Policy Debates

Leading experts weigh in on current policy issues and challenges

Revisiting Housing Finance: Why a Federal Role?

Almost 10 years into the conservatorship of Fannie Mae and Freddie Mac; a homeownership rate that is stuck in general and continues to fall for African Americans; skyrocketing rents and house prices in places with the greatest job opportunities—not a pretty picture for housing finance in the United States. With tax reform completed, Treasury's desire to make reform a priority, and major personnel changes on the horizon in Congress and the Federal Housing Finance Agency, there is a new push for legislative action on reform. In this debate, we explore a critically important aspect of the path forward: how the federal government should support housing—both homeownership and rental—for those the market will not.

The Urban Institute is talking with...

Mike Calhoun, Laurie Goodman, Tim Howard, Shekar Narasimhan, Ed Pinto, Rob Randhava, Lisa Rice, Mark Zandi, Barry Zigas

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Moderated by:

Ellen Seidman

Non-Resident Fellow, Urban Institute

Ellen Seidman

Non-Resident Fellow, Urban Institute

said at 8:31 am on March 14th, 2018:

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Welcome to our Policy Debate on housing finance reform, with a focus on access and affordability. Many thanks to all our debaters—a lively group with diverse opinions.

The confluence of a new administration, the announced retirements of major champions of housing finance reform in the House and Senate and the end of Mel Watt's term as FHFA Director early next year, the drawdown of Fannie's and Freddie's capital—and a fairly widespread belief that our housing finance system is not optimally serving the country—have come together in a renewed debate on housing finance reform. Spurred by a draft Senate bill, many parties, with varying perspectives, have weighed in. As with the Urban Institute Housing Finance Policy Center's (HFPC) previous Housing Finance Reform Incubator, this Policy Debate brings together many of those voices. Unlike the incubator, however, this debate is focused on the critical issues of access and affordability—for both owned and rented housing.

The problems in the current system manifest in multiple ways, as our participants have recognized in their writings over the past several years. HFPC research has set the number of "missing mortgage loans" because of an overly tight credit box at 6.3 million between 2009 and 2015 and HFPC's February Chartbook shows only limited signs of credit easing. And the gap in the homeownership rate between black and white households is large and, in most places, growing. HFPC authors have also noted that high rents in many major metros make it cheaper to own—at the same time that ownership is also expensive.

For our first question, I'd like debaters to (i) define the federal government's responsibility to support housing both in terms of the type of support and who should be supported; (ii) highlight the major flaws you see with the current system; and (iii) provide a succinct bottom line description of how you think the system (including if you wish FHA, VA, RHS and the Home Loan Banks) should be reformed to better meet the government's responsibility as you've defined it. I'd like to hold the pros and cons of the draft Senate bill until the second round if possible.

Ed Pinto
Codirector, AEI Center on Housing Markets and Finance
said at 9:06 am on March 14th, 2018:

(i) The only plausible reason for government to back the housing market is to help low- or moderate-income (LMI) families buy homes in a sustainable manner that reliably builds wealth. Current policies fail to meet this simple test.

(ii) Since the early 1990s government housing policies have resulted in higher and more volatile home prices trends, particularly at the entry level. In a seller's market, which has predominated, prices rise faster than incomes, so long as marginal buyer, who sets the price for all, has access to higher leverage. The marginal buyer determines not only price level, but also the degree of stability, as price is not necessarily equal to value, especially in a supply constrained market. Cross-subsidies and expanded access to credit push up demand against a

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regulation-constrained supply. In a seller's market, when choice is restricted and the seller virtually dictates sales terms, more liberal credit is likely to be capitalized into higher prices. (Ernest Fisher).

(iii) Eliminating the GSEs and greatly reducing government support will slow price growth and homes will become more affordable with greater price stability for first-time LMI buyers. The FHA should focus on sustainable and wealth-building home purchases by first-time LMI buyers.

