FANNIE MAE AND FREDDIE MAC: HOW GOVERNMENT HOUSING POLICY FAILED HOMEOWNERS AND TAXPAYERS AND LED TO THE FINANCIAL CRISIS

HEARING

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FANNIE MAE AND FREDDIE MAC: HOW GOVERNMENT HOUSING POLICY FAILED HOMEOWNERS AND TAXPAYERS AND LED TO THE FINANCIAL CRISIS

Wednesday, March 6, 2013

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Bachus, Royce, Neugebauer, Bachmann, Westmoreland, Huizenga, Grimm, Stivers, Mulvaney, Hultgren, Ross, Wagner; Maloney, Sherman, Moore, Perlmutter, Scott, Himes, Peters, Ellison, Watt, Foster, Carney, Sewell, and Kildee.

Ex officio present: Representative Waters.

Also present: Representative Miller.

Chairman GARRETT. Good morning, everyone. Today's hearing of the Capital Markets and Government Sponsored Enterprises Subcommittee is now called to order. Today's hearing is entitled, "Fannie Mae and Freddie Mac: How Government Housing Policy Failed Homeowners and Taxpayers and Led to the Financial Crisis."

Before we begin, without objection, I move that the Chair can put the committee into a recess at any time. Without objection, it is so ordered. Also note that we are starting today, pretty close to on time, which is 10 a.m., and I appreciate everyone being here despite the weather. We may have—I was told that the votes may have been moved up. So we will try to move things along expeditiously.

Again, I thank the panel. We will begin with opening statements, and then go to the panel. So at this point, I yield myself 4½ minutes for an opening statement.

So, today's hearing does what? It seeks to examine in greater detail the role that Fannie Mae and Freddie Mac played in facilitating the 2008 financial crisis. Over the last 4 years, there has been a great deal of discussion as to what the main causes of the financial crisis were. However, I believe there is one similar fundamental trait that connects every analysis and that is bad mortgages. No matter what part of the financial crisis is discussed, it always comes back to bad mortgages.

Our friends on the other side of the aisle sometimes love to discuss a wide variety of other reasons that they believe led to this crisis, however, for each instance, the underlying message is bad mortgages. Some of their favorite things to highlight are: opaque and complicated derivatives; an overreliance on incompetent credit rating agencies; off-balance sheet and synthetic securitizations; procyclical accounting standards; and greedy Wall Street banks.

However, all those things are symptoms and not the actual disease. The disease was bad mortgages. The derivatives were written on bad mortgages. The rating agencies were rating bad mortgages. Securitization, the collateral of bad mortgages. The accounting standard market, the market had bad mortgages. Failing Wall Street banks were holding bad mortgages.

All of these symptoms led to the same disease: bad mortgages. So we have to ask ourselves, how did this disease infect the country? The evidence indicates the disease began back in the 1990s with the adoption of the Affordable Housing Goals for the Government-Sponsored Enterprises (GSEs) and the Clinton Administration's push to rapidly expand homeownership opportunities. And they did so by systematically reducing underwriting standards.

In May of 2001, Michael Zimbalist, a global head of investment strategy for J.P. Morgan's Asset Management business, who had originally believed that the private sector had underwritten a majority of the bad mortgages, wrote this to his clients, "In January of 2009, I wrote that the housing crisis was mostly a consequence of the private sector. Why? Because U.S. agencies appeared to be responsible for only 20 percent of the subprime, Alt-A and other mortgages. However, over the last 2 years, analysts have dissected the housing crisis in greater detail.

"And what emerges from new research is something quite different. Government agencies now look to have guaranteed, originated, and underwritten 60 percent of all non-traditional mortgages for a total of $4.6 trillion. What's more, the research asserts that the housing policies instituted in the early 1990s were explicitly designed to require U.S. agencies to make riskier loans with the ultimate goal of pushing private sector banks to adopt the same standards. To be sure, private sector banks and investors were responsible for taking the bait. And they made terrible mistakes. But overall, what emerges in an object lesson in well-meaning public policy gone spectacularly wrong."

So if my colleagues on the other side had taken the time and done the same due diligence that Mr. Zimbalist and others did to actually diagnose the appropriate causes of the financial crisis, they may have seen the same thing. But instead, they rushed forward with a 3,000-page Dodd-Frank Act which basically included a liberal's wish list of policy changes that have been pent up over the last 12 years, that had absolutely nothing to do with the crisis. They are not the issues that are strangling the economy, nor negatively impacting job creation. Unfortunately most of Dodd-Frank only dealt with the symptoms and not the actual disease, bad mortgages.

Many of the interest groups that directly benefit from large subsidization of the housing market continue to state that Fannie and Freddie fell victim to the bad private market participants. This is completely false. It was government housing policy coupled with loose money from the Federal Reserve, that caused the housing bubble. And those are the areas where we must focus on first.

One of my esteemed panelists, Mr. Rosner, points out so precisely and with many specific examples in his book, "Reckless Endangerment," "Fannie and Freddie systematically reduced underwriting standards to meet government regulatory requirements and to curry favor with the political class. Fannie and Freddie are the essence of crony capitalism. And if we recreate them in some form or fashion as so many in the industry and across the aisle want to do, we are doomed to repeat the same terrible outcomes that our Nation has experienced over the last 4 years."

An analysis that I read before said finally, "As regulators and politicians consider actions designed to stabilize the financial system and the housing mortgage market, reflection on the role that policy played in the collapse would seem like a critical part of the process."

I only hope so. And that is what we are about to do today. With that, I yield back. And I yield to the gentlelady from New York for 4 minutes.

Mrs. MALONEY. Thank you. I thank you for calling this hearing and I thank all the panelists for getting here. I mentioned that Dr. White is from the great City and State of New York. We are so pleased that you are here. And all of you, getting here in the middle of a snowstorm, I applaud you.

We are here on really one of the most important issues the subcommittee will be working on over the next 2 years. Many economists believe that 25 percent of our overall economy is housing and related industries. So getting this segment figured out and stable and moving forward is critical to the economic growth and security of our country.

I personally do not want to play the blame game. The title of this hearing is very confrontational. I hope we can work together in ways to find solutions and go forward. But since it was raised, I do want to point out the findings from the Financial Crisis Inquiry Report—this was an independent report, the final report of the National Commission on the Causes of the Financial and Economic Crisis in the United States. They interviewed 700 people, had 19 days of public hearings, and went through reams of materials from the private and public sector.

And on page 323, in their conclusions they state, "GSE mortgage securities essentially maintained their value throughout the crisis and did not contribute to the significant financial firm losses that were central to the financial crisis."

Fannie and Freddie themselves have come out with a report that I would like to place in the record on delinquent rates, comparing their work with the private sector. And in this report, the private sector had roughly 35 percent delinquency, whereas Fannie and Freddie were roughly at 3 to 5 percent. So anyway, I just wanted to put that into the record.

Chairman GARRETT. Without objection, it is so ordered.

Mrs. MALONEY. Okay, but now we are 4 years after the financial crisis and the GSEs are still in conservatorship. The hemorrhaging has stopped. The GSEs have even been profitable over the last few quarters. But we all agree that the current situation is not sustainable. There are a number of proposals that have come forward. One from FHFA came out to combine Fannie and Freddie, certain functions, and to standardize their securitization platform. There are others from the Bipartisan Policy Center.

I for one, look forward to reviewing them with my colleagues, and I truly do believe if Mr. Garrett and I can agree on anything, then we can get it passed in the entire Congress and we can move forward. Homeownership has played a critical role in the American Dream in our country. Nowhere in the world are mortgage products like the 30-year fixed-rate mortgage available without some form of government involvement. And I believe we need to be mindful of that as we look forward at the various plans.

We had roughly 70 years of a stable housing finance system with credit available to new home buyers, lower-income borrowers, and all types of borrowers in between. And I, for one, do not want to see the 30-year fixed-rate mortgage disappear. So while I agree that the current status is not sustainable, I do believe that at the very least, the GSE should return to what they did at their inception, be a source of liquidity to the markets to ensure that issuers have the cash to continue to lend in a prudent way to credit-worthy borrowers.

So I look forward to moving forward toward solutions. And I hope that we set a better tone for a path forward than the title of this hearing represents. I yield back, and again I welcome all of my colleagues and the witnesses.

Chairman GARRETT. And I thank the gentlelady. We turn now to the vice chairman of the subcommittee for 1½ minutes.

Mr. HURT. Thank you, Mr. Chairman. Mr. Chairman, thank you for holding today's subcommittee hearing on how Fannie Mae, Freddie Mac, and Federal housing policy failed taxpayers and helped to lead to the financial crisis of 2008. One thing that I hear as I travel across my rural Virginia district, the 5th District, is that Congress must end Washington bailouts. I believe it is our responsibility to end the bailouts of Fannie Mae and Freddie Mac and enact reforms that will protect the American taxpayer and strengthen our housing finance system.

With almost $190 billion in taxpayer funds provided to Fannie Mae and Freddie Mac to date, this has become, by far, the costliest bailout of the financial crisis. As this committee begins its work on housing finance reform, it is important that we understand what caused these historic losses. Before the housing market collapse precipitated a wider crisis, Federal housing mandates required Fannie Mae and Freddie Mac to buy riskier and riskier loans.

These aggressive actions by the GSEs, aided by their implicit government backing, fed the housing bubble and facilitated the explosion of the market share of subprime and Alt-A mortgages. As Fannie Mae and Freddie Mac purchased and securitized more of these loans, loan originators took this as an incentive to write more subprime and Alt-A loans, regardless of their quality.

As we all know, when the housing bubble burst, the American taxpayers were left to foot the bill. And yet Dodd-Frank which was sold to the American people as a reform of our financial system, failed to address any of the problems with Fannie Mae and Freddie Mac. Now is the time for Congress to act on this issue. And I appreciate Chairman Hensarling and Chairman Garrett's leadership in putting this committee on a path to fundamentally reforming our Nation's housing finance system and protecting the American homeowner and the American taxpayer.

I would like to thank our witnesses for appearing before the subcommittee today. And I look forward to their testimony.

Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. And I thank you. I now recognize the ranking member of the full Financial Services Committee, the gentlelady from California, Ms. Waters, for 2 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman, for holding this hearing today. It is very important. Nearly 5 years have passed since this committee worked with the Republican Administration to stop the losses at Fannie Mae and Freddie Mac by strengthening their regulator and putting them into conservatorship to prevent the collapse of the housing market.

At that time, this committee and others raised important questions about what happened in the financial markets to necessitate such extraordinary actions. Since then, a consensus emerged that the 2008 crisis was the result of a complex mix of factors including: credit rating agencies being paid to give AAA ratings to toxic assets; securitization and reselling of those assets to uninformed investors; and predatory loans including the no-income, no-job, no-asset loans or NINJA loans. It is overly simplistic and untrue to suggest that Fannie Mae and Freddie Mac caused the financial crisis or were even the leading cause of the crisis.

Every credible analysis, including the Financial Crisis Inquiry Commission report, and a book by former FDIC Chairman Sheila Bair, say otherwise. With that in mind, it is important to note that the world is dramatically different today compared with 2008. Freddie Mac reported a profit of $11 billion for 2012, and the total amount given to the GSEs net of repayments continues to decline. The tourniquet to stop the bleeding worked, providing legislators with time to consider how to reform the housing market.

There are several comprehensive bipartisan reform proposals that were introduced last Congress, none of which have yet had a hearing before this committee. To each of our witnesses, I hope that you will help guide our discussion about how to actually reform the markets. For example, I would like to discuss what reforms are needed to preserve stable market products like 30-year fixed-rate loans, and how we can provide liquidity at times of market distress. And how we can ensure that all banks, including community banks and credit unions, can participate in the secondary mortgage market.

I thank you, and I yield back the balance of my time.

Chairman GARRETT. The gentlelady yields back. Mr. Royce for 1 minute.

Mr. ROYCE. Thank you Mr. Chairman. I remember very vividly the Federal Reserve Chairman speaking with me, the warnings that we were given on the inability of the Fed to regulate Fannie and Freddie for systemic risk. I remember the questions from those at the Fed on, why won't Congress allow us to regulate Fannie and Freddie for systemic risk?

It was pretty clear at the time, with the housing goals that we were putting in place with the requirement that of the $1.7 trillion that existed in those portfolios, the percentage of that which was subprime, this was the objective of Congress. Zero downpayment loans. We were driving a policy and the one request from the regulator was that they be able to regulate the GSEs.

I had legislation before the House, and the Senate had legislation on the Floor. And that legislation on the Senate side was filibustered by Mr. Dodd and here we failed to pass it on the House side as well. That would have allowed the regulation for systemic risk. To deleverage those portfolios that were leveraged at 100 to 1. Now, an implicit government backstop created a level of moral hazard unseen anywhere else in our capital markets and it astounds me that people would try to pretend that in not listening to the regulators, that this had nothing to do with the problem in the housing market. I yield back, Mr. Chairman.

Chairman GARRETT. I thank the gentleman. Mr. Peters is recognized now for 2 minutes.

Mr. PETERS. Thank you, Mr. Chairman, and good morning. And I would like to thank our witnesses for being here today. I would also like to thank Chairman Garrett and Ranking Member Maloney for convening our first Capital Markets and Government Sponsored Enterprises Subcommittee. And I would like to additionally thank them for starting off by examining the role of GSEs in our economy.

In addition to looking back at the collapse of the housing market in 2007, which is a topic I think it is very safe to say that we have already spent a great deal of time looking at, I hope that today, we also look forward. Our housing market continues to recover with improving home prices including across much of the greater Detroit area that I represent. Rental demand is increasing in many regions across the United States. But the number of renters spending more than they can afford is high and it is growing.

The government continues to support the vast majority of mortgage financing, both for homeownership and rental housing. Our economy cannot afford to have an outdated housing system. We must look for ways to ensure our system can keep pace with today's demands and the challenges of the imminent future.

For this reason we must look forward. And I hope that we can spend a portion of our time here today examining not just the role the GSEs played last decade, but what role our government should play in the housing markets of the future. Clearly, we need to put an end to taxpayer-funded bailouts. But we must also ensure that responsible hardworking families can still achieve the dream of homeownership.

Our status quo is unsustainable but completely eliminating any government role in the mortgage market would likely undermine the housing recovery and risk eliminating the 30-year fixed-rate mortgage. Despite the housing collapse, responsible homeownership can produce powerful economic, civic, and social benefits that serve not just individual homeowners, but their communities and our Nation as a whole.

I believe our committee has a real window of opportunity this Congress to meaningfully engage in GSE reform on a bipartisan basis. And I look forward to working with my colleagues on both sides of the aisle on this critical issue. I yield back.

Chairman GARRETT. The gentleman yields back. Thank you. The gentleman from Texas for 1 minute.

Mr. NEUGEBAUER. Thank you, Mr. Chairman, for holding this important hearing today. I think it is important to understand the consequences of all of this policy. We have talked about the huge losses that were accreted by these entities and the fact that the taxpayers had to inject massive amounts of their money into that.

But there is another victim in all of this and that is the homeowners who did the right thing. The people who took out mortgages, who bought homes, who could afford those and are making their payments on it. What we realized is when we have monetary policy or fiscal policy that creates these bubbles, when the bubbles bust, it not only hurts the people who were a part of the bubble, but also hurts some of the people on the sidelines.

And so, I think one of the things that I am hopeful that we can begin to work on is the fact that we make sure that history does not repeat itself. We have to understand that homeownership in America is about the opportunity to own a home, but it is not an entitlement. And in some ways, the government has turned homeownership into entitlement. We need to make sure it is an opportunity. So, I will look forward to our discussion today.

Chairman GARRETT. Thank you. The gentleman yields back. Mr. Scott for 2 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman. I think that this is indeed an important hearing. But here is what we must remember and this is for both Democrats and Republicans: As Fannie and Freddie prepare to wind down and have private lenders take on more responsibility in providing credit to the U.S. housing market, Congress, both Democrats and Republicans, must commit to ensure that Americans who require extra assistance in obtaining a sound mortgage are able to do so.

We have to make sure that there is a willingness on the part of the private market to fill the gap that will be left by the absence of Fannie and Freddie. To do less than that is meaningless. We can sit here and debate the merits or demerits of Fannie and Freddie, but the problem remains. We must remember that the GSEs were formed to increase liquidity in the market, to provide long-term fixed-rate mortgages. This type of option for potential homeowners is valuable, and is often necessary in obtaining a mortgage that is sustainable, that is sound, and is less likely to fall into foreclosure.

I have heard a lot of criticism about Fannie and Freddie. But they, in fact, were created to fill a very important purpose. And without Fannie and Freddie, millions of those who own homes now would have not been able to do so. Because the private market, the private sector, must be willing. That is a fundamental issue we have to make sure happens.

Thank you, Mr. Chairman. If I have a moment? I guess I don't.

Chairman GARRETT. Thank you. The gentleman yields back. Mrs. Bachmann is recognized for 1 minute.

Mrs. BACHMANN. Thank you, Mr. Chairman. I thank you for this hearing that finally admits the truth, that it was government housing policy that failed homeowners. And as Mr. Neugebauer said, it is truly the taxpayers and the homeowners who lost in this issue.

And who lowered these lending standards? We know now it was government policies. Why was it that we agreed to zero down mortgages? Government policies. Who agreed to the so-called "liar loans?" It was government policies. And who pushed Fannie and Freddie to buy more and more of these inferior performing loans? It was government policies.

And why was no one in the lending chain ever willing to say no, in a game that was destined for failure? We know now it was because a lot of people made a lot of money selling inferior products. And why? Because of the implied promise that if anything went wrong, don't worry, the taxpayers would bail it out and the taxpayers would pay.

This is a game that can never happen again. We have to raise lending standards to what they were historically and we will once again have a strong housing market. I yield back.

Chairman GARRETT. Thank you. And for the last word on the matter, Mrs. Wagner is recognized for 1 minute.

Mrs. WAGNER. Thank you, Mr. Chairman, and I thank our witnesses. At the signing ceremony for the Dodd-Frank Act in July of 2010, President Obama proclaimed, "Unless your business model depends on cutting corners, or bilking your customers, you have nothing to fear from reform."

Unfortunately, the bill the President signed that day did nothing to reform the two entities that cut the most corners, bilked taxpayers out of billions of dollars, and were more responsible than anybody or any institution for the financial crisis of 2008. I am of course referring to Fannie Mae and Freddie Mac, the government mortgage giants that for years worked to drive down underwriting standards and increase borrower leverage in the housing market. All under the guise, I believe, of promoting homeownership. These policies created an enormous housing bubble which inevitably crashed and in the process, hurt the very families, real families who were supposed to be helped, and instead stuck the taxpayers with the bailout bill.

As our committee works to bring real and lasting reform to the housing market, I hope that today's hearing serves as a vivid reminder of where misguided government policies have gotten us in the past.

I thank you, Mr. Chairman, for this hearing. I thank our witnesses for being here today and I yield back my time.

Chairman GARRETT. The gentlelady yields back. We now turn to our esteemed panel. We again thank the panel for being with us on this snowy day. We also remind those who have not been here before that you will all be recognized for 5 minutes, and your complete written statements will be made a part of the record. The lights will come on green, yellow, and red; there is 1 minute remaining at the yellow light.

And I will also remind you to please make sure that you bring your microphone as close to you as you can when you begin.

We will begin with Mr. Ligon from The Heritage Foundation, and you are recognized now for 5 minutes.

STATEMENT OF JOHN L. LIGON, POLICY ANALYST, CENTER FOR DATA ANALYSIS, THE HERITAGE FOUNDATION

Mr. LIGON. Good morning. My name is John Ligon, and I am a policy analyst in the Center for Data Analysis at The Heritage Foundation. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

I thank Chairman Scott Garrett, Ranking Member Carolyn Maloney, and the rest of the subcommittee for the opportunity to testify today. The focus of my testimony is that the Federal housing policies related to the Government-Sponsored Enterprises, Fannie Mae and Freddie Mac, have proven costly, not only to the Federal taxpayer but also to the broader financial system. We should recognize their failure and move toward a mortgage market without the distortions of GSEs.

Allow me to offer several observations. First, Fannie Mae and Freddie Mac are the ultimate guarantors of the U.S. mortgage market. Fannie and Freddie own or guarantee approximately half of all outstanding residential mortgages in the United States, including a share of subprime mortgages. Additionally, they finance about 60 percent of all new mortgages.

These GSEs fall within Federal conservatorship. Their combined agency debt, mortgage, and mortgage-related holdings are directly guaranteed by the Federal Government. Their level of debt is massive and has exploded over the last 40 years. In 1970, agency debt as a share of U.S. Treasury debt was 15 percent. And as of 2010, this share was 81 percent, a combined $7.5 trillion.

This brings me to my second observation. Fannie Mae and Freddie Mac have actually undermined the stability of the U.S. financial system. Beginning in the 1990s, Fannie and Freddie began relaxing credit standards for the mortgages they purchased. In 1995, the Department of Housing and Urban Development, HUD, established a target goal relating to the homeownership rate among low-income groups which was eventually set at 70 percent.

Then, in 1999, HUD directed Fannie Mae and Freddie Mac to further relax their requirement standards for purchased mortgage loans, including a move toward sub and non-prime loan approval.

Starting in 2000, there was yet a further easing of mortgage lending standards which stretched more broadly across the private mortgage system.

The erosion of lending standards spread throughout the U.S. mortgage market from 2000 to 2006, and severely weakened the quality of holdings in the GSE's portfolios since a sizable share of their mortgage back-holdings were securitized for non-prime loans.

The total level of non-prime loans in the U.S. mortgage market peaked at 48 percent of the overall market in 2006. Looked at from the perspective of homeowners, between 2002 and 2008, there was a $1.5 trillion increase in household debt attributable to existing homeowners borrowing against the increased value of their homes.

By 2009, aggregate household debt increased $9.4 trillion over the prior decade while home equity as a share of aggregate household wealth decreased from 62 percent to 35 percent from 2005.

As a result, 39 percent of new defaults on home mortgages occurred in households that had aggressively borrowed against the rising value of their homes.

This brings me to my third and final observation. Ending the present role of Fannie Mae and Freddie Mac would lead to a more stable housing market. After more than 3 decades of experience with boom-and-bust cycles, which have affected not only household income and wealth, but also financial markets, Federal policymakers should seriously reconsider the Federal Government's role in shaping housing policy through Government-Sponsored Enterprises.

These institutions distort the U.S. housing and mortgage markets at substantial risk to taxpayers and households.

Eliminating the present role Fannie Mae and Freddie Mac play would save taxpayers billions of dollars by eliminating the tax, regulatory, and debt subsidy that has held mortgage rates lower and induced U.S. households to take on more debt-related consumption; many of these households end up underwater.

In conclusion, Congress should consider beginning the process of winding down the GSEs and housing finance market and establish a market free from the distortions of this institutional arrangement.

Thank you for your time. I welcome your subsequent questions.

[The prepared statement of Mr. Ligon can be found on page 48 of the appendix.]

Chairman GARRETT. And I thank you.

Next, Mr. Rosner, author of "Reckless Endangerment." We appreciate you being on the panel. You are recognized for 5 minutes.

STATEMENT OF JOSHUA ROSNER, MANAGING DIRECTOR, GRAHAM FISHER & CO.

Mr. ROSNER. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee for inviting me to testify on this important subject.

In July 2001, I authored a paper entitled, "Housing in the New Millennium: A Home Without Equity is Just a Rental with Debt." The executive summary of that paper noted, "There are elements in place for the housing sector to continue to experience growth well above GDP." But I noted, "It appears that a large portion of the housing sector's growth in the 1990s came from the easing of the credit underwriting process. That easing included drastic reduction in minimum downpayments, focused effort to target the low-income borrower, changes in the appraisal process that have led to widespread over-appraisal, over valuation problems."

I concluded, "If these trends remain in place, it is likely that the home purchase boom of the past decade will continue unabated," but warned, "The virtuous cycle of increasing homeownership due to greater leverage has the potential to become a vicious cycle of lower home prices due to an accelerating rate of foreclosures."

In the mid-1990s, the GSEs were repurposed to direct social policy through the mortgage markets. The combination of using the

GSEs as tools of social policy and falling interest rates built the foundation of the housing bubble.

In early 1993, the Clinton Administration realized the GSEs could be used to drive capital investment for housing and community development and, as Susan Wachter noted in 2003, "The goal of Federal chartering of Fannie Mae and Freddie Mac is to achieve public policy objectives, including the promotion of nationwide homeownership through the purchase and securitization of mortgages."

She went on to note that, "Through lower mortgage and downpayment rates that would not prevail but for the presence of the GSEs, they expanded homeownership."

In 1994, the Administration set out to raise the homeownership rate from 65 to 70 percent by the year 2000 and recognized this can be done almost entirely off-budget through among others, Fannie Mae and Freddie Mac.

In 1994, the Administration created the national homeownership strategy with the goal of using the GSEs to provide low and no downpayment loans to low-income purchasers even those "the private mortgage market had deemed to be uncreditworthy."

Treasury Secretary Rubin recognized many of the risks associated with increasing lending to the most at-risk borrowers. Still, the Clinton Administration plans continued.

Reversing major trends, homeownership began to rise in 1995. In 1989, only 7 percent of home mortgages were made with debt less than 10 percent down. By 1999, that number reached 50 percent.

While the GSEs were certainly a key driver of these results, other government actions, including fraud and falling interest rates also fueled the expansion.

By increasing investor confidence in low and no downpayment mortgages, the GSEs seasoned the market, but they were surely not the only culprits.

In 2001, after much lobbying, the Basel Committee determined that private label securities should carry the same risk ratings as correspondingly rated GSE products. This action opened the floodgates to reckless, private label securitization of the most toxic mortgage products.

Banks and investment banks, which had sought to reduce their exposures to consumer lending, used their branch network and third-party lenders to originate loans to distribute through securitization.

By 2002, the private label securitization market was now at ease with changes made in 2000 by the GSEs which had expanded their purchase to include Alt-A and subprime mortgages as well as private label mortgage securities.

Private issuers aggressively targeted borrowers with lower downpayments, lower FICO scores, lower documentation, and higher debt-to-income and higher loan-to-value. PLS activity exploded.

Securitization rates skyrocketed. As the PLS market took off, investment banks and third-party originator partners created more and more risky products with the support of credit rating agencies, their absurd analysis and the CDO market.

For the first few years, the GSEs avoided direct competition with these lenders, but became the largest purchasers of private label securities. By 2007, interest-only, subprime, Alt-A, and negative amortization loans were 20 percent of the GSEs book of business.

By early 2006, it was clear that decreased funding for RMBS could set off a downward spiral in credit availability that could deprive individuals of homeownership and substantially hurt the U.S. economy.

Now, on the GSEs, there is nothing specifically wrong with the entities whose purpose it is to support liquidity in the secondary mortgage market. In fact, there is a substantial need for such a function.

The problem is the use of quasi-private institutions as tools of social policy to drive housing subsidies to markets through an off-balance sheet subsidy arbitraged by private market participants.

The GSEs were no longer merely supporting liquidity in the secondary market, as they had been created to do, their purchase of almost 25 percent of private label securities fostered distortive excess market liquidity.

Still, there is much to be lauded in the GSEs as they existed prior to the 1990s. Some of those features are still in place and provide value.

While there are proposals to replace the GSEs with alternatives, those seem to transfer many of the subsidies the GSEs receive to other private institutions. To merely replace GSEs will result in significant loss of value of their proprietary assets.

Understandably, the GSEs have become a politically charged subject, but it is important to remember they had previously been valuable tools of financial intermediation. Repairing their failures, seeking repayment of $140 billion owed to U.S. taxpayers, reducing risk to the taxpayer, eliminating implied guarantees, preventing their use as tools of social policy, eliminating investment portfolios and ensuring they provide backstop liquidity rather than excess liquidity is an achievable goal and would place them in their proper role as countercyclical buffers in support of private mortgage markets.

Thank you.

[The prepared statement of Mr. Rosner can be found on page 62 of the appendix.]

Chairman GARRETT. And I thank you for your testimony. Next, Dr. Wachter from the Institute for Urban Research, among other titles. You are recognized for 5 minutes.

STATEMENT OF SUSAN M. WACHTER, RICHARD B. WORLEY PROFESSOR OF FINANCIAL MANAGEMENT, PROFESSOR OF REAL ESTATE AND FINANCE, AND CO-DIRECTOR, INSTITUTE FOR URBAN RESEARCH, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

Ms. WACHTER. Thank you, Chairman Garrett, Ranking Member Maloney, and other distinguished members of the subcommittee. I am honored by the invitation to testify at today's hearing.

Government has, in policy, failed homeowners and taxpayers and it is important to understand why. The GSEs contributed to the meltdown. The direct cause of the crisis was the proliferation of poorly underwritten and risky mortgage products.

The most risky products were funded through private label securitization. We know now, but we did not know in real-time to what extent the shift towards unsound lending was occurring.

Non-traditional and aggressive mortgages such as teaser rate ARMs and interest-only mortgages proliferated in the years 2003 to 2006 changing from their role as niche products to become nearly 50 percent of the origination market at the height of the bubble.

In addition, the extent to which consolidated loan-to-value ratios increased through second liens was not then, nor is it known today. Non-agency, private label securitizers issued over 30 percent more mortgage-backed securities than the GSEs during these years.

As private label securitization expanded, leverage to these entities increased through financial derivatives and synthetics, such as CDO, CDO-squared, and CDS.

The amount of the increasing leverage introduced by the issuance of CDO, CDO-squared, and CDS was not known. The deterioration in the quality of the underlying mortgages was not known. The rise in prices enabled by the credit expansion masked the increase in credit risk.

If borrowers were having trouble with payments, which they were, homes could be sold and mortgages could be refinanced as long as prices were rising.

But after 2006, when prices peaked and started to decline, mortgage delinquencies, defaults, and foreclosures started their inevitable upward course.

In the panic of mid-2007, private label security-issuing entities imploded. The issuance of new private label securities went from $1 trillion to effectively zero.

The U.S. economy faced the real threat of a second Great Depression. The housing price decline of 30 percent, only now being reversed, was due to this dynamic: an unknown, unsourced, unidentified, unrecognized increase in leverage and deterioration in the quality of leverage.

As I stated, the GSEs contributed to the crisis. The GSEs were part of the irresponsible expansion of credit, but other entities securitized the riskiest products.

There is, in fact, a simple way to measure the failure of the GSEs relative to other entities. All we have to do is examine default rates. The GSE's delinquency rates were and are far below those of non-GSE securitized loans.

The distribution of mortgage failure is apparent in the performance of mortgages underlying securitization, as shown in Exhibit C, which I request be entered in the official record along with the other exhibits in my testimony.

Failure of the GSE-securitized loans was one-fifth or less of the failure of other entities' securitizations.

However, in a broad sense, the GSEs or their overseer had a larger responsibility, which they did fail to fulfill. The failure to identify credit and systemic risk in the markets in which they operated was at the heart of the financial crisis. No entity was looking out for the U.S. taxpayer.

We know from this crisis and from previous crises that markets do not self-correct in the absence of arbitrage, in the absence of security sales, pricing and trading of risk. For this, we must have market standardization and transparency.

This role is an essential requirement for effective markets and it requires a coordination platform for its realization. This need not be performed by the GSEs or their regulator, although such a role had been theirs in the stable decades before the crisis.

The role is a necessary one. We can rebuild a resilient housing finance system. We can provide an opportunity for sustainable homeownership for future Americans.

But, in order to do so, we must understand and correct the failures of the past. I thank you for the opportunity to testify today and I welcome your questions.

[The prepared statement of Dr. Wachter can be found on page 72 of the appendix.]

Chairman GARRETT. Thank you. Thank you for your testimony.

Dr. White, from our neck of the woods at NYU, you are welcomed to the panel and you are recognized now for 5 minutes.

STATEMENT OF LAWRENCE J. WHITE, PROFESSOR OF ECONOMICS, STERN SCHOOL OF BUSINESS, NEW YORK UNIVERSITY

Mr. WHITE. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. I appreciate the opportunity to testify today. I am pleased to be here on this important topic. My name is Lawrence J. White. I am a professor of economics at the NYU Stern School of Business.

As my statement makes clear, during 1986 to 1989, I was one of the Board Members of the Federal Home Loan Bank Board and, in that capacity I also served on the board of Freddie Mac.

When I left government service in August of 1989, I also left the board of Freddie Mac. Now, in the interest of full disclosure, I think I owe it to you to provide two more pieces of information.

In 1997, Freddie Mac asked me to write an article on the importance of capital for financial institutions. I wish they had listened more closely.

It was published in the journal that they published at the time, "Secondary Mortgage Markets." That article is available on my Web site, easily accessed. I am very proud of it. I said all the right things. I was paid $5,000 for that article.

In 2004, Fannie Mae asked me to come into their Wisconsin headquarters and talk to their advisory committee on the importance of capital. Again, I wish they had listened more closely.

I was paid $2,000 for that talk plus my transportation expenses. I flew coach class both ways between New York City and Washington, D.C. I took street-hail taxi cabs to and from the airports. Full disclosure, ladies and gentleman.

All right, I want to talk a little bit about the financial crisis. As Professor Wachter just indicated, in this process of housing prices going up sharply, for reasons that I don't fully understand, there was this boom. We now know it to have been a bubble. It started around 1997.

And, as Professor Wachter just said, in that context, mortgages—if you believe that housing prices are always going to go up, mortgages are not going to be a problem because even if a borrower loses his or her job, gets hit by a truck, or has a serious illness, he or she can always sell the house at a profit and satisfy the mortgage in that way.

Consequently, mortgage securities built on those mortgages are never going to be a problem. And, consequently, the traditional lending standards, the 20 percent downpayment, the good credit history, the adequate income, the adequate documentation; all of that goes out the window as well because mortgages are never going to be a problem.

At the time, as Professor Wachter just said, we didn't really understand these things, but looking back, you can understand why this happens.

Now, why people got into this mindset that housing prices would always go up, I don't really understand. That is not what we teach at the Stern School of Business. I am sure that is not what Professor Wachter and her colleagues teach at Wharton, but it was so.

Flip your house, all the books, all the television programs, they were real. Where were Fannie and Freddie in all this? They were special enterprises as you know. Unfortunately, among their specialness, they had inadequate capital.

They went into those lower quality mortgages somewhere in the mid-1990s, and may have been responsible for a little bit of the starting of the boom.

The boom went on primarily, as Professor Wachter just pointed out, because of the private sector expansion of the lower quality mortgages for the reasons I just described and their securitization.

Then, Fannie and Freddie do go more deeply into lower quality mortgages around 2003, 2004. There are just some striking diagrams, figures at the end of my testimony that show how from 2004 onward, those mortgages through 2008 are just different from what preceded them.

Unfortunately, all good things must come to an end. Bubbles will eventually burst. And, in 2006, prices started to go down. Those mortgages can't survive even a stable environment rather than—as well as a declining environment.

Foreclosures increase, the mortgage sector experiences losses, Fannie and Freddie, being inadequately capitalized, not enough capital, experience losses; Freddie for the first time in 2007, Fannie for the first time since 1985.

The losses are so severe in 2008 that they are put into conservatorship. The Treasury covers all their liabilities. At the time, I wasn't so sure. Looking back, I think this was a smart thing. It prevented the crisis from getting worse at the time.

But Lehman goes into bankruptcy 1 week later and, then, the thin capital levels across the financial sector really bite. There are two important lessons from all of this.

First, beware of implicit guarantees, which is what protected Fannie and Freddie. Beware of underpriced guarantees. Indeed, beware of guarantees more generally.

And, second, the importance of good, rigorous, vigorous, prudential regulation of systemic, large financial institutions with high capital requirements at their heart, terrifically important.

Thank you for the opportunity. I would be happy to respond to questions.

[The prepared statement of Dr. White can be found on page 79 of the appendix.]

Chairman GARRETT. Thank you for your testimony. Thank you for your clarification on your travel arrangements and what have you. I appreciate that as well for all the transparency. Would that always be the case. Thank you.

I now recognize myself for 5 minutes for questions. And just to start off with, I know Dr. Wachter made the comment that no entity was looking out for the U.S. taxpayer.

I will just give a little response to that by saying that, at least as the gentleman from California mentioned before, some people within this entity were attempting to look out for the U.S. taxpayers by putting some capital requirements and other requirements onto the GSEs, but we were stymied, as he indicated, across the aisle and in the Senate.

But I will start with Mr. Rosner. Can you go into a little bit more detail as to the effect of the lower underwriting standards, and maybe you can just play off of what Dr. Wachter said, that GSEs were part of the problem, but the default rate outside of the GSEs was higher?

What I heard there, and you can tell me if I am right or wrong, is that with lower underwriting standards, maybe you get the effect of, what, cherry-picking going on? Am I right or wrong? I will just throw it to you.

Mr. ROSNER. First of all, I think cherry-picking was a real issue for a very long time. The GSEs would cherry-pick both the private market and FHA for a long time. And that was one of the market complaints about the Enterprises for a long time.

I would also point out that definitionally where the market was—the private market was completely unfettered, the GSEs did, in fact, still have some statutory limitations upon them which constrained them somewhat.

That said, I think we have to also consider, as I said, the large impact that their purchases of private label securities had on the rest of the private label market because they were the bid in the market when you are buying 25 percent and you are adding comfort to the market.

In terms of the 2004 or the dating of the actual bubble, it is interesting to note that what we think of as the bubble is really 2004 onward. And, in reality, home prices peaked in the fourth quarter of 2004, the first quarter of 2005.

All of the activity that we saw—

Ms. WACHTER. That is not true.

Mr. WHITE. Case-Shiller—

Mr. ROSNER. The Case-Shiller—

Mr. WHITE. 2006.

Mr. ROSNER. If you look at the—I will show you the numbers.

Mr. WHITE. Okay.

Mr. ROSNER. Anyway, 40 percent of all—

Mr. WHITE. —two people can differ.

Mr. ROSNER. Forty percent of all home sales between 2004 and 2007 were essentially second homes and investment properties and the bulk of the rest of the remaining were refinancings.

So the push for homeownership—the goals of increasing homeownership really didn't have anything to do with the bubble—

Ms. WACHTER. Oh I see. I am sorry. You meant to say homeownership rates—

Mr. ROSNER. I am sorry. Right. I apologize. Homeownership rates—I am sorry.

Chairman GARRETT. Looks like we have three academics here.

Mr. WHITE. These two people can agree.

Mr. ROSNER. Peaked in the further quarter of 2004—

Ms. WACHTER. Right.

Mr. ROSNER. And so, all of the bubble period was really refinancing, second home, and investment property speculation. The GSE's purchase during those periods of large portions of private-label securities fostered that speculation and access liquidity unnecessarily.

And rampantly, I would also take a little bit of a disagreement with the notion that nobody was trying to ensure the safety and soundness. I remember very well—I was very involved in spending time in Washington at the time—a very weakened and hobbled regulator that was constantly neutered by Congress, constantly neutered by the Administration, constantly neutered by HUD performance goals, when it did try and take actions for safety and soundness.

Chairman GARRETT. Great. Thank you for that last point as well. Let me just move down the aisle there then. Mr. Ligon, so we have the subsidy for the GSEs. And the question is, who benefits, and who is hurt by it? We heard part of the explanation with regard to failure, the underwriting standards. But who actually—does the homeowner benefit directly, significantly from the subsidy, or are the other players; the investors, the executives over there, the homebuilders, the home sellers, that sort of thing? Who benefits and who is hurt by this?

Mr. LIGON. The subsidy to Fannie Mae and Freddie Mac, in particular, cost the taxpayer, in normal-market circumstances, anywhere between roughly $7 billion to $20 billion annually. Not all of that is going to be transferred down to the borrower. There is a portion that is retained by the shareholder. Some of it is retained down to the—or passed down to the borrower.

In terms of interest rate terms, probably anywhere between 7 basis points and 25 basis points of a subsidy to home borrowers.

Chairman GARRETT. Okay. So a small percentage, only of 25 basis point goes to the homebuyer—homebuyer. So the rest—

Mr. LIGON. —given the tradeoff—

Chairman GARRETT. At the same time, isn't what we are seeing here that the price of houses is going up? So I guess that benefits who, if the price of houses go up, the homebuyer or somebody else?

Mr. LIGON. If home prices are going up, that benefits the home buyers.

Chairman GARRETT. The buyers are paying a higher amount.

Mr. LIGON. Homebuyers, yes.

Chairman GARRETT. So wouldn't it be the home seller, and the builder, and the REALTOR®, and all those who benefit? So those parts of the complex are benefiting. But the homebuyer actually is put at a disadvantage, is he not, because his price is higher, and he is only getting a marginal benefit. Would that be fair to say?

Mr. LIGON. Yes, I would agree with that.

Chairman GARRETT. Thank you. And with that, I now yield to the gentlelady from New York for 5 minutes.

Mrs. MALONEY. Professor Wachter, could you elaborate on what would happen in the private market? Would the private market be able to, or would they assume the volume of business done by Fannie and Freddie? And what would the impact be on the 30-year mortgage loan, the cost of it? Would it be affordable? Could you elaborate on that?

Ms. WACHTER. Yes. Thank you for those questions. There are two questions. First of all, what would happen to the 30-year, fixed-rate mortgage in the absence of an entity that took on the role of Fannie and Freddie? And the answer is that there very likely would not be an option of a 30-year, fixed-rate mortgage.

Throughout the world, the adjustable-rate mortgage is in fact what prevails. There are only a few other economies with sustainable—of course, we did not have a sustainable mortgage system. But there are only a few other economies with a sustainable, fixed-rate mortgage as part of the mortgage system. And that includes Germany.

It is possible to have a 30-year, fixed-rate mortgage in a sustainable system. But in order to do so, there needs to be an entity that is overseeing and identifying risk. And other countries can give us some insight into this.

But a banking system alone, there is no banking system with a fixed-rate mortgage. Banking systems support the adjustable-rate mortgage, and for good reason. We had a crisis in this country, the savings-and-loan crisis, which occurred because commercial banks and S&Ls were putting into their portfolio 30-year, fixed-rate mortgages. That was not sustainable. It will not be sustainable going forward. Therefore, in order to protect American homeowners and taxpayers going forward, we need to replace Fannie and Freddie with other entities that will support the 30-year, fixed-rate mortgage.

Why is this? I think we can all agree the interest rates have nowhere to go but up. If interest rates go from where they are today, perhaps double, go from 3 percent to 6 percent, that is equivalent to doubling mortgage payments. We would then put mortgage borrowers in a payment shock, which could bring down the entire economy, if we were only in our mortgage book of nooses, if we were relying on adjustable-rate mortgages. Fortunately, we are not, we have not, and hopefully, we will not, going forward.

Mrs. MALONEY. Could you comment on whether or not you believe the private market can or would absorb the volume? You mentioned that they wouldn't for the 30-year mortgage. Would a 15-year or a 5-year be replaced?

Ms. WACHTER. I think that yes, it could very well be a 5-year. It could also be a 1-year, adjustable-rate mortgage. Of course, in any of those cases, it would be very subject to interest rate risk.

There is no possibility—I think industry experts will confirm this—for the trillions of dollars that are supported today by the

Fannie-Freddie entities to be taken over, at this point, by individual banking institutions.

There is no likelihood at this point of entities stepping up to do this. That doesn't mean that we can rely on Fannie and Freddie going forward. It means that we must have a path to an alternative going forward.

Mrs. MALONEY. Could you discuss the differences between the single-family portfolio and the multi-family portfolio? Do the single-family and multi-family books of business need to be treated in the same way or a different way? How would they be treated in reform, going forward?

Ms. WACHTER. Thank you. I apologize. We should note that the multi-family portfolio is doing quite well in both Fannie and Freddie. We should also note that the bipartisan commission has come out in support of the multi-family functions continuing with government support. This is their position.

There is a lack of clarity going forward as to whether multi-family and single-family should be supported by the same entity or a different entity, that is, whether they should be separate or not. There are arguments pro and con on that. But certainly, the need for information, for standards, and for monitoring is important on both the multi-family and the single-family.

And also, the issues of affordability are extremely important, not only on the single-family, but also on the multi-family, as rents continue to increase across America.

Mrs. MALONEY. Dr. White, can you name any country in the world that has a mortgage product like the 30-year, fixed-rate mortgage, that does not have some form of government support?

Mr. WHITE. International comparisons are not my strongest suit.

Mrs. MALONEY. So then, you agree with the professor?

Mr. WHITE. —on this. However, thank you for asking. First, despite the absence of securitization over the past few years, generally, the jumbo market, which isn't supported by any guarantee, has been able to support a 30-year fixed-rate mortgage.

Second, and Professor Wachter is certainly right, that too much 30-year paper in depository institutions is just a recipe for disaster. I can show you the scars from my almost 3 years on the Federal Home Loan Bank Board about that.

But there are large financial institutions. They are called "insurance companies," they are called "life insurance companies," they are called "pension funds," that have long-lived obligations that ought to be interested in matching those obligations with long-lived assets, 30-year fixed-rate mortgages.

And doing more things like helping deal with prepayment risk, and having reasonable prepayment fees in structure can help expand the market for 30-year, fixed-rate paper.

Chairman GARRETT. Great. Thank you very much for that answer. I will now turn to our vice chairman of the subcommittee, Mr. Hurt, who is recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman. Thank you again for holding this hearing. Obviously, it strikes me that as we try to figure out what the future of housing finance is, we need to understand the past. And the testimony here is very helpful.

It also strikes me that what I have heard, and what I have learned in studying this, is that clearly, relaxed underwriting policies contributed to the crisis. The implicit government guarantee, that contributed.

These are policies that come out of Washington and create, it strikes me, the moral hazard that leads to taxpayers being hurt, having to bail out these entities to the tune of $190 billion. And it also obviously hurts the homeowner and the marketplace generally.

And I guess my question is, as we look to the future—and I think that there are many on this panel, if not most, who would like to see the private sector come back into the secondary mortgage market. I guess as we look back over the history of this crisis—well, the history of housing finance over the last 10, 15 years, I guess my question would be directed to Mr. Ligon and Mr. Rosner.

What is the effect of the implied guarantee, and the relaxed underwriting standards? What effect has that had on the private marketplace? What is the effect of that?

And if the GSEs had behaved differently in entering the subprime mortgage market, would that have prevented—is there a theory that says that we could have avoided and prevented the crisis in 2008? I will start with Mr. Ligon.

Mr. LIGON. Most of those questions I will defer to Mr. Rosner. What I would say is to the extent that the guarantees had an effect on interest rates, there is research showing that there is little correlation between interest rates and prices.

So removing that subsidy shouldn't have a huge effect going forward on the housing market and the economy. On the other questions, I will defer to Mr. Rosner.

Mr. ROSNER. Yes. Look, I don't think that the crisis itself would necessarily have been avoided were it not for the GSEs. I think that they certainly accelerated, exacerbated the issues.

There were a lot of borrowers, though, who might not have qualified for a GSE loan in the first place, but were able to re-fi ahead of the crisis into one with appreciation, et cetera. And I think that does need to be considered, because that ends up also becoming the chance for further refinancing into riskier products down the road, which occurred.

I think that we are overcomplicating something which is quite simple. If there are borrower classes that we feel need to have a subsidy behind them, that is an acceptable—I think a rightful purpose of government. Do it on balance sheet.

That shouldn't be expected to be delivered through the markets, because definitionally, it ends up distorting an arbitrage. And by the way, the subsidies end up arbed away, not to the benefit of the borrower.

So I think that is one of the things we should consider. I think it was—look, there was a conflict. There was a perfect storm. There was the falling interest rates, was a reality of this, and a major backdrop of this. And it accelerated behaviors that otherwise might not have occurred, along with the implied government guarantee, and the push to expand homeownership beyond reasonable levels. And I think that is also very important.

The leverage that was in the system—and Professor Wachter is right—the leverage in the securities—which I wrote about extensively in 2006, warning we were going to have a CDO and MBS market meltdown that was going to bring the housing market with it—were part of it.

But also, the leverage of increasing homeownership rates in borrower classes that probably couldn't be sustained is something that, frankly, if you will see in the footnotes, Secretary Rubin warned about in, I think it was 1998, if the Administration pushed forward.

Mr. HURT. Got it. Thank you. I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back. The gentleman from California is recognized.

Mr. SHERMAN. I have a few preliminary comments. First, almost no one in this country saw, in 2007, where we would be in 2008. The few who did sold Countrywide stocks short, and they are billionaires.

Now, a few others had an inkling, had a fear, had some anxiety, maybe made a comment. But if you didn't bet your house on Countrywide going bankrupt, you weren't sure that this thing—I see Mr. Rosner believes otherwise.

I am applying this to only 99 percent. There may have been a few people who knew that we were headed for disaster, but didn't bet on it. I think there are one or two people who actually bet on this happening. And they are billionaires today.

Looking back on it, it is pretty obvious. I saw one of the most interesting charts, which shows median home price compared to median family income. And if you had looked at that chart on the first day of 2007, you would have sold your Countrywide stock short. But nobody—I didn't look at that then. I looked at it afterwards.

Everybody who bought mortgages in 2007 lost money, even if they were buying the primest of the prime, because even if you have the best underwriting standards in the world, some people get divorced, some people get ill, some people lose their job.

And in the real-estate market of 2006, that meant they sold their house at a big profit. The divorce lawyers fought over the profit, and the bank got paid. That same thing happens in 2010, and it is a short sale at best.

Next, we needed better prudential regulation of the GSEs. Mr. Royce pointed out that he had a bill.

I should point out that Richard Baker had a bill. We passed it through this committee. We passed it through this House. Chairman Oxley describes what happened to that bill. He says that it "got the digital salute from the White House." He has failed to inform us which digit.

And I am not saying that bill would have solved everything. Even those of us who voted for the bill didn't realize just how big a cliff we were headed off. But this House and this committee knew that we needed better prudential regulation.

I will disagree with our chairman on one criticism of Dodd-Frank, and that is, I don't think it was a rushed process. It certainly didn't seem rushed while I was in this room.

We haven't commented on the credit rating agencies. They are the ones that gave Triple-A to Alt-A. They got paid by the bond issuers. They gave the bonds that were being issued a very high rating. Dodd-Frank gives the SEC the tools and the mandate to do something about this. And the SEC, of course, hasn't.

There is a lot of comparison here of the GSEs to the private market. What is the ratio of the default rate of the private label versus the GSEs? I believe it was Dr. White, but it might have been Dr. Wachter, who said it was 5 to 1?

Ms. WACHTER. I have that in Exhibit 6. And I have the foreclosure rates for Fannie and Freddie, which were never higher than 2 percent. They are closer to 1—these are foreclosure rates—1 percent per quarter. Whereas, they were—

Mr. SHERMAN. One percent per quarter?

Ms. WACHTER. Per quarter. Whereas, they were 5 percent to 7 percent per quarter for private-label securities.

Mr. SHERMAN. Now, when you say "private label," that includes both the private subprime and the private prime?

Ms. WACHTER. Correct.

Mr. SHERMAN. Wow. So you have the private label doing a very bad job of underwriting. You have the private sector credit union—credit rating agencies—doing an extremely bad job of evaluating the risk. You have private investors and banks doing a terrible job of evaluating the risk, and buying these CDOs. And some of our biggest banks needed bailouts as a result.

And we are here to see why the GSEs didn't get it right. The whole world didn't get it right. I believe this is a question that has somewhat been answered. But not only do we have 30-year mortgages here in this country, but they are freely pre-payable.

If we didn't have those elements, 30-year, fixed—has my time expired?

Chairman GARRETT. Indeed, it has.

Mr. SHERMAN. Indeed, it has. I will submit additional questions for the record. Thank you.

Chairman GARRETT. We turn now to—and this may be the last question, depending on when votes are, before we come back from votes. The gentleman from Alabama is recognized for 5 minutes.

Mr. BACHUS. Thank you, Mr. Chairman. I would like unanimous consent to introduce a report that Chairman Frank and I called for in April of 2007, when we warned of the increasing foreclosures and the subprime lending. One thing we actually specifically asked for an investigation of, is what role has been played in the rise in subprime lending and risk-based loan practicing by alternative or exotic mortgages, including interest-only, high-loan-to-value, no documentation—

Chairman GARRETT. Without objection, it is so ordered.

Mr. BACHUS. Thank you. I yield my time to the gentlelady from Missouri, Mrs. Wagner.

Mrs. WAGNER. Thank you very much. I thank the gentleman from Alabama, for yielding his time.

Mr. Rosner, one of the things we have heard from Fannie and Freddie defenders since the crisis is that the GSEs were basically innocent bystanders, as underwriting standards deteriorated over the last couple of decades. And that in the mid-2000s, they were only trying to "catch up" with what the private sector was doing.

I know in your book, which we have spoken about, "Reckless Endangerment," you seem to refute that argument, saying in the prologue, "Fannie Mae led the way in relaxing loan underwriting standards, a shift that was quickly followed by private lenders."

Then in chapter 4, you describe Fannie Mae's 1994 trillion-dollar commitment to be "spent on affordable housing goals."

This was 14 years before the financial crisis and way before anyone had ever heard of NINJA, or Alt-A, or no-doc loans. I am just wondering, what came first here, the chicken or the egg? Were Fannie and Freddie the ones that led the charge to decrease underwriting standards, or were they innocent bystanders as things went haywire?

Mr. ROSNER. As you point out, they did lead the charge. And frankly, it is not just the easing of underwriting standards. I think it is very important to remember that it is easing of underwriting standards and reductions of downpayments.

And that is critically important, because the foreclosure rates would be significantly lower nationally if people had equity in their homes as home prices were falling. And the GSEs again, led the way to lower downpayments.

In fact, the subprime industry—I was on the sell side in the space for the 1990s. And there was a subprime industry. It disappeared in 1998 and 1999 because of the Russian debt crisis.

But at that point, subprime was defined by the borrower, not by the product. And for the most part, the borrower was self-employed, or had a ding in their credit history. But they were required to bring more equity to the table in terms of a downpayment to get the mortgage. So it really was the GSEs in the market. It really was the GSEs making the rest of the market comfortable with concepts of lower downpayments, eased underwriting standards, lending to borrowers who historically would not have met underwriting standards.

Remember, Beneficial and Household, two of the original subprime lenders in this country, which existed since the 1950s, were subprime lenders to non-traditional borrowers, but again, required significant amount of equities be brought to the table on those products.

We ended up with the GSEs offering low downpayment loans to lower and lower-quality borrowers.

Mrs. WAGNER. Let me ask you on that point, can you trace these activities of the GSEs back to the 1992 Act that created affordable housing goals for the GSE?

Mr. ROSNER. Yes. There is absolutely a piece of it that goes back to the 1992 Act in terms of affordable—in terms of the goals. But also in terms of the safety and soundness problems, and in terms of the cronyism that ultimately led to this, right?

Again, it is not even just the GSEs per se, in terms of the role, as a provider of liquidity—not excess liquidity, liquidity to the secondary mortgage market. It is the special ties to government that created all of the perversions that ensued.

Mrs. WAGNER. We had Ed Pinto here from AEI who spoke with us in the past week. And he noted in a post-crisis study that in

1990, 1 in 200 mortgages in the United States had downpayments of less than 3 percent. In 1999, that number was 1 in 10. And by 2006, that number was 1 in 2.5 downpayments of 3 percent. That is a dramatic increase in borrowing throughout the financial system.

What role did GSEs play in increasing borrower leverage, and how did that cause or exacerbate this crisis? And I know our time is limited.

Mr. ROSNER. Again, the GSEs did lead the way in lowering downpayment. That was one of the concerns that I really highlighted in the 2001 report, "Home Without Equity is a Rental with Debt," and one of the reasons that it became clear that we were going for an increasing leveraged system.

And while that posed opportunities for growth well in excess of GDP, it ultimately would come at the risk of a vicious spiral downward in home prices on the other side.

Mrs. WAGNER. I thank you.

Chairman GARRETT. The gentlelady yields back. The gentlelady from Wisconsin, Ms. Moore, is now recognized for 5 minutes.

Ms. MOORE. Thank you, Mr. Chairman. I believe my colleague, Mrs. Wagner, had a very interesting line of questioning. And I guess I would like to follow up on that. She asked you if the—first of all, let me back up and say that I am a little distressed about the name of this hearing, "Fannie Mae and Freddie Mac: How Government Housing Policy Failed Homeowners and Taxpayers and Led to the Financial Crisis."

Would I be wrong to say that it is just government housing policy that led to the financial crisis, and that there are no other bad actors out there in the private sector? Is this a misleading title for this hearing? Maybe I will ask Dr. Wachter and Mr. White that question. Just yes or no?

Chairman GARRETT. —or gentlelady, is this a rose by any other name?

Ms. MOORE. Is that misleading? Are we just to assume that it is government housing policy and the GSEs that led to the meltdown Is that—

Ms. WACHTER. I don't think there is anybody on this panel who would agree that it is Fannie and Freddie Mac who are the primary cause of the meltdown.

Ms. MOORE. Okay. All right. Good. Thank you.

Mr. WHITE. Can I add something?

Ms. MOORE. Yes, Dr. White.

Mr. WHITE. Again, we have this bubble. The bubble bursts. If you look at the value of mortgages in 2006, and the value of mortgages in 2012, there was about a $7 trillion meltdown. Nobody likes $7 trillion of loss. But that turns out to be roughly the same amount as the tech bubble bursting.

Ms. MOORE. All right. I am reclaiming my time, because I will give you another chance to answer some other questions. I guess the point that I am making is that we are talking about government housing policies that led to this problem.

Did the government—did the GSEs have anything to do with the faulty appraisals, the criminal appraisals, I would say, that were involved in the meltdown? Did they actually underwrite these loans where people didn't bring in—these NINJA loans? Did the GSEs give Triple-A ratings to these mortgage-backed securities, and CDS's?

I am not trying to say that the GSEs are totally innocent here, but I guess what I am saying is, are there no other bad actors here other than the government policy that said that you ought to try to give more loans to low- and moderate-income borrowers?

And by the way, that suggestion may have come about to the historians of the panel, because we found, as in the case of Milwaukee, Wisconsin, that there were a lot of moderate-income people, minorities, who qualified for loans, who were given subprime loans simply because they were Black or Hispanic, and led into higher, riskier loans because of that kind of prejudice.

So were the government policies—there are plenty of good loans out there if you would give them an opportunity. So I guess I want to hear what Dr. White and Dr. Wachter say about that.

Mr. WHITE. All right. As I had said earlier, once you are in this mindset of housing prices are always going to go up, then deterioration of underwriting standards, along with all those sorts of things that—

Ms. MOORE. But did the GSEs cause deterioration?

Mr. WHITE. They are part of it, but they are not the whole story. The other part is the extent to which there were households who were defrauded, put into inappropriate loans. I am going to have to use a technical term in economics here. The people who were responsible ought to burn in hell.

Ms. MOORE. And it is right, because—I sort of resent the implication that it was low-income Black people, and so on, that—and trying to serve good borrowers. And the GSEs that caused the problem, that there were no other bad actors in the private underwriting, and appraisal, and—

Dr. Wachter, take the last 10 seconds.

Ms. WACHTER. It was definitely not the Community Reinvestment Act. It was not affordable housing goals that created this crisis.

I think—and I think Dr. White and Mr. Rosner will agree with me—homeownership, as Mr. Rosner pointed out, peaked in 2004. Minority homeownership peaked in 2004, and low-income homeownership peaked in 2004.

The worst years of the crisis were after that: 2004; 2005; and 2006. This was not about support for low-income homeownership. This was not about support for undoing the years of discrimination against minorities where household wealth could be built up in sustainable homeownership.

