

**Response* to Department of Housing and Urban
Development and Department of the Treasury
Notice and Request for Information, “Public Input
on Reform of the Housing Finance System”**

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Prepared by
The Mortgage Finance Working Group
Sponsored by
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* Our answer to Question 4 is being submitted a separate file and can also be found at
http://www.americanprogress.org/issues/2010/07/housing_finance.html

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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Question 1: How should federal housing finance objectives be prioritized in the context of the broader objectives of housing policy?

U.S. housing policy should return to its historical focus of ensuring an adequate supply of affordable, quality housing—regardless of whether that housing is owner-occupied or rental property—rather than trying to increase the homeownership rate for its own sake, regardless of cost or sustainability. The availability of decent housing that does not excessively drain the incomes of working families is a prerequisite for the wealth accumulation that has always been the basis for American social mobility. Homeownership is an important strategy in service of economic opportunity and security, but so too is affordable rental housing in strong communities. Our housing finance system should thus work to advance economic security and opportunity for a growing middle class through a balanced approach to both homeownership and rental housing. Moreover, the housing finance system must provide sufficient liquidity to meet these housing needs of Americans, in a way that promotes stability and does not lead to excessive risks for the taxpayer or the financial system, and inexpensively, so that excessive costs are not levied on market participants due to market inefficiencies or arbitrage.

Housing policy in the United States has historically been about more than merely providing shelter for Americans. It has also been a means for facilitating the social mobility upon which the American Dream is based. The availability of affordable and stable housing that is not excessively priced vis-à-vis income has been a critical factor for wealth accumulation in the modern U.S. economy.

The current crisis has taught us that reckless, expensive, and unstable mortgage products foster instability and jeopardize consumers, and has thrown into sharp relief the difference between lending practices that work and those that don't. The fact is, we know how to do affordable homeownership right. The lending practices that work are those that work to prudently lower the risk to both borrowers and lenders: careful underwriting assessing the borrower's ability to repay, full documentation of income and assets, and, for some borrowers, risk mitigation approaches such as pre-purchase counseling. We have ample, empirical evidence that these factors increase responsible homeownership, and the low defaults rates associated with these features demonstrate the value of good mortgage products.

Unfortunately, in recent years, many policy makers lost sight of the importance of the affordability and sustainability of housing and instead overly emphasized homeownership as an end unto itself. As a result, regulators and legislators allowed and even encouraged a proliferation of mortgage products extending high-cost homeownership that was inherently unstable and unsustainable. Loans with features such as teaser rates, nonamortization of principal, and stated income underwriting seemed to broaden entry into homeownership and provide existing homeowners with expanded access to credit by tapping into their existing home equity. Unfortunately, the expanded homeownership and consumer credit that accompanied this type of lending was ephemeral and extraordinarily costly not only for the recipients of these loans, but also for society as a whole, draining the

savings of new homeowners, stripping the home equity of existing homeowners, and ravaging the portfolios of investors in U.S. mortgages.

Going forward, policy makers must refocus on the goal of promoting affordable and stable housing options, and pull back from the idea of emphasizing homeownership, regardless of sustainability or cost, as a goal for its own sake. Homeownership has historically been the primary means to wealth accumulation for many Americans, but this is only true when homeownership has been affordable and sustainable. Home equity is best built with a mortgage that pays down principal, and savings best accrued when a mortgage does not exceed the amount of income a household can afford to pay.

But doing homeownership right is not sufficient. Policy makers must pay greater attention to ensuring adequate supplies of affordable rental housing. Rental housing is a critical component of any housing policy, and this is particularly true today, for a number of reasons. First, clear demographic trends indicate that increases in the population of both young adults and the elderly—categories of Americans that are historically more likely to rent—are coming. Second, the fallout from the mortgage crisis means that many Americans will be exiting the ranks of homeownership, and with impaired credit. Third, due to the financial crisis, most Americans have seen their savings and retirement accounts eviscerated, limiting funds available for down payments and other costs associated with purchasing and owning a home. Finally, because of the continued sluggishness of the overall economy, the flexibility and mobility of rental housing are increasingly likely to be sought by the many Americans with unstable or declining incomes, particularly given the need of working Americans to be able to move to follow good jobs.

As we have learned from the current mortgage crisis, the structure and priorities of the housing finance system are critical for housing policy. A poorly designed mortgage market can wreak havoc on larger housing policy goals, as well as on the larger economy. Conversely, a well designed mortgage system can efficiently and capably serve the interests of housing and broader economic policy.

We believe that housing finance reform should be structured around three broad principles, upon which modern U.S. housing finance policy has historically rested:

- Broad and constant liquidity
- Systemic stability achieved through responsible risk oversight
- Wide and fair availability of affordable housing finance¹

Public policy based on these goals served our country well over many generations, and it was departure from these goals that led to the unsustainable mortgage bubble and ensuing crisis. We believe a return to these principles is necessary and appropriate for considerations of comprehensive mortgage finance reform.

Broad and constant liquidity

Liquidity should be *broad* and serve a wide range of communities and housing types, particularly for those that are otherwise underserved. Quality housing finance should be available to all suitable homebuyers, to give them the socioeconomic opportunities associated with homeownership, and it should be available to create and maintain sufficient stocks of affordable rental housing, for those Americans who choose to rent. Liquidity must also be *constant* to avoid exacerbating housing booms and busts, and to lessen the prospect of economic downturns. Liquidity should also flow broadly to a wide variety of different types of intermediaries, including both large and small financial institutions.

