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A Framework for Improving Access and Affordability in a Reformed Housing Finance System

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With policymakers gearing up to reform the housing finance system, it is worth revisiting one of the issues that stymied negotiators in the reform effort of 2014: how to ensure adequate access to credit in the new system. The political landscape has changed substantially since 2014. For those who are focused on financing affordable housing and promoting access to mortgage credit, the status quo—the continued conservatorship of Fannie Mae and Freddie Mac—may no longer be as appealing as it was during those negotiations. This brief draws upon the lessons learned from that experience to outline a framework for bipartisan consensus in this transformed political environment.

The "middle-way" approach described here is not dependent upon any one structure or future role for the government-sponsored enterprises (GSEs), though it does assume the continuation of a government guarantee of qualified mortgage-backed securities (MBS). It is this guarantee that forms the basis of the obligation to ensure that the benefits flowing from the government backstop are as broadly available as possible, consistent with safety and soundness and taxpayer protection.

In recent months, at least three such proposals have been developed that preserve a federal backstop (see Mortgage Bankers Association, Bright and DeMarco, and Parrott et al. proposals).[1] Should the administration and Congress pursue a strict privatization approach to reform, lacking a guarantee, it's unlikely that any affordable housing obligations would be imposed in the reformed system.[2]

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The Affordable Housing Triad

Over the years, Congress has made it clear that the GSEs' public purpose includes supporting the financing of affordable housing and promoting access to mortgage credit "throughout the nation, including central cities, rural areas, and underserved areas," even if doing so involves earning "a reasonable economic return that may be less than the return earned on other activities."[3] As part of this mandate, policymakers have created a triad of affordable housing and credit access requirements:

1. Meeting annual affordable-mortgage purchase goals set by the regulator;
2. Paying an assessment on each dollar of new business to help capitalize two different affordable housing funds; and
3. Developing and executing targeted duty-to-serve strategies, the purpose of which is to increase liquidity in market segments underserved by primary lenders and the GSEs, defined by both geography and housing types.

Only one of these requirements—the requirement to meet annual affordable-mortgage purchase goals—has a sufficiently long operational history and empirical record to draw conclusions about its efficacy, and that record is decidedly mixed (see research from Bhutta, Bunce, and Weicher).[4] Congress instituted these goals in 1992 because the GSEs were generally seen to be underserving creditworthy low- to moderate-income (LMI) households living in low-income and high-minority communities. Whatever their shortcomings, however, through their normal course of business and targeted efforts, the GSEs have purchased a significant number of affordable loans since the goals were instituted. Last year, for example, Fannie Mae and Freddie Mac bought more than 375,000 purchase-money mortgages originated to low-income borrowers and acquired multifamily mortgages on properties containing nearly 750,000 rental units occupied by low-income families.[5]

The two other affordable housing and credit access requirements are of a more recent vintage. Created in 2008 as part of the Housing and Economic Recovery Act, the affordable housing assessment was levied for the first time in 2015, and resulted in $455 million flowing into HUD's Housing Trust Fund and the Treasury Department's Capital Magnet Fund in 2017. The Federal Housing Finance Agency (FHFA) finalized the rules for its Duty to Serve Program in December 2016, and the GSEs' inaugural three-year strategic plans are now posted for public comment (see plans from Freddie Mac and Fannie Mae), with execution scheduled to begin in 2018.[6]

Taken together, these three approaches help ensure that mortgage financing supported by government guarantees serves the broadest range of creditworthy borrowers; pays particular attention to hard-to-serve or underserved markets; and generates funding to support market-expanding efforts as well as more deeply subsidized affordable housing.

Revisiting Johnson-Crapo

The bill that the Senate Banking Committee voted out of committee in May 2014, commonly referred to as Johnson-Crapo, repealed the affordable housing goals and adopted a system-wide "duty to serve."[7] The bill did not apply the duty to serve to the individual guarantors replacing the GSEs, nor did it provide the regulator with the authority to sanction individual firms if they failed to contribute to system-wide needs. On the other hand, it provided considerably more funding for affordable housing. The bill authorized an annual five to ten basis-point fee on the outstanding balance of government-guaranteed securities to support market access, affordability, and other public policy goals. It also directed the regulator to determine the size of the initial fee and set subsequent incentive-based fees to encourage all guarantors to do significant business in underserved markets. Compared to the current one-time 4.2 basis-point fee, this larger annual fee would have raised between five and ten times more resources for affordable housing.

