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Comments on the Federal Housing Finance Agency's Draft Strategic Plan for Fiscal Years 2013-2017

Prepared by the Mortgage Finance Working Group

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The Mortgage Finance Working Group is a collection of housing finance experts, affordable housing advocates, and leading academics sponsored by the Center for American Progress, with the generous support of the Ford Foundation and the Open Society Institute. We began gathering in 2008 in an effort to better understand the causes of the mortgage crisis and create a framework for the future of the U.S. mortgage system.

In January 2011 we released a proposal for reform of the secondary mortgage market, "A Responsible Market for Housing Finance."[1] Our plan builds off five guiding principles for any effort to responsibly wind down Fannie Mae and Freddie Mac and bring private capital back to the mortgage market:

- **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.

- **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 and access.** 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 represent the essential functions of the government-sponsored enterprises, or GSEs, that must be maintained and preserved through the period of conservatorship and transition to any new system of mortgage finance. As conservator of Fannie Mae and Freddie Mac, the Federal Housing Finance Agency, or FHFA, will play a critical role in that effort.

FHFA's efforts must focus on its three-part congressional mandate: ensuring that Fannie and Freddie operate in a safe and sound manner; fostering a liquid, efficient, competitive, and resilient housing finance market; and maximizing assistance for homeowners by minimizing foreclosures.[2] With these goals in mind, we are encouraged by FHFA's pledge in its draft strategic plan to pursue initiatives that "improve current mortgage processes, inspire greater confidence among prospective market participants, and set the stage for recovery and an improved future system of housing finance."[3]

As the draft strategic plan points out, it is the role of lawmakers to develop a plan to bring in private capital to share in credit risk while maintaining the liquidity, stability, standardization, transparency, affordability, and consumer protection that are hallmarks of a well-functioning housing finance system.

In the meantime, FHFA can prepare for the transition by building and maintaining a durable framework for GSE reform—using these five overarching principles as a guide—but must do so without disrupting investor and consumer confidence.

We respectfully submit the following comments, laying out aspects of the draft strategic plan we support, elements that should be given more thought, and possible next steps in the reform process. We organize our comments around the general principles of GSE reform listed above.

Broad and constant liquidity

In the aftermath of the housing crisis and the severe structural problems it exposed with the private-label securitization of mortgages, investors have completely lost confidence in the credit quality of mortgages that are not guaranteed by the federal government. As a result, the government has backed roughly 90 percent of residential mortgage originations since the fall of 2008.

Restoring that investor confidence is a critical hurdle to transferring a meaningful portion of the credit risk from taxpayers to private investors, a central goal for any reform effort. FHFA's draft strategic plan suggests some early steps in that effort. The agency plans to explore ways to share risks by shifting some "first-loss" default risk to private investors, which could both limit taxpayer exposure and inform the GSEs of the private-market price of their guarantees.

Conceptually, this is consistent with many of the most developed and sound plans for GSE reform, and interim steps described in the plan appear to move in the right direction. That said, we have a few concerns.

Market-based risk pricing can be problematic

The draft strategic plan describes intentions to raise fees to move them "closer to the level that other market participants would charge to assume the credit risk." That can be problematic, since private firms' capital costs will depend in part on how the market is structured and what role the federal government plays in that market. Moreover, private firms engage the market for very different reasons, namely making a profit instead of facilitating smooth-functioning markets or promoting certain social or economic goals.

There is also little evidence that the private sector is any better at pricing these risks than the federal government. Indeed, a recent analysis from the Center for American Progress shows that the government is actually quite good at pricing and managing taxpayer risk in federal loan and loan guarantee programs. In fact, most credit programs cost the government less than initially expected, according to the analysis.[4]

At the same time, recent credit blunders in the private sector, such as the billions lost on risky trades in J.P. Morgan's Chief Investment Office, show that the private sector often has trouble pricing risk accurately.[5] Indeed, mispriced risk was one of the primary reasons for the subprime bubble and bust in the mid- to late-2000s, as sophisticated private-sector actors across the financial sector, including mortgage insurers, large institutional investors, rating agencies, large institutional investors, and investment analysts routinely underestimated the risk of default on private-label mortgage-backed securities, ultimately requiring taxpayer bailouts.[6,7]

Risked-based pricing should focus on the product, not the borrower

The draft strategic plan describes strategies to "align guarantee fees to risk." While a certain degree of risk-based pricing is sound policy, too much variation in pricing—especially when based on borrower characteristics instead of loan characteristics—could have severe implications on access to affordable mortgages, especially for traditionally underserved populations. It can also lead to high levels of customization and variability in mortgage products, making it difficult for consumers to shop around and compare rates. Moreover, risk-based pricing spreads widen out dramatically in destabilized environments, leading to volatile market outcomes.

