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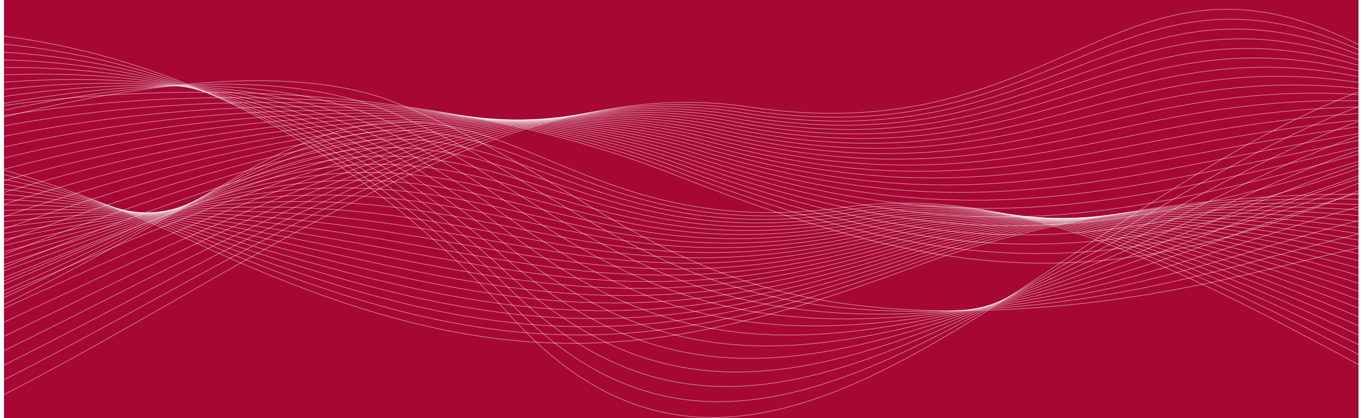
A Guarantee for the Guarantee:

Two Proposals to Ensure that the Future Secondary Mortgage Market Serves All Creditworthy Borrowers



About the National Community Reinvestment Coalition (NCRC)

The National Community Reinvestment Coalition is a nonprofit, nonpartisan association of more than 600 organizations dedicated to the mission of building and protecting wealth in America's underserved communities. For more than 20 years, we've advocated to ensure vibrant communities for America's working families by actively promoting access to basic banking services and products, homeownership and the development of affordable rental housing, local business growth, and workforce training. Our members include community reinvestment organizations, community development corporations, community development financial institutions, local and state government agencies, faith-based institutions, community organizing and civil rights groups, minority and women-owned business associations, and social service providers from across the nation.

This white paper contains NCRC policy recommendations on the issue of access reforms to the secondary mortgage market. We believe that the adoption of either of these two recommendations by lawmakers will help to ensure future access to conventional lending for all creditworthy borrowers.

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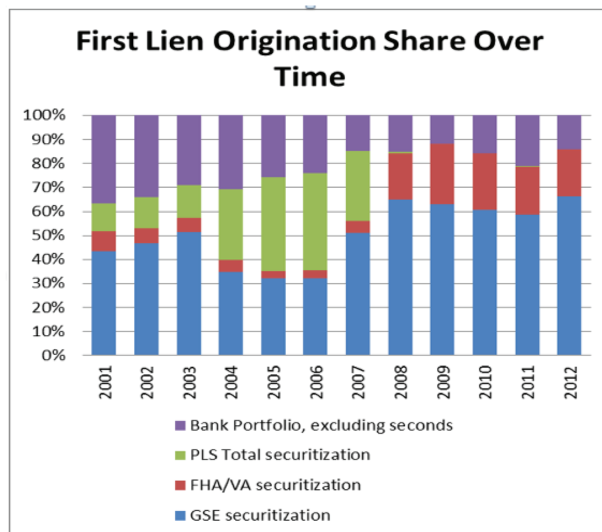
A Guarantee for the Guarantee: Two Proposals to Ensure that the Future Secondary Mortgage Market Serves All Creditworthy Borrowers

By Mitria Wilson, Josh Silver, and Elizabeth Kemp

INTRODUCTION

Lately, there is a flurry of activity in Washington centered on reforming the secondary mortgage market. The activity has consisted of a series of papers and proposals by think tanks and advocacy groups,[1] legislative proposals from both the U.S. House of Representatives and U.S. Senate,[2] and even a pointed address by President Obama as part of the Administration's effort to turn the American public and Congress' focus back to the economy. The timing and amount of attention indicates the obvious: the debate over the future of America's mortgage market is taking shape right now.