In order to ensure broad and constant liquidity, it is necessary to effectively intermediate between *borrower demands for long-term illiquid loans* and investor demands for short-term liquid investments. The existing mortgage finance system has relied on a robust and liquid secondary market for mortgage-backed securities to achieve much of this intermediation and help finance the roughly \$12 trillion in outstanding U.S. residential mortgage debt, and it is likely that securitization will continue to be a major source of mortgage liquidity going forward. Measures to safeguard this important source of credit are necessary.

One key to ensuring a strong flow of mortgage finance is *standardization* of investment vehicles, which allows for deeper and more liquid trading in the secondary markets and more efficient management of risk.

Systemic stability achieved through responsible risk oversight

Another key goal for a reformed mortgage finance system must be to appropriately manage risk, to limit the systemic risks posed by the bubble-bust cycles inherent to housing finance. As we saw during the recent financial crisis, poor risk oversight can lead to catastrophic consequences, not just for homeowners and intermediaries, but also for neighborhood stability, the larger financial system and macro-economy. Taxpayers must also be protected, both from implicit exposure, such as the systemic risks posed by “too big to fail” institutions, and from explicit exposure, such as the government guarantee on Ginnie Mae securities. Loopholes that allow gaps in regulation must be eliminated, to ensure that all actors are appropriately overseen.

To minimize risk, there must be a framework in place to ensure there is adequate transparency, market discipline, and oversight of risk across all actors in the mortgage markets, including both those who originate loans and those who operate in the secondary markets. This framework should include, at a bare minimum, the enforcement of strong underwriting standards, robust capital adequacy requirements, and effective monitoring and mitigation of other forms of risk. In addition, origination level protections must be enforced to ensure that homebuyers are being fairly presented with sustainable home mortgage options. These standards must be applied across all financing channels equally, so as to prevent regulatory arbitrage of the sort that allowed a largely unregulated private securitization channel to capture nearly 40 percent of the mortgage market, with dire consequences.

At the same time, considerations of risk must be appropriately balanced against considerations of extending sustainable homeownership. A mortgage finance system that seeks to entirely eliminate risk will excessively limit credit, with dire social consequences. The goal should be to appropriately understand and manage risk, and allocate it to those with the capacity to bear it. For example, the 1990s saw significant innovation in products, underwriting, and delivery systems in ways that managed the risk of lower down payment loans and borrowers with limited credit history, but these good practices were overwhelmed in the recent mortgage bubble. Stability can also be secured by a return to a focus on additional ways to mitigate risk, such as pre- and post-purchase counseling, shared equity, and cooperative ownership structures.

Wide and fair availability of affordable housing finance

Given that homeownership is the primary vehicle for wealth accumulation for most Americans, there is a critical social interest in ensuring that the affordable mortgage finance necessary to achieve sustainable homeownership is broadly available. Thanks to governmental support, the wide availability of affordable, long-term fixed-rate mortgages is a mainstay of U.S. housing finance and the principal means by which many generations of lower- and middle-class Americans have entered the ranks of homeownership. A key standard against which any proposed reform should be measured is in how well it would provide access to fair and affordable mortgage credit in all communities, including underserved communities, on terms that are fair to and sustainable for the borrower.

At the same time, it is clear that ensuring a sufficient supply of good quality affordable rental housing must also be a major priority for housing finance policy. The fallout from the current foreclosure crisis, coupled with clear demographic trends, strongly suggest rising demand for rental housing and a continued gap between incomes (especially in the lower half of the income distribution) and the rents those incomes can afford. Reform of the housing finance system must ensure that sufficient capital is directed towards the creation and maintenance of sufficient stocks of affordable rental housing to meet this rising demand.

One key to ensuring the wide and fair availability of affordable housing finance is a diversity of lending institutions, and this can be done by maintaining level playing fields so that smaller, more regional lenders can remain competitive with larger, national financial institutions.

Question 2: What role should the federal government play in supporting a stable, well-functioning housing finance system and what risks, if any, should the federal government bear in meeting its housing finance objectives?

A government role is necessary for the smooth and efficient functioning of the mortgage markets. This government role should generally consist of both regulation and support. Broad and consistent regulatory oversight of all mortgage financing channels is necessary to prevent regulatory arbitrage, ensure that risk is sufficiently capitalized, and encourage sound market practices such as standardization, transparency, and good lending practices. Federal support should be offered to further public policy goals, in three areas: 1) ensuring the broad availability of affordable long-term fixed-rate housing finance; 2) improving access to mortgage credit for traditionally underserved borrowers; and 3) providing countercyclical credit.

We start with the premise that private actors and private capital should serve the mortgage markets to the greatest extent possible, and that federal involvement should be limited to ensuring that important public policy goals are met. That being said, it is important to consider what the mortgage markets would look like in the total absence of a governmental role.

Prior to the implementation of the modern U.S. framework for banking and housing finance in the late 1930s, the typical single-family home mortgage was available only for a short term (typically 5-10 years), came with extraordinarily high down payment requirements (typically 50 percent), and was nonamortizing, thus requiring a “bullet” payment of principal at the maturity of the loan. If borrowers were unable to refinance the loan when it came due, they were forced to pay off the outstanding loan balance or face foreclosure. Because mortgages were scarce, expensive, and high-risk, homeownership levels were much lower—approximately 40 percent in 1940.

Without any governmental role, the strongly pro-cyclical tendency of mortgage lending also meant that the mortgage markets were highly vulnerable to catastrophic bubble-bust cycles, as there were no checks on excessive risk-taking during good times, and no sources of countercyclical mortgage liquidity during bad times. As a result, prior to the introduction of governmental support and regulation, banking and foreclosure crises were frequent and regular.

In short, in the absence of a significant government role, the mortgage markets would be considerably riskier and costlier, and much less stable and accessible. But while government involvement is necessary for a stable, well-functioning housing finance system, we believe this involvement should be tailored to serve important public purposes that will not otherwise be satisfied by the markets, and that its potential costs or risks should not outweigh the benefits it provides.