Risk pooling is a more efficient solution, where the government sets standards that limit the variability of risk-based pricing to only well demonstrated, easily measured factors such as loan term and loan-to-value ratios. That way the primary focus is on the riskiness and sustainability of the product, not the perceived riskiness of the borrower. During the subprime bubble most borrowers identified as "high-risk" were given the most volatile and high-cost mortgage products, actually increasing the risk of default. But when given more stable, low-cost mortgages, these tenuous borrowers experience very low default rates, according to research from the UNC Center for Community Capital.[8]

Repurchase requests should be monitored closely

The draft strategic plan only makes passing references to Fannie and Freddie's loan repurchase requests, through which the GSEs ask originators to buy back mortgage due to underwriting errors, fraud, or other issues with the loan. As the plan mentions, these so-called "put-backs" are critical to enforcing sound underwriting in the mortgage market.

But going forward there need to be practices in place that limit put back risk. Investors regularly cite put-back risk as a primary reason why creditworthy borrowers are not given a loan. According to a recent survey from the Federal Reserve, lenders are less likely today to give a loan to a GSE-eligible borrower with credit scores are below 620 than they were in 2006, regardless of their down payment amount. About 60 percent of lenders pointed to the put-back risk as a primary reason, according to the survey.[9]

FHFA must strike the right balance between enforcing sound underwriting and promoting reasonable access to mortgage credit.

No mention of multifamily housing

The draft plan does not make a single reference to multifamily housing. This is a significant omission at a time when the need for affordable rental housing is growing, thanks to rising rents and stagnant middle-class wages. Moreover, the number of renters in the United States is on the rise and the number of homeowners is declining, a trend that will continue for the foreseeable future. Any balanced housing policy, including a look at the GSE businesses, must include a review of both single and multifamily finance.

Fannie and Freddie's multifamily platforms are generally effective and profitable, but many segments of the rental market remain underserved. Multifamily properties in second-and third-tier markets, smaller rental properties, federally assisted housing, bond-financed properties with credit-enhancement, and tax-credit properties are all inadequately served today.[10] The private market has become more interested in the rental sector, especially as rents rise. Nevertheless, the GSEs still generate nearly 50 percent of the multifamily debt in the United States, and the vast majority of their loans serve households who earn less than median income.

Despite that fact, FHFA's sole focus seems to be on the single-family side of the GSE business. We urge FHFA to lay out clear steps to strike the right balance of public and private capital risk in the multifamily market, with the explicit goal of creating and preserving affordable rental housing.

Housing market stability

Most people think of housing market stability in terms of safety and soundness. But while ensuring that Fannie and Freddie have sufficient capital to cover their losses is an important goal, it is not sufficient. We must carefully consider the important role the GSEs are playing in the current market, and steps must be taken to ensure that we do not jeopardize the ability of these entities to continue to perform that role.

FHFA's draft strategic plan underscores the ongoing importance of government support to the U.S. residential mortgage market, as well as the perils of a quick and drastic transition to a purely-private market. The GSEs today are showing the effects of a drawn out conservatorship without clarity as to the future. Still, such a state is preferable to disruptive moves that could unravel the housing market, such as prematurely winding down the GSEs without a viable government presence to take its place.

Limiting losses from reductions in staff and other resources

The negative effects of prolonged conservatorship are perhaps most apparent in the halls of Fannie and Freddie. Both enterprises have seen key executives leave in recent months, often citing worries over compensation and low morale. According to *The Wall Street Journal*, both Fannie and Freddie saw their voluntary-turnover rates rise in the first six months of 2011 compared to recent averages.[11]

In its strategic plan, FHFA must take steps to limit future losses at Fannie and Freddie due to debilitating reductions in staff and loss of essential talent. This includes establishing executive pay rules that enforce accountability while allowing the GSEs to retain top talent, and establishing similar pay and accountability standards for lower-level employees. If the GSEs continue to lose the expertise and human resources that have been built up over decades, the companies will have serious trouble managing their large staffs and $5 trillion in combined business.

