Inequality, Opportunity, and the Housing Market

Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Housing, Transportation, and Community Development

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Good morning, Chairman Robert Menendez (D-NJ), Ranking Member Jim Moran (D-VA), and members of the committee. My name is Julia Gordon, and I direct the Housing Finance team at the Center for American Progress, a nonpartisan think tank dedicated to improving the lives of Americans through progressive ideas and action. Thank you so much for convening this hearing on the critical topic of inequality and opportunity in the housing market. I greatly appreciate the opportunity to testify today about the state of our housing recovery and its relationship to the well-being of families and the broader economy.

Research and our lived experience confirm the link between housing and opportunity in this country, from the many benefits of homeownership for families and communities to the central role of the housing economy in economic vitality. A healthy housing market, when coupled with appropriate protections to ensure responsible and sustainable lending, offers opportunities for young people to begin building wealth through homeownership, for growing families to access good schools and high-opportunity neighborhoods, and for older people to choose whether to age in place or seek a smaller or more supportive environment.

Yet at present, our nation's housing recovery is neither strong nor equitably distributed. Not only has the mortgage market shrunk nationally, but many communities—especially communities of color—also lag far behind other parts of the country, with hard-hit neighborhoods continuing to suffer the ongoing effects of multiple foreclosures, negative equity, vacant homes, and blight. We have turned back the clock nearly 20 years on homeownership rates, and rental costs are soaring relative to incomes.[1]

Historically, the housing sector has led economic recoveries following downturns. Unfortunately, the market is not yet strong enough to play that role, which is one of the reasons why the overall recovery still has a lot further to go. While we have had 57 months of consecutive private-sector job growth, too many people are still out of work or under-employed, small-business formation remains depressed,[2] and consumer demand has not rebounded sufficiently. The combination of stagnant wages and rising costs for basic needs, including housing, has squeezed the budgets of all families in America, with the result that entering or even staying in the middle class has become increasingly difficult.[3]

Despite this bleak picture, we see many options for policy choices that can help strengthen the housing market, aid struggling families, and revitalize hard-hit neighborhoods. In this testimony, we provide a set of recommendations to help. While no single recommendation is a silver bullet, taken together, we believe we could move the dial significantly. Many of these recommendations do not require legislative action and can be accomplished by regulatory agencies, while others would require Congress to act.

To increase access to safe and affordable credit, we recommend that the following steps be taken:

- Congress should complete comprehensive reform of the housing finance system.
- The Federal Housing Finance Agency, or FHFA, should play a powerful role in increasing access to credit.
- As a provider of credit to so many underserved populations, the Federal Housing Administration, or FHA, should continue to improve access to and affordability of credit.
- Congress and regulators should support alternative mortgage channels, innovative products to reach underserved borrowers, and effective housing counseling.
- Congress should extend the Mortgage Forgiveness Debt Relief Act, and it should convert the mortgage interest deduction to a tax credit.
- Regulators should collect better mortgage data to help identify problems and potential solutions in the market.

In addition, to assist struggling families and neighborhoods, we recommend the following:

- FHA should improve its Distressed Asset Sale Program to better promote home retention and neighborhood stability.
- FHFA should take additional steps to aid struggling homeowners and communities.
- The Consumer Financial Protection Bureau should continue to improve its servicing rules.
- Policymakers should take steps to help renters, particularly very-low-income renters.

Background: The state of the housing market

Overall, the national mortgage market today is significantly smaller than it was before the Great Recession, both in terms of overall volume and home sales.[4] The national homeownership rate has dropped from close to 70 percent to 64 percent. Cash investors made 29 percent of all purchases in 2013, way above their historic norm of 10 percent to 12 percent.[5] Housing starts remain depressed, and even optimistic projections for 2015 remain well below levels seen before the housing boom.[6]

Additionally, access to credit remains tight. For a conventional home purchase mortgage, the average FICO score is 754. While Federal Housing Administration credit is easier to obtain, with average credit scores for purchase-money mortgages around 680, it is still tighter than historical norms.[7] The Urban Institute estimates that approximately 1.2 million fewer purchase mortgages were made in 2012 than would have been the case had credit availability remained at pre-housing-bubble 2001 levels.[8] Testimony today from the National Association of Realtors provides considerable additional detail on the size and condition of the market.[9]

In terms of specific populations, homeownership rates for young people ages 25 to 34 are among the lowest in decades.[10] While this could in part be explained by the timing of the Great Recession and by the later ages at which this demographic group is forming families, even 35- to 54-year-olds—or Generation X, which should be in its prime homeownership years—have a homeownership rate lower than expected.[11]

The health of the mortgage market is also important for the Baby Boomer generation, many members of which will soon be seeking to sell their homes. The Bipartisan Policy Center estimates that Echo Boomers—those born between 1981 and 1995—will drive 75 percent to 80 percent of owner-occupied home acquisition before 2020 as Baby Boomers sell off their homes.[12] Homes are significant reservoirs of wealth, and a lack of sufficient effective demand for homes could significantly affect these families' retirement security and their ability to remain independent.

Perhaps most troubling, homeownership rates for people of color have dropped dramatically, with Latinos falling by 9 percent from their peak and African Americans falling by 13.7 percent.[13] Because the majority of families formed in America going forward will be families of color, a steep reduction in the numbers of Latinos and African Americans buying homes spells trouble for the housing market for decades to come.[14]

The drop in homeownership rates plays a significant role in the ever-increasing wealth disparities between whites and people of color. The median white household lost 29 percent of its home-equity-based wealth between 2005 and 2011, while the median African American household and the median Hispanic household lost 38 percent and

55 percent of their home-equity wealth, respectively.[15] Loss of home equity translates directly into overall asset reductions, especially for households of color, since their homes are their largest asset; for African American families, homes account for more than half of all wealth, compared with 39 percent for whites.[16] Specifically, whites lost about 26 percent of their net worth during this period, while African Americans lost 50 percent and Hispanics lost 61 percent.[17]