Broadly speaking, there are two ways in which the federal government can play in the housing finance system: regulation and support.

With respect to regulation, we believe a key lesson from the recent mortgage crisis is the need to ensure appropriate levels of regulation over all financing channels and all actors within those channels. The rapid growth of the “shadow banking system”—which relied on nondepository sources of financing (such as private-label mortgage-backed securities) for loans that were primarily originated by unregulated nonbank lenders—led to a rapid deterioration in underwriting and precipitously risky extension of leverage.

The safety and soundness problems generated by this new lending and financing channel, which grew to nearly 40 percent of all outstanding mortgage debt by the mid-2000s, negatively impacted the rest of the mortgage finance system as well, by fomenting a “race to the bottom,” where other financing channels (including for loans originated and held by regulated banks and thrifts, and loans securitized by the government-sponsored entities Fannie Mae and Freddie Mac) similarly lowered their underwriting standards and increased their leverage, in an effort to compete. At the same time, because of the increasing concentration and interconnectedness of the financial system, the excessive risks created by these unregulated channels were often systemic in nature, with the ability to devastate the larger financial system. In fact, this unregulated market was a key contributor to the bubble-bust pattern over the last decade, not unlike the housing crisis of the 1920s and 1930s.

Going forward, all mortgage financing channels—and all actors within those channels—must be subject to sufficient and parallel levels of regulatory oversight. Mortgage lenders and intermediaries alike should be supervised to ensure that they are sufficiently capitalized to be able to bear the risks that they are creating and that they are not creating excessive external risks to the system. Furthermore, this regulation should be periodically reviewed to ensure that there are no significant differences in the way that different mortgage financing channels are treated, to minimize the possibility of regulatory arbitrage and a “race to the bottom” problem.

Government regulation should also aim to improve the efficiency of the markets, by promoting the transparency of market transactions, encouraging standardization, requiring fair and full disclosures, and discouraging unfair lending practices, in both the primary and secondary markets.

In addition to regulation, federal involvement in the housing markets should also offer support to further public policy goals. This support should be tailored, and provided where the private markets would otherwise not consistently meet the priorities of policy makers.

In general, and recognizing that there are significant differences in the levels of support warranted for different market segments and housing types, as outlined in our response to Question 3, we believe there are three critical areas where federal support is needed.

First, federal credit enhancement and support are required to ensure the availability of relatively affordable long-term fixed-rate housing finance. As we have seen in our own

country's history, and in the experiences of other countries, private intermediaries lacking some form of government credit support (either implicit or explicit) are simply unwilling, under most interest rate scenarios, to take on the risks associated with long-duration mortgages without demanding an enormous premium in return. But long-term fixed-rate financing, such as the 30-year fixed-rate mortgage for single-family homes or 10-plus-year financing for multifamily rental properties, is the safest and most sustainable, best serving the public policy goals of increasing the availability of affordable housing options and of improving the overall stability of the housing system.

Second, federal credit enhancement and support are necessary to improve access to mortgage credit for traditionally underserved borrowers, such as young adults, seniors, low- and moderate-income households, and racial minorities, as well as residents of lower-income, minority, and rural communities. Because these borrowers may have atypical and hard-to-serve credit profiles, or limited access to mainstream financial intermediaries, they often have limited—and costly—credit options. Some government support for this sector (for both rental and owner-occupied housing) must be ongoing. But additionally, the government can help support innovative pioneers who develop and test sustainable mortgage products, enabling these borrowers and communities to be capably served by the private sector.

Finally, federal institutions and mechanisms are critical to ensuring a readily available source of countercyclical liquidity. As we have seen all too frequently, private mortgage financing channels are inherently and excessively pro-cyclical, withdrawing credit availability during financial and housing downturns. To prevent housing-driven recessions from turning into depressions, it is necessary to provide countercyclical credit during those periods. The reluctance of private actors to lend during downturns requires that public sources of credit must be at the ready for these times.

Question 3: Should the government approach differ across different segments of the market, and if so, how?

We start with the premise that the housing finance system should efficiently serve the housing policy goal of ensuring a sufficient supply of affordable and stable housing options, and that government involvement should be tailored to this end. This premise should inform the overall government approach to housing finance, including its differentiation between different types of housing, and between different market types.

Home mortgages

The single-family residential mortgage market can be defined both by borrower characteristic as well as by product type. Loosely speaking, there are three categories of borrower and three secondary market channels, but the channels are designed to deliver liquidity to multiple categories of borrower. There is explicitly no one-to-one correspondence between the three categories of borrower and the three securitization channels.

Underserved Borrowers

There is a broad segment of society, including but not limited to low-and moderate-income households and communities of color, that has historically been poorly served (or entirely unserved, and in recent years, detrimentally served) by the purely private mortgage markets. Unfortunately, much of good work done through the Federal Housing Administration, the government sponsored enterprises Fannie Mae and Freddie Mac, and conventional lenders to extend credit to the borrowers and places on sustainable terms during the 1990s and early part of the last decade was undone when unregulated lenders came into this market with an originate-to-sell model. The costly, unsustainable products that looked attractive to many borrowers at first glance ultimately led to high foreclosure rates and devastated communities.

Many families in this category of borrower remain candidates for homeownership using traditional underwriting and long-term, fixed-rate mortgage products. It is entirely appropriate for the government to ensure that these products remain available. While few of these borrowers will have sufficient wealth and savings to make large down payments (particularly in high-cost markets), some will avail themselves of private mortgage insurance, while others will need the government to ensure access to sustainable and affordably priced credit through FHA mortgage insurance.