This was not the Community Reinvestment Act, which was a 1990s phenomenon. This was not affordable housing goals. I think what we heard from Mr. Rosner and Dr. White is that there was some kind of "in the ether" change that allowed the private sector to take these concepts well.

Indeed, the private sector did take these concepts, and they did in fact lead to FHA going from a market share of, what, about 10 percent to 3 percent, squeezing FHA down to 3 percent. And also, Fannie and Freddie lost their market share as well in this period.

Ms. MOORE. Mr. Chairman, thank you for your indulgence.

Chairman GARRETT. The gentlelady yields back. The gentleman from Texas is recognized.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Just kind of a follow-up here. There was some question about the title of this hearing. It says, "Fannie Mae and Freddie Mac: How Government Housing Policy Failed Homeowners and Taxpayers and Led to the Financial Crisis."

Mr. Ligon, is that a fair assessment?

Mr. LIGON. It is a very fair assessment. Without Fannie and Freddie, it is entirely likely that the vast expansion of mortgage finance could not have taken place. GSEs were always backed by the Federal Government.

And they have continued to extend their mortgage holdings at all quality levels, including a dangerous increase in risky holdings. That entirely weakened the entire financial position. And that, in turn, required even more government support, and at the end of the day, a substantial amount of taxpayer—

Mr. NEUGEBAUER. Thank you. I don't mean to cut you off. I have a couple of questions.

Mr. Rosner, just your reflection on the title of the hearing?

Mr. ROSNER. Again, I think the GSEs are really seizing the market. I think while we could say that they didn't make the worst loans, I think it is sort of disingenuous to suggest that their purchase of large portions of the private label market were meaningless and had no impact on the market.

Mr. NEUGEBAUER. In fact, it validated it. Isn't that correct?

Mr. ROSNER. That is exactly right.

Mr. NEUGEBAUER. Yes, it was a validation. While they are not a rating agency, the fact that they would buy that paper, and they were AAA-rated, was a validation. They thought that was a legitimate—

Mr. ROSNER. And I think that is a point, when it was raised before, they were, in fact, putting their AAA rating on these securities through the purchase.

Mr. NEUGEBAUER. And they were actually buying paper that they couldn't actually underwrite themselves.

Mr. ROSNER. Right. And to be fair in that regard, had they been kept to their original goal of having portfolios only for liquidity purposes rather than speculative purposes, the impacts would have been greatly diminished.

Mr. NEUGEBAUER. I want to move to another topic here because I think one of my colleagues mentioned that we need to talk about moving forward. And moving forward, housing finance is an important part of our economy. Financing is an important part of our economy. We finance cars, we finance houses, we finance small businesses.

Not all of those transactions have to have a Federal nexus to be completed in the marketplace. And so moving forward, there are a number of plans out there that folks are bringing and I am glad to see all of the people who have a stake in this bringing these proposals forward. We welcome those.

From your perspective, is there a necessity for a Federal nexus in housing finance across-the-board in this country?

Mr. ROSNER. Across-the-board, as in, outside of very defined borrower classes explicitly done by the government?

Mr. NEUGEBAUER. Yes.

Mr. ROSNER. Other than potentially as a well pricing, monoline insurer, no.

Mr. NEUGEBAUER. Because one of the things I find since I have been to Congress is that government doesn't know how to price risk. We have a flood insurance program that is underwater. No pun intended. We just heard a report the other day that FHA is now underwater because they have not been pricing.

And so the question is, if we have a structure there, how can we be assured that government is getting compensated for that risk?

Mr. ROSNER. Especially when government policy, more broadly in this area relative to any other area of lending that the government supports, incents leverage more than equity. And so part of the reason for a 30-year mortgage, or part of the value and part of the reason that we saw it distorted in this crisis, was the mortgage interest deduction, the ability to maximize leverage.

And so we are still not thinking in terms of any of the proposals that are out there. How do we help borrowers go back to the traditional notion of home-ownership where, at about the age of household formation, you take out a mortgage. Thirty years later at about the age of retirement, you have a mortgage burning party and you retire with what is your single largest retirement—wealth transfer asset.

That is the proper role and that is what conveyed all of the social benefits of homeownership. Housing policies have been, in the past 15 years, inverted against that.

Mr. NEUGEBAUER. And I think you make an extremely good point there. I have been in the housing business for a number of years. We encourage people for homeownership. It is a way of saving for the future, building a nest egg.

But what we want to make sure is that we are not creating, as I said in my opening statement, these policies where it blows up and a lot of these people who just got to retirement found out that instead of having equity in their house, or that they were going to have a greater asset value, their nest egg actually shrank because of the housing policy.

And so what we want is a sustainable housing market and a sustainable housing finance system in this country.

Thank you, and I yield back, Mr. Chairman.

Chairman GARRETT. The gentleman yields back. The last panelist will be the gentleman from Colorado and then, after that, we will go into recess. And we will be back in at noon.

Mr. Perlmutter?

Mr. PERLMUTTER. I want to thank the chairman and the panel for this hearing today, for livening up what is a rather gray and gloomy day outside. And I really do appreciate the chairman bringing this because it always gets my blood going.

Because a crash on Wall Street, the failure of Fannie Mae and Freddie Mac, an abysmal response to Hurricane Katrina, and a misguided war in Iraq have one thing in common: the Bush Administration.

And it is no coincidence that Fannie Mae and Freddie Mac did well before the Bush Administration and are making billions of dollars now. It was the abuse and misuse of Fannie Mae and Freddie Mac by the Bush Administration that led to the failure of the housing market.

So the title to today's hearing should be, "Fannie Mae and Freddie Mac: How the Bush Administration Housing Policy Failed Homeowners and Taxpayers and Led to the Financial Crisis." And this is what I really appreciate, Mr. Chairman.

I never thought I was going to get a chance to read the article which quotes a former chairman of the committee, Mr. Oxley. But on September 9, 2008, Chairman Oxley was interviewed by the Financial Times.

He was upset, and he said, "The dominant theme has been that Congress let the Government-Sponsored Enterprises morph into a creature that eventually threatened the U.S. financial system. Mike Oxley will have none of it.

"Instead, the Ohio Republican who headed the House Financial Services Committee until his retirement after midterm elections last year blames the mess on ideologues within the White House as well as Alan Greenspan, former Chairman of the Federal Reserve.

"Oxley fumes about the criticism of his House colleagues that they didn't do anything. He says, 'All the hand-wringing and bedwetting is going on without remembering how the House stepped up on this to reform the GSEs.' He says, 'What did we get from the White House? We got a one-finger salute.'"

So this is a situation. And Professor White, I was looking—or maybe it was Professor Wachter's report, but there is an Exhibit A to somebody's report.

Ms. WACHTER. Mine, yes.

Mr. PERLMUTTER. Which definitely shows the bulge in purchases that were made between 2004 and 2007, which is when the no doc loans and the no downpayment loans were purchased and proliferated across the country.

And it was in this period of time, it wasn't during the Clinton Administration, it wasn't during the prior Bush Administration, it wasn't during the Reagan Administration that we had this; it was just in this period of time.

So Dr. Wachter, I have made a lot of statements because I just feel like there was been a lot of revisionist history going on here. This is an abuse of Fannie Mae and Freddie Mac during this period of time that I think led to what became a big housing crash and a crash on Wall Street.

How do you respond to that?

Ms. WACHTER. Let me describe exhibit A. It shows almost perfect correlation between the market share of non-traditional mortgage products and private label securitization. It shows that these doubled in the years 2003 through 2007.

It shows that they were at very moderate and very low levels from 1990. Non-traditional mortgages, from 1990 through 2000, were niche products. In 2002, 2003, and 2004 is when, starting in December of 2003, when these non-traditional, very risky products gained market share, along with private label securities—

Mr. PERLMUTTER. And I want to jump on something Dr. White said. There was a belief, or at least a sales job, that housing prices only go up.

And in this period of time, and one of the reasons we have not placed Fannie Mae and Freddie Mac into liquidation, we have just placed them in a conservatorship, is because we repatriated a lot of money from China, from Saudi Arabia, and from Europe by, in effect, selling Fannie Mae and Freddie Mac bonds on the premise that housing prices only go up.

Are you familiar with that at all?

Mr. WHITE. I know that there were substantial non-U.S. purchases, central banks of other countries, important financial institutions buying the Fannie and Freddie obligations.

That indeed was one of the contributing factors to the Treasury's decision to put them into conservatorship rather than a receivership, something that might involve liquidation. They needed to provide the reassurance to the non-U.S. purchasers that they were going to be kept whole. That is correct.

Mr. PERLMUTTER. Thank you. And I would ask to put the article from September 9, 2008, into the record, Mr. Chairman.

Chairman GARRETT. Actually, I think that may have been done once already during this hearing. I assume it will be brought up repeatedly. And so, without objection, and also, before the gentleman from Colorado leaves—

Mr. PERLMUTTER. Yes, sir.

Chairman GARRETT. —without objection, I would also—since you are the only person here who could object—like to put into the record a statement from HUD's affordable housing goals during not Bush's Administration but during the Clinton Administration.

And I will share it with you before I put it in the record—which says, "Because the GSEs have a funding advantage over other market participants, they have the ability to under-price their competitors and increase their market share.

"This advantage could allow the GSEs to eventually play a significant role in the subprime market and the line, therefore, between what today is considered a subprime loan versus a prime loan will likely deteriorate, making expansion by the GSEs look more like an increase in the prime market.

"So the difference between the prime and the subprime market will become less clear. And this melding of markets will occur even if many of the underlying characteristics of the subprime borrowers in the markets, i.e., non-GSEs, evaluation of the risk posed by these borrowers remains unchanged."

Again, this was during the Clinton Administration in the year 2000 by HUD's affordable lending goals.

Mr. PERLMUTTER. And to my friend, the chairman, I have no objection to the introduction, just the conclusions you draw from these things.

Chairman GARRETT. I am just reading what they said back in 2000. So with that, the committee stands in recess and, again, we will try to reconvene right at noon.

[recess]

Chairman GARRETT. The committee will reconvene at this point and I thank the Members for coming back so promptly.

Before we proceed, without objection, I ask unanimous consent to enter into the record a letter from the National Association of Federal Credit Unions with regard to today's hearing.

Without objection, it is so ordered.

We will now turn to the gentleman from California, Mr. Royce, for 5 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

Let me start with Mr. Rosner with a point here, nobody has pointed out that if the GSEs were not playing in the market during 2004 and 2007, they would have been able to provide liquidity to the market as they are chartered to do in the aftermath.

So in a way, this was so countercyclical by moving to a position where they were leveraged 100 to 1, $1.7 trillion or so in the portfolios.

You had a situation where it was almost guaranteed and this was the fear of the Fed, because I remember the chairman conveying this to us, that if it started in the housing market, it would collapse the financial system. This is why they wanted regulation for systemic risk.

But the other aspect of this that I think nobody attributed to it at the time, and I wanted to ask you about now, is that—so instead, when everything collapses, they then have no capital, they then back away because of insolvency, so it is also the other side of that coin that hits us at exactly that moment.

Could you comment on that?

Mr. ROSNER. Absolutely. I totally agree and that is one of the areas of failing that I think needs to be considered. It is under-considered and as we think about ways forward, which I think is very important, we need to make sure that whatever we replace them with is able to be countercyclical rather than procyclical and has the capital base to do exactly that or provide the functions of providing liquidity to the secondary mortgage market at the time that the market needs it because they did not provide excess liquidity; they underpriced that liquidity and put themselves at risk.

Mr. ROYCE. Let me also make another observation because I think your analysis has been the most inclusive of any that I have seen, including your explanation of the Basal standards and how that also contributed to this.

The one element of this that I think we haven't spent enough emphasis on because I do think that the setting of interest rates by the central bank at negative real interest rates 4 years running helped create the bubble to begin with. But what was so unusual here was that we set in place a moral hazard situation with the GSEs like no other.

Other countries had the same problem because their Fed had followed—Ben Bernanke was then head of the New York Fed,—I went through the minutes at the time because we were arguing that the interest rate was set too low and that was his initiative, he pushed that and I think he got that very wrong.

But what really compounded this was the GSEs; that collapsed the entire housing market, but on top of it, the GSE's instruments, oddly enough, were also used for capital, essentially by the banking systems.

So maybe you could comment on that and my thoughts about those negative real interest rates which ran for that 4-year cycle and the role that played.

Mr. ROSNER. Obviously, that was one of the key drivers of that 2004 to 2007 period, because at a point where homeownership had already peaked, we saw the industry, both the GSEs and private players, have every incentive to get every last drop of juice that they could out of the system, squeezing it for refinancing, for speculative purchase of second homes and investment properties, frankly to the ultimate determent of the public.

None of those features are likely to occur anytime soon—the negative interest rate issue—in a going-forward system. But I do think that it speaks to the need for us to consider whether private enterprises securities should considered capital for the banking system because it also complicated the resolution, both of the banks that needed to be resolved and of the enterprise.

Mr. ROYCE. Let me make one last point, and that was one of the things that impressed me about your work was that you were the first to recognize the accounting problems of the GSEs, at least as far as I recall, and you were the first to identify the peak that we hit. Ideas do have consequences and for the members here, I would really suggest a re-read of your testimony about the—how these different factors came together to create the crisis because going forward, we are going to have to do a lot of—we are going to have to overcompensate in terms of—it is going to take us a long time to get out of this because everything is overleveraged now and deleveraging is a very painful thing for societies to go through.

But we have to learn the lessons in retrospect and that is why I think this hearing is so important.

Mr. Chairman, thank you.

I yield back.

Chairman GARRETT. The gentleman yields back. Thank you.

Mr. Scott from Georgia is recognized for 5 minutes.

Mr. SCOTT. I thank the chairman.

I stated my concern and great worry about this whole issue in my opening statement. But last year in this very committee, we witnessed a strategy whereby the majority of some of our Republican friends attempted to pass piecemeal legislation to accelerate the dismantling of the GSEs without clearly identifying what should replace it. What is the alternative? And this is especially true. I don't think sometimes we gather the magnitude of what we are talking about here.

These GSEs, Fannie and Freddie, accounted for 90 percent of the new mortgages in the last recordable year, I think around 2008. That is a significant void, and I just think it is the height of irresponsibility for us to do this without some good discussion as to what is going to take its place? Should anything take its place? What impact will this have? We can talk about the bad things about Fannie and Freddie all we want, but still, that void is out there.

And so I would like to ask this panel if each of you might be able to comment, especially you, Dr. Wachter, because I believe you hit the nail on the head, that should Congress even begin to consider the future of our housing finance without first taking a look to see what this would look like before we throw the baby out with the bath.

What are the consequences of moving ahead without giving any thought to what will take the place of this gigantic void? Would you comment on that, Dr. Wachter? Because I think you were right when you said and raised doubts, everybody says the private sector is not going to be able to accomplish this. And those 30-year mortgages that you talk about will not continue to be affordable.

So could we put some attention on this issue? What are we going to do?

Ms. WACHTER. I think the private sector itself would agree that they, at this point, could not step in to replace Fannie, Freddie, and FHA, which you are quite correct are 90 percent of the market.

What we must do is set up a—we must move to a consensus where there is a coordinated platform, an understood way of going forward, we can't simply just dismantle Fannie and Freddie. If we did, that would lead to the destruction of the recovery. It would turn the recovery it into a disaster again, housing prices would plummet, bringing down financial sector—causing systemic risk and this time, we are out of solutions. So it would be Great Depression 2.0 if we simply withdrew Fannie and Freddie and FHA without an alternative in place.

Mr. SCOTT. And what might that alternative be? Is there an alternative that can take the place of Fannie and Freddie?

Ms. WACHTER. There is no alternative today, however, there are beginnings of discussions of, and we have heard some allusions on this panel, to some alternatives.

Mr. Rosner suggests a monoline-government backstopped and that is a one possibility. The New York Fed has a utility approach. The bipartisan commission has come out with an insurance approach with again, a government backstop. I think it is quite similar to the proposal that Larry White and his team have come out with.

So there are a number of alternatives and I think this first step is necessary is to build a consensus on the pros and cons of these alternatives before we think of dismantling the system which is keeping our economy afloat.

Mr. SCOTT. Mr. Ligon from the Heritage Foundation, do you concur with what she just said?

Mr. LIGON. Any redesign of the mortgage market must enforce competition between mortgage originations and the securitization and also ensure property capital requirements for all forms involved.

I think a big problem of what we have right now is that a lot of the stuff is off balance and that there is a huge finance subsidy to Fannie Mae and Freddie Mac doing business. So—

Mr. SCOTT. But beyond that, you do agree that: one, the private market cannot fill this void alone; and two, we do need to replace it with something.

Mr. LIGON. No, I don't agree with that. I think that the private market—there—you can make an argument that the private market is crowded out right now because of Fannie Mae and Freddie Mac and what they are doing.

So to say that the private market couldn't step in or wouldn't step in is not necessarily the way I would put it.

Mr. SCOTT. All right, thank you, Mr. Ligon.

Ms. WACHTER. If I may, I—

Chairman GARRETT. The gentleman's time has expired—

Ms. WACHTER. —is the private market itself would agree that they would step in or could step in.

Chairman GARRETT. Okay.

Mr. Mulvaney is recognized for 5 minutes.

Mr. MULVANEY. Thank you, Mr. Chairman.

Ordinarily, I sort of ignore the political blame game in these meetings, but since my colleague from Colorado, who is now no longer with us, was so effusive in his praise of the Bush Administration, in an attempt to sort of bring a balanced approach, Mr. Rosner, let me ask you a couple of quick questions. Who is James Johnson?

Mr. ROSNER. The former Chairman of Fannie Mae.

Mr. MULVANEY. Did he have any political ties?

Mr. ROSNER. Significant political ties.

Mr. MULVANEY. With who?

Mr. ROSNER. Both to the—well to Mondale, to the Clinton Administration, and frankly to most of Congress.

Mr. MULVANEY. And I think he advised the Kerry Administration or the Kerry political candidate?

Mr. ROSNER. Absolutely.

Mr. MULVANEY. Who is Franklin Delano Raines?

Mr. ROSNER. The former OMB Director who was also Chairman of Fannie Mae.

Mr. MULVANEY. So, between 1991 and 2005, those were the two CEOs of Fannie Mae, right?

Mr. ROSNER. Correct.

Mr. MULVANEY. Did Mr. Raines have any political connections?

Mr. ROSNER. Absolutely.

Mr. MULVANEY. With what Administration is he most—

Mr. ROSNER. The Clinton Administration.

Mr. MULVANEY. Thank you very much. So I think there is probably plenty of blame to go around. Let's talk about what actually happened, because I was reading Dr. Wachter's testimony. She talked about the fact that the amount of increasing leverage introduced by the issuers of CDO, CDO-squared CDs was not known. Also, the deterioration of the quality of the mortgages used as collateral for these securities was not known. Is it so much they didn't know or they didn't care? Mr. Rosner?

Mr. ROSNER. First of all, it was known.

Mr. MULVANEY. Okay.

Mr. ROSNER. The degree wasn't known, and this goes to a point that I think was raised by Representative Scott, which I would like to point out. Look, there are two separate issues here involving the private market and the GSEs. We need to fix securitization. Private label securitization, investors did not have adequate information about the underlying collateral in the pools. There was no standardization of reps. There was no standardization of policing of servicing agreements. That needs to happen before you can ever have the private markets come back in any meaningful way.

I have been writing about this, screaming about this since 2006, and it is vitally important if we hope to have the private markets come back.

Mr. MULVANEY. But to a certain extent, isn't it true that I don't care about the risks if there is an implicit government guarantee of the underlying collateral?

Mr. ROSNER. I think there is a whole host of issues. So, yes that is true, but it is also true that if you are an investment grade chartered investor, you have the ability to say at almost—you are almost implored into the view that if I am—if I buy this and it fails, I won't get in trouble because everyone else ended up in this trade. And if I miss out on the outside returns of buying this highly risky AAA or AA rated security, I will get pegged by my investors.

There was also herd behavior that occurred. So, yes I think you are right that you don't care as much, but I think there are a number of reasons for that.

Mr. MULVANEY. Dr. Wachter, you go on to talk later in your testimony about—that we know from this crisis and from previous crises that markets do not sell correctly in the absence of arbitrage, that is, in the absence of markets in which securities sales can't price and trade risk. Would you at least agree with me that implicit government guarantee contributed to that lack of ability to price risk? There was no risk in this market, was there?

Ms. WACHTER. Yes, there was. There are private label securities, and private label securities were held in portfolio. AIG, for example, was creating CDS and those were held in portfolio, Lehman and other entities were heavily held private label securities, and they went under. The majority of riskiest mortgages were held by private entities, and they needed to be rescued by government. So the question of who cared and who knew is a very difficult question, if I may go back to that.

Some people did know and they didn't care, in part because they were making a lot of fees. And I think that we totally agree on that, and your point being that Fannie and Freddie had implicit subsidies, but these were not subsidies that were an implicit guarantee. This implicit guarantee was not used for the most poorly underwritten, the riskiest mortgages that ended up defaulting at a 30 percent rate.

Mr. MULVANEY. Mr. Ligon, let's talk a little bit about who benefited from these policies. I enjoyed your testimony, and I am trying to get a feel for the distribution of benefit. We spent a lot of money on this, the taxpayers did, over the course of the last several years. If you look back to the beginning of the—let's say the Johnson Administration to the early 1990's, who benefited most from the policies that this government put forward? The shareholders and the officers of Fannie Mae and Freddie Mac, taxpayers, or homeowners?

Mr. LIGON. I am not sure how exactly to comment on that. I don't know a lot about the profits and the upsides to—

Mr. MULVANEY. Mr. Rosner, did you—

Mr. ROSNER. Yes, absolutely, it was the management of the company. It was the shareholders who had the good fortune to own it at the right time. And in retrospect, it certainly wasn't many of the homeowners who ended up trapped in homes that they couldn't afford. Again, I think it is to some degree helpful to remember that none of these issues are necessarily implicit to the purpose of a government-sponsored entity, to provide liquidity to the secondary mortgage market, as much as it is a problem with the way they were distorted, manipulated, moved and ultimately run.

Mr. MULVANEY. Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman yields back. And we are cognizant of the fact that may happen if a new system is created, and allow for those problems to occur again. Mr. Peters is now recognized for 5 minutes.

Mr. PETERS. Thank you, Mr. Chairman, and I ask unanimous consent to enter into the record a letter from the National Association of Federal Credit Unions, and also the report from the Bipartisan Policy Center entitled, "Housing America's Future: New Directions for National Policy."

Chairman GARRETT. Without objection, it is so ordered.

Mr. PETERS. Thank you, Mr. Chairman. And I would like to reference briefly the report from the Bipartisan Policy Center, which I have just entered into the record. They released the report last week, and it made some recommendations on the future. I want to focus on the future of housing finance. And the report was adopted by what I think was a very impressive list of bipartisan folks, former Senators, Governors, Cabinet Secretaries, and others who called for the future of the mortgage market, and for there to be a diminished role of government in that mortgage market, nevertheless to be some role for the government in stabilizing it.

I would just like to ask a question of each of the panelists, if we could start with Mr. Ligon. Do you see any role for government in the mortgage market? And if so, what role do you see government playing in housing finance 10 years from now?

Mr. LIGON. To the extent that there is a role for the Federal Government in housing policy and subsidizing housing and homeownership, it should be much smaller in scale, and very minimal.

Mr. PETERS. What would it be?

Mr. LIGON. Definitely not guaranteeing loans through Fannie Mae and Freddie Mac, or an institution like the GSEs.

Mr. PETERS. Mr. Rosner?

Mr. ROSNER. Going forward, the government's role should be explicitly backstopping those segments of the market that all of you decide should be backstopped. And that private be private. That it be a fully private—whether it is the GSEs and they survive, or otherwise. There needs to be a function to provide—or provide a backstop of liquidity to the secondary mortgage market, and I think that is important. But it needs to be fully private with no implicit or explicit government guarantee, so that markets can price effectively.

And to the degree that there is any government role, it should be more along the lines of the VA loan program, where you define a borrower class and the government provides direct subsidies, and let the markets price private risk privately without government interference.

Mr. PETERS. Dr. Wachter?

Ms. WACHTER. There needs to be a role for government or a government-like entity in documenting risk. As we have heard from others, the problem of mispricing of risk was really a base cause of the problem. The underpricing of risk occurred across-the-board. But in any case, we did not have documentation of the creation of credit risk either of the private label securitization or indeed Fannie/Freddie's loans to the degree that second liens were not understood. The loan to value ratios increasing was not known, not recognized, not understood. So that role of documentation of risk is number one.

Number two, at this point, I think there is no doubt that there needs to be a government backstop, that needs to be explicitly priced. Number three, there needs to be private capital at risk and overseeing that market, setting up a platform to bring these parties together has to be the role of a cooperative utility and the government has to have an accountability behind this to make sure that the data standards are in fact in place.

We can over time move to a system where there is a utility approach where the government is stepping back. That could happen. But for now, I think it is quite clear that we absolutely need a government guarantee in place, even though hopefully we can bring more private capital at risk over time.

Mr. PETERS. Dr. White?

Mr. WHITE. There is, I think, a fair degree of agreement here. First, for sure, an FHA that is focused on low- and moderate-income households sees it as its mission on budget, and expected that there is going to be a subsidy element to pursue this socially worthwhile effort of encouraging low- and moderate-income households who are close to the edge of, "Do I buy? Do I rent?" to become homeowners. It is absolutely worthwhile.

In the current housing environment, with a lot of uncertainty, there does still need to be a government element, but over the longer run, I believe that the private sector is capable. Again, we have to make sure that the natural buyers of long-life paper, like insurance companies, like pension funds, are not discouraged from doing that. And again, I think prepayment fees have to be part of the story. I think the private sector, some expansion by depositories, a lot more expansion by insurance companies and pension funds.

I think that there can be a largely private, focused FHA on low- and moderate-income households, and the Fed will always be there as a backstop if things really do fall apart, as we have seen. The Fed is ready to step in and buy more mortgage securities. I think that kind of system is what the long run looks like.

Chairman GARRETT. I thank the gentleman and the gentleman yields back. The gentleman from Illinois is recognized for 5 minutes.

Mr. HULTGREN. Thank you, Chairman Garrett. Thank you all for being here today. Following up on a couple of points that my colleagues have brought up, I do have a few questions. I am going to address the first one to Dr. White. I wonder if you could comment briefly, I do have a couple of follow-up questions as well, but besides lower borrowing rates as a result of their implicit government guarantee, what other competitive advantages do Freddie and Fannie enjoy? My understanding is an estimated 40 basis point subsidy on GSE debt existed before the crisis. Would some of these other advantages add to that?

Mr. WHITE. It was primarily that they could borrow at 40 basis points—two-fifths of a percentage point, less—they—their rating, to the extent you want to believe ratings, were of—on a standalone basis AA-minus, but they were able actually to borrow in the markets at better than AAA rates, and that roughly translated to 40 basis points, two-fifths of a percentage point. Of that, about 25 basis points were passed through in the form of lower mortgage rates on conforming mortgages, about a quarter of a percentage point advantage.

And why did the financial markets do this? Because they perceived these guys as special, and it turns out the perception was correct. Now, in addition to that borrowing advantage, they had lower capital requirements for holding mortgages, only 2.5 percent, as compared with 4 percent for a depository institution, or at least 4 percent. And especially on their mortgage guarantees, they had to hold only 0.45 percent to cover the credit risk on the mortgage guarantee that a depository was expected to cover with 4 percent capital.

So they had a major capital—much lower capital requirement, and again at the end of the day, that is what did them in. They did not have enough capital to cover the riskier portfolio—it is unclear whether it was even enough for the safe portfolio of the 1980s and early 1990s, but for sure it was not enough for the riskier portfolio that they had as of 2008.

Mr. HULTGREN. Thank you. Let me—let's see, Mr. Rosner, you are nodding your head. I wondered if you would agree with some of those competitive advantages with the subsidy question? And just wondering, those benefits—that competitive advantage and benefits, were any of those passed on to homeowners?

Mr. ROSNER. Yes. I think as Professor White pointed out, some of it was passed on in lower rates. And other than that, no, most of them were retained. You also have to remember that the special relationship was further fostered by the fact that they weren't required to file with the SEC as other companies were, and they were tax exempt. Not the securities, the companies. So all of this led to the perception of them as being government-guaranteed entities all along. If I could, I would just make a quick point, transparency and liquidity led prices and value to converge. And one of the problems that has been absent in the mortgage market, the private label market, less important in the GSE market because there was an assumption that they were government guaranteed, is that price and value were always able to stay separate, because there was just not enough information. There was asymmetry of information, which really fostered the worst elements of the crisis. And so anything we do going forward, needs to repair that.

Mr. HULTGREN. Let me talk about going forward. And I just have about a minute left, but Congress does want to continue to subsidize the mortgage market, if we choose to continue to help homebuyers, is there a better way? Mr. Rosner, you talked about it a little bit, just helping us crystallize this. One of my passions is, let's do the right thing, but let's not do any harm either. And so, is a government guarantee in the secondary market really the best way for homebuyers to see that subsidy? Or is there something else we can do?

Mr. ROSNER. No, I don't think the government guarantee of the secondary mortgage market is either necessary or beneficial. I think it puts us back on the same path. And part of the problem I have with most of the proposals that have been floating around is they really demonstrate that a rose by any other name is still a rose. And most of the policy proposals that we have seen frankly, are slightly different, but still essentially the same. The BPC report preserves a lot of those implicit guarantees. I am also a little bit concerned that it was conceived of by many of the people who brought us the GSE issue in the first place.

And being run by some of those same people, as opposed to really coming in and saying, you know what? If we were to start with a clean slate, what would it look like? And again, it could include the GSEs, but you need to sever all of the government ties and implied government support, and we are still not really talking about that. We are rather talking about taking many of those same advantages, flushing $140 billion that the Enterprises owe us, wiping out what value they do have in data and systems, et cetera, and transferring many of those same perverse benefits to new players.

Mr. HULTGREN. My time has expired. Thank you very much, and I yield back.

Chairman GARRETT. The gentleman from Delaware?

Mr. CARNEY. Thank you very much, Mr. Chairman. Thank you for having this hearing, and thank you for those of you coming here on a snowy day for your testimony. It is been very interesting, and I am more interested in the future than I am in the past. I am more interested in what we should do to answer your last question, Mr. Rosner, which is, what should we do now? You said, what should we do if we could start from scratch? We are not exactly starting from scratch. What should we do, given where we are today? What we know happened? And where should we go? I thought there was some agreement among the three of you—Mr. Rosner, Dr. Wachter, and Dr. White—that there should be a role of some continuation of something that looks, maybe not similar, but has the same role in the second—to create a secondary market. Is that an accurate read of what you said? Or Mr. Rosner what you just said seemed to be different than that? That there is still an appropriate role for—

Mr. ROSNER. Liquidity provider, but that doesn't mean that it is government-owned, government-backstopped, or providing government subsidies, okay? So it could be a true private monoline, that prices credit—

Mr. CARNEY. So are the three of you—

Mr. ROSNER. —on a countercyclical—

Mr. CARNEY. I assume, Mr. Ligon, you are not interested in this? As I heard what you said, you don't think there is really an appropriate role? That the private market can handle it?

Let me move on because my time is—are you familiar with the Treasury Department's White Paper? The Administration's White Paper on the various options? Could you comment on the options, and what you think we ought to focus on, as we Democrats and Republicans hopefully on this committee and in this Congress try to address this issue going forward, and answer Mr. Rosner's question. Dr. Wachter?

Ms. WACHTER. Yes, I would be pleased to do so. There were three alternatives put out on that White Paper. One was to have an entity which could immediately move to support the private sector if it collapsed. And my concern with that as a solution is it takes time to stand up such an entity. It would take months, a year, whatever. What do we do in the meantime? So I do think we need to have an entity in place, which can in fact act in moments of crisis—

Mr. CARNEY. So what should it look like?

Ms. WACHTER. —so that—and if I may say, a crisis will come unless there is standardization and the ability to price and trade risk because there will be an underpricing race to the bottom, just as we have seen. So what should that entity look like? That entity at this point has to have, I believe, a government backstop with private capital. Going forward, that entity could be a monoline. Where I disagree is that monoline if "is purely private sector" would need to be carefully overseen by the Federal Government because the Federal Government, the taxpayer, owns that risk.

And it needs to recognize that it owns that risk. If that monoline goes under, it is the Federal taxpayer who will support it.

Mr. CARNEY. Regardless of whether it is explicitly defined, you don't believe in that?

Ms. WACHTER. We are absolutely back to the GSEs if we have a monoline, one monoline which is providing this, and that fails, we are back to the GSEs, that will be rescued.

Mr. WHITE. All right. As Dr. Wachter indicated, the Administration report 2 years ago had three choices. All three said there should be a clearly defined role for FHA, and I absolutely agree. They also said, and Dr. Wachter just reinforced that there has to be rigorous prudential regulation of any entities where the Federal Government, if push came to shove, would be on the hook. And again, strong, vigorous, prudential regulation. Adequate capital requirements have to be at the heart of that.

After that, there is this issue of, is a government presence as an explicit backstop necessary? And again, certainly in the current environment. There is so much uncertainty out there. Half of the Dodd-Frank rules have not been finalized. In the mortgage area, the QRM, the Qualified Residential Mortgage rules, have yet to be finalized.

Mr. CARNEY. My time is running out. So were you familiar with H.R. 1859, which is the Campbell-Peters bill, in the last Congress? Could you comment on that approach, Dr. Wachter?

Ms. WACHTER. Yes, it is an excellent approach.

Mr. CARNEY. Excellent approach. Thank you very much, I yield back.

Chairman GARRETT. The gentleman yields back. Without objection, we will put 30 seconds on the clock for the gentleman from Alabama for an additional question.

Mr. BACHUS. Thank you. We talked about the Federal Reserve and perhaps the low interest rates, but I want to sort of set the record straight. I do recall that starting in 2005, I think, the Fed became aware of the rise in prices, and I would like you to comment. Did they not bump the interest rate up, I think 17 consecutive times, from 2005 to 2007 and were criticized for that?

Ms. WACHTER. Yes, absolutely and I am glad you have raised that. Because I was wondering whether I should step in. Interest rates actually bottomed in 2004. The Fed started pulling out money supply and interest rates started increasing as of 2004. Interest rates across-the-board 10 years started increasing in 2004, 2005, 2006. The worst years of the bubble. The Fed started to pull money out. Interest rates started going up.

Nonetheless, interest rates on private label securities decreased in that period. There was a race to the bottom. Despite the fact that the quality of the book of business deteriorated substantially, interest rates, over Treasuries collapsed. So there was a race to the bottom, a race to take on risk by the private label securities, in part because the information was not out there as how bad credit quality was deteriorating.

Mr. BACHUS. Thank you. Now, I am going to ask unanimous consent to introduce three items. One is an article from June 6, 2006, in The Charlotte Observer that highlighted some of our attempts to pass a subprime lending bill.

Chairman GARRETT. Without objection, it is so ordered.

Mr. BACHUS. The second is a letter I wrote the Honorable Barney Frank on September 28th where we proposed, we had a draft and he and I, which had a suitability standard, a yield spread premium and points and figures trigger. A prohibition on mandatory arbitration. A prohibition on prepayment penalties on loans less than $75,000. All of those were drivers by, and the right of an individual consumer to initiate private rights of action to enforce the provisions of the law, which was pretty radical in that day but it showed an alarm.

Chairman GARRETT. Without objection, it is so ordered.

Mr. BACHUS. And third, we requested—and I have referred to this before—the GAO to do a study and talked about several problems we saw, which came out in April 2007.

Chairman GARRETT. Without objection, it is so ordered.

Mr. BACHUS. And I will add that it shows really the perverse effect of heavy lobbying by the industry, which unfortunately retarded our efforts.

Chairman GARRETT. Without objection, it is so ordered, and those items will be entered into the record. I thank the gentleman for each of those. At this point, I yield to the gentlelady from California, the ranking member of the full Financial Services Committee, for 5 minutes.

Ms. WATERS. Thank you very much.

Mr. Chairman and Mr. Ranking Member, I know that quite a bit of discussion has gone on during this hearing, and unfortunately I couldn't be here for all of it. But I have an early mission in this discussion about the future of the GSEs. I am anxious for both sides of the aisle to recognize the need and to come to grips with whether or not the private sector can supply the need for mortgages in a way that we have been accustomed to.

With nearly $10 billion of single family residential mortgage debt outstanding, and with the Joint Center for Housing Studies at Harvard University projecting one million new households per year over the next decade, the question is, do you think that bank portfolio lending can provide the capital necessary to supply the U.S. market and maintain the homeownership rates to which we have become accustomed?

If we can just agree, if both sides of the aisle can get an agreement on this, then I think we can start down the road to talking about what this perhaps private-public partnership can be. But if we get stuck thinking that somehow we have to get rid of these GSEs, and that somehow the private lenders can take care of the mortgage needs, I think we are in trouble.

So what do you think about this? Is this something that you think we need to pay special attention to and come to some agreement on? And I guess that would be for Dr. Susan Wachter.

Ms. WACHTER. I don't think that the $10 trillion can be taken on by the banking system at this point. It is just a no-starter, it won't, it cannot happen. And it is a recipe for disaster for the overall economy to assume that we can just pull Fannie and Freddie out and there will be funding for the mortgage market going forward.

I think that the private sector itself would confirm that they could not step up to the plate with that kind of funding in mind. This is the largest debt backed in the world, book of business. And there is no way that it can go to portfolios of the banking system at this point and still have a 30-year fixed-rate mortgage. That simply is, it is not, it cannot happen. I don't think anyone could disagree with that. But I am interested to hear what others say.

Ms. WATERS. I suppose I can ask the other members of the panel. Does anyone else think differently? Is there anyone on this panel who believes that the private market can handle this debt? This kind of mortgage lending?

Mr. ROSNER. I would suggest that at this very moment, the answer would be "no." But as Professor White has pointed out, the private market is a lot larger than bank balance sheets. It is the capital markets. So we first have to set about to repair the problems with securitization, to bring investors back. To bring comfort back to increased transparency and disclosure.

In 1939, I guess, we created the Trust Indenture Act. I am still trying to figure out why we haven't created something similar for the ABS market.

Ms. WATERS. Excuse me, are you suggesting that some of the problems that we had with the subprime meltdown, those problems must be cured before we take a look at what we do with the GSEs?

Mr. ROSNER. No, what I am suggesting is if you want the private markets to play a significant role and fill any void that Congress chooses to pull away from, you first need to make sure that the mechanisms are in place for private capital to be able to price risk.

Ms. WATERS. So what you are saying is, you agree that there is a role for both government and the private sector to play?

Mr. ROSNER. I think there is a role for the government to play because it is already in there and playing. I think the goal should be, medium- and long-term, to pull the government out of the market except where we explicitly backstop it on the balance sheet. And we need to foster the ability of private market to price risk. And we haven't done any of that.

The SECs had a Reg AB extension sitting in front of it for 2 years and did nothing to force the increased transparency that investors deserve. That would help standardize and create the transparency so that securitization markets, private securitization markets could come back. You can't expect the private markets to do anything, until they have clarity as to what their contractural rights are—

Ms. WATERS. Excuse me, if I may, we have allowed the private markets to do a lot. Which finds us in the situation that we are in today. And so my question really is whether or not you think government has a significant role to play in these GSEs? Can they be in partnership with the private sector in order to do the kind of mortgage lending that we need? That is really what the question is. It is not whether or not we should wait to repair—

Mr. ROSNER. In answer to that question, I think that we should have the government explicitly focus on areas that it wants to put loans on its balance sheet. And other than that, there should be no implicit or partnership, I should say, between the government and private markets. That was the basis of the distortions that we have lived through.

Mr. WHITE. I want to add one thing, Congresswoman. There has been a lot of talk about a revival, not of Fannie and Freddie, but a revival of some kind of government guarantee or government backstop. And somehow that is linked to a 30-year fixed-rate mortgage. And it is important to remember the guarantee, the backstop would be on credit risk, not on interest rate risk. But the 30-year fixed-rate mortgage and its problems, is primarily one of interest rate risk and a government guarantee doesn't really deal with that.

Now as Mr. Rosner just said, in the current environment with a lot of uncertainties and a lot of just unresolved, what are the rules? What is the information? There is clearly a strong role for government, as well as a focused role for FHA for dealing with the low- and moderate-income household segments of the market.

But going forward, as the uncertainties are resolved, as private sector, as insurance companies, as pension funds become more comfortable with properly structured, lots of information, 30-year paper, I think that can be handled. That doesn't mean eliminate FHA. FHA has a very valuable role to play. But it has to be clear, it has to be defined, it has to be on balance sheet. It shouldn't be implicit and foggy and hope for the best. That is a big part of how we got to where we are today.

Chairman GARRETT. The gentleman—

Mr. ROSNER. The concept of a partnership between private enterprise and government is, in and of itself, sort of a scary concept.

Chairman GARRETT. And on that scary concept, the gentlelady's time has expired. We will—

Ms. WATERS. I yield back.

Chairman GARRETT. The gentlelady yields back. And we yield—

Mr. ELLISON. Do you need more time? I yield to the gentlelady. Oh, okay, never mind.

Chairman GARRETT. The gentleman is recognized for the final 5 minutes, and the last word.

Mr. ELLISON. Thank you, Mr. Chairman, and thank you, ranking member. And also let me thank the panel, you all have been helpful to our deliberations as we figure out how to move forward. One of the things that we are doing today, is not only exclusively focusing on what to do next, which is what my preference would be. But it is talking about what happened, because I think many of us hope that there are at least some lessons to be learned.

I just want to ask a question, Mr. Rosner, again, thank you for your contribution. You were asked by one of my colleagues earlier, "If GSEs had behaved differently in a subprime market, would that have prevented the crisis of 2008?" Your answer was, "I don't think that the crisis itself would have necessarily been avoided if not for the GSEs. I do think that they accelerated and exacerbated those issues."

And so we are here today, trying to make sure the record is right. We have a hearing entitled, "Fannie Mae and Freddie Mac: How Government Housing Policy Failed Homeowners and Taxpayers—and here I want to emphasize—"Led to the Financial Crisis." Based on your response to Mr. Hurt, you do think that Fannie and Freddie played a role. But I think it is accurate to say that you don't agree that Fannie and Freddie's behavior led to the crisis. Is that a fair statement?

Mr. ROSNER. I would say that Fannie and Freddie's behavior seasoned the markets, created the foundation on which the crisis was able to occur. I would say separate housing policy from the GSEs further and government housing policies—

Mr. ELLISON. Okay.

Mr. ROSNER. —did in fact lead to the crisis.

Mr. ELLISON. It is interesting you would say that. Because on the one hand, you very clearly said they didn't lead it, but they exacerbated it. Now the statement you just gave me, made me think that you are sort of arguing that they did lead it. So I am not sure what you are saying.

Mr. ROSNER. "Led" and "become the ultimate cause of" are two different things. And so again, the crisis, let's go back to, one of the issues, I think the issue that a lot of us are having is, how do you date the crisis? How do you bound it? Did the crisis begin in 2004 and end in 2007, 2008, 2009?

Mr. ELLISON. Excuse me Mr. Rosner—

Mr. ROSNER. Or did the crisis begin before?

Mr. ELLISON. They only give me 5 minutes, I am sorry.

Mr. ROSNER. Sorry.

Mr. ELLISON. I wish we could hear more. But I read your book. And in your book you say, of all the partners in the homeownership push, no industry contributed more to corruption of the lending process than Wall Street. And then on another page, you say, "Wall Street had financed the questionable mortgages before, of course, but it was during the manias climactic period of 2005 to 2006 that these firms' activities as the same primary enablers to the freewheeling lenders really went wild. No longer were the firms simply supplying capital to lenders trying to meet housing demand across America. Now Wall Street was supplying money to companies making increasingly poisonous loans to people with no ability to repay, and the firms knew precisely what they were doing."

Now again, we are in the very messy business of trying to apportion blame and fault. And I think that, as I said, my first comments were, that is unfortunate. But I didn't bring this on you, Mr. Rosner. The committee chairman did by naming the hearing as he did. And I just want the record to be clear, you clearly are not trying to minimize the role of the GSEs. You have made it clear. But if I may just be explicit one more time, you don't contend that they led to it, not withstanding other things that you do think, you don't contend that they led to it?

Mr. ROSNER. I don't contend—

Mr. ELLISON. Can you give me a simple answer to that question?

Mr. ROSNER. I don't think it is a simple question.

Mr. ELLISON. Okay, that is fair. I get it. In other words, I will just let your words in the book and your comments on the record today stand—

Mr. ROSNER. "Led to" and "caused" are two different things.

Mr. ELLISON. And because my problem isn't with you, Mr. Rosner, my problem is that we are, this is a serious problem which should be approached in a bipartisan way, and it isn't. And you are coming here to help us understand this crisis as best you understand it. People are trying to use your words to sort of make a particular point. I am trying to, I am giving credit to what you said. You said they contributed. You said they ended up playing a fatal role. But you also said they did not lead to it. Isn't that right?

Mr. ROSNER. So you accept that I contend that they played a critical role?

Mr. ELLISON. Yes.

Mr. ROSNER. Then I will accept what you are suggesting.

Mr. ELLISON. Okay, thank you. How much time—I am on the yellow light. Let me just ask you this, if you could tell Congress what they need to do, to make sure that ordinary income people with good credit can get a 30-year mortgage, what would you tell us we need to think about? Anybody who wants to answer?

Ms. WACHTER. We can't have a race to the bottom. You have to have standards. We have to have information that allows standards so that we can't have this stealth underwriting crisis, brought about by Wall Street, happen again. We had years of growing homeownership before the crisis. We can get back on that path.

Mr. ELLISON. Thank you.

Mr. WHITE. "Conforming" and "conventional" are terms that should be definitionally standard terms. And they became constantly more and more distorted. I think that is really the problem, once you set a standard, that standard can't creep over time. And the markets need to understand that is the standard, it is inviolable, and that is where it will stay.

Mr. ELLISON. Let me thank all of the panelists and you, Mr. Chairman, and the ranking member.

Chairman GARRETT. The gentleman yields back. And with that, let me just say, first of all, thank you to the panel. It is important testimony that we received today. We heard unanimity from both sides of the aisle that we need to go forward on this issue of the mortgage housing market, to try to fix it.

Today's hearing was important in that regard, that before you can solve a problem, before we can fix a problem, you have to know what caused the problem. In order to go forward, you have to know where you have been. And so, that was the point of today's hearing. I think we heard significant testimony—

Mr. BACHUS. Mr. Chairman?

Chairman GARRETT. —out of that. The gentleman from Alabama?

Mr. BACHUS. Mr. Chairman, let me second that. I think Shakespeare originated, "the past is the prologue of the future," in "The Tempest." But this has been a very educational panel, and I want to thank all of you. And I would say that all our Members who didn't go through this crisis, should read and I think by reading all four testimonies, we can certainly get some guideposts for the future.

Mr. LIGON. Thank you, Congressman.

Chairman GARRETT. I thought that you were going to suggest that they all read Mr. Rosner's book to help support the sale of that book.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And again, thank you all. Thank you to the ranking member for staying with us through all of this and for her participation as well. The hearing is adjourned.

[Whereupon, at 1:01 p.m., the hearing was adjourned.]

A P P E N D I X

March 6, 2013

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CONGRESSIONAL TESTIMONY

Fannie Mae and Freddie Mac: How Government Housing Policy Failed Homeowners and Taxpayers and Led to the Financial Crisis

Testimony before the
Committee on Financial Services,
Subcommittee on Capital Markets and
Government Sponsored Enterprises
United States House of Representatives

March 6, 2013

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The Heritage Foundation

I. Introduction

My name is John Ligon. I am a Policy Analyst in the Center for Data Analysis at the Heritage Foundation. The views I express in this testimony are my own and should not be construed as representing any official position of the Heritage Foundation.

I thank Chairman Garrett, Ranking Member Maloney, and the rest of the committee for the opportunity to testify today.

The sections in this written testimony lead to the following conclusion: Federal housing policies related to the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, have proved costly not only to the federal taxpayer, but also to the broader financial system. We should recognize their failure and move toward a U.S. mortgage market without these finance GSEs.

II. Fannie Mae and Freddie Mac: Role in the U.S. Housing Finance Market

Fannie Mae and Freddie Mac are the Ultimate Guarantors of U.S. Mortgages. Fannie Mae, was originally chartered in 1938 as the Federal National Mortgage Association (FNMA). Freddie Mac, the Federal Home Loan Mortgage Corporation (FHLMC), was created in 1970. These institutions have grown significantly in size and scope in the U.S. mortgage market since their origination. Their asset holdings – either through mortgage securitizations or direct portfolio holdings – have increased from approximately 7 percent of total residential mortgage market originations in 1980 ($78 billion) to about 47 percent in 2003 ($3.6 trillion).[1]

By 2010, Fannie Mae and Freddie Mac owned or guaranteed approximately half of all outstanding mortgages in the United States, including a significant share of sub-prime mortgages, and financed 63 percent of new mortgages originated in that year.[2] Other federal agencies, including the Federal Housing Finance Agency and Department of Veterans Affairs, guarantee approximately an additional 23 percent of residential mortgages. This means that federal taxpayers guarantee approximately 90 percent of all new mortgage originations in the current market.[3]

Fannie Mae and Freddie Mac were placed into federal conservatorship under regulatory authority conferred to the Federal Housing Finance Agency (FHFA) in the

Housing and Economic Recovery Act (HERA) of 2008.[4] These institutions faced a combined loss on net income of $108 billion in 2008 on defaulted mortgage assets in their respective portfolios, and the federal government provided the capital to cover the losses.[5] The net loss to federal taxpayers has been $143 billion—$188 billion in transfers from the federal government less $45 billion in dividend pay-outs from the GSEs.[6]

Moreover, now that Fannie Mae and Freddie Mac fall within federal conservatorship, their combined agency debt, mortgage, and mortgage-related holdings are directly guaranteed by the federal government. The federal government provides direct financing, and the agency debt is not considered official government debt – therefore not included in the accounting of federal publicly held debt. The level of agency debt is massive and has exploded over the last 40 years: in 1970 agency debt as a share of U.S. Treasury debt was 15 percent, and as of 2010, this share was 81 percent (a combined $7.5 trillion).[7]

Federally Initiated Affordable Housing Goals Undermine Homeownership. Fannie Mae and Freddie Mac have operated under congressionally mandated missions to expand mortgage credit to specific income groups and achieve specific housing goals while trying to also compete for higher profits in the U.S. mortgage and secondary mortgage markets.[8] These federally initiated affordable housing goals led to gradual deterioration of lending standards in the entire U.S. mortgage market beginning in the 1990s.

The relaxation of lending standards in the U.S. mortgage market started in earnest in the 1990s. In 1995, the Department of Housing and Urban Development (HUD) established a target goal relating to the homeownership rate among low-income groups, which was eventually set at 70 percent. Then in 1999, HUD directed Fannie Mae and Freddie Mac to relax their requirement standards on mortgage loans, including a move toward sub- and non-prime loan approval, yet maintained their inability to make moves in the non-conforming market. (See Table 1.) During the 1990s, the GSE share of mortgage loans with high loan-to-value (LTV) ratios rose from around 6 percent of purchases in 1992 to 19 percent in 1995.[9]

Starting in 2006, there was further easing of mortgage lending standards combined with low interest rate policy by the Federal Reserve.[10] In 2002, the private mortgage market aggressively moved toward non-conforming and jumbo mortgage loans. Fannie Mae and Freddie Mac, constrained by the conforming-mortgage thresholds set on their mortgage originations, shifted their portfolio allocations towards private label mortgage-backed securities to achieve their affordable housing goals. Between 2002 and 2006, total mortgage-related securities holdings for Fannie Mae and Freddie Mac decreased approximately by half while their combined holdings of private label mortgage-backed securities increased substantially during this same time period. (See Chart 1.)

The erosion of lending standards that stretched across the U.S. mortgage market from 2000 to 2006 weakened the quality of holdings even in the GSEs portfolios since a sizeable share of their mortgage-backed security holdings were securitized from sub-prime and non-prime mortgages. From 2001 to 2006, sub-prime loans increased from $120 billion (5.5 percent of U.S. mortgage originations) to $600 billion (20 percent of the U.S. mortgage market originations).[11] Moreover, the level of borrowing against equity in home mortgages (home equity lines of credit (HELOCs)) increased from $130 billion (6 percent of the U.S. mortgage market) in 2001 to $430 billion (about 15 percent of the U.S. mortgage market) in 2006. Thus, the total level of non-prime mortgage loans peaked at 48 percent of the mortgage market in 2006.[12] Between 2006 and 2007, Fannie Mae held 25 percent of its total loans with LTV above 80 percent and 18 percent in loans with credit scores lower than 660 and nearly 23 percent in sub-prime and other high-risk mortgages and 15 percent in interest-only loans.[13]

During the 2002 to 2006 boom period, overall debt-to-income levels rose sharply for many U.S. households. Mortgage and non-home-related debt rose at a similar pace from 1996 to 2002, but mortgage-related debt accelerated faster than non-home-related debt from 2002 to 2006.[14] While housing-related asset valuations were rising, the level of borrowing activity against the higher home values – home-equity-based borrowing – also increased. This borrowing behavior remained mostly concentrated among younger households with low credit scores or households with high initial credit card utilization rates. Between 2002 and 2006, with lower lending standards and rising home values, a significant share of these younger and lower-credit-quality homeowners aggressively borrowed against the higher value of their homes. By 2008, homeowners who had borrowed against the increased value of their homes ended up with $1.25 trillion more in total household debt.[15] These same homeowners accounted for 39 percent of total new mortgage defaults between 2006 and 2008.[16]

Since 2006, national home prices have declined substantially, and some regional markets have experienced catastrophic decreases. In many regional housing markets, since 2007, these price changes and weakening macroeconomic fundamentals (e.g., high unemployment rates and falling household incomes) have put downward pressure on both the demand and the supply of housing and mortgage credit.[17] The combination of dramatic asset price reversion and macroeconomic instability left – and still leaves – many households unable to stay current on their home payments. Consequently, beginning in 2007, the rate of defaults and delinquencies spiked as prices began to plummet.

Fannie Mae and Freddie Mac Undermined Stability in the U.S. Financial System. Because of the broad reach of the mortgage assets – including direct mortgage holdings and market securitizations – to the U.S. financial markets, the recent downturn in prices dramatically affected household wealth. The loss in value in mortgage-related assets significantly affected financial institutions, especially Fannie Mae and Freddie Mac, which were systemically part of the financial system.

As economist Lawrence J. White notes, the aggregate financial losses during the "tech" bubble of the late 1990s and financial losses from the mortgage and housing bubble of 2007 were comparable at approximately $7 trillion.[18] While households absorbed many of these losses in both bubble episodes, nearly $1.3 trillion of the losses was in key financial institutions – from depository institutions to the mortgage GSEs.[19] Many of the largest financial institutions did not have the capital to cover these losses and this led to a bailout of hundreds of billions of dollars, and bankruptcies for some. The losses led to widespread uncertainty about the viability of many of the leading financial institutions, which triggered a sharp decline in the stock market and, subsequently, the overall economy.[20]

III. Fannie Mae and Freddie Mac: Estimated Value of Taxpayer Subsidy

Prior to FHFA conservatorship and the explicit backing of the federal government, market purchasers of the GSE debt believed that Fannie Mae and Freddie Mac's agency debt was implicitly backed by the federal government. This belief stemmed from the many borrowing, tax, and regulatory advantages not conferred to any other shareholder corporation. First, these two housing finance GSEs were exempt from many state investor protection laws, and received specific federal charters, mainly issuances of mortgage credit to income-specific groups of households.[21] Second, Fannie Mae and Freddie Mac were exempt from state and local income taxation. Third, they were exempt from Securities and Exchange Commission registration and bank regulations on security holdings. Fourth, they held a direct line of credit with the U.S. Treasury, issuing agency debt and borrowing between corporate AAA credit interest rate yields and U.S. Treasury interest rate yields. Last, they received U.S. agency status and the guarantee of the federal government on mortgage-backed securities.[22]

The annual estimated value of these subsidy benefits is substantial, ranging from about $7 billion to $20 billion before FHFA conservatorship. (See Chart 2.) This subsidy value translates into an estimate between 20 and 50 basis points on mortgage interest rates, a share of the value passed through to the shareholders of these firms and a share passed through to mortgage holders.

Economists have made several attempts to estimate the value of these federal subsidies. The Congressional Budget Office estimates that agency debt subsidy (lower borrowing costs) results in a 41 basis point value to shareholders and borrowers. Fannie Mae and Freddie Mac pass through 25 basis points of the subsidy value to borrowers and shareholders retain an estimated 16 basis points on each dollar of debt. These economists estimate a subsidy value on mortgage-backed securities at 30 basis points, where approximately 25 basis points are passed to the borrowers of mortgages.[23] Additionally, Wayne Passmore and his co-authors estimate a 40 basis point subsidy to GSE debt.[24] They estimate that the pass-through of the GSE debt subsidy lowers mortgage rates to homeowners by 7 basis points, or 16 percent of the total 40 basis point subsidy value.[25]

IV. Fannie Mae and Freddie Mac: The Economic Impact of Ending the Taxpayer Subsidy

The cessation of activity by Fannie Mae and Freddie Mac would effectively translate into a removal of an interest rate subsidy. Recent research by analysts at the Heritage Foundation indicates that removing this subsidy would have minimal effect on the U.S. housing market and the U.S. economy more broadly. This line of research encompasses three studies that estimate the impact of removing the GSE interest rate subsidy on housing starts, home prices, and overall homeownership. In a final study, we estimate the economic effect of eliminating the subsidy.

The Heritage studies on housing starts, home prices, and homeownership indicate that changes in the housing market are more responsive to changes in overall economic fundamentals (e.g., personal income levels, real output, level of household debt, etc.) relative to changes in interest rates or certain credit approval requirements, such as down payment levels.[26] Once the housing and financial markets recover from the recent turmoil, shutting down Fannie Mae and Freddie Mac would have, at most, a minimal impact on the overall housing market.

Additionally, our research studies the likely impact of removing the interest rate subsidy in a macroeconomic framework. Opponents of eliminating GSEs in the housing finance industry assert that phasing out the GSEs would leave the housing market and economy worse off. Heritage research suggests, however, that eliminating Fannie Mae and Freddie Mac would have a minimal and predictable impact on these markets and the overall economy.[27] The average annual decline in real output over the 10-year forecast period is 0.04 percent, or a $6 billion average difference from baseline levels, smaller than the estimated average annual subsidy value to these institutions and far less than the average annual cost of these institutions to the federal taxpayer. Thus, claims of drastic economic effects are overstated.

V. Fannie Mae and Freddie Mac: Eliminating Government-Sponsored Enterprises in Housing Finance

After more than three decades of experience with boom and bust cycles in the housing market, which have affected not only household income and wealth but also financial markets, federal policymakers should seriously reconsider the federal government's role in shaping housing policy through GSEs such as Fannie Mae and Freddie Mac. These institutions distort the U.S. housing and mortgage markets at substantial risk to households and U.S. taxpayers.

Eliminating the present role Fannie Mae and Freddie Mac play in the U.S. mortgage market could save billions of taxpayer dollars in the U.S. mortgage market through eliminating the subsidy that has induced U.S. households to take on more debt-related consumption, ending up underwater. Many households were never in position to handle such debt; therefore, subsidizing them to become homeowners is not only inconsequential in raising homeownership but also detrimental to the financial market.

