Center for American Progress

A Responsible Secondary Market System for Housing Finance

The Mortgage Finance Working Group
organized by
The Center for American Progress

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Membership in the Mortgage Finance Working Group

This presentation is a product of the Mortgage Finance Working Group sponsored by the Center for American Progress, with the generous support of the Ford Foundation, Living Cities, and the Open Society Institute. The members of this working group began gathering in 2008 in response to the U.S. housing crisis, in an effort to collectively strengthen their understanding of the causes of the crisis and to discuss possible options for public policy to shape the future of the U.S. mortgage markets. Our thoughts continue to evolve and this represents the preliminary views of the members whose names are listed below, in their individual capacities only. Affiliations are provided for identification purposes only.

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Goals of the Housing Finance System

- Ensuring that Americans have access to both decent, affordable rental housing and homeownership on fair, affordable, and sustainable terms, so that they have appropriate choices available for their families' housing and asset building needs throughout all stages of life.

- Ensuring there is a stable and liquid source of capital for housing credit to support a stable macro economy and strong communities.

Goals of the Housing Finance System—Details

Broad and Consistent Liquidity

- Across market segments, including for underserved borrowers. (See next slide.)
- Across housing types, including for small and large rental housing properties.
- Across geography, including for urban, suburban, and rural areas, and across the country.
- Across time periods, including in economic downturns.
- Across types of originators, including small banks and community-based lenders.

Stability

- Avoiding housing bubbles, market swings, and unpredictable housing costs.
- Preventing a destabilizing race to the bottom in market practices.
- Protecting the taxpayer.

Affordable and Sustainable Housing Finance

- Access to long-term, fixed-rate mortgages for homeownership.
- Adequate and reasonably priced financing for affordable rental housing.
- Affordable credit on fair and sustainable terms for low- and moderate-income borrowers.
- Empowering consumers to make sound choices, while protecting them from discriminatory and predatory practices.
- Recovery for distressed communities reeling from the aftermath of the foreclosure crisis.
- Sustainable community development and growth.

Market Segments

UNDERSERVED

Who are they?

- LMI and minority borrowers
- Residents of LMI communities, communities of color, and communities hard-hit by foreclosure crisis
- Young adults, seniors, others with limited access to credit
- Rural communities

Types of housing

- Rental housing
- Lower-priced owner-occupied (often first-time home buyer)

Challenges

- Limited wealth often a bar to down payments
- Limited access to credit
- Limited availability of affordable rental despite growing demand
- Limited consumer information

MIDDLE MARKET

Who are they?

- Primarily middle income households with some savings
- Communities of color and communities hard-hit by foreclosure crisis
- Middle income households in high cost areas
- Middle income households choosing to rent

Types of housing

- Moderate cost rental housing
- Moderately priced owner-occupied (first-time and subsequent)

Challenges

- Predictable housing costs via long-term fixed rate finance
- Consistent availability of credit allowing mobility
- Expanding demand for limited rental stock

HIGHER WEALTH/HIGHER INCOME

Who are they?

- Higher income households with lots of savings

Types of housing

- Higher-cost owner-occupied
- Second/vacation homes
- Investment properties

Challenges

- Encouraging investment to facilitate availability of rental housing
- Limiting systemic risks posed by speculation

Lending Channels in a Reimagined Secondary Mortgage Market

UNDERSERVED | MIDDLE MARKET | HIGHER WEALTH/HIGHER INCOME

FHA/VA via Ginnie Mae

FHA/VA mortgage insurance on lower down payment loans for underserved and higher risk borrowers, securitized by Ginnie Mae; also countercyclical resource.

Gradual reductions in reliance upon FHA/VA by borrowers who are able to tap other sources of mortgage credit; regulator can expand eligibility if private capital flees.

Chartered MBS Issuers (CMIs)

CMIs can issue mortgage-backed securities (MBS) with a government guarantee of timely payment, which is fairly priced and paid for, with guarantee fee held in an insurance fund. No guarantee of debt or equity. Limited to mortgages with a record of sustainability not otherwise be provided by market at competitive prices (like the 30 yr FRM).

CMIs have market segment limitations (such as loan limits) that restrict their ability to finance higher cost properties.

To limit systemic risk, only safe mortgage products may be securitized.

