Center for American Progress

ISTOCKPHOTO/ ARICVYHMEISTER

A Responsible Market for Housing Finance

A Progressive Plan to Reform the U.S. Secondary Market for Residential Mortgages

Prepared by the Mortgage Finance Working Group   January 2011
Sponsored by the Center for American Progress

Center for American Progress

A Responsible Market for Housing Finance

A Progressive Plan to Reform the U.S. Secondary Market for Residential Mortgages

Prepared by the Mortgage Finance Working Group January 2011
Sponsored by the Center for American Progress

About the Mortgage Finance Working Group and this report

This proposal is a product of the Mortgage Finance Working Group sponsored by the Center for American Progress, with the generous support of the Ford Foundation, 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. Unless otherwise noted, this proposal represents the views of the members whose names are below, in their individual capacities. Affiliations are provided for identification purposes only.

Membership in the Mortgage Finance Working Group

David Abromowitz, Senior Fellow, Center for American Progress

Michael Bodaken, President, National Housing Trust

Conrad Egan, Senior Advisor, Affordable Housing Institute

Maureen Friar, President and CEO, on behalf of National Housing Conference

Richard Green, Director, University of Southern California Lusk Center for Real Estate

Toby Halliday, Vice President, Federal Policy, National Housing Trust

Bill Kelley, President, Stewards of Affordable Housing for the Future

Adam Levitin, Associate Professor, Georgetown University Law Center

David Min, Associate Director, Center for American Progress

Shekar Narasimhan, Managing Partner, Beekman Advisors

Janneke Ratcliffe, Associate Director, University of North Carolina Center for Community Capital

Barbara Burnham, Senior Vice President for Policy, Local Initiatives Support Corporation

Ellen Seidman former Director, Officer of Thrift Supervision

Kristin Siglin, Vice President and Senior Policy Advisor, Enterprise Community Partners

Susan Wachter, Richard B. Worley Professor Financial Management, the Wharton School of the University of Pennsylvania

Sarah Rosen Wartell, Executive Vice President, on behalf of the Center for American Progress

Paul Weech, Senior Vice President for Policy, Stewards of Affordable Housing for the Future and Housing Partnership Network

Mark Willis, Resident Research Fellow, Furman Center for Real Estate and Urban Policy, New York University

Barry Zigas, Director of Housing Policy, Consumer Federation of America

Relationship to earlier work by the Mortgage Finance Working Group

In December 2009, our group released a draft of this report. This version supersedes that draft.

In July of 2010, we submitted a Response to the Departments of Housing and Urban Development and Treasury's notice and request for information (eDocket Number HUD-2010-0029) that included a slide deck describing our proposal in response to Question 4. This report supersedes that slide deck.

In October 2010, the multifamily subcommittee of the Mortgage Finance Working Group released a paper entitled "A Responsible Market for Rental Housing Finance." This report incorporates that paper by reference and does *not* supersede it, except to the extent it refers to terminology from earlier versions of the MFWG proposal that are not in this White Paper.

Introduction and summary

In the years prior to the Great Depression, American housing finance was characterized by wild boom-and-bust cycles, regionally disparate prices, and short-term balloon mortgages that severely restricted opportunities for average Americans to own a home. For close to 70 years following the reforms of the 1930s, that all changed. Well into the late 1990s, mortgage finance was continuously available, under terms and at prices that made sustainable homeownership available. A critically important element of this system was the development, starting in about 1970, of an effective secondary market for home mortgages—a marketplace where individual home mortgages are sold by lenders and packaged into mortgage-backed securities that can be sold to investors in the United States and around the world. This pool of capital provided widening opportunities for wealth accumulation for many American families, and supported significant, although not necessarily sufficient, quantities of affordable rental housing.

For some communities in our country, however, credit was constrained, leaving credit worthy borrowers behind. During the 1980s and 1990s, Community Development Financial Institutions, Community Development Corporations, and nonprofit organizations of all types, in partnership with local governments, mortgage lenders, and secondary market institutions demonstrated successful ways to discern the credit-worthy borrowers in underserved communities and to extend them safe, affordable mortgages. Unfortunately, just as these good innovations were picking up speed, so too were predatory mortgage finance products such as adjustable-rate mortgages with pricing gimmicks designed to encourage potential homeowners to borrow far more than they could manage.

These disastrous products exploded in volume, stole market share from the mainstream housing finance system, launched a precarious race to the bottom, and drove out sustainable affordable lending. Most of the predatory products were packaged into so-called private label mortgage-backed securities—securities backed by home mortgages that were not eligible to be guaranteed by the U.S. government-sponsored entities Fannie Mae and Freddie Mac, the two mortgage finance giants. In 2008, the system collapsed in a hail of badly designed loans, mispriced risk, excessive leverage, and lack of supervision, greatly exacerbating the Great Recession.