The housing finance GSEs played a central role in the systemic nature of the collapse of the financial market. It is necessary to learn from the failures of this institutional model and restore properly aligned incentives to the U.S. housing and housing finance markets.[28] Congressional leaders made the mistakes of creating Fannie Mae and Freddie Mac and subsidizing their activity in the U.S. mortgage market through special access to federal funds and an implicit guarantee prior to federal conservatorship in 2008. They need to wind down the GSEs and establish a U.S housing finance market free of the distortions this institutional arrangement generates.

Table 1 —Fannie Mae and Freddie Mac Interventions in the Housing Market

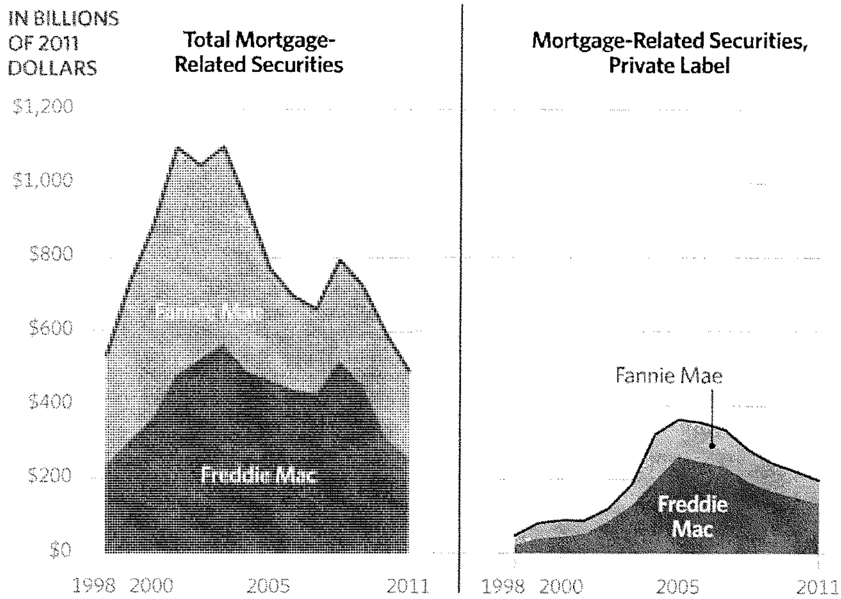
1975	Risk regulators, with secondary adoption of National Recognized Statistical Rating Organizations (NRSROs), begin moving from "prudent" to risk-based rating.
1986	Real Estate Mortgage Investment Conduits (REMICs), introduced by the Tax Reform Act of 1986, encourage private securitization by allowing credit tranches into subordinate securities. Opposition from the newly privatized Freddie Mac and long privatized Fannie Mae prevent private securitization from being established.
1992	Federal Housing Enterprise Financial Safety and Soundness Act establishes the Office of Federal Housing Enterprise Oversight (OFHEO) as a regulator.
1995	HUD gives target goals to Fannie and Freddie to raise homeownership rate among low-income groups. The Administration raises the homeownership rate goal to 70 percent.
1999	Fannie Mae eases the requirements on loans and moves to sub-prime mortgages.
2004	HUD urges Fannie and Freddie to increase their purchases of sub-prime and Alt-A (between prime and subprime) mortgages.
May 2007	The House passes Federal Housing Finance Reform Act of 2007, which would create a new regulator, but with no control over the mortgage-backed securities portfolios of Fannie and Freddie.
July 2008	When the Fannie and Freddie reach the financial precipice, the House and Senate pass the Federal Housing Finance Regulatory Reform Act of 2008.

Source: Nahid Kalbasi Anaraki, "A Housing Market Without Fannie Mae and Freddie Mac: Effect on Home Prices," Heritage Foundation *Special Report* No. 105, April 18, 2012, http://www.heritage.org/research/reports/2012/04/a-housing-market-without-fannie-mae-and-freddie-mac-effect-on-home-prices.

Chart 1

Securities Held for Investment

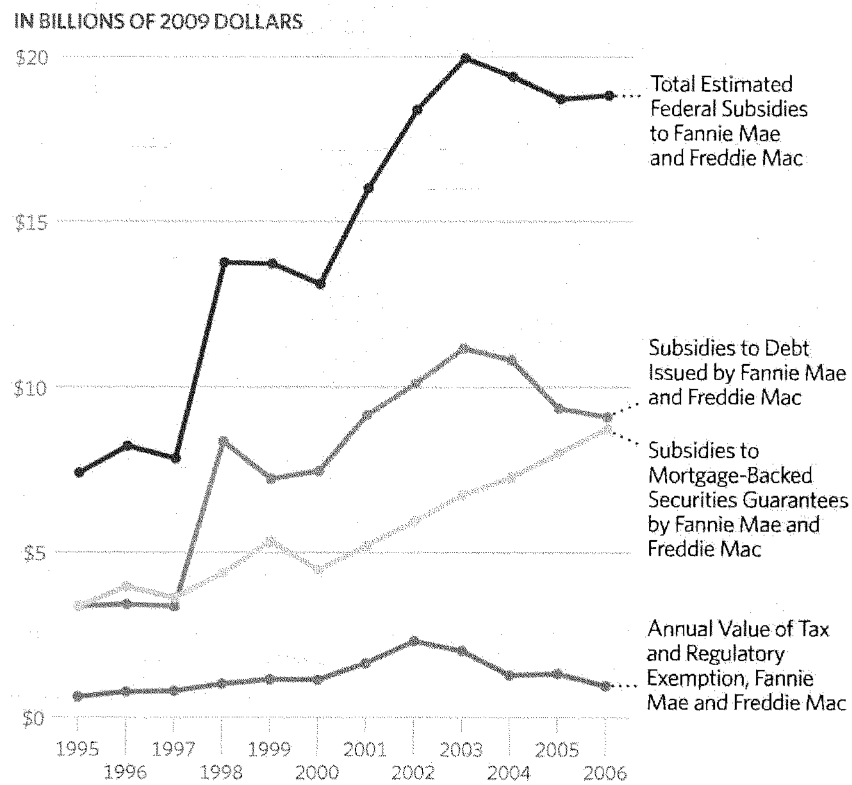
FHFA Conservatorship



Source: Federal Housing Finance Agency, *2011 Report to Congress*, June 13, 2012, pp. 77–79, Table 5b, and pp. 94–96, Table 14b, http://www.fhfa.gov/webfiles/24009/FHFA_RepToCongr11_6_14_508.pdf (accessed November 8, 2012).

Chart 2

Estimated Value of the Federal Subsidies to Fannie and Freddie Prior to FHFA Conservatorship



Sources: Heritage Foundation calculations based on data from Congressional Budget Office, "Federal Subsidies and the Housing GSEs," May 2001, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/28xx/doc2841/gses.pdf (accessed November 5, 2012); Congressional Budget Office, "Updated Estimates of the Subsidies to the Housing GSEs," April 8, 2004, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/53xx/doc5368/04-08-gse.pdf (accessed November 5, 2012); and Federal Housing Finance Agency, *2011 Report to Congress*, June 13, 2012, p. 72, Table 3, and p. 89, Table 12, http://www.fhfa.gov/webfiles/24009/FHFA_RepToCongr11_6_14_508.pdf (accessed November 8, 2012).

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[1] W. Scott Frame and Lawrence J. White, "Fussing and Fuming over Fannie Mae and Freddie Mac: How Much Smoke, How Much Fire?" *Journal of Economic Perspectives*, Vol. 19, No. 2 (Spring 2005), pp. 159-162.

[2] Deborah Lucas, "The Budgetary Cost of Fannie Mae and Freddie Mac and Options for the Future Federal Role in the Secondary Mortgage Market," statement before the Committee on the Budget, U.S. House of Representatives, June 2, 2011, p. 7, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/122xx/doc12213/06-02-gses_testimony.pdf (accessed June 4, 2012).

[3] Ibid., p. 162.

[4] Prior to FHFA conservatorship, Fannie Mae and Freddie Mac were regulated by the Office of Federal Housing Enterprise Oversight (OFHEO). The Housing and Economic Recovery Act (HERA) of 2008 transferred the regulatory responsibility to the FHFA.

[5] HERA conferred to the FHFA the power to place Fannie Mae and Freddie Mac in federal conservatorship, which the FHFA did in September 2008.

[6] Rachelle Younglai, "U.S. Tightens Reins on Fannie Mae, Freddie Mac," Reuters, at http://www.reuters.com/article/2012/08/17/us-usa-housing-idUSBRE87G0EN20120817 (accessed March 5, 2013). Through March 2011 the net loss to federal taxpayers totaled $154 billion in capital subsidies ($180 billion net $24 billion in dividends on its preferred stock). Lucas, "The Budgetary Cost of Fannie Mae and Freddie Mac," p. 2.

[7] Alex J. Pollack, "The Government's Four-Decade Financial Experiment," *The American*, July 13, 2011, http://www.american.com/archive/2011/july/the-government2019s-four-decade-financial-experiment (accessed June 4, 2012)

[8] Frame and White, "Fussing and Fuming over Fannie and Freddie," pp. 162-163.
[9] Karl Case r indicates that during the 1990s, "[the] sum of outstanding mortgages with some form of mortgage insurance or guarantee (from the Federal Housing Administration or Veterans Affairs, or through private mortgage insurance), the risk-tranched securities of Fannie Mae and Freddie Mac, and the subprime market has increased from 16 percent to just under 40 percent of total mortgage credit." Karl E. Case, "Real Estate and the Macroeconomy," Brookings Papers on Economic Activity, 2000, pp. 119-162, http://www.brookings.edu/~/media/Projects/BPEA/Fall%202000/2000b_bpea_case.PDF (accessed November 6, 2012)
[10] The inflation-adjusted yield on 10-year Treasury notes fell 120 basis points from 1996 to 2006, and 190 basis points from 2000 to 2005. Edward L. Edward L. Glaeser, Joshua D. Gottlieb, and Joseph Gyourko, "Can Cheap Credit Explain the Housing Boom?" National Bureau of Economic Research *Working Paper* No. 16230, July 2010, http://www.nber.org/papers/w16230 (accessed November 5, 2012).Additionally, there is debate about the role that interest rates play in the pattern of home prices in the lead-up to the price peak of 2006. Numerous economists acknowledge that interest rate policy was one of many factors that drove the most recent housing bubble. See John B. Taylor, "Housing and Monetary Policy," National Bureau of Economic Research *Working Paper* No. 13682, December 2007, http://www.nber.org/papers/w13682 (accessed June 4, 2012); Karl E. Case and John M. Quigley, "How Housing Busts End: Home Prices, User Cost, and Rigidities During Down Cycles," University of California, Berkeley, Institute of Business and Economic Research, Program on Housing and Urban Policy *Working Paper* No. W08-008, September 1, 2009, pp. 460-471, http://www.escholarship.org/uc/item/6mh9m4ff (accessed November 5, 2012); Adam J. Levitin and Susan M. Wachter, "Explaining the Housing Bubble," September 1, 2010, revised May 16, 2012, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669401 (accessed June 4, 2012). Some posit that interest rate policy can substantially affect price movements during bubble periods, particularly the bubble of 2000-2005. Charles Himmelberg, Christopher Mayer, and Todd Sinai, "Assessing High House Prices: Bubbles, Fundamentals, and Misperceptions," *Journal of Economic Perspectives*, Vol. 19, No. 4 (Fall 2005), pp. 67-72, http://pubs.aeaweb.org/doi/pdfplus/10.1257/089533005775196769 (accessed November 6, 2012), and Taylor, "Housing and Monetary Policy." Case and Quigley make the case that expansionary monetary policy by the Federal Reserve induced strong demand pressures in the U.S. mortgage and housing markets, beginning in 2002 with a strong demand for refinancing. Case and Quigley, "How Housing Busts End." Still, others argue that interest rates have little role and that other factors, such as price expectations of homeowners, matter more in the strong price movement during bubble periods. Glaeser et al., "Can Cheap Credit Explain the Housing Boom?" Additionally, Fannie Mae and Freddie Mac pass a substantial interest rate subsidy in the mortgage market due to their low-cost borrowing advantage with the Treasury. Taylor, "Housing and Monetary Policy"; Case and Quigley, "How Housing Busts End"; Levitin and Wachter, "Explaining the Housing Bubble".
[11] Viral V. Acharya et al, *Guaranteed to Fail: Fannie Mae, Freddie Mac, and the Debacle of Mortgage Finance* (Princeton, NJ: Princeton University Press, 2011), p. 46.
[12] Ibid.
[13] Acharya et al, *Guaranteed to Fail*, p. 39.
[14] Atif Mian and Amir Sufi, "House Prices, Home Equity-Based Borrowing, and the U.S. Household Leverage Crisis," *American Economic Review*, August 2011, Vol. 101, No. 5 (August 2011), pp. 2132-2156.
[15] Mian and Sufi, "House Prices," pp. 2132-2156. Acharya et al. note that, including credit card debt, by 2008, households in the U.S. collectively owed more than 114 percent of total gross domestic product, or $16.4 trillion. By 2010, households still owed $12.8 trillion in mortgage debt and $15.8 trillion in total debt. These changes in debt levels correspond to a declining share of home equity as a share of aggregate household wealth—the share fell from 62 percent in the third quarter of 2005 to 35 percent in the first quarter of 2009. Acharya et al., *Guaranteed to Fail*, pp. 92-92.
[16] Mian and Sufi find that "a total of $1.25 trillion of the rise in household debt from 2002 to 2006 is attributable to existing homeowners borrowing against the increased value of their homes [and that] at least 39% of total new defaults seen between 2006 and 2008 are from 1997 homeowners who borrowed aggressively against the rising value of their houses. [Lower] credit quality households living in high house price appreciation areas experience a relative decline in default rate from 2002-2006 as they borrow heavily

against their home equity, but experience very high default rates from 2006-2008. [There is] a very strong home equity-based borrowing effect for low credit quality borrowers. [In] contrast there is almost no effect for high quality borrowers." Mian and Sufi, "House Prices," pp. 2132-2156.

[17] Changes to mortgage credit will likely affect both supply and demand and respond to changes in home prices. Additionally, a decline in housing prices does not in itself lead to a downturn in the U.S. housing and mortgage market. First, there is a psychological attachment to homes and areas of residence. It is not easy to leave and relocate for many families. Second, homeowners, while negatively affected by dramatically declining prices, do not necessarily need to sell their homes. Homeowners' behavior significantly affects price adjustments in housing-related asset markets, especially residential markets. In particular, there is sticky downward adjustment to market clearing equilibrium because homeowners generally hold out on lowering home prices. In many cases, if homeowners still have jobs and income to make monthly payments, they may not want to leave their location and home. Third, a drop in home prices makes it easier for non-homeowners to enter the housing market by making homes more affordable. Case and Quigley, "How Housing Busts End," pp. 477-479.

[18] Lawrence J. White, "The Way Forward: U.S. Residential Mortgage Finance in a Post-GSE World," March 3, 2011, pp. 11-13, http://web-docs.stern.nyu.edu/old_web/economics/docs/workingpapers/2011/white-residential%20mortgage%20finance%203.3.11.pdf (accessed November 5, 2012)

[19] Ibid.

[20] Ibid.

[21] Dwight M. Jaffee and John M. Quigley, "Housing Subsidies and Homeowners: What Role for Government-Sponsored Enterprises?" University of California, Berkeley, Institute of Business and Economic Research and Fisher Center for Real Estate and Urban Policy *Working Paper* No. W06-006, January 2007, pp. 120–123, http://urbanpolicy.berkeley.edu/pdf/JQ_Housing_Subsidies_Proof_053007.pdf (accessed November 8, 2012).

[22] Ibid., p.122

[23] Congressional Budget Office, "Federal Subsidies and the Housing GSEs," May 2001, pp. 23 and 26-28, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/28xx/doc2841/gses.pdf (accessed November 5, 2012). Douglas Holtz-Eakin, "Updated Estimates of the Subsidies to the Housing GSEs," letter to Senator Richard C. Shelby, Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. House of Representatives, April 8, 2004, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/53xx/doc5368/04-08-gse.pdf (accessed November 5, 2012)

[24] Wayne Passmore, S. Sherlund, and G. Burgess, "The Effect of Housing Government-Sponsored Enterprises on Mortgage Rates," *Real Estate Economics*, Vol. 33 No 3 (2005), pp. 19-22.

[25] Ibid.

[26] See Nahid Kalbasi Anaraki, "A Housing Market Without Fannie Mae and Freddie Mac: The Effect on Housing Starts," Heritage Foundation *Special Report* No. 120, October 4, 2012, http://www.heritage.org/research/reports/2012/10/a-housing-market-without-fannie-mae-and-freddie-mac-effect-on-housing-starts. See also, Nahid Kalbasi Anaraki, "A Housing Market Without Fannie Mae and Freddie Mac: Effect on Home Prices," Heritage Foundation *Special Report* No. 105, April 18, 2012, http://www.heritage.org/research/reports/2012/04/a-housing-market-without-fannie-mae-and-freddie-mac-effect-on-home-prices. See also, Nahid Kalbasi Anaraki, "A Housing Market Without Fannie Mae and Freddie Mac: Effect on the Homeownership Rate," Heritage Foundation *Special Report* No. 109, June 11, 2012, http://www.heritage.org/research/reports/2012/06/a-housing-market-without-fannie-mae-and-freddie-mac-effect-on-the-homeownership-rate.

[27] John L. Ligon and William W. Beach, "A Housing Market Without of Fannie Mae and Freddie Mac: The Economic Effects of Eliminating Government-Sponsored Enterprises in Housing," Heritage Foundation *Special Report* No. 127, January 8, 2013, http://www.heritage.org/research/reports/2013/01/a-housing-market-free-of-fannie-mae-freddie-mac#_ftn17 (accessed March 3, 2013)

[28] David C. John, "Free the Housing Finance Market from Fannie Mae and Freddie Mac," Heritage Foundation *Backgrounder* No. 2577, July 12, 2011, http://www.heritage.org/research/reports/2011/07/free-the-housing-finance-market-from-fannie-mae-and-freddie-mac.

Testimony of Joshua Rosner

Subcommittee on Capital markets and Government Sponsored Enterprises: Fannie Mae and Freddie Mac: How Government Housing Policy Failed Homeowners and Taxpayers and Led to the Financial Crisis:

10:00 a.m. March 6, 2012

Room 2128 Rayburn House Office Building

Thank you Chairman Garrett, Ranking Member Maloney and members of the subcommittee for inviting me to testify on this important subject.

In July 2001 I authored a paper titled *"Housing in the New Millennium: A Home Without Equity is Just a Rental with Debt"*.[1] That paper, written in the aftermath of the "dot com" crash, sought to answer questions about the relationship between the broader economy and the housing market and whether housing would be hurt by a faltering economy.

The executive summary of the paper noted *"there are elements in place for the housing sector to continue to experience growth well above GDP. However, we believe there are risks that can materially distort the growth prospects of the sector". Specifically, I warned, "it appears that a large portion of the housing sector's growth in the 1990's came from the easing of the credit underwriting process"* and that easing included:

- "The drastic reduction of minimum down payment levels from 20% to 0%";
- "A focused effort to target the "low income" borrower";
- "The reduction in private mortgage insurance requirements on high loan to value mortgages";
- "The increasing use of software to streamline the origination process and modify/recast delinquent loans in order to keep them classified as 'current'"; and
- "Changes in the appraisal process that have led to widespread over-appraisal/over-valuation problems."

I concluded: *"If these trends remain in place, it is likely that the home purchase boom of the past decade will continue unabated. Despite the increasingly more difficult economic environment, it may be possible for lenders to further ease credit standards and more fully exploit less penetrated markets. Recently targeted populations that have historically been denied homeownership opportunities have offered the mortgage industry novel hurdles to overcome. ...**The virtuous circle of increasing homeownership due to greater leverage has the potential to become a vicious cycle of lower home prices due to an accelerating rate of foreclosures.**"*

As you will see in my testimony, the GSEs, which were originally government agencies intended to provide liquidity to the secondary mortgage market, were repurposed by the Clinton administration to direct social policy through the housing and mortgage markets. The combination of using the GSEs as "tools"[2] of social policy and falling interest rates built the foundation of the housing bubble by supporting acceptance of low- and no-down payment loans, lower FICO scores, higher debt-to-income and loan-to-value ratios. These "benefits" are exemplified by the 1999 comments of Fannie Mae's Chairman that "a record of prompt utility bill and rent payments can be substituted for the traditional credit report to verify a potential borrower's willingness to pay a mortgage loan".[3]

In early 1993, the Clinton administration realized that, among the "available Federal resources", "capital investments for housing and community development" could be driven "through Fannie Mae, Freddie Mac, FHA, and HUD/USDA programs"[4] and HUD has established performance goals for Fannie Mae and Freddie Mac.

As Susan Wachter noted in 2003:

> ***"The goal of the federal chartering of Fannie Mae and Freddie Mac…is to achieve public policy objectives including the promotion of nationwide homeownership through the purchase and securitization of mortgages.*** *The Federal government provides a number of economic privileges to the GSEs, most important of which is the implied Federal government guarantee which decreases the enterprises' funding costs…*
>
> *Fannie Mae and Freddie Mac have contributed to the expansion of homeownership in America, providing affordable residential mortgages for low- and moderate-income households who otherwise might not have the opportunity to become homeowners…GSEs have accomplished this in part through their special affordable lending programs but also importantly through lower mortgage and down payment rates that would not prevail but for the presence of the GSEs."*

In 1994, the Administration set about to "raise the ownership rate by 0.5% - 1.0% per year for the seven years, from 65% to 70% by the year 2000" and recognized this "can be done almost entirely off-budget-through creative leadership and partnerships with HUD, FHA, Fannie Mae, Freddie Mac, FHLBS, CDFIs, the private mortgage and insurance companies, and the banks and thrifts".[5]

The Administration created a "National Homeownership Strategy"[6] which included the goal of using the GSEs to "provide low- and no-downpayment loans to eligible low- and moderate-income purchasers"[7] even to borrowers "the private mortgage market has deemed to be un-credit-worthy"[8].

In a 1998 memorandum, then Secretary of the Treasury Robert Rubin recognized many of the risks associated with increasing lending to the most 'at risk' borrowers noted:

- Lowering the down payment requirement is likely to reduce saving among low-income people who would like to be home owners;
- We may not want to encourage poor people especially those who cannot save to purchase their homes. In an economic downturn, these home owners may be more vulnerable and more likely to lose their homes; and
- It is not clear that home ownership causes the effects attributed to homeowners.

Still, the Clinton Administration's plans continued.[9]

Reversing major trends, homeownership began to rise in 1995 and continued to rise through the late 1990's. Existing home sales grew from 27.5 million units in the 1970's to 29.8 million units in the 1980's and ended the 1990's at 40 million units. New home sales grew from 6.5 million units in the 1970's to 6.1 million units in the 1980's and ended the 1990's at 7.0 million. By 2000, US homeownership exceeded 67%.

"In 1989 only 7 percent of home mortgages were made with less than 10 percent down payment. By August 1994, low down payment mortgage loans had increased to 29 percent". This trend continued unabated throughout the 1990's and by 1999, over 50 % of mortgages had down payments of less than 10%. In 1976 the average down payment by first time homebuyers was 18% and by 1999 that down payment had fallen to 12.6%. In 1999, more than 5% of all residential mortgages had no equity or had negative home-equity. Eliminating down payment barriers has created a homeownership option for Americans who previously were forced to rent, due to savings or credit issues.[10] While the GSEs were certainly a key driver of these results other government actions,[11] fraud,[12] and the impact of falling interest rates also fueled the expansion.

By increasing investor confidence with low and no downpayment mortgage products, the GSEs seasoned the market. But they were surely not the only culprits. *In 2001, after much lobbying from the banking industry and rating agencies, the Basel Committee determined that AAA and AA rated private label securities should carry the same risk weightings as correspondingly rated GSE products.[13] This action, as much as any other, opened the floodgates to the reckless private label securitization of the most toxic mortgage products.*

Banks that had only a few years before sought to reduce their exposures to consumer lending used their branch network to originate loans to distribute through securitization markets. Investment banks, which had no branch networks, began to expand their provisioning of warehouse lines of credit to third party mortgage originators.

By 2002 the private label securitization (PLS) market was now at ease with changes made in 2000 by the GSEs "which expanded their purchases to include "Alt-A," A-minus, and subprime mortgages, in addition to private-label mortgage securities".[14] Private issuers began to aggressively target borrowers with lower down payments, lower FICO scores, lower documentation, higher debt-to-income and higher loan-to-value ratios. PLS activity exploded. Conforming securitization rates increased from 60 percent in 2000 to 82 percent in 2005 and non-conforming securitization rates from 35 to 60 percent over that same period.

As the PLS market took off the investment banks and their third-party mortgage origination partners created more and more risky products, including many negative amortization products – with support of the credit rating agencies,[15] their absurd analysis[16] and the CDO market.[17] With strong investor demand for these relatively higher yielding debt securities the PLS issuers began to take significant market share from the GSEs.

As the "law of large number" made it increasingly difficult to find new homebuyers the entire industry sought to employ these riskier, negative amortization and hybrid products to take advantage of falling interest rates and refinance existing homebuyers, encourage cash-out refinancing and encourage the speculative frenzy for second homes and investment properties.

For the first few years, the GSEs avoided direct and aggressive competition with the looser standards of these lenders and instead, used their portfolios to become the largest purchasers of private label securities. By 2004, Freddie Mac decided to expand its direct exposure to Alt-A lending.

As I noted in a 2007 report, as early as 2004, 16% OF Fannie Mae's portfolio had FICO scores below 660 (S&P 12/06) and Fannie Mae's 2004 exposure to second homes and vacation properties was already about 8%. It also appears that prior to the Joint Guidance on non-traditional mortgages, one or both of the GSE were offering negative-amortization products that would not begin to fully amortize until after the reset period. ***As OFHEO noted in their April 2007 Annual Report to Congress, "higher-risk products such as interest-only, sub-prime, Alt-A and negative amortization loans are growing, but are currently about 20 percent of the book of business".*** *I also noted that "recently, 7 private mortgage insurers insured about 17% of the GSE's book (roughly $400BB) and it is unclear how the PMI industry's capital base (roughly $40BB) would have the ability to absorb the possibly sizeable impact to their first loss exposures to the GSE's book".*

In the fall of 2004 the Fed began to increase interest rates and with few new buyers and most mortgage market activity tied to refinancing, ownership peaked late that year. On November 16, 2005 I warned "we continue to expect consumer mortgage credit quality to show deterioration in the third quarter (largely from energy prices and Hurricane Katrina) and expect that it will continue to rise from there".

With many borrowers still seeking to lock in low but rising interest rates, refinancing and the 40%[18] of all sales that were investment or vacation homes continued to stoke the bubble. Informational asymmetry in PLS hid risks to investors and supported uneconomic activity.

By early 2006 it was clear that "dramatic shrinkage in the RMBS sector is likely to arise from decreased funding by the CDO markets as defaults accumulate. Of course, mortgage markets are socially and economically more important than manufactured housing, aircraft leases, franchise business loans, and 12-b1 mutual fund fees. Decreased funding for RMBS could set off a downward spiral in credit availability that can deprive individuals of home ownership and substantially hurt the U.S. economy".[19]

The GSEs: What Went Wrong:

There is nothing specifically wrong with the existence of entities whose purpose is to support liquidity in the secondary mortgage market. In fact, there is a substantial need for such a function to exist.

The problem was the use of quasi-private institutions as tools of social policy for the purpose of driving housing subsidies to the market through a perverse off-balance-sheet subsidy that was arbitraged by private market participants.

The GSEs were no longer merely supporting liquidity in the secondary market as they had been created to do. When their public mission was combined with the desire to provide outsized private returns to shareholders the increasing use of their portfolios and their purchase of almost 25% of private-label-securities, Fannie and Freddie fostered uneconomic and distortive excessive market liquidity.

Still, there is much to be lauded and recognized in the purpose and function of the GSEs as they existed prior to the 1990's. Some of those features are still in place and provide value both to the housing and mortgage market. Beside the GSEs' purpose as lender of last resort to banks seeking to fund conforming/conventional home mortgages, a purpose which while now distorted could be repaired, the GSEs offer standards still absent in the market, particularly as examples of standardized representations and warranties and pooling and servicing agreements.

While there are proposals to replace the GSEs with alternatives, many of those seem to transfer many of the subsidies the GSEs received to other private institutions.[20] Besides the other problems embedded in many of the proposals is the reality that such an approach does not seek, as a key purpose, the repayment of over $140 billion of funds owed to the U.S. Treasury. Moreover, merely replacing the GSEs will result in significant loss of value that exists in their proprietary data sets, millions of loans time series, patent processes, underwriting technology, connectivity on both the front end and the back end of the origination and servicing process, their securitization technologies or their existing capability for scale in securitization and investor relations.

Although it is understandable that the GSEs have become the subject of politically charged debate in Washington it is important to remember that, between the chartering of Fannie Mae (1938) and Freddie Mac (1970) and the 1990's, they served as valuable tools of financial intermediation. Repairing their failures is an achievable goal and would place them in their proper role as counter-cyclical buffers supporting the private mortgage market.

Any consideration of repair of the GSEs functions so that they could serve as Congress intended, in support of a functioning secondary mortgage market, should:

- Seek repayment of the almost $140 billion that the GSEs owe the U.S. Treasury[21];
- Sever the government's sponsorship to prevent the provisioning of an implied government guarantee or the inherent conflicts between the agencies' public, political and private purposes;
- Prevent the deterioration of underwriting standards through both private market mechanisms (greater data disclosure, accurately represented and warrantied mortgages with clear, standardized and enforceable putback remedies) and by better regulation
- Move pricing and credit risk bearing functions fully into the private sector with proper supervision;
- Limit the GSEs activities exclusively to prime borrowers to ensure that banks are able to use the GSEs, as originally intended, as liquidity tools for the funding of new mortgages rather than as risk transfer mechanisms.
    - Non-prime business should be left to either:
        - A standardized private market; or
        - Direct government programs intended to deliver explicit subsidies to specific borrower classes.
- Ensure proper equity capital levels:
    - raise guarantee-fees to market levels;
    - limit the portfolios to liquidity purposes only;
    - Regulate appropriate levels of capital.

[1]Rosner, Joshua, Housing in the New Millennium: A Home Without Equity is Just a Rental with Debt (June 29, 2001). Available at SSRN: http://ssrn.com/abstract=1162456or http://dx.doi.org/10.2139/ssrn.1162456
[2] Executive Office of the President, RE: Thursday Meeting on Urban issues, August 1,1994 03: 38pm p. 2 available at http://www.clintonlibrary.gov/assets/storage/Research%20-%20Digital%20Library/rascomeetings/Box%20058/005%20647140-urban-meeting-bob-rubins-office-5-august-1994-2-00-3-00-pm.pdf (See e.g. "Use tools of HUD, FHA, Fannie and Freddie to provide low- and no-downpayment loans to eligible low- and moderate-income purchasers")
[3]Private MI Today, Not Someday, MICA Membership Directory, 2000-2001 Fact Book, Washington, DC: Mortgage Insurance Companies of America
[4] The White House, Memorandum for the Vice President, "Community Empowerment: Resources and Strategy", October 5, 1993, p. 1, available at: http://www.clintonlibrary.gov/assets/storage/Research%20-%20Digital%20Library/Reed-Subject/105/647386-community-empowerment.pdf
[5] MEMORANDUM FOR CHRIS EDLEY & STEVE REDBURN, "HOUSING POLICY", PAUL DIMOND, CC: GALSTON, REED, WEINSTEIN, CASHIN, SEIDMAN, SPERLING, CUOMO, KATZ, RETSINAS, STEGMAN, May 31, 1994 available at: http://www.clintonlibrary.gov/assets/DigitalLibrary/BruceReed/Subject/Box%20114/647386-housing-ideas.pdf
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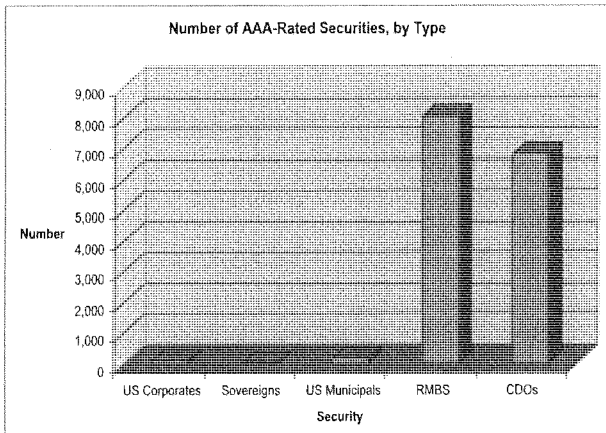
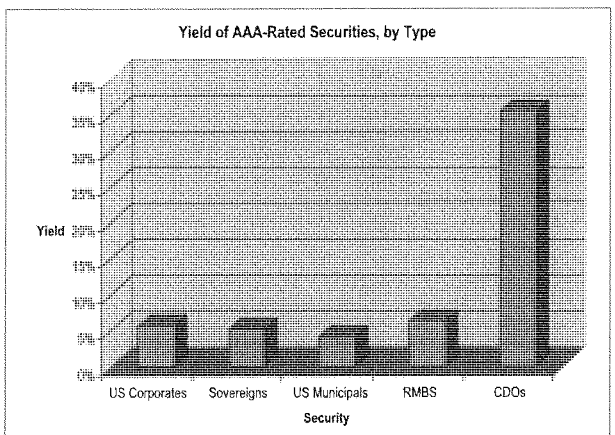
[8] Rubin, Robert, Secretary of the Treasury, Department of the Treasury, Memorandum for Gene Sperling, Director of the National Economic Council, "Meeting on tax Cut Options", December 2, 1998 p. 18 Available at: http://www.clintonlibrary.gov/assets/DigitalLibrary/BruceReed/Subject/Box%20126/647386-taxes.pdf
[9] White House, "Race Report Meeting", January 20, 1999, Oval Office, http://www.clintonlibrary.gov/assets/storage/Research%20-%20Digital%20Library/Reed-Subject/124/647386-race-book-1.pdf (See: "*Recommendation,'* Launch a major refocusing o f the large housing-related GSEs – FNMA, Freddie Mac and the Federal Home Loan Bank Board System... in general, GSEs commonly assert that they are "private" and cannot be expected to make uneconomic investments. But their profitability is fueled by their access to "cheap" money via a government debt guarantee or a discount Fed window...Specifically, the President should propose to: First, adopt new regulatory and statutory provisions to (a) press the GSEs to focus more of their housing activity on severely distressed

communities. and(b)give the GSEs more effective tools to promote targeted lending for community development purposes."
[10] See: Rosner, Joshua, Housing in the New Millennium p. 7
[11] E.g. - In 1999, the Congress enacted the "First-time Homebuyer Affordability Act of 1999". The premise of the Act is that "it is desirable to make funds available from individual retirement plans to encourage first-time homeownership". This legislation reduces the difficulty a potential buyer may have in financing a down payment, but with risks. In the event of a decline in real estate values or in the event of a foreclosure, some or that borrower's entire retirement asset may be lost. Also, in 2000, Congress enacted "The American Homeownership and Economic Opportunity Act of 2000". Title I of the Act is termed "REMOVAL OF BARRIERS TO HOUSING AFFORDABILITY". Among the bill's provisions is one that allows families receiving federal rental assistance to accumulate up to a year's worth of that assistance toward the down payment, appraisal and closing costs of a home. President George W. Bush, based on public comments, seems to have agreed with the previous administration that low-income families should be allowed to apply rental vouchers toward down payments.
[12]Niesen Roger E., "Audit Report: Family Production Home Ownership Centers", March 30, 2000, US Housing and Urban Development, p. ii (HUD's 1999/2000 internal audit of single family FHA loan production found that56% of defaulted loans in their study had significant underwriting deficiencies that were not detected by HUD or the contractor. Those deficiencies included fraud, excessive ratios, source or adequacy of funds issues, improper income analysis and/or debt or credit issues.)
[13]Morgenson, Gretchen and Joshua Rosner, Reckless Endangerment, Times Books, New York, 2011 p. 141
[14]DeVenti, Theresa R. , "**Fannie Mae and Freddie Mac: Past, Present, and Future**", HUD Policy Briefs p. 236
http://www.huduser.org/periodicals/cityscpe/vol11num3/ch11.pdf
[15] See: Mason, Joseph R. and Rosner, Josh, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions (May 3, 2007). Available at SSRN:
http://ssrn.com/abstract=1027475or http://dx.doi.org/10.2139/ssrn.1027475
[16]Rosner, Joshua (2007) "Financial Services Exposures to Subprime, Why we are not 'Seeing Red'", Graham Fisher, 26 July





[17] See: Mason, Joseph R. and Rosner, Josh, How Resilient are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions? (February 13, 2007). Available at SSRN: http://ssrn.com/abstract=1027472or http://dx.doi.org/10.2139/ssrn.1027472

[18] See: http://www.scribd.com/doc/110442571/October-2012-Housing-Draft (National Association of Realtors data)

	Primary Residence	Vacation Hom	Investment Property
2003	67	12	22
2004	64	11	25
2005	60	12	28
2006	64	14	22
2007	67	12	21
2008	70	9	21
2009	73	10	17
2010	73	10	17
2011	62	11	27

[19]Mason, Joseph R. and Rosner, Josh, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions (May 3, 2007), p. 75 Available at SSRN: http://ssrn.com/abstract=1027475or http://dx.doi.org/10.2139/ssrn.1027475

[20] "Housing America's Future: New Directions for National Policy", Bipartisan Policy Center, February 2013 Available at: http://bipartisanpolicy.org/sites/default/files/BPC_Housing%20Report_web_0.pdf

[21] Rosner, Joshua, OpEd Contributor, "Hey Fannie and Freddie, Pay Us Back!", The New York Times, November 19, 2012 Available at: http://www.nytimes.com/2012/11/19/opinion/a-140-billion-iou.html?_r=0

"THE FINANCIAL CRISIS AND THE ROLE OF THE GSES"

Testimony prepared for

"FANNIE MAE AND FREDDIE MAC: HOW GOVERNMENT HOUSING POLICY FAILED HOMEOWNERS AND TAXPAYERS AND LED TO THE FINANCIAL CRISIS"

ON

MARCH 6TH, 2013

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT-SPONSORED ENTERPRISES

U.S. HOUSE OF REPRESENTATIVES

WRITTEN TESTIMONY
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Chairman Hensarling, Ranking Member Waters, and other distinguished members of the Subcommittee:

Thank you for the invitation to testify at today's hearing on "Fannie Mae and Freddie Mac: How Government Housing Policy Failed Homeowners and Taxpayers and Led to the Financial Crisis." I am the Richard B. Worley Professor of Financial Management at The Wharton School of the University of Pennsylvania. Together with co-authors, I have researched and written scholarly papers on the GSEs and the mortgage crisis. Recent publications are listed at the end of this statement. It is an honor to be here today to discuss a critical issue for the future of the housing finance system, that is, the role of Fannie Mae and Freddie Mac in the financial crisis.

Government housing policy failed homeowners and taxpayers and it is important to understand why. The GSEs contributed to the meltdown. The direct cause of the crisis was the proliferation of poorly underwritten and risky mortgage products. The majority of these products, and the most risky products, were funded through private label securitization.

We know now but did not know in real time the shift toward unsound lending. Nontraditional and aggressive mortgages (such as teaser rate ARMs and interest only mortgages) proliferated in the years 2003 to 2006 changing from their role as small niche products to become nearly 50% of the origination market at the height of the bubble in 2006. In particular, the extent to which the loan-to-value ratio of the underlying loans was increasing through second liens was not monitored, tracked, or known. As the market share of these products expanded, the market share of the GSEs declined, as shown in Exhibit A.

In the years that I have identified as "the housing bubble" – that is, 2003 to 2006 – the GSEs saw their market share plummet. According to the Financial Crisis Inquiry Commission (FCIC), private-label securitizers issued over 30 percent more mortgage-backed securities (MBS) than the GSEs during these boom years. As shown in Exhibit B, this dominance by private-label securitization (PLS) was a new phenomenon. It is only during the years when housing prices rose to unprecedented heights that PLS achieved this unprecedented takeover.

As non-agency private label securitization was expanding, overall leverage was increased by the creation and growth of financial derivatives, collateralized debt obligations (CDOs), CDOs squared, and CDS. The so-called B-rated pieces of MBS were re-securitized as triple-A rated CDO securities, increasing leverage. Credit default swaps were issued to insure the providers of funding to MBS, but without requiring reserves. The amount of the increasing leverage introduced by the issuance of CDOs, CDS squared, and CDS was not known. The deterioration of the quality of the mortgages used as collateral for these securities was not known. These risk sources were obscured due to the lack of consistent and transparent reporting requirements.

The rise in prices that the expansion of credit enabled initially masked the increase in credit risk. If borrowers were having trouble with payments, homes could be sold and mortgages could be refinanced, thus concealing the increases in credit risk. In mid-2006, prices peaked and mortgage delinquencies, defaults and foreclosures started their inevitable upward course. In the panic of mid- 2007, private label security issuing entities imploded and financing was no longer available: the issuance of new PLS went from $1 trillion to effectively zero.

The US economy faced the real threat of a second Great Depression. As housing prices declined, below mortgage values, forced sales through foreclosures caused prices to fall further. The resulting wealth destruction together with the freezing of finance caused the real economy to falter, leading to the recession of 2009. The recession itself brought about the so-called double trigger: households who lost their jobs could not sell their homes making ongoing foreclosures inevitable, with the potential of an outcome of a vicious downward spiral.

The housing price decline of 30%, only now being reversed, was due to this dynamic. The Federal government, the Treasury and the Federal Reserve Board policy responses supported the housing mortgage market, preventing the worst case outcome. Nonetheless, the loss of jobs, the decline in household wealth and the increase in US debt are continuing legacies of the crisis.

As I stated, the GSEs contributed to the crisis. Prior to 2007 the GSEs purchased the triple-A rated portion of MBS and they also securitized alt a loans. The GSEs were part of the irresponsible expansion of credit both before and after 2007 but other entities were far more responsible for the riskiest product originated and securitized.

There is, in fact, a simple way to measure the success or failure of the GSEs, relative to other entities. All we have to do is examine default rates. The GSEs' delinquency rates were far below those of non-GSE securitized loans. The distribution of mortgage failure is apparent in the performance of mortgages underlying securitization as shown in Exhibit C. I ask that these three Exhibits be entered into the official record.

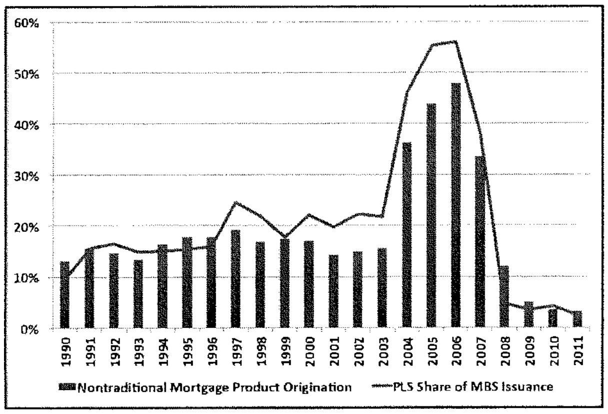
However, in a broad sense, the GSEs or their overseer may have had a larger responsibility which they failed to fulfill. The failure to identify credit and systemic risk in the markets in which they operate was at the heart of the financial crisis. No entity was looking out for the US taxpayer: Neither the Fed nor other financial regulatory agencies, nor the Treasury, nor OFHEO which at that time oversaw Fannie Mae and Freddie Mac. Financial markets did not operate to correct the growing risk. We know from this crisis and from previous crises, that markets do not self-correct in the absence of arbitrage, that is, in the absence of markets in which securities' sales can price and trade risk, and for arbitrage and market trading of securities to occur we must have market standardization and transparency.

The failure to identify credit and systemic risk is at the heart of the financial crisis and must be corrected going forward. This will require the reform of the housing finance system, in particular, to assure mortgage security standards and transparency. There must be a monitoring function to identify credit risk through the documentation and identification of risks in mortgage products and in mortgage securities. This role is a central requirement for effective markets and it requires a standardization and coordination function for its realization. This need not be performed by the GSEs or the regulator, although such a role had been theirs in the stable decades before the crisis, but the role is nonetheless a necessary one. We can rebuild a resilient housing finance system, one which can protect homeowners and the US taxpayer going forward, but in order to do so we must understand and correct the failures of the past.

I thank you for the opportunity to testify today and I welcome your questions.

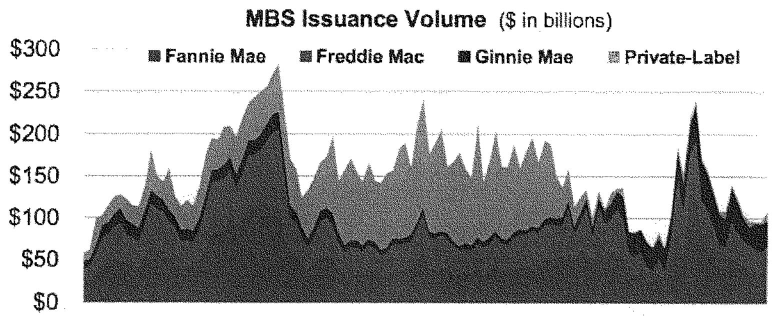
Exhibit A

Market Share of Nontraditional Mortgage Products and Private Label Securitization



Source: Inside Mortgage Finance 2012 Mortgage Market Statistical Annual. Nontraditional mortgage products are subprime, Alt-A and home equity loans.

Exhibit B

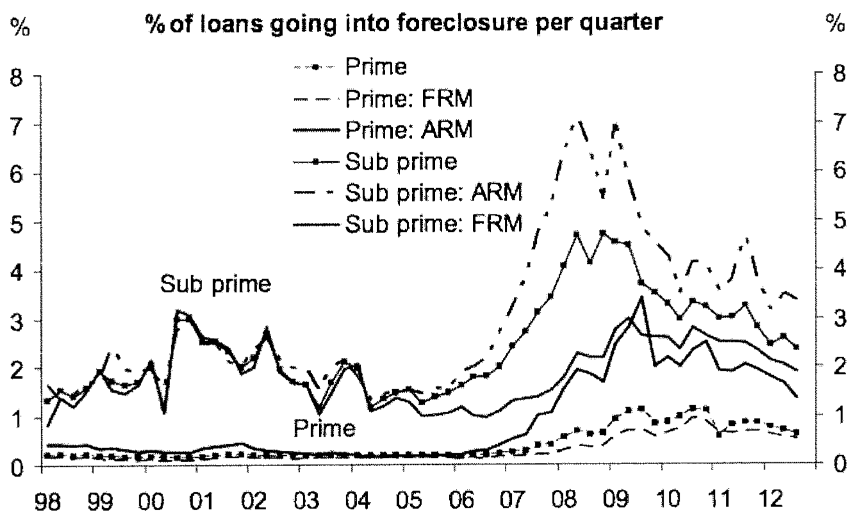


	2001	2002	2003	2004	2005	2006	2007	2008	2009	YTD
Enterprises	67%	68%	70%	47%	41%	40%	58%	73%	72%	66%
Ginnie Mae	13%	9%	8%	7%	4%	4%	5%	22%	25%	29%
Total Agency	80%	77%	78%	54%	45%	44%	63%	95%	97%	95%

Sources:
Inside Mortgage Finance, Enterprise Monthly Volume Summaries.
Issuance figures exclude MBS issued backed by assets previously held in the Enterprises' portfolios.

Source: Federal Housing Finance Agency (2010)

Exhibit C: Foreclosure by Market Segment



Note: ARM=Adjustable Rate Mortgage, FRM=Fixed Rate Mortgage

Source: MBA, Datastream, DB Global Markets Research

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TESTIMONY

Lawrence J. White
Professor of Economics
Stern School of Business
New York University

Before the
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
Hearing on
"Fannie Mae and Freddie Mac: How Government Housing Policy Failed Homeowners and Taxpayers and Led to the Financial Crisis"
March 6, 2013

Chairman Hensarling, Ranking Member Waters, and members of the Subcommittee: My name is Lawrence J. White. I am a Professor of Economics at the NYU Stern School of Business. During 1986-1989 I served as a Board Member of the Federal Home Loan Bank Board; in that capacity I was also one of the three Board Members of Freddie Mac. I have written extensively on the subject of the government-sponsored enterprises (GSEs);[1] a chronological list of these writings is at the end of this statement, as is my short biographical summary and the "Truth in Testimony" disclosure form. I represent solely myself at this hearing.

Thank you for the opportunity to testify today on this important topic. Despite having been in government conservatorships since September 2008, Fannie Mae and Freddie Mac remain at the center of the U.S. residential mortgage finance system. Although there is a general consensus that this dominant role for these GSEs is not a viable long-run pattern for the mortgage finance system, there is no consensus as to what should replace them; and this political stasis has led de facto to the GSEs' continued dominant position.

[1] As a technical matter, the Federal Home Loan Bank System (FHLBS) should also be included in the category of "housing-oriented GSE". However, since the topic of today's hearing is solely Fannie Mae and Freddie Mac, my references to GSEs will apply solely to Fannie Mae and Freddie Mac, unless otherwise indicated.

Accordingly, a review of their history is surely worthwhile. After all, in order to know "Where should we go?" it is often useful to know "How did we get here?" Or, to quote George Santayana, "Those who cannot remember the past are condemned to repeat it."

In the remainder of this statement I will first provide some general background on the two GSEs and then discuss their specific roles in the housing bubble of the late 1990s and early and mid 2000s and the subsequent housing collapse and the financial crisis of 2008-2009.

Some general background.

Fannie Mae and Freddie Mac are two private-sector, publicly traded corporations, with shareholders. Until their conservatorships in 2008, the shares of each company were traded on the New York Stock Exchange.

The two companies do fundamentally the same things: They operate in the secondary market for U.S. residential mortgages. They buy mortgages from originators – the first-instance lenders to mortgage borrowers – and then do either of two things:

(a) They may bundle pools of hundreds of mortgages into residential mortgage-backed securities (RMBS) and sell the RMBS to investors. These RMBS represent "pass-through" claims on the streams of interest payments and principal repayments by the underlying mortgage borrowers. These RMBS carry the guarantee of the issuing GSE (for which the GSE charges a fee) that, in the event that the underlying borrower of a mortgage in the bundle defaults on his/her payment obligation, the GSE will keep the RMBS investor whole by making payments from the company's resources in lieu of the borrower's payments. Or

(b) The GSEs may hold the mortgages in their own portfolios, with the funding for these portfolio holdings coming almost entirely (prior to 2008) or entirely (since 2008) from their issuance of debt obligations that represent direct claims on each company.

Fannie Mae had its origins in 1938, as an agency within the Federal Housing Administration. After modest growth through the 1960s (see Table 1), Fannie Mae was privatized in 1968 and became a publicly traded company. However, it retained many special ties with the federal government (which will be detailed below). Freddie Mac came into existence in 1970. Both GSEs grew modestly in the 1970s and early 1980s. The contraction of the savings & loan (S&L) industry (which had hitherto been the major financer of residential mortgages) in the mid 1980s gave both GSEs an expanded opportunity to grow, as did legislation in 1989 (the Financial Institutions Reform, Recovery, and Enforcement Act, or FIRREA) and 1992 (the Federal Housing Enterprises Financial Safety and Soundness Act, or FHEFSSA).

Prior to their conservatorships in 2008, both companies might have looked like ordinary U.S. corporations, since they had public shareholders, their shares were traded on the NYSE, and their corporate governance structure included a chief executive officer (CEO) and board of directors. However, they had many other features that clearly made them special:

- Their corporate charters were created through specific congressional legislation;
- The board of directors of each company was mandated to have 18 members, of which the president of the United States could appoint five members;
- They paid no state or local income taxes;
- They each had a potential line of credit with the U.S. Treasury of up to $2.25 billion;
- Their securities were considered to be "government securities" under the Securities Exchange Act of 1934;
- They were not required to register their securities with the U.S. Securities and Exchange Commission (SEC), and they were exempt from SEC fees;

- Their securities could be purchased and held in unlimited quantities by U.S. banks and savings institutions;
- Their securities could be purchased by the Federal Reserve for the latter's "open market operations";
- They each could use the Federal Reserve as their fiscal agent; and
- Their insolvencies could not be resolved by a bankruptcy process or by a regulatory agency but instead would have to be resolved by the U.S. Congress.

There were also limitations:

- Their activities were specifically restricted (again, by statute) to the secondary mortgage market; they were specifically prohibited from originating mortgages;
- The size of mortgage that they could buy (the "conforming loan limit"), either for investment or for securitization, was limited in amount (which was adjusted each year in accordance with an index of house prices); as of early 2008 that amount was $417,000, which continues to apply today in most areas of the U.S. (but the Congress subsequently expanded this amount for high-cost housing areas to as high as $729,750 and today to $625,500 in those high-cost housing areas);[2] "conforming loans" were also expected to be high-quality mortgages that met "investment quality standards";
- They were subject to prudential regulation by a federal regulatory agency (until 2008, this was the Office of Federal Housing Enterprise Oversight [OFHEO]; in the summer of 2008 the Federal Housing Finance Agency [FHFA] replaced OFHEO); and
- They were subject to "mission regulation" (i.e., regulatory requirements that they meet targets with respect to their mortgage purchases in areas with low- and moderate-income

[2] Mortgage loans that are larger than the conforming loan limit are typically described as "jumbo" loans.

and underserved households), which was under the jurisdiction of the U.S. Department of Housing and Urban Development (HUD) until the summer of 2008 (when FHFA absorbed this role).

It was thus no accident that the GSE label came to be applied to these two companies.

There was at least one other characteristic that made the GSEs special: their sheer size. From the early 1990s onward, their holdings of mortgages plus the RMBS that they issued and guaranteed accounted for over a third of the value of all residential mortgages in the U.S. (see Table 1); and from 1999 onward (with the exception of 2005 and 2006) they accounted for over 40%. As of year-end 2008, the aggregate value of their mortgages held and guaranteed exceeded $5.2 trillion.

The GSEs' specialness had an important consequence: The GSEs were able to borrow at interest rates that were lower than their financial condition would have otherwise justified. In essence, the financial markets believed (correctly, as it turned out) that if either (or both) of the GSEs were to experience financial difficulties, the federal government would intervene and make sure that the companies' creditors would remain whole. The consensus of academic studies is that this perception – this belief in an "implicit guarantee" – allowed the GSEs to borrow at rates that were approximately 2/5 of a percentage point lower than would otherwise have been the case.

In turn, their favorable borrowing costs translated into lower mortgage interest rates for conforming mortgages (i.e., the mortgages that the GSEs were allowed to buy and hold or securitize). The academic consensus is that conforming mortgages carried interest rates that were approximately ¼ of a percentage point lower than would otherwise have been the case.

In addition to these favorable borrowing costs, the GSEs had other important advantages that encouraged them to grow rapidly in the 1990s and the early 2000s (see Table 1): They had lower capital requirements (2.5% of the value) for holding mortgages in their portfolios than did depository institutions (for which the comparable capital requirement was at least 4%); and they had much lower capital requirements (0.45%) for covering the credit risk on their RMBS than was required for depository institutions (again, 4%) to cover the same category of risk. As a consequence, their balance sheets were highly leveraged, with capital (net worth) equal to only 3-4% of assets (and thus debt providing the funding for 96-97% of assets).[3] Further, when depository institutions held the GSEs' RMBS (and, starting in 2002, other issuers' highly rated RMBS), the capital requirement was only 1.6%, as compared with the 4% requirement for holding unsecuritized "whole" mortgages, which provided a favorable market for the GSEs' RMBS.

Given these advantages – plus the shrinking of the S&L industry after the mid 1980s, the conversion of Freddie Mac into a less restrained company in 1989, and the discarding of Fannie Mae's caution after experiencing financial difficulties in the early 1980s – the rapid absolute and relative growth of the GSEs in the 1990s and the early 2000s was not surprising. It was only accounting scandals at Freddie Mac in 2003 and at Fannie Mae in 2004 that gave their prudential regulator (OFHEO) the ability to put caps on the sizes of their portfolio holdings of residential mortgages. Limits (other than the 0.45% capital requirement) were not, however, placed on the securitization of their RMBS, which continued to grow.[4]

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[3] This could also be described as an assets-to-capital leverage ration of 25-to-1 or 33-to-1. If the "off balance sheet" guarantee on their RMBS were included as an additional claim for which their capital was supposed to provide protection, the GSEs' leverage ratio could be described as 75-to-1.

[4] Since the GSEs were experiencing little or no credit-related losses at the time, the major fears by the GSEs' critics were of interest-rate risks: that the GSEs were not adequately hedging their portfolios against the financial damage that changes in interest rates could bring to the value of the 30-year fixed-rate mortgages that dominated their balance sheets. Since the GSEs' guarantees on their RMBS covered only credit-related losses – the RMBS investors

Finally, it is worth emphasizing that the special governmental advantages for the GSEs were not an anomaly in U.S. economic policy. Instead, these advantages – with the expectation that they would reduce the cost of housing finance – were a part of a much larger and wider set of government policies – at the federal, state, and local levels – that are intended to reduce the cost of housing for households.[5] At the federal level, these have encompassed widespread tax deductions (such as the mortgage interest deduction for households), the existence and widespread involvement of other government agencies (such as the FHLBS, FHA, and Ginnie Mae), tax advantages and direct subsidy programs for housing construction, direct subsidies for renters, etc.

With respect to housing and housing policies, the characterization "Too much is never enough!" seems appropriate.

The housing boom – and bust.

Starting around 1997, the U.S. economy experienced a major housing boom (which is now, with hindsight, recognized to have been a bubble).[6] Annual housing starts increased, home ownership rates rose, and housing prices increased above the general rate of inflation in the U.S. Between 1997 and 2006, the S&P/Case-Shiller national index of house prices rose by about 125%, while the U.S. Consumer Price Index (CPI) rose by only 28%. By the early 2000s there was a widespread belief that housing prices could only go up.

The growth of Fannie Mae and Freddie Mac in the 1990s surely helped support this boom – although, as the data in Table 1 indicate, the GSEs had been growing vigorously since the late

were the parties that would have to deal with the interest-rate risk on those RMBS – the expansion of the GSEs' RMBS issuances was not seen as a problem.

[5] It is important to realize that these efforts at lowering the costs of home ownership and of rental housing have effectively lowered the "price" of housing and have thereby encouraged U.S. households to buy and consume more housing than they otherwise would have – at the expense of other things that households, and American society more generally – could have consumed and/or invested in.

[6] The U.S. was not alone in this regard. Other countries – e.g., the U.K., Ireland, and Spain – experienced similar housing booms at roughly the same time.

1980s, whereas the housing boom only took off around 1997. At least as important in helping stoke the boom was the development and growth of "private label" residential mortgage securitization – i.e., the development of techniques and structures whereby financial institutions (typically investment banks, commercial banks, and mortgage banks) that were not GSEs and that could not provide the kind of guarantee that the GSEs provided were nevertheless able to issue RMBS that could be sold to financial institution investors.[7]

The widespread belief that housing prices could only go up had an important implication for mortgages: *Residential mortgage loans would rarely fail to be repaid!* Even if a borrower could not repay the mortgage from his/her normal income – say, because of an accident or extended illness, or because of loss of employment – he/she could still repay the mortgage by selling the house (at a profit) and repaying the mortgage from the proceeds.[8]

There was a further important implication: The traditional creditworthiness criteria for a mortgage borrower – sufficient household income to make the necessary mortgage payments, sufficient household financial resources to make a 20% down payment, a good credit history, etc. – as well as the importance of the monthly mortgage amortization payment were increasingly seen as less important to protect the lender in a context where housing prices would only go up and mortgages would rarely fail to be repaid. Accordingly, increasing numbers of "alt-A" and "sub-prime" mortgages were granted to borrowers with flawed credit histories, inadequate incomes, poor documentation, or other irregularities and with lower down payments. And the initial experience with these mortgages in the environment of rising prices in the late 1990s and

[7] After other methods were tried, the "tranching" technology became the method of choice in the early 2000s. This involved the pooling of hundreds of mortgages into a bundle and then issuing multiple layers of junior and senior securities, such that the junior securities would be the first absorbers of losses from any defaults by the underlying mortgage borrowers, which thereby gave greater protection and assurance to the holders of the more senior securities.