Other MBS Issuers (OMIs)

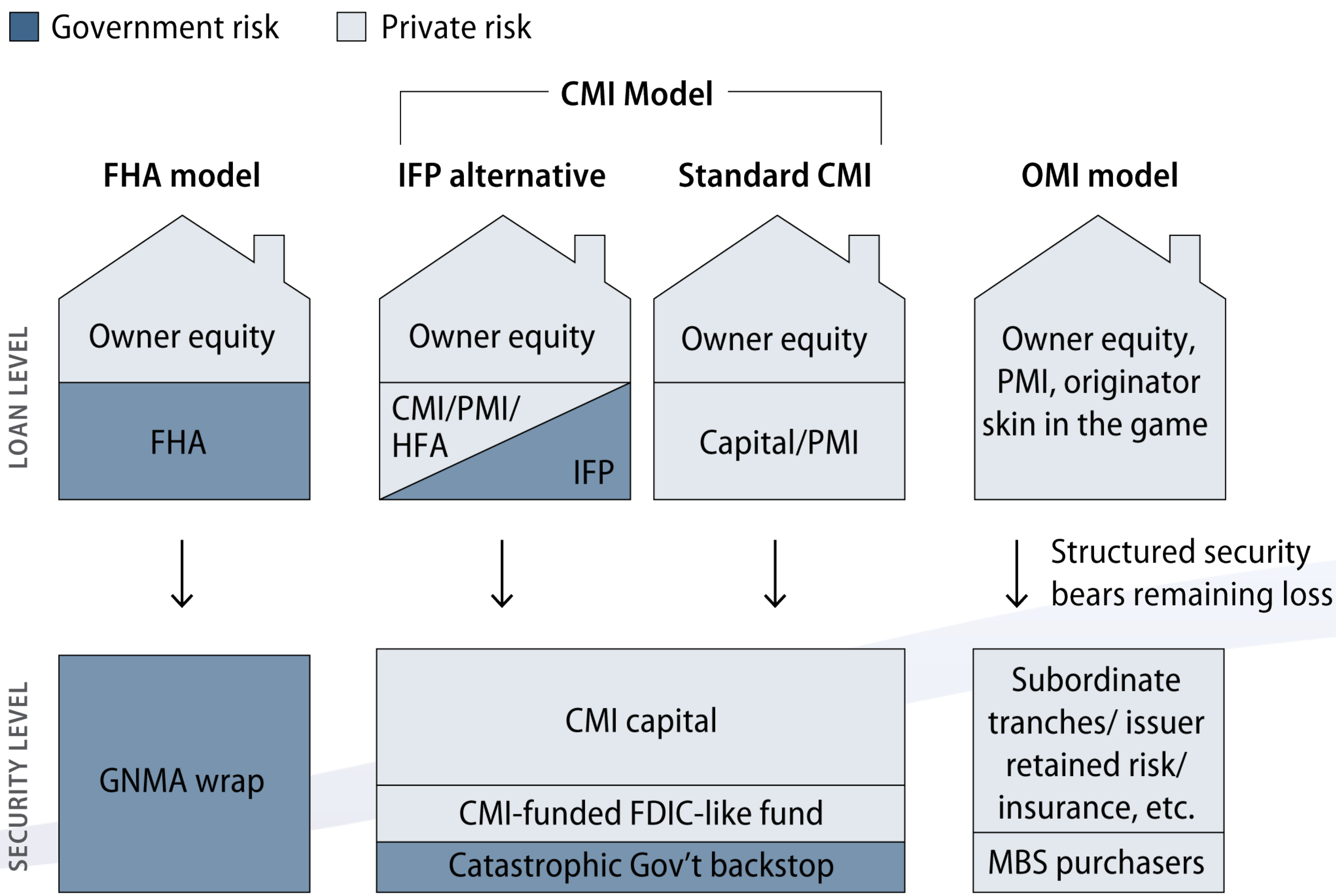
Non-chartered issuers of MBS do not have access to a government guarantee, but do have a wider range of permissible mortgage products. Limited to securitizing mortgages with a demonstrated record of sustainability.

Innovation Fund Partnerships (IFPs)

Credit enhancement/risksharing/other types of support are awarded competitively to CMIs, State HFAs, Private MIs, and others who design innovative sustainable products and delivery channels to meet underserved and community needs with goal of “mainstreaming” successful innovations.

