business cycle; b) access to sustainable homeownership for all creditworthy families; and c) support to affordable housing for low- and moderate-income renters. Below we go into more detail on our specific recommendations for achieving those overarching goals.

Single-Family vs. Multifamily Housing Finance

The primary function of Fannie Mae and Freddie Mac is to provide liquidity to the nation's mortgage finance system. The GSEs do not make loans, but instead purchase eligible single-family and multifamily mortgages made by private firms, package those loans into securities and guarantee the timely payment of principal and interest on those securities to outside investors. The GSEs create liquidity because lenders can use the proceeds from the sale to originate new loans. If lenders had to hold onto the mortgages the originate, they would need to wait for the loans to be repaid before making new ones.

In considering any reform proposal, it is important to understand the key differences between the single-family and multifamily mortgage markets:

	Single-Family Mortgages	Multifamily Mortgages
Purpose	✓ Help borrowers purchase or refinance their homes	✓Help borrowers purchase or recapitalize rental properties with five or more units
Market Size	✓ ~$10 trillion in total debt outstanding	✓~$1 trillion in total debt outstanding
Loan Size	✓ ~$250,000 on average	✓~$10 million on average
Risk-Sharing	✓ GSEs hold most of the risk on the securities with relatively little risk-sharing with private investors (i.e. GSEs in first-loss position)	✓Risk-sharing is a key component of the GSE business model (i.e. GSEs buffered from losses on the securities)
Private Competition	✓Relatively few sources of private capital at risk beyond the GSEs and FHA	✓Several private sources of capital for certain market segments
Loan Standardization	✓Massive loan volume requires highly standardized products	✓Underwritten on a loan-by-loan basis with substantial customization
Historical Performance	✓Source of significant GSE losses during the mortgage crisis	✓GSE businesses were profitable throughout the mortgage crisis

RECOMMENDATIONS FOR REFORM

To create a more stable, liquid and accessible housing finance system that works for the full spectrum of renters and homeowners in the U.S., we recommend that the following policies be a part of any reform effort. These recommendations build on Enterprise's proposals from October 2013, which helped to inform key provisions in the bipartisan Johnson-Crapo legislation, which Enterprise endorsed in 2014.[14]

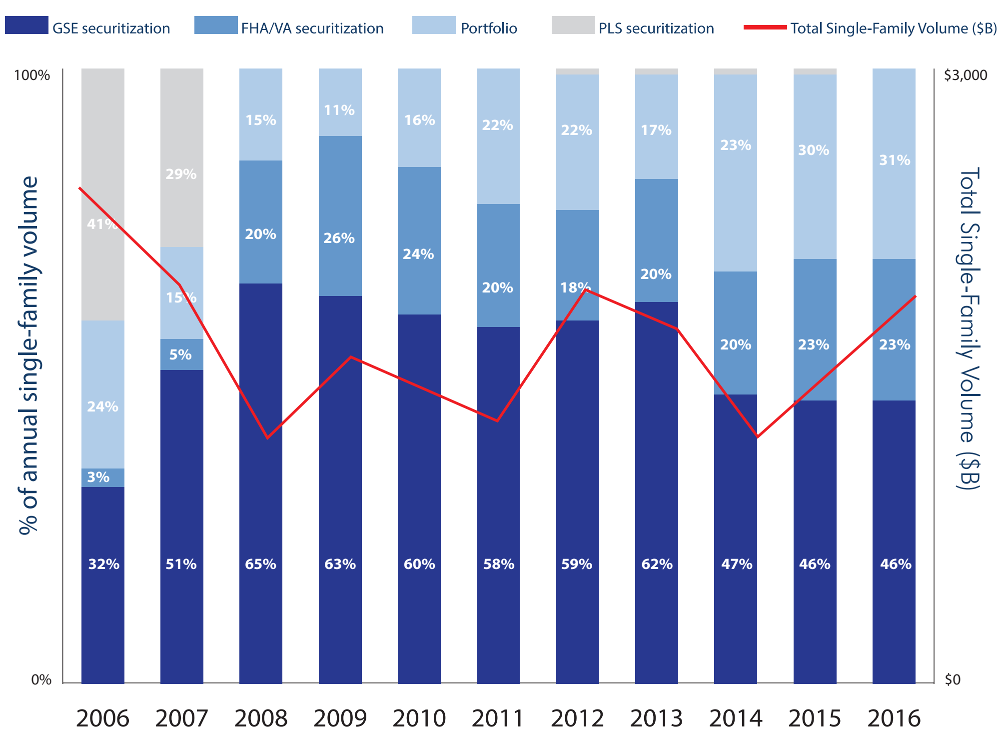
1. Establish an explicit, limited and paid-for government guarantee on qualifying single-family and multifamily mortgage-backed securities, with private investors taking a loss before taxpayers.