Lisa Rice
Executive Vice President, National Fair Housing Alliance
said at 5:10 pm on March 15th, 2018:

I would like to proffer an additional, critically important reason for the federal government to back the housing market - to overcome and undue the effects of previous government-sponsored, de jure discriminatory housing policies. The federal government created policies, procedures and an infrastructure for institutionalizing residential segregation and redlining in the U.S. We are still suffering from the impacts of those policies today. But it is not only low- or moderate- income communities of color that are affected; middle and higher income communities of color are also dealing with the fallout from these discriminatory policies and practices. In fact, the stark racial wealth gap in America has been primarily caused by harmful policies put in effect decades ago that have never been addressed or cured. The federal government cannot turn its head from its obligation and responsibility to right this wrong. The economic viability of our families, communities, and indeed the nation, depend on the government supporting communities that have been under-served the same way it has helped the broader market since our country's inception.

Ed Pinto
Codirector, AEI Center on Housing Markets and Finance
said at 2:02 pm on March 16th, 2018:

FHA has been rightly criticized for condoning segregation based on race and national origin and enforcing local customs and practices including racial and ethnic covenants through its underwriting practices. It was wrong to condone long-outdated segregation attitudes and policies. Yet a total of 1 ¼ pages of its five hundred page Underwriting Manual consisted of references to racial and ethnic customs and practices. Lost in the redlining criticism was the fact that for the 20-year period ending in 1954, FHA's sustainable underwriting standards led to the virtual elimination of foreclosures and loss severity was in the single digits.

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Racial and ethnic segregation long preceded FHA—at least going back to the 1890s. For level of segregation in early-1930s, before the FHA set up shop, see Hoyt, Homer. 1939, *The Structure and Growth of Residential Neighborhoods in American Cities.* https://archive.org/details/structuregrowtho00unitrich

Government policies hurting first-time home buyers by unsustainably driving up prices and forcing them to take on more risk.

Reliable wealth building should be the goal of federal home ownership policy.

Tim Howard
Former Vice Chairman and CFO of Fannie Mae
said at 12:35 pm on March 14th, 2018:

The federal government's housing responsibilities should be to (a) devise and implement subsidy programs in support of underserved populations, and (b) foster the development of a housing finance system that will provide the lowest-cost mortgages to the widest range of borrower types, consistent with an agreed-upon standard of taxpayer protection.

The biggest flaws in the current system are that the centerpieces of the secondary mortgage market, Fannie and Freddie, have not yet been given updated, true risk-based capital standards, and that they remain in conservatorship without the ability to retain earnings or raise private capital. During and after the crisis these two companies had by far the lowest default rates of any source of mortgage credit. There is no policy reason to replace them with an untested alternative; they should be allowed to recapitalize to new risk-based standards, be given utility-like return limits and made subject to tighter regulation, and be released from conservatorship.

For subsidized housing programs, I propose a small (5-10 basis point) fee assessed on all new residential mortgages, not just those financed in the secondary market.

Mike Calhoun
President, Center for Responsible Lending
said at 10:43 am on March 14th, 2018:

Market participants that benefit from implicit federal government-backing must serve the public interest through enforceable obligations. Compliance with fair lending is required along with affirmative duties on regulators to further fair lending. The GSEs are required to serve all markets, credit-worthy borrowers, lenders, and must protect taxpayers. The charters of Fannie Mae and Freddie Mac require them to ensure the flow of affordable mortgage credit to

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undeserved borrowers and communities – in urban and rural areas. They are subject to enforcement provisions, restrictions on business, and penalties to ensure these duties are met.

Despite these mandates, our current system is far from perfect. For instance, despite the cross-subsidy in the current system, lower wealth borrowers are still assessed far too much in fees/insurance with loan level price adjustments and PMIERS. Excessive risked-based pricing has an adverse effect on people of color and leads to under service by conventional lenders.

FHFA and the GSEs must eliminate excessive risk-based pricing and do more to average price. The 2008 housing crash was caused by systemic failure and working families should not bear the burden of the risk by being forced to pay for the cost of the probability of another financial meltdown.