Table 1: A Growing Government Footprint[4]

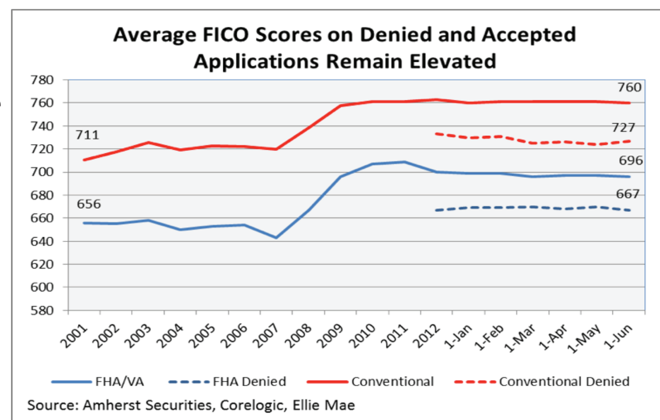


So far, each of the reform proposals has focused on two primary aims: (1) reducing the scale of government involvement in housing finance and increasing private capital requirements as a means for minimizing taxpayer risk;[3] and (2) ensuring that an adequate supply of mortgage capital remains available in the primary market so that Americans can continue to realize the dream of homeownership.

Yet, despite all the discussion, an omission from these considerations remains glaring. Little, if any, detailed attention has been paid to addressing the need to provide affordable, conventional mortgage credit to the full spectrum of America's creditworthy borrowers[5]—including millenials, working-class people, rural residents, and minorities. The National Community Reinvestment Coalition believes that this omission renders the current proposals lacking.

Over the next ten years, more than seven out of ten net new households created in the United States will fit within the aforementioned categories.[6] That number is only projected to grow in the years that follow.[7] In a healthy market, first-time borrowers constitute approximately 50 percent of buyers.[8] Thus, today—and in the future—questions of providing access to these growing communities are more important than ever.

Past experience demonstrates that, without an effective policy mechanism that encourages lenders and investors to serve the full range of creditworthy mortgage borrowers, underwriting criteria grows increasingly strict—cutting off access to conventional lending for many creditworthy individuals. This phenomenon, known as market creaming, leads to private institutions and even the nation's government-sponsored enterprises—Fannie Mae and Freddie Mac largely ignoring the mortgage capital needs of most Americans. For example, in 2012, Fannie Mae and Freddie Mac required FICO credit scores as high as 769.[9] Yet, barely one in five households in the United States actually has a credit score high enough to meet that requirement.[10] The result is that most Americans face incredible difficulty getting a conventional mortgage loan in today's market.



Source: Amherst Securities, Corelogic, Ellie Mae

Table 2. Tighter Underwriting Requirements [12]

Recent headlines suggest that traditionally underserved borrowers will be facing even more difficulty soon. According to news reports, Fannie Mae may curb its program that purchases mortgages that require a minimum downpayment of only 3 percent.[11] Freddie Mac's remaining programs require a 5 percent downpayment. Yet, the reality is that many millenials, minorities, and working-class Americans—the buyers of America's future—are often unable to come up with large downpayments.

With demographics, stagnant wages, and growing student loan debt indicating that a significant majority of new households in the U.S. will fit within these traditional affordable housing categories, a mortgage reform proposal that does not address the need for the conventional mortgage market to actively serve these communities all but guarantees that either the government will continue to dominate housing finance or America will become a nation of renters. Yet, despite these stark realities, none of the existing reform proposals make any clear commitment to ensuring access to conventional lending for the full scope of America's creditworthy borrowers.