At the time the bill was voted out of committee, a number of senators decided that repealing the affordable housing goals in exchange for these provisions—a more robust affordability fee and a system-wide duty to serve, but without the same enforcement authority—was not worth the trade, and ultimately chose to oppose the bill.

Reassessing the Status Quo

The expected departure of FHFA Director Mel Watt at the end of his term in 2019 portends a dramatic shift in how the current access and affordability regime could be implemented. As both conservator and regulator, the FHFA director has substantial administrative authority over each of the GSEs' affordable housing obligations. For example, the Housing and Economic Recovery Act allows the FHFA director to suspend the affordable housing fee when it would undermine the GSEs' financial stability. Watt's predecessor, Acting Director Ed DeMarco, exercised this authority upon taking office. Though Watt restored the fee in late 2014 when FHFA forecasts showed the GSEs would remain profitable for the foreseeable future, his successor could suspend it once again.[8]

As a matter of policy, the Trump administration may also seek to reduce the federal presence in the mortgage market in an effort to attract more private capital. The FHFA director could seek to achieve this objective by systematically lowering conforming loan limits and raising guarantee fees. These actions would significantly reduce affordable housing funding from the current assessment while raising mortgage costs, especially for higher-risk borrowers.

Similarly, the FHFA director could administratively reduce the affordable housing goals and significantly narrow the GSEs' underserved markets obligations. However, the director would be constrained by the statutory obligation to base such a decision on robust market analysis. To see the extent of the regulator's discretion in this area, compare the narrow duty-to-serve rule proposed under DeMarco with the more expansive final rule issued under Watt.[9]

Under the new political circumstances stemming from the 2016 elections, the status quo may no longer be as appealing an outcome to progressives as it was in 2014, suggesting they should be more open to alternatives during the next round of legislation.

During the debate and discussions around the consideration of the Johnson-Crapo bill, some conservative senators and groups raised concerns regarding access and affordability. First, they wanted to repeal the affordable housing goals, insisting the goals were a primary contributor to the financial crisis and the GSEs' financial collapse. Second, they believed that any support for the production and preservation of low-income rental housing should be explicit and transparent. Third, some argued that government subsidies to homebuyers should be direct and accounted for on-budget, not through the cross-subsidy of guarantee fees that disconnect the cost of a mortgage from the risk of loss it poses to the investor.

Finally, the conservatives contended that the federal government should not interfere in the business judgment of a private company on how to define and best serve its customers, as long as the company was acting in accordance with fair lending laws. The result was support for a more robust affordability fee and a requirement that the regulator support the primary mortgage market on an "equitable, nondiscriminatory, and non-exclusionary basis to help ensure that all eligible borrowers have access to mortgage credit," but without the previous enforcement authority.[10]

Now that Republicans control both houses of Congress and the White House, a failure to achieve long-sought reform will begin to have greater political consequences for them than it did in 2014. A couple of factors raise the stakes. First, the GSEs are more likely to draw on their Treasury backstop, as their capital buffer goes to zero in a few short months. In the event of another recession, the prospects for a second GSE bailout may loom large. Moreover, the momentum for so-called "recap and release"—a proposal to recapitalize the GSEs and end their conservatorship without significant reforms—has increased, despite virtually non-existent support in the run-up to Johnson-Crapo. This suggests that its odds as a viable administrative reform will rise in the absence of legislation.

For different reasons, both sides of the aisle may find themselves converging on a new consensus: that the status quo is less desirable than a new approach to the issues of access and affordability.

Finding a Bipartisan Path Forward

The following three options identify a middle ground that does not compromise the obligation to provide liquidity to all corners of the market at the least possible cost, consistent with taxpayer protection and safety and soundness. Each option attempts to ensure that the system as a whole provides access and affordability at least as much as the existing system; includes an explicit and transparent fee on the outstanding balance of guaranteed MBS; and includes a duty to serve the broadest possible market.