[8] And if mortgages would rarely fail to be repaid, then private-label RMBS would largely be safe investments.

early 2000s – that defaults were few and that the losses to lenders were small when those few defaults did occur – seemed to confirm that lending to these below-prime borrowers was not as risky as had previously been believed. In turn, of course, this experience encouraged yet more lending of this type.

As mentioned above, the "conforming" mortgages that the GSEs were allowed to buy were expected to meet "investment quality standards" (as determined by OFHEO). In the early 1990s and before, these standards had usually meant mortgage loans where the borrower had made at least a 20% down payment (or, equivalently, the loan-to-value [LTV] was 80% or less) or had private mortgage insurance for loans where the down payment was as little as 5%; where the borrower had a good credit history (as represented by a good "credit score" that was usually compiled by Fair, Isaac and Company and that came to be known as the "FICO score"); where the borrower's income was deemed adequate so that the monthly payments on the mortgage were affordable; and where there was good documentation. These indicia meant that the borrower was unlikely to default and that even in the event of default the sizable down payment (or mortgage insurance) provided a buffer that would protect the GSEs (as investors or as guarantors) against losses.

Beginning in the mid 1990s, however, the GSEs began buying some mortgages that would not otherwise meet these quality standards; this was done partly because lower-quality mortgages provided an additional area for expansion for the GSEs and partly because the regulatory pressures (which were encompassed in FHEFSSA) on the GSEs to increase their purchases of mortgages from low- and moderate-income households and households that were located in underserved areas were increasing. Some combination of the upward trend in housing prices, especially after 1996, and the GSEs' expertise in selecting higher-quality borrowers among those with apparently lower qualifications, kept the GSEs' losses low. From 1990 through 2007 Freddie Mac's credit losses on its mortgages in portfolio plus guaranteed RMBS never exceeded 0.11% annually; for Fannie Mae the comparable credit losses never exceeded 0.06%. For the years 1999-2005 (for Fannie Mae) and 2000-2006 (for Freddie Mac) the credit losses were only 0.01% annually!

Around 2003 the GSEs' involvement in lower-quality mortgages became more substantial. From around 2000 onward, the growth in alt-A and sub-prime mortgage lending and the related private-label securitization threatened the market shares of the GSEs. At first glance, this should not have been so, since the higher quality mortgage standards of the GSEs should have kept them separate and aloof from the sub-prime borrowers and lenders, and vice-versa. However, in the environment of rising prices and the widespread expectations that prices would continue to rise, lenders were encouraging borrowers who otherwise would have qualified for a conforming loan to borrow larger amounts (which would push them into "jumbo" territory) and/or to structure their loans in ways that would not meet the GSEs' underwriting standards (which would push them into nonconforming territory). The latter was done, for example, by allowing the borrower to make a down payment that was less than 20% but not insisting on (costly) mortgage insurance; or by allowing a second-lien mortgage loan to cover some or even all of the down payment; or by allowing a higher ratio of mortgage payments to income; or by providing initial low "teaser" rates but with a scheduled upward adjustment after two or three years (these were the so-called "2/28" or "3/27" mortgage loans); or by tolerating reduced levels of documentation.

In addition to these market share pressures, the GSEs were subject to increased regulatory pressures to expand their shares of mortgage purchases from low- and moderate-income households and from households in underserved areas. These regulatory pressures also led to the GSEs' decisions to buy significant amounts of private-label high-rated RMBS tranches that had sub-prime and/or alt-A mortgage loans as their underlying collateral, since many of these borrowers were households in the designated regulatory categories and the GSEs received regulatory credit for these securities purchases.

The continued increase in house prices initially masked the consequences of these actions, and annual credit losses for the GSEs stayed extremely low. But the S&P/Case-Shiller national index of house prices peaked in the second quarter of 2006 and then began to decline. Without the safety valve of "the borrower can always sell the house at a profit", mortgage delinquencies began to rise, and mortgage defaults followed. Although the increases were especially pronounced for sub-prime mortgages, all categories of mortgages suffered increases, including (not surprisingly) the GSEs' mortgages.

The patterns of cumulative defaults by cohort based on year of origination can be seen in Figures 1 and 2 for Fannie Mae and Freddie Mac, respectively. It is clear that the cohort of originations in 2004 marked the beginning of a different default experience, as compared to the cohorts of earlier years. This was due to the combination of the lower quality mortgages that the GSEs bought and the lesser amount of time (until mid 2006) for house price appreciation to cover the "sins" of the lower quality mortgages that had been bought. The successive annual cohorts through 2008 were even worse.

The rising defaults on sub-prime and alt-A mortgages and then on the private-label RMBS that had these mortgages as collateral also meant that the GSEs suffered losses on their investments in these apparently safe high-rated private-label RMBS.

<u>The financial crisis of 2008-2009</u>.

The GSEs failed to earn profits in 2007, instead running losses – for the first time ever for Freddie Mac and for the first time since 1985 for Fannie Mae.

The first major "casualty" from the rising defaults in mortgages and in private-label RMBS was the large investment bank Bear Stearns. Like the four other large investment banks,[9] Bear Stearns had a capital-to-assets ratio at the end of 2007 that was less than 4%. In early 2008 the financial markets came to believe that the mortgage- and RMBS-related losses that were embedded in Bear Stearns' balance sheet might well cause its insolvency, and Bear Stearns found it increasingly difficult to refinance its short-term debt. In March 2008 the Federal Reserve engineered the absorption of Bear Stearns by JPMorgan Chase.

In the first two quarters of 2008 the losses of both GSEs continued to rise. Although the delinquencies on the GSEs' mortgages were at lower rates than for the general population of mortgages economy-wide, nevertheless *the GSEs' thin capital levels were an insufficient buffer against these losses*. By the end of the summer of 2008, their insolvencies were looming, and the financial markets were beginning to worry whether the Treasury really would come to the rescue of their creditors. Like Bear Stearns six months earlier, the GSEs found it increasingly difficult to refinance their short-term debt. On September 6, 2008, in coordination with the Treasury, the FHFA placed both GSEs into conservatorships. In principle, the companies were still intact, with their shareholder/owners still in place; in practice, the GSEs had become the wards of the U.S. Government (which immediately dismissed and replaced their senior managers). The Treasury agreed to cover their losses and thus keep their creditors whole. The financial markets' belief in the "implicit guarantee" had proved correct.

[9] These were Goldman Sachs, Morgan Stanley, Merrill Lynch, and Lehman Brothers.

Because the Treasury did keep the GSEs' creditors whole, the GSEs' insolvencies did not create a cascade of other financial difficulties elsewhere in the U.S. financial sector.[10] However, their insolvencies and conservatorships likely did heighten the financial markets' concerns in September 2008 about the possible insolvencies and instabilities of other large and thinly capitalized financial institutions in the U.S. economy, such as the remaining four large investment banks, A.I.G., and the large Citigroup holding company. The Lehman Brothers bankruptcy filing a week later converted these concerns into a reality, which then unleashed the full forces of the financial crisis.

Conclusion.

As of March 2013, the Treasury's capital injections into Fannie Mae and Freddie Mac have been approximately $188 billion. Although initial estimates had raised the possibility that the Treasury's losses could rise as high as $400 billion, the stabilizing of the U.S. housing markets in 2012 appear to have meant the stabilizing of the GSEs' losses as well. FHFA now predicts a range of aggregate losses to the Treasury of $191-$209 billion. By any indicator, this has been a costly experience.

Although each of the GSEs has remained in a conservatorship since September 2008, they both have remained actively involved in residential mortgage finance. When private-label securitization collapsed at the end of 2007, the GSEs plus FHA expanded to fill the gap. Their expanded roles have been maintained: The three agencies account for the financing of approximately 90% of all new residential mortgages; the two GSEs alone account for 60-70% of the aggregate.

[10] The presence of significant foreign central bank holdings of the GSEs' obligations also appears to have been a significant factor in the Treasury's decision to keep all of the GSEs' creditors whole.

There are at least two major policy lessons to be learned from the GSE experience: First, there are rarely (if ever) "free lunches" to be found in economic policy. The lower mortgage costs that the GSEs provided – ¼ of a percentage point on conforming mortgages – appeared to be a free lunch, since there were no budgetary implications at the time in connection with the GSEs' special status and the "implicit guarantee". However, the "lunch" has become costly indeed. It behooves the federal government to be extremely wary of situations where the financial markets assume that the Treasury will come to the rescue of a financial institution's creditors.

Second, large systemic financial institutions – in this case, involved with residential housing finance – must be subject to rigorous prudential regulation, with high capital requirements at the center of this regulation. Anything less is an invitation to a repeat of this costly experience.

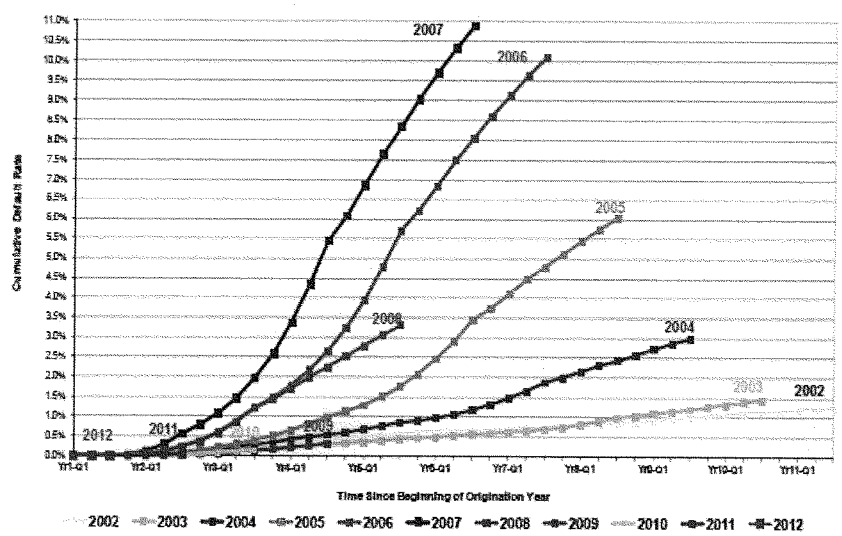
Table 1: Mortgages Held and MBS Outstanding, by Fannie Mae and Freddie Mac, 1948-2009
(all dollar amounts are in $ billions)

	Fannie Mae		Freddie Mac			
Year	Mortgages Held in Portfolio	MBS Outstanding	Mortgages Held in Portfolio	MBS Outstanding	Total U.S. Residential Mortgages	Total (F+F)/ Total Res. Mort.
1948	$0.2				$39.8	0.5%
1949	0.8				45.2	1.8
1950	1.3				54.3	2.4
1951	1.8				62.3	2.9
1952	2.2				69.9	3.1
1953	2.5				78.1	3.2
1954	2.4				88.0	2.7
1955	2.6				101.4	2.6
1956	3.1				112.8	2.7
1957	4.0				121.9	3.3
1958	3.9				133.7	2.9
1959	5.3				148.7	3.6
1960	6.2				162.1	3.8
1961	6.1				177.6	3.4
1962	5.9				195.0	3.0
1963	4.7				215.1	2.2
1964	4.4				136.9	3.2
1965	4.7				257.6	1.8
1966	7.1				274.0	2.6
1967	8.9				290.7	3.1
1968	7.1				311.1	2.3
1969	11.0				331.8	3.3
1970	15.5				352.2	4.4
1971	17.9		$0.9	$0.1	388.5	4.9
1972	19.7		1.7	0.4	440.2	5.0
1973	23.6		2.5	0.8	493.0	5.5
1974	28.7		4.5	0.8	535.1	6.4
1975	30.8		4.9	1.6	574.6	6.5
1976	31.8		4.2	2.8	640.9	6.1
1977	33.3		3.2	6.8	742.0	5.8
1978	42.1		3.0	12.0	863.4	6.6
1979	49.8		4.0	15.3	990.7	7.0
1980	55.6		5.0	17.0	1100.4	7.1
1981	59.6	$0.7	5.2	19.9	1172.6	7.3
1982	69.4	14.5	4.7	43.0	1216.3	10.8
1983	75.2	25.1	7.5	57.7	1347.3	12.3
1984	84.1	35.7	10.0	70.0	1507.2	13.3
1985	94.6	54.6	13.5	99.9	1732.1	15.2
1986	94.1	95.6	13.1	169.2	2068.8	18.0
1987	93.7	135.7	12.4	212.6	2186.1	20.8
1988	100.1	170.1	16.9	226.4	2436.6	21.1
1989	108.0	216.5	21.4	272.9	2655.9	23.3

1990	$114.1	$288.1	$21.5	$316.4	$2893.7	25.6%
1991	126.7	355.3	26.7	359.2	3058.4	28.4
1992	156.3	424.4	33.6	407.5	3212.6	31.8
1993	190.2	471.3	55.9	439.0	3368.4	34.3
1994	220.8	486.3	73.2	460.7	3546.1	35.0
1995	252.9	513.2	107.7	459.0	3719.3	35.8
1996	286.5	548.2	137.8	473.1	3967.7	36.4
1997	316.6	579.1	164.5	476.0	4214.0	36.5
1998	415.4	637.1	255.7	478.4	4603.9	38.8
1999	523.1	679.1	322.9	537.9	5070.0	40.7
2000	607.7	706.7	385.5	576.1	5524.3	41.2
2001	706.3	863.4	503.8	653.1	6118.0	44.6
2002	820.6	1040.4	589.9	729.8	6911.9	46.0
2003	919.6	1300.5	660.5	752.2	7809.1	46.5
2004	925.2	1408.0	664.6	852.3	8895.9	43.3
2005	736.8	1598.9	709.5	974.2	10070.6	39.9
2006	726.4	1777.6	700.0	1122.8	11189.6	38.7
2007	723.6	2118.9	710.0	1381.9	11985.1	41.2
2008	768.0	2289.5	748.7	1402.7	11922.3	43.7
2009	745.3	2432.8	717.0	1495.3	11717.8	46.0
2010	704.2	2399.6	681.6	1468.0	11248.5	46.7
2011	639.0	2433.7	640.6	1422.1	10988.2	46.7

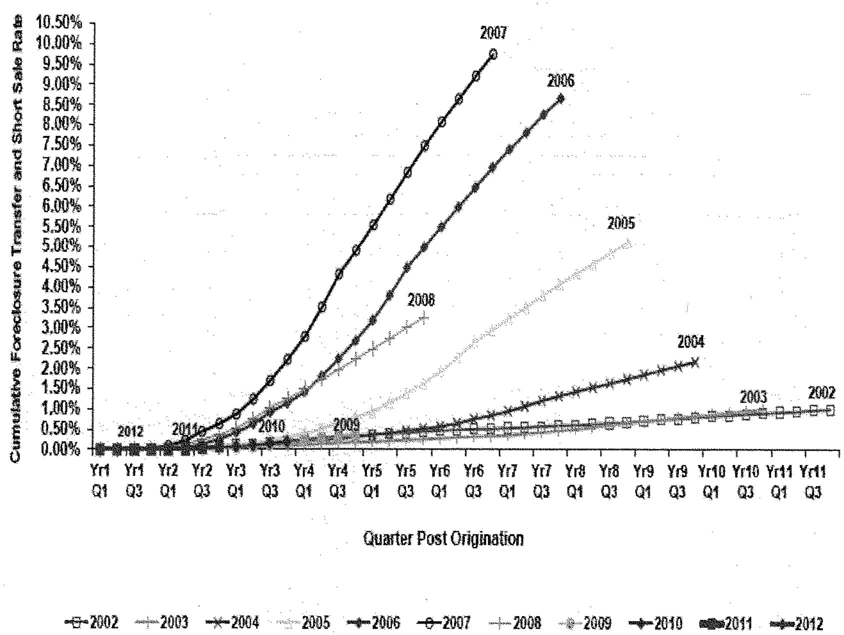
Note: All mortgage amounts encompass single-family mortgages plus multi-family mortgages.
Sources: Federal Reserve "Flow of Funds", various years; FHFA Report to Congress, 2011.

Figure 1: Fannie Mae Cumulative Default Rates by Year of Origination



Source: Fannie Mae, "2012 Third-Quarter Credit Supplement," November 7, 2012, p. 14; available at: http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2012/q32012_credit_summary.pdf

Figure 2: Freddie Mac Cumulative Default Rates by Year of Origination



Source: Freddie Mac, "Fourth Quarter 2012 Financial Results Supplement," February 28, 2013, p. 29; available at: http://www.freddiemac.com/investors/er/pdf/supplement_4q12.pdf

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June 6, 2006 Tuesday ONE-THREE EDITION

BROKERS IN THE BALANCE;
CONGRESSIONAL PROPOSAL MAY CHANGE ROLE BROKERS PLAY IN MORTGAGES
DO HOMEOWNERS NEED PROTECTION FROM LENDERS?

BYLINE: BINYAMIN APPELBAUM, BAPPELBAUM@CHARLOTTEOBSERVER.COM

SECTION: BUSINESS; Pg. 1D

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Under federal law, people shopping for home mortgage loans are largely responsible for protecting themselves.
The main limit on the interest rate and fees is the borrower's willingness to pay.
A study released last week underscored that the system is not working for everyone. The Center for Responsible Lending, a Durham nonprofit that critiques the industry, found blacks and Hispanics are more likely to pay high interest rates for mortgage loans than whites with similar financial circumstances.
But even before its release, a bipartisan group in Congress was meeting quietly to discuss new rules for the lending industry, rules to inhibit lenders from leading borrowers into bad choices.

The most dramatic proposal would transform the relationship between customers and the independent brokers who sell most loans: It would make the brokers represent the interests of the customers.
Other ideas focus on regulating the terms of loans, and limiting the fees charged by lenders and brokers.
The negotiators, including N.C. Democrats Mel Watt of Charlotte and Brad Miller of Raleigh, say the discussions could end a years-long deadlock over how to regulate the mortgage lending industry, and particularly the fast-growing "subprime" business of lending at high interest rates.
"We've been quietly trying to find common ground," Watt said. The new study, he said, "will increase the pressure to do something in this area."
Rep. Spencer Bachus, an Alabama Republican who chairs a subcommittee of the House Committee on Financial Services, is the driving force behind the negotiations. He is trying to mediate between a bill favored by Miller, Watt and consumer advocates, and a bill favored by several Republican legislators and the lending industry.
Observers say the prospects for a compromise were bleak until Bachus got involved. A spokeswoman for Bachus said he hoped to hold a "mark-up" session where a compromise bill would be discussed later this month.
That would be the first of many steps required to change the law. It will be difficult not least because the discussion is brimming with emotion.
For many loan sellers, the idea that discrimination is widespread - and that they require additional regulation - is personally offensive. The industry has argued that borrowers are responsible for educating themselves, and for shopping around to find the best rate.
"The only discrimination that occurs in the mortgage industry is against the lazy," Kyle Killian, a Charlotte loan seller, wrote in an e-mail. He said he considers only financial factors in lending decisions.
For many minorities, personal experience makes the opposite argument.

"I grow tired of the assumption that biased practices are the result of our collective inability to budget, get ready, think," said Tressie Cottom, a black Charlotte resident who said her mother was lured into a bad loan. "There is a higher cost associated with being black in this country."

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Mortgage brokers' role

The discussions are focused heavily on the role of mortgage brokers, partially because they sell most high-interest loans, partially because the law says little about their role.

The federal laws that govern the mortgage industry largely were written in the 1970s, when lenders sold loans directly to borrowers. Now lenders are mostly national companies that sell their loans through small, independent brokers.

Brokers can offer better rates than a lender will quote directly, and they can eliminate the hassle of shopping around. Studies sponsored by the industry show the average customer saves money by working through a mortgage broker.

But the government has found some brokers pad profits by rolling undisclosed fees into the cost of the loan. The Department of Housing and Urban Development estimated in 2002 that brokers overcharged customers by about $3 billion a year.

A Harvard study of the most common hidden fee, called a yield spread premium, found minorities were overcharged disproportionately.

"The broker is the one who knows what's going on," said Rep. Miller, who favors the idea of making brokers represent their customers. When brokers overcharge customers, "That is unconscionable to me and a real betrayal of trust by the broker."

A compromise proposal offered by lenders and consumer advocates, the groups on either side of the brokers, suggests a cap on the fees that brokers can charge. That would limit the cost to any individual, and reduce the opportunity for discrimination.

Both ideas have been strongly opposed by the National Association of Mortgage Brokers.

"I don't think that price controls are the American way of life," said Kate Crawford, an N.C. mortgage broker and a member of NAMB's board.

The brokers also have made clear they will oppose any law that does not focus equally on loans sold to customers directly by mortgage lenders.

"We are not going to be singled out as the only industry that would have certain restraints on our business practices," Crawford said.

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State laws vary

In the absence of a federal law, many states have passed their own mortgage lending laws. The fate of those laws is another issue at the heart of the congressional discussions.

In 1999, North Carolina passed a predatory lending law still widely regarded as a national model. It restricted the sale of loans with the highest interest rates, and barred certain fees and restrictions on most loans. For example, it limited the use of prepayment penalties - fees charged by lenders when borrowers attempt to repay a loan ahead of schedule. Such fees can prevent customers from refinancing to a lower interest rate.

Other states have adopted similar laws, but the efforts have created a jagged regulatory landscape for lenders. In recent years, they have pushed Congress to adopt a single national standard.

Consumer advocates and state regulators say any national law should not replace state laws, because states can respond faster to changes in the mortgage industry. Instead, they have pushed Congress to adopt a national law that would define minimum regulations, leaving states free to go further.

The recent negotiations began when Bachus suggested a compromise: A national law similar to North Carolina's, but still replacing the state laws. The discussions now center on areas that are ignored in the N.C. law. Among those areas is the thorniest: The role of mortgage brokers.

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What This Means to Borrowers

A national lending law could add protections for people shopping for mortgage loans - or it could replace an existing N.C. law with a weaker federal standard.

Ideas for Improvement

There are three basic ideas for protecting borrowers. A compromise bill would probably require some combination of these strategies:

Regulate the product. Congress could restrict the types of loans that can be sold, or the fees that can be charged. A 1999 N.C. law is often cited as a possible model. It limits the terms of loans with high interest rates. It also bars certain fees, such as penalties for repaying a loan ahead of schedule.

The problem: Most products on the market are suitable for at least some borrowers. Blanket restrictions would limit the availability of those loans, potentially reducing the ability of some people to buy homes or tap their equity.

Regulate the seller. Congress could require mortgage brokers to serve the interest of the borrower, something that is already required of stock brokers, for example. Such a law could require the broker to find the best deal for a customer. Congress could also set national standards for brokers.

The problem: Brokers say they work for both the lender and the borrower, so they cannot solely represent either party. They also say any law should apply equally to loan sellers employed directly by lenders.

Educate the borrower. Congress could increase support for programs that teach borrowers to navigate the lending process. It could also reform the way loan prices are explained to borrowers, making the true cost of a loan easier to understand and easier to compare with other offers.

The problem: Consumer advocates say the interaction between an experienced lender and a borrower is inherently unequal. Education and disclosure, while important, are not sufficient by themselves.

SPENCER BACHUS
5TH DISTRICT, ALABAMA

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FINANCIAL SERVICES
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September 28, 2006

The Honorable Barney Frank
Ranking Member
House Financial Services Committee
2252 Rayburn Office Building
Washington, DC 20515-0001

Dear Mr. Frank,

Enclosed is a legislative draft of a Sub-prime Lending Bill which I believe closely tracks the proposal submitted to you and your Democratic colleagues in mid-June of this year. This proposed legislation is intended to provide a national standard to extend protection against predatory lending practices to consumers in all 50 states.

The draft bill is based upon the North Carolina Anti-predatory Lending Law with some provisions from New Jersey law. Importantly, it contains significant new or enhanced protections for consumers including:

- A suitability standard;
- Yield spread premiums in the points and fees trigger;
- Prohibition on mandatory arbitration;
- Prohibition on prepayment penalties on loans of less than $75,000;
- The right of an individual consumer to initiate private rights of action to enforce the provisions of this law.

Hopefully this draft can move the process forward and serve as a focus for our continued discussions of this important area of consumer protection law. I look forward to working with you and your colleagues to reach a consensus which will allow enactment of legislation which both protects and benefits consumers.

Sincerely,

Spencer Bachus
Member of Congress

cc: Hon. Paul Kanjorski
Hon. Melvin Watt
Hon. Brad Miller

April 25, 2007

The Honorable David M. Walker
Comptroller General
GAO
441 G Street, N.W., Room 7100
Washington, D.C. 20548

Dear General Walker,

As Chairman and Ranking Member of the Committee on Financial Services, with jurisdiction over both federal housing policy and the financial services industry, we are, very concerned with the significant increase in foreclosures on residential mortgages seen in recent months. Developing workable solutions to the current problems in the subprime mortgage market is a high priority for Members of both Houses and both parties, and our Committee will be considering legislation on the subject in the coming months.

To assist the Committee in its deliberations, we are requesting that the GAO conduct a thorough study of the reasons for the recent surge in foreclosures. It seems clear that the type of mortgages that have been offered to borrowers in recent years is one such factor, but there is no reason to conclude that that it is the only factor. Moreover, even if the types of mortgages recently being offered are the predominant factor, the question is why they have only now begun to lead to higher foreclosure rates.

In performing its analysis, GAO should examine the current state of the problem, its causes, and potential solutions, and should seek to provide answers to the following questions, as well as any others that the GAO finds to be relevant.

Current State of Problem. What is the scope and magnitude of the current increase in foreclosures, and has the increase been concentrated: geographically; in the subprime or prime market; in refinancing or purchase money transactions; among first-time homebuyers or speculators; in loans made by or through particular classes of lenders (e.g., federally chartered versus other lending institutions)? How does the recent rise in foreclosures compare to the scope of foreclosures in previous housing downturns? Are foreclosure rates higher in regions that are also experiencing higher unemployment levels?

Causes of the Problem. What role has been played by: the rise in subprime lending and risk-based loan pricing; "alternative" or "exotic" mortgages (e.g., interest-only, high loan-to-value, no-documentation and similar loans); predatory practices (e.g., loan flipping and deceptive sales practices, among others); evaluations of borrowers' ability to repay? What effect has the increased involvement of secondary markets (securitization, parceling and packaging of risk, and the like) had on foreclosures? What impact have the 17 consecutive Federal Reserve interest rate increases had on borrowers with adjustable rate mortgages (ARMs)? What role have federal and state regulators played in monitoring and averting foreclosures, and have their actions been adequate and effective? What effect have trends in employment both nationally and regionally had on delinquency rates? What impact has the slow down or absence of home price appreciation had on foreclosure rates, particularly in high unemployment regions? Have life events, such as job loss, major sickness or death had an impact on current foreclosure rates?

Potential Solutions. What constructive role in resolving the problem and averting future foreclosures can be played by: mortgage counseling, financial education, lender forbearance and loan "work-outs," among other tools? What role can the Federal Housing Administration (FHA) and the housing Government Sponsored Enterprises (GSEs) play in refinancing failing loans and offering new mortgage products? What impact, if any, will use of these tools have on the number of borrowers who will have access to mortgage credit?

Given the potential effects of foreclosures on consumers and the economy, and the potential need for Congressional action on these issues, we look forward to GAO's prompt response.

BARNEY FRANK SPENCER BACHUS

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. CST
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TROUBLED ASSET RELIEF PROGRAM

Status of Efforts to Address Defaults and Foreclosures on Home Mortgages

Statement of Mathew J. Scire, Director,
Financial Markets and Community Investment

GAO
Accountability * Integrity * Reliability

GAO-09-231T

December 2008

GAO
Accountability·Integrity·Reliability

Highlights

Highlights of GAO-09-231T, a testimony to Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. Senate

TROUBLED ASSET RELIEF PROGRAM

Status of Efforts to Address Defaults and Foreclosures on Home Mortgages

Why GAO Did This Study

A dramatic increase in mortgage loan defaults and foreclosures is one of the key contributing factors to the current downturn in the U.S. financial markets and economy. In response, Congress passed and the President signed in July the Housing and Economic Recovery Act of 2008 and in October the Emergency Economic Stabilization Act of 2008 (EESA), which established the Office of Financial Stability (OFS) within the Department of the Treasury and authorized the Troubled Asset Relief Program (TARP). Both acts establish new authorities to preserve homeownership. In addition, the administration, independent financial regulators, and others have undertaken a number of recent efforts to preserve homeownership. GAO was asked to update its 2007 report on default and foreclosure trends for home mortgages, and describe the OFS's efforts to preserve homeownership.

GAO analyzed quarterly default and foreclosure data from the Mortgage Bankers Association for the period 1979 through the second quarter of 2008 (the most recent quarter for which data were available). GAO also relied on work performed as part of its mandated review of Treasury's implementation of TARP, which included obtaining and reviewing information from Treasury, federal agencies, and other organizations (including selected banks) on home ownership preservation efforts. To access GAO's first oversight report on Treasury's implementation of TARP, click on GAO-09-161.

To view the full product, including the scope and methodology, click on GAO-09-231T. For more information, contact Mathew Sciro at (202) 512-8678 or sciremj@gao.gov.

What GAO Found

Default and foreclosure rates for home mortgages rose sharply from the second quarter of 2005 through the second quarter of 2008, reaching a point at which more than 4 in every 100 mortgages were in the foreclosure process or were 90 or more days past due. These levels are the highest reported in the 29 years since the Mortgage Bankers Association began keeping complete records and are based on its latest available data. The subprime market, which consists of loans to borrowers who generally have blemished credit and that feature higher interest rates and fees, experienced substantially steeper increases in default and foreclosure rates than the prime or government-insured markets, accounting for over half of the overall increase. In the prime and subprime market segments, adjustable-rate mortgages experienced steeper growth in default and foreclosure rates than fixed-rate mortgages. Every state in the nation experienced growth in the rate at which loans entered the foreclosure process from the second quarter of 2005 through the second quarter of 2008. The rate rose at least 10 percent in every state over the 3-year period, but 23 states experienced an increase of 100 percent or more. Several states in the "Sun Belt" region, including Arizona, California, Florida, and Nevada, had among the highest percentage increases.

OFS initially intended to purchase troubled mortgages and mortgage-related assets and use its ownership position to influence loan servicers and to achieve more aggressive mortgage modification standards. However, within two weeks of EESA's passage, Treasury determined it needed to move more quickly to stabilize financial markets and announced it would use $250 billion of TARP funds to inject capital directly into qualified financial institutions by purchasing equity. In recitals to the standard agreement with Treasury, institutions receiving capital injections state that they will work diligently under existing programs to modify the terms of residential mortgages. It remains unclear, however, how OFS and the banking regulators will monitor how these institutions are using the capital injections to advance the purposes of the act, including preserving homeownership. As part of its first TARP oversight report, GAO recommended that Treasury, among other things, work with the bank regulators to establish a systematic means for determining and reporting on whether financial institutions' activities are generally consistent with program goals. Treasury also established an Office of Homeownership Preservation within OFS that is reviewing various options for helping homeowners, such as insuring troubled mortgage-related assets or adopting programs based on the loan modification efforts of FDIC and others, but it is still working on its strategy for preserving homeownership. While Treasury and others will face a number of challenges in undertaking loan modifications, including making transparent to investors the analysis supporting the value of modification versus foreclosure, rising defaults and foreclosures on home mortgages underscore the importance of ongoing and future efforts to preserve homeownership. GAO will continue to monitor Treasury's efforts as part of its mandated TARP oversight responsibilities.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to provide an update on our 2007 report on default and foreclosure trends for home mortgages and to discuss the Department of Treasury's efforts to preserve homeownership as part of its implementation of the Troubled Asset Relief Program (TARP).[1] My statement is grounded in recent work we did to update our 2007 report and in our ongoing review of Treasury's implementation of TARP as authorized by the Emergency Economic Stabilization Act of 2008, TARP's enabling legislation.[2]

Today the U.S. financial markets are undergoing stresses not seen in our lifetime. These stresses were brought on by a fall in the price of financial assets associated with housing, in particular mortgage assets based on subprime loans that lost value as the housing boom ended and the market underwent a dramatic correction.[3] Defaults and foreclosures have affected not only those losing their homes but also the neighborhoods where houses now stand empty. They have imposed significant costs on borrowers, lenders, and mortgage investors and have contributed to increased volatility in the U.S. and global financial markets.

The Emergency Economic Stabilization Act, which Congress passed and the president signed on October 3, 2008, in response to the turmoil in the financial and housing markets, established the Office of Financial Stability (OFS) within the Department of the Treasury and authorized the Troubled Asset Relief Program (TARP), which gave OFS authority to purchase and insure troubled mortgage-related assets held by financial institutions. One of the stated purposes of the act is to ensure that the authorities and facilities provided by the act are used in a manner that, among other things, preserves homeownership. Additionally, to the extent that troubled mortgage-related assets were acquired under TARP, Treasury was required to implement a plan that sought to "maximize assistance to homeowners" and use the Secretary's authority to encourage the use of the HOPE for Homeowners Program or other available programs to minimize

[1]GAO, *Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments*, GAO-08-78R (Washington D.C.: October 16, 2007).

[2]Pub. L. 110-343, 122 Stat. 3765 (October 3, 2008).

[3]Subprime loans are loans generally made to borrowers with blemished credit that feature higher interest rates and fees than prime loans.

foreclosures. The HOPE for Homeowners program was created by Congress under the Housing and Economic Recovery Act of 2008 (HERA). The program, which was put in place in October 2008, is administered by the Federal Housing Administration within the Department of Housing and Urban Development. It is designed to help those at risk of default and foreclosure refinance into more affordable, sustainable loans. HERA also made a number of other significant changes to the housing finance system, including creating a single regulator for the government-sponsored enterprises (GSEs)—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—and giving Treasury authority to purchase obligations and securities of the GSEs.

To update information contained in our 2007 report on default and foreclosure trends, we analyzed data from the Mortgage Bankers Association's quarterly National Delinquency Survey, which covers about 80 percent of the mortgage market. The survey provides information dating back to 1979 on first-lien purchase and refinance mortgages on one- to four-family residential properties.[4]

For the period 1979 through the second quarter of 2008 (the most recent quarter for which data were available for the dataset we were using), we examined national and state-level trends in the numbers and percentage of loans that were in default, starting the foreclosure process, and in the foreclosure inventory each quarter. For the second quarter of 2005 through the second quarter of 2008, we disaggregated the data by market segment and loan type, calculated absolute and percentage increases in default and foreclosure measures, compared and contrasted trends for each state, and compared default and foreclosure start rates at the end of this period to historical highs. In our previous report, we assessed the reliability of the NDS data by reviewing existing information about the quality of the data, performing electronic testing to detect errors in completeness and reasonableness, and interviewing MBA officials knowledgeable about the data. We determined that the data were sufficiently reliable for purposes of the report. To describe Treasury's efforts to develop a homeownership preservation program as part of its TARP implementation efforts, we relied on the work that we performed as part of our mandated review of

[4]The National Delinquency Survey presents default and foreclosure rates (i.e., the number of loans in default or foreclosure divided by the number of loans being serviced).

Treasury's implementation of TARP.[5] Specifically, we obtained and reviewed available information, including public statements by Treasury officials, terms for participation in the Capital Purchase Program (CPP), data on loan modification program efforts of other agencies and organizations, and OFS organization charts. Additionally, we interviewed Treasury officials to obtain information on actions taken to date and to discuss their planned actions and priorities regarding homeownership preservation. We also held discussions with the first 8 financial institutions that received TARP funds under its CPP.

The work on which this testimony is based was performed in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our finding and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Summary

Default and foreclosure rates for home mortgages rose sharply from the second quarter of 2005 through the second quarter of 2008, reaching a point at which more than 4 in every 100 mortgages were in the foreclosure process or were 90 or more days past due.[6] These levels are the highest that have been reported in the 29 years since the Mortgage Bankers Association began keeping complete records. The subprime market experienced substantially steeper increases in default and foreclosure rates than the prime or government-insured markets, accounting for over half of the overall increase in the number of loans in default or foreclosure during this time frame. In both the prime and subprime market segments, adjustable-rate mortgages experienced relatively steeper growth in default and foreclosure rates compared with fixed-rate mortgages, which had more modest increases. Every state in the nation experienced growth in the rate at which foreclosures started from the second quarter of 2005 through the second quarter of 2008. By the end of that period, foreclosure

[5] GAO, *Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency*, GAO-09-161 (Washington, D.C.: December 2, 2008).

[6] Although definitions vary, a mortgage loan is commonly considered in default when the borrower has missed three or more consecutive monthly payments (i.e., is 90 or more days delinquent).

start rates were at their 29-year maximums in 17 states. The foreclosure start rate rose at least 10 percent in every state over the 3-year period, but 23 states experienced an increase of 100 percent or more. Several states in the "Sun Belt" region, such as Arizona, California, Florida, and Nevada, had among the highest percentage increases in foreclosure start rates.

In light of its initial decision not to conduct large-scale purchases of troubled mortgage-related assets held by financial institutions, Treasury's OFS has been considering different approaches to preserving homeownership. OFS had initially intended to purchase troubled mortgage-related assets and use its ownership position to influence loan servicers and achieve more aggressive mortgage modification standards, which would help meet the purposes of the act. Instead, OFS chose to use $250 billion of TARP funds to inject capital directly into qualified financial institutions through the purchase of equity. According to OFS, this shift in strategy was intended to have an immediate impact on the health of the U.S. financial and housing markets by ensuring that lenders had sufficient funding and encouraging them to provide credit to businesses and consumers, including credit for housing. Treasury also has indicated that it intends to use its CPP to encourage financial institutions to work to modify the terms of existing residential mortgages. However, Treasury has not yet determined if it will impose reporting requirements on the participating financial institutions, which would enable Treasury to monitor, to some extent, whether the capital infusions are achieving the intended goals. As a result, we recommended in our first TARP oversight report that Treasury work with the bank regulators to establish a systematic means for reviewing and reporting on whether financial institutions' activities are consistent with the purposes of CPP.[7] Treasury is taking additional steps toward the act's goal of preserving homeownership. It has established an Office of the Chief of Homeownership Preservation within OFS that is considering various options, such as insuring troubled mortgage-related assets or adopting programs based on the loan modification efforts of FDIC and others. These include recent efforts announced by the GSEs and their regulator to streamline loan modifications. While loan modification presents a number of challenges, rising defaults and foreclosures on home mortgages underscore the importance of ongoing and future efforts to preserve homeownership. We will continue to monitor Treasury's efforts to preserve home ownership as part of our TARP oversight responsibilities.

[7]GAO-09-161

Background

As of June 2008, there were approximately 58 million first-lien home mortgages outstanding in the United States. According to a Federal Reserve estimate, outstanding home mortgages represented over $10 trillion in mortgage debt. The primary mortgage market has several segments and offers a range of loan products:

- The prime market segment serves borrowers with strong credit histories and provides the most competitive interest rates and mortgage terms.
- The subprime market segment generally serves borrowers with blemished credit and features higher interest rates and fees than the prime market.
- The Alternative-A (Alt-A) market segment generally serves borrowers whose credit histories are close to prime, but the loans often have one or more higher-risk features, such as limited documentation of income or assets.
- The government-insured or -guaranteed market segment primarily serves borrowers who may have difficulty qualifying for prime mortgages but features interest rates competitive with prime loans in return for payment of insurance premiums or guarantee fees.

Across all of these market segments, two types of loans are common: fixed-rate mortgages, which have interest rates that do not change over the life of the loans, and adjustable-rate mortgages (ARM), which have interest rates that change periodically based on changes in a specified index.

Delinquency, default and foreclosure rates are common measures of loan performance. Delinquency is the failure of a borrower to meet one or more scheduled monthly payments. Default generally occurs when a borrower is 90 or more days delinquent. At this point, foreclosure proceedings against the borrower become a strong possibility. Foreclosure is a legal (and often lengthy) process with several possible outcomes, including that the borrower sells the property or the lender repossesses the home. Two measures of foreclosure are foreclosure starts (loans that enter the foreclosure process during a particular time period) and foreclosure inventory (loans that are in, but have not exited, the foreclosure process during a particular time period).

One of the main sources of information on the status of mortgage loans is the Mortgage Bankers Association's quarterly National Delinquency Survey. The survey provides national and state-level information on mortgage delinquencies, defaults, and foreclosures back to 1979 for first-lien purchase and refinance mortgages on one-to-four family residential units.[8] The data are disaggregated by market segment and loan type—fixed-rate versus adjustable-rate—but do not contain information on other loan or borrower characteristics.

In response to problems in the housing and financial markets, the Housing and Economic Recovery Act of 2008 was enacted to strengthen and modernize the regulation of the government-sponsored enterprises (GSEs)—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—and expand their mission of promoting homeownership.[9] The act established a new, independent regulator for the GSEs called the Federal Housing Finance Agency, which has broad new authority, generally equivalent to the authority of other federal financial regulators, to ensure the safe and sound operations of the GSEs. The new legislation also enhances the affordable housing component of the GSEs' mission and expands the number of families Fannie Mae and Freddie Mac can serve by raising the loan limits in high-cost areas, where median house prices are higher than the regular conforming loan limit, to 150 percent of that limit. The act requires new affordable housing goals for Federal Home Loan Bank mortgage purchase programs, similar to those already in place for Fannie Mae and Freddie Mac.

The act also established the HOPE for Homeowners program, which the Federal Housing Administration (FHA) will administer within the Department of Housing and Urban Development (HUD), to provide federally insured mortgages to distressed borrowers. The new mortgages are intended to refinance distressed loans at a significant discount for owner-occupants at risk of losing their homes to foreclosure. In exchange, homeowners share any equity created by the discounted restructured loan as well as future appreciation with FHA, which is authorized to insure up to $300 billion in new loans under this program. Additionally, the borrower cannot take out a second mortgage for the first five years of the loan, except under certain circumstances for emergency repairs. The program became effective October 1, 2008, and will conclude on September 30, 2011. To participate in the HOPE for Homeowners program, borrowers must also meet specific eligibility criteria as follows:

[8]NDS data do not separately identify Alt-A loans but include them among loans in the prime and subprime categories. State-level breakouts are based on the address of the property associated with each loan. The NDS presents default and foreclosure rates (i.e., the number of loans in default or foreclosure divided by the number of loans being serviced).

[9]Pub. L. 110-289, 122 Stat. 2654 (July 30, 2008).

- Their mortgage must have originated on or before January 1, 2008.
- They must have made a minimum of six full payments on their existing first mortgage and must not have intentionally missed mortgage payments.
- They must not own a second home.
- Their mortgage debt-to-income ratio for their existing mortgage must be greater than 31 percent.
- They must not knowingly or willfully have provided false information to obtain the existing mortgage and must not have been convicted of fraud in the last 10 years.

The Emergency Economic Stabilization Act, passed by Congress and signed by the President on October 3, 2008, created TARP, which outlines a troubled asset purchase and insurance program, among other things.[10] The total size of the program cannot exceed $700 billion at any given time. Authority to purchase or insure $250 billion was effective on the date of enactment, with an additional $100 billion in authority available upon submission of a certification by the President. A final $350 billion is available under the act but is subject to Congressional review. The legislation required that financial institutions that sell troubled assets to Treasury also provide a warrant giving Treasury the right to receive shares of stock (common or preferred) in the institution or a senior debt instrument from the institution. The terms and conditions of the warrant or debt instrument must be designed to (1) provide Treasury with reasonable participation in equity appreciation or with a reasonable interest rate premium, and (2) provide additional protection for the taxpayer against losses from the sale of assets by Treasury and the administrative expenses of TARP. To the extent that Treasury acquires troubled mortgage-related assets, the act also directs Treasury to encourage servicers of the underlying loans to take advantage of the HOPE for Homeowners Program. Treasury is also required to consent, where appropriate, to reasonable requests for loan modifications from homeowners whose loans are acquired by the government. The act also requires the Federal Housing Finance Agency, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve Board to implement a plan to maximize assistance to homeowners, that may

[10] Pub. L. 110-343.

include reducing interest rates and principal on residential mortgages or mortgage-backed securities owned or managed by these institutions.

The regulators have also taken steps to support the mortgage finance system. On November 25, 2008, the Federal Reserve announced that it would purchase up to $100 billion in direct obligations of the GSEs (Fannie Mae, Freddie Mac, and the Federal Home Loan Banks), and up to $500 billion in mortgage-backed securities backed by Fannie Mae, Freddie Mac, and Ginnie Mae. It undertook the action to reduce the cost and increase the availability of credit for home purchases, thereby supporting housing markets and improving conditions in financial markets more generally. Also, on November 12, 2008, the four financial institution regulators issued a joint statement underscoring their expectation that all banking organizations fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers, and that banking organizations work with existing mortgage borrowers to avoid preventable foreclosures. The regulators further stated that banking organizations need to ensure that their mortgage servicing operations are sufficiently funded and staffed to work with borrowers while implementing effective risk-mitigation measures. Finally, on November 11, 2008, the Federal Housing Finance Agency (FHFA) announced a streamlined loan modification program for home mortgages controlled by the GSEs.

Most mortgages are bundled into securities called residential mortgage-backed securities that are bought and sold by investors. These securities may be issued by GSEs and private companies. Privately issned mortgage-backed securities, known as private label securities, are typically backed by mortgage loans that do not conform to GSE purchase requirements because they are too large or do not meet GSE underwriting criteria. Investment banks bundle most subprime and Alt-A loans into private label residential mortgage-backed securities. The originator/lender of a pool of securitized assets usually continues to service the securitized portfolio. Servicing includes customer service and payment processing for the borrowers in the securitized pool and collection actions in accordance with the pooling and servicing agreement. The decision to modify loans held in a mortgage-backed security typically resides with the servicer. According to some industry experts, the servicer may be limited by the pooling and servicing agreement with respect to performing any large-scale modification of the mortgages that the security is based upon. However, others have stated that the vast majority of servicing agreements do not preclude or routinely require investor approval for loan modifications. We have not assessed how many potentially troubled loans face restrictions on modification.

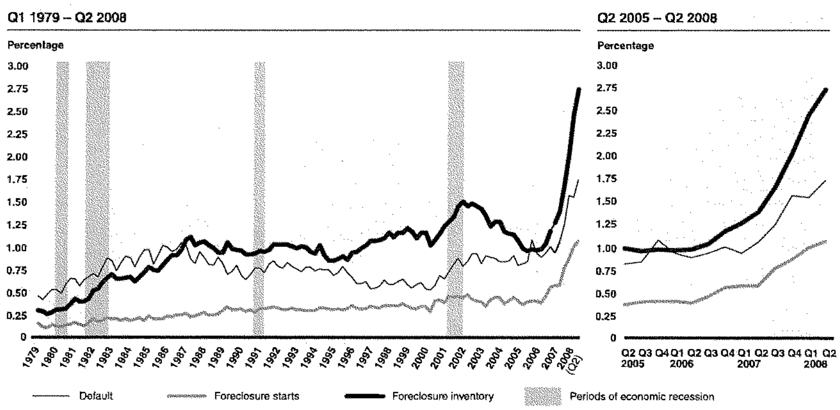
Default and Foreclosure Rates Have Reached Historical Highs and Are Expected to Increase Further

National default and foreclosure rates rose sharply during the 3-year period from the second quarter of 2005 through the second quarter of 2008 to the highest level in 29 years (fig.1).[11] More specifically, default rates more than doubled over the 3-year period, growing from 0.8 percent to 1.8 percent. Similarly, foreclosure start rates—representing the percentage of loans that entered the foreclosure process each quarter—grew almost three-fold, from 0.4 percent to 1 percent. Put another way, nearly half a million mortgages entered the foreclosure process in the second quarter of 2008, compared with about 150,000 in the second quarter of 2005.[12] Finally, foreclosure inventory rates rose 175 percent over the 3-year period, increasing from 1.0 percent to 2.8 percent, with most of that growth occurring since the second quarter of 2007. As a result, almost 1.25 million loans were in the foreclosure inventory as of the second quarter of 2008.

[11]In the second quarter of 2005, foreclosure rates began to rise after remaining relatively stable for about 2 years.

[12]We calculated the number of foreclosure starts and the foreclosure inventory by multiplying foreclosure rates by the number of loans that the National Delinquency Survey showed as being serviced and rounding to the nearest thousand. Because the survey does not cover all loans being serviced, the actual number of foreclosures is probably higher than the amounts we calculated.

Figure 1: National Default and Foreclosure Trends, 1979 – Second Quarter 2008



Source: GAO analysis of MBA data, National Bureau of Economic Research.

Default and foreclosure rates varied by market segment and product type, with subprime and adjustable-rate loans experiencing the largest increases during the 3-year period we examined. More specifically:

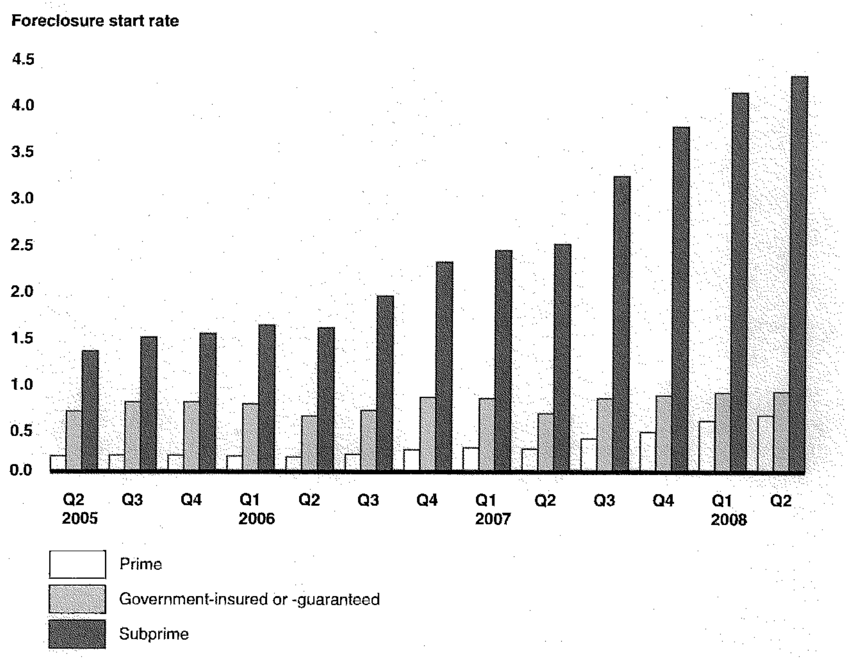
- In the prime market segment, which accounted for more than three-quarters of the mortgages being serviced, 2.4 percent of loans were in default or foreclosure by the second quarter of 2008, up from 0.7 percent 3 years earlier. Foreclosure start rates for prime loans began the period at relatively low levels (0.2 percent) but rose sharply on a percentage basis, reaching 0.6 percent in the second quarter of 2008.

- In the subprime market segment, about 18 percent of loans were in default or foreclosure by the second quarter of 2008, compared with 5.8 percent 3 years earlier. Subprime mortgages accounted for less than 15 percent of the loans being serviced, but over half of the overall increase in the number of mortgages in default and foreclosure over the period. Additionally, foreclosure start rates for subprime loans more than tripled, rising from 1.3 percent to 4.3 percent (see fig. 2).

- In the government-insured or -guaranteed market segment, which represented about 10 percent of the mortgages being serviced, 4.8 percent of the loans were in default or foreclosure in the second quarter of 2008, up from 4.5 percent 3 years earlier. Additionally, foreclosure start rates in this segment increased modestly, from 0.7 to 0.9 percent.

- ARMs accounted for a disproportionate share of the increase in the number of loans in default and foreclosure in the prime and subprime market segments over the 3-year period. In both the prime and subprime market segments, ARMs experienced relatively steeper increases in default and foreclosure rates, compared with more modest growth for fixed rate mortgages. In particular, foreclosure start rates for subprime ARMs more than quadrupled over the 3-year period, increasing from 1.5 percent to 6.6 percent.

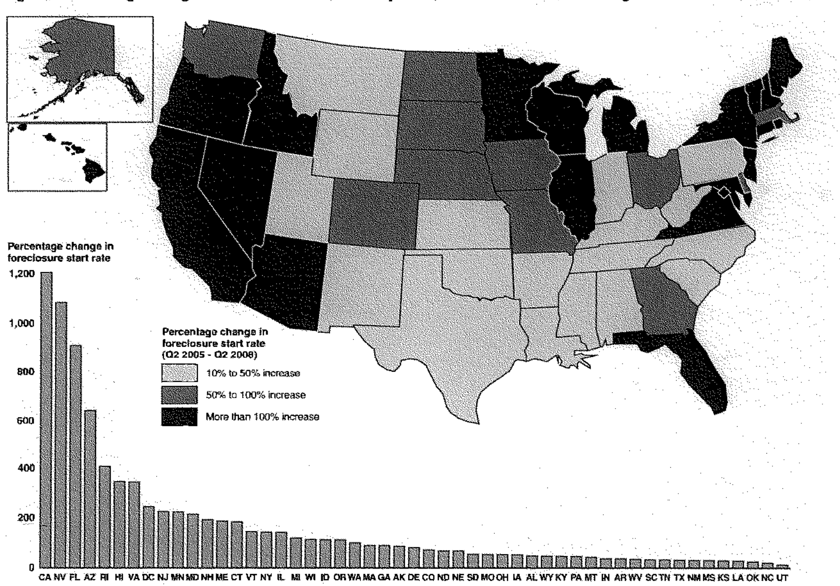
Figure 2: Foreclosure Start Rates by Market Segment, Second Quarter 2005 through Second Quarter 2008



Source: GAO analysis of MBA data.

Default and foreclosure rates also varied significantly among states. For example, as of the second quarter of 2008, the percentage of mortgages in default or foreclosure ranged from 1.1 percent in Wyoming to 8.4 percent in Florida. Other states that had particularly high combined rates of default and foreclosure included California (6.0 percent), Michigan (6.2 percent), Nevada (7.6 percent), and Ohio (6.0 percent). Every state in the nation experienced growth in their foreclosure start rates from the second quarter of 2005 through the second quarter of 2008. By the end of that period, foreclosure start rates were at their 29-year maximums in 17 states. As shown in figure 3, percentage increases in foreclosure start rates differed dramatically by state. The foreclosure start rate rose at least 10 percent in every state over the 3-year period, but 23 states experienced an increase of 100 percent or more. Several states in the "Sun Belt" region, such as Arizona, California, Florida, and Nevada, had among the highest percentage increases in foreclosure start rates. In contrast, 7 states experienced increases of 30 percent or less, including North Carolina, Oklahoma, and Utah.

Figure 3: Percentage Change in Foreclosure Start Rates by State, Second Quarter 2005 through Second Quarter 2008.



Sources: GAO analysis of MBA data; Art Explosion (map).

Some mortgage market analysts predict that default and foreclosure rates will continue to rise for the remainder of this year and into next year. The factors likely to drive these trends include expected declines in home prices and increases in the unemployment rate. The Alt-A market, in particular, may contribute to increases in defaults and foreclosures in the foreseeable future. According to a report published by the Office of the Comptroller of the Currency and the Office of Thrift Supervision, Alt-A mortgages represented 10 percent of the total number of mortgages at the end of June 2008, but constituted over 20 percent of total foreclosures in process.[13] The seriously delinquent rate for Alt-A mortgages was more than four times the rate for prime mortgages and nearly twice the rate for all outstanding mortgages in the portfolio. Also, Alt-A loans that were originated in 2005 and 2006 showed the highest rates of serious delinquency compared with Alt-A loans originated prior to 2005 or since 2007, according to an August 2008 Freddie Mac financial report.[14] This trend may be attributed, in part, to Alt-A loans with adjustable-rate mortgages whose interest rates have started to reset, which may translate into higher monthly payments for the borrower.

Treasury is Examining Options for Homeownership Preservation In Light of Recent Changes in the Use of TARP Funds

Treasury is currently examining strategies for homeownership preservation, including maximizing loan modifications, in light of a refocus in its use of TARP funds. Treasury's initial focus in implementing TARP was to stabilize the financial markets and stimulate lending to businesses and consumers by purchasing troubled mortgage-related assets—securities and whole loans—from financial institutions. Treasury planned to use its leverage as a major purchaser of troubled mortgages to work with servicers and achieve more aggressive mortgage modification standards. However, Treasury subsequently concluded that purchasing troubled assets would take time to implement and would not be sufficient given the severity of the problem. Instead, Treasury determined that the most timely, effective way to improve credit market conditions was to strengthen bank balance sheets quickly through direct purchases of equity in banks.

[13]U.S. Department of the Treasury, Comptroller of the Currency and Office of Thrift Supervision, *OCC and OTS Mortgage Metrics Report, Disclosure of National Bank and Federal Thrift Mortgage Loan Data*, January-June 2008.

[14]Freddie Mac, *Freddie Mac's Second Quarter 2008 Financial Results*, August 6, 2008.

The standard agreement between Treasury and the participating institutions in the CPP includes a number of provisions, some in the "recitals" section at the beginning of the agreement and other detailed terms in the body of the agreement. The recitals refer to the participating institutions' future actions in general terms—for example, "the Company agrees to work diligently, under existing programs to modify the terms of residential mortgages as appropriate to strengthen the health of the U.S. housing market." Treasury and the regulators have publicly stated that they expect these institutions to use the funds in a manner consistent with the goals of the program, which include both the expansion of the flow of credit and the modification of the terms of residential mortgages. But, to date it remains unclear how OFS and the regulators will monitor how participating institutions are using the capital injections to advance the purposes of the act. The standard agreement between Treasury and the participating institutions does not require that these institutions track or report how they use or plan to use their capital investments. In our first 60-day report to Congress on TARP, mandated by the Emergency Economic Stabilization Act, we recommended that Treasury, among other things, work with the bank regulators to establish a systematic means for determining and reporting on whether financial institutions' activities are generally consistent with the purposes of CPP.[15]

Without purchasing troubled mortgage assets as an avenue for preserving homeownership, Treasury is considering other ways to meet this objective. Treasury has established and appointed an interim chief for the Office of the Chief of Homeownership Preservation under OFS. According to Treasury officials, the office is currently staffed with federal government detailees and is in the process of hiring individuals with expertise in housing policy, community development and ecouomic research. Treasury has stated that it is working with other federal agencies, including FDIC, HUD, and FHFA to explore options to help homeowners nnder TARP. According to the Office of Homeownership Preservation interim chief, Treasury is considering a number of factors in its review of possible loan modification options, including the cost of the program, the extent to which the program minimizes recidivism among borrowers helped out of default, and the number of homeowners the program has helped or is projected to help remain in their homes. However, to date the Treasury has not completed its strategy for preserving homeownership.

[15]GAO-09-161.

