NATIONAL COMMUNITY REINVESTMENT COALITION NCRC

ISSUE BRIEF

Analysis of the Obama Administration's Housing Finance Proposals

February 2011

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Issue Brief: The Obama Administration's Plan to Eliminate Fannie Mae and Freddie Mac

As required by Congress, the Obama Administration released "Reforming America's Housing Finance Market: A Report to Congress" on February 11, 2011. The paper addresses the future of Fannie Mae and Freddie Mac by describing three possible scenarios for future government involvement in the marketplace. After a transitional period (likely to be 5-7 years) in which Fannie Mae and Freddie Mac are dissolved, the Administration seeks a financial system in which the private sector is the primary source of mortgage credit. The paper also addresses broader policy issues, making the point that reforms must occur throughout the marketplace, changing lending practices and secondary market financing, in order to ensure that future lending is safe and sound, and serves all Americans.

NCRC Critique

The Obama Administration correctly states that the financial crisis was caused by abusive lending practices, excessive risk taking, and outdated regulations. They also correctly state that Fannie Mae and Freddie Mac's affordable housing goals did not cause the crisis. However in their plan to shift primary responsibility to the private sector for financing housing in America, they run the risk of shutting out future generations of working Americans from homeownership.

The Obama Administration's paper also intentionally leaves out detail in many areas in order to generate debate and discussion. Yet, its ambiguities provide an opening for undesirable outcomes. While the paper does not specify which institutions will replace Fannie Mae and Freddie Mac, it is reasonable to assume that five to ten large big banks will assume functions of securitizing and guaranteeing mortgages. However this is like the fox running the hen house; it was the securitization practices of Wall Street banks financing toxic mortgages that was a major factor plunging this country into the current foreclosure crisis.

Several of the proposed reforms of the Obama Administration are appropriate and needed, including tougher consumer protection laws and reforms in securitization and servicing of mortgages. Yet, the Administration is overly optimistic that the Financial Stability Oversight Council and the elimination of the Office of Thrift Supervision (OTS) will end regulatory arbitrage or charter shopping. Consumer protection oversight, including CRA, should have been fully consolidated into the new Consumer Financial Protection Bureau (CFPB). One agency, the CFPB, with responsibility for protecting consumers and communities is the surest way to stop regulatory shopping. In contrast, eliminating the OTS will not stop regulatory shopping because financial institutions can still choose among the Federal Reserve Board, the FDIC, and the Office of the Comptroller of the Currency. Furthermore, the current configuration of regulatory agencies will not be able to adequately oversee secondary market activities if Fannie Mae and Freddie Mac's functions are assumed by large banks.

The mechanism proposed by the Administration to wind down Fannie Mae and Freddie Mac has the potential to significantly restrict access to credit for modest income Americans. The Administration seeks to significantly reduce market share of the FHA, Fannie Mae, and Freddie Mac by raising guarantee fees. If government guarantees of Fannie Mae, Freddie Mac, and FHA are priced too high, the availability of 30-year fixed-rate mortgages will drop precipitously.

In addition, the 10 percent down payment requirement for Fannie Mae and Freddie Mac mortgages will place homeownership out of reach for large numbers of low- and moderate-income households who can afford monthly mortgage payments but cannot pay large down payments. Even though FHA can guarantee loans with down payments of 3.5 percent, the FHA may not be able to support lending at high enough levels to reach all of the creditworthy low- and moderate-income borrowers that cannot pay 10 percent down payments. The paper also discusses raising down payment requirements (lower loan to value ratios) for FHA. Moreover, while private sector lenders not selling their loans to Fannie Mae and Freddie Mac could offer lower down payments, Fannie Mae and Freddie Mac are often trendsetters, establishing practices and products for the entire market. Finally, the down payment assistance proposed by the Administration may also not be enough to compensate for the higher down payment requirements. If down payments end up being too high on FHA mortgages and mortgages guaranteed by Fannie Mae and Freddie Mac, the window of opportunity for homeownership for modest income Americans will be narrowed.