Access to credit can no longer be a discussion put off for later. This issue is far too important and the need is far too significant and immediate to ignore.

Accordingly, in this white paper, the National Community Reinvestment Coalition introduces two proposals designed to promote access and ensure that the future secondary mortgage market serves all creditworthy borrowers:

Proposal One: A ***Status Quo Access Model*** that applies the existing requirements of Fannie Mae and Freddie Mac's affordable housing goals to any future secondary market entity; or, alternatively

Proposal Two: An ***Incentive Model*** that introduces a sliding-cost scale that varies based on a secondary market entity's business activities that address unmet housing needs. The cost would apply to either: (1) an affordable housing assessment, or (2) the government guarantee.

At the end of the day, the need to integrate an access-driven policy mechanism into any proposed secondary market reform is a matter of basic accountability to American taxpayers. Private financial institutions do not have to seek a government guarantee for their mortgage-backed securities, but, when they do, they should at least be obligated to serve the full scope of America's creditworthy taxpayers.

ACCESS PROPOSAL ONE: The Status Quo Access Model

Under the Status Quo Access model, Fannie Mae and Freddie Mac's existing affordable housing goals would remain a requirement for any future secondary market entity that uses a government guarantee. Specifically, the regulator would set minimum percentages as goals and sub-goals for each secondary market entity. The goals would specifically address the entity's business activity in low-income, moderate-income, and underserved geographic areas. As a condition for using the government guarantee, the entities would be required to meet and maintain the specified percentages of business activity in each of the three categories.

On an annual basis, the regulator would determine the minimum percentage within each category by considering: (1) national housing needs; (2) economic and demographic conditions; (3) the number of secondary market entities; (4) past performance on each goal; (5) the size of the corresponding primary mortgage market; and (6) the need to maintain the sound financial condition of the secondary market entities.

The appeal of the Status Quo Access model is that it preserves a tried and true mechanism, Fannie Mae and Freddie Mac's affordable housing goals. In 2012 alone, the goals supported accessibility by generating $267 billion in lending in traditionally underserved communities. In the past, affordable housing goals produced millions of well-performing loans that allowed many of America's rural, minority, and working-class families to achieve the dream of homeownership. Therefore, keeping these goals would ensure that the secondary mortgage market of the future serves all creditworthy individuals.

Debunking the Myth

When controlling for all credit risk factors, Fannie Mae and Freddie Mac's affordable housing goal loans demonstrate no appreciable difference in default risk. Despite this fact, critics of affordable-housing goals continue to peddle the false claim that the goals caused Fannie and Freddie's financial woes. Many scholars, financial regulators, and executives at Fannie and Freddie have publicly stated that this claim is untrue. Even some vocal critics of Fannie and Freddie and government intervention in housing markets generally have expressly rejected the allegation:

"The affordable-housing goals are a wonderful excuse ... The goals are even blamed by some conservatives, who see them as credit allocation, and overlook the special privileges conferred on the GSEs by their federal charters which create something close to a federally sponsored duopoly in the mortgage market. But this convenient explanation doesn't fit the facts. The GSEs began buying subprime mortgage-backed securities (MBS) heavily in 2002. Their purchases of subprime MBS doubled between 2002 and 2003, and doubled again in 2004 – from $38 billion to $81 billion to $176 billion. All this happened before the housing goals were changed in 2005. After the new goals went into effect, their subprime MBS purchases actually declined ... If the affordable-housing goals don't account for the GSEs' behavior, what does? The best explanation is the simplest: The GSEs badly misjudged the risk of subprime mortgages."

– John Weicher, a Senior Fellow at the Hudson Institute and a former Assistant Secretary for Housing at HUD, "The Affordable Housing Goals, Homeownership, and Risk: Some Lessons from Past Efforts to Regulate the GSEs," National Review, Nov. 17, 2008.