Today's lending patterns mirror our long history of unequal access to mortgage credit for low- and moderate-income and minority communities and borrowers. Census tracts with low levels of any type of home purchase lending are disproportionately minority—45 percent, on average, compared with 33 percent in other areas—and lower income—with an average income of 82 percent of area median income versus 107 percent of area median income in other areas.[18] In 2013, African Americans received only 4.8 percent of home purchase mortgages, despite making up 13 percent of the population, and Hispanics received 7.3 percent of these loans, despite constituting 17 percent of the population.[19] Minority households disproportionately lack access to the more affordable mortgage credit offered in the conventional market, as 70 percent of home purchase loans made to African Americans and 63 percent of these loans made to Hispanics in 2013 were government supported.[20]

Recently, the Urban Institute's Housing Finance Policy Center developed a groundbreaking methodology for measuring the tightness of credit in the housing market.[21] This technique better accounts for the changing credit profile of applicants over time, an important adjustment because far fewer applicants with weaker credit profiles are applying for mortgages than did during the housing bubble from 2004 to 2007 or the more normal period of lending activity that preceded it from 1998 to 2003. Most notably, in the conventional sector,[22] only 8 percent of conventional borrowers in the postcrisis period were of lower credit quality, compared with 29 percent in the prebubble years, before the rise of the irresponsible practices that led to the crisis. This tightness in the conventional sector has a disproportionate impact on borrowers of color, who find themselves relegated to the more expensive government-backed channels or locked out of the mortgage market altogether.

At the same time, while home prices nationally have rebounded from the lows reached during the Great Recession, price recovery has been remarkably uneven, with some geographies still deeply underwater. Not only are 8.7 million—17 percent—of homeowners underwater nationally,[23] but in the 395 hardest-hit ZIP codes, between 43 percent and 76 percent of homeowners are also underwater.[24] More than 70 percent of these ZIP codes have incomes below the national median, and in two-thirds of them, African Americans and Latinos account for at least half the population.

The combination of tremendous home price declines, widespread negative equity, and the impact of the recession on unemployment resulted in the worst foreclosure crisis since the Great Depression. Since the start of the crisis, there have been 5 million completed foreclosures. Even today, with foreclosure rates much lower, about 630,000 homes are currently in some stage of the foreclosure process, while more than 1.6 million borrowers are seriously delinquent.[25] Foreclosures have cost homeowners, neighborhoods, and investors dearly. A typical foreclosure costs borrowers up to $7,000 in administrative costs alone,[26] costs investors more than $75,000,[27] reduces the value of neighboring homes,[28] and burdens local governments through reduced property taxes and increased anti-blight expenditures.[29] A recent study even linked foreclosures to declines in neighbors' health.[30]

Weakness in the housing market deprives our economy of the economic multiplier effects of a strong housing market, including additional construction jobs, consumer demand for household-related items, and local and state tax revenue. The stubborn persistence of negative equity also continues to depress aggregate consumer demand for all goods and services, with significant macroeconomic consequences; homeowners with high levels of debt relative to the value of their assets have experienced larger declines in consumption than less highly leveraged homeowners, even after taking into account declines in net worth.[31] Additionally, fewer small businesses are being founded in the aftermath of the Great Recession,[32] which is not surprising given that roughly one in four small-business owners uses home equity as a source of capital or collateral.[33]

Finally, the decline in homeownership has led to an increase in renters, placing significant upward pressure on rent prices. As of 2012, more than half of all renters spent more than 30 percent of their income on housing, which is the historical upper limit of rent affordability. More than one-quarter of all renters spent in 2012 more than half of their gross income on rent, significantly reducing their ability to pay for food, child care, health care, and other necessities.[34] While the number of households experiencing "worst case" housing needs—either because they live in severely inadequate housing or because they spend more than half of their income on rent—has increased, Congress has repeatedly cut rental assistance programs, and the share of households eligible for these benefits that actually receive them has continued to fall.[35]

Policy Recommendations: Increasing access to safe and affordable credit

Ironically, even as home prices experienced historic declines over the past six years, the tightness in the credit market meant that far too many households—especially families of color and lower-wealth families—missed what otherwise could have been an ideal opportunity to access affordable and sustainable homeownership, build family wealth and security, and provide better opportunities for their children. Too many communities that lost significant wealth due to foreclosures are now failing to rebuild it through homeownership; as more people rent, and especially as more formerly owner-occupied homes transition to long-term rental, payments that could be contributing to rebuilding residents' wealth continue to flow to investors, many of whom live outside the community.

It is not too late to turn this situation around, but we must focus our efforts on enabling more families to join the ranks of homeownership. While there is no one silver bullet, there are many dials and levers that can help increase access without opening the door to predatory or unsafe lending.

At the same time, it is critical to ensure that any expansion of access not lead to the same predatory and abusive market practices that led to the crisis. While the Dodd-Frank Wall Street Reform and Consumer Protection Act[36] created strong protections for mortgages, and while the Consumer Financial Protection Bureau, or CFPB, has tried to set a sensible, moderate course in implementing those protections, some industry participants continue to fight for broader and more exemptions from Dodd-Frank's mandate for creditors to assess a borrower's ability to repay a mortgage loan. An exemption for an entire class of assets, such as portfolio loans, is overly broad and would undermine existing incentives that deter creditors from ignoring the damage caused by making unaffordable loans.

Moreover, we do not believe the Dodd-Frank rules will adequately protect consumers unless all market participants—including brokers, appraisers, lenders, securitizers, and investors—bear liability for noncompliance. Additionally, while we commend regulators involved in the so-called Qualified Residential Mortgage, or QRM, rulemaking for choosing not to impose a down-payment requirement—which we believe would have unfairly excluded lower-wealth households from homeownership—we support the overall risk-retention rule as an important tool to require securitizers to take risks on their securities.

