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BankThink Five simple ways GSE reform can narrow the homeownership gap

By **Karen Shaw Petrou**
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With house prices reaching new highs each month, it is easy to come to the conclusion that U.S. residential housing has fully recovered since the depth of the financial crisis. However, the housing recovery is as unequal as the rest of U.S. income and wealth distribution.

When it comes to housing, the gap between those at the upper ends of the wealth ladder and lower-income Americans has widened markedly since the financial crisis, despite the trillions of direct and indirect subsidies that taxpayers provide to the housing finance system.

Homeownership, of course, isn't always the right decision for households at the very bottom of the income spectrum, but it's still the best path to long-term wealth accumulation for younger and low-to-moderate-income Americans. With Congress and the administration set to reconsider how Fannie Mae, Freddie Mac, the Federal Housing Administration and the Federal Home Loan banks support residential finance, now is the time to assess why a market in which 90% of mortgages are backed by the U.S. taxpayer fails to meet the housing market's most urgent needs.

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Here are five ways that mortgage policy reforms could promote housing equality and encourage private capital to return to mortgage finance. Each action plan is meant to provide taxpayer-backed support for underserved markets and otherwise get the government out of the market's way.

Income-targeted loan programs

Currently, the government-sponsored enterprises (Fannie and Freddie) and the FHA provide backing for high-principal loans in "high-cost" areas, where home prices exceed the national median. But in many instances, subsidies are being directed to ultra-expensive home purchases, taking resources away from mortgages at the national average and more affordable price.

The GSEs are now allowed to buy or back loans over $600,000 and approaching $1 million in certain high-cost areas. Loan limits are tighter in most of the country, but there too the maximum support allowed is not only well above median national existing house prices — about $256,000 — but often far beyond actual house prices in lower-income and/or hard-hit communities. In some states, the government-sanctioned limits in certain areas far exceed the statewide prices.

When the GSEs guarantee or the FHA insures loans for higher-price housing for upper-income people, taxpayers put their hard-earned funds at risk for borrowers eligible for private-sector mortgages. The rationale for this is that government backing ensures mortgage liquidity for 30-year fixed-rate loans without prepayment penalties. However, the small-dollar savings this liquidity affords in mortgage rates does not warrant huge taxpayer risk. Government risk subsidies should be directed to borrowers who need the most help.

Affordability credit risk transfers

Fannie and Freddie have structured portions of their mortgage portfolios into tranches that share risk with reinsurers, hedge funds and other investors. Even so, the GSEs take a first-loss position and subsidize risk-share pricing. Why not encourage more private capital into equality-boosting mortgage finance by pushing the GSEs to structure credit risk transfers for the mortgages that most need their help?

That the GSEs can sell off much of the credit risk for most of the higher-quality mortgages they hold suggests that available private capital can take it on without a taxpayer-backed middleman. The GSEs should only subsidize risk transfers and retain first-loss tranches for underserved markets and the innovative products needed to meet the needs in those markets.

Limits on equity extraction

Because a home is the most important source of wealth accumulation for LMI households, equity extraction — in which homeowners borrow against the value of their home — can lead to financial ruin. For good measure, it can also threaten financial stability if cash-out refinancing transactions or second liens convert first liens, in which a borrower owned a substantial amount of equity, into mortgages with sky-high loan-to-value ratios.

GSE or FHA backing for cash-out refinancing keeps loan volume up, but it only supports consumption, not homeownership. This is because a refinancing — by definition — benefits only a borrower who already has a home. Some of this consumption is necessary under financial stress or as a source of wealth for retirement or education. Much of it, though, supports spending on vacations, home improvements or automobiles that — however much desired — could be acquired through other credit sources without taxpayer support or market risk. As with U.S.-backed mortgages for higher-income borrowers, U.S.-backed lending for consumption crowds out other credit providers even as it encourages wealth destruction.

Sharing buyback risk

After the housing crisis, the GSEs and the FHA have put a lot of risk back onto originators, blaming lenders for poor underwriting. Those with capital to back this risk — i.e., banks — often decided that the terms of these repurchases were so sweeping and the associated capital costs were so high that they simply walked away from all but the safest loans. Put-back risk has since been rolled back.

But originators' reluctance to make loans that they may have to buy back remains a formidable barrier for bank originations of the higher-risk loans most important to economic equality. Government agencies should identify products most likely to benefit younger and LMI borrowers, designing mortgages that ensure sustainable homeownership and sharing put-back risk with originators. This is a meaningful way for taxpayer-backed risk to enhance private capital instead of replacing it.

Better-designed mortgage products

A housing market that is 90% dependent on the government means that trillions of dollars of government support go to the types of mortgages that are the easiest to securitize in huge quantities. These are the least risky loans that support the greatest volume of mortgage origination, home-building and real estate transactions. But this commoditized underwriting and delivery system exacerbates the scarcity of mortgage products supporting sustainable homeownership for underserved housing markets (those with underwater mortgages and remaining stocks of vacant homes), young borrowers with student-debt loads, and borrowers such as the disabled or those in communities with unusual needs. Housing is indeed an important engine of U.S. prosperity, but taxpayer support should go first to ill-served borrowers and communities, not those who would do well even if forced to go it alone.

The need for efforts to improve housing equality has never been more evident. A new report by the Department of Housing and Urban Development found that housing affordability has never been worse. It's time to move past the old arguments about whether GSE affordable-housing goals caused the crisis or if big banks are inherently predatory lenders that need a regulatory straitjacket.

The GSEs' pre-crisis goals did no one any good and large banks made all too many lending and servicing mistakes, but that was then. Now, we have ever-worsening economic inequality. Mortgage disparities, which play a critical role in that inequality, warrant rapid reform.

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Posted By **teknoscribe**
Monday, August 21 2017 at 9:54 PM

Speaking for myself, I can say GSE reforms will never restore any trust I might have had in any mortgage. Losing your life savings will do that to a person. It seems obvious that the game is stacked to serve the lenders, and anyone with less than a million should not, under any circumstances, reach for that home ownership mirage. After torching a generation's worth of customers, perhaps the mortgage lenders should focus exclusively on the top end - it might be fun to watch that snake eat itself.

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