Some version of a government guarantee is essential to a well-functioning mortgage market. On the single-family side, the guarantee makes it possible for lenders to offer long-term, affordable products like the 30-year fixed-rate mortgage, now a pillar of the U.S. housing market. Most experts agree that this product would largely disappear without a government guarantee, making it far harder for households to purchase homes. And in both the single-family and multifamily markets, the guarantee protects the market from wild boom-and-bust cycles, allowing lenders to continue offering credit during severe market downturns.

For example, as recently as 2006, the GSEs backed less than one-third of single-family and multifamily loan originations, while private investors absorbed the rest of the market in their eagerness for mortgage debt. By 2008 – the year the housing market collapsed – the GSEs backed 65 percent of new single-family mortgages and 79 percent of new multifamily mortgages, as investors were leery of putting their money into housing without a government guarantee. Without that support, financing for home purchases, refinancings and multifamily housing would have all but dried up, essentially halting all new construction and deepening the Great Recession.

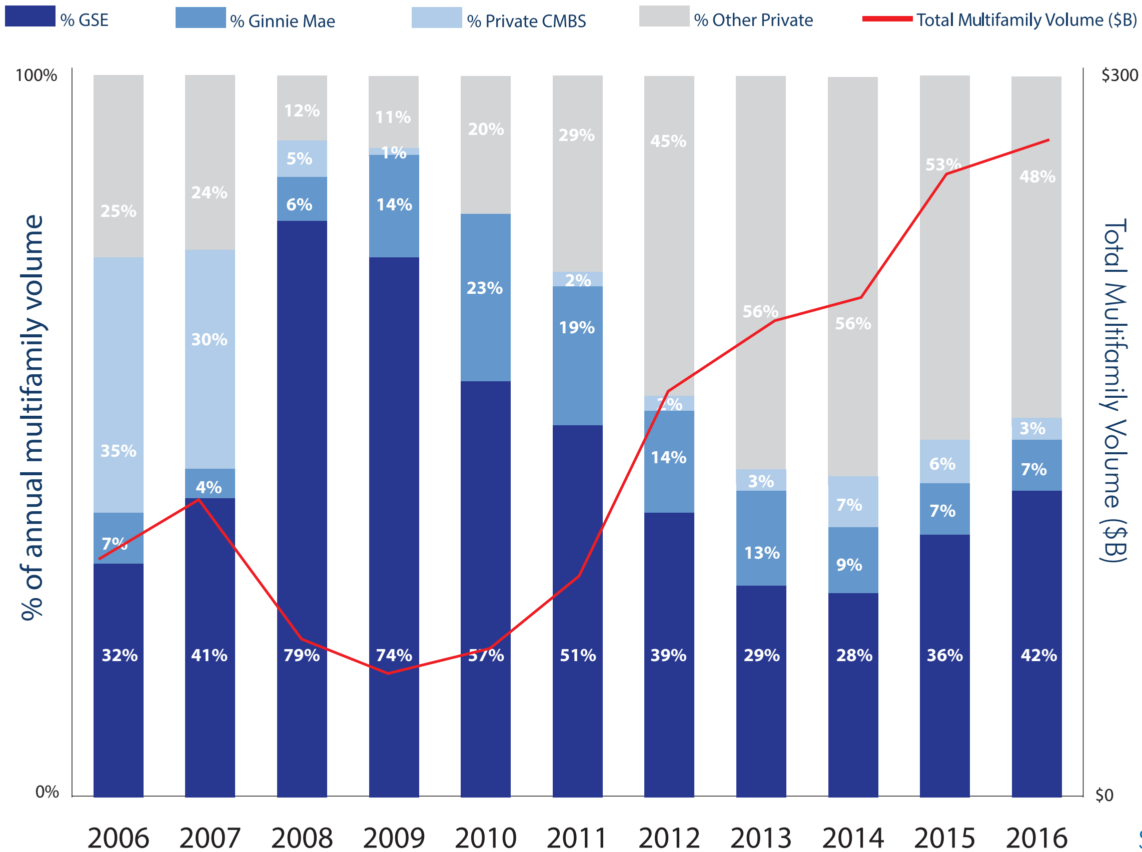
Prior to the financial crisis, Fannie and Freddie benefitted from an implicit guarantee from the federal government – meaning the government would step in if either company failed – but the companies never paid for those guarantees. We urge Congress to establish an explicit and paid-for government guarantee on qualifying single-family and multifamily mortgage-backed securities, with private investors taking a loss before taxpayers. Only the securities themselves should be covered by the guarantee, not the entities that issue them, similar to the insurance on bank deposits provided by the Federal Deposit Insurance Corporation (FDIC). And to the extent feasible, the guarantee should be widely available to all issuers and guarantors of qualifying securities, so long as those entities meet minimum financial, capital and oversight requirements.