Congress should complete comprehensive reform of the housing finance system

One thread that runs throughout most policy recommendations about easing tight credit is the need to provide as much certainty as possible to market participants and stakeholders. Perhaps the largest of such uncertainties is the fate of mortgage giants Fannie Mae and Freddie Mac, which have now been under conservatorship for more than six years.

Some advocate for simply returning to the system we had before the crisis, in which Fannie and Freddie's private shareholders profited from an implicit government guarantee with minimal capital requirements. While we agree the conservatorship should not last forever, it is critical that in the process of ending it, we fix the misaligned incentives that resulted in the government-sponsored enterprises', or GSEs', financial crisis and that we create an explicit, priced, and paid-for government guarantee to protect the taxpayer.

In our view, S. 1217 provided a very useful framework for this conversation. However, the legislation as passed by the Senate Banking Committee lacked a number of essential elements that we have recommended, particularly with respect to the access to and affordability of credit.[37] Placing the goal of access to affordable, sustainable credit at the center of the new system's purpose will provide the greatest benefit in the long run not only to families but also to lenders and investors and will also protect taxpayers from future bailouts.

We look forward to working with the 114th Congress to craft a housing finance system that can take this country into the future smoothly and successfully.

The Federal Housing Finance Agency can play a powerful role in increasing access to credit

While comprehensive housing finance reform proceeds through the legislative process, we urge the Federal Housing Finance Agency to use its extraordinary powers of conservatorship to promote a robust, inclusive mortgage market that provides liquidity for the broadest possible range of credit needs.

FHFA should use its housing goals and duty-to-serve rulemakings to expand access to populations that are being left out of the housing recovery

Given the GSEs' dominance in the secondary market, their appetite for mortgages essentially determines whether the mortgages will be made at all by the primary market. Understanding this dynamic, Congress has charged FHFA with advancing access to credit by setting specific goals for the GSEs to meet in supporting underserved borrowers and communities and by asking the GSEs to provide "leadership to the market in developing loan products and flexible underwriting guidelines to facilitate a secondary market," supporting very-low- to moderate-income families in the areas of manufactured housing, affordable housing preservation, and rural markets.[38]

Housing goals

In recent years, FHFA has failed to set strong goals that push the enterprises to responsibly innovate and serve broadly, instead setting single-family goals that allow the enterprises to lag behind the primary market's performance. During this time, whole segments of the market have moved to the Federal Housing Administration or have not been served at all. In 2012, for example, the enterprises financed only 16 percent of home purchase loans that originated in low-income and minority Census tracts, one-quarter of home purchase loans to African Americans, and under one-third of home purchase loans to Latinos.[39]

This year's goals rulemaking is an important opportunity to push the enterprises to support low- and moderate-income communities. We recommend that FHFA set strong single- and multifamily benchmarks for GSE performance, including a 27 percent goal for low-income home purchase lending; take strong and predictable enforcement action that considers the performance of the overall market when the enterprises fail to meet the housing goals; and establish subgoals for small multifamily properties and reporting requirements for single-family rental.[40]

Duty to serve

Although more than six years have passed since Congress asked FHFA to create this requirement for the GSEs, the rule proposed in 2010 has not been finalized or implemented. Because the housing market and the financial status of the enterprises have evolved significantly in the intervening years, we urge FHFA to repropose the rule and once again take public comment. The proposal should encourage responsible innovation and give the enterprises strong incentives to serve broadly and to lead the market.[41]

FHFA can make a significant contribution to greater affordability in the manufactured housing area by using the duty-to-serve rule to push the market toward more responsible practices in the area of chattel lending. The majority of manufactured housing is titled as chattel rather than real property, meaning that buyers often lack basic consumer protections.[42] In the affordable housing preservation and rural markets, we similarly believe that the enterprises can actively support these markets through new products, flexible underwriting, affirmative outreach, and other activities, including grants to and partnerships with high-performing nonprofits devoted to this work.

FHFA should adjust its pricing to pool risk and to charge only for its actual risk, thereby making loans more affordable, and should align pricing policies with private mortgage insurer counterparty requirements

We consider it critical for FHFA to return to a pricing structure that is transparent, countercyclical—or, at the very least, not procyclical—and to take full advantage of the enterprises' unique ability to pool risk.

After the inception of the conservatorship, Fannie and Freddie instituted across-the-board, risk-based pricing through a system of loan-level price adjustments, or LLPAs. The LLPAs charge different prices for different loans depending on the profile of both the loan and the borrower. This change from more of a risk-pooling approach occurred at a time when housing prices were dropping, foreclosure rates were rising, and the enterprises were in dire straits financially. FHFA also was concerned about the financial woes of private mortgage insurer counterparties, many of which struggled or even went under financially during the crisis and could not pay all their claims.

Today, the enterprises are in a very different financial condition, having returned to profitability due to a very strong book of new loans, a decline in foreclosure rates, an increase in home prices, and numerous big-dollar settlements with financial institutions. These profits also have enabled them to use deferred tax assets, further improving their financial position. At the same time, the private mortgage insurers also have returned to financial health, and FHFA is now instituting a set of capital and management requirements for those companies that will significantly reduce the enterprises' exposure to counterparty risk.

Yet the LLPAs remain in force, where they play a significant role in driving less-wealthy borrowers out of the conventional market and making loans for those borrowers more expensive—which in and of itself increases the risk of the loans. We recommend that FHFA immediately discontinue use of the LLPAs and return to the historical norm.

Additionally, we do not believe additional increases to the base guarantee fee, or G-fee, are required at this time. FHFA has justified these increases by claiming they are needed to encourage the return of private-label securitization. Yet analysts believe current fees more than cover outstanding risk,[43] and even the dramatic increase in G-fees over the past several years has not succeeded in "crowding in" private capital, though it has undoubtedly driven business to FHA, which carries a 100 percent explicit government guarantee.

As we recommended in our comment letter to FHFA,[44] we think FHFA should price based on what is needed to cover expected losses and costs—including a justifiable level of capital and revenue to support its cost—and to protect the taxpayer in the event of stress scenarios, rather than on pursuing particular market shares for non-GSE entities or sectors.