The Essential Role of a Market Access Fund

In the last go-round, both progressives and conservatives supported a modest levy to finance the production and preservation of affordable rental housing that the private market could not generate without deep subsidy. Johnson-Crapo was voted out of committee with bipartisan support for a five to ten basis-point fee (up to $250 a year on a $250,000 mortgage) to be assessed on the outstanding aggregate balance of government-guaranteed MBS. Importantly, the bill would have allocated portions of the fee proceeds not just to the Housing Trust Fund and the Capital Magnet Fund (both supported by the current affordable housing levy), but also to a new Market Access Fund (MAF) that would have been administered by the regulator.[a]

The regulator would deploy the MAF to ensure that the system meets its duty-to-serve obligations without exposing taxpayers to undue risk. With the MAF, the housing finance system would have the same resources as the current system to maintain the size of the credit box, the universe of loans that are available to borrowers. The MAF could increase the universe of qualified

[a] Fee allocation outlined in Johnson-Crapo section 501 and fund established by section 504. Available at: https://www.congress.gov/113/bills/s1217/BILLS-113s1217rs.pdf.

borrowers, help expand products to serve qualified borrowers with non-traditional credit profiles, and support efforts by the primary market to expand access safely and sustainably. The MAF's resources would be deployed with full transparency, enhancing their efficiency and effectiveness.

Going forward, both sides should continue to support an enhanced affordable housing levy and the addition of the MAF—progressives because of the significant increase in revenues available to support access and affordability, and conservatives because it does so in a clear, targeted, and transparent way.

Incorporate Affordable Housing Goals into Duty-to-Serve Plans

In each of the variations on the new duty to serve, policymakers should terminate the current stand-alone regime of affordable housing goals and instead reconfigure the duty-to-serve requirement to embrace both quantitative measures of service and qualitative measures to encourage strategies to responsibly expand mortgage credit. The affordable housing goals, first adopted 16 years before the current duty-to-serve provision, measure whether and how well the secondary market is supporting better developed primary markets that require liquidity, with particular regard to low-income households and geographies of special concern. The more recent duty-to-serve obligation is about helping to generate greater market demand by creating new products, and increasing the flow of sustainable primary mortgage credit in underdeveloped market segments.

What both statutory requirements have in common is getting the government-supported secondary market to do a better job of serving challenging markets and populations where costs may be higher and economic returns lower than in easier-to-serve and more profitable parts of the housing market. Because of this shared objective, it makes sense to harmonize both requirements within a single regulatory framework.

Whether duty to serve ends up at the individual firm or system-wide level, strategies for meeting obligations would be spelled out in an "underserved markets plan" in which each guarantor would describe the specific activities that it would undertake to meet expanded duty-to-serve obligations over a three-year period in each underserved market segment designated by the regulator. As under the current FHFA duty-to-serve system, each guarantor's plan would be required to identify objectives that are "strategic, measurable, realistic, time-bound, and tied to an analysis of market opportunities." The regulator's performance evaluations would be expanded from the current model to incorporate activity benchmarks for primary market lending, and other quantitative and qualitative metrics, as appropriate.

The reformed system's integrated duty-to-serve obligation could be accomplished best in one of the following three ways.

Option I: A Firm-Level Duty to Serve

The inability to bridge the gap between the progressives' demand for a firm-level duty-to-serve requirement and the conservatives' willingness to impose such a standard only on the system as a whole, without significant enforcement authority, largely doomed Johnson-Crapo. The most effective way to strengthen mortgage lending across the market, and increase liquidity in underserved markets that are the focus of the current duty-to-serve rule, would be to require that all users of the government securities guarantee have national footprints and firm-level obligations to serve all corners of the market and specifically designated underserved markets.

When accompanied by appropriate regulatory oversight authorities, this would be the most effective way of ensuring that a reformed system will devote the necessary resources to underserved markets with weaker local economies, fewer and smaller loan originators, higher costs, and lower profits than more developed parts of the market. Since the most likely potential new entrants to the guarantor network are private mortgage insurance companies that have widespread lender relationships and deal regularly with high loan-to-value and credit-challenged borrowers, neither having a national footprint nor a mandatory duty to serve should be a deal breaker. The result would be a more competitive landscape and a stronger bipartisan base of support for the program.

