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Hearing on

Public Proposals for the Future of the Housing Finance System

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Good morning Chairman Johnson, Ranking Member Shelby, and members of the committee. I am Janneke Ratcliffe, a Senior Research Fellow at the Center for American Progress Action Fund and the executive director for the Center for Community Capital at the University of North Carolina at Chapel Hill.

Today I am especially honored to be asked to speak to you as a member of the Mortgage Finance Working Group. The members of this working group began gathering in 2008 to chart a path forward for the mortgage market. Our "Plan for a Responsible Market for Housing Finance" is the result. I will summarize our proposal, which is included in full in my written statement, but I speak only for myself in any views expressed here today.

Our collective experience and the three years we spent hashing out these issues has made us well aware of the difficult challenge you now face. The immediate task is to restore confidence in the housing market but we are also convinced that, long term, housing can continue to be core to Americans' prosperity and economic security, and the foundation of middle-class opportunity. To meet this mission, housing finance reform must meet three key goals:

- First, provide broad access to reasonably priced financing for both homeownership and rental housing so that more families, including the historically underserved, can have safe and sustainable housing options to meet their needs.
- Second, preserve the 30-year fixed-rate mortgage, which allows families to fix their housing costs, build assets, and plan for their future in an ever more volatile economy.
- And third, ensure that lenders, large and small, in communities large and small, can competitively offer the affordable, transparent, safe mortgage loans that borrowers need.

Our proposal achieves these goals by building on lessons from the past, both what went wrong and what was done right.

Principles of a new system based on lessons learned from the past

History has shown us that a housing finance system left to private markets will be subject to a level of volatility that is not systemically tolerable, given the importance of housing to the economy and to the American family.

The past decade exposed flaws in our housing finance architecture.[i] The availability of mortgages was wildly cyclical, resulting in excessive mortgage credit during the housing boom, followed by a nearly complete withdrawal of credit when the bubble burst. The risk of many of the mortgages originated during the housing bubble was underpriced. At the same time, these mortgages were not sustainable for consumers, as low teaser rates and opaque terms masked their high overall cost over time.

The housing bubble was driven by the development of a "shadow banking system" in which mortgage lending and securitization was largely unregulated and certainly undisciplined. In time, this system drew in the quasi-governmental entities Fannie Mae and Freddie Mac who increased their own overall risk during the "race to the bottom" that implicated almost all mortgage lenders during the 2000s. In particular, as Fannie Mae and Freddie Mac lost market share to private mortgage-backed securities issuers who were underpricing risk, the two mortgage finance giants lowered their own underwriting standards and increased their leverage in an attempt to compete. The result: Taxpayers were left exposed to major losses.

The new system must be designed to avoid the same pitfalls in the future. Keeping this in mind, we built our proposal on five key principles: liquidity, stability, transparency, affordability, and consumer protection.

First, there must be broad and constant liquidity

The new system needs to provide investors the confidence to deliver a reliable supply of capital to ensure access to mortgage credit for both rental and homeownership options, every day and in every community, during all kinds of different economic conditions, through large and small lenders alike.

Broad and constant liquidity also requires effective intermediation between borrower demands for long-term, inherently illiquid mortgages and investor demands for short-term, liquid investments. The capital markets have therefore come to play an essential role in mortgage finance. But as the past decade so stunningly demonstrated, left to their own devices, capital markets provide highly inconsistent mortgage liquidity, offering too much credit sometimes and no credit at other times with devastating effects on the entire economy.

To communities, liquidity means that lenders of all sizes can offer their customers in all communities beneficial mortgage products. Currently, an estimated 70 percent of all mortgage originations flow through four lenders—JPMorgan Chase Co., Bank of America Corp., Citigroup Inc., and Wells Fargo & Co.—all of which benefit from federal deposit insurance and an perceived and unpaid too-big-to-fail guaranty. Without consistent and equitable access to a fairly priced secondary market, the country will be in danger of losing the services of community banks, credit unions, and other lenders that can meet the needs of their communities on a more tailored and targeted basis than these larger institutions. These many small but important financial institutions need a well-functioning secondary market so they can access the capital they need to originate more mortgages.