Similarly, while we support the overall effort to impose meaningful requirements on private mortgage insurer counterparties, we have serious concerns about the financial requirements as proposed.[45] Because the cost of private mortgage insurance by definition falls on lower-wealth borrowers, first-time homebuyers, and borrowers of color, the Private Mortgage Insurer Eligibility Requirements, or PMIERs, are as important, if not more important, than G-fees when it comes to affordable credit. In our view, the proposed requirements will unnecessarily raise the cost of credit for the very borrowers for whom the GSE mission is most important, and we suggest that significant adjustments be made before finalizing these requirements. It is also critical to coordinate G-fees and LLPAs with the private mortgage insurance requirements.

Providing a 97 Loan-to-Value product is a good start, and FHFA also should provide public, loan-level data on past efforts to promote access to credit

We support the recently announced policy change permitting Fannie and Freddie to buy mortgages with as little as 3 percent down under certain circumstances. Properly underwritten, low-down-payment mortgages with long-term, fixed interest rates have performed well even throughout the Great Recession. The predatory mortgages that brought down Wall Street's house of cards sometimes included low down payments but also layered multiple risks—such as exploding interest rates, exorbitant fees, and steep prepayment penalties—with little or no underwriting. Most of these practices are now prohibited by the Dodd-Frank mortgage rules.

We also generally support FHFA's intention in its strategic plan to ask the enterprises to "assess whether there are additional opportunities to reach underserved creditworthy borrowers."[46] Prior to their conservatorship, the enterprises undertook diverse efforts to promote access to affordable mortgage credit, with flexible underwriting standards for core affordability products, such as MyCommunityMortgage, as well as specialized products that met the particular needs of borrowers, such as SmartCommute and Construction-to-Permanent mortgages. They also worked to serve harder-to-serve markets—such as community land trusts, tribal lands, and small multifamily properties—and partnered with diverse entities in support of their affordable housing mission, including nonprofits; housing counseling agencies; Housing Finance Agencies, or HFAs; and Community Development Financial Institutions, or CDFIs.

However, in considering how Fannie and Freddie should proceed, FHFA should instruct the enterprises to conduct detailed analyses of their past efforts to promote access to affordable mortgage credit to use in the design of effective programs for the future. In addition to analyzing previous efforts, we encourage FHFA to release to the public performance data on affordable lending efforts so that external stakeholders working in the housing finance field can better understand how to reach underserved borrowers and communities. We commend the enterprises for releasing loan-characteristic and performance data on a large number of their acquisitions in recent years,[47] but data released so far are limited to single-family, 30-year, fixed-rate, full-documentation, fully amortizing mortgages.

FHFA should require Fannie Mae and Freddie Mac to update the credit-score model used by their automated underwriting systems

Currently, the enterprises require the use of a classic credit score—FICO 04—in their automated underwriting systems.[48] However, newer scoring models, including both FICO 09 and VantageScore, have made some critical changes that will improve the reliability of scores and/or allow the scoring of tens of millions of consumers.

These newer models no longer consider paid collection items, including medical debt collections, and give less weight to unpaid medical debts. Given that the CFPB has found that the presence of medical debt on a credit report results in a credit score that is typically lower by 10 points than it should be—and for paid medical debt, up to 22 points lower than it should be[49]—and given that about 35 percent of Americans—or 77 million—have debt collection items on their credit reports,[50] about half of which are for medical debt,[51] this is a critical issue.

In addition, these newer models are better able to deal with consumers with limited credit history, or thin-file consumers. For example, FICO 09 has enhancements to better assess thin-file consumers, and VantageScore claims to be able to score an additional 30 million to 35 million thin-file consumers.[52]

While Fannie Mae and Freddie Mac have already agreed to study the issue, we do not believe more research is necessary to demonstrate the advantages of alternative models. Instead, FHFA should instruct them to modernize their systems forthwith.

As a provider of credit to so many underserved populations, FHA should continue to improve access to and affordability of credit

The Federal Housing Administration has played a crucial role in supporting our economic recovery, preventing not only even more catastrophic home price declines but also a double-dip recession. While this support came at a cost to the agency's capital ratio, a combination of strong management and improvement in the economy has put the agency on track to fully replenish its reserves by 2016. Particularly, FHA has supported first-time homebuyers and buyers of color, who are all currently poorly served by the conventional market. The following are two suggestions for FHA to help expand affordable credit further.

FHA should reassess its insurance premium structure to see if it is possible to reduce premiums

As noted above, FHA has of necessity focused very heavily in recent years on making programmatic changes to help replenish its insurance fund. While such a focus is important, we believe the fund is strong enough at this point for FHA to reconsider the pricing of mortgage insurance premiums. Forty percent of the agency's home purchase loans made in the second half of 2013 qualified as high cost, which—despite otherwise providing fixed-rate, long-term credit—can in and of itself make a loan more risky.[53] If FHA's fees are not set correctly, its customers, who are more likely to be minority and first-time homebuyers, will be saddled with additional unnecessary expenses, perpetuating an unequal mortgage market. Additionally, the dramatic increases in premiums appear to be driving borrowers away from FHA, reducing its volume significantly, and with FHA operating as the only program available for many lower-wealth borrowers and borrowers of color, we fear those borrowers will not find alternative credit sources.

While we do not believe we have sufficient information at this time to recommend a specific change to the premium structure, we strongly encourage FHA to examine the impact its premiums are having on access to credit and to consider whether some reductions could provide sufficient additional volume to offset any harm to the fund.

FHA should complete its work to provide clarity to lenders and reduce overlays

To address lender concerns about indemnification, FHA has proposed a new system for detecting defects in loan quality and holding lenders accountable for such defects. In this proposal, FHA more clearly identifies and classifies defects in loan applications, establishes severity levels of such defects, and provides a more objective approach to analyzing appropriate cures for defects. We support this effort and believe it is extremely important, though we believe more work is required to clarify and align definitions and to further reduce subjectivity in defect and cure classifications. Additionally, we believe it would be sensible for FHA to work closely with FHFA to align its policies protecting lenders, such as providing a three-year window of clean payment history for indemnification, with exceptions for fraud, data inaccuracies, and compliance with responsible lending practices.