In addition to availing themselves of traditional mortgage products eligible for securitization through FHA or directly through the Chartered MBS Issuers we detail in Question 4, we believe there is another role for government to support lending to underserved borrowers. Specifically, we propose a Federal Housing Innovation Fund to competitively allocate credit subsidy for risk-sharing and other forms of support (e.g., funding for product R&D or technical support) to help private and nonprofit actors better meet underserved needs through establishing innovative products and delivery channels. The goal of this initial support is to establish 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, eventually reducing or eliminating the need for public support.

Strong regulatory oversight should also be a part of the government’s approach to this market segment, to prevent predatory lending practices, to promote the availability of sustainable lending products to these borrowers, and to prohibit discriminatory lending.

Middle market

The second group of borrowers is the so-called middle market, who have historically had access to affordably priced long-term mortgages (such as the 30-year fixed-rate loan) with government credit support (via the GSEs) but who may also access affordably priced, shorter duration mortgage credit (such as a 7-year adjustable-rate loan) from other lending channels (such as deposit-backed lending or private securitization of mortgages).

Given the inherent stability provided by long-term fixed-rate mortgage finance, and the steep premiums required by purely private lenders to offer such products, the government should maintain its role of ensuring the broad availability of affordably priced long-term fixed-rate products for owner-occupied housing, whether through credit support or otherwise. Strong regulatory oversight of private lending channels should be maintained to prevent excessive systemic risk and provide consumer protection against misleading loan products.

The federal government should also be ready to provide countercyclical credit liquidity in this market.

Higher income/ higher wealth

The third group includes higher-income and higher net-worth borrowers who have sufficient capital and collateral to access credit without any support from the federal government. Many also have the financial sophistication to accept the risks associated with adjustable rate mortgages or nontraditional loans. Members of this group, however, looking for the stability offered by 30-year fixed-rate mortgages can still choose to use government-supported channels. However, as the quality and size of the houses increase far beyond the levels of shelter and investment afforded by the average home, the public purpose of ensuring liquidity for the corresponding mortgages diminishes. Accordingly, most borrowers in this category will choose private mortgages that would be either retained by the originator or potentially eligible for securitization in heavily regulated, privately issued mortgage backed securities.

By extension, it becomes difficult to argue that there is broad public purpose in offering government support for mortgages on second homes, vacation properties, or for speculative purposes. To the extent that single-family houses are purchased as rental investment properties, the criteria for evaluating public purpose should be drawn from the discussion of support for rental, below.

There is a potential countercyclical role for the federal government in this market segment, however, and we would expect the system to be capable of expanding the level of public support during housing downturns. While during normal conditions, government credit support should be limited to the underserved and middle markets, we envision that if, countercyclically, the private sector were unable to provide liquidity for higher priced homes, eligibility criteria would be temporarily expanded to assure broad availability of credit.

While government credit support to this group of borrowers should be minimal, government regulation should be robust. High-balance loans carry more risk for lenders, which can cause ample systemic risk. Contrary to the popular mythology, the foreclosure rates were greater on higher-balance loans, rather than smaller loans made to low- and moderate-income households. To prevent such a disaster from recurring, appropriate levels of regulatory oversight at both the primary and secondary markets for so-called “jumbo” loans are necessary.

Rental financing

Rental housing comes in the form of both single-family and multifamily properties. This analysis focuses on multifamily properties, but its conclusions largely apply to single-family (1-4 unit) homes made available for rent as well.

The multifamily mortgage market is best defined by who is served by the rental housing (i.e., who lives there) and by the types of buildings financed (building size, age, and type of owners) when considering appropriate financing.

Roughly 20 million American households live in apartments in buildings containing 5 or more units, of which only some 4.5 million households live in subsidized apartments. (Another 16 million households live in single family, or 2-4 units buildings, currently generally financed through the single-family mortgage system.)

These 20+ million households contain over 50 million Americans, who are, on average, working families making less than median income. Many households are paying more for rent (over 30 percent of income) than is generally considered affordable, with millions paying more than 50 percent of income for basic shelter costs. Moreover, most economists predict more renters in the coming decade, as foreclosures may force 5 million households back into the rental market, tens of millions of “echo boomers” are coming into prime household formation age (22-30), and immigration of 1 million or more new Americans is likely to resume as the economy improves. These demographic forces are converging in a decade beginning with a generationally low level of rental apartment construction. In addition, large segments of the existing rental stock are 40 years old or even pre-World War II, with many older apartment buildings becoming obsolete. Multifamily starts totaled only 109,000 units in 2009, less than one-third of the 353,000 units in 2005, and less than 40 percent of the 284,000 units in 2008, which was itself a weak year.²

Publicly subsidized affordable housing (such as that created by the Low Income Housing Tax Credit, public housing, or subsidized by Section 8 rental assistance) currently addresses only a portion (perhaps 25 percent) of the need for those households earning at 60 percent or less of area median income, or AMI. This sector is in need of additional capital to meet the needs of the lower income population. However, current subsidy programs do very little to provide rental options for the greater bulk of America's workforce earning between 60 percent and 100 percent of AMI (roughly \$30,000 to \$50,000 per year, nationally, for a family of 4.) This is a very large segment of the population, for which an improved multifamily finance system could provide real benefit without necessarily requiring more direct subsidy.