To American families, consistent liquidity also means that developers will find capital to finance new and rehabilitated apartments and other homes so inadequate supply does not put decent rental options out of reach. It means that regardless of what community they live in, lenders will offer credit at a fair price. It means that families will be able to afford a long-term mortgage they can budget for without fear that interest rates will drive up their costs. It means they can put their hard-earned savings into a home with confidence that, whether the economy is up or down, when they need to sell, potential buyers will have access to credit from an array of competing lenders and the family will be able to sell their home at a fair market price.

Second, any new system must foster financial stability

Stability is achieved by reining in excessive risk taking and promoting reasonable products and sufficient capital to protect our macro economy and household economies from destructive boom-bust cycles. A totally private mortgage market is inherently inclined toward extreme bubble-bust cycles, which cause significant wealth destruction that brings with it devastating repercussions not only for homeowners and lenders but also for neighborhood stability, the larger financial system, and the broader economy.

Private mortgage lending is inherently procyclical. Mitigating that tendency requires strong, consistently enforced underwriting standards and capital requirements that are applied equally across all mortgage financing channels for the long cycle of mortgage risk. As we saw in the previous decade, capital arbitrage can quickly turn small gaps in regulatory coverage into major chasms, causing a “race to the bottom” that threatens the entire economy.

Stability for the market requires sources of countercyclical liquidity even during economic downturns. For families, stability means that they will not experience wild fluctuations in home values, allowing them to plan financially for their families, education, businesses, or retirement.

Third, transparency and standardization will support these other principles

Underwriting and documentation standards must be clear and consistent across the board so consumers, investors, and regulators can accurately assess and price risk and regulators can hold institutions accountable for maintaining an appropriate level of capital.

During the housing bubble, the housing finance system experienced a seismic shift toward complex and heterogeneous products that could not be understood by consumers at one end of the chain to securities that could not be understood by investors at the other. The lack of transparency and standardization set the stage for adverse selection because the issuers knew more than the investors.

Because the state of the whole secondary market affects the pricing of each packaged pool of mortgages in it, a safe and liquid securitization market can only exist if investors have access to information about all mortgage-backed securities in the market place. A private mortgage-backed securities market will not reemerge unless investors are convinced these issues have been resolved. Secondary market transparency and standardization lower costs and increase availability.

For borrowers, standardization and transparency means that they can make good choices from among well-understood and standard mortgage products. The mortgage products they can choose from are not so complex that their consequences are hidden.

Fourth, the system must ensure access to reasonably priced financing for both homeownership and rental housing

Liquidity and stability are essential to affordability and, for most families, the lower housing costs produced by the modern mortgage finance system over the past half century (before the recent crises) facilitated wealth building, enabling them to build equity, save, and invest. This contributed to the building of a strong middle class and has been an important guiding concept in modern U.S. housing finance policy—and a key component of the American socioeconomic mobility of the 20th century.
A pillar of this housing system is affordably priced long-term, fixed-rate, fully self-amortizing, prepayable mortgages, such as the 30-year mortgage. The long term of this loan provides borrowers with an affordable payment while the fixed-rate, the option to prepay, and self-amortization features provide the financial stability and forced savings that are critically important to most families, while retaining the opportunity for mobility.

Multifamily rental housing also gains stability from long-term, fixed-rate financing. Banks and other lenders, however, are reluctant to offer long-term, fixed-rate mortgages to homebuyers or multifamily mortgage borrowers unless the lenders have a consistently available secondary market outlet. In the absence of government policies designed to explicitly support long-term, fixed-rate mortgages, it is likely that this type of mortgage would largely disappear from the U.S. housing landscape or become unaffordable to the nation's middle class, which has been so effectively served by 30-year residential mortgages, and to the nation's many renters who rely on multifamily property owners' ability to finance and refinance their apartment buildings.