Today, the federal government backstops some 90 percent of all home mortgage loans. Nearly half of the new home loans are guaranteed by the Federal Housing Administration, the Department of Veterans Affairs, or the Department of Agriculture's Rural Housing Services programs. Almost all other home mortgage loans and most mortgage refinancings are financed through Fannie Mae and Freddie Mac, both of which are now in government conservatorship. The private secondary market in home mortgages disappeared in 2008 and remains moribund. Fannie Mae and Freddie Mac also now purchase more than 80 percent of all multifamily mortgages, loans to owners, and developers of rental residential properties. This new status quo is unsustainable.

We have the knowledge and the tools to create an American housing finance system that will be stable over the ups and downs of the economy—a system that relies upon private capital to equitably serve homeowners, renters and landlords, lenders, investors, and the larger American economy while promoting residential integration, the elimination of housing discrimination, and the provision of safe, decent, and affordable housing in all urban, suburban, and rural communities. The first step taken was Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, named after its two main sponsors, Sen. Christopher Dodd (D-CT) and Rep. Barney Frank (D-MA), which provides for creditable supervision of our nation's banking and securities system, including greater standardization and transparency of mortgage-backed securities, and enhanced consumer protection for home mortgages.[1]

The next step is to move away from our current nationalized mortgage finance system toward a system that once again relies on private-sector capital, through both depository institutions and the secondary mortgage market, to provide the bulk of mortgage finance for American homeowners and owners of rental property. This new mortgage finance system should be guided by five overarching principles:

- Liquidity: Provide participants in the capital markets with the confidence to deliver a reliable supply of capital to ensure access to mortgage credit, every day and in every community, through large and small lenders alike

- Stability: Rein in excessive risk taking and promote reasonable products backed by sufficient capital to protect our economy from destructive boom-bust cycles such as the one we are now struggling to overcome, and the ones that used to plague our economy before the reforms of the 1930s

- Transparency and standardization: Require underwriting, documentation, and analytical standards that are clear and consistent across the board so consumers, investors, and regulators can accurately assess and price risk, and regulators can hold institutions accountable for maintaining an appropriate level of capital

- Affordability: Ensure access to reasonably priced financing for both homeownership and rental housing

- Consumer protection: Ensure that the system supports the long-term best interest of all borrowers and consumers and protects against predatory practices

These principles form the framework for this proposal. We also focus on three specific goals:

- Preserving the availability of 30-year fixed-rate mortgages, which allow families to fix their housing costs and thus better plan for their futures in an ever more volatile economy

- Rebalancing U.S. housing policy so that private markets are the primary source of decent affordable rental housing, with public support where deep subsidy is needed

- Ensuring that a broad array of large and small mortgage lenders (such as community banks, credit unions, and Community Development Financial Institutions) have access to secondary market finance so that they can continue to provide single- and multifamily mortgage loans in every community across our country

To develop a new mortgage finance system based on these principles and with these goals in mind, we approached the problem by dividing both the homeownership and rental housing markets into three parts:

- Underserved borrowers or tenants, whose housing needs (whether as homeowners or renters) may require some direct government support

- Middle-market borrowers or tenants whose housing needs require secondary market liquidity and long-term finance, both of which can be achieved through a limited government backstop of the mortgage finance marketplace
- Higher income and wealthy borrowers and tenants, whose housing needs require government financial intervention only when mortgage markets freeze

Purchasing a home is one of the most important financial decisions most Americans will ever make. But the transactions between borrower and lender that happen in this primary market represent only a part of the housing finance system. To fund mortgage loans for homeowners and support rental housing, lenders need access to a pool of capital that in turn depends on a transparent, effectively regulated secondary market. This paper is concerned primarily with the secondary market, and in particular, the mortgage-backed securities market, which currently has about $9 trillion in securities outstanding.

Today (as before the crisis), the largest participants in this housing finance market are Fannie Mae and Freddie Mac. These two mortgage finance giants are currently in conservatorship and essentially owned by the federal government.[2] They perform an array of secondary market functions that together provide financing for a significant portion of our nation's rental housing and enable Americans to access long-term, fixed-rate mortgage finance. Access to stable, long-term mortages is a key to household stability and a means to accumulate assets that support retirement, education, and other family responsibilities.

Specifically, Fannie and Freddie buy loans from lenders. They hold some of these loans, particularly multifamily loans, on their balance sheet. But for the most part, the companies issue securities backed by those loans—mortgage-backed securities, or MBS. They also guarantee investors the timely payment of interest and principal on those securities, relieving investors of concerns about credit risk.