ACCESS PROPOSAL TWO:
The Incentive Model

If a private financial institution would like to use the full faith and credit of the U.S. government to remove credit risk from its mortgage-backed securities (MBS), it seems logical that the institution should have an affirmative obligation to serve the full scope of creditworthy U.S. households with conventional lending. After all, the government is guaranteeing the mortgage-backed securities by pledging the tax dollars of these very same Americans. Yet, a fresh opportunity to consider the issue of promoting accessibility in the secondary mortgage market suggests that there are multiple mechanisms and/or policy tools that could ensure accountability. In this second proposal, NCRC considers the possibility of creating an incentive-based structure to ensure that entities address unmet housing needs.

I. Creating an Incentive Model by Introducing a Sliding-Cost Scale

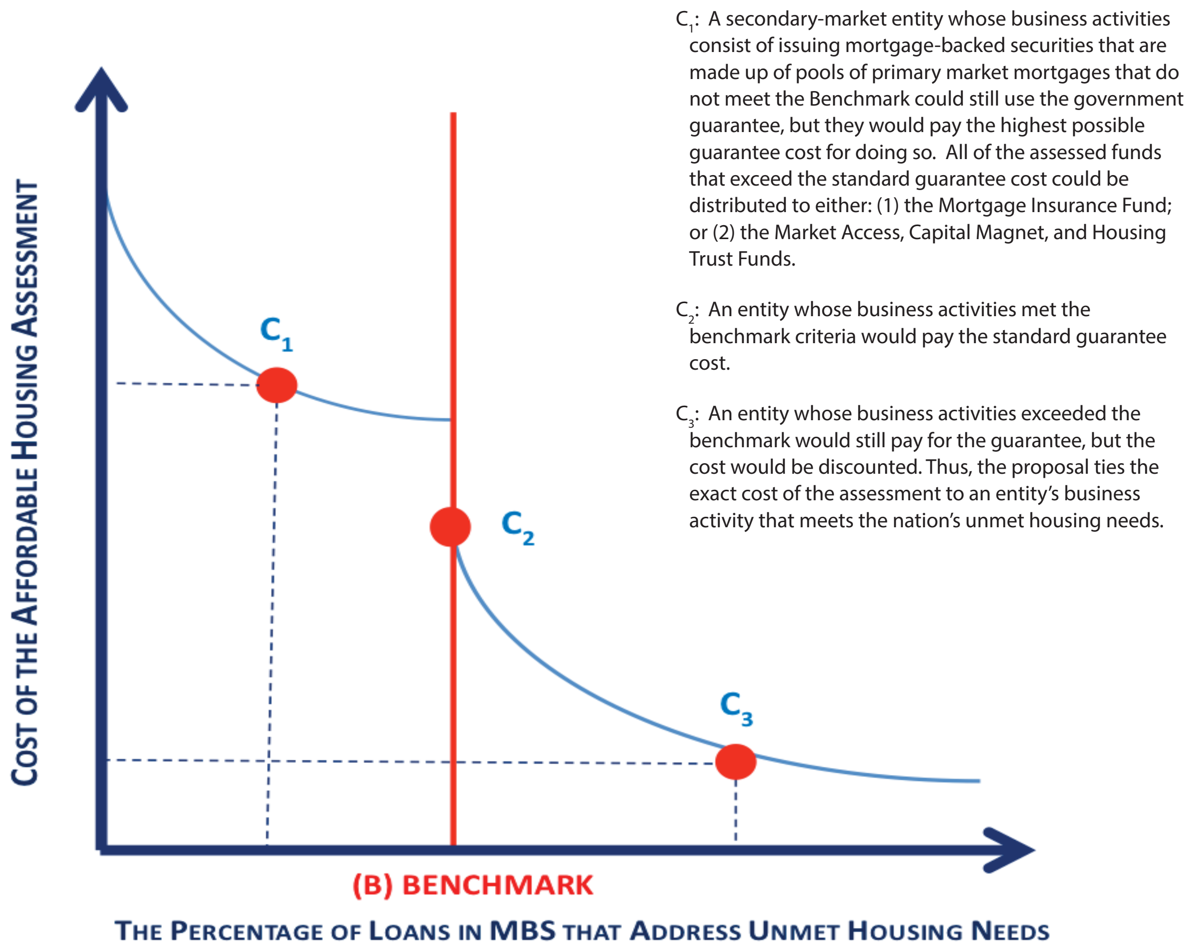
Our second proposal includes both a tangible duty to serve all creditworthy borrowers and an incentive-based pricing scale. The model consists of a sliding scale, which, by definition, is a variable scale where specified costs fluctuate in response to changes in some other factor, standard, or condition. In the proposal and each of the representations below, the variable cost paid by the secondary market entity is tied to its commitment to purchasing and securitizing mortgages for a broad and diverse set of borrowers, especially mortgages that address identified unmet housing needs. The logic is that the more an entity supports unmet housing needs, the less costs it should incur when accessing the government guarantee. The proposed model, and its various representations, are all designed to fit within any regulatory structure, including the Federal Mortgage Insurance Corporation described in the Corker-Warner GSE reform bill.