One of the most important accomplishments of the modern U.S. housing finance system is the broad availability of mortgage credit, but the benefits of this system have not been equally shared by all qualified households. Who is qualified for homeownership? We have ample evidence that many households who may not fit the "20 percent down, established credit, 30 percent debt-to-income" model can become successful long-term homeowners, when given access to well-underwritten, affordable, fixed-rate financing.[ii] For example, at UNC, we follow a portfolio of nearly 50,000 mortgages made by banks across the country over the decade preceding the crisis; loans made under affordable housing and CRA programs. The median borrower earned $30,792 a year, more than half of them had credit scores of 680 or below, and 69 percent put down less than 5 percent on their home purchase. Some of the conversations going on now suggest they were not qualified. But as of today, less than 5 percent of these loans have experienced foreclosure. Their delinquency rate is a fraction of that of subprime mortgages. In fact, the households have on the median, and over the period, managed to build more assets than through any other available mechanisms. They were able to do so because they had access to prime, fixed-rate, long-term amortizing mortgages that they could afford to repay.[iii]

Liquid, stable, and affordable financing must also be more available for multifamily and rental housing because it results in more affordable and stable rents. The housing opportunity ladder begins with access to stable rental housing in reach of good jobs, where households can pay their rent and still have money left over to begin saving. It is projected that the shortage in affordable rental housing is only going to be exacerbated in the wake of the foreclosure crisis. Over the next 30 years, we may need to add more than 40 million new housing units of all types to meet the demand. We cannot get on track without a strong rental housing finance system.

Access to affordable credit does not mean that people should stretch to purchase more house than they can afford. It does mean that homeownership's benefits of forced savings and wealth appreciation are available to those with sustainable incomes and strong credit history without regard to race or geography. It also means that there is enough supply of quality rental housing appropriate for individuals and families so that rents charged are affordable—meaning housing costs are no more than 30 percent of incomes.

Finally, the system must support the long-term best interest of all borrowers and consumers and protect against predatory practices

The purchase of a home is a far more complicated, highly technical transaction than any other consumer purchase and occurs only a few times in a consumer's life. Mortgage consumers are at a severe information disadvantage compared to lenders. In addition, a mortgage typically represents a household's largest liability. A mortgage foreclosure therefore has outsized consequences for the borrower. As the current crisis so sadly demonstrates, mortgage foreclosures also deliver devastating consequences to communities, the financial markets, and the broader economy.

During the housing boom, unregulated and often predatory subprime lending not only failed to maintain or promote sustainable homeownership opportunities but also established a dual credit market where factors other than a borrower's creditworthiness—such as race or neighborhood location—determined the type and terms of the mortgages available. All too often, families were denied the best credit for which they qualified because their communities were flooded with unsustainable mortgage credit—in part because secondary market pressures created incentives to make and sell these loans instead of the safer, lower-cost products.

How the goals of our proposal support these principles

In order to support these fundamental policy principles, our proposal for a new housing finance system sets out to achieve four key goals:

- Preserve the availability of 30-year fixed-rate mortgages, which allows families to fix their housing costs and better plan for their future in an ever more volatile economy.

- Provide access to reasonably priced financing for both homeownership and rental housing so families can have appropriate housing options to meet their circumstances and needs.

- Ensure that a broad array of large and small lenders (such as community banks, credit unions, and community development financial institutions) have access to secondary market finance so they can continue to provide single and multifamily mortgage loans in every community around the country.

- Address the continuing concerns of underserved borrowers or tenants whose housing needs may require some direct government support.

The importance of the 30-year fixed-rate mortgage

One important reason why the 30-year fixed-rate mortgage is superior to other mortgages is that it provides cost certainty. A U.S. household with a 30-year fixed-rate mortgage always knows what its mortgage payments will be. Because shorter-duration products are basically designed to be refinanced every two to seven years, homeowners with these types of loans face significant risks that interest rates may rise, making their home payments unaffordable after that initial two-to-seven-year period expires.

This is true even when interest rates are stable or declining. Adjustable-rate and short-term mortgages expose borrowers not only to ordinary interest-rate risk but also to the risks that they may not be able to refinance when they need to, due to adverse changes in market conditions.