Chart 1: GSE Share of Single-Family Mortgage Originations by Year, 2006-2016



SOURCE: Urban Institute, using data from Inside Mortgage Finance[15]

Chart 2: GSE Share of Multifamily Mortgage Originations by Year, 2006-2016



SOURCE: Fannie Mae[16]

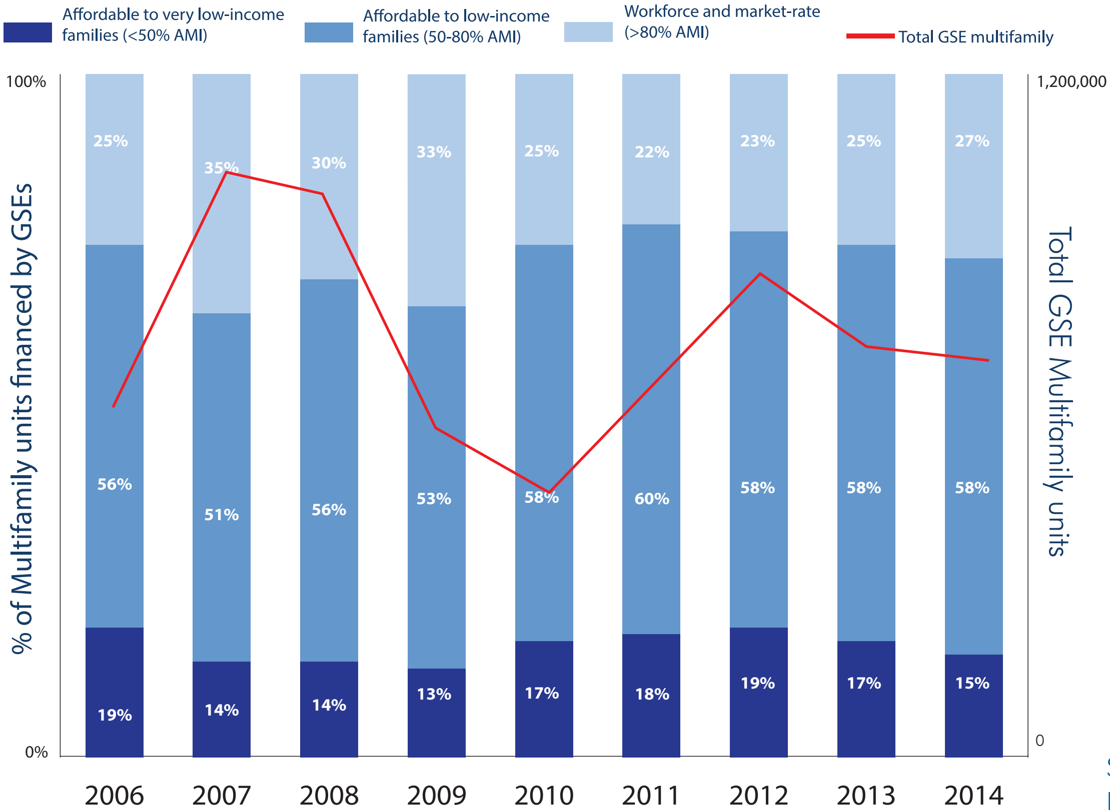
2. Preserve the current multifamily businesses at Fannie and Freddie while ensuring that those businesses continue to focus on affordable rental housing.