MBS Risk-Bearing Varies by Lending Channel

Regulatory oversight across channels prevents taxpayer losses, discriminatory lending, and excessive risktaking



FHA/VA Insurance via Ginnie Mae Securitization

Publicly backed mortgage securitization channel

Purpose:

- A modernized, nimble FHA and VA, as well as RHS and PIH, will continue to serve as needed low- and moderate-income borrowers and others underserved by the private mortgage markets absent an explicit government loan-level backstop.
- FHA, VA, RHS, and PIH will also provide an again proven-to-be-essential countercyclical backstop. This function provides important benefits to the underserved market that needs support. Moreover, the assurance of continued liquidity supports the larger housing market and macro economy.

Mechanism:

- FHA and VA to offer mortgage insurance to lenders originating affordable, lower down payment, sustainable home loans and loans for multifamily rental housing.
- Ginnie Mae will continue to offer (for an actuarially determined fee) a “wrap” on MBS issued by private lenders providing investors in the MBS a guarantee of timely payment.
- Other guarantors or issuers of loans eligible as collateral for Ginnie Mae MBS to include the Department of Agriculture's Rural Housing Service (RHS) and the Department of Housing and Urban Development's Office of Public and Indian Housing (PIH).
- Gradual reduction in market share to regionally adjusted historical levels, to reduce unnecessary competition with the private sector and reduce use of this channel by borrowers who are able to tap other sources of mortgage credit that involve less government support.
- Eligibility criteria can be adjusted when private capital is unavailable.

Chartered MBS Issuers (CMIs)

Privately securitized MBS with an explicit & paid-for government guarantee

Purpose:

- Liquidity remains available for affordable and sustainable mortgage products that the private sector would not otherwise support, e.g. 30-year FRM and 10+ year rental property finance.
- All borrowers and communities have access to credit.
- CMIs have obligation to provide access to secondary mortgage market for lenders of all sizes

Mechanism:

- CMIs' MBS are eligible for an explicit government guarantee of timely payment.
- Government guarantee only comes into play if CMI fails. Government is protected by the capital of the CMI and a taxpayer-held insurance fund, as well as any existing loan-level protections (such as private mortgage insurance or shared-risk agreements).
- Capital adequacy oversight and resolution authority, akin to FDIC regulation, to ensure that CMI has sufficient capital to support MBS issued.
- Guarantee is actuarially priced and fees held in taxpayer insurance fund.
- No government guarantee of CMI's debt or equity.
- Eligible mortgages are ones with a demonstrated record of sustainability, not otherwise consistently provided by the market at competitive prices.
- CMIs have a duty to abide by all non-discrimination and consumer protection laws and to serve underserved markets and borrowers (see details below).
- CMIs must be required to offer services to originating lenders of all sizes, in all locations, on reasonable terms without regard to their affiliation with or commercial relationships to the CMI
- To extent CMIs can demonstrate that fulfilling their duty to serve requires concessionary returns, they may design risk-sharing partnerships with support from the Innovation Fund.

Who/What Can Get a CMI Charter?

Different CMI Structures:

- Public policy need not decide between a utility, co-operative, mutual or other private investor model of CMI, only determine the capital structure needed to protect taxpayers and the products eligible so as to protect consumers.
- Private sector innovation should determine the form that CMIs may take.
- CMIs may focus on single-family or multifamily products, or both.

CMI Eligibility Criteria:

- Sufficient startup and operating capital for business authorized to undertake.
- Single-purpose entity dedicated to MBS issuance; may be affiliated with other types of for profit and nonprofit financial institutions, but assets must be fully segregated.
- Layered risk: Capital stack must include at-risk capital of non-CMI people or entities. Capital can be borrower equity, private MI, or other shared risk arrangements that provide a second underwriter with capital at risk.
- Limited to MBS backing sustainable products.
- Pays a guarantee fee into insurance fund.
- Assumes a duty to comply and serve all communities and borrower groups. Such activities may qualify for further risk sharing through Innovation Fund Partnerships to lower costs and increase feasibility.
- Strong management with expertise in mortgage securitization.

CMI Regulation:

- Ongoing regulation for capital adequacy, product, and other eligibility criteria.