The 30-year fixed-rate mortgage insulates borrowers against these risks since their payment streams are fixed. If we transitioned to an economy where the 30-year fixed-rate mortgage was no longer the dominant mortgage product, Americans would face the risk of losing their home every time they refinanced, due to rising interest rates or an unavailability of refinancing options, even if they otherwise could have been able to make their payments.

The “Plan for a Responsible Market” ensures that the 30-year fixed-rate mortgage remains a widely available, efficiently priced choice for all qualified homeowners.

An appropriate government role

History and experience shows that a government role is necessary for a smoothly functioning mortgage market.

Prior to the introduction of the major housing and finance reforms of the 1930s (which established the Federal Housing Administration, the Federal Home Loan Bank System, the Federal Deposit Insurance Corporation, and Fannie Mae, among others), the United States had a mortgage system that closely resembled the purely private system conservatives are arguing for today. From our contemporary perspective, this system was a total failure, demonstrating the perils of calls to “reform” the mortgage system back into a purely private endeavor.

Residential mortgages prior to the 1930s had many of the same features as the unregulated mortgage loans of the 2000s, with products similar to the subprime mortgages and so-called Alt-A mortgages—then as in the 2000s they were short term (typically 5-10 years), they were interest only, they carried a variable rate of interest, and they featured “bullet” payments of principal at term (unless borrowers could refinance these loans when they came due, they would have to pay off the outstanding loan balance).

Moreover, mortgages in this earlier era had high down-payment requirements, typically more than 50 percent, and were offered at rates much higher than the ones we take for granted today. They were effectively confined to a very narrow band of Americans, with a much higher percentage of home purchases being cash only. As a result, homeownership was far less attainable than it is today, with a homeownership rate of 43.6 percent in 1940.

Some have asserted that the significant development of the financial sector since the 1930s means that a purely private mortgage system could effectively serve the mortgage needs of Americans today. They point to the nascent recovery in the so-called jumbo mortgage markets, an area that lacks any government support because these mortgages are for the high end of the housing market, as evidence supporting the idea that the purely private markets can capably serve the mortgage markets.

This argument is fundamentally flawed for a number of reasons. First, it ignores the enormous size of the U.S. mortgage market, which currently has some $11 trillion in residential mortgage debt outstanding. The fact that the purely private markets may be able to meet the mortgage needs of a narrow, wealthy slice of homebuyers does not mean that they will be able to meet the mortgage needs of all Americans.

Second, and relatedly, this argument ignores the limited investor appetite for long-term debt investments—the type of investments that fund home mortgages—in the absence of a government backstop. While investor demand for long-term sovereign debt is enormous, totaling many trillions of dollars for U.S. Treasuries alone, the demand for privately issued long-term mortgage obligations that don’t carry a government backstop is small in comparison.[iv]

Without a government backing, there is unlikely to be sufficient investment capital to fund the $11 trillion in U.S. residential debt outstanding, let alone to fund longer-term mortgages, such as the 15-year to 30-year fixed-rate mortgages that dominate the U.S. mortgage market. Almost certainly, the removal of the government’s role in the mortgage markets would result in sharp reductions in the availability of mortgage credit and an immediate transition to short-duration mortgages, such as the two-year and three-year adjustable-rate mortgages that dominated the purely private subprime and Alt-A markets during the 2000s.

Finally, this position ignores the highly cyclical nature of private mortgage lending. One of the major weaknesses of exclusively private mortgage lending is the unavailability of mortgage credit during housing market or economic downturns as lenders become highly risk averse. This in turn can quickly lead to a "vicious circle" where a lack of available mortgage credit exacerbates the housing downturn, accelerating price declines and causing more mortgage defaults, which then leads to an even greater risk aversion on the part of lenders to provide credit.[v]

The inability of a purely private mortgage finance system to meet the housing needs of a modern economy is also evident from the experience of developed economies around the world. While the exact particulars vary from country to country, every advanced economy in the world relies on significant levels of government support, either explicit or implicit, in their mortgage markets.