Looking at multifamily by housing type, smaller multifamily properties (5-50 units) house one-third of all renters, while larger apartment buildings house less than 10 percent of the renter population. Smaller buildings also tend to have a higher proportion of all middle income or lower income occupants. Yet investors and owners of smaller properties have long had a different set of lenders and products than did owners of properties with 50 or more units: 86 percent of larger properties had a mortgage, and of these, 65 percent of the larger properties with a mortgage had a longer-term, fixed-rate mortgage. In contrast, only 58 percent of five-to-nine unit buildings had a mortgage and just one-third of these had level-payment, fixed-rate mortgages.³ Consequently, while all segments of the rental housing finance market can benefit from the stability, liquidity, and risk sharing aspects of fluid access to a secondary market, the smaller multifamily property market is the most challenged. At the same time, such smaller buildings, which are common in many cities and towns as the primary rental housing stock for moderate income families, can easily become community eyesores when owners find themselves unable to pay off debt or obtain refinancing.⁴ This is similar to the situation in many rural areas, where the rental stock tends to be in such smaller buildings.

Finally, we must recognize that the investor-owned (i.e., for-rent) portion of the single-family mortgage market was particularly subject to speculative excesses in the recent meltdown. However, the solution is neither to ignore the special challenges of the segment nor to deny it credit. Thirty-nine percent of all unsubsidized rental households live in single-family homes. It is absolutely critical that we ensure that there remains liquidity to support financing these properties but that such financing be structured and underwritten to be cash-flow based and sustainable, even if property values decline.

In short, given the overwhelming demand for affordably priced rental housing that is emerging, the federal government must play a much greater role in ensuring sufficient supply of rental housing, with a particular emphasis on units affordable to those households with income below the local area median, and on smaller multifamily properties.

Question 4: How should the current organization of the housing finance system be improved?

Our answer to Question 4 is submitted as a PowerPoint presentation, also available at http://www.americanprogress.org/issues/2010/07/housing_finance.html.

Question 5: How should the housing finance system support sound market practices?

There are several keys to supporting sound market practices and ensuring that the mortgage finance system is stable and promotes sustainable lending.

- Regulatory oversight of mortgage finance channels must be robust and consistent, so that there are not major regulatory gaps that lead to excessive risk and a “race to the bottom.”
- Given the systemic risk that securitization potentially creates, access to the secondary mortgage markets should be limited to safe and sustainable loans.
- Certain risks, such as interest rate risk, are difficult to hedge for consumers, and should largely be borne by financial institutions and other parties who are able to hedge against these risks.
- The incentives of all actors in the mortgage finance channel must be better aligned to promote the origination of good mortgage products that increase the stability of the housing markets, the financial markets, and the larger economy.
- Standardization of mortgage characteristics and mortgage-backed securities improves consumer choice, and it provides for deeper, more transparent and more liquid markets.
- Loan characteristics and underwriting are far more important than borrower characteristics in determining whether loans are safe and sustainable. To ensure sound market practices, while still extending the opportunities of homeownership to a wide swath of Americans, it is important to promote mortgage products that are affordable and well underwritten.

Strong and consistent regulatory oversight

One key to ensuring sound market practices is the maintenance of strong and consistent regulatory oversight, at both the primary and secondary markets levels. Regulation to ensure capital adequacy and sound underwriting for all financing channels, coupled with oversight measures to ensure fair and fully disclosed lending practices at the origination level, is the foundation upon which market stability stands. When good sustainable loans are made with strong underwriting practices, the system is more stable as a result.

One of the important lessons from the last crisis, however, is that regulatory oversight must encompass all relevant actors, across all financing channels. The existence of gaps in oversight will inevitably lead to regulatory arbitrage, as capital flows to under-regulated areas, as we saw with both private mortgage securitization and non-bank lending. Both of these largely unregulated areas of the mortgage finance system were very small parts of the market prior to the 2000s, and both grew tremendously during the mortgage bubble.

Regulation should be horizontal, covering all financing channels effectively and consistently. Regulation should also be vertical, in that the supervision of lending practices and institutions must be take place at both the origination level and at the secondary market level. The origination of mortgages and the securitization of mortgages are

intimately interconnected, and allowing standards to lapse in one area will surely lead to a degradation of standards in the other.

Limit access to the secondary markets

We also believe that in the interests of systemic stability, access to the secondary mortgage markets should be limited to products that are safe and sustainable. There is a market and a role for exotic loans with risky features, such as nonamortizing adjustable-rate mortgages with low teaser rates, but these products should be held as whole loans on the balance sheet of a party willing to take on that risk. We have seen that the secondary markets can act as an accelerator for risk, amplifying real risk through the use of complex financial instruments such as collateralized debt obligations or credit default swaps.

Given the high degree of interconnectedness in the financial markets and the large levels of concentration, such that certain firms are now “too big to fail”, we believe it is prudent and necessary to implement restrictions on the types of mortgage credit that may be securitized, so that only products shown to be safe and sustainable can have access to the financing provided by the secondary markets.

Shifting risk to the parties best equipped to bear it

Policy makers should promote products and practices that shift risk onto the parties best able to bear it. Too many of the mortgage products in the past decade left interest rate and other risks with unsophisticated borrowers who were unable to hedge this risk, or otherwise capably deal with it. Mortgage products with long durations and fixed rates leave these risks with financial intermediaries and investors that should be better able to understand these risks and predict economic volatility. As a result, these types of mortgages are more stable, leaving homeowners with predictable housing costs and promoting sustainable homeownership.

Aligning incentives

The interests of the various stakeholders in the mortgage finance system should be better aligned, especially when there are systemic risks or other potential externalities. This is particularly necessary, given the high degree of attenuation in mortgage securitization, where a number of actors stand between the mortgage borrower and the investor funding that mortgage. Given the potential shocks that bad securitization can cause to the financial markets and macro-economy, it is imperative that the incentives of actors in this financing channel be structured so as to encourage good and sustainable lending practices that improve the overall stability of the housing markets, the financial markets, and the larger economy.

The retained risk requirement that is included in the Dodd-Frank Act is a good example of how to better align interests, as are the proposed restrictions on “yield spread premiums” (the practice of paying brokers bonuses for originating loans with higher effective rates). Policy makers should consider further steps to try to incentivize mortgage lending that is

sustainable rather than toxic, such as encouraging compensation schemes based on the long-term performance of loans.