Among the strategies for loan modification that Treasury is considering is a proposal by FDIC that is based on its experiences with loans held by a bank that was recently put in FDIC conservatorship. The former IndyMac Bank, F.S.B., was closed July 11, 2008, and FDIC was appointed the conservator for the new institution, IndyMac Federal Bank, F.S.B. As a result, FDIC inherited responsibility for servicing a pool of approximately 653,000 first-lien mortgage loans, including more than 60,000 mortgage loans that were more than 60 days past due, in bankruptcy, in foreclosure, and otherwise not currently paying. On August 20, 2008, the FDIC announced a program to systematically modify troubled residential loans for borrowers with mortgages owned or serviced by IndyMac Federal. According to FDIC, the program modifies eligible delinquent mortgages to achieve affordable and sustainable payments using interest rate reductions, extended amortization, and where necessary, deferring a portion of the principal. FDIC has stated that by modifying the loans to an affordable debt-to-income ratio (38 percent at the time) and using a menu of options to lower borrowers' payments for the life of their loan, the program improves the value of the troubled mortgages while achieving economies of scale for servicers and stability for borrowers. According to FDIC, as of November 21, 2008, IndyMac Federal has mailed more than 23,000 loan modification proposals to borrowers and over 5,000 borrowers have accepted the offers and are making payments on modified mortgages. FDIC states that monthly payments on these modified mortgages are, on average, 23 percent or approximately $380 lower than the borrower's previous monthly payment of principal and interest. According to FDIC, a federal loss sharing guarantee on re-defaults of modified mortgages under TARP could prevent as many as 1.5 million avoidable foreclosures by the end of 2009. FDIC estimated that such a program, including a lower debt-to-income ratio of 31 percent and a sharing of losses in the event of a re-default, would cost about $24.4 billion on an estimated $444 billion of modified loans, based on an assumed re-default rate of 33 percent. We have not had an opportunity to independently analyze these estimates and assumptions.

Other similar programs under review, according to Treasury, include strategies to guarantee loan modifications by private lenders, such as the HOPE for Homeowners program. Under this new FHA program, lenders can have loans in their portfolio refinanced into FHA-insured loans with fixed interest rates. HERA had limited the new insured mortgages to no more than 90 percent of the property's current appraised value. However, on November 19, 2008, after action by the congressionally created Board of Directors of the HOPE for Homeowners program, HUD announced that the program had been revised to, among other things, increase the maximum amount of the new insured mortgages in certain circumstances.[16] Specifically, the new insured mortgages cannot exceed 96.5 percent of the current appraised value for borrowers whose mortgage payments represent no more than 31 percent of their monthly gross income and monthly household debt payments no more than 43 percent of monthly gross income. Alternatively, the new mortgage may be set at 90 percent of the current appraised value for borrowers with monthly mortgage and household debt-to-income ratios as high as 38 and 50 percent, respectively. These loan-to-value ratio maximums mean that in many circumstances the amount of the restructured loan would be less than the original loan amount and, therefore, would require lenders to write down the existing mortgage amounts. According to FHA, lenders benefit by turning failing mortgages into performing loans. Borrowers must also share a portion of the equity resulting from the new mortgage and the value of future appreciation. This program first became available October 1, 2008. FHA has listed on the program's Web site over 200 lenders that, as of November 25, 2008, have indicated to FHA an interest in refinancing loans under the HOPE for Homeowners program. See the appendix to this statement for examples of federal government and private sector residential mortgage loan modification programs.

Treasury is also considering policy actions that might be taken under CPP to encourage participating institutions to modify mortgages at risk of default, according to an OFS official. While not technically part of CPP, Treasury announced on November 23, 2008, that it will invest an additional $20 billion in Citigroup from TARP in exchange for preferred stock with an 8 percent dividend to the Treasury. In addition, Treasury and FDIC will provide protection against unusually large losses on a pool of loans and securities on the books of Citigroup. The Federal Reserve will backstop residual risk in the asset pool through a non-recourse loan. The agreement requires Citigroup to absorb the first $29 billion in losses. Subsequent losses are shared between the government (90 percent) and Citigroup (10 percent). As part of the agreement, Citigroup will be required to use FDIC loan modification procedures to manage guaranteed assets unless otherwise agreed.

Although any program for modifying loans faces a number of challenges, particularly when the loans or the cash flows related to them have been bundled into securities that are sold to investors, foreclosures not only

[16] See http://www.hud.gov/news/release.cfm?content=pr08-178.cfm.

affect those losing their homes but also their neighborhoods and have contributed to increased volatility in the financial markets. Some of the challenges that loan modification programs face include making transparent to investors the analysis supporting the value of modification over foreclosure, designing the program to limit the likelihood of re-default, and ensuring that the program does not encourage borrowers who otherwise would not default to fall behind on their mortgage payments. Additionally, there are a number of potential obstacles that may need to be addressed in performing large-scale modification of loans supporting a mortgage-backed security. As noted previously, the pooling and servicing agreements may preclude the servicer from making any modifications of the underlying mortgages without approval by the investors. In addition, many homeowners may have second liens on their homes that may be controlled by a different loan servicer, potentially complicating loan modification efforts.

Treasury also points to challenges in financing any new proposal. The Secretary of the Treasury, for example, noted that it was important to distinguish between the type of assistance, which could involve direct spending, from the type of investments that are intended to promote financial stability, protect the taxpayer, and be recovered under the TARP legislation. However, he recently reaffirmed that maximizing loan modifications was a key part of working through the housing correction and maintaining the quality of communities across the nation. However, Treasury has not specified how it intends to meet its commitment to loan modification. We will continue to monitor Treasury's efforts as part of our ongoing TARP oversight responsibilities.

Going forward, the federal government faces significant challenges in effectively deploying its resources and using its tools to bring greater stability to financial markets and preserving homeownership and protecting home values for millions of Americans.

Mr. Chairman, this concludes my statement. I would be pleased to respond to any questions that you or other members of the subcommittee may have at this time.

Appendix I: Examples of Federal Government and Private Sector Residential Mortgage Loan Modification Programs

Institution	Program or Effort	Selected Program Characteristics
Federal Government Sponsored Programs		
Federal Deposit Insurance Corporation (FDIC)	IndyMac Loan Modification Program	• Eligible borrowers are those with loans owned or serviced by IndyMac Federal Bank • Affordable mortgage payment achieved for the seriously delinquent or in default borrower through interest rate reduction, amortization term extension, and/or principal forbearance • Payment must be no more than 38 percent of the borrower's monthly gross income • Losses to investor minimized through a net present value test that confirms that the modification will cost the investor less than foreclosure
Federal Housing Administration (FHA)	Hope for Homeowners	• Borrowers can refinance into an affordable loan insured by FHA • Eligible borrowers are those who, among other factors, as of March 2008, had total monthly mortgage payments due of more than 31 percent of their gross monthly income • New insured mortgages cannot exceed 96.5 percent of the current loan-to-value ratio (LTV) for borrowers whose mortgage payments do not exceed 31 percent of their monthly gross income and total household debt not to exceed 43 percent; alternatively, the program allows for a 90 percent LTV for borrowers with debt-to-income ratios as high as 38 (mortgage payment) and 50 percent (total household debt) • Requires lenders to write down the existing mortgage amounts to either of the two LTV options mentioned above
Federal Housing Finance Agency (FHFA)	Streamlined Loan Modification Program[1]	• Eligible borrowers are those who, among other factors, have missed three payments or more • Servicers can modify existing loans into a Freddie Mae or Fannie Mac loan, or a portfolio loan with a participating investor • An affordable mortgage payment, of no more than 38 percent of the borrower's monthly gross income, is achieved for the borrower through a mix of reducing the mortgage interest rate, extending the life of the loan or deferring payment on part of the principal
Private Sector Programs		
Bank of America	National Homeownership Retention Program	• Eligible borrowers are those with subprime or pay option adjustable rate mortgages serviced by Countrywide and originated by Countrywide prior to December 31, 2007 • Options for modification include refinance under the FHA HOPE for Homeowners program, interest rate reductions, and principal reduction for pay option adjustable rate mortgages • First-year payments mortgage payments will be targeted at 34 percent of the borrower's income, but may go as high as 42 percent • Annual principal and interest payments will increase at limited step-rate adjustments
JPMorgan Chase & Co.	General loan modification options	• Affordable mortgage payment achieved for the borrower at risk of default through interest rate reduction and/or principal forbearance • Modification may also include modifying pay-option ARMs to 30-year, fixed-rate loans or interest-only payments for 10 years • Modification includes flexible eligibility criteria on origination dates, loan-to-value ratios, rate floors and step-up adjustment features

[1]This program was created in consultation with Fannie Mae, Freddie Mac, HOPE NOW and its twenty-seven servicer partners, the Department of the Treasury, FHA and FHFA.

Institution	Program or Effort	Selected Program Characteristics
JPMorgan Chase & Co. (Continued)	Blanket loan modification program	• Eligible borrowers are those with short-term hybrid adjustable rate mortgages owned by Chase • Chase locks in the initial interest rate for the life of the loan on all short-term adjustable rate mortgages with interest rates that will reset in the coming quarter
	American Securitization Forum Fast Track	• Eligible borrowers are those with non-prime short term hybrid adjustable rate mortgages serviced by Chase • Under the program developed by the American Securitization Forum Chase freezes the current interest rate for five years
Citi	Homeowner Assistance program	• Eligible borrowers are those not currently behind on Citi held mortgages but that may require help to remain current • Citi will offer loan workout measures on mortgages in geographic areas of projected economic distress including falling home prices and rising unemployment rates to avoid foreclosures
	Loan Modification Program	• Affordable mortgage payment achieved for the delinquent borrower through interest rate reduction, amortization term extension, and/or principal forbearance • According to Citi, program is similar to the FDIC IndyMac Loan Modification Program
HOPE NOW Alliance	Foreclosure prevention assistance programs	• HOPE NOW is an alliance between Department of Housing and Urban Development (HUD) certified counseling agents, servicers, investors and other mortgage market participants that provides free foreclosure prevention assistance • Forms of assistance include hotline services to provide information on foreclosure prevention, which according to HOPE NOW receives an average of more than 6,000 calls per day; and access to HUD approved housing counselors for debt management, credit, and overall foreclosure counseling • Coordinates a nationwide outreach campaign to at-risk risk borrowers and states that it has sent nearly 2 million outreach letters • Since March 2008, has hosted workshops in 27 cities involving homeowners, lenders, and HUD certified counselors

Source: Publicly available information from agencies and organizations listed above.

Contacts and Staff Acknowledgement

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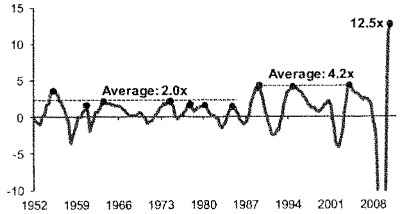
Retractions: US earnings growth, the Euro, and the primary catalyst for the US housing crisis

By May of each year, we get a sense for where we need to revise expectations. Several things panned out as we expected in January (stocks outperforming bonds; another good year for credit; an M&A rebound, benefiting certain hedge fund and mid cap equity strategies; Japan underperforming other regions; another leg to rising commodity prices; a rise in Asian currencies versus the dollar; and the resilience of municipal bond prices in the face of selling and notable skeptics [see EoTM Feb 14]). But this note is not about that, it's about expectations we need to revise. This week: a note on **Retractions of Prior Views.**

US large cap operating earnings growth in 2011 may exceed our 10% forecast

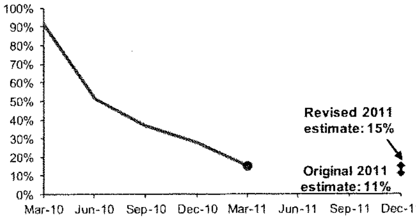
We showed the first chart below last week. It highlights how atypical this earnings cycle has been relative to weak nominal GDP growth. We had been forecasting 10% earnings growth for 2011, but now it looks like earnings growth will exceed these levels. To put this exercise in context, consider the second chart. After earnings collapse in a recession, they tend to rebound sharply, with earnings growth tailing off after a year or two. By the end of Q1, year-on-year earnings growth will have slowed to 15% from 90% in March 2010. Estimating earnings growth for all of 2011 is like projecting where a large boulder will stop rolling after having been released from the top of a hill. It now looks like it will roll a bit further than we thought.

US profits recovery outpacing economic recovery
Ratio of 2 year earnings growth to 2 year nominal GDP growth



Source: Standard & Poor's, Bureau of Economic Analysis, J.P. Morgan PB.

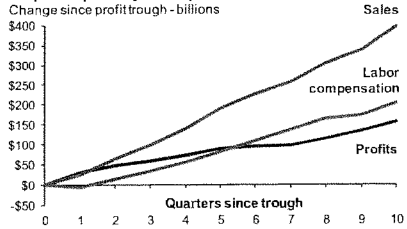
Where will the earnings boulder stop rolling?
S&P 500 quarterly operating earnings per share, % change - YoY



Source: Standard & Poor's.

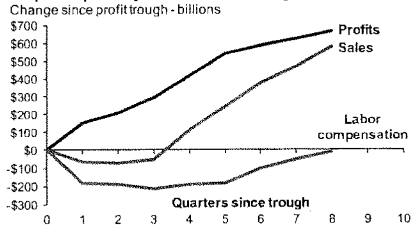
Before we discuss the implications of rising earnings projections, let's look one more time at the drivers of corporate profits during this recovery. In the 5 prior earnings recoveries, sales rose, labor compensation rose as well (though not as fast as sales), resulting in rising profits (see first chart). In the *current* cycle, labor compensation is unchanged after two years given the abysmal condition of the job markets (second chart). As a result, almost the entire increase in sales flows through to bottom-line profits. This is what is referred to as "*high incremental margins*", a topic we wrote about in April of 2010.

Corporate profit cycle - 5 past recoveries
Change since profit trough - billions



Source: Bureau of Economic Analysis, J.P. Morgan PB.

Corporate profit cycle - current recovery
Change since profit trough - billions

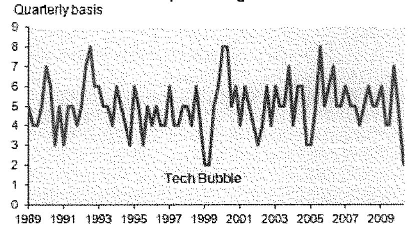


Source: Bureau of Economic Analysis, J.P. Morgan PB.

The profits recovery is not *entirely* a story of lower labor costs. As shown above, sales are rising. But the labor compensation picture, in our view, throws some cold water on the valuation implications of corporate profits right now. The reason: **weak labor compensation has resulted in outsized government transfers to households and businesses, and the largest fiscal deficits in decades.**

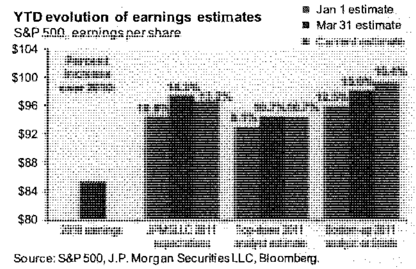
In terms of breadth, the profits recovery is spread across sectors. So far in Q1 2011, with 2/3 of companies reporting, 78% are outperforming estimates, with earnings beating estimates by around 5%. The outperformance is spread across all sectors, with the best performance (vs expectations) from Technology, Healthcare, Industrials, Materials and Consumer Discretionary. **Three cautionary notes, however.** First, rising energy earnings (up ~40% in Q1) may eventually have negative feedback loops for other sectors. Second, energy and industrials were the only sectors to outperform the S&P 500 on a price basis in Q1, resulting in the narrowest market leadership since 1999 (see chart below). And third, financial sector profits benefitted from the reduction in loan loss provisions, which is a lower-quality source of earnings than top-line increases in loan demand.

Number of sectors outperforming the S&P 500
Quarterly basis



Source: Bloomberg.

YTD evolution of earnings estimates
S&P 500, earnings per share



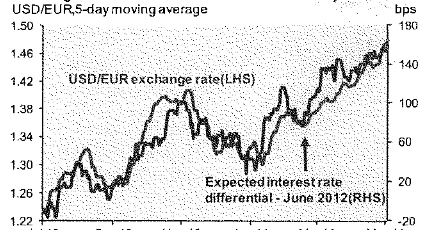
Source: S&P 500, J.P. Morgan Securities LLC, Bloomberg.

How much earnings growth should we expect in 2011? The second chart shows the evolution of earnings forecasts this year from company analysts, market strategists, and J.P. Morgan Securities. Even without factoring in any multiple expansion, earnings growth of 13% to 15%, times a forward P/E multiple of 14x-15x, yields an S&P 500 valuation range of 1,350 to 1,470. The higher end of earnings growth and P/E multiple ranges would result in 17% returns this year. While the 16% bottoms-up estimate looks high to us, 2011 earnings growth is likely to exceed the 10% expectations we had in January. M&A trends and stock buybacks are helping as well; global M&A volumes are up 18% from 2010, and announced stock buybacks are on pace to double. **There are still uncertainties related to energy prices, China slowing and tightening across the developing world, the collapsing dollar and the debt ceiling (now pushed to August due to better than expected Treasury tax receipts).** As a result, we are not making major changes to overall equity and hedge fund allocations from levels shown on April 18[1].

The Euro continues to rally, reflecting widening Fed and ECB policy differences we did not expect

We did not have a strong view on the US$/Euro exchange rate heading into 2011, but perhaps we should have. As shown, the Euro has been moving lock step with interest rate differentials between the two regions. Since January, these rate differentials widened again, and the Euro rallied from $1.30 to $1.48. Why are policy rate expectations for 2012 so much higher in Europe than in the US? Tight German labor markets[2], and a focus on rising energy prices and headline inflation by the ECB, mostly. On the other hand, the Fed appears content to sit tight and let Bernanke's "Portfolio Rebalancing Channel" (e.g., rising stock prices) run a bit more, since the Fed's reading of US *core* inflation is benign, and believes that rising energy prices are "transitory". When considered in local currency terms, European equities trail the US and Asia ex-Japan this year (as they did in 2010). But after factoring in the higher Euro, European equities generated the highest returns by region in 2011. Our view is that the ECB will not tighten as much as the markets expect (6 times by June 2012), which should slow the Euro's appreciation vs. the dollar.

Exchange rate has moved with interest rate expectations
USD/EUR, 5-day moving average



Source: Bloomberg, J.P. Morgan PB.

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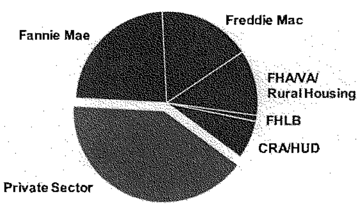
[1] For example, in Balanced portfolios allocate 32%-35% to public equities, 25% to hedge funds and 5% to private equity.

[2] Tight labor markets in Germany (a record number of job vacancies in April) and Spanish unemployment rising to 21.3%? With strong growth and an aging population, Germany needs around 400,000 immigrants per year to maintain labor productivity. For historical reasons, job-seekers are more likely to come from Poland than from Spain, highlighting structural tensions in the European Monetary Union.

US Agencies played a larger role in the housing crisis than we first reported

In January 2009, I wrote that the housing crisis was mostly a consequence of the private sector. Why? US Agencies appeared to be responsible for only 20% of all subprime, Alt A and other mortgage exotica[3]. However, over the last 2 years, analysts have dissected the housing crisis in greater detail. What emerges from new research is something quite different: government agencies now look to have guaranteed, originated or underwritten 60% of all "non-traditional" mortgages, which totaled $4.6 trillion in June 2008. What's more, this research asserts that housing policies instituted in the early 1990s were explicitly designed to require US Agencies to make much riskier loans, with the ultimate goal of pushing private sector banks to adopt the same standards. To be sure, private sector banks and investors are responsible for taking the bait, and made terrible mistakes. Overall, what emerges is an object lesson in well-meaning public policy gone spectacularly wrong.

Exposure to Subprime and Alt-A loans using AEI expanded definition, Percent of total as of June 30, 2008

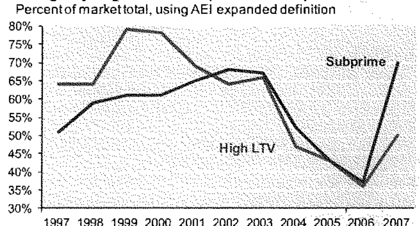


Source: American Enterprise Institute.

Sources

- Edward Pinto, "*Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study*", November 2010. During the 1980's, Mr. Pinto was Fannie Mae's SVP for Marketing and Product Management, and subsequently its Executive Vice President and Chief Credit Officer.
- Peter Wallison, "*Dissent from the Majority Report of the Financial Crisis Inquiry Commission*", published January 2011. Mr. Wallison, a member of the Financial Reform Task Force and Financial Crisis Inquiry Commission, worked in the US Treasury Department under President Reagan.

US Agency High LTV & Subprime loan exposure
Percent of market total, using AEI expanded definition



Source: American Enterprise Institute.

For Pinto and Wallison, this quote from the Department of Housing and Urban Development in 2000 is a **smoking gun of sorts, and lays out a blueprint for the housing crisis**:

"Because the GSEs have a funding advantage over other market participants, they have the ability to under price their competitors and increase their market share. This advantage, as has been the case in the prime market, could allow the GSEs to eventually play a **significant role in the subprime market.** As the GSEs become more comfortable with subprime lending, **the line between what today is considered a subprime loan versus a prime loan will likely deteriorate, making expansion by the GSEs look more like an increase in the prime market.** Since, as explained earlier in this chapter, one could define a prime loan as one that the GSEs will purchase, the **difference between the prime and subprime markets will become less clear. This melding of markets could occur even if many of the underlying characteristics of subprime borrowers and the market's (i.e., non-GSE participants) evaluation of the risks posed by these borrowers remain unchanged.**" (HUD Affordable Lending goals for Freddie Mac/Fannie Mae, Oct 2000)

The strategy worked, as shown in the chart: the Agencies took the lead in the 1990s and early 2000's in both subprime and high LTV (>=95%) loans, acquiring over $700 billion in non-traditional mortgages **before** private markets had even reached $100 billion. Then in 2002-2003, private sector banks took the bait and jumped in with both feet. According to Wallison, the distortion of the housing bubble from 1997 onward obscured what would otherwise have been rising delinquencies and losses. As a result, when investors, banks and rating agencies finally got involved in a substantial way, they ended up looking at under-stated default statistics on subprime, Alt A and high LTV borrowers.

---

[3] Why was it hard to figure this out in the immediate aftermath of the housing collapse? ***Creative Reporting.*** According to Pinto, Fannie Mae classified a loan as subprime only if the loan was originated by a lender specializing in subprime, or by subprime divisions of large lenders. They did not use FICO scores to report all subprime exposure, despite their use to define subprime as far back as 1995 in Freddie Mac's industry letters, and guidelines issued by Federal regulators in 2001. As Pinto notes, this had the effect of reducing its reported subprime loan count.

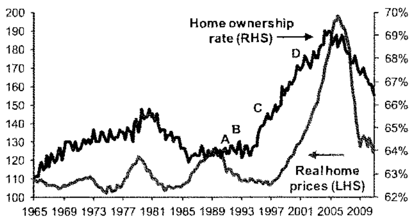
Retractions: US earnings growth, the Euro, and the primary catalyst for the US housing crisis

The Wallison/Pinto timeline of events looks something like this, and is best viewed when superimposed on home ownership rates and home prices (see first chart below), which had been stable for the prior 3 decades:

A: **Senate hearings in 1991** start the ball rolling with commentary from community groups that banks need to be pushed to loosen lending standards, and that Agencies must take the lead: *"Lenders will respond to the most conservative standards unless [Fannie Mae and Freddie Mac] are aggressive and convincing in their efforts to expand historically narrow underwriting."*

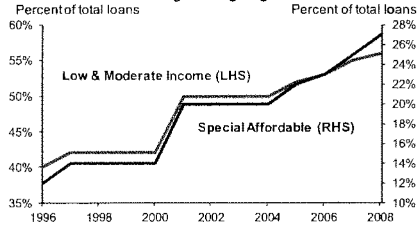
B: In 1992, **Congress imposes affordable housing goals on Fannie and Freddie** through the "Federal Housing Enterprises Financial Safety and Soundness Act of 1992", and become competitors with FHA. To meet these goals, the Agencies relaxed down payment requirements. By 2007, they guaranteed an estimated $140 billion of loans with down payments <=3% (after having done none at <=5% as of 1991). Half of these high LTV loans required no down payments at all. This was the driver behind a larger trend: by 2007, required down payments of <=3% were 40% of all home purchase loans.

Home prices, home ownership and government policy



Source: "Irrational Exuberance," Robert Shiller, 2005, U.S. Census Bureau.

HUD affordable housing lending targets



Source: American Enterprise Institute.

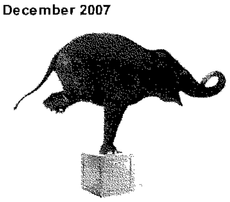
C: In its 1995 National Homeownership Strategy publication, HUD announces that while low down payment mortgages were already 29% of the market by August 1994, **they wanted more**: *"Lending institutions, secondary market investors, mortgage insurers, and other members of the partnership should work collaboratively to reduce homebuyer down payment requirements"*.

D: **In 2000, HUD raises affordable lending targets again**. The chart above shows the escalation of lending targets for low and moderate income borrowers, and "Special Affordable"[4] borrowers. The problem for Agencies: the only way to meet these targets was to relax down payment requirements even more, and income verification/loan to value standards as well. When announcing even higher affordable housing targets in 2004, HUD made it clear that their purpose was to get private sector banks to follow suit: *"These new goals will push the GSEs to genuinely lead the market"*. (HUD Press Release, Nov. 2004). Bad news: they did.

The rest, as they say, is history. Wallison and Pinto make a variety of assumptions in several hundred pages of research, some of which has unsurprisingly resulted in conservative and liberal policy groups disagreeing with each other. One point is not in dispute: dollar for dollar, **private sector banks and brokers made much worse loans than the Agencies**, when considering delinquency rates and losses per dollar of loan principal.

But Wallison and Pinto are not trying to find out who made the worst loans. They're trying to figure out why underwriting standards collapsed across the board; how policy objectives were designed to have private sector banks follow the Agencies off the cliff; and why Agency losses to taxpayers are estimated to be so large ($250-$350 billion). It's a hollow victory for Agency supporters to claim that their version of Alt A and Subprime was not as bad as private sector ones: the Agencies had almost no capital to absorb losses in the first place, given what their mandate was. According to the Financial Crisis Inquiry Commission, "**by the end of 2007, Fannie Mae and Freddie Mac combined leverage ratios, including loans they owned and guaranteed, stood at 75 to 1.**" After factoring out tax-loss carry-forwards, Agency capital ratios were probably below 1% on over $5 trillion of aggressively underwritten exposure.

US Agency Equity Capital Ratios December 2007



[4] "Special Affordable" goal: the percent of dwelling units financed by GSE's mortgage purchases be for very low-income families, defined as those with incomes no greater than 60-80 percent of median incomes.

Retractions: US earnings growth, the Euro, and the primary catalyst for the US housing crisis

The Wallison/Pinto research appears to be a well-reasoned addition to the body of work dissecting the worst housing crisis in the post-war era. It is convincing enough to retract what we wrote in 2009. As regulators and politicians consider actions designed to stabilize the financial system and the housing/mortgage markets, reflection on the role that policy played in the collapse would seem like a critical part of the process.

Michael Cembalest
Chief Investment Officer

Acronyms

HUD	Department of Housing and Urban Development
FHLB	Federal Home Loan Banks
VA	Veterans Administration
CRA	Community Reinvestment Act
FHA	Federal Housing Authority
GSE	Government Sponsored Enterprises (Freddie Mac, Fannie Mac)
ECB	European Central Bank
FCIC	Financial Crisis Inquiry Commission
LTV	Loan to Value

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March 5, 2013

The Honorable Scott Garrett
Chairman
House Financial Services Subcommittee on
Capital Markets & GSEs
United States House of Representatives
Washington, D.C. 20515

The Honorable Carolyn Maloney
Ranking Member
House Financial Services Subcommittee on
Capital Markets & GSEs
United States House of Representatives
Washington, D.C. 20515

Dear Chairman Garrett and Ranking Member Maloney:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association exclusively representing the interests of our nation's federal credit unions, I write today with respect to tomorrow's hearing, "Fannie Mae and Freddie Mac: How Government Housing Policy Failed Homeowners and Taxpayers and Led to the Financial Crisis." As you know, the future of housing finance is of great importance to our nation's credit unions. NAFCU member credit unions appreciate your leadership on this issue and look forward to working with the subcommittee on this issue moving forward.

NAFCU would like to stress the importance of retaining a system that provides credit unions with the access to the secondary market and the liquidity necessary to serve the mortgage needs of their 95 million members. We believe the core principles outlined below must be considered to ensure that credit unions are treated fairly during any housing finance reform process:

- A healthy and viable secondary mortgage market must be maintained. A secondary mortgage market, where mortgage loans are pooled and sold to investors, is essential in providing the liquidity necessary for credit unions to create new mortgages for their members.

- There should be at least two Government Sponsored Enterprises (GSEs). To effectuate competition in the secondary market and to ensure equitable access for credit unions, NAFCU supports the creation or existence of multiple GSEs that would perform the essential functions currently performed by Fannie Mae and Freddie Mac. These entities should have the ability to purchase loans and convert them into mortgage backed securities (MBSs), each of these functions serves to facilitate mortgage lending.

- The U.S. government should issue explicit guarantees on the payment of principal and interest on MBSs. The explicit guarantee will provide certainty to the market, especially for investors who will need to be enticed to invest in the MBSs and facilitate the flow of liquidity.

- Fannie Mae and Freddie Mac have been crucial partners for credit unions and have served an important function in the mortgage lending industry. Both have been valuable entities to the nation, particularly to the nation's economy. It is important that during any transition to a new system (whether or not current GSEs are to be part of it) credit unions have uninterrupted access to the GSEs, and in turn, the secondary market.

- We could support a model for the GSEs that is consistent with a cooperative or a mutual entities model. Each GSE would have an elected Board of Directors, be regulated by the Federal Housing Finance Agency, and be required to meet strong capital standards. The GSEs should also meet other appropriate regulatory standards to limit their ability to take on risk while ensuring safety and soundness. Rigorous oversight for safety and soundness is also paramount.

- A board of advisors made up of representatives from the mortgage lending industry should be formed to advise the FHFA regarding GSEs. Credit unions should be represented in such a body.

- While a central role for the U.S. government in the secondary mortgage market is pivotal, the GSEs should be self-funded, without any dedicated government appropriations. GSE's fee structures should, in addition to size and volume, place increased emphasis on quality of loans. Credit union loans provide the quality necessary to improve the salability of agency securities.

- Fannie Mae and Freddie Mac should continue to function, whether in or out of conservatorship, and honor the guarantees of the agencies at least until such time as necessary to repay their current government debts. Legislation to reform the GSEs should ensure that taxpayer losses are not locked in, but should allow for time for the GSEs to make taxpayers whole.

- At this time, NAFCU does not support full privatization of the GSEs because of serious concerns that small community-based financial institutions could be shut-out from the secondary market.

- The Federal Home Loan Banks (FHLBs) serve an important function in the U.S. mortgage market. Most importantly, they provide their credit union members with a reliable source of funding and liquidity. Throughout the financial crisis, despite experiencing financial stress, the FHLBs continue to be a strong partner for credit unions. Reform of the nation's housing finance system must take into account the consequence of any legislation on the health and reliability of the FHLBs. Importantly, access to FHLBs for small lenders should not be impeded in any way.

Thank you for this opportunity to provide input on this critical issue. NAFCU welcomes the opportunity to provide additional views on housing finance reform as the legislative process moves forward. If my colleagues or I can be of assistance to you, or if you have any questions regarding this issue, please feel free to contact myself, or NAFCU's Senior Associate Director of Legislative Affairs, Jillian Pevo, at (703) 842-2836.

Sincerely,

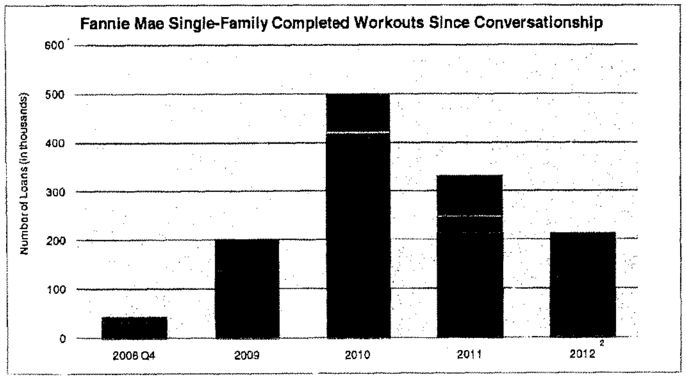
Brad Thaler
Vice President of Legislative Affairs

cc: Members of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises.

Fannie Mae Business and Financial Update for Congresswoman Carolyn Maloney

Timothy J. Mayopoulos
President and Chief Executive Officer
February 26, 2013

Fannie Mae remains focused on loss mitigation strategies



[2]Year-to-date through Q3 2012

[illegible]	[illegible]
Preforeclosure sales & Deeds-in-Lieu	**269,062**
Forbearances Completed	**15,465**
Repayment Plans Completed	**98,414**
Modifications	**845,440**
HomeSaver Advance (TM)	**70,178**
Total	**1,298,559**

[1] Totals in this column reflect the sum of Q4 2008 to Q3 2012 amounts

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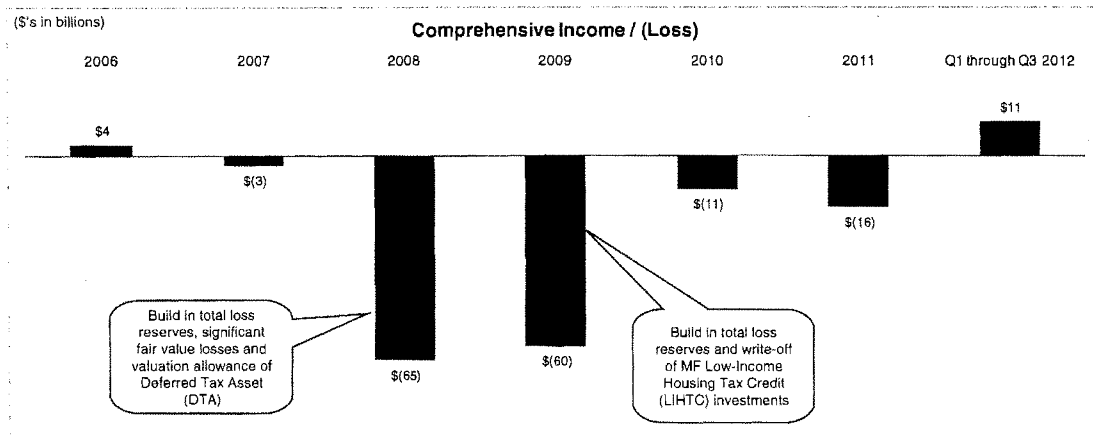
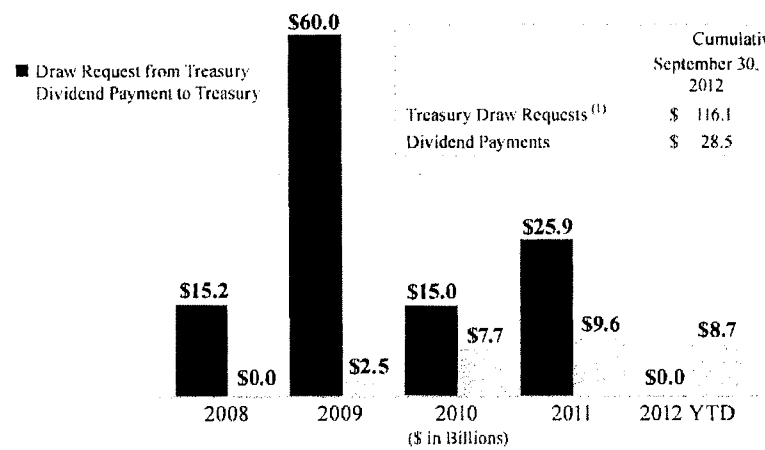
Fannie Mae continues to help homeowners avoid foreclosure through home retention solutions, such as modifications, pre-foreclosure sales (short sales), and deeds-in-lieu.

After several years of losses, Fannie Mae posted profits in the first three quarters of 2012



Positive results during the first three quarters of 2012 reflect improvements in national home prices.

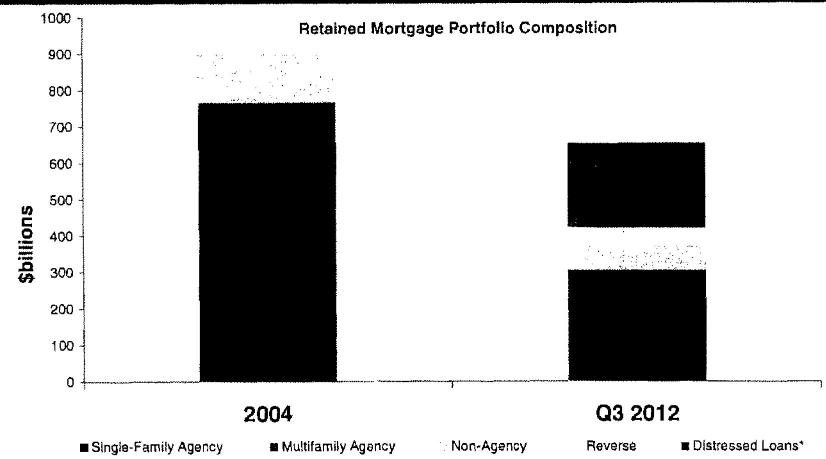
Treasury Draw Requests and Dividend Payments



	Cumulative Total as of September 30, 2012	Cumulative Total as of December 31, 2011
Treasury Draw Requests [1]	$ 116.1	$ 116.1
Dividend Payments	$ 28.5	$ 19.8

Through Q3 2012, Fannie Mae has paid $28.5 billion in cash dividends to Treasury.

Capital Markets –Portfolio Management



* Prior to 2008, amounts were immaterial

- The retained mortgage portfolio consists of assets that serve different purposes:
  - Legacy assets purchased prior to Conservatorship – acquired for long-term return
  - Transactional assets – held for short periods to facilitate lender liquidity
  - Delinquent and modified loans – acquired as part of credit loss mitigation process
- Loans or securities are no longer purchased for long-term investment purposes.

Balance sheet assets are evaluated for their risk-return profile and their impact on the Company's core business functions.

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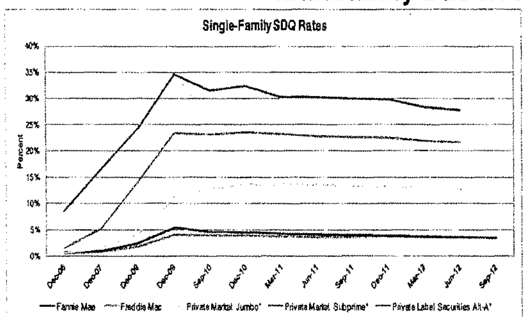
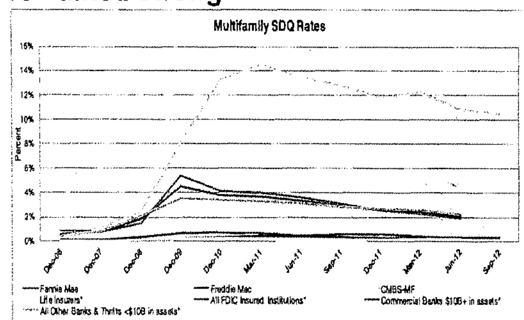
As of September 30, 2012, smaller percentage of Fannie Mae loans were seriously delinquent across the Single-Family business segment, while Multifamily business remained strong



Source: FDIC, TREPP, Fannie Mae and Freddie Mac
* September 2012 data not yet available



Source: FDIC, TREPP, Fannie Mae and Freddie Mac
* September 2012 data not yet available

The Single-Family SDQ rate began declining from 5.47% in the first quarter of 2010 through the third quarter of 2012 to 3.41% as a result of home retention solutions, foreclosure alternatives, and completed foreclosures in addition to acquisition of loans with a stronger credit profile.

- The Multifamily SDQ rate began to decrease from 0.79% in first quarter of 2010 to 0.28% in Q3 2012 as national multifamily market fundamentals continued to improve over the years.

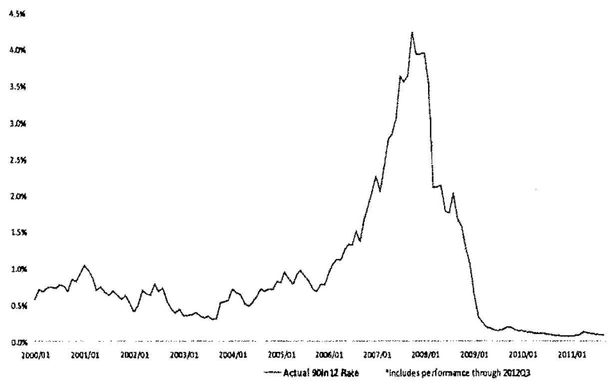
As of September 30, 2012, Fannie Mae's Single-Family and Multifamily SDQ rates remained below private market levels.

Performance of newly acquired loans has significantly improved

- Since late 2008, Fannie Mae has taken significant steps to strengthen the underwriting and eligibility standards through Desktop Underwriter (DU), Fannie Mae's automated underwriting system and with manual underwriting guidelines.
- These changes have resulted in significant improvement in the performance of newly acquired loans.
- The chart below shows the percentage of our single family acquisitions excluding HARP and RP Flex that became delinquent for 90 days or longer within the first 12 months of acquisition.

90in12 Rate

(Conventional Acquisitions from Jan 2000 - Sep 2011; Excluding HARP & RPFlex)



Key Underwriting and Eligibility Changes

- Discontinued newly originated Alt-A*, Reverse, Second Liens, and Subprime*
- Reduced maximum LTV for fixed loans to 97% for DU and 95% for manual underwriting
- Reduced maximum LTV for ARM loans to 90%
- Increased minimum credit score to 620
- Implemented a 45% maximum debt-to-income ratio (DU allows up to 50% with strong compensating factors.
- Significantly tightened eligibility guidelines on interest only loans
- Required ARM borrowers to qualify at a similar or higher rate than fixed-rate borrowers
- Reduced eligible risk layering

* Except for refinancings of loans acquired prior to 2009.

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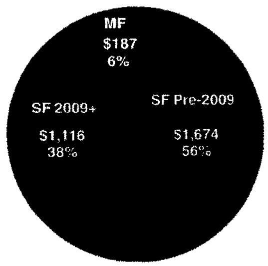
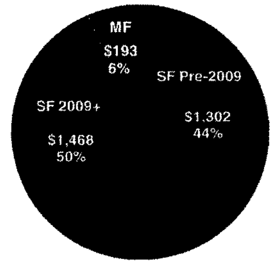
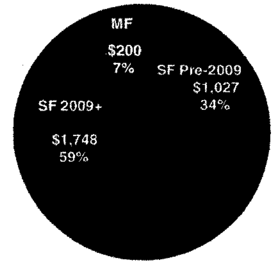
2010: $2,977B



2011: $2,963B



Q3 2012: $2,975B



Numbers may not foot due to rounding.

- As of September 30, 2012 SF 2009+ vintage continued to become a larger portion of the total book. The 2005-2008 and 2001-2004 vintages had serious delinquency rates of 9.62% and 3.49%, respectively, as of September 30, 2012.
- The information above reflects the SF and MF conventional guaranty book of business. Additionally, the SF 2009+ category includes Refi Plus® (including HARP).

Fannie Mae is focused on building a profitable Single-Family Book of Business with its acquisitions since the beginning of 2009 while managing losses on the legacy book through foreclosure prevention and other efforts.

FINANCIAL TIMES

September 9, 2008 7:25 pm

Oxley hits back at ideologues

By Greg Farrell in New York

In the aftermath of the US Treasury's decision to seize control of Fannie Mae and Freddie Mac, critics have hit at lax oversight of the mortgage companies.

The dominant theme has been that Congress let the two government-sponsored enterprises morph into a creature that eventually threatened the US financial system. Mike Oxley will have none of it.

Instead, the Ohio Republican who headed the House financial services committee until his retirement after mid-term elections last year, blames the mess on ideologues within the White House as well as Alan Greenspan, former chairman of the Federal Reserve.

The critics have forgotten that the House passed a GSE reform bill in 2005 that could well have prevented the current crisis, says Mr Oxley, now vice-chairman of
Nasdaq.

He fumes about the criticism of his House colleagues. "All the handwringing and bedwetting is going on without remembering how the House stepped up on this," he says. "What did we get from the White House? We got a one-finger salute."

The House bill, the 2005 Federal Housing Finance Reform Act, would have created a stronger regulator with new powers to increase capital at Fannie and Freddie, to limit their portfolios and to deal with the possibility of receivership.

Mr Oxley reached out to Barney Frank, then the ranking Democrat on the committee and now its chairman, to secure support on the other side of the aisle. But after winning bipartisan support in the House, where the bill passed by 331 to 90 votes, the legislation lacked a champion in the Senate and faced hostility from the Bush administration.

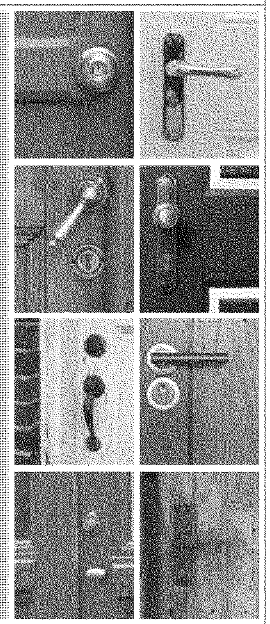
Adamant that the only solution to the problems posed by Fannie and Freddie was their privatisation, the White House attacked the bill. Mr Greenspan also weighed in, saying that the House legislation was worse than no bill at all.

"We missed a golden opportunity that would have avoided a lot of the problems we're facing now, if we hadn't had such a firm ideological position at the White House and the Treasury and the Fed," Mr Oxley says.

When Hank Paulson joined the administration as Treasury secretary in 2006 he sent emissaries to Capitol Hill to explore the possibility of reaching a compromise, but to no avail.

Economic Policy Program
Housing Commission

Housing America's Future:
New Directions for National Policy



February 2013

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ACKNOWLEDGMENTS

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DISCLAIMER

This report is the product of the BPC Housing Commission with participants of diverse expertise and affiliations, addressing many complex and contentious topics. It is inevitable that arriving at a consensus document in these circumstances entailed compromises. Accordingly, it should not be assumed that every member is entirely satisfied with every formulation in this document, or even that all participants would agree with any given recommendation if it were taken in isolation. Rather, this group reached consensus on these recommendations as a package.

The findings and recommendations expressed herein are solely those of the commission and do not necessarily represent the views or opinions of the Bipartisan Policy Center, its founders, or its Board of Directors.

Housing Commission

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Economic Policy Figures

Letter from the Co-Chairs

We formed the Housing Commission to help set a new direction for federal housing policy. More than five years after the collapse of the housing market, it is now all too apparent that current policy, and the institutions that support it, are outdated and inadequate.

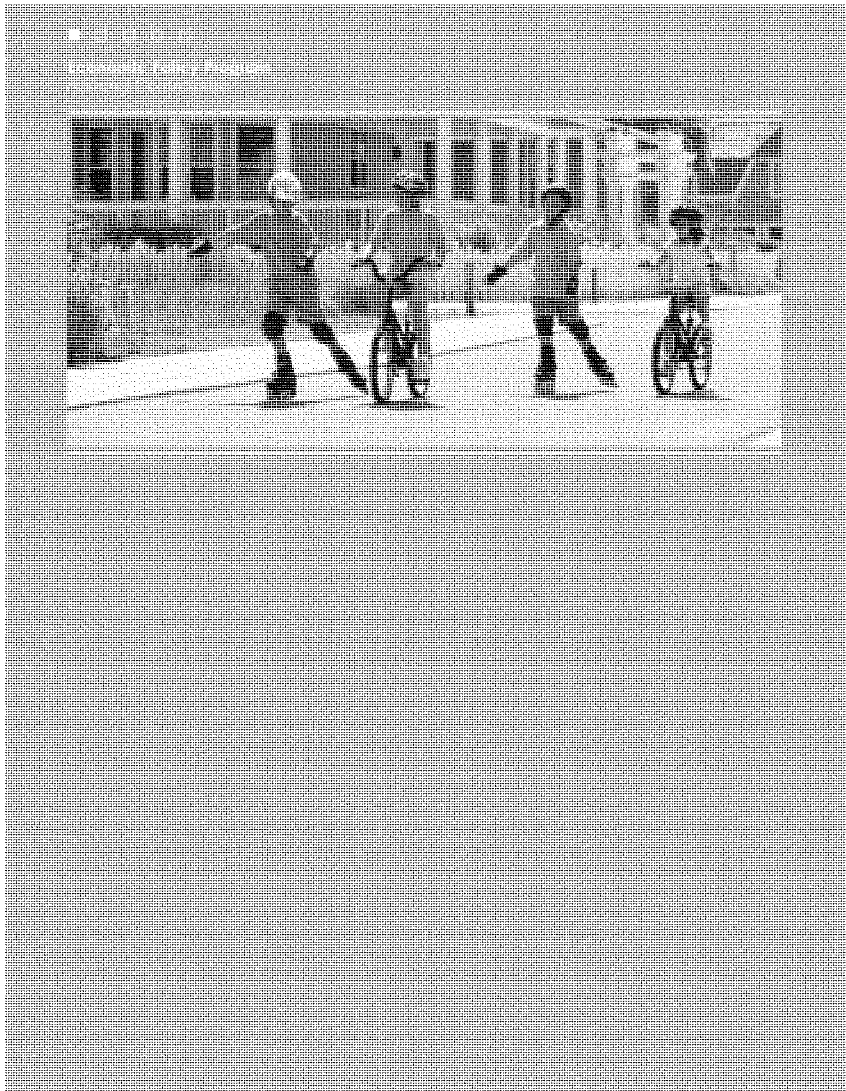
This report, the culmination of a 16-month examination of some of the key issues in housing, provides a blueprint for an entirely new system of housing finance for both the ownership and rental markets. Under this new system, the private sector will play a far greater role in bearing credit risk and providing mortgage funding, and taxpayer protection will be a central goal. We also propose a new, outcome-oriented approach to the distribution of federal rental subsidies that responds to the housing needs of our nation's most vulnerable households and rewards providers who demonstrate strong results at the state and local levels with increased flexibility in program administration. The report highlights how our nation's burgeoning senior population and dramatic demographic changes will present new challenges and opportunities for housing providers in communities throughout the country.

Over the years, Republicans and Democrats have worked together to establish policies to address the diverse housing needs of the American people. After World War II, for example, Republican Senator Robert Taft worked with President Truman to remedy a national housing shortage and respond to the housing needs of America's returning veterans with the Housing Act of 1949. Two decades later, President Johnson and Everett Dirksen, the Republican Senate Leader from Illinois, worked collaboratively to pass the Fair Housing Act of 1968. Both parties came together again to pass the Tax Reform Act of 1986, which created the Low Income Housing Tax Credit. There is a simple explanation for this history of bipartisanship: Americans of all political backgrounds intuitively understand that ensuring access to decent, suitable, and affordable housing is a goal worth striving for, and one that our country must never abandon. The commission follows this bipartisan tradition.

We wish to express our gratitude to our fellow commissioners who have labored long hours, and made many sacrifices, over the past 16 months. It has been a great privilege to work with this distinguished group of Americans, and their dedication to solving some of the most perplexing issues in housing has been an inspiration to us.

The challenges we face in housing are so great and so urgent, that new ideas and approaches must be brought to the policy table. It is our hope that our work will contribute to the dialogue and help further the housing policy reform debate.

CHRISTOPHER S. "KIT" BOND | HENRY CISNEROS | MEL MARTINEZ | GEORGE J. MITCHELL



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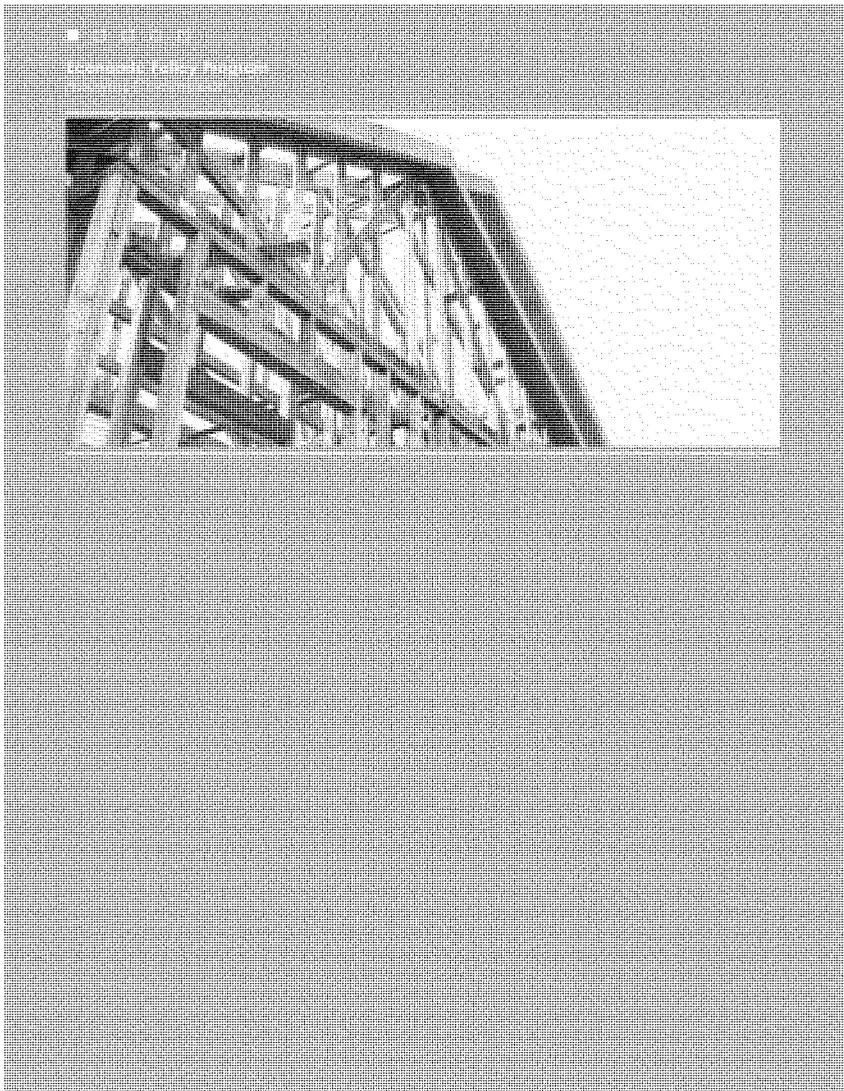

Economic Policy Program

Executive Summary and Recommendations

Our nation's numerous and urgent housing challenges underscore the need for a review of federal housing policy. Since the collapse of the housing market in 2007, the federal government has stepped in to support the vast majority of all mortgage financing, both for homeownership and rental housing. At the same time, rental demand is increasing in many regions throughout the United States, and the number of renters spending more than they can afford on housing is unacceptably high and growing. These developments are taking place against a backdrop of profound demographic changes that are transforming the country and our housing needs. These changes include the aging of the Baby Boomers, the formation of new households by members of the "Echo Boom" generation (those born between 1981 and 1995), and the growing diversity of the American population.

In many respects, our housing system is outdated and not equipped to keep pace with today's demands and the challenges of the imminent future. The Bipartisan Policy Center (BPC) launched the Housing Commission in October 2011 to develop a new vision for federal housing policy that provides a path forward during this period of great change. This report, the centerpiece of an ongoing effort by the Housing Commission to examine key issues that together form the basic elements of a resilient housing system, proposes:

- A responsible, sustainable approach to homeownership that will help ensure that all creditworthy households have access to homeownership and its considerable benefits.
- A reformed system of housing finance in which the private sector plays a far more prominent role in bearing credit risk while promoting a greater diversity of funding sources for mortgage financing.
- A more targeted approach to providing rental assistance that directs scarce resources to the lowest-income renters while insisting on a high level of performance by housing providers.
- A more comprehensive focus on meeting the housing needs of our nation's seniors that responds to their desire to age in place and recognizes the importance of integrating housing with health care and other services.

In preparing the recommendations that follow, an overarching goal of the commission was to ensure that the nation's housing system enables individuals and families to exercise choice in their living situations, as their needs and preferences change over time. While today's challenges are great, the opportunity to create a new system that expands the range of housing options for individuals and families is even greater.

Reforming Our Nation's Housing Finance System

A successful housing finance system should maximize the range of ownership and rental housing choices available at all stages of our lives. Meeting our nation's diverse housing needs requires a strong and stable system of housing finance. This system, when functioning at its full potential, offers millions of Americans and their families the opportunity to choose the type of housing that best responds to their individual situations. The mortgage boom and bust has rocked the system on which the United States has relied for more than 75 years and has forced a reevaluation of the government's role in supporting mortgage credit and how this role should be structured. Private, risk-bearing capital in the mortgage market has shrunk dramatically, while the tremendous uncertainty surrounding the future of our housing finance system has greatly limited consumers' choices, particularly for creditworthy borrowers seeking to obtain a mortgage. In response to this recent unraveling and subsequent uncertainty, the commission proposes a blueprint for a new system of housing finance that will support homeownership and provide for a vibrant rental housing market.

Key Policy Objectives

The private sector must play a far greater role in bearing credit risk. Greater federal intervention was necessary when the market collapsed, but the dominant position currently held by the government is unsustainable. Today, the government supports more than 90 percent of single-family mortgages through entities such as Fannie Mae, Freddie Mac, Ginnie Mae, and the Federal Housing Administration (FHA) as well as roughly 65 percent of the rental mortgage market. Reducing the government footprint and encouraging greater participation by risk-bearing private capital will protect taxpayers while providing for a greater diversity of funding sources. A durable housing finance system must provide open access to lenders of all types and sizes, including community banks and credit unions. It must also serve as wide a market as possible and assure consumers fair access to sustainable and affordable mortgage credit.

While private capital must play a greater role in the housing finance system, continued government involvement is essential to ensuring that mortgages remain available and affordable to qualified homebuyers. The commission recommends the establishment of a limited, catastrophic government guarantee to ensure timely payment of principal and interest on qualified mortgage-backed securities (MBS). This guarantee should (1) be explicit and fully paid for through premium collections that exceed expected claims (with a safe reserve cushion); (2) be triggered only after private capital in the predominant loss position has been fully exhausted; and (3) apply only to the securities and not to the equity or debt of the entities that issue or insure them.

As part of this rebalancing, the commission proposes the winding down and ultimate elimination of Fannie Mae and Freddie Mac after a multiyear transition period. The business model of these government-sponsored enterprises (GSEs)—publicly traded companies with *implied* government guarantees and other advantages—has failed and should not be repeated. During the transition period, the Federal Housing Finance Agency should continue its efforts to reduce the size of the GSE portfolios and move the GSE pricing structure closer to what one might find if private capital were at risk. Congress should also gradually lower the GSE loan limits to allow larger loans to flow to the private sector.

Through the gradual reduction in loan limits to pre-crisis levels, the commission also supports a more targeted FHA that returns to its traditional mission of primarily serving first-time homebuyers.