Proposals that recommend complete privatization of the housing finance system (or privatization with occasional government intervention) would not achieve stability and they, in fact, would expose families and taxpayers to even more risk. These radical privatization proposals would present as extreme a change in the housing finance system as we have witnessed since the 1930s and would leave the U.S. economy vulnerable to the kind of boom-bust cycle that unfettered private market forces caused then and again in the last decade. They also would result in some stark consequences for American families.

The predominant form of finance would be in the form of loans with shorter durations and higher costs, putting more households at greater financial risk. The 30-year fixed-rate mortgage would not be available under terms affordable to most families. Rental housing would be less available and more costly, even as there would be greater demand for it. Finally, fewer working families would have access to the asset-building potential of homeownership, and this pillar of the economic mobility that has characterized the American economy until recently would be lost—and with it part of the American Dream.

History has shown us that a purely private market will not work. Similarly, we know that the current overreliance on federal government intervention is unsustainable. Private capital must be encouraged to bear as much of the load as possible in our housing finance system going forward, but that is different from saying the market must be "privatized."
The proposal does induce private capital back into the system and structures an appropriate government role to ensure that the broader housing policy goals are satisfied.

Features of the "Plan for a Responsible Market for Housing Finance"

Let me now describe the key features of the "Plan for a Responsible Market." The reforms and enhanced consumer protections enacted in the Dodd-Frank Act were an essential first step as is proper implementation of that law. The proposal of the Mortgage Finance Working Group creates a system that preserves the traditional roles of originators and private mortgage insurers, but assigning functions previously provided by the government-sponsored enterprises, or GSEs, Fannie Mae and Freddie Mac, to three different actors—issuers; chartered mortgage institutions, or CMIs; and a catastrophic risk insurance fund, or CRIF.

Issuers will originate or purchase and pool loans; issue mortgage-backed securities, or MBSs; and may purchase credit insurance on MBSs that meets certain standards from CMIs.

CMIs also will be fully private institutions not owned or controlled by originators. They will be chartered and regulated by a federal agency and their function would be to assure investors of timely payment of principal and interest only on MBSs that are eligible for the government guarantee.

The CRIF would be an on-budget fund (similar to the FDIC's Deposit Insurance Fund) that is run by the government, and funded by premiums on CMI-guaranteed MBSs. In the event of the CMI's financial failure, the explicit guarantee provided by the CRIF would protect only the interests of holders of only qualified CMI securities.

The government would price and issue the catastrophic guarantee, collect the premium, and administer the fund. The fund would establish the product structure and underwriting standards for mortgages that can be put into guaranteed securities and the securitization standards for MBSs guaranteed by the CMIs. The government would also establish reserving and capital requirements for CMIs, and these would be at higher levels than those held by Fannie and Freddie.

It is important to note that under our plan, there would be several layers of protection standing ahead of any taxpayer exposure. Borrower equity, the CMI's capital, and in some cases private mortgage insurance all would stand ahead of the CRIF. All of these private sources of funds would need to be exhausted before the CRIF would have any exposure to loss.

We believe this system will serve the needs of the vast majority of households that are looking for the consistent availability of affordable credit and predictable housing costs that can be achieved through a limited government market backstop.

This system will serve the vast majority of households seeking consistent, affordable credit and predictable housing costs that can be achieved through a limited government backstop. We also include new mechanisms to see that the benefits of this system are made available in a fairer and more equitable way than ever before and to prevent the problem of a dual market where certain classes of borrowers and communities are relegated to separate, unequal markets. These mechanisms prohibit the CMIs from "creaming the market" and require them to extend the benefits of the system to all qualified borrowers, including those historically underserved. Further, to effectively serve those underserved borrowers or tenants whose housing needs require greater government support, our plan proposes two parallel strategies: (1) establishing a new "market access fund" to provide responsible credit support and research and development funds to promising new products that close market gaps, and which would complement the Affordable Housing Trust Fund and Capital Magnet Fund established by the Housing and Economic Recovery Act of 2008; and (2) revitalizing the Federal Housing Administration, or FHA.

Ensure nondiscriminatory access to credit

CMIs in the new housing finance system would be responsible for providing an equitable outlet for all primary market loans meeting the standards for the guarantee, rather than serving only a limited segment of the business, such as higher-income portions of that market.