Principal reduction can help minimize near-term losses FHFA can take other immediate actions to minimize the GSEs' near-term losses by stabilizing the housing market and preventing unnecessary defaults. We're encouraged by FHFA's strategy to "implement modification and refinancing initiatives and refine them as needed," but one critical foreclosure prevention tool remains missing from the agency's plan: mortgage principal reduction. FHFA continues to ban Fannie and Freddie from using principal write-downs as part of their modifications, despite FHFA's own analysis showing that principal reductions would save the enterprises about $1.7 billion compared to alternative foreclosure mitigation tools.[12]

It's time for FHFA to rethink its position. At the very least, the agency should allow Fannie and Freddie to pursue principal reductions when they would be net-present-value positive for the GSEs. There's no compelling reason for FHFA to stand in the way of any initiative that could save the GSEs money while helping more struggling homeowners avoid unnecessary foreclosure.

As part of that effort, FHFA should permit Fannie and Freddie to accept the subsidies recently made available to them through the Home Affordable Modification Program. Congress and the Obama administration allocated these funds to keep more troubled borrowers in their homes through principal reduction. It is beyond the limits of FHFA's mandate to obstruct those funds from reaching the borrowers who need them, and for whom they were initially intended.

A more ambitious action would be for FHFA to establish principal reduction pilots at Fannie and Freddie. The Center for American Progress recently proposed one particularly promising approach, a "shared appreciation" pilot where the GSEs agree to write down some principal in exchange for a portion of the future appreciation on the home.

The pilot would focus on deeply underwater borrowers facing long-term economic hardships and include special rules to maximize returns to Fannie, Freddie, and the taxpayers supporting them without creating skewed incentives for borrowers.[13]

Transparency and standardization

As mentioned above, the recent crisis has taught us that unregulated private capital poses a tremendous destabilizing risk to the broader financial market. Without clear rules of the road, private investors are not likely to have the confidence to fund the needs of the U.S. residential mortgage market without a government guarantee.

As FHFA's draft strategic plan points out, no private infrastructure exists today that's capable of securitizing the more than $1 trillion in newly originated mortgages each year. Indeed, many of the failures of the private-label securities market during the crisis stemmed from a flimsy infrastructure marred by poor underwriting, flawed servicing and pooling contracts, little transparency, and a general lack of oversight, leaving many investors unaware of the risks they were taking.

More details needed on the single securitization platform

To help solve this problem in the future, FHFA proposes to create a single securitization facility through which all mortgage-backed securities are issued, consisting of uniform underwriting requirements, servicing standards, and pooling and servicing contracts. This can be an important first step toward re-establishing rules of the road for all stakeholders while utilizing the valuable infrastructure already in place at Fannie and Freddie.

That said, we would like to see more details on FHFA's proposal. While a single securitization platform is promising in theory, it is unclear exactly how it would work, how it would be monitored, and who would ultimately benefit.

It is crucial to align rules of the road for both the government-backed and purely-private segments of the market. Before the subprime bubble began to grow and the GSEs still led the housing finance market, sound credit underwriting was barely a serious concern, mostly because Fannie and Freddie bore all the credit risk and thus had a natural incentive to maintain standards. As the purely-private segment of the market grew in the mid-2000s, financial institutions often passed this credit risk along to misinformed investors, creating few incentives to curb excessive risk-taking.

Set clear rules for the entire secondary mortgage market

FHFA must work with other financial regulators to recalibrate those incentives for the mortgage market of the future. That means setting rules for the entire secondary mortgage market—such as adequate capital standards and risk retention requirements—that ensure every market player is held accountable for their actions and maintains some skin in the game.

Therefore, the single securitization platform effort should also carry a supervisory element. After all, Fannie and Freddie's existing infrastructure is a valuable public asset, and there's no sense in simply handing it over to private institutions without expecting something in return. This could include prerequisites for participation in the new platform, such as strong risk and capital standards, affordability requirements, consumer protections, or other provisions regarding the safety and soundness of mortgage products.