Mark Zandi
Chief Economist, Moody's Analytics
said at 10:45 am on March 14th, 2018:

The federal government should ensure that affordable mortgage credit is widely available to creditworthy borrowers under all economic conditions. This is especially important for lower and middle income households and underserved communities.

This requires that the federal government makes available an explicit government guarantee to parts of the housing finance system. A guarantee that should be paid for by mortgage borrowers.

The current system with Fannie Mae and Freddie Mac in conservatorship is not sustainable long-term. The system will not be able to sufficiently keep up with the nation's changing demographics and mortgage needs. Moreover, the support provided by the government to the system and the underserved will be variable and uncertain. Private capital can and should also play a bigger part in the system.

The most politically and economically viable approach to ending the GSEs' current conservatorship is to move to a multiple guarantor system. In this system, several highly-regulated and appropriately capitalized private guarantors compete head-on. The government backstops the system for a fee that fully compensates taxpayers for any risk. To ensure that low and moderate income households are well served, high income households are charged a fee to pay to lower the costs to the underserved of becoming homeowners.

FHA reform should also be part of any housing finance reform, given the importance of the FHA, VA and USDA to promoting responsible homeownership, particularly in the most difficult times.

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Laurie Goodman
Director, Housing Finance Policy Center
said at 10:48 am on March 14th, 2018:

I agree with Tim's description of the Federal Government's housing responsibilities. And he said it so well, that I will not repeat it.

In executing the goals, the present system has a number of policy objectives for the GSEs: preserving the liquidity of the mortgage market, which reduces the mortgage rate for all borrowers; preserving the 30-year fixed rate mortgage; ensuring equal access to the system for lenders of all sizes; bringing competitive private capital in to bear most of the credit risk; and giving all credit worthy borrowers access to the system. The problem is, the last two of these goals are inconsistent. If you ask the private market to bear the credit risk, they are going to want to price that risk at as granular a level as possible. However, that is going to price some credit-worthy borrowers out of the system.

The current system handles this tension by having the GSEs provide some cross-subsidy through their level guarantee fees and some risk-based pricing through their loan level price adjustments. Not only is this a muddled way of going about it, it's utterly inefficient, as much of the subsidy is going to those who don't really need it; they just happen to have poor credit. Moreover, it's not at all clear how this support for access relates to that provided by the FHA, whose mission it is to play this very role. Any reformed system should clean this up, making the support we provide for access more transparent, more efficient and more effective.

Tim Howard
Former Vice Chairman and CFO of Fannie Mae
said at 1:16 pm on March 14th, 2018:

I think it's important to keep the issues of cross subsidy and direct subsidy distinct. The two are not substitutes; they are complements. That is, our mortgage finance system should be set up so that credit guarantors can do cross-subsidy as effectively and efficiently as possible, and we should complement that with a workable mechanism of direct subsidy. Affordable housing constituents will be best served by such an approach.

I respectfully disagree with Laurie's statement that, "bringing competitive private capital in to bear most of the credit risk; and giving all credit worthy borrowers access to the system" are "inconsistent." For the time I was CFO at Fannie Mae (1990 to 2004) I believe we did that extremely well. It was in our best economic interest to do so. The most important determinant of our ability to cross-subsidize was our very low credit guaranty capital requirement (in retrospect, of course, too low). Capital remains the key to effective cross-subsidy, and I believe requiring the credit guarantors of the future—whether Fannie and Freddie or other entities—to hold capital unrelated to the risk of the loans they guarantee, as many reform proposals

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insist upon, will have significant negative consequences for affordable housing borrowers that are entirely avoidable under a true risk-based capital regime.

Barry Zigas
Director of Housing Policy, Consumer Federation of America
said at 7:28 pm on March 14th, 2018:

Tim is right that capital (and expected rate of return on it and modeled losses) will drive mortgage pricing and that requiring too much capital will drive prices higher than necessary. Conversely, as Tim notes, insufficient capital levels can lead to guarantee fees that are too low to compensate for the risk. This is an especially good reason for Congress to leave decisions about capital levels to a well resourced regulator that can change them as market circumstances change, and not try to legislate levels.