Promoting standardization

In order to have a sound market, borrowers must have effective informed choice, and this is facilitated through standardization. As we saw during the last decade, the proliferation of nonstandard options that have different rates and features that cannot be compared disempowers consumers, effectively taking away any real choice they may have and forcing them to rely on the expertise of mortgage brokers. Standardization of mortgage products allows consumers to effectively compare and price their options, allowing them to make effective and efficient decisions.

Standardization also helps improve the efficiency of the financial markets. The securitization that drives so much of our mortgage lending is dependent on the assumption that mortgage loans can be treated almost as commodities, but this assumption only works if there is strict consistency of loan characteristics and underwriting. Standardization of loan characteristics and underwriting provides confidence for investors. Meanwhile, standardization of the mortgage-backed securities based on these underlying loans allows for deeper, more liquid markets, introducing more market discipline into the pricing of risk.

Standardization is also an absolute prerequisite for the “To Be Announced” (TBA) market, which allows borrowers to lock in their mortgage rates in advance of their closings.⁵ This market is critical for the U.S. housing market, as it allows consumers to enter into the home purchase process, which typically takes weeks to close, with certainty as to the mortgage costs they will bear, and consequently to determine how much they can afford to pay. Without a TBA market, many more home sales would fall through at the last minute, as expected financing disappeared or became more costly.

Affordable lending and innovation

Contrary to the arguments of many observers, it was *not* lending to low-income borrowers that drove the credit bubble, but rather lending to middle- and upper middle-income borrowers, as a recent McKinsey and Co. study found.⁶ In fact, in understanding which mortgages suffered the highest default rates, the characteristics of the borrower were far less relevant than the characteristics of the loan product.

The mortgage crisis has thrown into sharp relief the difference between lending practices that promote stability and soundness, and those that do not. In short, loans that are designed to be affordable and sustainable over time, and which take into account the borrower’s ability to repay, perform well; whereas loans that are high cost and have little regard for the borrower’s ability to repay, perform poorly.

The past decade saw a proliferation of mortgage products with minimal underwriting and high cost features such as nonamortization, low “teaser” rates that reset to much higher

rates, and no documentation of income or assets (so-called “liar loans”). Unsurprisingly, these loans defaulted at high rates.

On the other hand, we know from past experience that loans that are well underwritten and designed to be affordable can open the doors to sustainable homeownership for the vast majority of Americans, including those who are currently underserved by the system. There is significant empirical data supporting the proposition that products with careful underwriting for the ability to repay, compensating risk management approaches like pre-purchase counseling, and down payment assistance work to lower the risk to both borrowers and lenders, and as a result, they have comparatively low default rates.⁷

But sound market practices depend on a system-wide approach that goes beyond the loan origination and underwriting process. By applying specialized credit enhancements and sharing certain risks with well-capitalized institutions who understand how to manage them, such as private mortgage insurers and—where appropriate and necessary—government agencies, the system overall can support more flexibility without increased instability.

A well functioning housing system requires a pathway for positive, sustainable innovation, that is, innovation that increases opportunity for families to build financial security through buying and keeping homes, and for owners of rental property to make decent returns while keeping rents affordable and properties well-maintained, not for speculators to get rich quick. True innovation should not be stifled, but should arise from research and development. Where risks are poorly understood, new approaches can be tested and this testing can be enabled via strictly limited government supports: when a product has been proven, it can be expanded and eventually mainstreamed.

Question 6: What is the best way for the housing finance system to help ensure consumers are protected from unfair, abusive, or deceptive practices?

The housing finance system should set appropriate standards for both primary and secondary market actors that drive the market toward responsible, sustainable home loans. In addition to the establishment and enforcement of rules that improve consumer decision making, such as by limiting predatory lending practices, improved pre- and post-purchase counseling, and meaningful and timely disclosures that enable comparison shopping, there must also be good secondary market practices that limit the demand for loans with abusive or high-risk features.

Primary and secondary market standards should be mutually reinforcing in promoting sustainable mortgage products and good lending practices, and should limit the potential for bad products and bad actors to destabilize the housing markets and financial system. The current foreclosure crisis has taught us certain important lessons that bear directly upon the role of housing finance in consumer protection.

- Basic consumer protection and fair dealing standards must be applied to all participants in the mortgage origination, purchase, and securitization chain.
- Beyond the original creditor, subsequent assignees should retain some responsibility for the terms of the mortgage loan.
- Third parties empowered to service a mortgage loan on behalf of diffuse investors must have the authority and capacity to deal responsibly with the homeowner in the face of delinquency or default.
- Disclosures, consumer education, and consumer “choice” are no substitute for actual consumer protection standards, although they are important in helping consumers make appropriate choices among well-designed and well-priced products.
- Regulators need the flexibility and tools to respond in real time to market abuses as they arise.

Consumer protection standards must apply across the mortgage securitization chain

The current foreclosure crisis has shown the importance of basic standards for all participants in the origination and financing of home mortgages. While loan originators bear enormous responsibility for the peddling of predatory mortgage loans, nothing exacerbated the crisis as much as Wall Street’s enthusiasm for financing predatory mortgage loans. As the subprime market grew, investment bankers sought more and more loans with risky characteristics, encouraging the development of higher-risk investments that appeared to offer higher short-term returns.