In the mid to late 1990's before the surge in subprime lending, millions of modest income Americans benefited from low down payment, prime loans made by banks. These loans were sustainable and performed well because they were devoid of the risk factors such as no income documentation, prepayment penalties and adjustable rates that plagued subprime loans. We urge the Administration and other stakeholders to carefully study this experience before devising high down payment requirements. Equity sharing and other risk mitigating procedures could also be explored as alternatives to high down payment requirements.

As discussed below, the Obama Administration's paper proposes three options for the future of the secondary market. Under each of the three options, FHA (Federal Housing Administration), VA (Veterans Administration), and the United States Department of Agriculture (USDA) would continue to exist and would offer government guarantee for mortgages. In Option One, government guarantees outside of FHA/VA/USDA mortgages would be eliminated. In Option Two, government guarantees outside of FHA/VA/USDA mortgages would be available only during times of crisis. In Option Three, government guarantees outside of FHA/VA/USDA mortgages would be available for a targeted range of mortgages.

Option 1 and 2 would dramatically decrease the availability of 30-year fixed rate mortgages and would shut out a large segment of modest income Americans from homeownership. FHA would not be able to accommodate the flood of modest income Americans shut out from mainstream

mortgages. The commitment to FHA would also wax and wane depending on the policies of various Administrations. The last seven decades since the Great Depression has demonstrated the need for carefully designed government guarantees that make the 30-year mortgage widely available. For 95 percent of their history, Fannie Mae and Freddie Mac were successful in promoting responsible loans and sustainable homeownership. Abruptly terminating Fannie Mae and Freddie Mac without a well thought out plan risks leaving minority and low- and moderate-income borrowers at the whim of an overwhelmed and overburdened FHA that could easily become stigmatized and then eviscerated.

Of the options for the future housing finance system, Option 3 is the only one that has the potential to be built upon to achieve widespread and sustainable homeownership. However, this Option will need to be substantially improved upon; for example, we need specifics about which institutions are envisioned as secondary market institutions. Allowing five to ten large banks and Wall Street firms to grow larger by absorbing Fannie Mae and Freddie Mac's market share will not work. We urge the Administration and Congress to more fully develop Option 3 and ensure that the secondary market institutions created will be able to promote the widespread availability of the 30-year fixed-rate mortgages, which is key to avoiding a new redlining of working class and minority communities.

Finally, and importantly, we applaud the Administrations recognition that the financial industry has an obligation to serve all communities equitably. Its proposal to require securitizers to submit data on the demographics and geographic characteristics of mortgages they securitize will increase transparency and enable stakeholders to determine if all communities are served in an equitable manner.

The Administration, however, could have taken this one step further. The Administration correctly states that the Affordable Housing Goals did not cause Fannie Mae and Freddie Mac to finance risky mortgages but that the Affordable Housing Goals were ineffective in achieving their objectives. In fact, NCRC has documented over the years that banks under the Community Reinvestment Act (CRA) financed higher percentages of prime mortgages to low- and moderate-income borrowers than Fannie Mae and Freddie Mac did. In the new book, *All the Devils are Here: the Hidden History of the Financial Crisis*, by Bethany McLean and Joe Nocera, a former Fannie Mae executive boasts about how they helped design affordable housing goals so that Fannie Mae could easily meet them and that "they had no teeth."

Instead of affordable housing goals, NCRC recommends CRA-like exams for a broad array of financial institutions, including secondary market institutions. Per the Housing and Economic Recovery Act, the Federal Housing Finance Agency (FHFA) proposed CRA-like exams in the summer of 2010 for Fannie Mae and Freddie Mac in measuring their performance financing the needs of underserved markets including manufactured housing, historic preservation, and rural markets. In addition, during the 111th Congress, members of the House introduced H.R. 1479 and

H.R. 6334 which expanded CRA to several types of non-bank institutions. Building upon the FHFA proposal and the legislation in the 111th Congress, policymakers ought to consider applying CRA to secondary market institutions. CRA exams do not require any quotas but rather compare financial institutions against each other and demographic characteristics and economic conditions in assessing whether the financial institutions have met community needs. And CRA requires institutions to meet credit needs in a safe, sound and balanced manner, and balances rental housing needs with homeownership.