Access and affordability

We applaud FHFA for setting a goal to "expand access to housing finance for diverse financial institutions and qualified borrowers," including the inclusion of minority- and woman-owned financial institutions in GSE activities. Thousands of small community-based financial institutions are a critical to providing broad-based access to the mortgage market. Community-based institutions excel at high-touch, "know your customer" origination and servicing, and are often well-situated to reach areas of the market not commonly served by larger institutions.

The GSEs have traditionally played a critical role in leveling the playing field, enabling small and community-based banks to offer the same mortgage products as the largest financial institutions. That role must continue in any new system of U.S. housing finance. Otherwise, large institutions will use their market dominance to increase costs and decrease competition, likely leading to less transparency, a reduction in consumer power, higher costs, and less competition.

Carefully assess the GSEs' current credit box

A critical goal for FHFA should be for borrowers to access the same terms and conditions from all lenders at all times. Unfortunately, mortgage investments today are concentrated among four or five large banks, and mortgage lending is mostly confined to higher-income, lower-risk borrowers compared to historical norms. In 2007, the average Fannie-backed loan origination carried a loan-to-value ratio of 75 percent and a credit score of 716. Last year the GSEs' credit standards were much tighter, with an average loan-to-value ratio of 69 percent and credit score of 762, according to FHFA's latest conservator's report.[14]

We urge FHFA to carefully examine the mortgage market's current credit profile and assess whether borrowers that were successfully served by the GSEs in the past are now being forced into alternative credit enhancements, such as insurance programs offered by the Federal Housing Administration, or out of the market entirely.

While we commend FHFA for restating its dedication to broad and equitable access to the mortgage market, we'd like to see the agency go one step further by laying out a clear path forward. Promoting access and affordability should not be an afterthought in FHFA's strategic plan but a central objective. Without a serious commitment from the federal government, originators, guarantors, and issuers will naturally serve only high-profit, low-cost borrowers, leaving many creditworthy borrowers without access to affordable homeownership.

Next steps

Before we can move toward a more responsible and sustainable system of U.S. housing finance, Congress and the Obama administration must answer several key public policy questions. In the meantime, FHFA must focus on mitigating losses on GSE assets, overseeing the strategy and business activities at Fannie and Freddie, promoting a stable and accessible national housing market, and laying the foundation for a smooth transition toward any new system.

With those priorities in mind, we urge FHFA to take the following steps today, none of which require further authority or guidance from lawmakers:

- Work with other federal entities, such as the Consumer Finance Protection Bureau and the Treasury Department, to develop a unified solution that reaches beyond FHFA's jurisdiction, including underwriting standards, servicing requirements, and pooling and servicing agreements for all securitized loans

- Publish further details on the possible structure, mechanics, and benefits of a single securitization platform for all conforming and private-label mortgage-backed securities

- Calibrate guarantee fee-pricing based on the riskiness of the mortgage product offered, not the perceived riskiness of the borrower, accounting for the government's cost of issuing the guarantee, not the private sector's

- Develop plans with concrete benchmarks for promoting access and affordability in GSE-backed loans, as well as any entity that takes their place in the future

- Assess whether current origination practices and GSE re-purchase requests are creating barriers to creditworthy borrowers that were successfully served by the GSEs in the past

- Establish executive pay and other employment rules that enforce accountability while allowing the GSEs to retain top talent

- Consider implementing a principal reduction pilot, operating through the Home Affordable Modification Program, that focuses on deeply underwater borrowers facing a long-term economic hardship

Nearly four years into the conservatorship of Fannie and Freddie, with no clear path forward for winding down Fannie and Freddie, FHFA is right to be thinking long-term. We commend FHFA for the work it has done so far to protect taxpayer investments in the GSEs, and look forward to working with the agency to help mend a housing market that remains one of the biggest drags on our economic recovery.

Sincerely,

The Mortgage Finance Working Group
Sponsored by the Center for American Progress

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Endnotes

1 See the full MFWG white paper on GSE reform at: Mortgage Finance Working Group, "A Responsible Market for Housing Reform" 2011, available at http://www.americanprogress.org/issues/2011/01/responsible_market.html.

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