The Structure of the New System

The commission proposes to replace the GSEs with an independent, wholly owned government corporation—the "Public Guarantor"—that would provide a limited catastrophic government guarantee for both the single-family and rental markets. Unlike the GSEs, the Public Guarantor would not buy or sell mortgages or issue MBS. It would simply guarantee investors the timely payment of principal and interest on these securities. The model endorsed by the commission is similar to Ginnie Mae, the government agency that wraps securities backed by federally insured or guaranteed loans. Other than the Public Guarantor, all other actors in this new system—originators, issuers of securities, credit enhancers, and mortgage servicers—should be private-sector entities fully at risk for their own finances and not covered by either implicit or explicit government guarantees benefitting their investors or creditors.

In the new system, the limited catastrophic guarantee of the Public Guarantor would only be triggered after all private capital ahead of it has been exhausted. The government would be in the fourth-loss position behind (1) borrowers and their home equity; (2) private credit enhancers; and (3) the corporate resources of the issuers and servicers.

The Public Guarantor will have significant standard-setting and counterparty oversight responsibilities. These responsibilities include (1) qualifying institutions to serve as issuers, servicers, and private credit enhancers; (2) ensuring that these institutions are well-capitalized; (3) establishing the guarantee fees to cover potential catastrophic losses; (4) ensuring the actuarial soundness of two separate catastrophic risk funds for the single-family and rental segments of the market; and (5) setting standards (including loan limits) for the mortgages backing government-guaranteed securities. With respect to rental finance, the Public Guarantor would also have the authority to underwrite multifamily loans directly and would be responsible for establishing an affordability threshold that would primarily support the development of rental housing that is affordable to low- and moderate-income households.

> Meeting our nation's diverse housing needs requires a strong and stable system of housing finance.

Obstacles to the Housing Market Recovery

The commission has identified a number of regulatory obstacles that are restricting mortgage credit and inhibiting the housing market's recovery. These obstacles include overly strict mortgage lending standards; the lack of access to mortgage credit for well-qualified self-employed individuals; uncertainty about the extent of "put-back" risk for mortgage lenders; the demand for multiple appraisals and the use of distressed properties as market comps; the application of FHA compare ratios; and the uncertainty related to pending mortgage regulations and the implementation of new rules.

To overcome these obstacles, the commission recommends that the President of the United States direct the Department of the Treasury, in coordination with the various federal banking agencies, to assess the impact of current and pending regulatory requirements on the affordability and accessibility of mortgage credit. The Treasury Department should develop a plan to align these requirements as much as possible to help get mortgage credit flowing again. A top official within the Treasury Department or in the White House should be tasked with day-to-day responsibility for coordinating the implementation of this plan.

The Continuing Value of Homeownership

Homeownership will continue to be the preferred housing choice of a majority of households. According to research performed for the commission, the national homeownership rate is likely to remain above 60 percent for the foreseeable future. Millions of Americans continue to see homeownership as a critical cornerstone of the American Dream with benefits well beyond the financial investment. This sentiment is especially strong within the growing Hispanic community.

Despite the collapse of the housing market, the commission strongly believes that, when responsibly undertaken, homeownership can produce powerful economic, social, and civic benefits that serve the individual homeowner, the larger community, and the nation. A combination of proper regulation, adequate liquidity, and the right incentives in the private market can help ensure that homeownership remains a vital housing and wealth-building option. When coupled with reasonable down payments, solidly underwritten, fixed-rate mortgages—as well as straightforward adjustable-rate mortgages with clear terms and limits on adjustments and maximum payments—can also open the door to homeownership and its benefits for individuals with modest wealth and incomes.

Housing counseling can improve prospective borrowers' access to affordable, prudent mortgage loans, especially for families who otherwise might not qualify or who may experience other barriers to conventional lending. Four key elements are necessary: (1) a strong counseling infrastructure; (2) clear standards; (3) an understanding of the proper role for counselors; and (4) the adoption of best practices for integrating counseling into the mortgage market. The commission supports continued federal appropriations for housing counseling and recommends that all stakeholders who benefit from a borrower's access to counseling services be expected to contribute to the cost of the service.

Affordable Rental Housing

The nation's 41 million renter households account for 35 percent of the U.S. population. In the coming decade, the number of renters is likely to grow significantly as members of the Echo Boom generation form their own households for the first time and as members of the Baby Boom generation downsize from their current homes. Growing pressure for rental housing may push rents further out of reach for the low-income households that are least able to afford it. Our nation's housing system should aim to minimize the trade-offs these households often face when seeking affordable housing—in terms of neighborhood quality, access to good jobs and high-performing schools, and spending on other essentials like health care and nutritious food.

Federal Assistance Falls Far Short of What's Needed

Nationally, a majority of extremely low-income renter households spend more than half of their incomes on housing. For the most part, renters live in housing that meets basic quality standards. However, nearly half of renters at all income levels report paying more than 30 percent of their income for rent—the federal standard for housing affordability. Among extremely low-income renters (those with incomes at or below 30 percent of area median income), the situation is far worse. Nearly 80 percent of these lowest-income households report spending more than 30 percent of their income for rent, and nearly two-thirds spend 50 percent or more.

There are far more extremely low-income renters than available units they can afford.

Federal housing assistance meets only a fraction of the need. Federal assistance programs currently help approximately five million low-income households afford housing.

Growing pressure for rental housing may push rents further out of reach for the low-income households that are least able to afford it.

However, only about one in four renter households eligible for assistance actually receives it. Because demand so far outstrips supply, these scarce rental subsidies are often allocated through lengthy waiting lists and by lotteries.

Responding to the Crisis

The commission recommends that our nation transition to a system in which our most vulnerable households, those with extremely low incomes (at or below 30 percent of area median income) are assured access to housing assistance if they need it. Assistance should be delivered through a reformed Housing Choice Voucher program that, over time, limits eligibility to only the most vulnerable families.

The commission recommends increasing the supply of suitable, affordable, and decent homes to help meet both current and projected demand. To achieve this goal, the commission recommends:

- Expansion of the Low Income Housing Tax Credit (LIHTC) by 50 percent over current funding levels and the provision of additional federal funding to help close the gap that often exists between the costs of producing or preserving LIHTC properties and the equity and debt that can be raised to support them.
- Additional federal funding beyond current levels to address the capital backlog and ongoing accrual needs in public housing to preserve the value of prior investments and improve housing quality for residents.

The commission recommends federal funding to minimize harmful housing instability by providing short-term emergency assistance for low-income renters (those with incomes between 30 and 80 percent of area median income) who suffer temporary setbacks. This assistance, delivered as a restricted supplement to the HOME Investment Partnerships program, could be used to help cover payment of security deposits, back rent, and other housing-related costs to improve residential stability and prevent homelessness.

These recommendations, if fully implemented, would help to meet the needs of an additional five million vulnerable renter households and contribute to the elimination of homelessness—through production, preservation, and rental assistance.

The commission recommends a new performance-based system for delivering federal rental assistance that focuses on outcomes for participating households, while offering high-performing providers greater flexibility to depart from program rules. The commission proposes a new performance-based system that will evaluate housing providers' success in five key programmatic areas: (1) improving housing quality; (2) increasing the efficiency with which housing assistance is delivered; (3) enabling the elderly and persons with disabilities to lead independent lives; (4) promoting economic self-sufficiency for households capable of work; and (5) promoting the de-concentration of poverty and access to neighborhoods of opportunity. Providers that achieve a high level of performance across these five areas should be rewarded with increased flexibility to depart from standard program rules, while substandard providers should be replaced. The federal government spends tens of billions of dollars annually to support the nation's valuable infrastructure of publicly and privately owned rental housing. Neither landlords nor program operators who fail to provide tenants with homes and services of reasonable quality should benefit from this investment.

Funding the Solutions

In light of today's difficult fiscal environment, the commission recognizes that a transition period will be necessary before these recommendations can be fully implemented. The commission therefore recommends that its approach for meeting the needs of the nation's most vulnerable households be phased in over time.

The commission supports the continuation of tax incentives for homeownership, but as part of the ongoing debate over tax reform and budget priorities, the commission also recommends consideration of modifications to these incentives to allow for increased support for affordable rental housing. The commission is aware of the difficult issues that will need to be addressed in the coming years to balance federal budget priorities. The federal government currently provides substantial resources in support of housing, the majority of which is in the form of tax subsidies for homeownership. The commission supports the continuation of tax incentives for homeownership—recognizing the importance of this tax policy to homeowners in the United States today. The commission notes that various tax benefits provided to homeowners, including the mortgage interest deduction, have been modified over the years. In the ongoing debate over tax reform and budget priorities, all revenue options must be evaluated. In that context, the commission recommends consideration of further modifications to federal tax incentives for homeownership to allow for an increase in the level of support provided to affordable rental housing. Any changes should be made with careful attention to their effects on home prices and should be phased in to minimize any potential disruption to the housing market. A portion of any revenue generated from changes in tax subsidies for homeownership should be devoted to expanding support for rental housing programs for low-income populations in need of affordable housing.

The Importance of Rural Housing

The U.S. Department of Agriculture (USDA) bears primary responsibility for administering housing assistance in the nation's rural areas that, under the current definition used by USDA, are home to one-third of the U.S. population. Overall, rural areas tend to have higher poverty rates and lower incomes, so although housing costs are often lower than in other parts of the country, a substantial portion of rural households spend an unsustainable share of income on rent or mortgage payments. USDA offers both rental housing and homeownership programs to enable lower-income residents of rural areas to afford high-quality homes.

The commission supports current approaches to the administration of housing support in rural areas. More specifically, the commission recommends that housing assistance in rural areas continue to be delivered through USDA and the standards currently used to define "rural areas" maintained through the year 2020.

The commission also recommends enhancing the capacity of USDA providers to serve more households. Modest incremental funding for the Section 502 Direct Loan program, in particular, would enable USDA to provide homeownership assistance to more low-income rural households at relatively low cost. In light of recent elevated delinquency rates, however, the commission believes that any additional federal support for the Section 502 Direct Loan program should be conditioned on a thorough program evaluation. USDA providers should also be provided with resources to improve the delivery of technical assistance and the technology used to process loans, collect data, and monitor program performance.

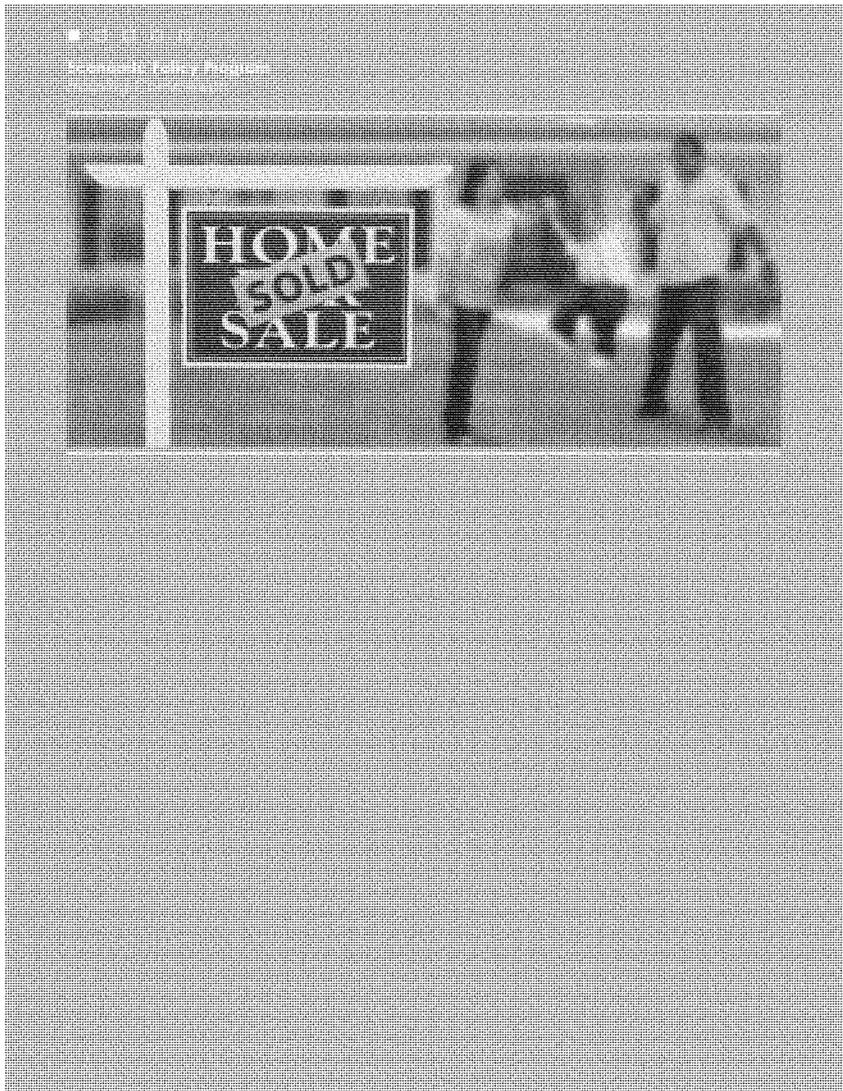
Aging in Place: A New Frontier in Housing

The aging of the population will necessitate major changes in the way we operate as a nation, including in the housing sector. While the number of Americans aged 65 and older is expected to more than double between 2010 and 2040, we are still largely unprepared to meet the needs of the overwhelming numbers of seniors who wish to "age in place" in their own homes and communities. Industry groups have begun to educate their members about ways to improve the safety of existing homes through relatively simple modifications, and the importance of applying universal design principles in the construction of new homes. States and localities have also risen to the challenge, targeting programs to deliver health care and other supportive services to the naturally occurring retirement communities where older residents are aging in place.

The commission recommends better coordination of federal programs that deliver housing and health care services to seniors. The U.S. Department of Housing and Urban Development (HUD) and the Department of Health and Human Services (HHS) should jointly identify and remove barriers to the creative use of residential platforms for meeting the health and long-term care needs of seniors. In evaluating the costs of housing programs that serve frail seniors, Congress and the Office of Management and Budget should identify and take into account savings to the health care system made possible by the use of housing platforms with supportive services.

We are still largely unprepared to meet the needs of the overwhelming numbers of seniors who wish to "age in place" in their own homes and communities.

The commission supports better integration of aging-in-place priorities into existing federal programs and urges a more coordinated federal approach to meeting the housing needs of the growing senior population. The scope of the U.S. Department of Energy's Weatherization Assistance Program should be expanded to include home assessments and modifications for aging in place. In addition, steps should be taken to provide effective guidance to ensure consumers understand the mechanics of reverse mortgages, including the risks and benefits of these products. A White House conference could bring together top federal officials and key players in the private and public sectors to draw national attention to the issue of senior housing and to catalyze development of a coordinated approach to aging in place.


HOME
SOLD
SALE

Chapter 1. Introduction: Our Nation's Housing

Our homes are where life among family and friends is centered and nurtured. They are the backbones of our communities—where our children prepare to go to school, where we form attachments with our neighbors, and where we participate in civic life. Our homes are the very platforms from which our lives develop. Increasingly, we have come to understand that our homes and the communities in which they are located are also important determinants of specific outcomes: early childhood development and health; access to quality educational opportunities; and our ability to reach stable, good-paying jobs. As the population ages and as we stay longer in our homes, where we live will increasingly affect how critical medical and social services are delivered and will shape the quality of seniors' lives.

Owning a home has been a strong aspiration since at least the mid–20th century, when the postwar economic expansion, new government support for veterans and working families, the construction of new highways, and suburban development created opportunities for families to buy a home at an affordable monthly cost. Over the next 50 years, many families not only enjoyed the security that homeownership offered, they also accumulated wealth through the pay down of mortgage principal and long-term home price appreciation. America's homes financed millions of college educations, retirements, and medical and other necessities. The divide between those families with significant net wealth and those without was marked most clearly by whether or not a family owned a home of its own. Unfortunately, not all Americans shared in this prosperity, as homeownership rates for minority families have consistently lagged behind those of white households.

During the same period, national policy focused on eliminating slums and blight and constructing in their place new, affordable rental homes. Over time, our success at removing blight and slums outpaced our ability to replace the lost housing, and market forces that drove up the cost of rental housing accelerated the loss of affordable rental homes in many communities. A very high percentage of renters today, primarily those with modest incomes but also increasingly more economically secure households, are forced to spend large shares of their income on rent.

Housing is also a critical driver of the U.S. economy. For generations, our nation has looked to housing as a source of economic vitality and growth. Statistics like "sales of new and existing homes" and "multifamily starts" have become key indicators of national economic performance. When these indicators are trending upward, it generally means the U.S. economy is on the march; when they are trending downward, the economy is often in trouble. What is clear is that a stable, vibrant housing market directly translates into more jobs, higher family incomes and household wealth, and a stronger, more prosperous nation. It is equally clear that a strong economy with robust employment and income growth is the surest way to support strong housing markets throughout the country. When these elements lag and families cannot keep pace with the rising costs of a home, all parts of the housing sector suffer, with impacts reverberating throughout the economy.

The unprecedented collapse of the housing market that began in 2007 has undermined our confidence in the system built over the last 75 years. In the wake of regulatory and market failures that enabled the growth of unsafe and unstable mortgage products and an unsustainable increase in house prices, that system is in disarray. The impact of the collapse is still being felt today, as millions of families have lost their homes, trillions of dollars in household wealth have vanished, and scores of communities remain decimated by foreclosures. The federal government's conservatorship of Fannie Mae and Freddie Mac—the institutions established by Congress to ensure a stable supply of mortgage financing through the sale of mortgage-backed securities—has cost the taxpayers tens of billions of dollars to date.[1] And mortgage credit continues to elude millions of creditworthy borrowers as very tight credit practices have become the norm.

At the same time, the demographics of the United States are changing in transformative ways. As a society, we are becoming older, more likely to delay marriage and childbearing, and more racially and ethnically diverse. Members of the Echo Boom generation (those 62 million Americans born between 1981 and 1995) are also beginning to strike out on their own, many leaving the homes of their parents for the first time to form their own households. These changes will profoundly impact housing demand and the types of housing that Americans will need and want in the coming decade. Developing an effective response to these demographic changes will be a great challenge for policy makers and housing practitioners, and a valuable opportunity for a fundamental rethinking of our nation's housing system.

Recognizing the need for action and a new vision to guide federal housing policy, BPC launched the Housing Commission in October 2011 to examine the many challenges in housing today and to advance a coherent national strategy in response. As a result of this effort, we are more convinced than ever that housing must assume a more prominent place on the national policy agenda. A nation that can offer a broad range of affordable housing options to its citizens will be stronger and better poised to compete on the global economic stage. A stable housing finance system will support housing consumption and investment, which in turn will be a vital source of new jobs, economic activity, and tax revenue for all levels of government. In short, restoring our nation's housing sector is a necessary precondition for America's full economic recovery and future growth.

Housing Commission Principles

The commission developed the following five principles as the foundation for its deliberations and recommendations:

A healthy, stable housing market is essential for a strong economy and a competitive America.

The economy will not reach its full potential without a robust housing sector that is supported by a strong and stable system of housing finance. In the post–World War II era, the United States has suffered through 11 recessions,[2] and new homebuilding and housing-related construction have often led the way to economic revitalization.[3] Likewise, the recent housing and mortgage crisis demonstrated that an unstable housing finance system can hurt not only housing, but, through our increasingly integrated banking and finance system, the entire global economy. A good quality of life for the nation's workforce and population, based on safe and secure homes and communities of opportunity, is critical to the global competitiveness of our national and regional economies.

The nation's housing finance system should promote the uninterrupted availability of affordable housing credit and investment capital while protecting American taxpayers.

Tens of millions of American families have benefited from the stability and affordability provided by the U.S. housing finance system and its traditional support of a variety of mortgages, including sustainable, long-term home financing. The commission received a wealth of testimony calling into question the availability of certain consumer-friendly products, including the long-term prepayable fixed-rate mortgage, absent some level of government intervention. The commission believes that the government role in the housing finance system can be structured in a way that narrowly circumscribes taxpayer risk of loss, while promoting the goals of stability and affordability.

The Changing Demographics of America

The United States is fortunate to have a growing population fueled by both natural increase (net births over deaths) and immigration. According to projections of the U.S. Census Bureau, the national population will likely increase from 310 million in 2010 to nearly 334 million in 2020.[5] By mid-century, the Census Bureau projects that the U.S. population will exceed 400 million.[6] As the population grows, the demand for new and upgraded housing will grow as well. The production of new housing units as well as the preservation and renovation of existing units, both owner-occupied and rental, should be a major dynamic force in the overall national economy.

Against this backdrop of population growth, three important demographic trends will help shape the housing landscape: the aging of the Baby Boom population, the formation of new households by members of the Echo Boom generation, and the increasing diversity of the general population as members of minority groups (particularly Hispanics) make up a greater percentage of total households.[7]

The Baby Boom Generation

We live in a time when medical and other technological advances make it possible for more Americans to enjoy longer, more productive lives. This development, while certainly welcome, challenges our country to ensure that our existing and future housing stock can support healthy living by older Americans. This challenge will only grow as the Baby Boom generation matures.

The United States should reaffirm a commitment to providing a decent home and a suitable living environment for every American family.

This commitment, first articulated in the Housing Act of 1949 and repeated in subsequent federal legislation, should be embraced as an essential aspiration of an economically dynamic and just society. Housing policy should recognize the importance of community, economically diverse neighborhoods, and access to education, nutritious food, transportation, and other services, as well as aim to break up concentrations of poverty. Despite our current economic problems, the United States remains one of the wealthiest countries in the world and should have a housing system commensurate with this status.

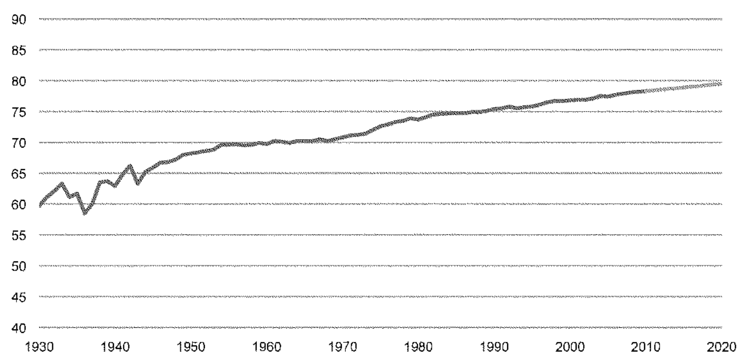
The primary focus of federal housing policy should be to help those most in need.

As our nation's leaders continue their efforts to restrain federal spending and reduce our national debt, it is clear that federal resources for housing will be significantly constrained for the foreseeable future. These limited funds should be deployed in a more targeted and efficient manner to first help the most vulnerable households, including the more than 600,000 people sleeping on the streets, in shelters, or in their cars because they cannot afford a home.[4]

Federal policy should strike an appropriate balance between homeownership and rental subsidies.

Owner-occupied housing and rental housing are complementary—not competing—components of a housing system that serves individuals and families at all stages of life. The support the federal government devotes to housing through direct outlays and tax subsidies should be allocated in a manner that reflects differences in the circumstances, needs, and preferences of households throughout the life cycle.

Chart 1-1: Life Expectancy at Birth in the United States, 1930 to 2008 with Projections through 2020



Sources: 1930–2008 data from Elizabeth Arias, "United States Life Tables, 2008," *National Vital Statistics Reports* 61, no. 3 (2012); 2010–2020 projections from U.S. Census Bureau, "Table 104. Expectation of Life at Birth, 1970 to 2008, and Projections, 2010 to 2020," *Statistical Abstract of the United States: 2012* (131st Edition) (Washington, D.C.: 2011).

Between 1946 and 1965, the Baby Boom added approximately 78 million individuals to the U.S. population, making Baby Boomers one of the largest demographic cohorts in U.S. history.[8] The oldest members of this group, those born in 1946, first joined the senior population (those aged 65 or older) in 2011 and are the vanguard of what is likely to be an explosion in the number of older Americans.

According to Census Bureau projections, the aging of the Baby Boom generation will cause the number of seniors to grow by 30 million over the next 20 years to 72-million strong, accounting for approximately 20 percent of the national population, up from 13 percent today. Among seniors, the number of people aged 85 or over is also expected to grow, from 4.2 million in 2000 to more than 9 million in 2030.[9]

Health challenges often become more complex with age. More than half of Americans aged 75 or older have some difficulty with vision, hearing, mobility, or activities related to personal care and independent living.[10] Yet many older Americans have a strong desire to remain in their current homes and communities as they age, even though their existing homes may not be fully equipped with the features necessary for independent living and access to supportive services may be limited. This desire to "age in place" will challenge seniors and their children to renovate and remodel existing homes in response to health care and safety needs or seek out affordable rental options within their communities to accommodate a desire to downsize.

Housing affordability is also a serious problem for many seniors. Most older Americans own their homes. Those with fixed incomes or limited resources may struggle to cover the sometimes unpredictable costs associated with homeownership such as utility bills, property taxes, and expenses related to home repair and upkeep.[11] Among senior renters, 70 percent spend at least 30 percent of their income covering housing costs.[12] Paying too much for housing leaves seniors with inadequate income to pay for medications, healthy food, and other necessities. This trade-off in turn jeopardizes their health, potentially leading to increased health care costs, hospitalization, and nursing-home placement. Federally assisted housing is an important resource for the low-income senior population. More than one-third of the five million HUD-assisted households are headed by an individual who is at least 62 years of age.[13] Today, however, the number of low-income seniors in need of such assistance greatly exceeds the available subsidies. *See Chapter 6, Aging in Place: A New Frontier in Housing.*

The large share of elderly households that receives HUD assistance also illustrates another hard truth about the U.S. housing subsidy landscape: While the non-elderly (and non-disabled) tenants that HUD assists are in a position to use their stable housing as a platform to improve their incomes and eventually exit the program, these elderly tenants will continue to need subsidies as their incomes are relatively fixed and unlikely to go up over time. As their numbers grow, it will become even more important to think creatively about the use of scarce housing assistance in ways that maximize impact for all households.

The Echo Boomers

The Echo Boom generation, a cohort of approximately 62 million individuals born between 1981 and 1995, will be the major force fueling demand for rental housing in this decade (2010 to 2020), particularly in expensive urban housing markets where the cost of homeownership is already high. According to projections prepared by the Urban Institute, between five million and six million new renter households will form through 2020, with almost all of that increase reflecting new household formations among Echo Boomers.[14]

Echo Boomers are more racially and ethnically diverse than the Baby Boomers. They are also largely single and childless. As of 2009, only 21 percent of Echo Boomers were married, compared with approximately 50 percent of Baby Boomers at the same stage of life. In addition, only 20 percent of Echo Boomers have children in their homes compared with 30 percent of Baby Boomers when they were the same age.[15]

Echo Boomers have attained higher levels of education than members of previous generations, with more than half (54 percent) having completed at least some college education.[16] In particular, female Echo Boomers have reached levels of educational achievement that far exceed the levels attained by the women of previous generations.[17] These educational experiences should enhance the long-term financial position of the Echo Boomers while raising earnings expectations.

The Great Recession's impact on Echo Boomers has been significant. Despite higher educational attainment, young households are struggling with high unemployment. Many young adults also carry high levels of credit card and student loan debt that may delay the decision to form new households and may affect, at least in the short term, the type of housing they seek. Not surprisingly, during the latter half of the last decade, many young adults delayed forming their own households. Instead, some decided to live with parents or share housing with roommates. As a result, growth in the number of new households declined from an average of 1.2 million annually from 2000 to 2007 to an average of only 568,000 annually from 2007 to 2011.[18] As the job market improves, new household formation by the Echo Boomers will likely increase as this pent-up demand is released.

While the Echo Boomers will fuel rental demand in the near- to mid-term, during the decade that follows 2020, large numbers of Echo Boomers will likely transition from rental housing to homeownership. In many communities, Echo Boomers will play a leading role in absorbing owner-occupied single-family housing that has been released into the market by Baby Boomers who have either downsized to more suitable housing, moved in with their children, transitioned into nursing homes and assisted-living facilities, or passed away. This process of housing absorption by the Echo Boomers will be critical to the ongoing vitality and stability of local housing markets, particularly those with large numbers of Baby Boomer households.[19]

The Increasing Diversity of the American Public

According to Harvard's Joint Center for Housing Studies, about 70 percent of the 11.8 million net new households that form in the United States between 2010 and 2020 will be headed by members of minority groups, with much of this growth attributable to Hispanic households.[20] By 2020, minority households are projected to constitute one-third of all U.S. households and a growing share of the younger renter population.[21]

Despite the disproportionate impact of the recent housing crisis on minority homeownership and wealth, many members of the African American and Hispanic communities continue to aspire to homeownership, with Hispanics accounting for a significant share of new-owner households.[22] As the Hispanic share of the overall population grows, there may be a greater need for structural accommodations to the housing stock in light of the large families and multigenerational households common in the Hispanic community.[23]

The recession substantially slowed the pace of immigration to the United States. For the first time in recent memory, growth in the foreign-born population slowed in the 2000s, and growth in the number of foreign-born households appeared to stall as the recession unfolded. These developments contributed significantly to the overall decline in new household formations. As the economy improves, immigration will likely have a significant impact on the housing market, especially in gateway cities like New York, Los Angeles, Miami, and Houston. Households headed by foreign-born individuals are more likely to live in high-density areas and multifamily rental housing, especially soon after arrival, and to settle in communities where others from their home countries already reside.[24] In addition, many medium- and smaller-sized cities find their immigrant communities growing in response to federal resettlement programs as well as work opportunities and family connections in those cities.

Housing and the Economy: The Challenge and the Opportunity

Historically, housing has been a key driver of the U.S. economy. Housing contributes to our nation's gross domestic product (GDP) through investment in residential properties (both single-family homes and multifamily buildings) and through private consumption of home-related goods and services, such as new appliances and furniture, landscaping, and home repair. According to one estimate, the construction of a typical 100-unit multifamily development creates 80 jobs directly (through construction) or indirectly (through the supply chain), plus another 42 jobs in a range of local occupations as a result of construction workers spending their wages.[25] Similar economic benefits apply to single-family construction as well as renovation activity.[26] Construction and renovation also generate tax revenue for states and localities, helping to support the provision of essential public services.

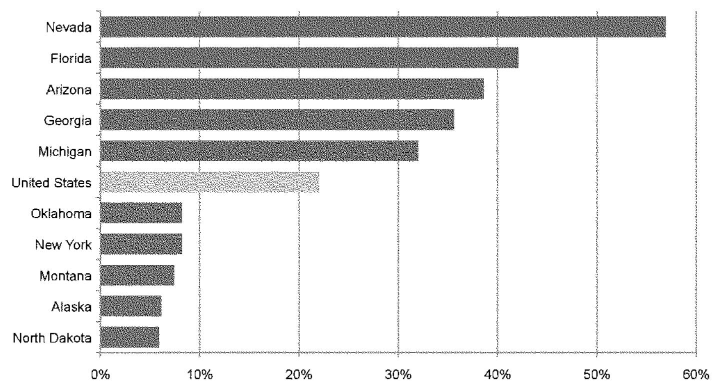
During the past four decades, the contribution of housing to national GDP through both residential fixed investment and consumption of services has averaged between 17 to 19 percent.[27] Today, housing's contribution stands at slightly more than 15 percent,[28] largely because of a significant decline in fixed investment in home construction and remodeling. This decline is a major reason why the recession and its damaging effects have lingered for so long. According to some estimates, if residential fixed investment reflected its historical average, the current rate of economic growth could double.[29]

In the decades preceding the housing market's collapse, homeownership was also the dominant means by which millions of American families accumulated household wealth. Through the "forced savings" of a monthly mortgage payment, families were generally able to build up equity slowly over time, ultimately transforming their homes into their most important and valuable asset. Whether the American people will continue to view homeownership as an effective way to build household wealth remains to be seen. What is clear is that our country's economic situation would be vastly improved with the re-establishment of a housing market in which home prices remain stable and gradually appreciate over time and a resolution of those local markets where large numbers of homeowners are underwater on their mortgages, owing more than their homes are currently worth.

In recent months, we have witnessed a welcome pick-up in sales of new and existing homes after these sales dropped to historic lows. Nevertheless, for the immediate future, it is likely that the market for single-family homes will continue to be troubled, as the backlog of foreclosures and the nearly 11 million households who are underwater on their mortgages have a strong dampening effect on market values.[30] This dampening effect will likely be most pronounced in those states where the housing market took the biggest climbs during the boom years and the steepest drops after the market's collapse.

In addition, even though mortgage rates are at historic lows and home prices have dropped by as much as 30 percent in some markets, the credit needed to purchase a home is scarce and hard to attain. This credit scarcity particularly affects low-wealth households who are more likely to be African American and Hispanic.

Chart 1-2: Share of Residential Properties in Negative Equity, 2012 Third Quarter



Source: CoreLogic, "CoreLogic Reports 1.4 Million Borrowers Returned to "Positive Equity" Year to Date Through End of the Third Quarter 2012." January 17, 2013.

While the homeownership market faces some difficult challenges at least for the foreseeable future, the rental housing market has picked up steam in many urban areas throughout the United States. In these markets, rental vacancy rates are declining and rental costs are increasing. Yet today, an astonishing one in two rental households is *already* cost-burdened, paying more than 30 percent of household income on rent and utilities. In fact, more than one-quarter of all renters bear severe cost burdens, allocating 50 percent or more of their incomes to rent.[21] Unless action is taken, rising rents will put additional affordability pressures on these households as they struggle to make ends meet. In the coming decade, demand for rental housing is likely to be strong and sustained, fueled in large part by new household formation among Echo Boomers. The production of new affordable multifamily rentals, which dropped dramatically following the collapse of the housing market, will need to keep pace with this growth in demand.

The United States cannot respond effectively to these challenges unless and until it has a world-class system of housing finance that supports both the single-family and multifamily sectors and a coherent and balanced federal approach to assuring decent, affordable homes for the most vulnerable households. Meeting our nation's future housing needs will depend upon a steady and sufficient supply of capital to support a wide variety of participants in the housing market—first-time homebuyers, those seeking to refinance their mortgages, private mortgage originators, seniors who wish to stay in their homes and age in place, low-income renters, the owners and developers of large multifamily rental projects, and the mom-and-pop owners and managers of small rental properties.

Housing and Environmental Sustainability

Efforts to restore housing's traditional role in the U.S. economy must be accompanied by a commitment to reducing household energy costs and advancing national energy goals. Energy use associated with residential buildings accounts for some 21 percent of the nation's overall energy use, and the greenhouse gas emissions of a typical home are double that of the average vehicle.[32] Accordingly, efforts to improve the energy efficiency of both existing and newly constructed homes can contribute significantly to the national goals of reducing greenhouse gas emissions and improving energy security. Given the additional energy and greenhouse gas emissions associated with long car trips, these goals can further be advanced by increasing the share of homes developed in walkable neighborhoods near public-transit stations and in other areas where households can meet more of their transportation needs through walking, biking, public transit, or shorter car trips. These approaches are additive[33] and together can help reduce household expenditures for transportation and utilities, which already consume a significant share of the budgets of low- and moderate-income households.

Why Housing Is Important: It's All About People

Of course, the economics of housing tells only part of the story. Housing is important because it is first and foremost about meeting the basic needs of people.

Housing is shelter, and more.

Like food and clothing, it is a necessity of life. But a burgeoning body of research is also showing us that housing that is stable, affordable, of good quality, and located in neighborhoods that provide opportunities and services is the foundation for many other benefits that accrue to both the individual and the broader community.

Access to stable, affordable, and well-located housing can improve educational outcomes.

Stable, affordable housing can be a platform for better educational outcomes. When children move frequently from one school to another, they tend to do less well in school and disrupt the educational environment for others.[34] Stable, affordable housing can help to improve educational achievement by reducing the frequency of unwanted moves. Affordable housing strategies that help low-income families access low-poverty neighborhoods or communities with high-performing schools can also contribute to positive educational outcomes.[35] Better educational performance, in turn, may lead to greater employment opportunities, higher incomes, and a boost to national wealth and productivity.

Quality, affordable housing helps improve the health of children, older adults, and others and can be a platform for more effective delivery of health care services.

Housing that combines the attributes of stability and good quality promotes positive physical and mental health outcomes for children and adults alike.[36] Well-constructed and maintained housing can substantially reduce children's risk of lead poisoning and respiratory ailments, like asthma, as well as exposure to toxic substances, such as pesticides, radon, and carbon monoxide.[37] Well-equipped housing, with working smoke detectors and window guards, can also reduce the risk of injury or death.

Stable housing also enhances the impact of a variety of health and treatment services, improving outcomes and saving public funds. As we age, for example, housing can serve as a platform to support the more effective delivery of services, particularly for seniors who need these services to live independently. Housing that is co-located with or near service providers can yield significant savings and efficiencies by allowing older adults to age in place, thereby delaying or avoiding the need for much more costly institutional care that can draw heavily upon limited state and federal resources.[38] While additional research is needed, it is increasingly clear that modest interventions and services delivered through seniors' housing can reduce emergency-room visits and the severity of illnesses, which translates to lower health care costs for seniors and public and private insurers.[39]

Stable housing also improves the ability of individuals with chronic illnesses to maintain a consistent treatment regime[40] and provides a context within which health care services may be more effectively delivered. For example, permanent supportive housing—i.e., stable subsidized housing linked with treatment and other services—has been shown to be effective in improving the impact of services and in ending homelessness.[41] Rigorous studies of homeless people with HIV-AIDS, mental illness, and chronic alcoholism have shown that, when people lack housing, services are not effective and have to be frequently repeated, whereas outcomes are significantly better for similar groups placed in permanent supportive housing.[42] Further, for such high-need populations, cost savings may accrue, both from the reduction in service utilization and improvement in effectiveness, as well as from the reduced use of acute-care services, such as shelter, transitional housing, hospital emergency rooms, and jails.[43]

Housing affordability is also a critical part of this equation: If household budgets are consumed by mortgage or rental costs, then fewer resources remain to secure nutritious food, pay for prescription medication, and access regular medical care.

The New Fiscal Reality

To complement our housing finance system, the federal government deploys substantial fiscal resources to support housing through an array of direct spending, tax subsidies, and credit-enhancement programs. For example, the Section 8 Housing Choice Voucher and Project-Based Rental Assistance programs provide a subsidy to assist some 3.4 million low-income households[44] in covering their rental housing costs, and through them support the property owners and investors whose capital is critical to maintaining this housing stock. The federal tax code encourages private investment in the construction, preservation, and rehabilitation of affordable rental housing through the Low Income Housing Tax Credit program, while the mortgage interest deduction and the deduction for state and local property taxes aim to promote homeownership. And the insurance and guarantee programs of the FHA, the U.S. Department of Veterans Affairs (VA), and the Rural Housing Service of the U.S. Department of Agriculture have helped millions of American families gain access to affordable mortgages over the past decades. Together, the federal government devotes more than $180 billion annually through these and other initiatives to help meet the diverse housing needs of the American people.

The commission recognizes that our nation's unsustainable debt burden is the dominant, overarching issue in Washington today. This new fiscal reality has the following implications for federal housing policy:

- First, every federal housing program must be evaluated on a forward-looking basis, with attention to how effectively it responds to the housing needs of today and tomorrow rather than those of the past.

- Second, federal housing programs must operate on a more efficient basis and deliver services in a more effective manner, leveraging to the maximum extent possible the resources of the private and nonprofit sectors as well as state and local governments.
- Finally, the commission recognizes that any proposals for increased spending must be offset either by reductions in federal outlays, savings from systems' reforms, and/or through the adoption of new revenue sources.

The hallmark of a successful housing system is whether it offers affordable and secure housing options to Americans at *all* stages in their lives—the young graduate looking for an affordable rental as she enters the workforce, the newly married couple in the market for a starter home, the single mother seeking a house with more space for her two active teenagers, and the retired widower who cannot imagine living anywhere but in the same "Cape Cod" and in the same community he has called home for more than 40 years.

We live in times of great turmoil and uncertainty for millions of Americans, particularly for those at the lower end of the income scale. So, it is our view, too, that a housing system earns the mantle of success only if it adequately meets the changing needs of the nation.

Chapter 2. The Continuing Value of Homeownership

For generations, millions of American families have aspired to purchase and live in a home they can call their own. This aspiration is so tightly woven into our nation's cultural fabric that owning a home has become synonymous with achieving the American Dream and joining the nation's middle class.

Research shows that homeownership has positive impacts on the stability of communities as families support and nurture their homes and surrounding neighborhoods.[45] Homeownership has also been linked with increased civic engagement, higher voter turnout, enhanced home maintenance, and reduced crime rates.[46] Moreover, homeownership, and the stability afforded by homeownership, has been linked with positive behavioral outcomes and educational achievement among children.[47]

For many families, purchasing a home is also the most critical investment decision they ever make. Through the forced savings of a monthly mortgage payment and as a result of house price appreciation, homeownership has enabled millions of families to build up equity over time, which has usually translated into greater household wealth and more financial security. For many households, a home is their primary asset and homeownership represents their single greatest wealth-building opportunity. Over the years, millions of homeowners have sensibly leveraged the equity in their homes to send their children to college, start a new business, pay for health care and other emergency costs, and meet their retirement needs.

Dating back to the Homestead Acts of the 1860s, the federal government has promoted land ownership and homeownership as ways to spur personal and community investment. Subsequent policies—such as the establishment of the Federal Home Loan Bank system, the creation of the FHA and VA mortgage insurance programs, and the establishment of Fannie Mae and Freddie Mac—were designed with this same goal in mind. In many respects, these policies helped to build a resilient and broad middle class in which assets were shared across generations, contributing to financial stability and social mobility as well as stronger communities.

As outlined in Figure 4-2 on page 107, the federal government has also historically supported homeownership through specific tax subsidies. In 1986, for example, Congress protected mortgage borrowers by retaining their ability to deduct interest payments on mortgages while eliminating such deductions for all other forms of consumer debt. These tax subsidies remain the most significant form of financial support for housing in the federal budget.

The collapse of the housing market in 2007, however, has led many to question the elevated status of homeownership in American society. This reassessment is understandable in light of the hundreds of thousands of families who have lost their homes to foreclosure and is essential if we are to avoid repeating the mistakes of the past. As part of this reassessment, the commission recommends the adoption of policies that can accommodate the changing demographic profile of new households described earlier in this report, striking a balance between support for homeownership and renting, and prioritizing such support to help those with the greatest needs in both sectors.

Learning from Past Mistakes

The housing boom and bust generated an economic downturn from which the nation has yet to recover. Some analyses have attributed the root cause of the downturn to the push for homeownership and fix the blame principally on policies to support homeownership. A complete and correct analysis would recognize that overly exuberant home buying provided an important stimulant, but would place it in the context of a wide range of factors that converged to create a global crisis. These factors include:

- A credit bubble formed as a result of excess capital surpluses built up by China and the large oil-producing nations.
- New Wall Street securitization instruments that used complex hedging strategies and generated massive global demand both for mortgage-backed securities and for subprime mortgages to go into these securities, and the decisions by credit-rating agencies to grant top ratings to tranches of subprime mortgages.
- The emergence of abusive and predatory mortgage products that required no documentation and no down payments, as well as the activities of unqualified borrowers who exploited opportunities and submitted false or inadequate credit information.
- The relaxation of underwriting standards by major banks and mortgage lenders in order to compete for market share with new subprime products.
- Fannie Mae and Freddie Mac's drive to recapture market share lost to securitization of subprime and other nonprime mortgages, which led them to relax underwriting standards and take on risk for which they were not prepared.
- Regulatory failure caused in part by a maze of government oversight agencies with overlapping jurisdictions and, in some instances, no regulatory authority.

Because of the scale and importance of the nation's housing market, these factors and others converged to create a boom of massive proportions and a bust of historic impact. The point of this litany of convergent forces is not to assess blame or to oversimplify complex interactions but to encourage a complete diagnosis so that policy recommendations and corrective measures address the problems effectively. It would be erroneous and damaging to misread the origins of the crisis, to attribute it solely to the expansion of homeownership during a period of economic growth, and as a result, to unduly curtail support of homeownership for households that can responsibly assume the obligations of a mortgage.[48]

Of course, at the end of the day, prudent underwriting is the essential ingredient of a system of responsible, sustainable homeownership. During the housing boom, a major factor contributing to the abandonment of prudent underwriting was the mistaken belief shared by actors across the mortgage chain—lenders, borrowers, regulators, and investors—that home prices were inalterably heading upward. Many borrowers took out short-term mortgages that were structured with large payment shocks at the end of the term, believing that ever-increasing home prices would allow them to refinance before rates reset. When house prices declined, however, refinancing was no longer an option for many households, who found themselves locked into mortgages they could no longer sustain. In addition, as the housing bubble expanded, far too much emphasis was placed on owning a home as an investment asset and as a fast track to acquiring wealth, leading some to assume unsustainable levels of debt in the hopes of making a quick gain or out of fear they would be left behind if they did not act. Contributing to an already unsustainable situation, many homeowners took out Home Equity Lines of Credit to cover other expenses, leaving them with little to no home equity when home prices dropped.

At the same time, practices like "reverse redlining" and steering families into riskier mortgage products (such as adjustable-rate mortgages and loans with high prepayment penalties) led to higher default rates, especially within the Hispanic and African American communities. Research shows that many of the families who did default on these loans had good credit, a decent income, and everything else necessary to qualify for a traditional long-term, fixed-rate loan, but instead were steered into exotic and costly mortgages they did not fully understand and could not afford.[49] The regulatory system failed to properly monitor and regulate these practices. Uneven regulation left mainstream banks heavily supervised while mortgage finance companies and subprime lenders acted in a largely unaccountable manner. Even regulated institutions acquired subprime and other nonprime businesses in an attempt to share in the market's seemingly endless growth.

Homeownership Remains the Preferred Housing Choice of Most Americans

Despite these experiences, the commission strongly believes that homeownership can produce powerful economic, social, and civic benefits that serve the individual homeowner, the larger community, and the nation. The key is to ensure that mortgage borrowers understand their obligations and are well-positioned to fulfill them and that lenders underwrite loans based on the borrowers' ability to repay. When coupled with reasonable down payments, solidly underwritten fixed-rate mortgages—as well as straightforward adjustable-rate mortgages with clear terms and limits on adjustable and maximum payments—can open the door to homeownership and its benefits for individuals with modest wealth and incomes.

Lenders and investors have tightened their credit standards significantly since the collapse of the housing market. The Consumer Financial Protection Bureau (CFPB) and a collection of other federal agencies are considering a number of regulations called for in the Dodd-Frank Act to create and regulate effective underwriting practices. However, the pendulum has swung too far from the excesses of the pre-bust era, and today's credit box is tighter and more restrictive than underwriting practice and experience justify. The commission cautions against well-meaning regulations that may go too far and end up reducing credit to consumers. Going forward, a combination of proper regulation, adequate liquidity, and the right incentives in the private market can help ensure that homeownership remains a vital housing and wealth-building option. *See Text Box, Developing Sound Principles of Regulation, page 53.*

Getting Homeownership Right

In a study of 46,000 low-income homeowners, researchers at the University of North Carolina's Center for Community Capital found that more than 95 percent of these homeowners—who received traditional 30-year, fixed-rate mortgages between 1999 and 2009 through Self Help Credit Union's Community Advantage Program—were continuing to make mortgage payments at the end of the decade, despite the collapse of the housing market. The default rate for these loans—made to households with a median income of $30,000 who often put down less than 5 percent on their home purchase—was less than one-quarter the default rate of the subprime loans that they might otherwise have received (although higher than rates for prime loans without the program's features). The researchers found that mortgages to low-income households that are well-serviced and correctly structured and avoid risky features—such as no documentation of income or assets, high upfront fees, prepayment penalties, teaser rates, and balloon payments—perform quite well and lead to both sustainable homeownership and sound business opportunities for lenders.[50]

In addition, homeownership remains a strong aspiration for millions of Americans. Surveys indicate that an overwhelming majority of Echo Boomers hope to purchase a home someday.[51] Other research shows that Americans continue to see homeownership as a critical cornerstone of the American Dream with benefits well beyond the financial investment. This sentiment is especially strong within the rapidly growing Hispanic community.[52]

Since the collapse of the housing market, the homeownership rate has fallen from 67.3 percent in 2005 to 64.6 percent in 2011.[53] Yet, according to research performed by the Urban Institute that assesses a number of projected demographic scenarios, the overall national homeownership rate is unlikely to fall below 60 percent at any time before 2030 and is more likely to be higher than 60 percent.[54] A homeownership rate in excess of 60 percent is generally consistent with the rate that existed over the past 50 years (see Chart 2-1). For the foreseeable future, homeownership will continue to be the preferred housing choice of a majority of American households.

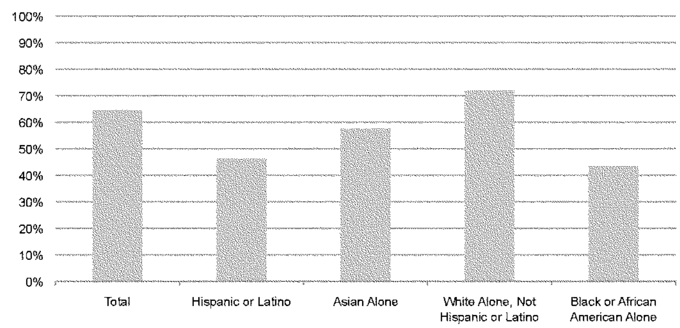
Closing the Homeownership Gap

As we look to the future, we must ensure that the opportunities and substantial benefits of homeownership are available to all members of our society who are prepared to assume the responsibilities of being a homeowner. Homeownership rates today continue to be dramatically dissimilar across racial and ethnic groups and income bands (see Charts 2-2 and 2-3). In 2011, the homeownership rates for Hispanics and African Americans were considerably lower than the homeownership rate for the overall population. This gap hampers economic prosperity and the growth of a stable and secure middle class. As our country grows more diverse, with members of today's minority groups accounting for an increasingly larger share of the national population, ensuring that the opportunity for homeownership is open to all creditworthy households is more important than ever.

Chart 2-1: National Homeownership Rate, 1960 to 2010

Sources: Homeownership rates, 1960 to 1990, from William S. Chapin, *We the Americans...Our Homes* (Washington, D.C.: U.S. Department of Commerce, 1993), 3. Homeownership rates, 2000 and 2010, from U.S. Census Bureau, "DP-1: Profile of General Demographic Characteristics: 2000" and "DP-1: Geography-United States: Profile of General Population and Housing Characteristics: 2010," *Decennial Census* (Washington, D.C.: 2001 and 2012).

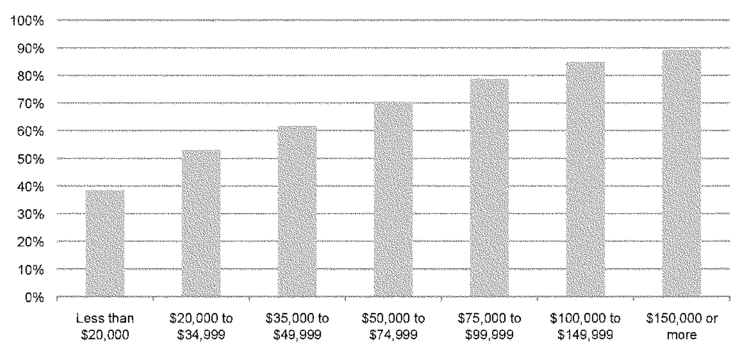
Chart 2-2: National Homeownership Rate by Race and Ethnicity, 2011



Source: U.S. Census Bureau, "B25003. Tenure," *American Community Survey* (Washington, D.C.: 2012).

Over the years, the federal government has made significant efforts to ensure that access to credit is available without regard to one's racial or ethnic background. The Fair Housing Act of 1968 and the Equal Credit Opportunity Act of 1970 prohibited discrimination in housing and lending. The Home Mortgage Disclosure Act of 1975 gave the public an opportunity to monitor the activities of regulated lenders in the home mortgage market. In 1977, Congress passed the Community Reinvestment Act requiring financial institutions to meet the credit needs of consumers in the communities where they are chartered, consistent with safe and sound financial practices. Homeownership rates were also a central focus of the presidencies of Bill Clinton and George W. Bush. Both challenged the markets to better serve minority homebuyers.

Chart 2-3: National Homeownership Rate by Income, 2011



Source: U.S. Census Bureau, "B25118. Tenure by Household Income in the Past 12 Months," *American Community Survey* (Washington, D.C.: 2012).

The Potential for Homeownership Growth in Majority-Minority Jurisdictions[35]

The Joint Center for Housing Studies of Harvard University projects that "minorities will account for more than 70 percent of net household growth in 2010–20." By 2011, there were already five majority-minority jurisdictions in the country: Hawaii (77.1 percent minority), the District of Columbia (64.7 percent), California (60.3 percent), New Mexico (59.8 percent) and Texas (55.2 percent). In estimates released in the summer of 2012 by the U.S. Census Bureau, the data showed that just over half (50.4 percent) of the nation's population under age one are minorities. While much growth is occurring in the American South and West, parts of the Pacific Northwest are also seeing significant changes. The potential for growth in homeownership in each of these communities is largely untapped, considering the currently low homeownership levels among these populations.

As the nation seeks to expand homeownership opportunities, certain principles should guide our policies:

- First, a new and reinvigorated commitment to homeownership requires a strong vibrant housing finance system where creditworthy borrowers can get a mortgage, along with responsible lending practices and a stable regulatory regime that provides clear rules of the road for mortgage lenders and borrowers.
- Second, we must support a production system capable of constructing homes that will be affordable and suitable for the millions of households who will seek to become homeowners for the first time.
- Third, housing counseling and education must be a central component of any strategy to expand homeownership opportunities, particularly as a means of preparing first-time homebuyers for the financial and other responsibilities of homeownership.
- Fourth, mortgage lending, zoning, and land-use policies should support new forms of homeownership that can lower costs and preserve affordable homeownership opportunities over time.

The commission also supports the continuation of tax incentives for homeownership, but recognizes that, in the ongoing debate over tax reform and budget priorities, all revenue options will be evaluated. See page 104 for further discussion of the commission's views on federal support for housing.

The remainder of this chapter sets forth the case for an enhanced national capacity for housing counseling and identifies emerging approaches to homeownership that merit further study and support. Chapter 3 outlines a redesigned housing finance system that can support new housing production and meet the mortgage credit needs of the American people.

The Power of Housing Education and Counseling

The Housing Counseling Assistance Program administered by HUD was established in 1968 and has traditionally enjoyed bipartisan support. Over time, funding has steadily increased, and the scope of the program has broadened to focus on providing education and advice to first-time homebuyers, renters, seniors, and homeowners facing foreclosure. Financial institutions and counseling organizations have developed partnerships as a result of the program, and policy makers are incorporating counseling in their rules and regulations. Over the last decade, the Housing Counseling Assistance Program has adapted to a dynamic housing market by increasing its capacity and sophistication. Today, housing counselors have experience in mortgage origination, loss mitigation, reverse mortgages, homeless counseling, and tenant rights, and they have a track record of providing objective information and guidance.

Current policy recognizes the importance of counseling for especially vulnerable borrowers. Counseling is already required as a condition to obtaining a reverse mortgage though the FHA's Home Equity Conversion Mortgage program, and the Dodd-Frank Act requires counseling for borrowers seeking to refinance into high-cost loans, as defined by the Home Ownership and Equity Protection Act. Dodd-Frank also elevated counseling's importance by creating a new Office of Housing Counseling within HUD.

The commission believes that housing counseling can improve prospective borrowers' access to affordable, prudent mortgage loans, especially for families that otherwise might not qualify or who may experience other barriers to mainstream lending. There is a wide public benefit from investment in housing education and counseling programs, and the commission therefore supports continued federal appropriations for housing counseling, and recommends that stakeholders who benefit from a borrower's access to counseling services be expected to contribute to the cost of the service. To achieve this vision, four key elements are necessary: (1) a strong counseling infrastructure; (2) clear standards; (3) an understanding of the proper role for counselors; and (4) the adoption of best practices for integrating counseling into the mortgage market.

Counseling Infrastructure

Technology and product development, human capital, brand awareness, and support are key aspects of the housing counseling network. Online technology allows counselors to better evaluate the financial circumstances of each borrower and homeowner.[56] And new technology and infrastructure developed in the wake of the housing market's collapse have increased counselors' efficiency and ability to respond to an increasingly complex marketplace, allowing counselors to reach clients in greater numbers than ever before and in more remote locations. HUD-approved housing counseling agencies can either connect with HUD directly or work through a national or regional intermediary. National intermediaries provide leadership that strengthens the counseling field and improves the quality and professionalism of counseling services. For instance, they help pool funds, broker partnerships, seed programs, and train counselors. The public campaigns that have brought record numbers of homeowners to housing counselors through the National Council of La Raza's Independent Foreclosure Review hotline and the Homeownership Preservation Foundation's Hope hotline are good examples of expanded capacity, structure, and coordination provided by intermediaries.

The vast majority of HUD-approved housing counseling providers are community-based nonprofits. Community-based organizations located in the neighborhoods they serve have established relationships with local leaders and have their pulse on community needs. They are often the first point of contact for struggling families. Many of these organizations bring a cultural competency that is critical when reaching underserved minority and immigrant populations.

Standards

HUD supports a network of nearly 2,700 agencies that, since 2005, has assisted more than 13.4 million households as they make decisions about their future housing.[57] The HUD Housing Counseling Handbook defines and guides the services provided by these agencies, all of which report activity annually and are subject to performance reviews every two years.

Intermediaries are responsible for ensuring that the organizations they fund comply with HUD standards, as laid out in the HUD Handbook. Intermediaries work closely with their networks to train new staff on proper counseling materials, technology, reporting requirements, and management techniques. This model not only ensures that HUD standards are implemented but also helps organizations remain stable over time. Should a HUD intermediary's grantee fail an audit, funding for their entire network would be jeopardized.

The National Counseling and Homebuyer Education Committee, hosted by NeighborWorks America, has developed additional industry standards for homeownership counselors and educational professionals. These standards have been endorsed or adopted by more than 700 national and local counseling agencies and funders across the country and include professional and ethical standards beyond those called for in the HUD Handbook.

Role of Counselors

As independent third parties, counselors offer unbiased information and advice to homebuyers, renters, victims of predatory lending, and families facing a financial emergency. While counselors can facilitate learning in groups, increasingly, they are providing one-on-one coaching, which has been shown to be a more effective way to generate positive outcomes for households in underserved communities. This approach allows private questions to be answered, and gives the counselor the opportunity to evaluate and develop tailored solutions for each family's unique circumstances.

Housing counselors have three critical roles in supporting and advancing homeownership for the underserved:

- Advisor to prospective homebuyers.
- Counselor to homeowners struggling to make payments.
- Coach to those not yet ready for homeownership but in need of advice about affordable rental options or other financial counseling.

Counselors coach clients to understand how lenders make loan decisions and can help prospective buyers or renters determine their monthly threshold for housing-related expenses. Homeowners who receive pre-purchase counseling exhibit substantially lower delinquency rates. For example, among a group of 40,000 Freddie Mac loans, the borrowers who received one-on-one or classroom style counseling were on average between 20 and 40 percent less likely to ever experience a serious delinquency than their peers who did not attend counseling sessions.[58]

Counselors can also be an ally in the event of an unexpected financial change and can start the conversation with a lender about ways to help struggling homeowners. For example, borrowers who received counseling under the National Foreclosure Mitigation Counseling program, created in the wake of the foreclosure crisis, were twice as likely to obtain a loan modification and 67 percent more likely to remain current on the mortgage nine months later as compared with their counterparts, who received a modification without the assistance of a counselor.[59]

While the HUD Housing Counseling Assistance Program is best known for its homeownership efforts, its most important contribution may be helping prospective buyers understand when it is *not* the right time for them to purchase a home. In light of the large number of households exiting homeownership, counseling agencies have seen an uptick in demand for rental counseling and financial coaching—a new line of service that helps households build credit, set up bank accounts, and engage in financial planning. People experiencing homelessness also utilize housing counseling programs as they transition into a viable rental arrangement. As the number of renter households increases, there is a unique opportunity to capture data on the impact and value of this form of counseling.