Fannie and Freddie provide investors with a basis for confidence that the securities will perform, as their own credit guarantee is backed by an implied—and since conservatorship, effectively explicit—guarantee by the U.S. government against the corporation's failure. With that backstop, investors believe there will be a market for any MBS they may wish to sell later, regardless of economic conditions. The result is a deep and liquid market for mortgage-backed securities that was able to continue to operate in 2008 even when other capital markets were frozen. Fannie and Freddie, with their government backing, were able to provide the countercyclical liquidity that kept mortgage money available when private firms without government backing could not do so.

The mortgage crisis occurred because we got away from the fundamental principles that guided the system for more than 70 years, and ignored the irresponsible actions of financial institutions and the dangers of unregulated, opaque markets. We know that when U.S. mortgage finance was essentially a purely private endeavor prior to the reforms of the 1930s, it failed. But we also know that the dominant role now played by the government through the conservatorship of Fannie and Freddie, and through federal agencies such as the Federal Housing Administration, which provides direct government guarantees, needs to be significantly reduced.

We need a new system that is capitalized with as much private capital as possible while still serving the nation's housing needs.

In short, we need a new system that is capitalized with as much private capital as possible while still serving the nation's housing needs. Any government guarantee must be explicit and paid for; we must avoid a repetition of the uncompensated implicit government guarantee that backed Fannie and Freddie before they collapsed into government conservatorship.

The challenge for policymakers is to reform the American housing finance system and create a new system that supports the American dream of homeownership, provides a sufficient stock of affordable rental housing, and restores integrity and accountability to the system. This new system must protect consumers and the broader economy from the predatory loans, excessive leverage, and lack of regulatory supervision that caused the recent financial crisis and led to an unsustainable reliance on federal government intervention in the mortgage market.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, with its reforms of the banking and securities systems, and enhanced consumer protections for mortgages and investor safeguards for mortgage-backed securities, was the first step. We build on these reforms and propose a system that preserves the traditional roles of mortgage originators but separates some of the functions previously provided by Fannie and Freddie, into the hands of three different actors: issuers, Chartered Mortgage Institutions, and a Catastrophic Risk Insurance Fund. These three actors would interact in this new system in the following way:

- Issuers are fully private entities that originate or purchase and pool loans, and issue mortgage-backed securities. Where the MBS themselves and the loans backing them meet certain standards, issuers may purchase credit insurance on the MBS from the new Chartered Mortgage Institutions for the benefit of their investors.

- Chartered Mortgage Institutions are fully private institutions, not owned or controlled by originators (other than potentially through a broad-based cooperative structure), chartered and regulated by a federal agency. These CMIs would provide investors in mortgage-backed securities a guarantee of timely payment of principal and interest on the securities, typically issued by others, backed by loans eligible for government support through the Catastrophic Risk Insurance Fund.

- The Catastrophic Risk Insurance Fund would be a government-run fund fully accounted for in the federal budget and funded by premiums on CMI-guaranteed mortgage-backed securities.The new fund would provide in exchange for these premiums an explicit guarantee of the Chartered Mortgage Institutions' obligations in the event of their financial failure. The government would price and issue the catastrophic guarantee, collect the premium for the guarantee, and administer the Catastrophic Risk Insurance Fund, much like the Federal Deposit Insurance Corporation's Deposit Insurance Fund. The new Catastrophic Risk Insurance Fund would set the product structure and underwriting standards for mortgages that can be put into securities guaranteed by the CMIs and securitization standards for MBS guaranteed by the CMIs.

To protect taxpayers and ensure that all requirements for the guarantee are met, the federal government also would regulate the Chartered Mortgage Institutions for both capital adequacy and compliance with consumer protection and other responsibilities. Finally, the government would serve as conservator or receiver for CMIs that fail, with responsibilities that include ensuring that the servicing of the remaining guaranteed securities is carried out by a qualified entity.

The primary function of CMIs would be to provide investors with assurance of timely payment of principal and interest on mortgage-backed securities that are eligible for the government guarantee. The CMIs would be allowed to hold some loans in their own portfolios, such as troubled loans removed from mortgage-backed securities as well as some multifamily mortgages, which are not easily securitized, but such on-balance-sheet activities would be limited.

The government would guarantee that in the event of the failure of the CMI investors would continue to receive timely payment of principal and interest on CMI-guaranteed mortgage-backed securities that meet product structure, underwriting, and securities structure standards. The government guarantee would be explicit and appropriately priced, and the proceeds would be held in a Catastrophic Risk Insurance Fund. The CMI's equity, which would be set by the government at significantly higher than levels required of Fannie Mae and Freddie Mac, as well as borrower equity and, in some cases, private mortgage insurance, would stand ahead of the Catastrophic Risk Insurance Fund in the event of a CMI failure. The Catastrophic Risk Insurance Fund would only be exposed to losses if a CMI collapsed, wiping out its shareholders and most of its creditors. Neither the equity nor the corporate debt of the CMIs would have any government backing.