While the single-family businesses at Fannie and Freddie led to billions of dollars in losses during the most recent downturn, the multifamily businesses remained steadily profitable. The GSE multifamily portfolios experienced very low default rates throughout the crisis – neither company experienced 60-day delinquency rates above 0.7 percent in any year – due in part to prudent underwriting and risk-sharing with private investors.[17]

Under Fannie Mae's Delegated Underwriting and Servicing (DUS) Program, approved lenders originate eligible multifamily loans and agree to cover a portion of all losses on a pari-passu basis, meaning losses are split between the lender and Fannie as they are incurred.[18] Under Freddie Mac's K-Series Program, Freddie purchases eligible multifamily loans, aggregates the loans into pools and sells off the top 15 percent of losses to private investors, while Freddie guarantees the remaining 85 percent. Regardless of what happens to the GSEs as legal entities, those multifamily businesses must be preserved in any reform effort.

The GSE multifamily businesses are also crucial sources of capital for affordable housing developments. In exchange for an explicit government guarantee, both GSEs must hit annual unit targets for support to low-income and very low-income households, as well as affordable small multifamily properties. Due in large part to those goals, in each of the past 10 years at least 65 percent – and as much as 78 percent – of the multifamily units financed by the GSEs were affordable to low-income households, including roughly 15 percent that were affordable to very low-income households. Any future housing finance system must establish similar targets for issuers of government-backed multifamily securities.

Chart 3: Affordability Levels of GSE-Financed Multifamily Units, 2006-2014



SOURCE: Federal Housing Finance Agency[19]

3. Establish an annual assessment of at least 10 basis points on all government-insured mortgage-backed securities to fund affordable housing initiatives.

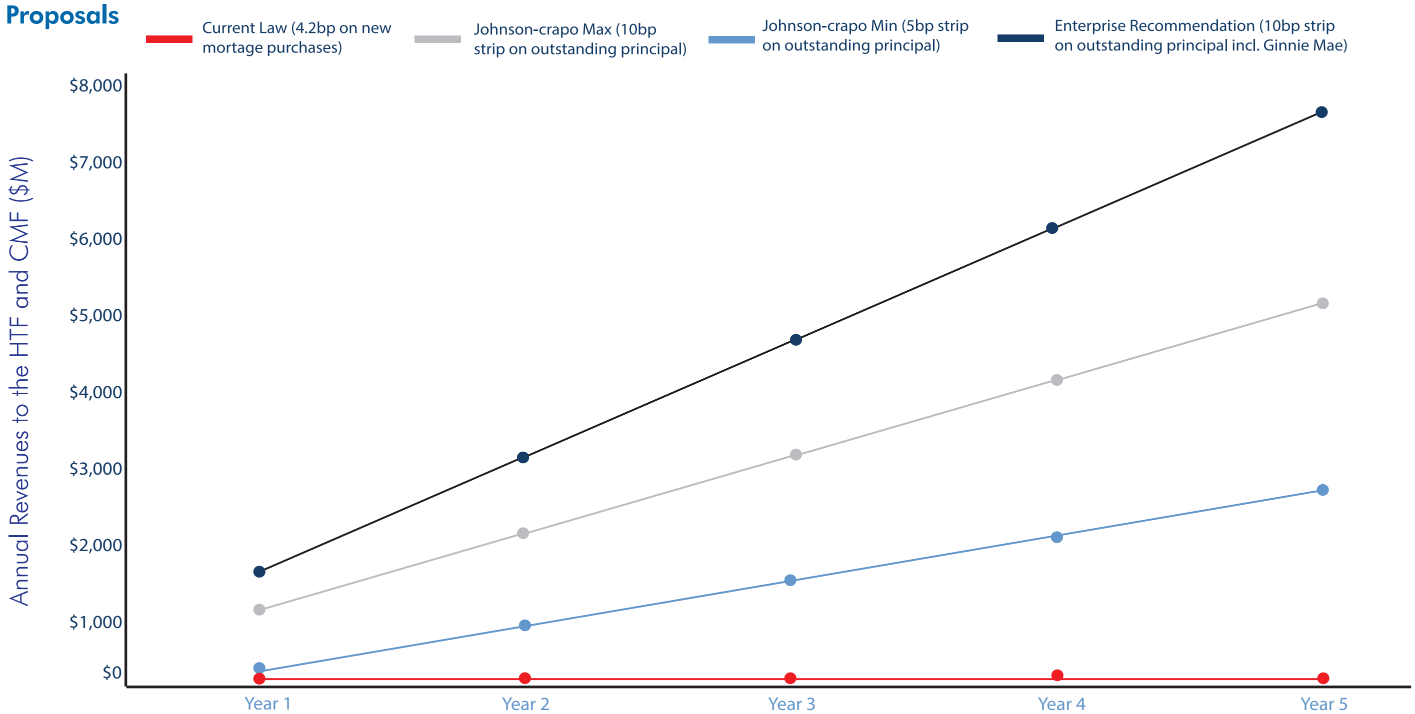
In 2008, Congress established the Housing Trust Fund and the Capital Magnet Fund to promote the production and preservation of affordable housing for lower-income families. The Housing Trust Fund is intended to support state efforts to build affordable rental housing and provide homeownership opportunities for very and extremely low-income families – meaning they earn less than 50 percent or 30 percent of the area median income, respectively – while the Capital Magnet Fund helps community development financial institutions (CDFIs) attract private funds to finance their affordable housing activities.