Integrating Counseling into Mortgage Delivery

Despite the success of housing counseling and the growing sophistication of the industry, its effectiveness is limited by its scale and positioning in relation to the rest of the mortgage industry. Promising partnerships between the counseling field and lenders have emerged, but more could be done to build upon these models. Lenders, investors, and regulators could provide counseling incentives for borrowers on the margins of creditworthiness. For example, one idea that has been discussed is for FHA to offer an insurance discount for those borrowers who receive counseling.[60] Clearly, such programs would have to be tested before scaling and priced consistent with risk- and capital-management principles.

Lenders and others can require counseling for certain products. For example, the Federal Home Loan Banks' homeownership set-aside programs include counseling as a required condition for eligibility. A study conducted by the Federal Home Loan Banks on foreclosures within its homeownership programs between 2003 and 2008 found that only 1.7 percent of homebuyers assisted by those programs requiring counseling (1,177 of 70,163 participants) entered the foreclosure process.[61] These programs are designed to assist lower-income and first-time homebuyers, yet the foreclosure rates reported by the Home Loan Banks were notably better than rates reported for prime loans through conventional mortgage programs. Clearly, as indicated by the numbers, homeownership counseling works.

Regulators are also seeing the promise of housing counseling. The CFPB recently proposed a rule that will require all lenders to provide a list of federally approved counseling agencies to a consumer who applies for any mortgage loan within three business days. A second proposed rule, under the Truth in Lending Act, would require a lender to confirm that a first-time borrower received counseling from a federally approved agency before making them a "negative amortization" loan in which the mortgage principal owed increases over time.

Many observers are concerned about the extent to which mortgages will be accessible and affordable to underserved market segments in the future. Housing counseling can and should play an important role as a credit enhancer, mitigating the risk of lending to borrowers on the margins of creditworthiness. Counseling organizations can also serve as a reliable pipeline of households for whom a slow and steady approach to homeownership is prudent. Thanks to the infrastructure created by HUD, the counseling field will be able to maintain its depth and capacity. The HUD Housing Counseling Assistance Program is an excellent example of an effective and highly functional public-private partnership that should be thought of as a credit enhancer and important entry point for underserved communities to achieve homeownership.

Innovations and Opportunities in Homeownership

In the coming decades, millions of Americans will continue to find value in homeownership and seek to become homeowners for the first time. In recent years, a number of innovative ownership models have been introduced to help make homeownership more affordable and accessible.

Shared Equity and Land Trusts

Growing numbers of "hybrid" homeownership models, variously known as "shared-equity" or "limited-equity" models, combine lower up-front costs for consumers with features that keep home prices affordable for subsequent buyers. For example, some shared- or limited-equity programs give the lender a right of purchase upon sale of the home, at a price determined using a formula that provides the seller with modest appreciation while keeping costs affordable to the next buyer. These programs can involve community land trusts with nonprofit sponsors who own the land under the properties. Either through covenants on individual deeds for homes, or through continued ownership and lease-back of the land by the sponsor, these trusts incorporate a long-term affordability goal by limiting the sales prices of homes over time. There are also well-established models of limited-equity cooperatives in multi-unit buildings where the terms of the cooperative limit appreciation to a set amount.

Land trusts using lease-back provisions can be particularly attractive for local governments that have acquired abandoned homes or for employer-assisted housing programs using land the employer owns. Another advantage of land trusts is the continuing participation by the sponsoring organization in the ongoing life of the community and the transfer of properties. There is recent evidence that owners in such trusts were less susceptible to subprime and predatory refinancing loans and performed better than other, comparable households through the mortgage bust and foreclosure crisis.[62]

These programs serve a succession of buyers over time, making effective use of scarce funds and helping to maintain homeownership at affordable levels. Many have demonstrated significant success but have not yet been taken to scale. These models deserve further support and study as alternatives that could help build effective and sustainable homeownership opportunities.

Manufactured Homes

In many parts of the country, and particularly in rural areas, manufactured homes are a significant and often overlooked source of affordable housing. Access to affordable, sustainable conventional financing for these homes remains a serious obstacle for buyers, particularly for manufactured homes placed on rented land.

Given the characteristics of those now entering the homeownership market for the first time, policy makers should give continued attention to ways to increase the availability of affordable, long-term mortgage financing for manufactured homes and should re-examine those policies that may unnecessarily restrict the ability of first-time buyers to purchase these homes.

The Formula for Sustainable Homeownership

Whatever the vehicle may be, the formula for sustainable homeownership is clear: the broad availability of prime, fixed-rate mortgage financing—as well as straightforward adjustable-rate mortgages with clear terms and limits on adjustments and maximum payments—combined with counseling and financial education for those who may need it. Add to this mix a regulatory system that is vigilant and sufficiently equipped to address misconduct in the marketplace.

One other ingredient is absolutely essential: a strong, vibrant system of housing finance that can ensure a steady flow of affordable mortgage funds to prospective homeowners and those seeking to refinance. Following the recent housing market crash and the ongoing challenges that creditworthy prospective homebuyers face in accessing mortgage credit, a sound housing finance system will be of primary importance to support and sustain homeownership going forward.

Chapter 3. Reforming Our Nation's Housing Finance System

Meeting our nation's diverse housing needs will require a strong and stable system of housing finance. This system, when functioning at its full potential, can offer millions of Americans and their families the opportunity to choose the type of housing that best meets their unique needs. Whether it is the recent graduate entering the workforce, the working couple with children seeking to purchase a home for the first time, the young single looking for an affordable apartment in the central city, or the retired widower hoping to downsize from his three-bedroom home, it is the housing finance system that helps transform these aspirations into concrete realities. A successful housing finance system maximizes the range of ownership and rental housing choices available to us at all stages of our lives.

In many respects, the housing finance system is also a key part of the economy's plumbing, a complex series of financial pipes and drains through which capital flows to both the single-family and rental segments of the housing market. Without the liquidity provided by this system, mortgage lending would be scarce and more expensive, new homebuilding would stall, the construction of new apartment units and preservation of existing units for our nation's burgeoning renter population would slow down, and our economy would suffer.

Our nation's housing finance system is complex, varied, and global in scope. As Figure 3-1 below demonstrates, it consists of banks, thrifts, mortgage brokers, and other originators of mortgage loans; organizations that service the loans on behalf of the originators; public and private institutions that buy the loans and then pool them into securities; and institutional and individual investors who purchase these securities in the secondary market.

A key feature of our housing finance system is the critical role of securitization. By taking loans off the balance sheets of banks and other mortgage originators, the securitization process frees up additional capital for mortgage lending. It also shifts some of the risks inherent in the mortgages to the investors in the mortgage-backed securities who are willing to assume these risks in return for a yield that may be higher than that of other investments. In this way, securitization helps circulate funds from a variety of domestic and international sources into the mortgages that finance housing for millions of American families.

Our housing finance system is the largest in the world, with almost $10 trillion in single-family mortgage debt outstanding[63] and $825 billion in mortgage debt outstanding in the multifamily sector.[64] To put these figures

Figure 3-1: Simplified View of the Single-Family Housing Finance System

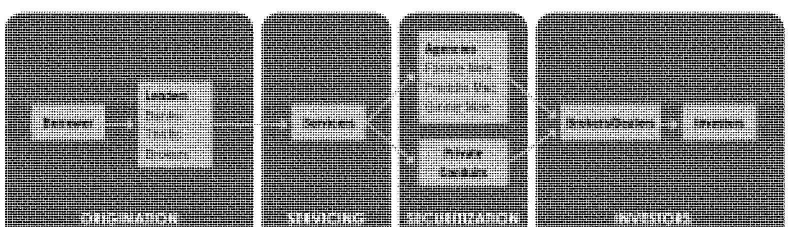
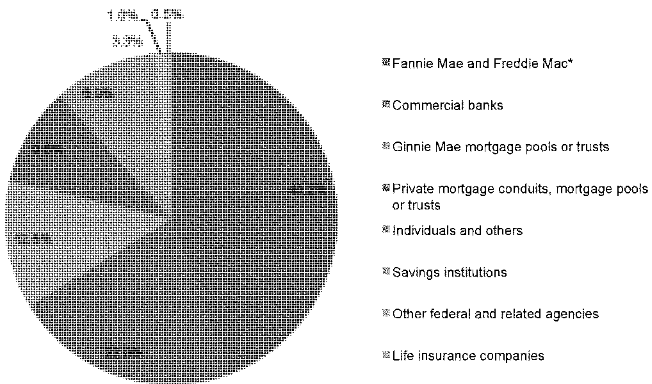


Chart 3-1: Holders of Mortgage Debt Outstanding, 2012 Third Quarter



*As of 3Q 2012, Fannie Mae and Freddie Mac reported approximately $4.64 trillion in mortgage loans on their consolidated balance sheets, of which $502 billion was held in portfolio, and the balance ($4.1 trillion) was in mortgages held by third parties, principally in mortgage-backed securities that were guaranteed by the companies.

Sources: Board of Governors of the Federal Reserve System, Economic Research and Data, "Mortgage Debt Outstanding (1.54)," December 7, 2012; Fannie Mae, *Form 10-Q*, p. 100, November 7, 2012; and Freddie Mac, *Form 10-Q*, p. 129, November 6, 2012.

in perspective, the size of the U.S. single-family mortgage market exceeds the entire European market and is nearly six times larger than that of the United Kingdom, which is home to the world's second-largest single-family market.

The sheer size of the U.S. mortgage market requires that we retain diverse sources of mortgage credit. In 2006 and 2007 the amount of outstanding mortgage debt exceeded the total value of all assets held by U.S. banks. Today, outstanding mortgage debt nearly equals the total value of the assets on banks' books and is held by a diverse array of entities and institutions (see Chart 3-1). For the foreseeable future, there is simply not enough capacity on the balance sheets of U.S. banks to allow a reliance on depository institutions as the sole source of liquidity for the mortgage market. Given the size of the market and capital constraints on lenders, the secondary market for mortgage-backed securities must continue to play a critical role in providing mortgage liquidity.

Historical Context: The Path to Today's Housing Finance System

The Great Depression was a watershed period in the history of housing in the United States. Up until the mid-1930s, residential mortgages generally had short terms (usually three to ten years), variable interest rates, and featured "bullet" payments of principal at term. Borrowers would normally refinance these loans when they became due or pay off the outstanding loan balance. At the time, large down payments were common, and mortgages typically had very low loan-to-value (LTV) ratios of 60 percent or less.[65] The homeownership rate, however, was significantly lower than it is today—around 45 percent, compared with 64.6 percent—as fewer families had the financial wherewithal to enter into mortgages with these more stringent terms. Homeownership was generally reserved for the wealthy or, in rural areas, for those who lived on and farmed their land.

As the Great Depression swept the nation, housing values declined by as much as 50 percent. Banks that held the mortgages on these homes refused to or were unable to refinance when the loans came due. Thousands of borrowers then defaulted, having neither the cash nor the home equity available to repay the loans. The consequence was a wave of about 250,000 foreclosures annually between 1931 and 1935.[66]

In response to these events, the federal government established the Federal Home Loan Bank system in 1932 to increase the supply of mortgage funds available to local financial institutions and to serve as a credit reserve. Two years later, in 1934, the government created the FHA to help stabilize the mortgage market through its insurance programs. By insuring only mortgages that met certain limits on the maximum principal obligation, interest rate, LTV ratio, and loan duration, the FHA helped set the foundation for the modern standardized single-family mortgage.[67] In 1944, the government established the VA loan guarantee program, similar in approach to the FHA loan-level insurance programs but targeted to helping military veterans and their families secure homeownership. In the years following World War II, the homeownership rate rose steadily, from 43.6 percent in 1940 to 55 percent in 1950 and to 66.2 percent in 2000, as measured by the Decennial Census.

In addition to ownership housing, the FHA also provides credit support for multifamily rental housing through a separate reserve fund first established by the National Housing Act of 1938. The FHA's authority to support multifamily housing was not widely exercised until the 1960s when several programs were created to encourage the construction and preservation of rental housing for moderate-income households.[68]

In 1934, the government also authorized the FHA to create national mortgage associations to provide a secondary market to help mortgage lenders gain access to capital for FHA-insured loans. Only one such association was established, when the FHA chartered the Federal National Mortgage Association in 1937. In 1968, the Federal National Mortgage Association was partitioned into two separate entities—the Government National Mortgage Association, or Ginnie Mae, which remained in the government, and Fannie Mae, which became a privately owned company charged with the public mission of supporting the mortgage market by purchasing conventional (i.e., non-government-insured) mortgages. Until the 1980s, Fannie Mae carried out its mission by issuing debt—first as a government agency and after 1968 as a government-sponsored enterprise (GSE)—and using it to buy mortgages from their originators. In 1970, the secondary market grew with the creation of Freddie Mac, which was initially owned by the Federal Home Loan Banks and, with passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in 1989, reorganized as a private, for-profit corporation with a charter similar to that of Fannie Mae.[69]

Over the years, Fannie Mae, Freddie Mac, and Ginnie Mae helped bring greater transparency and standardization to both the single-family and multifamily housing finance system, which has lowered mortgage costs. By setting clear benchmarks for loans eligible for securitization, the three institutions also helped improve the overall credit quality of the system. Moreover, by linking local financial institutions with global investors in the secondary market, they helped expand access to mortgage credit.

However, the companies' role was a sore point for the lending industry almost from the start. Acting as a giant thrift, Fannie Mae profited from the spread it earned between its cost of funds, which was lower than other private companies because of its government ties, and the interest rates on mortgages. The creation of the first MBS by Ginnie Mae in the 1970s led Fannie Mae and Freddie Mac, and then private Wall Street firms, to engage in securitization. Depositories viewed Fannie Mae as a competitor for balance-sheet lending, and, after MBS became the prevalent funding source, private-sector competitors likewise saw the GSEs as unfairly competing with them in the securities markets. Both institutions did enjoy a number of benefits because of their unique charters, including a line of credit with the U.S. Treasury, exemptions from certain state and local taxes, which provided favorable treatment for their portfolio business, and most importantly, an *implied* government guarantee of their securities as well as their own corporate debt. In return, the charters restricted Fannie Mae and Freddie Mac only to residential mortgage finance in the United States, and the companies were expected to support mortgage markets throughout all market cycles, an obligation that did not apply to other fully private investors or guarantors.

In the wake of the Savings and Loan crisis in 1989, Congress imposed new capital requirements and strengthened the GSEs' mission requirements. But the pressure to deliver returns to shareholders, along with the mistaken view shared by actors throughout the mortgage market that housing prices would continue to rise without interruption, encouraged Fannie Mae and Freddie Mac to leverage their businesses to unsustainable levels. With insufficient capital buffers, both institutions suffered catastrophic losses when the housing market collapsed and the credit markets froze, leading to their conservatorship by the government in 2008.

Notably, during the housing crisis, the multifamily businesses of Fannie Mae and Freddie Mac continued to generate a profit for both institutions, as the default rates on their multifamily loans were substantially lower than the loans in their single-family portfolios. It is also worth noting that the 12 Federal Home Loan Bank cooperatives, which were designed to provide countercyclical liquidity for U.S. mortgage and housing market participants, remained a reliable source of liquidity for their more than 7,700 member institutions during the crisis. The Home Loan Banks provide a reliable flow of funds and liquidity to local lenders for housing and community development through advances funded by debt the banks issue and collateralized by mortgages or mortgage bonds exchanged by members in return for the advances. In late 2008, while other sources of credit froze, Federal Home Loan Bank advances increased by $400 billion (reaching $1 trillion) as the Home Loan Banks continued to support their members' participation in the housing market.

Despite our current difficulties, households in the United States have enjoyed a wider range of mortgage financing options than those in most other nations of the world. For instance, the most common mortgage product in the United States—the long-term, fixed-rate mortgage—is relatively rare in other countries where shorter-term and variable-rate mortgages are the norm.[70] The long-term, fixed-rate mortgage has been a tremendous boon to consumers who are provided with cost certainty and protection from the risks associated with fluctuating interest rates. The process

The Long-Term, Fixed-Rate Mortgage

Over the past several decades, the American people have benefited greatly from the wide availability of long-term, fixed-rate mortgage financing, most notably in the form of the 30-year fixed-rate mortgage. The 30-year fixed-rate mortgage provides a long amortization period that helps to keep monthly payments low and provides certainty to borrowers by protecting them against interest rate volatility over the life of the loan. While in recent years interest rates have fallen to historic lows and have remained low for a sustained period, rates will inevitably rise, perhaps significantly, making mortgage financing more expensive. A long-term, fixed-rate mortgage protects against these fluctuations and gives borrowers a clear sense of their monthly repayment obligations and the assurance that this obligation will not change dramatically over time.

The 30-year fixed-rate mortgage also enhances the stability of housing finance for the borrower. Long-term, fixed-rate mortgages shift interest-rate risk from borrowers to lenders and investors in mortgage-backed securities who are generally more sophisticated and better equipped to manage this risk than the average borrower household.[71] The presence of a government guarantee in the secondary market ensuring that investors will be paid even if borrowers default on their loans has eliminated much of the credit risk from these investments, thereby making them attractive to investors looking for instruments that are sensitive only to interest rate risk. In the absence of such a government guarantee, it is highly unlikely that private financial institutions would be willing to assume both interest rate *and* credit risk, making long-term, fixed-rate financing considerably less available than it is today or only available at higher mortgage rates.

The 30-year fixed-rate mortgage has enabled millions of Americans families to achieve their dreams of homeownership. The commission endorses product choice and strongly believes this type of mortgage product should continue to be available to a broad universe of qualified borrowers.

of securitization has played an instrumental role in setting the standards for these mortgages and making them widely available on affordable terms for millions of American families. By taking individual mortgages—inherently illiquid and difficult-to-price assets—and combining them with millions of other loans in stable securities based on cash flows from a broadly diversified portfolio of assets, securitization has opened the residential finance market to investors who otherwise could not participate in this market. The flow of cash has helped fuel one of the most stable, transparent, and efficient capital markets in the world and assured American consumers of a steady and reliable source of mortgage credit.

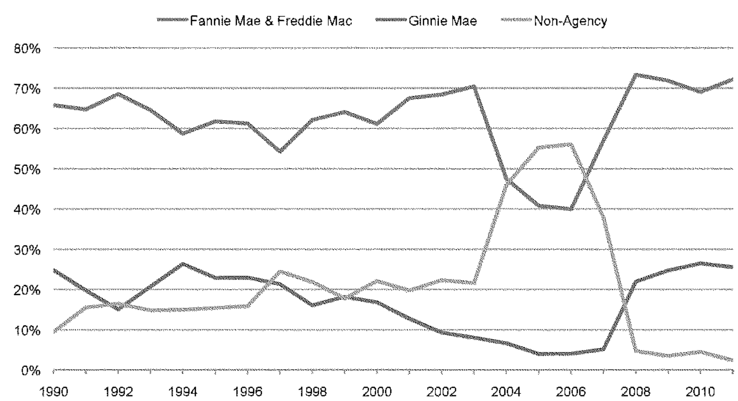
Single-Family Housing Finance Trends

In the wake of the collapse of privately funded and nongovernment-insured mortgages, the federal government has emerged as a dominant presence in the housing finance market, a role it has played before when private capital has fled the mortgage market. As Charts 3-2 and 3-3 show, the federal government currently insures and guarantees the largest share of mortgage-backed securities and assumes the major portion of credit risk in the U.S. mortgage market.

In 2011, securities backed by Fannie Mae, Freddie Mac, and Ginnie Mae (with credit insurance from the FHA and the VA) constituted 97 percent of all MBS, with non-agency funds less than 3 percent. By comparison, Fannie Mae, Freddie Mac, and Ginnie Mae accounted for 78 percent of the MBS market in 2000, with non-agency funds at 22 percent. The chart also shows that government and GSE shares of MBS remained relatively steady through the 1990s, a period of strong economic growth and stable interest rates.

Chart 3-2: Mortgage-Backed Securities – Market Share, 1990 to 2011

Funds for MBS, share of market by source, selected years	1990	1996	2000	2006	2011
Fannie Mae & Freddie Mac	65.76	61.22	61.11	39.95	72.14
Ginnie Mae	24.82	22.91	16.79	4.02	25.52
Non-Agency	9.42	15.87	22.11	56.03	2.33

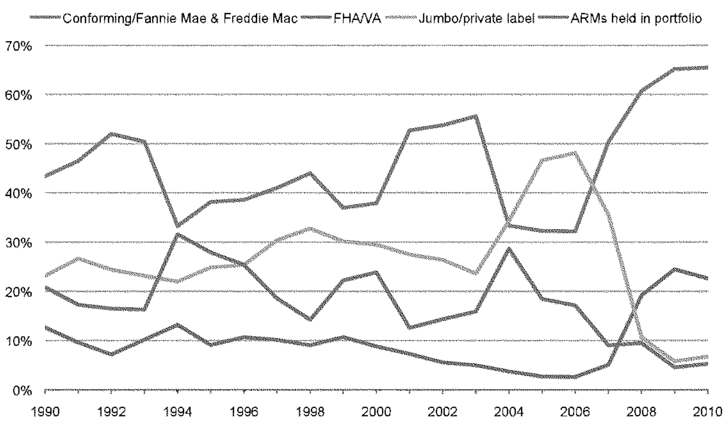


Source: Bipartisan Policy Center tabulations of data from Inside Mortgage Finance, "Mortgage and Asset Securities Issuance," *Inside MBS & ABS*.

The same general situation is true for all mortgage originations (whether originated to be held in portfolio or sold into the MBS market). Chart 3-3 shows that, in 2010, private-sector-related originations including jumbo loans, loans originated for private-label securities, and adjustable-rate mortgages (ARMs) to be held in portfolio constituted only 12 percent of originations (compared with 53 percent in 2000 and 44 percent in 1990), while FHA/VA loans and Fannie Mae and Freddie Mac conforming loans constituted 88 percent of originations (versus 47 percent in 2000 and 56 percent in 1990).

Chart 3-3: Mortgage Originations by Product, 1990 to 2010

Mortgage originations by product share of market by source, selected years	1990	1996	2000	2006	2010
Conforming/Fannie Mae & Freddie Mac	43.4	38.6	37.9	32.2	65.4
FHA/VA	12.7	10.7	8.8	2.6	22.6
Jumbo/private label	23.1	25.4	29.5	48.1	6.7
ARMs held in portfolio	20.8	25.4	23.8	17.1	5.3



Source: Bipartisan Policy Center tabulations of data from Inside Mortgage Finance, "Mortgage Originations by Product" and "ARM Securitization by MBS Type."

While there are nascent signs that we have turned a corner, the U.S. system of single-family housing finance continues to face serious challenges as significant problems related to the Great Recession persist. Sustained high unemployment, an unprecedented collapse in house prices—especially in certain highly affected states and metropolitan areas—the large volume of foreclosures, and a prolonged foreclosure process in some states continue to stand in the way of a full market recovery.

Further, while in most of the country the cost of buying a home has never been more affordable, stringent underwriting requirements prevent many would-be borrowers from taking advantage of these conditions. As illustrated in Chart 3-4, borrowers' credit scores at origination have increased by 40 to 50 points since 2001.

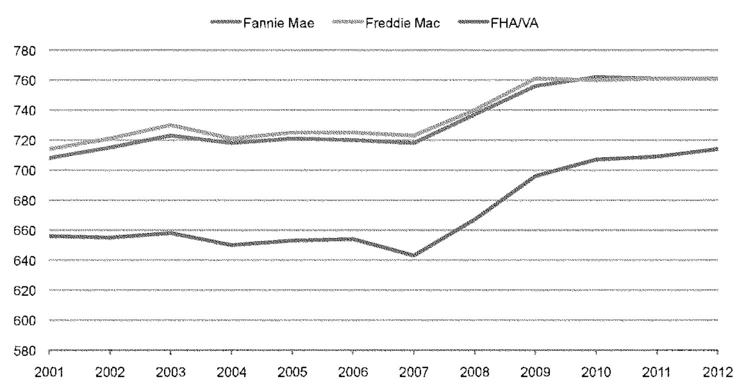
Today, a number of obstacles prevent a return to the conditions that prevailed in the late 1990s—before lax underwriting infiltrated the system and contributed to the crisis—and stand in the way of qualified borrowers accessing mortgage credit. Unprecedented investor demands placed on originators and sellers of mortgages have caused lenders to be increasingly cautious when considering new mortgage applications, and sales of new and existing homes remain well below historic levels going back several decades.

Obstacles to Market Recovery

The commission has identified the following obstacles that are making it difficult for qualified borrowers to obtain a mortgage and are therefore impeding a full market recovery:

1. **Overly strict lending standards.** Sales of new and existing homes remain well below historic levels going back several decades. Observers attribute the decline in home sales, in part, to unnecessarily rigid down payment, debt-to-income, and credit score requirements that were imposed in the aftermath of the housing market's collapse.[72] Restoring the appropriately conservative underwriting standards in place before the housing bubble, with their focus on the overall creditworthiness

Chart 3-4: Borrower FICO Score at Origination



Note: FICO scores are one of several metrics used to measure creditworthiness and range from a low of 300 to a high of 850. As of September 2012, 37.6 percent of the U.S. population had a credit score above 750, and 46.5 percent had a credit score below 700. See: Rachel Bell, "FICO Scores Reflect Slow Economic Recovery," *FICO Analytics Blog*, September 8, 2012.

Source: CoreLogic, 1010Data, Amherst Securities Group.

of the borrower, could help to improve the health of the housing market.

2. **Lack of access to credit for well-qualified self-employed individuals.** Self-employed borrowers face unique obstacles to providing income documentation and meeting other criteria required to qualify for a mortgage under current underwriting standards. Adjustments to these criteria could be made to acknowledge these limitations and provide access to credit while ensuring that lenders do not take on unnecessary risk.

3. **Put-back risk.** Fannie Mae, Freddie Mac, and the FHA hold lenders liable for representations and warranties associated with loans purchased by the agencies for a finite amount of time following origination. In the event of a default during that period, lenders may be required to buy back the delinquent loan. This retained risk is an important tool for ensuring that loan originators comply with the credit terms promulgated by the three agencies. But, uncertainty surrounding the circumstances around which this "put-back" option will be exercised has dampened lending and caused some lenders to impose additional requirements, or lender overlays, to existing agency underwriting criteria in order to further insulate themselves from potential liabilities.

   Guidance issued by the Federal Housing Finance Agency (FHFA) effective January 2013 helps to address some of these concerns by clarifying "lenders' repurchase exposure and liability," including promising earlier review of loans and providing relief from representations and warranties following 36 months of consecutive on-time payments.[73] While this guidance is an important start, and provides partial relief, several factors limit its effectiveness in stimulating new lending. For example, when determining lender eligibility for relief from put-back risk, the new framework takes into consideration borrower performance over a period of up to 60 months following acquisition of the loan by Fannie Mae and Freddie Mac. Some have argued that the 36-month and 60-month timeframes are too long, and any delinquencies beyond the first year following origination are likely to reflect changes in borrower circumstances (rather than the borrower's position at origination). In addition, the guidance does not apply to mortgages originated in 2012 or prior years and thus does little to relieve banks' concerns about exposure from these loans. Close attention should be paid to lenders' evolving practices and adjustments to these new guidelines. It is critical that regulators strike the right balance between giving lenders assurance that their liability is limited when selling loans into securities and ensuring that credit guarantors have the right tools with which to enforce their credit standards.

4. **Appraisals.** The sales price of distressed or foreclosed homes—whether disposed of through one-off deals or bulk sales—tends to be substantially lower than traditional (non-distressed) sales, often as a result of the increased time and risk associated with distressed sales, differences in the condition of the property, and the seller's interest in completing the transaction. However, distressed property sales continue to be recorded and used as comps in appraisals of non-distressed (retail) properties, a practice that depresses local home values and impacts would-be homebuyers' ability to secure financing. In some markets, demand for multiple reappraisals, sometimes just days before closing, also introduces substantial uncertainty into the home-buying process and can derail sales and disrupt the plans of homebuyers and sellers. To remedy this situation, Fannie Mae, Freddie Mac, and FHA could refuse to accept distressed sales as valid comps, forcing a reassessment of non-distressed properties. In markets that do not have sufficient sales volume to allow comps to be calculated without the inclusion of distressed sales, an alternative approach might be to require an addition to the value of a distressed sale based on the difference between the local market index of distressed sales versus retail sales.

5. **Application of FHA compare ratios.** An FHA "compare ratio" provides an indication of a lender's loan performance relative to other FHA lenders in a particular market. For example, if a lender has a compare ratio of 50, its default rate on FHA loans is only half the default rate for all lenders in that area. On the other hand, a ratio of 150 would mean that the default rate is one-and-a-half times that of other FHA lenders in the area. A high compare ratio may result in an enforcement action against a lender with the lender losing the ability to close FHA loans. Lenders with relatively high compare ratios typically attempt to lower the ratio by imposing tighter underwriting standards, which in turn has a cascading effect on other lenders in the area who must resort to similarly restrictive lending practices in order to maintain their relative position. While compare ratios serve as a useful analytical tool, the current application of the ratios may have the effect of tightening credit by FHA lenders to creditworthy borrowers. FHA should reconsider the way in which compare ratios are applied to ensure they do not unduly restrain credit and provide an accurate reflection of lender performance—both in originations and in servicing practices—in the current market.
6. **Uncertainty related to pending regulations and implementation of new rules.** In the past few months, several important federal rulemakings related to the U.S. mortgage market have been finalized while other proposed rules are still pending. These new and pending rules have the potential to significantly affect home finance in the United States. Lenders report that uncertainty as to their impact has led them to exercise caution and pull back on new mortgage originations for all but the lowest-risk borrowers. In addition, the potential impact of Basel III on the housing finance market is significant and not fully understood or appreciated. Policy makers deserve a much fuller understanding of how the current regulatory environment impacts mortgage lending as well as how the various regulatory initiatives now under consideration interact with each other.

   In light of the seriousness of the current situation, the commission suggests that the President of the United States direct the Department of the Treasury, in coordination with the various federal banking agencies, to inventory these regulatory initiatives and assess their current and likely future impact on the affordability and accessibility of mortgage credit. The Treasury Department should report back to the President without delay not only with this assessment, but also with a plan to align these requirements as much as possible to help get mortgage credit flowing again. A top official within the Treasury Department or in the White House should be tasked with day-to-day responsibility for coordinating the implementation of this plan.

Over the longer term, the future of the primary and secondary mortgage markets is even more uncertain. Many proposals put forth to date have laid out detailed plans for reform, but have failed to consider the fundamental underlying question: "What kind of housing system do we want?" In the following section, we set forth a longer-term vision and structure for a redesigned system of housing finance in which the federal government remains an active participant, but the private sector plays a far greater role in bearing credit risk.

Taking Stock – Lessons Learned from the Housing Crisis

The recent crisis exposed major deficiencies in our system of housing finance. At the height of the bubble, excess liquidity overwhelmed the system as traditional underwriting standards were abandoned and mortgage credit became widely available to large numbers of borrowers who were ill-prepared to assume these obligations. In some instances, the obligations were not disclosed to borrowers in a fully transparent manner that would have allowed for an assessment of a mortgage's true cost.

At the same time, private lenders substantially underpriced the risk of mortgage credit, while government regulators failed to keep pace with and adequately monitor new private-sector lending, securitization, and hedging practices. This regulatory failure extended to the operations of Fannie Mae and Freddie Mac, the two giant institutions now under government conservatorship. Both institutions also significantly underpriced mortgage credit risk and used the implied guarantee of government support to increase their leverage to unsustainable levels.

As we design a housing finance system for the future, we should be mindful of the lessons learned over the past decade. These lessons include:

Prudent mortgage loan underwriting is the foundation of a sound system of housing finance. Prudent underwriting is the single most effective way to mitigate risk in the system, while ensuring that mortgage credit flows easily to those who can afford it. In making decisions to extend credit, lenders should assess a borrower's ability to repay a mortgage loan based on such traditional factors as income, assets, current debt, and credit history. The interests of lenders, borrowers, and investors should be aligned to assure that all parties are at risk when underwriting is not based on prudent factors. But while underwriting standards became too lax in the years leading up to the foreclosure crisis, the pendulum has now swung too far in the opposite direction. Returning to the underwriting standards that prevailed in the marketplace before the housing bubble started, and then maintaining those careful but reasonable standards, would help restore balance to the system. See Chart 3-5 for an illustration of the relatively low default rate over time for loans originated in 2000.

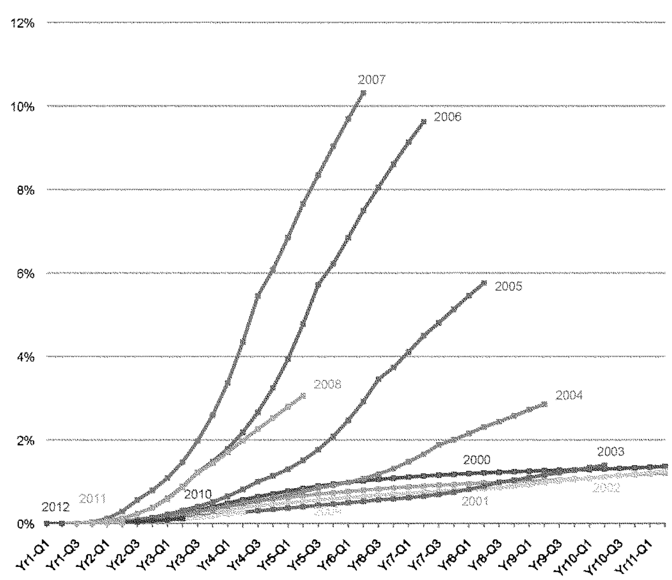
Home purchase education and counseling must become a central component of the mortgage process. As the housing bubble expanded, too many families believed they were entering into affordable mortgages when, in fact, these mortgages were unsustainable by any reasonable measure. Financial education and counseling, particularly for first-time homebuyers, may have helped some of these families avoid this mistake.

Government oversight of the housing finance system is essential to ensuring continued stability in the housing market. In the years leading up to the housing crisis, some private lenders made the system less stable by transferring risk to borrowers through mortgage products with shorter durations, adjustable rates, higher costs, and less-than-transparent terms. To prevent a recurrence of this behavior, the government has an important role to play in monitoring developments in the market on a real-time basis; ensuring transparency; establishing clear rules of the road, so lenders understand the standards they need to meet and the penalties for failing to do so; and protecting consumers, investors, and the market's ongoing stability.

Any government support for the housing finance system should be explicit and appropriately priced to reflect actual risk. Looking ahead, the government's support for the housing finance system—whether through insurance at the loan level or guarantees in the secondary market for mortgage-backed securities—should be designed with taxpayer protection as a critical goal.

Our housing finance system must be resilient enough to weather the inevitable periods when the housing market takes a downward turn. As the housing bubble expanded, many lenders, borrowers, and investors made the fatal error of convincing themselves that the market was heading in only one direction: up. Of course, this view ignored the cyclical nature of the housing market in which home prices have historically gone both up and down. A

Chart 3-5: Fannie Mae Cumulative Default Rates of Single-Family Loans by Origination Year



Note: Fannie Mae and Freddie Mac use different approaches to track loan performance: Freddie Mac calculates the cumulative rate of loans from a given book year that have proceeded to foreclosure, transfer, or short sale and resulted in a credit loss; whereas Fannie Mae includes in its cumulative default rates loans that have been liquidated through channels other than voluntary pay-off or repurchase by lenders, including foreclosures, pre-foreclosure sales, sales to third parties, and deeds in lieu of foreclosure. Despite these differences in methodology, performance data by book year is similar across both entities, with loans originated in 2000 and acquired by Fannie Mae having a 1.36 percent cumulative default rate, compared with a 1.10 percent foreclosure transfer and short-sale rate at Freddie Mac.

Source: Fannie Mae

redesigned system of housing finance must contain safeguards that will allow the market to remain stable and continue as a source of mortgage liquidity, even when these counter-cyclical periods occur.

A redesigned housing finance system should also adhere to sound principles of regulation. *See Text Box, Developing Sound Principles of Regulation, page 53.*

Recommendations for the Single-Family Housing Finance System

The current structure of the single-family housing finance system was largely patched together to keep mortgage credit flowing during the crisis. Almost all of the credit risk in the system is currently borne by the federal government, and a large portion of this government support is delivered through the conservatorship of Fannie Mae and Freddie Mac. Dynamic and flexible reform is needed, over a multiyear period, with a smooth transition to this new system in which private capital takes on a larger share of the credit risk.

The increase in the role for private capital would be accomplished in two ways. First, a gradual reduction of the loan limits for government-guaranteed mortgages would help to rebalance the distribution of mortgages held in the purely private market and those covered by a government guarantee. Ultimately, we anticipate that fewer loans will be eligible for a government guarantee. Second, the commission's recommendations call for the elimination of the Fannie Mae and Freddie Mac model over an appropriate phase-out period—replacing them with a new government entity, the "Public Guarantor," which would provide a limited and explicit government guarantee for catastrophic risk for certain mortgage-backed securities. Adequately capitalized private credit enhancers would bear all losses ahead of the government guarantee.

Similar to the model currently employed by Ginnie Mae, lenders approved by the Public Guarantor would issue mortgage-backed securities that would be placed into designated monthly pools for which the Public Guarantor would provide a common framework, or shelf.[74] Private issuers would decide whether to retain or sell off the servicing rights associated with loans backing the MBS and choose how to cover the credit risk, including through arrangements with well-capitalized private credit-enhancing institutions. As noted above, private credit enhancers of MBS would bear the predominant loss risk in the event of a market downturn, while the Public Guarantor would provide a wrap for the timely payment of principal and interest by the servicers of the MBS (similar to the wrap presently provided by Ginnie Mae) and bear the catastrophic risk in the event of borrower default and the failure of the private-sector credit-risk bearers. Servicers would look first to the private credit enhancers for reimbursement of advances on defaulted mortgages. Only upon failure of a private credit enhancer would the government guarantee be triggered.

The commission's proposed model includes a continued, but limited, role for the federal government to guarantee MBS to ensure mortgage market liquidity and stability, with a large role for private capital to assume credit risk and shield taxpayers from exposure to credit losses. The overall structure of the new model is intended to avoid the re-creation of a small number of entities viewed as "too big to fail" or as enjoying an "implied guarantee." Our new model clearly delineates the respective roles of the government and the private sector, and establishes a clear expectation that private firms suffer the consequences of poor business decisions by losing their capital, with no bailout for private shareholders or bondholders. The government would cover losses from an account pre-funded by payments of a separate catastrophic guarantee fee, but only after private credit enhancers have exhausted their own capital and reserves. The Public Guarantor must play a strong role as regulator of the new system, including establishing sound prudential standards for private-sector entities and structures that are permitted to participate in this system as originators, servicers, or credit risk bearers.

The following sections provide more detail on the policy objectives underlying this proposal, outline the key functions for this new structure for single-family housing finance, illustrate how the various elements of the system work together, and discuss the importance of a dynamic flexible transition and some type of countercyclical buffer. The goal is to create a redesigned housing finance system that will continue to support the opportunity for homeownership and access to mortgage credit for creditworthy borrowers in all communities across the country. These proposals for single-family housing finance, taken together, set forth the commission's primary recommendations related to continuing homeownership as an ongoing, viable choice for the nation's housing consumers.

Policy Objectives

In order to meet the nation's housing finance needs and to provide access to mortgage credit for qualified borrowers, the future system of single-family housing finance should have five primary policy objectives:

The elimination, phased out over an appropriate period of time, of Fannie Mae and Freddie Mac.

The model of a private company with publicly traded stock and an implicit government guarantee did not work. Fannie Mae and Freddie Mac should be phased out and replaced with a new Public Guarantor, described below.

A far greater role for the private sector.

The private sources of capital that are available today would continue in this new redesigned housing finance system. These sources of capital include a private secondary market for mortgages (private-label MBS without any government guarantee), jumbo loans originated and held in portfolio or sold by private lenders, adjustable-rate mortgages originated and held in portfolio by private lenders or sold into the secondary market, and other product offerings outside of the government guarantee. Competition among banks of all sizes and a regulatory environment that encourages community banks, credit unions, and smaller financial institutions to originate and hold loans and participate in the secondary market, are all essential elements in this system.

While lenders should be able to originate and hold adjustable-rate and fixed-rate mortgage loans in portfolio, backed by appropriate capital, a strong private secondary market is essential to an adequately liquid housing finance system. In recent years, the amount of outstanding mortgage debt has equaled or exceeded the total value of assets held by U.S. banks. Funds available through the banking system must be supplemented with additional sources of capital (e.g., securitization) to create the capacity to meet the demand for mortgage credit.

A continued but limited role for government-guaranteed MBS.

While private capital must play a greater role in the single-family housing finance system, including in the market currently dominated by government-guaranteed MBS, a government-guaranteed secondary market is essential to ensuring adequate liquidity. Even in 2006, when private-label securitization was at its peak, non-agency funds (many of which were backed by unsustainable mortgages) constituted only 56 percent of the market. Moreover, absent government involvement, the To-Be-Announced (TBA) market—which provides a forward commitment market for consumers, lenders, and investors—might be unable to function, and many of the benefits associated with the standardization of mortgage products would be lost. *See Text Box, The To-Be-Announced (TBA) Market, page 52.*

Moving forward, however, the government guarantee that wraps or covers MBS must be fully funded and its scope limited to protect taxpayers. Key characteristics of this new government guarantee include:

- *Applies only to catastrophic risk.* The government guarantee is triggered only after private-sector entities in the predominant loss position have fully exhausted their own equity capital to make timely payment to compensate MBS issuers for credit losses.

- *Is explicit and actuarially sound.* The government guarantee is fully funded and premium collections exceed expected claims (with a safe reserve cushion).
- *Applies only to mortgage-backed securities.* The government guarantee would not cover the equity or debt of the entities that issue or insure MBS.

The To-Be-Announced (TBA) Market

The TBA market was established in the 1970s with the creation of pass-through securities at Ginnie Mae. It facilitates the forward trading of MBS issued by Ginnie Mae, Fannie Mae, and Freddie Mac by creating parameters under which mortgage pools can be considered fungible. On the trade date, only six criteria are agreed upon for the security or securities that are to be delivered: issuer, maturity, coupon, face value, price, and the settlement date. Investors can commit to buy MBS in advance because they know the general parameters of the mortgage pool, allowing lenders to sell their loan production on a forward basis, hedge interest rate risk inherent in mortgage lending, and lock in rates for borrowers.

The TBA market is a benchmark for all mortgage markets—it is the reference by which other mortgage markets and products are priced. It is also the most liquid, and consequently the most important, secondary market for mortgage loans, enabling buyers and sellers to trade large blocks of securities in a short time period. The liquidity comes through homogeneity and fungibility, and through the government guarantee of Fannie Mae, Freddie Mac, and Ginnie Mae.

Access to safe and affordable mortgages for borrowers in all geographic markets through complete economic cycles, without discrimination, bias, or limitations not based on sound underwriting and risk management.

The housing finance system should be designed to support liquidity for a wide range of safe and sustainable mortgages to low- and moderate-income households without regard to race, color, national origin, religion, sex, familial status, or disability, consistent with sound underwriting and risk management. To help achieve this objective, all participants in the housing market should support and reaffirm the principles of the Fair Housing Act of 1968, as amended. *See Text Box, Principles for Access to Credit, page 66.*

A continued but more targeted role for the Federal Housing Administration (FHA).[75]

The FHA has traditionally been an important provider of mortgage liquidity to first-time homebuyers and borrowers with limited savings for down payments. As we have seen over the past few years, it also plays a critical role in ensuring the continued flow of credit during periods of economic crisis. While its expansion was appropriate to keep credit flowing during the recent downturn, the role of the FHA in the single-family mortgage market should contract as the market recovers. Tools for achieving such contraction and returning FHA to its traditional role could include lower loan limits and increased insurance premiums.

These five policy objectives provide the framework for the more detailed recommendations that follow. However, before outlining the specific elements of our recommendations, the commission wishes to stress the importance of the broad policy objectives. Details are obviously very important, but we do not want to get lost in them. The first essential step to reforming our nation's housing finance system is achieving bipartisan consensus on the fundamental objectives we are trying to achieve. The commission recognizes there may be sound alternative approaches to achieving the same objectives.

Developing Sound Principles of Regulation

The following principles are fundamental to an appropriately regulated system of single-family housing finance.

All stages of the process should reinforce the obligation of the mortgage borrower to pay back the mortgage debt and the consequences of failing to do so, and the responsibility of lenders to underwrite loans based on the ability of the borrower to repay them. A fundamental principle of the residential mortgage finance system is that borrowers have a legal and moral obligation to repay the debt and that the lender has the right to take possession of its collateral if the loan is not repaid. The obligation to repay does not diminish when the value of the underlying collateral goes down.

Credit standards should be prudent and based on sound performance-based underwriting. This principle attempts to strike a balance between prudent underwriting and current market conditions in which many quality borrowers do not have access to affordable mortgage credit. Household formation in the next decade will be dominated by households whose members are more likely to be racial or ethnic minorities, have lower income, lack family wealth for down payments, and have less family experience with homeownership. The mortgage system needs to assess credit risk with appropriate attention to compensating risk factors, historical performance of standard loans, and a greater understanding of nontraditional employment, credit, and family structures and experiences that are likely to be more prevalent with the rising population of new households. With appropriate disclosure, lenders should be able to use risk-based pricing to serve borrowers who have a blemished credit record in some areas and otherwise might not qualify for a loan.

National standards for mortgage origination and servicing for all mortgage assets intended for securitization are essential. Since mortgage-backed securities are sold into and traded in national markets, the assets that make up those securities should be subject to rigorous national standards.

All participants in the housing finance system should have a financial stake in the performance of mortgages and/or mortgage-backed securities for an appropriate period of time. All participants in the mortgage process (from sales to origination to servicing to securitization) share a financial stake in the loan and its performance.

Lenders, investors, and regulators should have access to sufficient mortgage data in order to assess and price risk, and mortgage consumers should be provided with clear disclosures and certainty in mortgage terms. Disclosure alone will not fully protect consumers from abuses. The average mortgage consumer can sometimes be overwhelmed with information and disclosures, often at the last stage of seeking a loan, which can impede a proper understanding of mortgage terms. In addition, in some cases, the availability of only a limited number of mortgage variables at the outset of a trade can actually serve to enhance liquidity without significantly detracting from investors' ability to understand and price risk. Despite these qualifications, access to data on the pricing, sales, and ownership of securities and transparency in markets is critical to sound oversight and public accountability.

Key Functions

In this redesigned system of single-family housing finance, at least four key functions must be performed after the origination of a mortgage. These functions are (1) securitization; (2) servicing; (3) credit enhancement; and (4) government guarantee for catastrophic risk.

1. **Securitization.** The process of securitization requires some entity or entities to issue the mortgage-backed securities. The issuers of securities can either be the lenders who originate the loans or other private institutions that buy loans from lenders and issue securities backed by these loans.
2. **Servicing.** The mortgage servicer is the company to which the borrower sends the mortgage payment. Besides collecting mortgage payments from borrowers and making the timely payment of principal and interest to MBS investors, the servicer is responsible for working with the borrower in case of a delinquency or default, negotiating the workouts or modifications of mortgages, and conducting or supervising the foreclosure process when necessary.
3. **Credit enhancement.** One of the most important elements of any new system is to ensure that private capital takes the predominant loss credit risk, and truly stands ahead of a government guarantee, and to carefully design and

set capital and other requirements so that private entities are equipped to withstand even a severe downturn in the housing market through the use of private credit enhancers.[76] Private credit enhancers either carry risk on their balance sheets, with appropriate offsetting capital, or transfer the risk to capital market participants. Credit-enhancement options include well-capitalized mortgage insurance, capital market mechanisms where the appropriate amount of capital required to withstand severe losses is reserved up front, or a premium-funded reserve model, where a premium-funded reserve is established.

4. **Government guarantee for catastrophic risk.** A government guarantee for catastrophic credit risk would cover the timely payment of principal and interest on certain MBS only in the event that the private sector credit enhancer can no longer fund its obligation to reimburse the MBS servicer for credit losses on the pool of mortgage loans underlying the MBS. As noted above, such a guarantee would be explicit and paid for by premiums based on sound actuarial analysis. The guarantee would apply only to the MBS and would not apply to the equity or debt of the private institutions that issue them or to any insurers of the loans or credit enhancers. Further, a new or existing public entity would be established to maintain the standards for the limited government guarantee and to collect the premiums for a guarantee reserve fund.

In this redesigned system, a single entity could fulfill more than one of these functions: For example, an issuer of securities could choose to retain servicing rights for the loans backing the MBS. However, in order to obtain "sale treatment" for accounting purposes (discussed below), issuers would not provide credit enhancement. Instead, they would engage separate, well-capitalized private institutions to take responsibility for the predominant credit risk associated with the loans that collateralize the MBS.

Securitization—Approved Issuers

As noted above, the commission recommends a model similar to Ginnie Mae, where approved lenders are the issuers of mortgage-backed securities. The functions of an issuer of securities include:

- *Obtain certification from the Public Guarantor* that it is qualified to issue MBS based on such factors as (a) ability to meet credit and capital standards and cover all of the predominant loss risk through a separate well-capitalized credit enhancer, and (b) capacity to effectively pool mortgages and compete in the housing market.
- *Ensure that the guarantee fee is paid for* and collected from the borrower along with all other fees (e.g., the cost of predominant loss risk protection) and fully disclosed to the borrower as a part of originating the mortgage.
- *Issue the mortgage-backed securities* and, where appropriate, sell the MBS to investors through the TBA market. (The originator of the mortgage can either be the issuer, if approved, or can sell the mortgage to another approved issuer. The originator can also keep the servicing rights, if approved for this function by the Public Guarantor, or sell the servicing rights to another approved institution.)
- *Retain responsibility for representations and warranties* under the terms specified by the Public Guarantor.

In order to achieve "sale treatment," so the MBS will not be reported in the issuer's financial statements, the issuer must engage a third-party private credit enhancer. (In the context of a securitization transaction, "sale treatment" is an accounting term used to indicate that the seller of the now-securitized loans no longer reports the loans on its balance sheet.) This determination will require a judgment by the accounting profession that the expected loss in normal economic cycles has been transferred to the private credit enhancer and the Public Guarantor, these counterparties have the capacity to handle the credit risk, and the issuer and servicer of the security will not be required to set aside capital to cover such risk.

Under the commission's proposal, an approved issuer of MBS (generally the originator of the mortgage loan) should be able to "de-recognize" transferred loans from its balance sheet — that is, achieve sale accounting under U.S. generally accepted accounting principles. In addition, servicers operating as they do today should not have any duty to "consolidate" the loans that they service and the private credit enhancers should be able to manage any consolidation requirement without any detriment to the economics of the structure.

Servicing

Servicers will need to be qualified by the Public Guarantor. Responsibilities of a servicer include:

- *Make timely payment of principal and interest* should the borrower be unable to do so. The servicer will advance the timely payment of principal and interest out of its own corporate funds and will be reimbursed by the private credit enhancer at the time the amount of the loan loss is established.[77]
- *Work with the borrower* on issues related to delinquency, default, and foreclosure and advance all funds required to properly service the loan.

If the original issuer sells the servicing rights to another institution, all obligations move with the servicing to the new servicer, except the obligation for representations and warranties. In the event that a servicer fails, its servicing obligations will be transferred to a new servicer by the Public Guarantor. Losses due to default will continue to be covered by the private credit enhancer.

Credit Enhancement

The proposed single-family housing finance system depends on credible assurance that private institutions will bear the predominant credit risk, will be capitalized to withstand significant losses, and will provide credit that is generally unrestricted with little leverage. As such, private credit enhancers will bear the credit risk on the MBS they have guaranteed until they go out of business or have met their full obligation, as defined by the Public Guarantor, to stand behind their guarantee. Private credit enhancers will generally be single-business, monoline companies and will be required to:

- *Provide regular reports to the Public Guarantor* on the nature of the credit enhancement, who holds the risk, the amount and nature of the capital they hold, and other measures of credit strength. These measures would include a quarterly stress test to determine that available capital is adequate, with a "capital call" to assure there are sufficient reserves to protect the government guarantee from being tapped except in extreme cases.
- *Establish underwriting criteria* for the mortgages and mortgage pools they will be guaranteeing beyond the baseline underwriting criteria established by the Public Guarantor.
- *Reimburse servicers for their timely payment of principal and interest and other costs* at the time the amount of the loan loss is established. This reimbursement is paid out on a loan-by-loan basis until the private credit enhancer runs out of capital and goes out of business.
- *Establish and enforce servicing standards* (in conjunction with national servicing standards) in order to assure that the interests of the private credit enhancer and servicer are fully aligned. If these contractual standards are violated, the private credit enhancer will have the power to transfer servicing to another servicer.

- *Provide credit enhancement with standard, transparent, and consistent pricing to issuers of all types and sizes,* including community banks, independent mortgage bankers, housing finance agencies, credit unions, and community development financial institutions.
- *Meet credit enhancement requirements* through one or a combination of the following options: (1) well-capitalized private mortgage insurance at the loan level for any portion of the loan where specific capital requirements are established and the servicer and/or Public Guarantor has the ability to demand margins if there is an adverse move in house prices; (2) capital market mechanisms where the amount of capital required to withstand severe losses is reserved up front, either through a senior/subordinated debt model with the subordinated piece sized to cover the predominant risk or approved derivatives models using either margined Credit Default Swaps or fully funded Credit Linked Notes;[a] and (3) an approved premium-funded reserve model, where a premium-funded reserve is established, either fully capitalized at the outset or where the reserve builds over time. In all cases, the Public Guarantor will carefully monitor capital requirements to avoid arbitrage, ensure that real capital is set aside up-front, and maintain the alignment of interests among all participants (issuers, servicers, and private credit enhancers) with the new limited government guarantee.

These approaches to meet capital requirements are designed to ensure that private capital will stand ahead of any government guarantee for catastrophic risk.[78] The essential question will be where to draw the line between predominant loss and catastrophic loss—often referred to as the attachment point. The Public Guarantor will determine this attachment point and establish the minimum capital levels required to survive a major drop in house values resulting in significant mortgage losses. The Public Guarantor will require any private credit enhancer to have sufficient capital to survive a stress test no less severe than the recent downturn (e.g., a home price decline of 30 to 35 percent, which would correspond to aggregate credit losses of 4 to 5 percent on prime loans).

Government Guarantee for Catastrophic Risk

Under this proposal, the Public Guarantor would guarantee the timely payment of principal and interest on the MBS, but this guarantee would be triggered only after all private capital has been expended. Like Ginnie Mae, the government would be in the fourth loss position behind (1) borrowers and their home equity; (2) private credit enhancers; and (3) corporate resources of the issuers and servicers.[b] The government guarantee would be explicit, fully funded, and actuarially sound, and the risk would apply only to the securities and not to the equity and debt of the entity or entities that issue and/or insure them. The functions of the Public Guarantor would include:

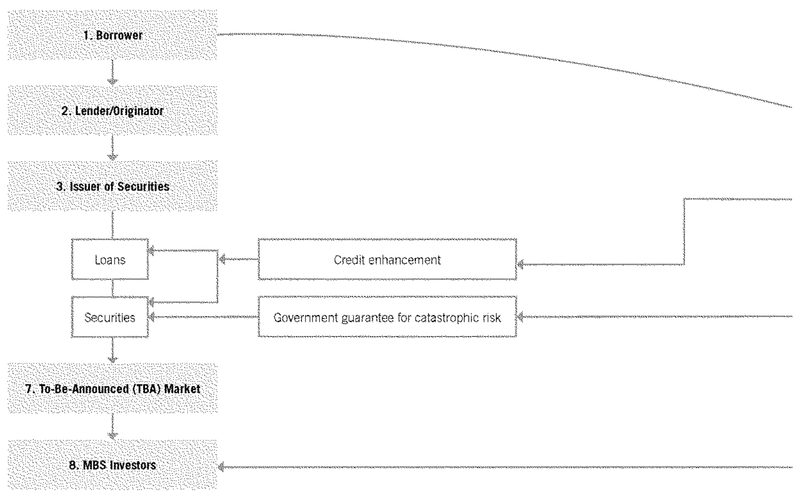
- *Guarantee investors the timely payment* of principal and interest on MBS.
- *Establish the level of capital* necessary to ensure that private-sector participants in the housing finance system (issuers, servicers, and private credit enhancers) are all properly capitalized.

a. A "credit default swap" is a transaction designed to transfer the credit exposure of fixed income products between parties. In a credit default swap, the purchaser of the swap makes payments to the seller up until the maturity date of a contract. In return, the seller agrees to pay off a third party debt if this party defaults on the loan. In this way, the purchaser of the swap receives credit protection, while the seller guarantees the creditworthiness of the debt. A "credit linked note" is a security with an embedded credit default swap that allows the issuer of the security to transfer a specific credit risk to investors. Source: Investopedia.

b. To be clear, the issuer and the servicer do not bear direct credit risk. That risk is borne by the private credit enhancer. However, the issuer and the servicer do bear other risks that help to shield the government from loss. The issuer is responsible for representations and warranties, and the servicer is responsible for the timely payment of principal and interest to investors out of corporate resources (as is currently the case with Ginnie Mae), although the servicer should eventually be reimbursed for this payment by the private credit enhancer.

- *Provide one common shelf* for the sale of government-guaranteed securities to offer greater liquidity for the market as well as establish an equal playing field for large and small lenders.
- *Establish a single platform* for the issuing, trading, and tracking of MBS. With multiple private issuers, this platform could provide greater uniformity and transparency, and therefore lead to greater liquidity. For example, in October 2012, the FHFA laid out a plan to build a single securitization platform to serve Fannie Mae, Freddie Mac, and a post-conservatorship market with multiple issuers. This single platform could serve as the securitization framework for the Public Guarantor and operate as a public utility, providing an established infrastructure for MBS guaranteed by the Public Guarantor or for private issuers of MBS. Development of this platform could build on the extensive intellectual and technological assets of Fannie Mae and Freddie Mac as they are phased out, providing taxpayers with a long-lasting dividend on the significant funds invested to support the GSEs' obligations after 2008.
- *Create and enforce uniform pooling and servicing standards governing the distribution of mortgage proceeds and losses to investors and ensuring compliance with relevant federal tax laws.* The Public Guarantor could build on the work already begun by FHFA to develop a model pooling and servicing agreement.
- *Encourage loan modifications when a modification is expected to result in the lowest claims payment on a net present value basis.* The Public Guarantor should require participants in the new government-guaranteed system to structure and service securities in a way that would facilitate such loan modifications.
- *Establish the guarantee fees* (g-fees) to be collected from the borrower to cover the operating costs of the Public Guarantor and to offset catastrophic losses in the event of a failure of the private credit enhancer and/or servicer failure. A reserve fund would be established for catastrophic risk that will build over time. (Other fees paid by the borrower would go to the issuer and the private credit enhancers to compensate them for issuing the securities and covering the predominant loss. These fees would be set by the private sector, but monitored by the Public Guarantor.)
- *Ensure access to the government-guaranteed secondary market on full and equal terms* to lenders of all types, including community banks, independent mortgage bankers, housing finance agencies, credit unions, and community development financial institutions. The Public Guarantor must ensure that issuers of securities do not create barriers using differential guarantee-fee pricing or other means to unfairly restrict or disadvantage participation in the government-guaranteed secondary market.
- *Ensure the actuarial soundness of the fund* through careful analysis and the use of outside expertise, and report to Congress regularly regarding the financial condition of the fund.
- *Qualify private institutions* to serve as issuers of securities, servicers, and private credit enhancers of MBS. The Public Guarantor will have the power to transfer servicing or credit enhancement to another servicer or credit enhancer (without compensation to the original servicer or credit enhancer) if it appears the government guarantee is put at risk. The Public Guarantor will also have the power to disqualify an issuer, servicer, or a private credit enhancer if it determines that requirements and standards are not met. (Although the Public Guarantor does not stand behind these private institutions nor does it cover their debt or equity, it would have resolution authority.) Ensuring the common alignment of incentives among all private entities serving as counterparties to the Public Guarantor will be essential to protecting taxpayers.