This obligation would have four parts:

- CMIs would be expected to roughly mirror the primary market in terms of the amount and the geography of single-family low- and moderate-income loans (other than those with direct government insurance) that are securitized and are eligible for the CMI guarantee. They would not be allowed to "cream" the market by securitizing limited classes of loans. This assumes that the primary market will be appropriately incentivized through the Community Reinvestment Act, which requires banks and thrifts to serve all communities in which they are chartered, including low- and moderate-income communities, consistent with safe and sound operations.

- CMIs that guarantee multifamily loans would be expected to demonstrate that at least 50 percent of the units supported by securitized multifamily loans during the preceding year were offered at rents affordable to families at 80 percent of the relevant area median income, measured at the time of the securitization.

- CMIs would be required to provide loan-level data on securitizations to the government (which will be required to make these data public) that are no less robust than those of the Public Use Database currently produced by the Federal Housing Finance Administration.

- All CMIs would participate in a yearly planning, reporting, and evaluation process covering their plans for and performance against both the single-family and multifamily performance standards and government-identified areas of special concern, such as rural housing, small rental properties, and shortages created by special market conditions such as natural disasters.

Like all other secondary market participants, CMIs would be required to abide by nondiscrimination and consumer protection laws. Substantial underperformance by a CMI could lead to fines and possible loss of its CMI license.

Market access fund

Some groups of borrowers and certain types of housing have not been well served by the system of the past. Rules against discriminatory lending and anticreaming provisions, such as those we have proposed for CMIs, will help, but are likely to be insufficient to fill all the gaps.

These gaps are especially important to fill in the aftermath of the housing crisis, where many communities saw equity stripped by subprime lending. Moreover, the larger economic downturn has hit underserved communities most heavily. These places most in need of capital to rebuild will be the last to get it from a private market left to its own devices.

Certainly, direct subsidies are critical where deep government support is needed, such as for low-income rental housing. In addition to existing programs like Section 8, the low-income housing tax credit, and HOME, a fully funded National Housing Trust Fund will help meet these needs. But beyond cash grants to support affordable housing, we need the entire housing finance system to provide access to credit for affordable rental housing and homeownership. Mortgage insurance provided by FHA and other similar programs brings private capital into underserved communities, but under these programs, a taxpayer insurance fund takes on almost all of the credit risk. Lenders who make FHA loans get fee and servicing income but they have very little capital at risk. Thus, FHA insurance ensures loans are available to markets and borrowers that private capital will not serve.[vi]

CMIs are unlikely to make loans that they perceive as too risky or that might provide below-market rates of return. But this sector cannot be allowed to see itself as having no responsibility to serve low- and moderate-income communities, communities of color, and communities hard hit by the foreclosure crisis and other adverse conditions, claiming that the risks are inconsistent with their fiduciary duty to shareholders. The result could be a two-tiered system of housing finance, with FHA as the primary vehicle serving low- and moderate-income communities and communities of color and taxpayers absorbing all the risk, and private capital serving only the middle and upper parts of the market.

The market access fund offers a way to help CMIs and other private actors meet their obligations to serve the entire market.

Loan products that can successfully and sustainably meet underserved housing needs can eventually access the capital markets—if they can first gain a record of loan performance and market experience. Past examples include home improvement loans and guaranteed rural housing loans, as well as loans made less risky by quality housing counseling.

A market access fund would provide a full-faith-and-credit government credit subsidy to cover part of these risks to enable entities including CMIs and nonprofit and government (such as state housing finance agency) market participants to develop and establish a market for these innovative products. Examples of new products might include lease purchase loans, energy-efficient or location-efficient loans, shared equity loans, and loans on small multifamily properties.[vii] The fund could also make available research and development funds (grants and loans) to encourage initial development of such products.