Other MBS Issuers (OMIs)

Privately securitized MBS with no guarantee

Key insight:

- Competition from the unregulated PLS channel distorted market for regulated MBS. Thus, there is a need to create a more level playing field in the system of the future with limited regulation of all secondary market channels for housing assets.

Purpose:

- Provide access to credit for higher-priced assets and market rate rental projects.
- Ensure no race to the bottom and rein in pro-cyclicality.

Mechanism:

- Non-chartered issuers of MBS (OMIs) have a have a wider range of permissible mortgage products, but still are limited to securitizing mortgages with a demonstration of sustainability.
- Products not proven safe for mainstream market are denied access to secondary market or limited to borrowers meeting certain criteria.
- Limited oversight of OMIs for capital adequacy also required to prevent systemic risk and so CMIs not disadvantaged.
- OMIs have a duty to abide by all non-discrimination and consumer protection laws.

Assessments on MBS

Levied on all MBS issued by OMIs and CMIs

Rationale:

- The assessment on all MBS issued by both OMIs and CMIs would fund: (1) The National Housing Trust Fund to address the severe shortage of rental homes that are affordable for the lowest income families and the Capital Magnet Fund's economic development activities ; and (2) the Housing Finance Innovation Fund.
- Allows for broad-based funding of the National Housing Trust Fund, Capital Magnet Fund, and Housing Finance Innovation Fund by mandating a small fee on securitizations and maintains a level playing field and competitive pricing between OMIs and CMIs when offering the same products.
- Housing consumers throughout the mortgage system benefit from a wide range of supports, including tax benefits, regulated financial intermediaries, and in this proposal, federal guarantees of qualified mortgage securities. Levying a small millage on all securities transactions returns a small amount per individual borrowers who benefit from this system to assist those not able to benefit from the system without explicit subsidy support.

Housing Finance Innovation Fund

Innovation and Underserved Advanced through Risk-sharing

Rationale:

- Private market participants must play a role in serving needs of underserved borrowers and helping distressed communities rebuild. They need experience to learn how to serve these communities profitably. If we only tax and divert funds to public programs, we consign ourselves to a two-tier credit system.
- However, management faces a tension with their duty to shareholders when meeting underserved needs yields concessionary rates of return.
- The remedy proposed is to use government credit subsidy on a shared-risk basis or other forms of support to help private, nonprofit, and public actors better meet underserved needs.
- The goal of these partnerships would be to promote responsible and sustainable innovation, establishing a market and track record for successful new mortgage products that are able to increase sustainable homeownership and affordable rental housing, thus paving the way for private capital to “mainstream” these products and eventually reduce or eliminate the need for public support.

Housing Finance Innovation Fund

Innovation and Underserved Advanced through Risk-sharing

Mechanism:

- The Housing Finance Innovation Fund would be a competitive program through which innovative products and delivery channels would be tested to demonstrate their potential for providing sustainable credit to serve underserved borrowers and communities.
- For credit enhancement support, shared risk between the applicant and the HFIF would be a requirement, but the particular structure of the transaction would be proposed by the applicant and negotiated with the Fund.
- HFIF funds might also be used to provide support for R&D and/or technical assistance required to launch new product or delivery innovations.
- Managers of the HFIF would have the flexibility to design features of the risk-sharing partnership, including credit enhancement premiums, use of subsidy, etc. within the limitation of the funding available from the MBS assessment, under the terms of the Federal Credit Reform Act.

CMIs' Role in Multifamily Finance

CMIs may focus on SF or MF products or both. CMIs securitizing MF would have the same structure, regulation, and purposes as above, with additional attributes:

Charter Eligibility:

- To ensure benefit to renters, and not just to owners/developers, CMI issuances would only be eligible for a government guarantee if the loans securitized during some measurable period, in the aggregate, serve a majority of occupants at rents that are affordable to households earning no more than 80 percent of area median income, as measured at the time of securitization.
- Additional incentives and benefits would accrue to CMI pools that provide deeper affordability as shown below.

