Center for American Progress

Principles to Guide Development and Regulation of a Renewed Mortgage Finance System

1. Access to credit and liquidity

The first goal of a mortgage finance system must be to provide sufficient credit for the development and purchase of single family and multifamily units adequate to meet the housing needs of the country. Consistent and adequate liquidity is essential to the availability of quality credit. To achieve this goal our country needs:

a. Strong primary lending facilities

Although secondary mortgage markets have grown to encompass a large share of overall mortgage lending—discussed in greater detail below—primary lenders are still the foundation of the mortgage finance system. Bank lenders are directly and intimately overseen by regulators, and their relationship to borrowers is typically a direct one. As such, primary lenders are a key to maintaining consistent and comprehensive access to credit and liquidity, and are less likely to see fluctuations in these areas that occur as a result of rising and falling investor demand.

b. Well-functioning secondary markets

Over the past few decades, funding from capital markets became an increasingly important part of mortgage lending. Initially this funding came through guaranteed mortgage backed securities from Fannie Mae, Freddie Mac, and Ginnie Mae; then through private-label, mortgage-backed securities, and most recently through the introduction of mortgage derivative products such as collateralized debt obligations. Worldwide investor demand for high yields spurred excessive risk taking to create ever larger issuances of bonds and derivatives based on mortgages. Coupled with a lack of regulatory oversight, this high demand created improper incentives and skewed the market into excessively complex and risky products, without any concomitant safeguards or changes in risk pricing.

Secondary market incentives must be aligned with credible and sustainable credit risk management (discussed in greater detail below). Secondary markets, however, remain important to liquidity and thus to a renewed mortgage finance system. Well-functioning and robust secondary markets will attract investors to provide capital for housing finance and maintain market confidence in mortgage-backed securities—on a continuous basis—in all economic environments.

c. Careful but creative innovation

While recent history suggests that innovation without adequate regulation or standards is dangerous, a system that encourages appropriate innovation remains essential to ensuring sufficient credit access and liquidity. At its best, financial innovation has the potential to provide increased liquidity at lower cost and thus make credit more available to serve more of the market. Innovation is important in origination, business processes, and secondary market vehicles. For example, innovations such as CAP's proposal for Shared Equity Ownership, which would pay down the principal owed by troubled homeowners in exchange for homeowner concessions that would effectively place the home into an affordable housing trust, have the potential to help communities and lenders alike. Process innovation that leverages technology to improve workflow and document management, enhances communication between borrowers and lenders, and enables more transparent mortgages and securitized mortgages, is a critical feature of a well-functioning market. While innovation can be highly beneficial for consumers, it must also be augmented by direct government support for some types of housing and carefully balanced with the goal of consumer protection.

d. Adequate access to credit for all appropriate forms of housing

Public subsidies, tax policy, fiscal policy, and systemic biases toward homeownership may have contributed to an imbalance in capital availability for homeownership and rental housing. While there can be significant societal and individual wealth accumulation benefits from homeownership, there are many consumers for whom it is not appropriate at certain times. A renewed system of mortgage finance should provide liquidity and capital access for all forms of housing and meet the needs of consumers throughout society whatever their income and wherever located. Special attention should be paid to ensure that the renewed system provides sufficient capital to meet society needs for affordable rental housing. While the current market-based model is providing adequate capital for large multifamily properties and in the luxury end of the market, there is significant room for improvement in the delivery of credit to smaller properties that provide much of the supply of affordable rental housing.

2. Countercyclicality: measures to ensure consistent access to credit and liquidity

A successful housing financing system should ensure a consistent flow of credit, appropriately priced for market risks whether in good or bad times. This means preventing the overextension of credit during periods of expansion in order to prevent asset bubbles and reduce the impact of consequent deleveraging. This also means creating mechanisms to provide countercyclical liquidity during periods of contraction. One possible mechanism might be the adoption of fluctuating capital requirements, increased during times of easy credit, and decreased during times of deleveraging.