The best way to prevent a recurrence of investor-fueled bad lending is to hold the secondary market responsible for the quality of mortgage securitizations. While we support strong origination-level regulatory oversight to ensure fair disclosures and prevent predatory lending practices—such as the Consumer Financial Protection Bureau outlined in the Dodd-Frank Act—it is also critical to reinforce this regulation with

appropriate oversight of the secondary markets. The new risk-retention provisions contained in Title IX of the Dodd-Frank Act should help push the market in this direction, and it is essential that those provisions do not get watered down during the rulemaking phase. We also support detailed disclosure requirements for mortgages in any securitization pool to make it easier for market participants to examine mortgages carefully prior to securitizing them or investing in the securities, as well as facilitating oversight by appropriate regulatory agencies.

We also propose restricting access to the secondary mortgage markets to safe loans, such that only mortgages that have been proven to be safe can be securitized. As we note in greater detail in our answer to Question 5, the secondary markets can act as an accelerator for risk, effectively increasing leverage when risk is poorly underwritten. To improve systemic stability, limit the probability of future financial bailouts, and encourage the availability of better loan products and lending practices for consumers, we believe that access to the secondary markets should be reserved for sound mortgage products only (with higher risk loans provided by those lenders who are willing to bear the risk themselves).

Assignees should retain some responsibility for the terms of mortgages.

Although we support the Dodd-Frank risk-retention requirements mentioned above, experience has demonstrated that reliance on risk-retention provisions alone is not enough to ensure compliance. In the past, risk was also retained through recourse arrangements and buy-back requirements, yet the system still failed. Subsequent holders of a mortgage should have some responsibility for violations of lending law that occur at the time of origination, providing incentives to avoid risky behavior and to protect the interests of both consumers and investors.

Third party loan servicers must deal responsibly with homeowners.

As we have learned the hard way during the current foreclosure crisis, servicing agreement contracts must permit servicers to conduct effective loss mitigation. Servicers need clear authority to modify loans prior to instituting foreclosure proceedings, and they also need clarity regarding their duty to act in the best interest of all investors as a whole. It is also necessary to align servicer financial incentives with the best interest of both the investors and the homeowners, as the misalignment of these incentives is a primary stumbling block to current efforts to modify troubled mortgages.

Most important, enforcement mechanisms should be created to ensure mortgages do not go into foreclosure when other forms of loss mitigation could better serve the economic interests of the mortgage-holders and any investors. While regulatory enforcement is important, establishing that homeowners have the right to loss mitigation would be the most effective way to ensure that servicers act in the best interests of both their clients and homeowners.

While disclosures and consumer education are important, they are not a substitute for substantive rules prohibiting predatory mortgages.

Financial education and literacy, as well as disclosure and choice, are important to personal financial stability, but they are not substitutes for substantive standards that prohibit abusive products and encourage products that are straight-forward and understandable. For example, in connection with the Federal Reserve Board's HOEPA rules issued last year, the use of real consumers to test various disclosures on yield spread premiums demonstrated that some matters are simply too complex and their actual utility too limited to be appropriately addressed through disclosures.

More broadly, the real-life way home loans are originated renders written disclosures inadequate to counteract the oral representations and explanations of mortgage brokers and lenders who are experienced and persuasive in dealing with consumers. The asymmetries of information and experience are too great, and always will be, for consumer education or disclosures alone to be a meaningful buffer against abuse.

Regulators need the flexibility and tools to respond in real time to market abuses as they arise.

Regulators must have the tools and flexibility to respond to problems as they arise, as the current foreclosure crisis demonstrates. In 1994, Congress addressed the subprime abuses of the late 80s and early 90s with "narrowly targeted" legislation. Within five years, the nature of the abuses had evolved largely beyond the legislation's reach, but it was not until July 2010 that Congress enacted further mortgage reforms. Enacted five years earlier, these recent changes would have substantially mitigated the foreclosure crisis we now face; but by 2010, the reforms came too late.

The creation of the Consumer Financial Protection Bureau will help correct this problem at the loan origination level. It is important that regulatory supervision of the secondary market be similarly flexible and responsive to the emergence of new market abuses.

Question 7: Do housing finance systems in other countries offer insights that can help inform U.S. reform choices?

The experiences of other countries with sophisticated banking and mortgage markets can provide some key lessons for us as we reform our mortgage finance system. In general, the countries that did poorly, including Spain, the United Kingdom, and Ireland, allowed weakly regulated or unregulated institutions to play a major role in their mortgage markets, resulting in the broad origination of unsustainable lending practices and products. On the other hand, countries that survived the global mortgage bubble-and-bust cycle relatively unscathed, including Germany, Australia, and Canada, maintained strong and consistent regulatory oversight of mortgage lending, and did not allow less regulated financing channels or products to gain significant share. As a result, these countries did not experience the wide scale origination of unaffordable and unsafe mortgage lending that undermined the mortgage and housing markets of so many other countries.

The key to preventing catastrophe seems quite simple—it is robust and consistent regulation of risk and underwriting for all mortgage lending and financing institutions.

There are two categories of countries that are instructive in considering a new United States mortgage finance system: those with housing finance systems that have remained stable through this period of crisis, and those that have not. The presence of common threads in countries that performed better, or the absence of such commonalities in countries that performed poorly, can provide us with a foundation for drawing important inferences.

We would point to the experiences of seven countries as ones we should draw upon: Germany, Australia, Canada, the United Kingdom, Spain, Ireland, and Denmark. Housing finance in Germany, Australia, and Canada has continued to perform well, even in the face of the financial crisis, while the experience in the United Kingdom, Ireland, and Spain has been roughly as catastrophic as the United States. We would characterize Denmark as being somewhere in between.

One aspect of the era that preceded the mortgage crisis is that it featured substantial changes in mortgage markets around the world. In the United States, the traditional, prime, well-documented, fixed-rate, pre-payable mortgage lost market share to mortgages with adjustable rates, low documentation requirements, prepayment penalties, and zero-or-negative amortization. These mortgages have performed far worse than fixed-rate mortgages.