But it's also important not to wax too nostalgic about the breadth of GSE lending before the crisis. First, robust housing goals and a 1992 charter mandate to pursue LMI lending even at lower returns than non-targeted business pushed Fannie and Freddie much further into lending to more diverse (in every respect) borrowers than either would have done on their own. It's also worth remembering that both companies in the past could cross subsidize the credit guarantee business with the portfolio investment business (and vice versa), something no longer available to them or likely to be available to any successor guarantors. Finally, both companies cross subsidized lenders by negotiating guarantee fees to gain and keep market share, sometimes but often not at all connected to the delivery of goals to underserved borrowers.

All in all, the cross subsidy picture for the pre-crisis GSEs is hard to fully parse. What's not debatable is that a system relying wholly on private capital without the benefits Tim mentions and with no constraints on that capital's returns is unlikely to be able to extend credit as affordably in the future as it may have done in the past.

Lisa Rice
Executive Vice President, National Fair Housing Alliance
said at 5:55 pm on March 15th, 2018:

I would like to add another element to the tete-a-tete between Laurie and Tim and that is the need for laser-focused attention on a particular segment of under-served consumers, namely, borrowers of color and other consumers, ie. persons with disabilities, etc., who have been ill-served by the financial markets. I think Laurie hit the nail on the head. There is an unresolved clash between extending credit access to borrowers that the traditional market has deemed to be more risky from a credit standpoint and pricing consumers who are in that bucket.

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For the entirety of our nation's history, this tension has meant precisely what Laurie suggested - some credit-worthy borrowers are priced right out of the system. That is because it is the non-traditional credit market that provides credit access for many under-served consumers. And those credit providers have practices that artificially deflate the credit scores of the consumers they serve. For example, many non-traditional credit providers do not report timely credit payments to any credit repository and this means borrowers lose the benefit they might have gleaned from their timely payments had they been able to access credit in the financial mainstream.

What this has meant is that the GSEs have never had a representative market share when it comes to their investments in communities of color. I can remember - each year - generating GSE market penetration maps for the city of Toledo - my home town. Those maps often revealed that the GSEs had not purchased one single loan in Toledo's African-American and Latino neighborhoods. Now, I was creating those maps in the 1990s and 2000s but I am afraid this is still the case in today's market. GSE market penetration is abysmally low in these areas and that simply means that the Enterprises are not providing liquidity for mortgage credit in communities of color - something that, as Mike Calhoun pointed out - flies directly in the face of the GSEs' charters and fair lending obligations.

The secondary housing finance system must operate in a way that does not price (or underwrite) under-served groups out of the system, better affixes pricing for borrowers who have been under-served - including low-wealth borrowers, and provides meaningful and effective cross-subsidies.

Barry Zigas

Director of Housing Policy, Consumer Federation of America

said at 7:41 pm on March 14th, 2018:

I think it's important to clarify what the point of cross subsidies in a broad insurance pool is. It's not necessarily to deliver subsidy to a specific income group. It is to level out the pricing of risk in the pool so those with lower risk profiles can support the expected higher costs of higher risk profiles, with an average price that evens out these differences. This is more a matter of *equity* as in equitable treatment of like profiles than *subsidy* of certain groups regardless of their profile. The 1992 and 2008 legislative mandates that the GSEs serve the broadest market possible through the use of housing goals and a directive to *accept* lower returns for some business did not mandate subsidies. They directed the GSEs to incorporate the cost of extending credit to higher risk borrowers in their overall business model.

Barry Zigas

Director of Housing Policy, Consumer Federation of America

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said at 1:06 pm on March 14th, 2018:

There has been a broad bipartisan consensus about the government's roles in housing since its first interventions during the New Deal and this is broadly reflected in the other comments. These are support for affordable rental housing through direct subsidies and tax preferences, and support for a broad national mortgage market that assures consumers of access to responsible mortgage credit across a broad range of down payment and credit profiles throughout business cycles.