Congress and regulators should support alternative mortgage channels, innovative products to reach underserved borrowers, and effective housing counseling

Many communities hardest hit by the housing crisis and the economic downturn have long been either underserved or not served by traditional financial institutions that could provide safe and affordable credit. Similarly, for many borrowers, the most popular mainstream products will always be difficult to access. For this reason, we recommend taking steps to strengthen alternative mortgage channels and to experiment with safe but innovative products to reach more borrowers.

The strong need for alternative lenders in underserved communities can be attributed to years of discrimination, redlining, and market failures in which mainstream financial institutions lacked incentives to lend to projects where the aggregate social return was positive. CDFIs and HFAs, which combine deep knowledge of local communities' needs with safe, targeted products, can identify and assist potential homeowners, and CDFIs can also provide business and consumer loans, investments, and retail banking services to neighborhoods that need critical economic catalysts to overcome years of disinvestment.

Congress and regulators should consider whether there are changes to regulations such as the Community Reinvestment Act, or CRA, that can be used to strengthen these institutions. For example, changing the way that financial institutions subject to the CRA receive credit for investing in CDFIs could provide a win-win solution for banks unwilling to take risks on certain populations, especially since CDFIs and nonprofits receive special treatment in the Dodd-Frank mortgage rules to enable them to better serve lower-income families. Similarly, sources of funding such as recent settlements between government agencies and large banks could be directed to helping alternative mortgage channels scale their operations.

Similarly, a typical mortgage product is not always accessible to some households due to the down-payment requirements or fear of placing assets in a first-loss position. Shared-equity or shared-appreciation approaches can provide a middle ground between renting and traditional homeownership. In general, these products share certain common features: owner occupancy of residential properties, initial affordability, and sharing of risk and equity or appreciation. These strategies can potentially support modest individual asset accumulation while protecting consumers against home price declines and providing more stability to the macroeconomy in times of market disruption.[54] Congress and regulators should consider how to encourage safe experimentation with alternative products.

Finally, it is critical to support housing and credit counseling to help more people achieve sustainable homeownership. Whether counseling a first-time homebuyer to avoid predatory loans, negotiating a modification that will allow a distressed homeowner to stay in their home, helping a low-income family find affordable rental housing, or helping a homeless person find emergency shelter, nonprofit housing counselors are advocates for housing consumers, especially those from traditionally underserved communities such as communities of color, low- and moderate-income communities, and the elderly. A growing body of research demonstrates that those who receive housing counseling realize better outcomes than similarly situated people who do not.[55]

Recently, FHA proposed a program entitled Homeowners Armed with Knowledge, or HAWK, that would offer reductions on the upfront and annual mortgage insurance premiums, or MIPs, to FHA borrowers who participate in a specified housing counseling curriculum. Other government agencies such as the U.S. Department of Veterans Affairs and the U.S. Department of Agriculture could create the same type of program, and FHFA could work with Fannie and Freddie to create a similar incentive structure in the secondary market through preferential pricing for counseled mortgages. Borrowers could yield additional incentives if they committed to postpurchase counseling as well. Bonus points could be awarded under the goals that would incent this kind of proven, safe, and sustainable lending. Additionally, Congress should grant the Department of Housing and Urban Development's, or HUD's, Office of Housing Counseling the authority to accept funds from private entities to be distributed and used for housing counseling activities.

Congress should extend the Mortgage Forgiveness Debt Relief Act, and it should convert the mortgage interest deduction to a tax credit

Mortgage Forgiveness Debt Relief Act

When a lender forgives mortgage debt through a short sale or a principal reduction modification or even after a foreclosure, the amount that the borrower no longer owes counts as taxable income to the borrower unless it fits into an exemption in the tax code. Given the deep inappropriateness of this result for those losing their homes, Congress created a tax code exemption in 2007 entitled the Mortgage Forgiveness Debt Relief Act, or MDRA. For several years, the MDRA was extended on a year-to-year basis.

The MDRA has been crucial to virtually every effort to assist troubled homeowners and restore the housing market to health. However, this past year, the MDRA was not extended. Consequently, the number of short sales dropped, adding to the continued woes of the housing market. What's more, principal reduction is less valuable to homeowners if they must pay tax on the forgiven debt, which hampers loss-mitigation efforts. Congress must extend the MDRA not just until the end of 2014 but at least until the end of 2015. Ideally, this exemption would become permanent.[56]

Mortgage interest deduction

The federal government spends $70 billion per year on the mortgage interest deduction—more than $1 trillion over a 10-year period and more than the entire HUD budget for a year.[57] Yet the benefit of the mortgage interest deduction is heavily skewed to households in upper-income tax brackets. As taxpayers' income increases, their tax rate increases and so does the value of the deduction. In addition, the mortgage interest deduction is only available to those who are able to itemize deductions rather than take the standard deduction. According to the Tax Policy Center's analysis of 2010 data, less than one-third of taxpayers itemize their deductions, and the majority of those who itemize fall in the top income tax brackets.[58]

As part of comprehensive tax reform, we recommend replacing the current mortgage interest deduction with a tax credit. Our proposal would gradually phase out the current deduction and replace it with an 18 percent nonrefundable tax credit.[59] The effect of this change would be to provide the same benefit to all taxpayers, rather than a much larger benefit to those with higher incomes. Increasing the value of the credit to low- and moderate-income taxpayers not only increases fairness and access to homeownership but also contributes to economic growth, since it puts more money in the hands of a large number of families who typically need to spend every dollar they earn just to get by.