3. Risk management and oversight

A vital component of a stable and successful mortgage finance system is ensuring that credit risk is appropriately measured, priced, distributed and overseen. Regulation of credit risk should be comprehensive and robust, covering all aspects of the mortgage markets, including the secondary markets. A commitment to improving credit risk oversight will help craft a fairer system that will see fewer homeowners default on their mortgage obligations. Key steps to ensure this happens are:

a. A level-playing field: robust and comprehensive regulation

Regulators possess ample regulatory authority over the federally insured primary lenders to address capital adequacy and levels of risk, but largely failed to exercise it during the housing bubble. Non-bank lenders were not subject to similar regulation. Going forward, bank regulators must exercise their significant regulatory power over primary lenders consistently and thoroughly.

Currently, there is a large gap in regulatory coverage of the secondary markets. Major market players, such as Bear Stearns Cos. and American International Group, Inc., were woefully under regulated, as were complex financial products such as credit derivatives, which became an enormous part of the financial system. The market events of the last few years have made clear the interconnectedness of our financial system—unregulated products and institutions can have enormous consequences on regulated products and institutions. Regulatory coverage must be extended over many of the currently unregulated products and institutions.

It is also important to ensure that opportunities for regulatory arbitrage, such as charter shopping, are eliminated. All financial transactions should be treated uniformly by regulators, regardless of the charter held by the institution engaging in the transactions.

b. Strong underwriting standards

Stronger underwriting criteria that are based on a thorough understanding of these variables will undoubtedly be a part of minimizing credit risk both institutionally and systemically. Mortgage finance cannot ultimately be successful in managing risk if its core underwriting standards are weak. Strong underwriting means both the incorporation of stringent documentation and measures to eliminate fraud—such as in assessments or borrower stated income—as well as a better allocation of credit based on the borrower's risk profile.

Stronger underwriting standards should, however, be tied into actual credit risk, and not simply be a proxy for withdrawing credit availability from underserved communities. Much of the credit failure driving the current crisis is the result of loan features such as prepayment penalties, adjustable rates, reduced or no documentation, as well as other factors that were not directly linked to borrower credit risk. More analysis must be done to understand the underlying credit drivers of mortgage performance, especially for borrowers with a low level of assets seeking access to non-traditional credit.

c. Risk assessment and capital adequacy

Risk assessment was horribly mismanaged during the past decade. Financial institutions and regulators alike were overly reliant upon credit risk ratings of private label mortgage-backed securities provided by the rating agencies, which we now know were terribly flawed. As a result, these bonds were mispriced against the risk they represented, contributing to the overextension of credit and the creation of an asset bubble. Consequently, banks were left holding inadequate capital against their actual risk, which has exacerbated the deleveraging process and contributed to the credit crunch. Any reforms of credit risk oversight must include changes to how the markets assess risk, currently through the rating agencies, as well as how risk-based capital requirements are determined for banks and bank holding companies, as well as other financial institutions.

4. Standardization

Standardization provides benefits to consumers and investors, helps ensure the safety and soundness of financial institutions and improves the transparency and liquidity of housing finance. The benefits of standardization, however, must be balanced against the benefits of innovation and meeting unique needs, especially of underserved borrowers.

For consumers, standardization provides products that are more easily compared. As we saw during the lending boom earlier this decade, many borrowers are ill-equipped to assess different types of mortgages, such as an interest-only adjustable rate mortgage as compared to a standard 30-year-fixed rate loan. While innovative products may help to meet consumer needs in unique circumstances, they should be limited to places where appropriate and the terms should be written so their features are easily compared and understood.

For investors, standardization provides certainty which increases liquidity and thus capital availability. The diversity in the terms of pooling and servicing agreements for private label mortgage-backed securities is one reason why restructuring mortgages has proven so difficult, creating greater uncertainty and risk for investors than was properly understood.

Standardization also allows for better risk regulation. Where underwriting and documentation standards are the same across the board, it is easier for regulators to assess risk and set capital and liquidity requirements accordingly. Case in point: Fannie Mae and Freddie Mac sustained their greatest credit losses from their investments in non-standard Alt-A mortgage products. Losses on their standard books of business are more severe than predicted in large part because economic conditions have been more severe than anticipated.

Ultimately, standardization appears most likely to be created in one of two ways. The first is through secondary market institutions, which are in an excellent position to drive standardization through their provision of capital—either through their existing structures (Fannie Mae and Freddie Mac) or through something new—throughout the system and across primary lending platforms. The second is through comprehensive regulation of primary and secondary market actors.