Option II: A Hybrid Duty-to-Serve Obligation

A variation of the first option would be a hybrid system that would, by statute, require that the system as a whole serve all corners of the market, with firm-level duty-to-serve obligations imposed only on individual guarantors that exceed a specified percentage, say ten percent, of the total market. As in Johnson-Crapo, the regulator would have the authority to identify a specified number of underserved market segments for special regulatory attention and oversee execution of the strategic plans of large guarantors that have firm-level duty-to-serve obligations.

Alternatively, rather than waiting until new entrants pass a market-share threshold, a firm-level obligation could be triggered after a certain period of active participation in the market, say five years. This would prevent these firms from managing market share to keep themselves below the threshold and competing exclusively with larger players at the low-credit-risk part of the curve, who charge higher guarantee fees to cross-subsidize their higher-risk business.

This approach has particular merit in the context of post-Johnson-Crapo proposals that build in continuing roles for the GSEs while encouraging the entry of new guarantors to create a more competitive system (see Mortgage Bankers Association and Bright and DeMarco proposals).[11] Under this scenario, re-chartered and reorganized GSEs with their major market shares and national footprints would continue to have firm-level duty-to-serve obligations, while new guarantors would not—at least not until they trigger a threshold market share or time limit. This variation would not require all new entrants to have a national footprint, while helping them compete head-on with the large guarantors. Progressives should support this approach because it maintains statutory duty-to-serve obligations for the successors to Fannie and Freddie and other large guarantors, while conservatives should appreciate how a hybrid system would encourage the entry of new players to compete with the GSE duopoly using risk-based pricing strategies and operating along various points of the risk curve.

Another variation of this option would be to impose firm-level obligations on new entrants but to allow guarantors to contract out to other guarantors some of their duty-to-serve obligations. This could reduce the costs for guarantors to meet their duty-to-serve requirements, and promote the entry of more guarantors. It might also incentivize the creation of guarantors whose business model focuses on reaching underserved communities, just as the financial crisis stimulated development of hightouch specialty servicers that became loan originators, with a focus on underserved markets. These guarantors would develop the idiosyncratic knowledge, practices, and relationships with lenders necessary to operate effectively in these markets. Large guarantors might find it more cost-effective to work with smaller guarantors that operate in underserved communities than to underwrite the loans themselves, further expanding the availability of credit.

Option III: System-Wide Obligations

An alternative that would be less robust substantively, but perhaps an easier sell with conservatives, would be to create a guarantor-level obligation that would kick in only when empirical analysis demonstrates that the system is leaving significant gaps in affordable housing coverage. In other words, the access and affordability regime would initially involve only the market-access fee described above and a system-wide duty-to-serve mandate on the regulator. If that system failed to meet certain clear targets, then a guarantor-level duty to serve would kick in, along with appropriate enforcement authority. This idea was proposed by progressives late in the Johnson-Crapo process, but there was insufficient time to explore it with conservative members.

Conclusion

Ensuring that any system that supports mortgage lending with a government guarantee does not discriminate against LMI borrowers should be an essential feature of any reform.[12] The aim of this brief is to suggest a path forward to ensure that any reformed housing finance system meets the nation's access and affordability needs, and gains bipartisan support. To prompt a fresh conversation, this framework leaves many important questions and details for further discussion.

Endnotes

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8 Federal Housing Finance Agency, Letter to Timothy Mayopoulous, December, 14, 2014. Available at: https://www.fhfa.gov/Media/PublicAffairs/Documents/FNM_HTFCMF12112014.pdf.

9 See note 6 above.

10 'Housing Finance Reform and Taxpayer Protection Act of 2014, S. 1217, Section 210.

11 Mortgage Bankers Association, *GSE Reform: Creating a Sustainable, More Vibrant Secondary Mortgage Market.* Bright and DeMarco, *Toward a New Secondary Mortgage Market.*

12 Michael Stegman, *Building on the Johnson-Crapo Consensus,* Bipartisan Policy Center, August 2016. Available at: https://bipartisanpolicy.org/blog/johnson-crapo-housing/.

Notes

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