If applying CRA to the successors to Fannie Mae and Freddie Mac does not occur, then new affordable housing goals that require safe and sound loans and that are meaningful need to be crafted. The Administration alludes to an obligation for secondary market institutions. The paper states that the Administration "will work with Congress to ensure that *all* communities and families – including those in rural and economically distressed areas, as well as those that are low- and moderate-income – have the access to capital needed for sustainable homeownership and a range of rental options. We will consider measures to make sure that secondary market participants are providing capital to all communities that reflect activity in primary markets, consistent with their obligations of safety and soundness."

This section of the white paper implies an affirmative obligation that would ensure that secondary market institutions would not trail CRA covered banks in serving low- and moderate-income communities. What is needed is more specifics about how this affirmative obligation would work.

Detailed Summary of the Paper

Causes of the Financial Crisis

Before developing a plan to promote a safe and sound lending market, the Administration's paper succinctly and accurately describes the causes of the financial crisis. These include:

> *Abusive Lending Practices and Inadequate Consumer Protections:* The paper describes lending beyond a borrower's ability to repay, stating that brokers and lenders peddled unsustainable option ARM loans and other risky products, and steered consumers to higher cost loans when they qualified for lower cost loans.
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> *An Inadequate and Outdated Regulatory Regime:* The paper discusses the failure to update the regulatory system since the 1930's and how the current system allowed financial institutions to "shop" for the weakest regulatory agency.
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> *A Complex and Opaque Securitization System*: Brokers and lenders could sell poorly underwritten and risky loans to investors who did not understand the risks because of a

lack of data and transparency regarding the characteristics of these loans. Rating agencies failed to recognize the deterioration in underwriting standards.

Inadequate Capital: Financial institutions did not maintain sufficient capital reserves to protect against loan losses. In particular, laws and regulations allowed financial institutions to decrease capital levels if they held securities rather than keeping mortgages in portfolio.

Servicing Industry Ill-Equipped to Serve Needs of Borrowers: The servicing industry was not equipped to handle assisting borrowers that were defaulting in record numbers; servicing contracts did not define servicer responsibilities to minimize losses on defaulting loans; servicers compensation did not induce them to prevent foreclosure.

According to the Administration, Fannie Mae and Freddie Mac were not leaders in financing risky mortgages but followers. Between 2001 and 2005, private label securitizations of subprime and Alt A mortgages grew fivefold, but Fannie Mae and Freddie Mac focused on fully documented, higher quality mortgages. As their market share declined from 70 percent of originations in 2003 to 40 percent in 2006, Fannie Mae and Freddie Mac pursued market share and increased profits by purchasing riskier loans, particularly in 2006 and 2007. The Administration's plan states that Fannie Mae and Freddie Mac's private shareholder structure encouraged them to take on excessive risks in pursuit of profit. Fannie and Freddie benefited from certain advantages including preferential tax treatment and the implicit government guarantee which gave them pricing advantages. Finally, Fannie and Freddie were also required to hold less capital than other institutions, further giving them an advantage.

The Administration found that the affordable housing goals for Fannie and Freddie were not culprits, forcing Fannie and Freddie to purchase riskier loans in order to meet the goals. Rather, Fannie Mae and Freddie Mac made mistakes similar to the private label securitization market which did not have affordable housing goals. Moreover, Fannie Mae and Freddie Mac made fewer mistakes in financing risky loans as reflected in lower default rates on loans held by Fannie Mae and Freddie Mac, including loans qualifying for the affordable housing goals, than loans held by private sector institutions.

Reforms in the Broader Housing Market

Recognizing that the financial crisis was caused by multiple failures as described above in the financial system, the Obama Administration recommends the following reforms:

Ending Unfair and Deceptive Lending Practices: The paper endorses the reforms in the Dodd-Frank Wall Street and Consumer Protection Act ("Dodd-Frank") that prohibited abusive features on high-cost loans and requires the new Consumer Financial Protection Bureau (CFPB) to write

rules mandating that lenders verify borrowers' incomes and ensuring that borrowers have the ability to repay their mortgages.