The market access fund would provide "wholesale" government product support on a risk-sharing basis, in contrast to the retail, 100 percent insurance offered by the Federal Housing Administration. The fund would be required to meet specific performance goals relating, for example, to financing for housing in rural areas or places with high foreclosure rates, unsubsidized affordable rental housing, and manufactured housing. And the fund's credit subsidy would only be available for products on a shared-risk basis, meaning that other capital would need to be at risk as well, providing both market discipline and an opportunity for these actors to learn how to serve underserved markets well. This in turn would pave the way for private capital to "mainstream" the products, increasing sustainable homeownership and affordable rental housing, and eventually reducing or eliminating the need for public support.

The market access fund would be funded by an assessment on all MBS issues. A portion of the assessment would go to the National Housing Trust Fund (for direct subsidy) and to the Capital Magnet Fund (for credit programs by Community Development Finance Institutions), as established under the terms of the Housing and Economic Recovery Act of 2008. It is important that the assessment be levied on both those issues guaranteed by CMIs and those without CMI guarantees to ensure that the responsibility to support better service to underserved markets primarily through private finance is supported by the jumbo market as well as the middle market.

By sharing the risk of loss, the market access fund makes it easier for private capital to serve underserved communities. Without this mechanism, there is a significant risk that the taxpayer will continue to stand behind too large a segment of the housing market through FHA/VA and a two-tier housing finance system will develop.

The market access fund will help CMIs and other private actors meet their obligations to serve the entire market while simultaneously providing the market discipline of private risk capital for new products that serve underserved communities. And it will do so while limiting the government's role and exposure to risk.

Revitalized and improved FHA

The role of the Federal Housing Administration as an essential countercyclical backstop has been demonstrated by its performance during the recent housing and financial crises. While it insured only 3.3 percent of single-family mortgages originated in 2006, by 2009, after private capital fled the housing market, its market share increased to 21.1 percent. Over the past year, FHA provided access to credit for about 40 percent of purchase mortgages.[viii] In 2009, FHA insured 60 percent of all mortgages to African-American and Hispanic homebuyers, and mortgages for more than 882,000 first-time homebuyers.[ix] Earlier in the economic and financial crises, these percentages were even higher.

FHA reported in November 2010 in its annual report to Congress that, under conservative assumptions of future growth of home prices, and without any new policy actions, FHA's capital ratio is expected to approach the congressionally mandated threshold of 2 percent of all insurance-in-force in 2014 and exceed the statutory requirement in 2015. In other words, if correct, FHA will have weathered the worst housing crisis since its creation in the aftermath of the Great Depression and will have done so without costing taxpayers a dime. FHA's market share was small during the worst of the crisis and, while it is sustaining significant losses from loans insured prior to 2009, better-performing loans are now helping to stabilize its financial position.

FHA, however, lacks the systems, market expertise, and nimbleness one would hope to see in an institution with more than $1 trillion of insurance-in-force.[x] Its product terms and many practices are prescribed by statute with such specificity that it makes prudent management of an insurance fund extremely difficult.

In 1994, the Joint Center for Housing Studies at Harvard teamed up with FHA Commissioner Nic Retsinas to conduct a series of public hearings and study the future of FHA. Their report and recommendations concluded that Congress should reinvent FHA as a government corporation, under the direction of the secretary of the department of housing and urban development, with strict and independent oversight of its performance in serving underserved markets and maintaining financial soundness, but greater flexibility in product design to meet those ends.[xi]

The Harvard proposal would have created a new Federal Housing Corporation with far greater flexibility in procurement and personnel policies in order to jumpstart the transformation to a more business-like agency with a public purpose. The proposal was adopted by President Clinton in a HUD Reinvention Blueprint released in March 1995.[xii] Similar recommendations were endorsed by the Millennial Housing Commission in their report submitted to Congress in May 2002.[xiii] Each time, market, political, and inertial forces resulted in no action.

The thrust of these recommendations is on the mark. Most significantly, under these proposals, FHA could design loan products to help meet the needs of underserved markets. The FHA would need to charge premiums designed so the insurance funds would be actuarially sound. These products would be subject to independent credit subsidy estimates approved by the Office of Management and Budget and additional private market-like measures of risk. And the overall portfolio of insurance would be required to maintain adequate capital reserves to continue to protect taxpayers from insurance losses, as FHA has since done the Great Depression.