The current system fails miserably at the first objective. Securing a significant, dependable revenue source for affordable rental housing as part of mortgage finance reform through a fee as proposed in numerous models is essential. Given the outsized support homeowners receive through tax subsidies, rental assistance should get the lion's share of that fee.

The current system and most future models also fail to capitalize on the interrelated roles of FHA and other government mortgage insurance programs like VA and RHS to support the second objective. The current system fosters contradictory policy initiatives and can lead to them working at cross purposes. The tension between the political desire to see private capital bear more risk without subsidy and the imperative to assure broad access to credit is inescapable, as Laurie points out. FHA, et al., are designed to provide broad cross subsidies and level risk pricing. By design they offer cost advantages private insurance cannot and can serve consumers when private capital will not offer a competitive price. These features should be fully used in designing any new system.

Rob Randhava
Senior Counsel, The Leadership Conference on Civil and Human Rights
said at 6:47 pm on March 14th, 2018:

It looks like there is a good deal of agreement that if companies enjoy public protections – and I recognize that Ed questions the wisdom of that in this context – then they should be required to serve the public in return. Fannie and Freddie currently do this in a number of ways, including the affordable housing goals, compliance with civil rights laws, the trust fund, the duty to serve rule, and other policies. These policies have been helpful, and they should be preserved if not improved.

But we should clarify what we mean by "the current system." This summer will mark a decade since the enactment of HERA and since the GSEs were put in conservatorship, eight years since the passage of Dodd-Frank, and six years since GSE profits were eliminated and their capital reserves – something we usually think of as a cornerstone of sound financial regulation – were set on a course to zero. While FHFA Director Mel Watt wisely restored a buffer, it was a limited move and the GSEs still operate in a state of excessive restraint.

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While I'm open to proposals that preserve or improve on the goals and other access & affordability policies, I agree with Tim that we should end the conservatorship in the short term. This isn't in order to go back to the system we had before the crisis, as some have claimed, but because we no longer operate under the same system - and a decade later it might be wise to assess how the new one works in a "real world" setting before wiping out a multi-trillion dollar industry and starting from scratch. If we're still keeping the GSEs in conservatorship after ten years largely because so-called "recap and release" would undermine the momentum for reform, then perhaps we need a better case for it.

Ellen Seidman
Non-Resident Fellow, Urban Institute
said at 8:16 pm on March 14th, 2018:

Thank you all for your meaningful (and succinct!) responses to the first question, as well as for some serious interaction among you.

I think there's general agreement that there is a federal role in housing finance, and that it revolves around ensuring that there is decent affordable housing—including homeownership opportunities—for those the market would not serve on its own. And there also seems to be agreement that the current system—and Rob is right that we need to be careful about what we mean by "current system"—is not producing this result. But there are significant disagreements about mechanisms and, in particular, the role of entities beyond those that are wholly government owned (FHA, VA, RHS).

The draft Senate bill is one of many plans and proposals for how to get from the current, sub-optimal system to one that aligns with the goals you've articulated. But it is the plan currently in play. For the second question, please discuss why and how you think the Senate draft does or does not align with the goals you've set out for access and affordability. Please consider issues beyond dollars—both because we're dealing with a system, not just a series of transactions, and because the Senate bill touches on these issues (whether by commission or omission). What of housing goals, duty to serve, business judgment, fair lending, enforcement mechanisms? Suggestions as well as critiques are welcome; this debate can be the source of constructive improvements to the bill.

For those of you who think the FHA needs to be a critical element in a future housing finance system, please provide your thoughts about how the FHA can effectively overcome not only its redlining past, but also more recent issues involving ancient technology and spotty oversight of both lenders and servicers. Are the VA and RHS different, and could some of their experiences help guide a revitalized FHA?