Regulators should collect better mortgage data to help identify problems and potential solutions in the market

As a free and public database, the Home Mortgage Disclosure Act, or HMDA, provides critical data to housing market participants and stakeholders, especially to nonprofits and other entities without access to expensive proprietary databases. However, the HMDA database has long suffered from some key omissions, both in terms of who is reporting data and what data are reported.

Recently, the CFPB issued a set of proposed changes to the HMDA, including changes to definitions of covered institutions and transactions, as well as the addition of proposed new fields to improve the usefulness and quality of the HMDA data. We strongly support the CFPB's efforts. In addition to its proposals, we recommend additional data enhancements that would be of great benefit to researchers and community groups in the efforts to promote fair access to credit, while also helping equip regulatory and enforcement agencies with fair lending compliance.

For example, we think the CFPB should take further steps to simplify the reporting requirement to one eligibility standard, add further fields on various topics such as denials and language and race, and collect information on loan modifications and housing counseling.[60]

Policy Recommendations:
Assisting struggling families and neighborhoods

FHA should improve its Distressed Asset Sale Program to better promote home retention and neighborhood stability

Since 2012, FHA has been selling distressed loans in bulk prior to foreclosure in order to save money and potentially provide these borrowers with a last chance to save their homes. The Distressed Asset Stabilization Program has auctioned about 100,000 loans over the past two years, and FHA still insures about a half million seriously delinquent loans that could be eligible for the program. FHA's program sells some loan pools with almost no strings attached, while others are sold through a special neighborhood-stabilization channel that requires buyers to help families and neighborhoods. The loans sold through neighborhood-stabilization auctions tend to be geographically concentrated, while the loans sold through the national auctions are dispersed among many states.

This summer, FHA released outcome data about these pools for the first time since the program's inception.[61] Nearly one-quarter of loans sold through the neighborhood-stabilization outcome auctions and resolved have resulted in homeowners staying in their homes, at least for the time being. Another 35 percent of families have avoided foreclosure through a short sale or similar outcome. Loans that were sold in pools without requirements and later resolved, on the other hand, had a markedly different outcome. Less than 9 percent of those families remained in their homes, and 21 percent avoided foreclosure. In short, the data demonstrate that imposing even relatively modest and flexible requirements on auctioned loan pools can lead to much better outcomes for households and neighborhoods. The geographic concentration of the loans sold through the neighborhood-stabilization auctions may also make it easier for note buyers to service the portfolio.

Distressed mortgage sale programs, if designed responsibly, can limit the damage of the foreclosure crisis by helping homeowners access foreclosure alternatives, supporting neighborhood home prices, and limiting losses to taxpayers. However, if loans are simply passed off to the highest bidder without any built-in protections for homeowners and neighborhoods, we will have missed an extraordinary opportunity to support the housing recovery.

Thus, as FHA moves forward with more auctions, we suggest the following four overarching recommendations to promote home retention and neighborhood stability while still helping the agencies save taxpayer dollars.

- FHA should impose a set of basic requirements on all buyers in all pools. First, the agency should require all buyers to work with existing homeowners to keep them in their homes if possible through a sustainable, permanent loan modification—perhaps using the Home Affordable Modification Program, or HAMP. When a loan modification is not possible, buyers should be required to pursue short sales or deeds in lieu of foreclosure before foreclosing on a property. For properties that go to real estate owned, or REO, FHA should require the investor to provide an opportunity for owner-occupant purchase before either selling to another investor or transforming into long-term rental. Reasonable requirements of this nature may have less of an impact on price than FHA may fear, both because the loans with requirements have sold for prices similar to those of loans with no requirements and because demand for all of these pools is only growing with time.[62]

- FHA should help nonprofits participate effectively in the bidding process because neighborhood-based nonprofits often produce the best outcomes for families and neighborhoods. To the extent that nonprofits lack either capital or capacity, we believe the best option is for FHA to provide a preference to private investors that partner with nonprofits and have a track record of serving homeowners effectively.

Before placing loans in a sale pool, FHA should ensure that mortgage servicers have fully complied with the agency's requirements for attempting to assist borrowers and that the home is still occupied before placing a loan into distressed mortgage sale programs. Reports from buyers and from consumer representatives indicate that some loans are moving into the program before servicers have completed their work with homeowners and that many homes are vacant when buyers take possession of them. The government should be careful that servicers are prevented from using the program to evade their contractual responsibilities.

FHA should collect and share more detailed performance data about the programs so the public can fully understand their effectiveness. The agency took roughly two years to publish its first set of outcomes, and that information is very limited. These agencies have an obligation to track in detail what happens to the loans after they are sold and to share this information with taxpayers, neighborhoods, and local governments.

FHFA should take additional steps to aid struggling homeowners and communities

As with respect to access to credit, FHFA's singular role in the housing market provides it with many opportunities to support struggling families and communities. Over the past several years, the agency has made improvements to the Home Affordable Refinance Program, or HARP, and to its own Servicing Alignment Initiative—both of which have assisted many borrowers—but there are many additional steps it can take to ensure that both homeowners and neighborhoods are better protected.

To assist performing borrowers, improve HARP to reach more people

The Obama administration's HARP has already helped more than 2.7 million households refinance their mortgages and could reach many more with a few targeted improvements. The Responsible Homeowner Refinancing Act of 2013 would require that Fannie Mae and Freddie Mac eliminate all upfront participation fees to borrowers; that the same benefits be available to all eligible lenders, including waivers of certain representations and warrantees; and that all borrowers with Fannie- and Freddie-backed mortgages be notified about the program, its eligibility requirements, and participating lenders.[63] These changes could help more homeowners take advantage of low interest rates, lower their monthly mortgage payment, and reduce the risk that they will default on their mortgage.

FHFA should join the Department of the Treasury and FHA in extending the GSEs' HAMP at least through 2016

Some months ago, the Treasury Department announced it would extend HAMP at least through 2016. We urge FHFA to ensure that HAMP will continue to be available to Fannie and Freddie borrowers as long as HAMP is available to private-label borrowers. Moreover, when HAMP expires—and especially if FHFA does not require the GSEs to extend HAMP through 2016—FHFA should require Fannie and Freddie to implement a new proprietary modification that includes measures to ensure affordability, which the current Standard Modification does not do.