Under this proposal, we estimate the cost of a 30-year fixed rate mortgage would probably increase about one-half of 1 percent, or only 50 basis points. Based on today's market that would bring prices back to the level of July 2009—a small price to pay for a robust mortgage market supported largely by private capital.

Our reforms will create a system that will serve the needs of the vast majority of those households that are looking for the consistent availability of affordable credit and predictable housing costs, which can be achieved through a limited government market backstop. There will continue, however, to be underserved borrowers, tenants, and communities, whose housing needs (whether as homeowners or renters) may require some direct government support. To ensure a housing market that effectively combines private capital and public support in a continuum that effectively serves all, we propose three parallel strategies.

First, the Federal Housing Administration would be preserved and granted additional authorities to ensure that they have the talent, systems, and flexibility to meet their public purposes and protect taxpayers from risk. Housing programs run by these agencies provide a level of support, primarily through credit enhancement, to support homeownership opportunities for families with lower incomes and limited resources, as well as to enable landlords to provide affordable rental housing to low- and moderate-income households.

Second, each Chartered Mortgage Institution would have an obligation to provide an equitable outlet for all primary market mortgages (other than those with direct government insurance) meeting the standards for the guarantee of well-designed, sustainable loans, rather than serving only a limited segment of the business such as higher-income portions of that market. With respect to multifamily lending, CMIs that securitize multifamily loans would be required to demonstrate that they are providing housing for working households. In addition, CMIs would be required to provide service to areas of specific concern identified annually, such as shortages created by natural disasters, rural housing, and small multifamily housing.

Third, we propose the creation of a Market Access Fund, financed by a small fee on all mortgage-backed securities. The Market Access Fund would, on a competitive and shared-risk basis, provide credit enhancement and research and development funds to promising but untested mortgage finance products that could better serve underserved markets. Market Access Fund credit enhancements, unlike Federal Housing Administration guarantees would back only a portion of the risk of a loss and would be available only for a limited period of time. The fee on all mortgage-backed securities would also fund the National Housing Trust Fund and the Capital Magnet Fund, two funds that provide finance to states and Community Development Financial Institutions primarily to support affordable rental housing, and which were to have been funded by Fannie Mae and Freddie Mac before they fell into conservatorship.[3]

The new mortgage finance structure we propose will provide stable, broad-based, privately capitalized housing finance so long as the entire mortgage market is subject to strong and consistent regulation. The reforms to the broader mortgage market enacted in the Dodd-Frank Act must be implemented to adequately protect against another race to the bottom. Our paper recommends careful attention to the implementation of the new rules.

We believe our proposal will restore the opportunity of homeownership as one of the fundamental tenets of the American Dream, and to ensure that abundant rental properties are available so that all Americans have access to decent shelter at a reasonable price. From the 1930s to the late 1990s the United States enjoyed a vibrant, stable, housing market that evolved to provide mortgage money at all times, in all parts of the country, for sustainable homeownership and rental housing. The system was not perfect, but as we rebuild we have much to learn from what worked in the period before negligent oversight allowed market distortions to implode our economy.

Our proposal builds on those lessons to construct a housing finance system characterized by liquidity, financial stability, transparency, standardization, affordability, and consumer protection. In the pages that follow, we will examine why the current housing finance system is unsustainable, and offer a detailed proposal for reform that simultaneously can achieve these goals and put private risk capital back at the center of mortgage finance.

As policymakers in the Obama administration and Congress begin to debate the future of the housing finance system, we have the opportunity to transform the system so it serves this nation even better and longer than did the system established in the 1930s. The job is substantively complex and politically challenging but essential. Our proposal recognizes these challenges and offers a comprehensive approach to create an American housing finance system that will be stable over the ups and downs of the economy and will equitably serve homeowners, renters, landlords, lenders, investors, and the larger American economy.

The Center for American Progress is a nonpartisan research and educational institute dedicated to promoting a strong, just and free America that ensures opportunity for all. We believe that Americans are bound together by a common commitment to these values and we aspire to ensure that our national policies reflect these values. We work to find progressive and pragmatic solutions to significant domestic and international problems and develop policy proposals that foster a government that is "of the people, by the people, and for the people."

Center for American Progress

1333 H STREET, NW, 10TH FLOOR, WASHINGTON, DC 20005 • TEL: 202-682-1611 • FAX: 202-682-1867 • WWW.AMERICANPROGRESS.ORG