As originally envisioned, both funds would receive funding through a modest assessment on the ongoing business of Fannie and Freddie, but federal regulators suspended those obligations when the GSEs were put into conservatorship. In 2015, however, the GSEs began contributing money to the two funds, generating $174 million for the Housing Trust Fund and $91 million for the Capital Magnet Fund that year.

To meet the growing needs of low-income renters and homeowners, we recommend expanding the Housing Trust Fund and Capital Magnet Fund as part of any housing finance reform effort. Instead of the current arrangement, which funds the programs through a 4.2 basis-point assessment on new GSE loan purchases by Fannie and Freddie, Congress should establish an annual assessment of at least 10 basis points on all outstanding mortgages that are backed by the federal government – including all securities backed by Fannie Mae, Freddie Mac and Ginnie Mae, as well as any private entities that join or replace them in the future system.[20] We estimate that a 10 basis point annual assessment could generate more than $22 billion for the programs over the first five years and $7.5 billion per year after that.[21]

We also urge Congress to consider alternative fee structures that encourage lending to specific underserved segments of the mortgage market (see below). For example, Congress can authorize the federal regulator – currently the Federal Housing Finance Agency (FHFA) – to a set lower fee for low-down-payment mortgages to low- and moderate-income homebuyers, or an even lower fee for loans that support affordable rental housing in rural or Native American communities.[22]

Chart 4: Estimated Annual Revenues to the Housing Trust Fund and Capital Magnet Fund under Various Reform Proposals



SOURCE: Enterprise analysis of Fannie Mae, Freddie Mac and Ginnie Mae Data[23]

4. Ensure broad access to the mortgage market for all eligible borrowers and support small lenders and small multifamily properties, particularly those in low-income urban and rural areas.

In 2008 Congress established the "Duty to Serve" rule, which requires Fannie Mae and Freddie Mac to support segments of the mortgage market that are traditionally underserved by private investors – namely, preservation of affordable housing, manufactured housing and rural communities. Despite the congressional mandate, FHFA did not finalize the Duty to Serve rule until December 2016. Under the final rule, each GSE must develop and execute a three-year "underserved markets plan" that identifies the specific activities it will undertake to better serve each underserved market segment. FHFA then evaluates each GSE's progress on an annual basis.[24]

Any future housing finance system must include a similar regulatory requirement that issuers of government-backed securities serve all eligible borrowers across all geographies. However, that requirement should not be limited to the three market segments identified in the Duty to Serve rule. All approved issuers should also be required to develop plans for serving the following underserved segments of the mortgage market:

- Loans to low-income and minority homeowners, with a focus on first-time homebuyers
- Loans and equity investments that support affordable rental housing, with a focus on preservation of existing affordable properties
- Loans made by CDFIs and other small community lenders

- Loans in historically underserved neighborhoods, rural areas and Native American communities
- Small multifamily loans, which typically finance rental properties with between five and 50 units
- Loans that improve the energy-efficiency and long-term sustainability of the housing stock

5. Preserve the dual mission of the FHA – promoting broad access to homeownership for low- and moderate-income families while providing countercyclical support to the market as needed – while taking steps to shore up the agency's long-term financial health.