To assist troubled borrowers, FHFA should participate in the HAMP principal reduction alternative and enable borrowers who lose their homes through a short sale or foreclosure to buy back their homes at fair market value

We are encouraged that FHFA's strategic plan expresses a commitment to "develop and actively promote home retention and loss mitigation programs."[64] Unfortunately, FHFA still prohibits the enterprises from engaging in one of the most effective forms of loss mitigation: principal reduction. Numerous studies have demonstrated that principal reductions help keep troubled borrowers in their homes more effectively than loan modifications alone.[65] Additionally, the Congressional Budget Office has estimated that allowing principal reductions through HAMP on loans guaranteed by the enterprises would result in savings for the taxpayer.[66]

Lifting this prohibition should be an FHFA priority. FHFA could either design its own principal reduction modification or use the HAMP Principal Reduction Alternative, or HAMP-PRA. If FHFA is worried about strategic default, HAMP-PRA requires a borrower to be delinquent or in imminent default; to demonstrate a hardship; and to meet various other criteria related to the size of the loan, owner-occupancy, and more. The modification must be both net-present-value positive and affordable by the borrower. Working through HAMP also would provide access to the Treasury Department incentive payments and related Treasury programs such as the Second Lien Modification Program, or 2MP. HAMP-PRA also allows an investor to create a shared-appreciation modification, where any gains upon sale would be shared by the investor and homeowner, as some senators have recommended.[67]

FHFA has previously raised concerns about the operational burdens associated with implementing principal reduction. While these concerns are valid and real, the Treasury Department has offered to pay the additional administrative costs required to implement HAMP-PRA and to free up human and technical resources that would accelerate implementation of this program.

If FHFA will not provide principal reduction, or for homeowners for whom a new principal reduction program would not come in time, we encourage FHFA to continue to explore additional ways to enable former homeowners to buy back their homes at fair market value. Recently, FHFA announced that it will permit former homeowners who have gone through a foreclosure or deed in lieu to buy back their house at fair market value if they are able to obtain financing through a channel other than the GSEs. However, most homeowners whose homes are already in the REO portfolio are not likely to be in a position to return to their home or to obtain financing to do so, given the damage to their credit score and the need to have already moved out.

Instead, FHFA should focus on enabling mission-based organizations to assist troubled underwater borrowers in a short-sale transaction whereby a homeowner can repurchase their own home if they can afford the mortgage at the fair market value. Sometimes called a "structured short sale," this transaction provides a way for borrowers to right size their mortgage without forcing them through a foreclosure or risking an eviction. Borrowers should still be required to meet the GSEs' existing hardship requirements for obtaining a short sale.

If and when Fannie Mae or Freddie Mac sell nonperforming loans in bulk, FHFA should require that these sales actively promote home retention and neighborhood stability

Between them, Fannie Mae and Freddie Mac hold close to 700,000 seriously delinquent loans.[68] Many of these loans have languished for years, with foreclosures in process or imminent. Observers had long speculated that Fannie and Freddie would sell these loans to investors at a discounted rate to minimize enterprise losses, as FHA has been doing. Confirming this speculation, this past August, Freddie Mac auctioned its first pool of nonperforming loans.[69]

We encourage FHFA to follow the recommendations we outlined above for FHA in making home retention and neighborhood stability explicit goals for any further enterprise note sales. In particular, we recommend that FHFA impose on purchasers meaningful postsale requirements aimed at home retention and neighborhood stabilization, including an explicit loss-mitigation waterfall; encourage sales to nonprofit or other entities that will prioritize these goals; and collect and regularly share data on outcomes.[70] Especially given strong investor demand for nonperforming loans, we do not think such requirements would unduly impact investor bids for the loans.

FHFA should instruct Fannie and Freddie to reform their approach to lender-placed, or force-placed, insurance

FHFA has recognized that abuses within the lender-placed insurance market—the insurance a lender must obtain on behalf of a homeowner if a homeowner's property insurance lapses—are burdensome not only for consumers but also for Fannie Mae and Freddie Mac. The GSEs spent $360 million on lender-placed insurance premiums in 2012 alone, according to the FHFA Office of Inspector General.[71] The costs of force-placed insurance, or FPI, are exorbitant because mortgage servicers often receive kickbacks—in the form of free or below-cost services, commissions, or bonuses—from insurance companies. Homeowners, and the GSEs when a homeowner loses their home to foreclosure, are responsible for paying the FPI bill.

FHFA took an important step last year to lower FPI costs by prohibiting mortgage servicers from collecting commission from insurance companies for buying FPI. FHFA also included lowering FPI costs as an objective in the GSEs' 2014 performance scorecard.[72] However, these steps alone will not bring down the costs of FPI, since insurance companies and mortgage servicers are likely to find new ways to exchange kickbacks. FHFA must consider a more comprehensive approach to prevent the kickbacks between insurance companies and mortgage servicers, and we recommend that it consider allowing the GSEs to purchase insurance directly, instead of reimbursing mortgage servicers. Cutting out the middle man could help protect consumers and taxpayers from inflated costs.

The CFPB should continue to improve its servicing rules

The CFPB's servicing rules provide essential procedural protections that promote better servicing outcomes for homeowners, investors, and communities. The recent proposed amendments to those rules make substantial improvements in crucial areas including transfers of servicing, bankruptcy, and access to the loss-mitigation system for subsequent hardships. They also make important strides in protecting homeowners who seek assistance following the death or divorce of a co-homeowner.

However, there are still some basic building blocks to servicing reform that are not yet in place. First, servicer compensation reform has been sidetracked and must be revived. As long as servicers profit at the expense of homeowners and investors, the system will not reliably produce healthy outcomes for the housing market and communities regardless of the rules or enforcement thereof. Regulators must come together to develop a framework to modernize and rationalize servicer compensation.