However, the model does rest upon two notable assumptions. The first assumption is that a reformed secondary mortgage market will include a government guarantee, whether implicit or explicit. The second assumption is that, in addition to a government guarantee, a reformed secondary mortgage market will require secondary market entities to contribute funding to the Housing Trust Fund, Capital Magnet Fund, and any newly created fund focused on affordable housing. For example, both the Urban Institute and the Center for American Progress have endorsed the creation of a Market Access Fund.

Option 1: Attaching a Sliding Scale to the Cost of the Affordable Housing Assessment

In Option 1, the total cost to a secondary–market entity would include the cost of the guarantee and the cost of an affordable housing assessment. The cost of the guarantee would be fixed, while the cost of the assessment would be variable within a set range. To create an incentive that ensures the entire market of creditworthy borrowers and renters are served, secondary market entities would be able to reduce their total costs under the assessment by securitizing a greater number of loans that addressed unmet housing needs identified by the regulator. Any resulting funds from the assessment would be distributed to the Housing Trust Fund, the Capital Magnet Fund, and the Market Access Fund.

$$\text{Total}_{\text{(Fee)}} = \text{Fixed Cost}_{\text{(Guarantee)}} + \text{Variable Cost}_{\text{(Affordable Housing Assessment)}}$$



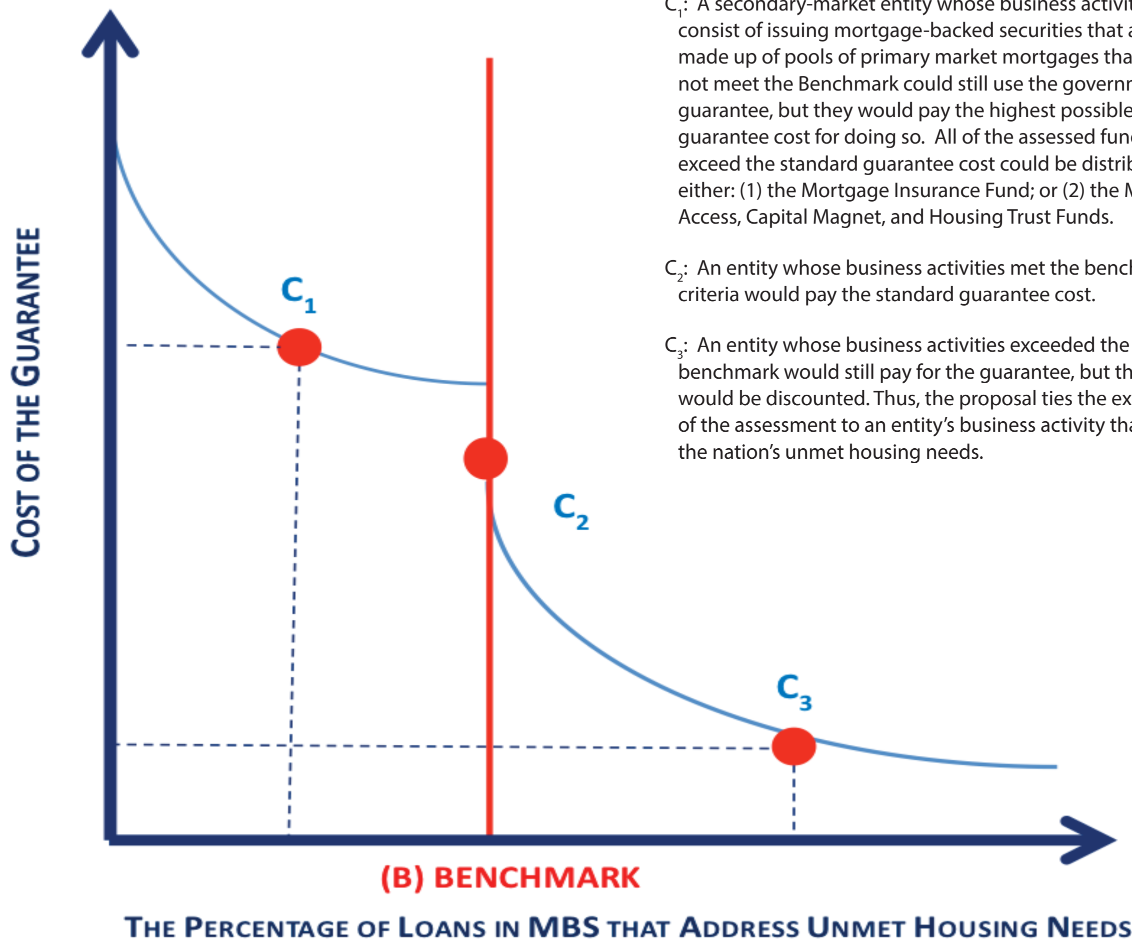
Option 2: Applying a Sliding Scale to the Cost of the Guarantee

Under Option 2, a secondary market entity would pay a fixed cost for the affordable housing assessment, but the guarantee fee would be a variable cost, with a fixed basis-point ceiling and floor. Secondary market entities would be able to reduce the total costs of the guarantee by securing a greater number of loans that addressed regulator identified unmet housing needs. This would help to ensure that the entire market of creditworthy borrowers and renters are served. Any funds accumulated above the standard guarantee rate could be distributed to either:

(1) the Housing Trust Fund, the Capital Magnet Fund, and the Market Access Fund; or

(2) the Mortgage Insurance Fund.

$$\text{Total}_{\text{(Fee)}} = \text{Variable Cost}_{\text{(Guarantee)}} + \text{Fixed Cost}_{\text{(Affordable Housing Assessment)}}$$



C_1: A secondary-market entity whose business activities consist of issuing mortgage-backed securities that are made up of pools of primary market mortgages that do not meet the Benchmark could still use the government guarantee, but they would pay the highest possible guarantee cost for doing so. All of the assessed funds that exceed the standard guarantee cost could be distributed to either: (1) the Mortgage Insurance Fund; or (2) the Market Access, Capital Magnet, and Housing Trust Funds.

C_2: An entity whose business activities met the benchmark criteria would pay the standard guarantee cost.

C_3: An entity whose business activities exceeded the benchmark would still pay for the guarantee, but the cost would be discounted. Thus, the proposal ties the exact cost of the assessment to an entity's business activity that meets the nation's unmet housing needs.

An incentive-driven model creates a win for every player: 1) Consumers win because this model incentivizes entities to securitize loans for every creditworthy borrower; 2) Lenders win because conventional mortgage credit remains accessible for a broad and growing base of consumers; and 3) secondary market entities win because they are in control of their own fees and risk assessments related to addressing unmet housing needs, empowering them to make business decisions that best fit their particular model.

II. Calculating the Benchmark

For an incentive-based sliding scale to be effective, is must be paired with a performance benchmark that is reflective of the unmet housing needs in our communities. That benchmark must be achievable while promoting access to all creditworthy borrowers.