Skin in the Game: The paper endorses the Dodd-Frank requirement that securitizers and lenders retain 5 percent of the mortgage backed securities' (MBS) risk, with exceptions for Qualified Residential Mortgages which will meet higher underwriting standards.

Strengthen Disclosure Requirements for Mortgage Backed Securities (MBS): Under Dodd-Frank, the Securities and Exchange Commission (SEC) will establish stronger disclosure requirements so that regulators and investors can more readily understand the risks posed by MBS. The SEC will have a new Office of Credit Ratings that will establish disclosure requirements for ratings methodology and set new requirements to prohibit conflicts of interest.

Closing Regulatory Gaps: The Administration states that the newly created Financial Stability Oversight Council (FSOC) has the authority to require consolidated supervision of any financial firm that poses systemic risk. The termination of the Office of Thrift Supervision should reduce the opportunities for regulator shopping according to the paper.

Establish National Standards for Mortgage Servicing: The Administration supports national servicing standards in order to establish consistency regarding treatment of borrowers in delinquency. The Administration will work with the Federal Housing Finance Agency and the Department of Housing and Urban Development (HUD) to explore alternatives to the current compensation mechanism for servicers to provide them with more incentives to modify distressed loans.

Improving Treatment of Lien Priority: Disagreements between first and second lien holders have impeded modifications of distressed loans. The Administration believes that mortgage documents should require disclosure of second liens and mortgage documents should define a process for modifying a second lien in the event that the first lien becomes delinquent. Finally, the Administration states that options should be explored for allowing primary mortgage holders to restrict, in certain circumstances, additional debt on the property.

Reforms for Fannie Mae, Freddie Mac, FHA

The Administration proposes to phase out Fannie Mae and Freddie Mac over a "responsible" period of time, which is left undefined in their paper but senior officials state in media interviews that the time period is five to seven years. Currently, Fannie Mae, Freddie Mac, and FHA guarantee and subsidize 90 percent of the loans in this country. The Administration proposes to reduce their role so that the private sector becomes the dominant lenders in the country, thus assuming most of the risk as well.

Winding Down Fannie Mae and Freddie Mac: The Administration recommends that Fannie Mae and Freddie Mac increase the fees for their guarantees under the assumption that they would be required to hold as much capital as private sector institutions. To further reduce risk, Fannie Mae and Freddie Mac would be restricted to financing mortgages with higher down payment requirements, eventually only financing mortgages in which borrowers have at least a ten percent down payment requirement. The loan limits (maximum size of loans allowable) for Fannie Mae and Freddie Mac would be reduced, increasing the private sector market share. In addition, their investment portfolio would be reduced by 10 percent annually. Eventually, under the Administration's plan, Fannie Mae and Freddie Mac would be dissolved, and replaced with a new secondary market structure.

Federal Housing Administration (FHA): FHA's role in the marketplace would also be reduced by lowering loan limits and increasing annual mortgage premiums by 25 basis points for 2012. The Administration notes that it will review and coordinate loan limits and pricing for FHA, Fannie Mae, and Freddie Mac on a regular basis. While the FHA remains an important source of financing for creditworthy first-homebuyers with modest incomes, the Administration seeks to ensure that FHA does not expand during normal times to attain a share of the market that is "unhealthy or unsustainable." Today, FHA's market share is about 30 percent, compared to its historic levels of 10 to 15 percent of the market, according to the paper.

Rental Housing: The Administration's paper is clear that the needs of renters must be fully addressed during the transitional years as Fannie Mae and Freddie Mac are wound down. One hundred million Americans rent; half of all renters spend more than a third of their income for housing and a quarter spends more than half.

The Administration notes that private financial institutions generally did not adequately serve multifamily rental properties with affordable rents. Fannie Mae and Freddie Mac, in contrast, had developed expertise in financial affordable rental properties. Accordingly, the Administration also seeks to bolster FHA's financing of rental housing to assume the role Fannie Mae and Freddie Mac has played in this market segment.