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Lisa Rice
Executive Vice President, National Fair Housing Alliance
said at 10:52 am on March 16th, 2018:

The leaked draft Senate bill falls short on fair lending and fair housing protections. It appears that the drafters of the bill were of the assumption that current fair housing protections are primarily contained in the federal Fair Housing Act. That is not the case. The existing legal framework, requiring the housing finance system to be free from discrimination and to promote the nation's fair housing goals, is comprised of a bevy of laws. Those laws are designed to provide fair access to credit, particularly for under-served consumers, and to eliminate discriminatory practices from the system.

The Senate bill eliminates important language that is contained in several of these pieces of legislation. It also includes language regarding the right of newly formed entities to exercise their business judgment without threat of liability. This is dangerous and I believe deliberate. This language threatens legal precedent and the Supreme Court's 2015 ruling that disparate impact is cognizable under the Fair Housing Act. The Senate's draft language regarding business judgment would weaken the ability of civil rights organizations to address systemic policies and practices that unfairly restrict access to quality, sustainable credit.

Any new GSE Reform legislation must strengthen fair housing and fair lending protections already in place and address a fundamental problem that has thwarted our ability to achieve fair lending in America. Our fair housing and fair lending laws and regulations have never been fully enforced and housing finance players, including the GSEs, have not done all they could to implement fair housing practices. New legislation must ensure fair access to quality credit – particularly for underserved consumers, incorporate clear statements of the non-discrimination obligations of entities that form the system, guarantee strong and effective enforcement and regulatory oversight, and provide transparency that serves the needs of borrowers, lenders, investors and the public.

Laurie Goodman
Director, Housing Finance Policy Center
said at 9:00 am on March 15th, 2018:

The leaked Senate bill makes the cross subsidization explicit. If you are going to have private bearing most of the credit risk, you need to either somehow force those bearing credit risk to provide the cross subsidy, as we do today, or have the government do it. The leaked Senate bill does the latter. This allows the subsidy to be much more clearly and effectively targeted to those who need it in ways they can use it. By introducing a 10 bps explicit charge to pay for the Housing Trust Fund, the Capital Magnet Fund and the a mortgage access fund (MAF) that supports LMI

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borrowers through a few specific uses, the bill manages to generate more subsidy that we have today, better target who gets it and how it's used. The subsidy is still largely moving from some who use the system to others who use the system: it's just done more effectively.

Of course, the devil is always in the details. The leaked bill provides for five different kinds of subsidies: interest rate reduction, down payment assistance, money deposited into a savings account to cover housing related activities in time of economic distress, housing counseling, subsidizing the cost of servicing delinquent loans, without a specific distribution plan. In a recent paper, Jim Parrott and I discuss the importance of each of these forms of support and talk through the mix of design issues they raise.

We concluded that a quarterly subsidy sheet in which qualifying borrowers can choose how they receive a prescribed amount of assistance—interest rate reduction, down payment assistance, or money deposited into a saving account—would be the most effective way to provide these forms of support, and that housing counseling can be readily allocated through a fund. We struggled with how to provide support for delinquent servicing in an effective way, concluding that it was best left out of the regime altogether. But the bottom line is that the regime as a whole is a more rational way to allocate subsidy than the opaque and inefficient way we do it today.

Ellen Seidman
Non-Resident Fellow, Urban Institute
said at 12:10 pm on March 15th, 2018:

Here's the link to the paper Jim Parrott and Laurie wrote on the implementation of the Market Access Fund subsidy under the draft Senate bill:

https://www.urban.org/research/publication/making-sure-senates-access-an...

Ed Pinto
Codirector, AEI Center on Housing Markets and Finance
said at 10:19 am on March 15th, 2018:

For over 60 years, "Affordable Housing" initiatives have eased credit, promoted price Instability, made housing less affordable, and led to many millions of needless foreclosures.

- 1950s: introduction of 30-year and minimal down payment loans for FHA
- 1960s: expands FHA to lower-income families unable to meet normal FHA credit requirements
- 1977, 1995: Community Reinvestment Act requires use of innovative and flexible lending practices to address LMI buyers
- 1992: GSE affordable housing goals

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