Since the 1930s, the FHA has promoted sustainable homeownership for creditworthy low-income and low-wealth families by insuring loans with relatively long terms and low down payments. In 2015, 80 percent of FHA-insured home purchase loans went to first-time homebuyers. That same year, as the FHA insured only about one in four home purchase loans in the U.S., it insured roughly half of all home purchases by black and Latino households. [25]

Like the GSEs, FHA also played a crucial counter-cyclical role during the most recent housing downturn. As private investors retreated from the mortgage business in the late 2000s, FHA increased its insurance activity to keep money flowing into the market. According to analysis from Moody's Analytics, the agency's actions during the crisis prevented home prices from dropping an additional 25 percent, which in turn saved 3 million jobs and half a trillion dollars in economic output.[26] Unfortunately, those actions came with a cost. Due to losses incurred on loans made leading up to and during the peak of the housing crisis, FHA required $1.7 billion in support from the Treasury Department in 2013, marking the first and only time in its 80-year history that the agency has needed support from taxpayers.

Even though FHA's finances are much stronger today, the 2013 support from taxpayers has caused some members of Congress to push for drastic and dangerous changes to the FHA.[27] Any future reform effort must preserve FHA's dual mission – promoting broad access to mortgage credit for first-time homebuyers and lower-incomes families while providing countercyclical support to the market as needed – while shoring up the agency's long-term financial health.[28]

NEXT STEPS

Enterprise looks forward to a thoughtful debate in the coming months about the future of the GSEs and the government's role in the housing market. The decisions made in Congress on GSE reform will have a profound impact on the U.S. housing market and the broader economy.

A liquid, stable and affordable market for single-family and multifamily mortgages is critical to a well-functioning housing market – and both depend on an explicit and paid-for government guarantee. It's also important that any reform effort preserves other components of the existing system that have proven to work, including Fannie's and Freddie's existing multifamily products and a clear requirement that investors who benefit from a government guarantee support underserved segments of the housing market. Through these and other changes, we can ensure that our country's housing finance system works for all Americans across the income spectrum, regardless of whether they own or rent their homes.

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ENDNOTES

1. Center for Responsible Lending, "Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures" (2011): http://www.responsiblelending.org/mortgage-lending/research-analysis/Lost-Ground-exec-summary.pdf.

2. Today 42.7 percent of black households are homeowners, while 71.8 percent of white households are homeowners. It is worth noting that much of this disparity is due to a legacy of federal housing policies that perpetuated racial segregation. See more at: http://www.enterprisecommunity.org/blog/2015/09/contributed-segregated-communities.

3. Harvard Joint Center for Housing Studies, State of the Nation's Housing 2017 (June 2017): http://www.jchs.harvard.edu/research/state_nations_housing.

4. Enterprise Community Partners and the Harvard Joint Center for Housing Studies, Projecting Trends in Severely Cost-Burdened Renters: 2015–2025 (September 2015): http://www.enterprisecommunity.com/resources/ResourceDetails?ID=0100886.

5. For a side-by-side comparison of these four bills, see http://www.enterprisecommunity.org/resources/comparing-four-housing-finance-reform-bills-congress-13224.

6. To read Enterprise's briefing before the Senate Banking Committee in April 2017, see https://www.enterprisecommunity.org/resources/briefing-multifamily-housing-finance-19542.

7. Joe Light, "Fannie-Freddie Watchdog Says He Can't Let Capital Go to Zero," Bloomberg Businessweek (May 2017): https://www.bloomberg.com/news/articles/2017-05-11/fannie-freddie-regulator-warns-he-can-t-let-capital-fall-to-zero.

8. John Griffith and the CAP Housing Team, "A Comparison of Plans to Reform Our Housing Finance System," Center for American Progress (July 2013): https://www.americanprogress.org/issues/economy/news/2013/07/19/69881/a-comparison-of-plans-to-reform-our-housing-finance-system.

9. Most recently this approach to reform was proposed by investors Paulson & Co. and Blackstone Group LP, in part because it would likely deliver a windfall to holders of Fannie and Freddie common stock. For more on this proposal, see: http://gsesafetyandsoundness.com.

10. For example, in the event of another market downturn, both Fannie and Freddie would still have access to a capped line of credit with the U.S. Treasury; however, the GSEs would not have to pay for access to that guarantee.

11. John Griffith and Andrew Jakabovics, "Inside Johnson-Crapo — What the Senate Housing Finance Reform Bill Could Mean for Low- and Moderate-income Communities," Enterprise Community Partners (2014): http://www.enterprisecommunity.org/resources/policy-focus-inside-johnson-crapo-what-senate-housing-finance-reform-bill-could-mean-low.