Ensuring Access to Capital and Housing in All Communities including Rural Areas: The Administration reiterates its commitment to the laws prohibiting discrimination in the provision of capital and credit to borrowers and communities. Specifically, the paper recommends that securitizers disclose information on the credit, geographic, and demographic characteristics of loans they are packaging into securities. This enhanced transparency will help determine whether all financial institutions are complying with their legal obligations, and which communities are or are not being served. The Administration pledges to work with Congress to ensure that all communities, including rural and economically distressed areas, have access to capital for financing "sustainable homeownership and a range of rental options." In addition, the

Administration will consider ways to ensure that secondary market institutions are providing capital in a safe and sound manner that reflect activities in the primary markets.

Finally, the Administration supports a budget neutral funding mechanism similar to the Housing Trust Fund (for which the President's Fiscal Year 2012 budget proposes $1 billion worth of funding) to finance homeownership and rental housing that the private market finds difficult to finance, such as small rental properties. The homeownership activities would include down payment assistance and counseling for low- and moderate-income homeowners.

Three Possible Models for Housing Markets and Government's Role

The Administration does not endorse any specific future blueprint for the nation's housing markets, and instead describes three options. Each of the options should be analyzed against the four goals for access to mortgage credit, incentives for investment in housing, taxpayer protection, and financial and economic stability:

Option 1: Privatized Housing Finance System with Government Insurance Limited to FHA, USDA, and VA

Under this option, the government guarantees would be offered only for FHA, VA, and USDA mortgages. The government would not offer guarantees to any secondary market institutions that would assume the functions of Fannie Mae and Freddie Mac. The Administration asserts that the benefits of this option is limited taxpayer exposure but that the costs include less access to mortgages, particularly 30-year fixed-rate mortgages, to a broad segment of Americans. Also, a private sector market with considerably less government guarantees is more susceptible to downturns and withdrawal of private sector investment.

Option 2: Privatized Housing Finance System with FHA, USDA, VA and a Government Guarantee only during Times of Crisis

This option is similar to Option 1 in that the government guarantees would be considerably less available than they are currently. Like Option 1, the primary responsibility for securitizing mortgages would likely fall to the five or ten largest banks. However, in contrast to Option 1, the government guarantee would be available outside of FHA, USDA, and VA during times of crisis. The government would develop a mechanism that would increase government guarantees available on non-FHA or VA mortgages when the economy is in a recession. The Obama Administration states that an advantage of this proposal is limiting the exposure of taxpayers and reducing moral hazard. However, like Option 1, the availability of 30-year fixed-rate mortgages maybe curtailed. In addition, it might be difficult operationally to offer small levels of government guarantees during normal economic times but to ramp up the guarantees during times of crisis.

Option 3: Privatized Housing Finance System with FHA, VA, USAD and Catastrophic Government Reinsurance Fund

In this option, as in all three, the primary responsibility for securitizing mortgages will be with the private sector. The secondary market institutions would be private mortgage guarantor companies that meet rigorous capital requirements and provide guarantees for MBS that meet stringent underwriting requirements (such as the new underwriting requirements in the Dodd-Frank Act). In contrast to Options 1 and 2, under Option 3 the government would provide reinsurance to a targeted range of securities on a regular basis (the paper does not elaborate on what the targeted range would be; advocates should ask for elaboration and insure that the targets include responsible loans to traditionally underserved populations). The government reinsurer would charge premiums, which would be used to pay claims and protect taxpayers. The government reinsurance becomes available to the holders of the MBS only after the shareholders of the mortgage guarantor companies have been wiped out.

The advantages of this system, according to the Administration, is that affordable 30-year mortgages would be more available than under either Option 1 and 2, and that it would promote more stability in the housing market. The disadvantage, according to the Administration, is that it may encourage excessive private market risk taking if the government guarantees are priced too low and thus potentially expose the taxpayer to losses.