Mechanism:

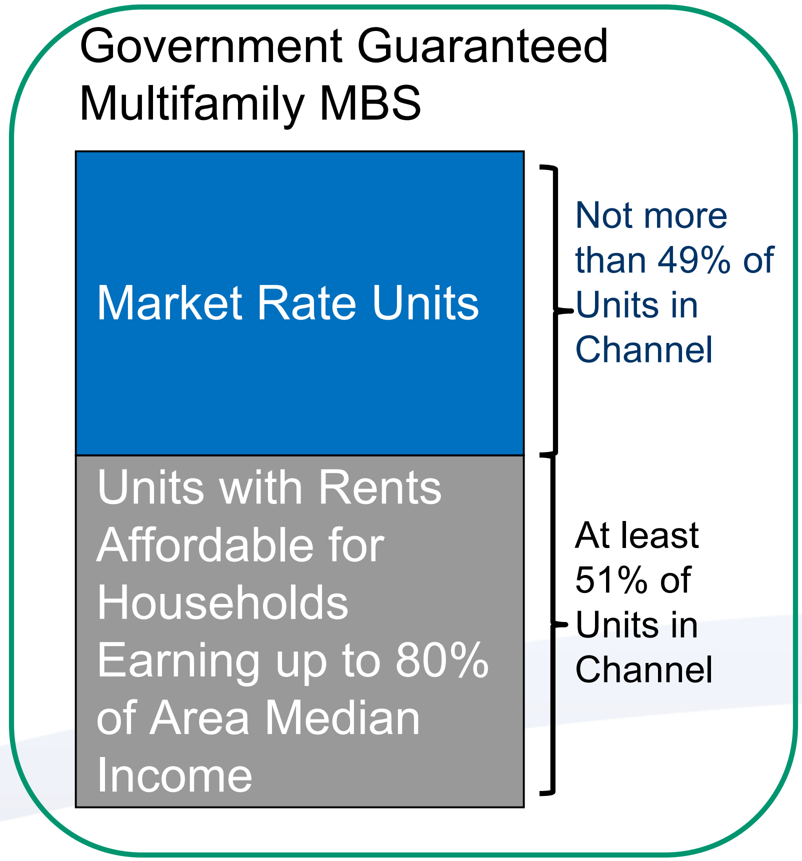
- CMIs securitizing MF would, by definition, only serve a majority of occupants with rents affordable at below 80 percent of median income (comprised of both lower- and middle- income households), but they would become eligible for risk-sharing partnerships with support from the Innovation Fund or other special benefits by meeting a more robust duty to serve underserved markets.
- To serve underserved segments such as smaller (under 50 unit) buildings and rural areas, channels need to be developed to facilitate CMI purchases of such loans (see below).

Multifamily Securitization

MBS Issued through CMIs Must Meet Affordable Rent Requirements

Mechanism:

- All Multifamily CMI issuers would be required to meet a test that at least 51 percent of the units in the properties financed have rents affordable to occupants at or below 80 percent of area median income to be eligible.
- Eligibility for government backstop measured at the security level, not the project level. It is possible over the period of measurement to pool 100 percent market rate developments with 100 percent low-income developments as long as the 51 percent affordable ratio is met in the aggregate.



Multifamily Securitization with Innovation Finance Partnership

MBS Issued in Partnership with HFIF to Achieve More Targeted Affordability Needs

Mechanism:

- Just as standard multifamily CMI pools would have an affordability test, pools meeting a deeper affordability or additional public purposes could have access to IFP credit enhancement or reduced MBS assessments.
- Public purposes defined by regulator might include: 5–50 unit projects, rural projects, and preservation of previously assisted housing.

Rationale:

- The large and increasing share of households occupying small rental properties of 2–50 units warrants incentives and structures designed to encourage lending and liquidity in this market segment.
- Thirty-five percent of subsidized rental units are 1–4 family structures, with another 44 percent in 5-49 unit buildings.
- Of 30 million unsubsidized renters in the United States, only 8 percent live in 50+ unit buildings.