What are Performance Benchmarks and How Would they be Determined?

A sound benchmark sets the standard for performance. It is a reflection of need, ability, and ambition and it must be the result of a thoughtful process.

Calculating a performance benchmark is not a quick or simple process. It is necessary to identify and understand the kind of information that will be most valuable for determining appropriate measurements.

By creating performance benchmarks, these values will also encourage other approved securitizing entities to emulate the performance of entities that excel in serving traditionally underserved populations, and to learn how they perform and why, and then establish their own competitive benchmarks.

For purposes of the Incentive model, the benchmark would be expressed as a percentage of loans in mortgage-backed securities that address the unmet housing needs identified by the regulator. In order to develop the benchmark(s) for the incentive model, the regulator would consider the following factors: (1) the size of the corresponding primary mortgage market; (2) the number of approved secondary-market entities; (3) an evaluation of unmet housing needs; (4) past performance on benchmarks; and (5) the safety and soundness of the secondary-market entities. The regulator would reset benchmarks every two years.

Constraints on the Market

The regulator's process for creating benchmarks would start with projections of the size of the mortgage market for the next benchmarking cycle, as well as an estimate of the total number of approved secondary market entities. In order for an incentive model to achieve the desired effect, the established benchmark must be attainable for secondary market entities. Moreover, since the number of loans produced by the primary market serves as a hard constraint, some entities will perform better than their peers by financing a higher percentage of loans for target populations than their peers while others will be financing a lower percentage than their peers. This understanding will influence the particular benchmark chosen and inform the incentive pricing structure.

Evaluation of Unmet Housing Needs

Regulators should complete a housing needs analysis. To successfully evaluate unmet housing needs, regulators will need to consider current and future economic and demographic data, in addition to considering input from a public participation process.

A demographic analysis would identify priority housing and credit needs for certain populations and/or geographical areas.[13] A lack of credit availability in rural areas, for example, may prompt the regulator to designate rural lending as an unmet housing need. Likewise, a demographic increase in racial minorities may elevate efforts to reduce racial disparities in access to credit and close homeownership gaps. On the other hand, if certain barriers to access have been alleviated for a group and that group is diminishing in population, the regulator may elect to not create a benchmark for that group. The key point is that the regulator would have the flexibility to highlight varying priorities in future years and would be free from explicit statutory constructs. Because there are a variety of unmet housing needs, the regulator can either establish separate benchmarks for each population group to be targeted or it can create one benchmark, which could be a weighted average of benchmarks for each group.

To make this public participation process as meaningful as possible, the insuring entity should present its evaluation and benchmarks in a clear and understandable manner that includes a well-written executive summary and meaningful graphs, tables, and maps. Additional material, including substantive discussions of needs assessments and economic forecasting, should be placed in an appendix. In the past, the U.S. Department of Housing and Urban Development and the Federal Housing Finance Agency have presented their proposed Affordable Housing Goals in documents that were dense, long, and difficult for the public to process and understand.

A repeating cycle of evaluations and strategic plans that encourages public input creates a rigorous and flexible accountability mechanism. It encourages the entities to be creative in addressing emerging housing and credit needs. It can initiate a rigorous dialogue among entities, lenders, regulatory agencies, and the general public using objective and evolving performance measures regarding how best to address housing and credit needs. This sustained dialogue is missing in current evaluations of financial institutions and is imperative to improving access to credit for affordable housing.

Past Performance and Economic Conditions

Once the target population groups have been identified, the regulator would use Home Mortgage Disclosure Act data and other publicly available data to assess the past performance of the secondary market entities as a factor for determining benchmarks. Entities would be compared against each other and the primary market in terms of percentages of loans financed for the population groups to be targeted by the benchmarks. In this analysis, the regulator would consider carefully that not every entity can be the market leader.