Other reforms would let FHA pay salaries at levels paid by the banking regulatory agencies, as comparable financial market expertise must be attracted to better protect taxpayers from the risks inherent in insurance. And procurement and budget flexibility would make it easier for FHA to use insurance fund resources to develop new systems and procure them more easily to better assess and manage risk in the insurance fund.

It is time to revisit these ideas. It is now evident that FHA is indispensable for economic stability and housing market equity. In light of its continued importance, we should ensure that FHA has the tools it needs to best meet underserved housing needs and provide countercyclical liquidity while doing what works to protect taxpayers optimally from any risk.

Conclusion

From the 1930s to the 2000s, the United States enjoyed a vibrant, stable, housing market that evolved to provide mortgage money at all times, in all parts of the country, for sustainable homeownership and rental housing. The system was not perfect but it contains valuable lessons for us as we look to rebuild. By applying those lessons to meet the goals outlined in this testimony, you have the opportunity to build a system that rebalances housing choices and works better for more households and more communities than the system that has been in place for the last 70 years.

Thank you for inviting me to talk about the work my colleagues and I have done and I would be happy to answer any questions.

[i] Markus K. Brunnermeier, "Deciphering the Liquidity and Credit Crunch 2007-08," *Journal of Economic Perspectives* 23 (1) (2009): 77–100.

[ii] David Abromowitz and Janneke Ratcliffe, "Homeownership Done Right: What Experience and Research Teaches Us," (Washington: Center for American Progress, 2010), available at http://www.americanprogress.org/issues/2010/04/pdf/homeownership_done_right.pdf.

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[iv] Bryan J. Noeth and Rajdeep Sengupta, "Flight to Safety and U.S. Treasury Securities," *The Regional Economist* 18 (3) (2010): 18–19, available at http://www.stlouisfed.org/publications/re/articles/?id=1984.

[v] Joint Economic Committee Majority Staff, "From Wall Street to Main Street: Understanding How the Credit Crisis Affects You" (2008).

[vi] FHA's history of service to low-income and minority communities has not, however, been without controversy, as in some communities and in some time periods, racial covenants, block busting, fraud, and other abuses by realtors, lenders, and other program participants that FHA failed to prevent have led to neighborhood deterioration. See: Sean Zielenbach, *The Art of Revitalization: Improving Conditions in Distressed Inner-City Neighborhoods* (New York: Garland Publishing, 2000).

[vii] For example, one idea that has been proposed for the market access fund has been to capitalize an equity pool that would purchase participations in local and state "shared equity" homeownership funds, providing scale to this affordability product that has been greatly successful in smaller settings but which lacks access to the secondary capital markets and is thus otherwise limited in the funds it has access to. The two major barriers to scale for this product have been a large degree of heterogeneity in local products and a lack of standard performance data. The leveraging of market access fund capital would clearly address these hurdles and allow shared equity to achieve a larger scale, potentially accessing the secondary markets in time.

[viii] Office of Policy Development and Research, *U.S. Housing Market Conditions* (Department of Housing and Urban Development, 2010), available at http://www.huduser.org/portal/periodicals/ushmc/fall10/hist_data.pdf.

[ix] *Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2010* (Department of Housing and Urban Development, 2010), available at http://www.hud.gov/offices/hsg/rmra/oe/rpts/actr/2010actr_subltr.pdf.

[x] Ibid.

[xi] Department of Housing and Urban Development and Harvard University's Joint Center for Housing Studies, "Creating a New Federal Housing Corporation" (1995), available at http://babel.hathitrust.org/cgi/pt?view=image;size=100;id=mdp.39015034895089;page=root;seq=3.

[xii] *HUD Reinvention: From Blueprint to Action* (Department of Housing and Urban Development, 1995).

[xiii] The Millennial Housing Commission, "Meeting Our Nation's Housing Challenges: Report of the Bipartisan Millennial Housing Commission Appointed by the Congress of the United States" (2002), available at http://govinfo.library.unt.edu/mhc/MHCReport.pdf.

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