5. Transparency and accountability

One of the major failures of the mortgage finance system that led to our current situation was the lack of accountability by key players at each rung of the mortgage finance delivery process, including mortgage brokers, originating lenders, securitizing banks, and rating agencies. In many cases, all of these institutions lacked sufficient incentives to insure that the mortgages or mortgage instruments they were promoting were ultimately sustainable. In the “originate to distribute” model, all too often key market participants lacked any “skin in the game.”

This lack of accountability was accompanied and exacerbated by a lack of transparency. Buyers, sellers, and issuers of mortgage-backed securities and collateralized debt obligations shrouded their credit risk and credit loss exposures in a cloud of opacity, lessening confidence in the overall financial system and contributing to extreme credit illiquidity. Loan-level data information about the make up of mortgage-backed securities and collateralized debt obligations are typically only available to those willing to pay a hefty price for it, again decreasing transparency and causing investors to assume the worst about individual mortgages and their ultimate loss levels. And at the origination level, mortgage brokers were less than transparent about the various mortgage options, and their relative benefits available to consumers, resulting in poor selections of mortgage products and a greater likelihood of defaults and foreclosures.

Reforms of the mortgage finance system must be cognizant of aligning incentives, promoting accountability, and ensuring adequate transparency. Greater accountability and transparency will inevitably lead to better risk assessment and management as well.

6. Systemic stability

A critical issue that needs to be addressed in any reform of U.S. mortgage finance is the need to curb systemic risk, with a reformed system able to lessen the possibility of future shocks through the entire financial system. As Federal Reserve Board Chairman Ben Bernanke has noted, systemic risk regulation is important to consider as the financial system has become less bank-centered and as the risks of contagion are high. It is important to ensure that risk is appropriately understood and allocated, such that those holding the ultimate risk can afford to bear it. Better measures of gauging counterparty and systemic risk must be adopted and consideration given to other mechanisms for containing and minimizing risk.

Design of a renewed mortgage finance system should also recognize the global nature of today's financial markets. While individual nations will inevitably retain separate regulatory regimes, far greater transparency and coordination through regulatory networks is necessary.

7. Enhanced consumer protection

The purchase of a home is a complicated, highly technical transaction unlike any other consumer purchase, and it usually represents a household's single largest asset. Buyers are understandably reliant on the professionals they encounter during the process; however, in recent years, these professionals who typically owe no fiduciary duties to borrowers, have been compensated through incentives that are misaligned with consumer interests.

To address unequal information in the transaction, the system should have a built-in bias towards the long-term best interests of the borrowers. One example of this is a proposal for default mortgage model in which consumers would have to explicitly opt out of a 30-year-fixed rate mortgage in order to enter into a more complex loan agreement. Reforms should not only protect borrowers against bad actors but also set up a system of better outcomes by default.

8. Equitable and fair access to credit for consumers and communities

The mortgage finance system should be designed so as to eliminate disparities in the allocation of capital, although it is a mistake to think this is solely a matter of finance. What is more, there is a societal interest in ensuring that communities that have historically suffered from denials of credit or credit on discriminatory or predatory terms have appropriate access to credit from all parts of the finance system. This means ensuring that low-income households and underserved communities, many of which have high concentrations of minorities, have access to credit on terms appropriate to the level of risk represented. These are the communities hardest hit by the mortgage crisis and it is imperative that it is these communities and their residents are better protected and also better served in the future.

While a drive for better risk management is likely to lead to tighter underwriting standards, as well as lower loan-to-value ratios and higher down payment requirements, we must be careful to ensure these changes are based on criteria that are empirically tied to credit risk rather than on theoretical or ideological assumptions about the credit profiles of certain communities of borrowers. Stronger underwriting should ultimately result in a more careful allocation of credit, not a deprivation of credit to underserved communities.

This product was developed in collaboration with the Mortgage Finance Working Group (MFWG) convened by the Center for American Progress (CAP), and made up of the members listed below. Affiliations are shown for identification purposes only. Neither the MFWG members nor their organizations have endorsed the views represented in this product or any other materials produced by CAP or the MFWG, unless expressly noted.

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