Second, with the eventual sunset of HAMP, policymakers need to find a way to require loss mitigation and to require sustainable modifications for homeowners that also benefit investors. Loss mitigation before HAMP did not always happen, and when it did, it did not always promote long-term home retention. Without rules in place, it is possible—perhaps even likely—that the system will soon forget the lessons of the crisis. To the extent that the CFPB does not or cannot mandate loss mitigation and a substantive requirement for loan modifications, Congress and other regulators should step in to ensure that such a requirement is developed.

Third, we encourage the CFPB to continue to address issues that remain outstanding in other follow-up actions to its servicing rules. For example, current rules do not yet clarify what homeowners need to submit to have their request for assistance reviewed. In addition, borrowers who do not speak English as their native language continue to face significant problems communicating orally and in writing with mortgage servicing companies.

Policymakers should take steps to help renters, particularly very-low-income renters

FHFA should capitalize the Housing Trust Fund and Capital Magnet Fund

In the Housing and Economic Recovery Act of 2008 that created FHFA, Congress created a mechanism by which Fannie and Freddie would capitalize the Housing Trust Fund and Capital Magnet Fund, both sources of subsidy to produce affordable housing for very-low-income families. After FHFA put Fannie and Freddie into conservatorship, however, it prohibited the companies from contributing these funds at all.

While this prohibition may have been justified when the enterprises were drawing on taxpayer funds to stay afloat, now that they have returned to profitability, there is no justification for continuing the prohibition. We believe that FHFA has both the right and the responsibility to direct the enterprises to begin contributing to these funds right away.

Congress should extend the Low-Income Housing Tax Credit, or LIHTC

Since its creation in 1986, the LIHTC has leveraged more than $100 billion in private investment capital through a dollar-for-dollar reduction in a developer's tax liability, providing critical financing for the development of more than 2.5 million affordable rental homes.[73] The program annually supports 95,000 jobs and finances approximately 90 percent of all affordable rental housing. Moreover, it is a critical resource to transform communities suffering from blight.[74]

Ever since the minimum LIHTC rate expired at the end of 2013, LIHTC developments have been underwritten using a floating rate, which has hovered near 7.5 percent. The tax extenders package from the House would provide a minimum 9 percent credit rate through January 1, meaning there are essentially no housing deals that will benefit from this provision. Congress should extend the Housing Credit's 9 percent minimum credit rate floor for two years until the end of 2015 so that at least one year would have the full benefit.

Congress should protect important programs for affordable housing from budget cuts

In 2012, 75 percent of extremely poor households paid more than half of their meager incomes for housing. This results in little money left over for groceries, medication, transportation, and other life necessities. It also is a strong determinant of homelessness, which is much more expensive than rental assistance to mitigate.

HUD's rental assistance programs—public housing, project-based Section 8, and housing choice vouchers—which serve about 5 million extremely low-income households, are facing a big threat next year: sequestration. HUD programs, although they serve the poorest households, are not exempt from sequestration's impacts. Sequestration has already led to 100,000 fewer low-income families receiving housing vouchers.[75] As a result of sequestration and other austerity measures enacted since 2011, nondefense discretionary funding in fiscal year 2014 was about 15 percent below 2010 levels when adjusted for inflation. Without action to stop sequestration, in FY 2016, nondefense discretionary programs will decline to 3.1 percent of gross domestic product—equal to the lowest level in at least 50 years. These programs already serve only one-quarter of those eligible, and it is critical not to cut these budgets further.[76] Congress must protect these most vulnerable residents from losing one of the few forms of housing assistance currently available.

Additionally, we recommend a renewed commitment of funding to the HOME Investment Partnerships program. This program creates affordable housing for people in need nationwide—since 1992, more than 1 million homes. It does so by giving states and localities the flexibility to deploy scarce resources to the affordable housing challenges particular to their communities. HOME leverages other resources almost four to one, and frequently is critical gap financing for LIHTC properties.

Congress and agencies should act to encourage renters to increase their savings

Another opportunity for addressing inequality in our housing market lies in developing programs that effectively encourage renters to build assets. Renter households in the United States have a median net worth of about $5,100, while households that own homes have a median net worth of more than $170,000.[77] This inequality remains true when comparing renters with incomes comparable to their homeowner counterparts.[78] A significant cause of this phenomenon is the fact that mortgage payments typically represent a form of forced savings, while renting lacks a similar mechanism to encourage households to save. The proportion of the population that rents is expected to grow in the coming years, portending an increase in our nation's already large wealth inequality.

Addressing this issue will not be easy, but research and experience suggest there are ways we can encourage more renters to save. HUD's Family Self-Sufficient Program, which escrows into a separate account the increased portion of rent public housing tenants would be expected to pay if their income were to increase, has proven to be a powerful savings vehicle for many participating households.[79] We support legislative efforts to enhance and extend this program to more groups of renters receiving some kind of government assistance.[80]

Programs implemented by nonprofits and for-profit landlords alike likewise show promise in promoting savings among renting households. And behavioral economics research suggests that an effective renter savings program would make savings automatic, make participation easy, give short-term rewards for saving and, if possible, provide a match for savings.[81] As more families rent rather than own homes, it is critical to ramp up the policy discussion about how to make it easier for renters to build wealth.

Conclusion

In the aftermath of the Great Recession, policymakers face some important choices. We can tolerate a weaker housing market in which fewer families build wealth through homeownership, more lower-income renters must choose between decent housing and other necessities, and too many communities lack access to safe and affordable mortgage credit. Alternatively, we can work to create a healthier and more equitable housing market by promoting sustainable homeownership, affordable rental housing, and stronger neighborhoods. Choosing the latter will require action by a wide array of policymakers and market participants, which is challenging. Ultimately, however, by working together, we can create a more robust, fairer housing market that drives economic growth and promotes opportunity for America's families.

Thank you again for inviting me to testify today. I look forward to continuing to engage with you on these and other issues.

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