The regulator would couple its analysis of past performance with an analysis of future economic conditions. Even if the regulator analyzed several past years of data, the regulator cannot assume that percentages of loans financed by entities for the targeted population groups will be the same in future years. If future years are likely to benefit from an economic expansion, the percentages of loans financed for targeted population groups could probably increase. In contrast, if future years are likely to experience a recession or slower growth, the percentages of loans financed would probably decline. In its final selection of benchmarks for various population groups, the regulator would take into account its assessment of future economic conditions. Fortunately, the existing affordable housing goals required by law have been shown to be safe. They did not play a role in the recent financial collapse. Their performance demonstrates that it is possible to create a structure that is able to meet the needs of all creditworthy borrowers without contributing to market or entity instability.

Metropolitan and Rural Considerations

The incentive model would create national benchmarks. While national benchmarks are necessary, it is also imperative to ensure a minimal level of performance in the metropolitan areas and rural communities where each secondary market entity has a significant share of the market.

Regional Assessment

As part of its evaluation, the regulator should review an entity's performance in their major metropolitan and rural markets. The regulator should identify those metropolitan areas and rural counties where the entities are significantly trailing their peers and the primary market and in which the regulator believes that the entity can feasibly improve their performance.

Strategic Evaluations

The regulator would then require the entity to develop a strategic plan for demonstrating progress. Specifically, the entity would indicate how it would improve performance in the identified markets. The strategic plan could also include the entity's proposals generally about how the entity will serve priority housing needs through innovative underwriting or product approaches and creative partnerships with lending institutions and nonprofit community organizations.

CONCLUSION

Protecting mortgage access for all creditworthy borrowers strengthens our communities and our nation as a whole. The shape of the secondary market will play a significant role in dictating access to mortgage credit for almost every household in this country. Establishing an affirmative obligation to serve the full spectrum of creditworthy borrowers with conventional lending is an important step for ensuring equal opportunity for consumers and accountability for private financial institutions that seek a federal guarantee.

Endnotes

1. Proposals have been offered by the Urban Institute, the Center for American Progress, the Bipartisan Policy Center, and others. For a more comprehensive list, review the Reform Matrix prepared by the Center for American Progress, available at http://www.americanprogress.org/wp-content/uploads/2013/03/NewGSEReformMatrix.pdf

2. In the House of Representatives, Rep. Jeb Hensarling (R-TX) introduced the Protecting American Taxpayers and Homeowners (PATH) Act (H.R. 2767), and Sens. Bob Corker (R-TN) and Mark Warner (D-VA) introduced the Housing Finance Reform and Taxpayer Protection Act of 2013 (S.1217). More bills from members of the Senate Banking Committee are expected in the fall of 2013.

3. See Table 1: A Growing Government Footprint.

4. Laurie Goodman, "Next Steps in GSE and Securitization Reform," Amherst Securities & Urban Institute Source: Amherst Securities and Urban Institute," July 9, 2013.

5. The Board of Governors of the Federal Reserve describes conventional loans as "non-government backed loans." http://www.federalreserve.gov/pubs/bulletin/2012/PDF/2011_HMDA.pdf (at 8)

6. Joint Center for Housing Studies of Harvard University, "The State of the Nation's Housing: 2013," Harvard University.

7. Id.

8. Id.

9. Kenneth Harney, "Mortgage Lenders Set Higher Standards for the Average Borrower." Washington Post, Sep. 28, 2012. Available at http://articles.washingtonpost.com/2012-09-28/news/35495052_1_fico-score-mortgage-lenders-debt-to-income

10. Id.

11. Nick Timiraos, "Fannie Could Curb Low-Down-Payment Loan Purchases." Wall Street Journal, Aug. 16, 2013. Available at http://blogs.wsj.com/developments/2013/08/16/fannie-could-curb-low-down-payment-loan-purchases/

12. Laurie Goodman, "Next Steps in GSE and Securitization Reform," Amherst Securities & Urban Institute Source: Amherst Securities and Urban Institute," July 9, 2013.

13. For example, in recent years, the nation's housing priorities and needs have included: rural housing needs, including manufactured housing, homeownership gaps for minorities and immigrants, senior housing, including aging-in-place options and affordable life care centers, REO reclamation, and affordable rental housing.