12. Jim Parrott, Lewis Ranieri, Gene Sperling, Mark Zandi and Barry Zigas, "A More Promising Road to GSE Reform: Governance and Capital," Urban Institute (June 2016): http://www.urban.org/sites/default/files/publication/81331/2000809-A-More-Promising-Road-to-GSE-Reform-Governance-and-Capital.pdf.

13. Mortgage Bankers Association, "GSE Reform: Creating a Sustainable, More Vibrant Secondary Mortgage Market" (April 2017): https://www.mba.org/issues/residential-issues/gse-reform-principles-and-guardrails.

14. Terri Ludwig, "Housing Finance Reform: Essential Elements of the Multifamily Housing Finance System," Testimony before the Senate Banking Committee (October2013):https://www.banking.senate.gov/public/_cache/files/486e5a45-8e63-43a0-90a7-cfba21ff8736/23C6AE00CC53D93492511CC744028B5E.ludwigtestimony10913.pdf.

15. Urban Institute, Housing Finance At A Glance: A Monthly Chart Book (May 2017): http://edit.urban.org/sites/default/files/publication/90451/may_chartbook.pdf.

16. Fannie Mae, "Fannie Mae Multifamily Mortgage Business Information" (May 2017): https://www.fanniemae.com/content/fact_sheet/multifamily-business-information.pdf.

17. Fannie Mae, "Fannie Mae Multifamily Mortgage Business Information."

18. The specifics vary from loan to loan, but in general, under Fannie Mae's Delegated Underwriting and Servicing (DUS) Program, licensed lenders can either agree to cover one-third of the total losses on the loan, or they can cover the first 5 percent and a portion losses beyond that point, capped at 20 percent.

19. Federal Housing Finance Agency, 2015-2017 Enterprise Housing Goals, 12 CFR Parts 1282, RIN 2590–AA65 (September 2014): https://www.gpo.gov/fdsys/pkg/FR-2014-09-11/pdf/2014-21118.pdf.

20. Notably, three of the four housing finance reform bills introduced in the 113th Congress would have significantly expanded funding for the Housing Trust Fund and Capital Magnet Fund. For more see: http://www.enterprisecommunity.org/resources/comparing-four-housing-finance-reform-bills-congress-13224.

21. This estimate assumes that future new business volumes stay roughly consistent with 2016 levels ($637 billion for Fannie, $446 billion for Freddie and $430 billion for Ginnie).

22. For more on how such an incentive-based fee structure could work, see: http://www.urban.org/sites/default/files/publication/22521/413094-Johnson-Crapo-GSE-Discussion-Draft.PDF.

23. This estimate assumes that future new business volumes stay roughly consistent with 2016 levels ($637 billion for Fannie, $446 billion for Freddie and $430 billion for Ginnie).

24. Learn more about the Duty to Serve rule at http://www.enterprisecommunity.org/blog/2016/12/fhfa-releases-final-duty-serve-rules-fannie-mae-and-freddie-mac.

25. Federal Housing Administration, Annual Report to Congress: The Financial status of the FHA Mutual Mortgage Insurance Fund, Fiscal Year 2016 (November 2016): https://portal.hud.gov/hudportal/documents/huddoc?id=2016fhaannualreport1.pdf.

26. John Griffith, "The Federal Housing Administration Saved the Housing Market," Center for American Progress (October 2012): https://www.americanprogress.org/issues/economy/reports/2012/10/11/40824/the-federal-housing-administration-saved-the-housing-market.

27. For example, the Republican-led PATH Act, which passed the House Financial Services Committee in July 2013 through a party-line vote, would have restricted the FHA's mission to insuring first-time homebuyers and lower-income families, increased the minimum down payment on all FHA-insured loans for non-first-time homebuyers, lowered the maximum insurance coverage, doubled the FHA's mandatory capital reserve, reduced the maximum loan size the FHA can insure and mandated new reporting requirements for the FHA under GAAP accounting rules.

28. The bipartisan FHA Solvency Act, which passed the Senate Banking Committee in July 2013, offers a few examples of concrete steps Congress can take to improve the FHA's finances. For more see: https://www.americanbanker.com/news/senate-banking-panel-passes-fha-bill.