But the United States was not alone in this regard. In Denmark, the era of the “Danish Mortgage” (which, like the American version, was a 30-year fixed-rate pre-payable mortgage) ended in 2000 with the onset of a wave of new types of mortgages, which became permissible under new legislation. Prominent among them were interest-only adjustable rate mortgages. In the United Kingdom underwriting standards allowed for far more risk layering and the interest-only mortgage became more prevalent. Spain also began to allow an influx of mortgages that had interest-only features.

Generally speaking, the countries that did poorly (such as in Spain with its cajas, and the United Kingdom and Ireland with their demutualized building and loan societies such as Northern Rock, Bradford & Bingley, and Alliance & Leicester) allowed weakly regulated or unregulated institutions to increase market share through unsustainable lending practices, thus undermining the overall financial system. Interestingly, both cajas and demutualized B&Ls used covered bonds for funding mortgages, showing that these instruments are not panaceas, because they are still dependent upon the strength of the financial institution as a whole.

In contrast, Germany, Canada, and Australia continued their robust underwriting standards (required by laws and government regulations), and engaged in best practices with respect to disclosure. As a result, these countries mostly continued to rely on their traditional, stable mortgage products, and did not experience a major influx of these new mortgage products and lending institutions.

Of these comparative countries Canada is most similar to the United States in many key respects, including demographics and homeownership rate, and there are some key lessons to be taken away from our northern neighbor. Like the United States, Canada's mortgage market is heavily dependent on a broad government guarantee—in the United States, this guarantee is on mortgage-backed securities issued by Ginnie Mae or the GSEs; in Canada, this explicit guarantee is on mortgage insurance issued by the government-owned corporation Canada Mortgage and Housing Corporation, CMHC, or one of several eligible private institutions (most notably, Genworth Financial). In 2006, some 45 percent of all outstanding mortgage debt in Canada was backed by federally guaranteed mortgage insurance.

CMHC, the dominant player in the Canadian mortgage markets, closely resembles the U.S. housing finance agencies (Ginnie Mae, Fannie Mae, Freddie Mac), insofar as its obligations are guaranteed by the Canadian government and it has a public mission that includes affordable housing policies and ensuring fair and broad access to affordable mortgage finance. In recent years, CMHC-backed mortgage securitization, similar to the securitization done by Ginnie and the GSEs, has become an increasingly important part of Canadian mortgage finance, growing to nearly 30 percent of total outstanding mortgage debt.

The most important difference between the experiences of the United States and Canada during the last decade was that Canada did not experience any appreciable exposure to the relatively unregulated financing provided by private-label mortgage-backed securities, nor did it allow any unregulated lenders (such as the nonbank lenders that grew to dominate U.S. subprime lending at the height of the credit bubble). Due to strict and consistent regulation, private mortgage securitization accounted for less than 3 percent of all Canadian mortgages, even as this financing source grew to account for roughly 40 percent of all U.S. mortgage debt in the mid-2000s. This strong and consistent regulation across all mortgage financing channels is the primary lesson we should draw from the positive Canadian experience.

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- ¹ In March 2009, the members of our Mortgage Finance Working Group issued a document entitled “Principles to Guide Development and Regulation of a Renewed Mortgage Finance System,” available at http://www.americanprogress.org/issues/2009/03/mortgage_finance_principles.html, which laid out our initial thoughts on this topic. These eight principles—access to credit and liquidity, countercyclicality, risk management and oversight, standardization, transparency and accountability, systemic stability, enhanced consumer protection, and equitable and fair access to credit for consumers and communities—generally fall into the three categories listed here.
- ² Joint Center for Housing Studies of Harvard University, “State of the Nation’s Housing 2010, Table A-2: Housing Market Indicators” (2010), p. 34.
- ³ Joint Center for Housing Studies of Harvard University, “America’s Rental Housing: The Key to a Balanced National Policy” (2008) p. 14.
- ⁴ Manny Fernandez and Jennifer Lee, “Struggling Landlords Leaving Repairs Undone,” *The New York Times*, July 15, 2009, available at <http://www.nytimes.com/2009/07/15/nyregion/15buildings.html>, accessed July 9, 2010.
- ⁵ The TBA market is essentially a futures market for mortgages meant to be securitized by Ginnie Mae, Fannie Mae, or Freddie Mac. The originating lender enters into a forward contract with the issuer (Ginnie, Fannie, or Freddie) in which the originator promises to deliver a package of loans meeting the issuer’s requirements in exchange for MBS at some point in the future. This futures market is only possible because of a high degree of standardization of the loan characteristics and MBS characteristics for the GSE and Ginnie Mae financing channels. Loans must be considered interchangeable, as must MBS, for a TBA market to work. One of the reasons that a TBA market never developed for private-label securities was the lack of homogeneity in private-label MBS and their underlying loans. A high degree of standardization is absolutely necessary to ensure a functioning TBA market in the future.
- ⁶ McKinsey Global Institute, “Debt and deleveraging: A global credit bubble and its economic consequences”, (2010).
- ⁷ See, e.g., Carolina Reid, “Sustaining homeownership: the experience of city-based affordable homeownership,” *Community Investments* 21 (2) (2009); Lei Ding and others, “Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models,” Working Paper (Department of Urban Studies and Planning and the UNC Center for Community Capital, 2008); Roberto G. Quercia, George W. McCarthy, and Susan M. Wachter, “The Impacts of Affordable Lending Efforts on Homeownership Rates,” *Journal of Housing Economics* 12 (1) (2003); David M. Abromowitz and Janneke Ratcliffe, “Homeownership Done Right,” (Washington: Center for American Progress, 2010), available at http://www.americanprogress.org/issues/2010/04/homeownership_right.html.