Public Purposes in the New Secondary Mortgage Markets

Non-discriminatory securitization of mortgages for all actors

All secondary market participants must abide by all applicable non-discrimination and consumer protection laws, including Fair Housing requirements:

- To be enforced by the regulator with supervisory jurisdiction over the secondary market actor
- Secondary market actors are responsible for the behavior of originating lenders as under other laws and regulations
- This obligation may apply at the holding company level, in which case it would be enforced by the Federal Reserve or the proposed Consumer Financial Protection Bureau

Public Purposes in the New Secondary Mortgage Markets

Affirmative obligation on CMIs to demonstrate fair lending

- CMIs have a broad obligation to serve a universe of borrowers and communities that mirrors that of the primary market, in terms of amount and (for single-family loans) geography of low and moderate income loans, consistent with safety and soundness
    - Consumer protection, fair lending, anti-discrimination and other similar statutory requirements must be met by all CMIs (as well as OMIs)
    - In addition to a market-serving standard, CMIs should be rewarded for innovative investments, program initiatives and other steps they may take to expand mortgage credit availability, alone or in partnership with other public and private partners.
- CMI performance assessments will take into consideration the following:
    - Whether they have been particularly innovative or responsive to underserved niches such as small multifamily, preservation of existing subsidized housing stock, or special-needs housing or investments in or with CDFIs.
    - For multifamily only, whether the LMI market within the geography served by the CMI is already well served
- CMIs will be required to collect and publish data on securitized loans, including both single- and multi-family
    - For single-family loans, this can be based on existing GSE reporting requirements
    - For multifamily loans, new data collection is necessary

Transitioning to the New System

- The GSEs have extensive infrastructure, resources, and expertise that would be extremely valuable in sustaining a system that serves many of the public purpose objectives we argue are paramount. For the stability of the housing finance markets, as tools of public policy in current conditions, and in the interest of efficiently building a new system in the future, preservation of the human capital, intellectual property, systems, and other capacities of the GSEs is in the public interest.
- Transition issues require further study once the long-term goal and structure for the housing finance system is established, including:
  - How to plan an orderly and deliberative transition process for the GSEs in conservatorship to be transformed into CMIs or have their assets (including portfolio loans and MBS, insurance in force, guarantee fee income streams, technology systems, databases etc.) be otherwise redeployed in a redesigned system?
  - How to transition the market from trading outstanding GSE MBS to the new instruments without disruption?
  - Whether and how to repay taxpayers for funds advanced to the GSEs during the Conservatorship?

Background:
Proposed System Emerges
from
Lessons Learned

From Lesson to Proposal

Lesson 1: *Government support is critical to a well-functioning secondary market. Long cycle and high variability of mortgage risk requires capital and risk regulation to ensure stable and accessible housing finance and protect taxpayer.*

Proposal:

- ☑ Preserves broad access to long-term, stable mortgage finance, such as the 30 year fixed rate mortgage for homeowners and 10+ year financing for rental properties.
- ☑ Continues to provide countercyclical liquidity.
- ☑ Maintains investor confidence.
- ☑ Favors broad network of originators by requiring access on comparable terms; Fosters efficient, commoditized market through a uniform and explicit federal guarantee of securities; Implements standards and transparency to benefit of borrowers AND investors.

From Lesson to Proposal

Lesson 2: *Private sector must put sufficient long-term capital at risk.*

Proposal:

- ☑ Limits government backing to support public policy goals: to those borrowers, loans, and housing types where needed.
- ☑ Requires adequate private capital through CMI channel. Allows multiple CMI's while setting consistent and robust capital rules for all.
- ☑ Further Protects taxpayer through FDIC-like fund, actuarially priced and capitalized by industry.

Lesson 3: *Implicit, opaque guarantees coupled with poor risk management exposed the taxpayer to excessive risk.*

Proposal:

- ☑ Makes government role explicit and limited.
- ☑ Establishes grounds for stronger risk and capital oversight.

From Lesson to Proposal

Lesson 4: *Gaps in oversight lead to race to the bottom*

Proposal:

- ☑ Imposes level regulatory standards for all mortgage capital providers to ensure systemic safety and soundness and protect taxpayers.

Lesson 5: *Quality rental housing should be an integral part of a sound national housing policy*

Proposal:

- ☑ Establishes more robust mechanisms for funding rental housing.
- ☑ Funds National Housing Trust Fund, Capital Magnet Fund and risk sharing partnerships to foster responsible innovation.

From Lesson to Proposal

Lesson 6: *We know how to do safe and affordable homeownership right.*

Proposal:

- ☑ Federal guarantee restricted to sustainable mortgages.
- ☑ Regulation across all channels to avoid “race to the bottom.”
- ☑ Creates constructive framework for R&D through Innovation Fund.
- ☑ Applies affirmative requirement to provide access to safe products and sets appropriate public purpose provisions.