Figure 3-2: Flow of Mortgages



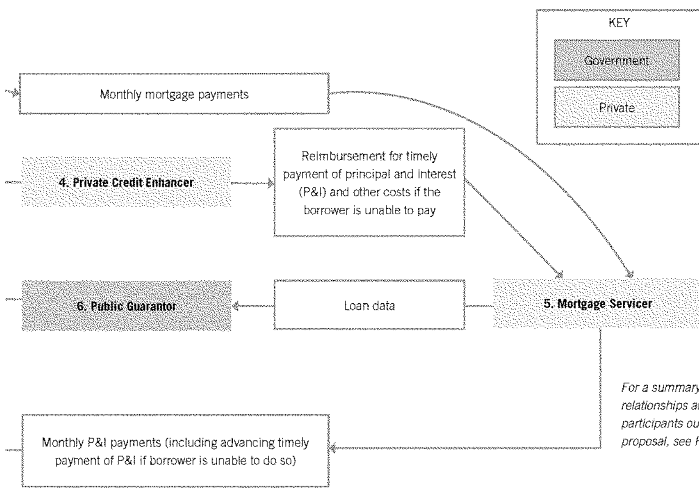
- *Establish loan limits, under the direction of Congress,* so that the loans backing the government-guaranteed MBS will be limited based on the size of the mortgage and any other criteria Congress may prescribe.
- *Set standards for the mortgages* that will be included in the MBS, including baseline underwriting criteria, permissible uses of risk-based pricing, and clear rules of the road related to representations and warranties.
- *Specify standards for mortgage data* and disclosures.

How Will This New System Work?

A number of parties and institutions will be involved in this new housing finance system. They include (1) borrowers; (2) lenders/originators; (3) issuers of securities; (4) private credit enhancers; (5) mortgage servicers; (6) a Public Guarantor; (7) the TBA market; and (8) MBS investors. Figure 3-2 provides a schematic of the proposal showing the flow of mortgages from the borrower to the investor. The steps involved in the process are outlined below with the text matching the numbers found on Figure 3-2.

1. Borrower. The borrowers—Mr. and Mrs. Jones—are buying a new house and need a mortgage. They approach a local financial institution, XYZ Savings Bank.

2. Lender/Originator. XYZ Savings Bank meets with Mr. and Mrs. Jones (by phone or in person). After a preliminary discussion where they provide basic information, authorize a credit check, and discuss and decide on the terms of the mortgage, the loan officer provides them with a conditional approval and locks in a mortgage rate for a specific period of time. (The lender locks in the rate through the TBA market where an investor will provide them a forward commitment to purchase the mortgage as a part of an MBS.) XYZ Savings Bank then continues with the borrower to underwrite the mortgage, taking into consideration the standards established by the private credit enhancer and



For a summary of the relationships among the participants outlined in the proposal, see Figure 3-3.

the Public Guarantor. The XYZ Savings Bank funds the loan and puts it on its balance sheet temporarily. In connection with the loan's securitization. The bank will "de-recognize" the loan (remove it from its balance sheet). (XYZ Savings Bank could choose to sell the servicing rights to another lender.)

3. Issuer of Securities. XYZ Savings Bank has been approved by the Public Guarantor to be an issuer of securities. XYZ Savings Bank prepares the loan to be part of a security and eventually pools the loan with other loans and issues the MBS, selling it to an investor through the TBA market. (If it had not been approved as an issuer, XYZ Savings Bank would have needed to sell the loan to an approved issuer who would then pool Mr. and Mrs. Jones' loan with other mortgage loans.) The issuer is compensated for issuing and selling the security.

4. Private Credit Enhancer. Before the loan is approved and closed, XYZ Savings Bank (as the issuer) must line up a private credit enhancer to cover the predominant loss credit risk—in this case, with ABC Private Credit Enhancer. The Public Guarantor has approved ABC Private Credit Enhancer based on its experience and ability to meet specific capital requirements and other credit standards. ABC Private Credit Enhancer can provide for the credit enhancement in a variety of ways. Multiple parties could also provide the credit enhancement as arranged by the issuer and approved by the Public Guarantor. The private credit enhancer will receive an ongoing fee for providing this enhancement.

5. Mortgage Servicer. The lender/originator can either keep or sell the servicing. In this case, XYZ Savings Bank decides to sell the servicing of Mr. and Mrs. Jones' loan to SERV Servicing, which has already been approved by the Public Guarantor. When SERV Servicing purchases the servicing from XYZ Savings Bank, it assumes all of the obligations of XYZ Savings Bank (with the exception of the representations and warranties under the loans in the MBS pool). As the servicer, SERV Servicing will work with Mr. and Mrs. Jones to assure the timely payment of principal and interest. As long as SERV Servicing stays in business, it will be responsible for working with Mr. and Mrs. Jones on issues related to delinquency, default, and foreclosure. In the event of a delinquency or default, it will make the timely payments of principal and interest and then look to ABC Private Credit Enhancer for reimbursement.

6. Public Guarantor. The Public Guarantor provides one shelf for all securities and issuers of securities, oversees the process as the regulator, and qualifies the issuer, the servicer, and the private credit enhancer. It has established a fund to guarantee catastrophic risk and sets and collects premiums for the fund—in this case, premiums are collected each month through SERV Servicing. It also ensures that the fund is actuarially sound.

7. To-Be-Announced (TBA) Market. The loan to Mr. and Mrs. Jones is delivered as a part of a security issued by the XYZ Savings Bank to an investor—in this case, The Invest Co.—utilizing the protocol outlined in the TBA market and agreed to by the savings bank and the investor.

8. MBS Investors. The Invest Co. secures delivery of the MBS issued by XYZ Savings Bank, protected at three levels—the commitment of the servicer to provide timely

Figure 3-3: Summary of Relationships Among Housing Finance System Participants

	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

payment of principal and interest, the private-sector guarantee provided by the ABC Private Credit Enhancer, and the guarantee for catastrophic risk provided by the Public Guarantor. Although The Invest Co. appreciates and benefits from the guarantee provided by ABC Private Credit Enhancer, its willingness to buy the MBS is largely based on the government wrap and the liquidity that comes from the large volume of standardized securities (including the Jones' loan) that are issued on the single MBS platform managed by the Public Guarantor.

[illegible]

Mortgage Rates in the New System

While the new housing finance system described above will minimize taxpayer risk, this protection will come at the cost of higher mortgage rates for borrowers. Three factors will contribute to the added costs:

1. The new housing finance system calls for a far greater role for the private sector in mortgage finance, with private capital taking the predominant loss risk and standing ahead of a limited government guarantee. Private credit enhancers will charge a fee to cover the cost of private capital to insure against the predominant loss if a mortgage default occurs.
2. The Public Guarantor will charge an unsubsidized fee to cover catastrophic risk should a private credit enhancer be unable to fulfill its obligations to investors.
3. The Public Guarantor will be structured as an independent, self-supporting government corporation that finances its activities through an operating fee.

The borrower will indirectly pay for all three of these activities through a g-fee that is included in the mortgage rate.

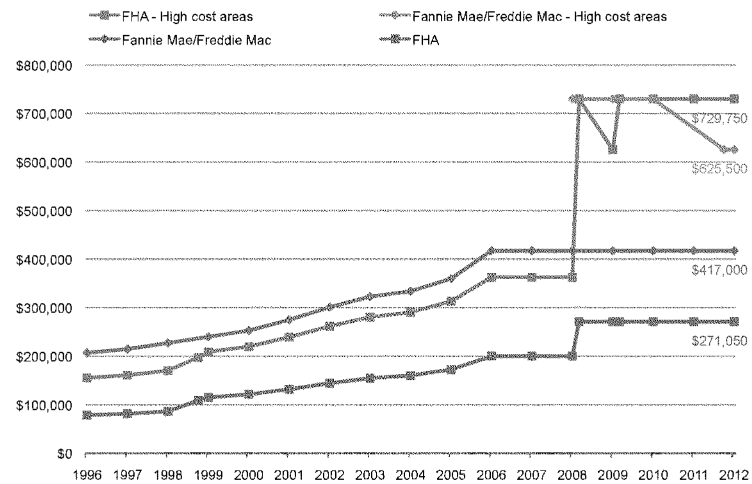
Analysis by Andrew Davidson & Co., Inc. using two research methods and a pool of nearly 5,000 conforming loans originated in 2012 (which has a broader cross section of loans than the universe of Freddie Mac and Fannie Mae loans as a whole) provides a range of estimates of the possible costs of the commission's recommendations.[c] Utilizing this pool of loans, Davidson & Co. estimates the g-fees paid by a borrower with no mortgage insurance (MI) will range from 59 to 81 basis points. This includes (1) the credit charges for the private sector to set aside capital to cover possible losses and a risk adjusted return—assuming no MI—estimated to be in the range of 45 to 67 basis points; (2) 8 basis points set aside for catastrophic risk to cover the limited government guarantee; and (3) 6 basis points to pay for the operating costs of the Public Guarantor.

By comparison, g-fees for mortgages currently guaranteed by Fannie Mae and Freddie Mac are in the range of 50 basis points (including a 10 basis point charge paid to the U.S. Treasury to pay for the payroll tax deduction), and the borrower has to pay for MI if the loan-to-value (LTV) ratio is above 80 percent. Given the very high quality mortgages currently served by the GSEs, the range of estimates in the Davidson & Co. study suggests—even accounting for the MI expenses—that the current g-fee may not need to rise for these high quality loans. However, the study does suggest that mortgage rates may need to increase by approximately 25 basis points if credit is extended to a wider group of borrowers than currently served by the GSEs (which now have average FICO scores of 760 and LTV ratios of 68 percent). Depending on market conditions and the credit quality of the mortgage pool, g-fees could be higher or lower. Also, increases in g-fees could be partially (or fully) offset by the fact that these MBS would have an explicit full faith and credit guarantee. This analysis is consistent with reviews conducted by others, including the Federal Housing Finance Agency, which have suggested that housing finance reform will entail higher mortgage rates.

These estimates assume a relatively stable housing market with modest growth in house prices as their base case. However, during weak economic periods of falling home prices or greater market uncertainty, the market price for credit guarantees would be higher. In addition, the modeling work found that while the g-fees for the private sector to set aside capital to cover predominant loss across the entire sample pool, including the higher-risk segments, appear to be relatively moderate, these estimates mask considerable variation across borrowers, depending on

c. Andrew Davidson & Co., Inc., has prepared a working paper on this topic that provides the details of their analysis. See *Modeling the Impact of Housing Finance Reform on Mortgage Rates* found on the BPC Housing Commission website at www.bipartisanpolicy.org/housing.

Chart 3-6: FHA and Fannie Mae/Freddie Mac Loan Limits



Sources: U.S. Department of Housing and Urban Development Mortgagee Letters on Federal Housing Administration maximum loan limits, 1996 to 2012; Fannie Mae, "Historical Conventional Loan Limits," December 31, 2011.

risk characteristics such as FICO scores and LTV ratios. For example, Davidson & Co. found that the credit cost for borrowers with FICO scores greater than 750 and LTV ratios below 80 percent could be less than 25 basis points a year, while the credit costs for borrowers with FICO scores below 700 and LTV ratios greater than 90 percent could be more than 10 times higher.

Transition

A dynamic, flexible transition is essential to the development of a redesigned system for single-family housing finance. The intent of the transition, especially at the outset, is to move toward a general policy direction rather than an absolute goal. After Congress has adopted a new model, an extended period of time (five to ten years) will be needed to unwind the single-family operations of Fannie Mae and Freddie Mac in an orderly fashion and rebalance capital flows as the private sector steps in and the government footprint becomes smaller. A dynamic problem-solving approach, where the design of a new housing finance system is based on lessons learned during the transition, will ensure that policy choices evolve in response to the changing realities of the marketplace.

The transition to the new system could be greatly facilitated by continued utilization of existing capabilities (e.g., process, skilled staffing) within Fannie Mae and Freddie Mac. These scalable, proven platforms for securitization have been developed over many years, and the familiarity and systems connectivity of mortgage market participants to these systems and processes might facilitate an orderly transition to the new system. In addition, the TBA market (the most liquid fixed-income market in the world) should be maintained in a new system to ensure a smooth transition and retain liquidity.

During this transition period, several mechanisms, or policy dials, could be applied to help reduce the size of government involvement in the single-family mortgage market. A gradual reduction in the maximum loan limits for Fannie Mae, Freddie Mac, FHA, and VA mortgages should serve as the primary policy dial to assist in this transition and will provide an indication of the private market's appetite for unsupported mortgage credit risk and valuable feedback on the development of the new system. A gradual approach will minimize market disruptions and safeguard against the sudden potential loss of access to mortgage credit. Chart 3-6 outlines the evolution of these loan limits since 1996.

Other policy dials have also been set in motion. The FHFA has recently increased the g-fees charged by Fannie Mae and Freddie Mac, in order to help move the government pricing structure closer to the level one might expect if mortgage credit risk were borne solely by private capital, making the private market more competitive. Changes to the terms of Treasury's treatment of Fannie Mae and Freddie Mac announced in August 2012 accelerate the reduction in their portfolios, from the 10 percent annual reduction called for in the Senior Preferred Stock Agreements between the FHFA and Treasury to 15 percent annually. In addition, FHFA has announced its intention to begin experimenting with single-family MBS structures to allow a portion of the credit risk currently held by Fannie Mae and Freddie Mac to be sold to the private sector.[79] Although only first steps, experimentation along these lines will enable greater private-sector involvement and set the stage for the transition to the new system.

Another major action that would encourage a greater role for the private sector in the housing finance system would be clarifying the rules of the road going forward. Despite the promulgation of CFPB's final rules on Qualified Mortgages and mortgage servicing, regulatory uncertainty continues to hold back private-sector involvement. The pending rule regarding Qualified Residential Mortgages (QRM), along with other outstanding questions related to the Dodd-Frank legislation, must be resolved for the private sector to return to the mortgage market in a more robust manner.

Subject to lessons learned during the transition period, the commission expects that the single-family housing finance system of the future will have three distinct segments:

1. Mortgages that are not covered by any government guarantee (including loans held in portfolio and private-label MBS) would comprise a substantial share of the overall market.
2. The market share of mortgages insured or guaranteed by FHA, VA, and USDA would return to pre-crisis levels.
3. Mortgages covered by the new, limited government guarantee provided by the Public Guarantor would make up the balance.

As noted above, gradually reducing maximum loan limits would be the primary policy dial to help achieve this eventual distribution. After a suitable transition period, the commission recommends that the loan limits for the two government-guaranteed markets be established for each metropolitan area using a formula that takes into account the median house price in that area. Future policy choices by the administration and Congress will determine the actual loan limits, but looking at historical loan limits before the crash, for many areas these loan limits might be in the range of $150,000 to $175,000 for the share of the market served by FHA, VA, and the USDA, and in the range of $250,000 to $275,000 for the share of the market served by the Public Guarantor (see Chart 3-6).

Countercyclical Buffer

During severe economic downturns, the limited government guarantee for catastrophic risk should help provide for the continued availability of mortgage credit because the government wrap will assure investors that the MBS will be repaid and the government will stand behind the credit risk. If credit-risk protection is no longer available through private credit enhancers, or if the price for such credit-risk coverage is too high, then Congress could adjust the loan levels for the FHA and VA insurance and guarantee programs, thus allowing the two institutions to expand their activities as they did during the recent crisis. In addition, the Public Guarantor should be given the authority to price and absorb the predominant credit risk for limited periods during times of severe economic stress in order to ensure the continued flow of mortgage credit. The Public Guarantor would be required to notify the Treasury Department, the Federal Reserve, and the chairs of the appropriate congressional committees before any action is taken to absorb predominant credit risk.

Under the model proposed by the commission, neither the Public Guarantor, FHA, VA, nor Ginnie Mae would have retained portfolios. The absence of these retained portfolios raises concerns about the availability and liquidity of mortgage credit during downturns when demand for mortgage-backed securities or the liquidity with which to purchase these securities could fall precipitously, as happened in 2008 to 2009. Therefore, federal policy should be clear on how mortgage liquidity would be managed in such circumstances. One alternative is through monetary policy and Federal Reserve actions in the market. During the 45-year history of Ginnie Mae in which it had no retained portfolio, the presence of a "full faith and credit" guarantee as well as Federal Reserve and Treasury purchasing authority have preserved ample liquidity in Ginnie Mae bonds through numerous credit crises, including the most recent one. Such policies should be established in advance of any crisis and should be understood by all market participants in order to forestall any issues that could raise the cost of housing and homeownership unnecessarily.

A Final Note about the Federal Housing Administration and the Single-Family Housing Market

Since its creation during the Great Depression, the Federal Housing Administration has periodically been called upon to act as a stabilizing force within the single-family housing market. When the oil-patch crisis in the mid-1980s roiled housing markets in Texas, Oklahoma, and Louisiana, the FHA stepped into these markets to provide much-needed liquidity.[80] When the national housing market collapsed in 2007, the FHA was a critical stabilizing force, with FHA market share of mortgage-purchase originations rising to more than 45 percent in 2010. The commission believes that, without the FHA's support for the housing market during this period of crisis, our nation's economic troubles would have been significantly worse. The FHA has also traditionally been an important source of mortgage credit for first-time homebuyers and borrowers with low wealth or home equity. Over the past decade, the share of FHA borrowers who are first-time homebuyers has hovered around 80 percent. During the same period, a significant percentage of FHA borrowers had incomes below 80 percent of area median income; many were minority families.

Looking ahead, the commission envisions an FHA that continues to play these two vital roles: serving as an important stabilizing force for the market, ready to be called upon in the time of crisis, and acting as an important gateway to homeownership for those families with more limited means.

The most recent independent audit of FHA, however, contained troubling news: It estimated that at the time of the audit, FHA's single-family mortgage insurance fund had a long-term shortfall of $16.3 billion, yielding a capital reserve ratio of *negative* 1.44 percent, far below the statutorily required ratio of 2 percent. (The FHA has $30.4 billion on hand to settle insurance claims as they come in. However, according to federal budget rules, the agency must hold

Principles for Access to Credit

The mortgage finance system must create a stable, liquid market that finances safe and affordable mortgages for borrowers in all geographic markets through complete economic cycles, without discrimination, bias, or limitations to access that are not based on sound underwriting and risk management. To achieve these goals, the commission recommends the following principles:

1. The government-guaranteed secondary market for mortgage-backed securities should be designed to support liquidity to a wide range of safe and sustainable mortgages to low- and moderate-income households without regard to race, color, national origin, religion, sex, familial status, or disability.[81] To help achieve this objective, the business practices of MBS issuers benefiting from a government guarantee should be fully consistent with the requirements of existing fair lending laws, including the Fair Housing Act and the Equal Credit Opportunity Act. The Public Guarantor should assure that it supports liquidity for lending consistent with the Community Reinvestment Act (CRA) and that it supports primary lenders' efforts to meet their requirements under the CRA or other, similar requirements imposed by their regulators. The Public Guarantor, in consultation with prudential regulators, should have the ability to limit or prohibit an issuer's eligibility to access the guarantee.
2. The transparency of the government-guaranteed secondary market is critical to ensuring that this market is functioning without discrimination or bias. MBS issuers should report annually to the Public Guarantor on their total production guaranteed by the Public Guarantor for the previous year providing information similar to that required of mortgage originators under the Home Mortgage Disclosure Act. To the greatest extent practicable, MBS issuer data should be made available to the public in an accessible form and on a timely basis that facilitates independent review and analysis.
3. The Public Guarantor should report annually to Congress on the composition of its own total insured portfolio and the individuals and communities it serves. This report should (a) identify communities whose credit needs the Public Guarantor believes are being underserved, (b) explain what factors may be inhibiting access to credit there, and (c) make recommendations on how to expand access to credit in a prudent manner in these communities. To help ensure there is no segmentation of the government-guaranteed secondary market for reasons unrelated to sound underwriting and risk management, this report should also provide detailed demographic and credit-profile comparisons of FHA/VA/USDA borrowers with those borrowers served in the remaining portion of the market.
4. The Public Guarantor should have a role to play in encouraging responsible innovation and broad market participation by facilitating liquidity for private lenders to develop and test new mortgage products that adhere to prudent, safe standards but have not yet been seasoned or adopted broadly enough to allow for securitization. The Public Guarantor should routinely share information on innovations available in the private market with lenders and MBS issuers.
5. Neither the Public Guarantor nor MBS issuers should be subject to numerical housing goals or quotas. Such measures could distort the prudent application of the government guarantee.
6. Access to the government-guaranteed secondary market must be open on full and equal terms to lenders of all types, including community banks, housing finance agencies, credit unions, and community development financial institutions. The Public Guarantor should neither create nor permit barriers to lenders using differential guarantee-fee pricing or other means to unfairly restrict or disadvantage participation in the government-guaranteed secondary market.

enough capital to cover all expected claims over the next 30 years, which would require an estimated $46.7 billion. That leaves a long-term shortfall of $16.3 billion.) According to the audit, loans insured prior to 2010 are the prime source of stress on the insurance fund, with $70 billion in future claims payments attributable to the FY 2007–2009 book of business alone. Seller-funded down-payment-assisted loans, now prohibited by federal law, were responsible for the largest share of FHA losses. It is unclear at this time whether the FHA will require a drawdown of federal funds to subsidize its single-family insurance fund. FHA has taken a number of remedial steps, including raising annual insurance premiums and other policy changes to increase revenue and reduce losses, and Congress is considering legislation to achieve similar objectives. And according to the independent audit, FHA loans insured since 2010 are of high quality and profitability.[82]

The recent developments surrounding FHA only underscore the urgency of what the commission has proposed—that far more risk-bearing private capital must flow into our nation's housing finance system. A system in which private risk-bearing capital is plentiful will help reduce the pressure that is sometimes placed on the FHA to act as the mortgage-credit provider of last resort and allow it to perform its traditional missions more effectively and at lower risk to the taxpayer.

Recommendations for Rental Housing Finance Reform

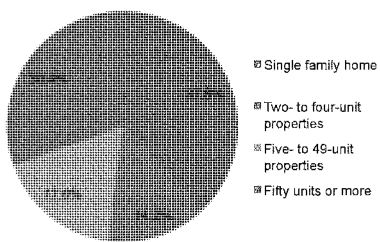
Today, about 35 percent of all U.S. households rent. In many markets, rental housing offers more affordable housing options for low-income and moderate-income families. Indeed, about nine in ten rental units are generally affordable to those households making the median income in the areas in which they live. As explained later in this report, however, rental housing is becoming increasingly unaffordable, particularly for those at the lower end of the income spectrum. A strong rental housing finance system can help to ameliorate this urgent problem and will be critical to meeting our country's future housing needs. Given the changing demographics of American households, the drop in homeownership following the collapse of the single-family housing market, and the higher hurdles consumers will face in obtaining mortgage credit in the near future, supporting policies that enable owners of rental property to sustain these homes and renters to afford them has become more critical than ever.

Finance is just as vital to rental housing as it is to housing occupied by homeowners. Rental developers need financing to build properties and property owners need it to buy, repair, rehabilitate, and preserve rental housing. The cost and availability of credit to support the rental sector is important to maintaining a supply of rental housing adequate to meet the demand for it, and because rental markets are competitive, credit costs and availability influence the rents that landlords charge.

The Key Segments of the Rental Market

Despite the popular perception that most renters live in large properties with many units, about half of renters in 2001 (the most recent year for which property-level data is available) lived in properties with fewer than five units (Chart 3-7). In fact, four in ten lived in single-unit properties. With the recent shift toward renting more single-family homes as homeownership rates have fallen, the share of renters living in rentals with fewer than five units has likely increased modestly.

Chart 3-7: Proportion of Rental Units by Size of Property



Source: Joint Center for Housing Studies of Harvard University tabulations of U.S. Department of Housing and Urban Development and U.S. Census Bureau, *Residential Finance Survey:* 2001, Census 2000 Special Reports, CENSR-27 (2005).

These one- to four-unit properties are treated as single-family properties by the finance system and are financed through the single-family divisions of Fannie Mae, Freddie Mac, and FHA. Bank regulators consider them single-family properties when establishing underwriting guidelines and setting capital requirements. These smallest rental properties pose unique financing challenges. The performance of loans to these properties and the reasons for differences in performance between single-unit rentals, two-unit rentals, and properties with more units is not well understood. This is especially true of the large number of foreclosed single-family homes that are being converted to rentals in the wake of the housing bubble. Whether these properties will become long-term rental assets or return to the for-purchase market when homeownership financing becomes more readily available and purchase demand increases, is also not known. This uncertainty makes designing effective rental financing approaches even more challenging.

The rental housing finance system in place today is primarily geared to serve multifamily properties—those with five or more units. These account for about half of all rentals, and much more is known about the performance of loans to these properties. Most of the discussion and recommendations that follow address this segment of the rental housing stock. Following the financial market conventions, we will refer to these properties and their finance as "multifamily."

The Federal Role in Supporting Multifamily Lending

The federal government helps to provide liquidity to multifamily rentals in normal times and is a crucial backstop in times of stress. When private lenders all but exited the market during the financial crisis, the federal role in rental housing finance expanded dramatically. With rental markets rebounding, private capital is once again increasing its exposure to credit risk from multifamily lending. While these are promising signs that rental finance is on the mend, federal support from Fannie Mae, Freddie Mac, and FHA remains essential to the recovery process and the market's long-term stability.

The mortgage debt outstanding for multifamily rental properties currently amounts to an $825 billion market, the vast majority of which supports refinancing.[83] Multifamily rental housing has historically been financed by a variety of private sources and by Fannie Mae, Freddie Mac, and FHA. Banks, thrifts, and insurance companies have all been important participants, using combinations of their own balance sheets and securities, along with other private sources like pension funds. A multifamily private-label commercial mortgage-backed securities (CMBS) market emerged in the 1990s and grew through the early 2000s, but shut down by 2009 in the wake of the financial crisis. Unlike the agency CMBS market supported by the federal government, the private-label CMBS market has neither explicit nor implicit federal backing. Like its single-family counterpart, this private-label securities market suffered at

[illegible]

A wide range of funders currently supplies capital to the rental finance system. In the private sector, banks and thrifts specialize mostly in short-term, adjustable-rate mortgages and in construction lending, while life insurance companies engage primarily in long-term, fixed-rate financing, largely for prime properties in prime locations. Fannie Mae and Freddie Mac provide mostly long-term [illegible] fixed-rate refinancing, including for some nonprime properties and in nonprime locations, but do not [illegible] any construction lending. FHA provides long-term, fixed-rate financing through refinance loans and construction-to-permanent loans for new and rehabilitated properties, but only for properties with per-unit costs below a strict statutory cutoff. See Table 3-1 for more detail on each of these providers of credit.

Table 3-1. Multifamily Finance Providers of Credit and Terms

	Fannie Mae/ Freddie Mac	Banks and thrifts	Life insurance companies	FHA	CMBS
Financing provided	Portfolio/insured – securitized	Portfolio	Portfolio	Insured-securitized	Securitized-REMIC
Loan type(s)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Recourse or non-recourse	Non-recourse	Recourse (partial)	Non-recourse	Non-recourse	Non-recourse
Typical loan term	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Loan-to-value ratio	Leverage up to 75-80%	Lower leverage (65-75%)	Lowest leverage (55-75%)	Highest leverage (80-85%)	Leverage (65-75%)
Cost to borrower	Low priced	Low priced	Low priced	Low priced	Higher priced
Flexibility to adjust loan terms	Moderately flexible	Most flexible	Moderately flexible	Least flexible	Least flexible
Availability – borrowers and neighborhoods	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

Source: [illegible]

FHA, Fannie Mae, and Freddie Mac do not originate loans. Except for multifamily loans held in portfolio, Fannie Mae and Freddie Mac also do not service the loans. Instead they rely on private, specially licensed firms to perform these functions. This reliance on the private sector is a positive aspect of the present system that should be preserved and expanded.

the height of the boom from overleveraging and declining credit quality. Many CMBS issues had to be restructured and investors' returns cut as the weakened economy and bad lending practices undermined their value. In contrast, the GSE and Ginnie Mae CMBS market was stable and experienced little loss of value and, as noted earlier, grew rapidly as private capital fled.

In recent years, annual multifamily originations have swung widely from a high of $148 billion in 2007 to a low of $52 billion in 2009. When private capital withdrew from the market in 2009, Fannie Mae and Freddie Mac expanded to support 86 percent of multifamily loan originations[84] — nearly triple their average share in the years leading up to the crisis.

After plummeting to record lows, new apartment construction has picked up to about 225,000 units in 2012.[85] But new construction has failed to keep pace with the growth in rental demand, driving vacancy rates down and rents up.[86] The growing demand for new multifamily rental units, fueled in part by demographic changes and more restrictive mortgage underwriting standards, lends urgency to ensuring credit continues to flow to multifamily housing.

Fortunately, strengthening rental markets have attracted renewed interest by banks, thrifts, and insurance companies. After dropping to historic lows in 2009, their participation rates in multifamily originations have started to pick up. With this return, the share of multifamily loan originations supported by Fannie Mae and Freddie Mac has fallen to 56 percent in 2011. Even private-label CMBS came back in 2011, though at a very low $2 billion level (far short of the 2007 peak of $36 billion).[87] Though bank balance-sheet lending especially has been picking up, overall federal support for multifamily lending remains high by historical standards.[88]

Table 3-2: Share of Multifamily Loans Financed that were 60+ Days Delinquent as of December 31, 2011

Acquisition or origination year	Fannie Mae	Freddie Mac	Private label CMBS lenders	FHA lenders
2005	0.73%	0.20%	5.60%	1.19%
2006	0.66	0.25	13.63	0.66
2007	0.89	0.74	23.94	0.54
2008	1.12	0.09	4.68	2.74
2009	0.05	0.00	N/A*	5.15
2010	0.04	0.00	0.00	0.02

*In 2009, CMBS lenders did not originate any multifamily loans.

Note: While not displayed in this table due to differences in the ways in which delinquencies are tracked, life insurance companies generally experienced lower default rates than Fannie Mae and Freddie Mac from 2005–2010.

Source: Shear, William B., et al. *Fannie Mae and Freddie Mac's Multifamily Housing Activities Have Increased.* GAO-12-849. (Washington, D.C.: U.S. Government Accountability Office, 2012), 58.

In sharp contrast to their single-family operations, the multifamily businesses of Fannie Mae and Freddie Mac were profitable throughout the financial crisis.[89] In addition, the performance of multifamily loans backed by Fannie Mae and Freddie Mac was dramatically better than that of loans made through other financing channels. The worst performance was turned in by the private-label CMBS market (see Table 3-2). The underwriting standards and risk-management strategies of Fannie Mae and Freddie Mac, and to a lesser extent of FHA, clearly paid off relative to the private-label CMBS market.

Building a New Rental Housing Finance System

The commission recommends that the federal government take the following four actions with respect to building a new system for rental housing finance:

- Gradually transition the multifamily operations of Fannie Mae and Freddie Mac to a new system similar in design to that for single-family finance. The intellectual, technological, and business assets of the GSEs' multifamily businesses could be transitioned in a number of ways, including through incorporation into a new publicly operated securities platform, operation as a legacy asset of the U.S. government, or sale to private interests.
- Put in place a new catastrophic guarantee for multifamily finance predicated on the same principles as proposed for single-family finance. This new multifamily backstop would provide an explicit guarantee of the MBS issued by private issuers in return for (1) paying a fee to the Public Guarantor; (2) agreeing to assume, or arrange for other private parties to assume, predominant losses before the catastrophic guarantee is triggered; and (3) submitting to the approval, underwriting, monitoring, and capital standards established by the Public Guarantor.
- Retain but streamline FHA's multifamily insurance operations, and pare back FHA's multifamily role to the extent that private-sector risk taking can take its place at somewhat comparable cost and enable FHA to focus on areas and products where private investment is not readily available.
- Make special provisions to better understand and support the financing needs of one- to four-unit and five- to 49-unit rentals, including review of the limitations on passive losses, consideration of treating properties made up of small scattered rentals on multiple sites as multifamily housing for finance purposes, and consideration of new financing tools for large-scale owner/operators of affordable rental properties that will increase their efficiency and ability to steward their inventory.

Each of these recommendations is discussed in greater detail below.

Gradually wind down the multifamily operations of Fannie Mae and Freddie Mac.

The commission recommends winding down the multifamily operations of Fannie Mae and Freddie Mac through a gradual transition process. This process should be undertaken at a pace that does not harm the nation's rental finance system and should not be completed until a new system of federal catastrophic guarantee support is firmly in place.

During this transition, the multifamily assets of Fannie Mae and Freddie Mac could be repositioned in a number of ways, including through incorporation into a new publicly operated securities platform, operation as a legacy asset of the U.S. government, or sale to private interests that have no special charter or implicit guarantee of their corporate equity or debt. These private firms would have to be approved by the Public Guarantor, pay a fee to help capitalize the government catastrophic risk fund, and submit to capital reserve requirements. The transition will only be complete when a wholly private system, backstopped only by a catastrophic government guarantee, replaces the liquidity functions that Fannie Mae and Freddie Mac have provided.

Put in place a new catastrophic guarantee for multifamily finance predicated on the same principles as proposed for single-family finance.

The commission has concluded that a continued—but *limited*—federal presence in rental housing finance is needed both to ensure liquidity in normal times and to guard against illiquidity during times of severe economic distress. As in the new single-family system, the commission envisions that:

- The Public Guarantor should be charged with and authorized to provide catastrophic risk insurance for multifamily CMBS in return for an explicit and actuarially sound premium charged to issuers, which is designed to cover losses (after private risk-sharers absorb predominant losses) as well as the operating expenses of the Public Guarantor.
- Private firms should be the originators, servicers, credit enhancers, and issuers of multifamily mortgages and CMBS with the government backstop of MBS limited to an explicit catastrophic guarantee. The issuer/servicers and credit enhancers should be monoline entities to ensure that the capital they have is protected against other uses.
- Except in the case of FHA-insured loans, in which the difficulty of serving the low-cost rental market justifies the government's assumption of 100 percent of the credit risk, the private sector should charge for and take a predominant share of potential losses before any government catastrophic risk insurance is triggered.
- The interests of the Public Guarantor and its private-sector counterparties should be aligned as much as possible.

Why a Government Guarantee is Necessary

The commission's support for a continued government guarantee of multifamily CMBS—built around private risk-sharing in which the government pays out only for catastrophic losses—is rooted in the following findings:

- A government guarantee against catastrophic risk is essential to a strong and deeply liquid secondary market for multifamily loans. The guarantee would completely wrap the multifamily CMBS, thereby converting largely illiquid multifamily mortgages into liquid multifamily securities with a broad investor base. A broad base of investors, in turn, helps ensure that interest rates are competitive and that capital is sufficient to fund the demand for rental housing.
- In the absence of a government backstop, there is a serious risk that liquidity will be impaired, particularly for long-term, fixed-rate multifamily rental mortgages, but also potentially for other types of mortgage products as well (e.g., at times Fannie Mae and Freddie Mac have provided important support to the longer-term, adjustable-rate market). The financial crisis clearly exposed the potential for private capital to exit the market during periods of sharp housing corrections or disruptions in financial markets. The retreat of private capital from exposure to multifamily credit risk underscores the importance of some form of a government backstop to avoid extended periods when credit is unavailable.
- Even under normal economic conditions, Fannie Mae and Freddie Mac have been important sources of finance in nonprime locations and when investment strategies have led private investors to shed existing investments or restrict new ones.
- The availability of a government backstop for multifamily CMBS benefits borrowers by keeping credit flowing. Furthermore, having a strong secondary market for multifamily mortgages allows banks, thrifts, and credit unions—which are funded mostly by short-term deposits—to originate longer-term, fixed-rate mortgages of

seven to 30 years, which are vitally important to managing the operating costs of affordable rental housing. Finally, the option to issue government-guaranteed securities with private risk-sharing provides lenders with an additional tool to manage their capital reserve requirements.

Mechanics of the New Rental Finance System

The Public Guarantor would provide multifamily mortgage lenders with the important option of placing loans in securities and paying for government catastrophic risk on these securities. Private-sector lenders operating without this backstop can and will play a role in a reformed housing finance system and will be in a position to judge when to use this option. Participating lenders or issuers would be permitted to either retain the risk of covering predominant losses ahead of the government guarantee or arrange for a private-sector third party to provide most of the credit enhancement.

The Public Guarantor would be limited to backstopping permanent finance for leased new properties and for existing properties, and expressly prohibited from supporting construction lending just as Fannie Mae and Freddie Mac are prohibited from doing so.

Although the Public Guarantor would not guarantee securities backed by multifamily rental construction loans, banks would have the option of rolling over the initial loan for newly built rental properties to a longer-term, fixed-rate permanent loan that is eligible for secondary market sale or securitization, just as they do today with Fannie Mae and Freddie Mac. In this way, the presence of a government-backstopped secondary market takeout for adjustable-rate construction loans would facilitate the flow of credit to new construction in normal times as well as times of stress.

Before the crisis, the private market supplied all the construction lending for rental properties—and did so mostly without FHA insurance. During any future crisis, the commission believes that the demand for financing for new construction would be minimal and that a reformed and strengthened FHA could keep the supply of construction finance flowing to low-cost rental housing just as it did during the previous downturn, but more efficiently and at greater scale than it managed to do in its pre-reform state.

Key Differences with the Proposed Single-Family System

The key differences between the proposed systems for single-family and rental finance lie not in the basic functions of the systems or the structure of the government guarantee but in (1) the cutoffs that would be established to ensure the Public Guarantor serves only a segment of the mortgage market and (2) the specific counterparty requirements for the two systems. Each of these differences is addressed in greater detail below.

An affordability requirement

Multifamily lending, by virtue of renter demographics and rental housing, has predominantly supported housing affordable to low- and moderate-income households. The commission recommends that the Public Guarantor establish an affordability requirement or threshold, intended to assure that the system continues to primarily support housing affordable to these households, while allowing access to the guarantee for a modest share of higher-rent units. This threshold should be neither overly generous nor unduly restrictive, to ensure a broad backstop for multifamily housing affordable to Americans with modest incomes and to avoid the overuse of the government guarantee for high-end rental properties. Compliance with the affordability requirement should be assessed using the rents established at loan origination. Compliance would be based on the issuer's portfolio of qualifying securities over a rolling two-to three-year period.[90] Issuers that fail to comply could be subject to a variety of actions, including losing approval status to do business with the Public Guarantor.

The proposed restriction of the catastrophic government guarantee to properties primarily serving low- and moderate-income residents may result in a relatively higher cost of capital for some projects at the higher end of the rental market. While the commission has concluded that this is an acceptable risk, in the event of an extreme stress to the financial system in which it is determined that private capital has fled from the market serving higher-income renters by a verifiable measure, the Public Guarantor should have the authority to extend catastrophic insurance to prudently written loans for these segments of the market until private capital returns.

Counterparty standards and requirements for multifamily lenders

As on the single-family side, the Public Guarantor would be charged with developing and periodically reviewing underwriting standards; approving the lenders, issuers, private credit enhancers, and servicers that participate in the government-guaranteed system; and maintaining minimum standards for the amount of capital that would have to be placed in reserve by private firms to cover predominant losses before the government catastrophic guarantee would be triggered. The Public Guarantor would also employ safeguards to ensure the alignment of interests of all entities serving as its counterparties.

Underwriting standards

In a new housing finance system, underwriting standards for the single-family and rental sectors would be different, just as they are now. For example, borrowers in the rental housing finance system are typically required to make much larger down payments (of 25 percent or more) than borrowers on the single-family side, a practice that would continue under the new system.[91] The Public Guarantor would have the flexibility to underwrite loans directly or establish process and documentation standards it would expect its counterparty originators to follow. The Public Guarantor would also conduct audits of its counterparties to ensure compliance.

Capital requirements

The capital that private firms would have to put at risk to cover predominant losses would be based on regular stress tests of their capital position to ensure that counterparties have adequate capital to cover their commitments. Capital reserve requirements would likely be set at different levels for rental MBS than for MBS backed by single-family loans because of the different risks they pose.

Alignment of incentives

The interests of all private entities serving as counterparties to the Public Guarantor must be tied to the long-term performance of multifamily loans, not just to the volume of loan originations and security issuances. These private entities include firms originating and servicing multifamily loans, issuing government-guaranteed securities with private risk-sharing, and sharing credit risk.

This alignment of incentives can be met using one of three methods that tie the interest of every entity in the chain to the long-term success of every mortgage loan that is ultimately backstopped by the Public Guarantor. The three methods are (1) placing capital at risk, (2) placing the franchise's ability to continue to do business with the Public Guarantor at risk, and (3) placing mortgage-servicing rights (MSRs) at risk.

The new system is designed around the first of these—putting private capital at risk and assuring one or more private entities hold capital sufficient, as determined by the Public Guarantor, to cover the predominant risk under extreme stress testing. While the issuer should be permitted to lay off most of this risk (to either a third-party mortgage insurer approved by the Public Guarantor or through a capital markets solution, such as a structured security or derivative), it should be expected to retain some portion of the risk and reserve capital to cover it, consistent with having an option to achieve sale treatment. The Public Guarantor should be authorized to set this amount at a level it deems sufficient to make sure the interests of the issuer are aligned.[92] In addition, issuers put capital at risk by retaining responsibility for repurchasing any loans that are found to have violated representations and warranties for a specified period of time, even if they sell their servicing rights.

It is not sufficient just to stipulate that the private counterparties hold a certain amount of capital to cover predominant credit losses. The Public Guarantor must also have the authority and be explicitly charged by Congress to monitor the capital positions of its counterparties and demand that they raise capital if they fall short of mandated levels.[93]

The second method of aligning incentives—placing the franchise's ability to do business at risk—is a powerful tool. Businesses with operations that depend on the continued ability to do business with the Public Guarantor, and the secondary market it supports, will avoid taking actions that could cause them to lose their status as approved actors in the new housing finance system. This is why the Public Guarantor must have approval and examination authority over its counterparties.

Finally, in cases where the issuer is also the originator of the loan, the issuer should be permitted to sell its MSRs. (It would already be obligated to retain some risk.) In cases where the originator sells the loan to an issuer or acts as a broker for the issuer, however, the originator should be required to retain the MSRs. Otherwise, it would not have an ongoing interest in loan performance that would help assure the quality of the loan at origination. Unlike Fannie Mae, both life insurance companies and Freddie Mac do not demand risk-sharing by the seller and currently often require that MSRs remain with the originating lender.

Reform, strengthen, and streamline FHA multifamily programs.

Like Fannie Mae and Freddie Mac, FHA ramped up its share of loan originations to offset the flight of private capital from the housing finance system during the Great Recession. FHA's multifamily loan performance has held up relatively well under the pressure of the economic downturn, with delinquencies peaking in December 2011. Even for loans originated in 2009—by far the worst book of multifamily business for FHA—the delinquency rate of 5.15 percent is substantially below the delinquency rate of nearly 24 percent for loans originated in 2007 that resulted in the worst book of business for private-label CMBS issuers.[94]

The commission believes FHA should continue to play its essential role in facilitating liquidity for the construction and refinance of rental properties with long-term, fixed-rate financing. The risks involved in this lending are perceived to be higher, and steady debt payments are often important to attract equity investment. Absent FHA's 100 percent guarantee of credit risk and the option for delivery into government-wrapped Ginnie Mae multifamily CMBS, lenders might not otherwise be able to offer these products to the owners and developers of rental properties in all parts of the country.

FHA is restricted in its activities by congressionally mandated statutory loan limits, which ensure it provides support only to properties that would typically be affordable to moderate-income households at loan origination. FHA plays a unique role in supporting this market with long-term, fixed-rate financing for new construction and rehabilitation (primarily through the Section 221(d)(4) program) and refinances of existing properties (primarily through the Section 223(f) program).[95] The combination of insuring 100 percent of the principal balance on existing, substantially rehabilitated, and new multifamily rentals—as well as offering long-term, fixed-rate financing without balloon risk, on fully amortizing loans with amortization periods as long as 40 years and with loan-to-value ratios as high as 85 percent—has made FHA an important source of liquidity to this segment of the market.

The commission believes the FHA should remain focused on providing standardization and liquidity to the markets it currently serves, and FHA-insured mortgages should continue to be guaranteed by Ginnie Mae. However, the commission also believes the FHA's multifamily operations should be streamlined to avoid lengthy delays often associated with doing business with FHA, and its role in the market should not extend beyond that which would not otherwise be served by private capital. More specifically, the commission recommends the following:

- *Address administrative inefficiencies.* Developers and lenders have long criticized FHA for being inefficient, and causing lengthy delays and uncertainties in loan approvals. HUD has recently made great strides to improve processing times and review of new applications, and these initiatives should be continued. In addition, the non-core multifamily programs administered by FHA that do not expand liquidity of capital for housing should be reviewed, and FHA should provide a rationale for their continuation or make a case for their discontinuation to Congress.
- *Take steps to avoid the crowd-out of private capital.* FHA provides a 100 percent loan guarantee and therefore risks crowding out private capital that might be willing to stand in front of the federal government or assume all of the credit risk—even in this more-difficult-to-serve market. Therefore, FHA should periodically evaluate its market share to ensure it is not crowding out private insurers and lenders who would serve the market at a comparable cost to FHA. FHA should keep in mind that one of its public policy objectives is helping to retain existing affordable rental properties.
- *Strengthen partnerships between FHA and Housing Finance Agencies.* FHA should continue to be authorized to insure properties that receive Low Income Housing Tax Credits (LIHTC) and should explore options for improving coordination with the LIHTC and HOME Investment Partnerships programs. It should also continue to offer risk-sharing programs with Housing Finance Agencies over a range of multifamily products (provided developments meet the affordability requirements enumerated above). FHA has proven useful in helping the Housing Finance Agencies pursue affordable rental housing goals, and these agencies typically make allocation decisions involving tax credits and subsidies.

Address the unique financing needs of small multifamily rentals.

As noted above, small (one-to 49-unit) properties make up about two-thirds of all rental units, with one- to four-unit rental properties making up somewhat more than half of all rentals.

While five- to 49-unit properties are served by the multifamily finance system, the commission heard repeatedly that these smaller properties have historically been more difficult to finance with long-term, fixed-rate financing and funding from the capital markets than have the roughly 30 percent of rentals in 50-plus-unit properties.[96] For example, in 2001 not only did a smaller share of five- to 49-unit properties—compared with 50-plus-unit properties—have mortgages; less than half of the five- to 49-unit properties that did have mortgages had fixed-rate payments compared with over 70 percent for 50-plus-unit properties. In looking at the share of small properties that have a mortgage (and, among those that do, the share that have long-term, fixed-rate financing), the commission was unable to determine how much of the observed differences are a result of the debt preferences of the investors in these properties or how much they reflect structural difficulties in supplying credit to them.

However, the commission was persuaded of the need to do more to understand the market for mortgage finance for one- to 49-unit properties and explore ways to better facilitate financing to it. In a reformed system with multiple issuers of multifamily securities eligible for a government catastrophic guarantee, some of these issuers might try to serve this niche market more effectively than past efforts by Fannie Mae and Freddie Mac. The Public Guarantor should be encouraged to be responsive to private issuers who express an interest in a guarantee on small multifamily CMBS, while maintaining a policy of requiring catastrophic insurance premiums to cover potential losses after private credit enhancements are exhausted.

In addition, the commission makes the following recommendations:

- *Explore opportunities to provide financing to small scattered-site rentals on a bundled basis.* Untapped opportunities exist for the bundling of several non-contiguous properties into a single multi-site, multifamily property for the purposes of financing their development and acquisition. For example, there are private firms interested in purchasing multiple single-family homes from Fannie Mae and Freddie Mac out of their real estate-owned (REO) stock and financing the acquisition with a single multifamily mortgage. Indeed, Fannie Mae is experimenting with bulk sales of its REO properties in a related way. The Public Guarantor should have the flexibility to explore opportunities to backstop loans to properties with five or more non-contiguous, single-family or two- to four-unit buildings as a single multi-site, multifamily property for financing purposes and to assess possible benefits and unintended consequences of this approach.[97] These opportunities would include purchases to be held in land banks, which are a promising mechanism to help distressed communities strengthen their property markets.[98] To the extent that the Federal Home Loan Banks or Fannie Mae and Freddie Mac have experience with multi-site, multifamily finance, review of these activities should be undertaken to inform development of future financing products.
- *Review the impact of passive loss rules for small rental properties.* The Tax Reform Act of 1986 disallowed the practice of using losses from "passive activities"—including investment in rental properties—to offset "active income" from other, unrelated activities. The limitation on passive losses, however, permits taxpayers with incomes under $100,000 (phased up to $150,000) to deduct up to $25,000 of losses from rental property that they actively manage. The limitation was intended to restrict the excessive tax benefits that contributed to overbuilding in the early 1980s (which contributed to supply overhangs into the early 1990s). However, it may also have led to declines in investment in small rental properties by individual investors—for example, a dentist who took a stake in a two-flat rental property to earn extra income. Further analysis should be undertaken to review the impact of the passive-loss rules, specifically to assess the potential to increase the number of affordable rental units by attracting greater equity into the investment market by exempting rental properties with fewer than 50 units and by indexing the $25,000 limit to inflation.
- *Re-assess the appropriate division (or divisions) of the Public Guarantor within which to site small multifamily rentals.* In a redesigned housing finance system, the Public Guarantor should be granted the authority to decide whether it is sensible for one and/or two- to four-unit properties that contain at least one rental unit to fall within the domain of its multifamily division (which could be renamed the "rental division") or its single-family division. The Public Guarantor should also have the authority to regulate the activities of its private issuer/servicers and credit enhancers so that they align with how two- to four-unit rental properties are handled.

- *Pursue additional research to enable improved decision-making and underwriting.* The FHFA, in conjunction with Fannie Mae and Freddie Mac, should study the loan performance of their two- to four-unit property portfolios at different points in time and simulate their performance under certain stress tests. The aim of these studies would be to identify factors that may have contributed to the poorer historical performance of these properties in terms of underwriting, valuation methods, product features, location, number of units, residence of owners, and other factors that may have contributed to higher serious delinquency rates and loss severities.

In conjunction with Fannie Mae and Freddie Mac, the FHFA should also conduct a thorough review of the experience of the two GSEs in purchasing and guaranteeing small (five- to 49-unit) multifamily rental properties in order to make recommendations about whether a future government guarantor of catastrophic risk could help facilitate a stronger secondary market for these properties and organize itself better to properly underwrite and price the risk of this lending.

Additional Recommendations

The commission examined other ways that the financing of rental housing could be improved and offers the following additional recommendations:

Facilitate partnerships with mission-driven lenders. A new system of rental housing finance should support and enhance the role of Community Development Financial Institutions (CDFIs) and other mission-driven lenders. While CDFIs typically provide pre-development and construction financing, access to long-term permanent financing—through direct issuance of securities or sale to an aggregator—would enable them to better support affordable rental housing of all sizes, including small properties. As part of these efforts, emphasis should be placed on strengthening CDFIs' access to debt financing, including by promoting their continued membership in, and access to, advances through the Federal Home Loan Bank System.[99]

Further, Congress should give immediate and serious attention to HUD's proposal to establish an FHA risk-sharing program with Housing Finance Agencies around small multifamily properties. Furthermore, HUD should build evaluation methods into the original program design.

Improve data collection. The federal government should improve its data collection and coverage for the multifamily housing finance system, including collection of information about originations, servicing, and loan performance. Better data would allow researchers and market analysts to develop a deeper understanding of activity and participants in the system, currently and over time.

Structure of the Public Guarantor

The commission envisions the establishment of a single Public Guarantor with responsibility for both the single-family and rental housing markets. The Public Guarantor would consist of two separate divisions each with responsibility for administering its own separate catastrophic risk fund. Each division would also establish its own approval standards for lenders, issuers, servicers, and private credit enhancers as well as underwriting standards, predominant loss coverage requirements, and catastrophic guarantee fees.

The Public Guarantor should be established as an independent, wholly owned government corporation. As a government corporation, the Public Guarantor will be a self-supporting institution that does not rely on federal appropriations but rather finances the two catastrophic funds and its own operational expenses through the collection of g-fees. The Public Guarantor should operate independently of any existing federal department and, with this greater independence, should be able to respond more quickly to contingencies in the market and operate with greater efficiency in making staffing, budgeting, procurement, policy, and other decisions related to mission performance. It should be given sufficient flexibility to set compensation levels that are at least somewhat competitive with other employers within the financial services industry, and it should have the ability to appoint and compensate such outside experts and consultants as necessary to assist the work of the organization.

To ensure continuity and build on existing government capabilities, Ginnie Mae—enhanced with greater authorities and flexibilities—could assume the role of Public Guarantor. In that case, Ginnie Mae would be removed from HUD, spun out as a separate and independent institution, and given the necessary authorities so that it could successfully discharge its responsibilities as the standard-setting body for a large segment of the mortgage market. In addition to discharging its responsibilities as the Public Guarantor, the enhanced Ginnie Mae would continue on an uninterrupted basis to perform its traditional function as the guarantor of the timely payment of principal and interest on MBS backed by single-family and multifamily loans insured by the FHA, VA, USDA, and the Office of Public and Indian Housing.

The Public Guarantor should be led by a single individual, appointed by the President of the United States and confirmed by the U.S. Senate, who would serve as director. Vesting ultimate leadership authority for the Public Guarantor in a single individual should promote accountability and ease of decision-making. This individual should have a demonstrated expertise in financial management and oversight, as well as a deep understanding of the capital markets, particularly the mortgage securities markets and housing finance.

An Advisory Council to the Public Guarantor should be established, consisting of the chairman of the Board of Governors of the Federal Reserve System as chairman of the Council, along with the director of the Public Guarantor, the secretary of the U.S. Department of the Treasury, and the secretary of HUD. The Advisory Council would meet on at least a quarterly basis to share information about the condition of the national economy, marketplace developments and innovations, and potential risks to the safety and soundness of the nation's housing finance system.

Chapter 4. Affordable Rental Housing

Demand for rental housing is increasing in many regions throughout the United States, and the number of renters spending more than they can afford on housing is unacceptably high and growing. Demographic trends, described earlier in this report, clearly highlight the continued and growing role that rental housing will play in meeting the nation's housing needs, including for young adults starting out and seniors looking to scale back their home-maintenance responsibilities. Most of us will rent at some point in our lives, and many American households prefer the flexibility and convenience of rental housing. It is therefore important that an adequate supply of stable, affordable rental housing is available to meet these needs and preferences.

Our proposals for rental housing finance reform, described in the previous chapter, are designed to ensure there is sufficient mortgage liquidity to support the continued availability of rental housing that is broadly affordable for households at all income levels. In this chapter, our proposals focus on meeting the rental housing needs of the lowest-income households—helping to provide high-quality, stable housing for the most vulnerable individuals and families, and promoting positive outcomes like improved educational performance by children and better physical and mental health. We also propose reforms to the rental assistance delivery system that focus on outcomes, helping to improve the effectiveness and efficiency of housing programs and providers.

The Crisis in Affordable Housing

Housing Challenges Facing Our Nation's Renters

According to the U.S. Census, the nation's 41 million renter households account for 35 percent of all U.S. households. Compared with the U.S. population as a whole, the renter population has lower incomes, with two-thirds of renter households reporting incomes below 80 percent of the area median income (AMI) and nearly half reporting incomes below 50 percent of AMI. The median household income for renter households in 2011 was just $30,934 compared with $64,063 for owner occupied homes.[100] In other words, renters as a group earn about one-half what homeowners do.

For the most part, renters live in housing that meets basic quality standards, but nearly half of all renters report paying more than 30 percent of their income for rent, signifying a "moderate rent burden" under federal standards for affordable housing. About 25 percent of the 41 million renter households report a "severe rent burden," spending more than half of their income for housing.[101]

Terms and Definitions

The federal standard for affordable housing is that a household should pay no more than 30 percent of its income for rent. "Rent burden" is a term used to indicate the extent to which a household spends a disproportionate share of its income on rental costs.

If expenditures on housing (rent plus utilities) account for:

- 30 percent or less of their income, a household is not considered to be rent burdened.
- Between 30 and 50 percent of income, a household has a "moderate rent burden."
- Above one-half of household income, a household has a "severe rent burden."

These standards are general rules of thumb and do not always tell the whole story. For example, a single person may choose to take on a moderate rent burden to live in a desirable neighborhood or larger apartment without experiencing any decrease in quality of life, while a family of four may rent a single-family home in an outlying area and have no formal rent burden but very high transportation costs, leading to combined housing and transportation costs that are unaffordable.

"Low income" is a term used to indicate a household's income level relative to other households in the same metropolitan area.

If a household has an income:

- Above 50 percent, up to and including 80 percent of the AMI, it's a "low-income" household.
- Above 30 percent, up to and including 50 percent of the AMI, it's a "very low-income" household.
- At or below 30 percent of the AMI, households are considered "extremely low-income."

As Chart 4-1 shows, rent burdens vary considerably by household income.

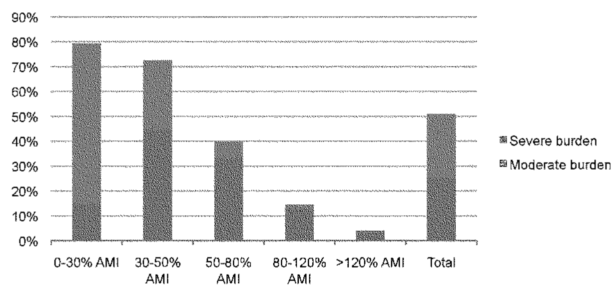
Nearly 80 percent of extremely low-income renters report a rent burden, with most—64 percent—reporting a severe rent burden. The overall incidence of rent burdens is nearly as high for the next income group—very low-income renters—but severe rent burdens are much lower for this group. The incidence of both moderate and severe rent burdens continues to fall as incomes rise, with severe rent burdens falling to 7 percent for low-income households and nearly disappearing for higher-income groups.

Chart 4-2 highlights a major reason why extremely low-income renters face such high housing cost burdens: the mismatch between the number of extremely low-income renters and the number of affordable units that are currently available to them.

In 2009, only 3.7 million rental housing units were both affordable and available to extremely low-income households—far fewer units than needed to provide affordable housing to the nation's 10.3 million extremely low-income renter households. (HUD defines a unit as available to a particular income group when it is either vacant or occupied by a household with that income or a lower income.) This mismatch would likely be even larger if we considered only those homes located in safe, amenity-rich neighborhoods with good-performing schools and access to jobs. By contrast, low-income households and higher- income households (those with incomes above 80 percent of AMI) experience surpluses of affordable and available units, although these surpluses are in specific markets and change over time.

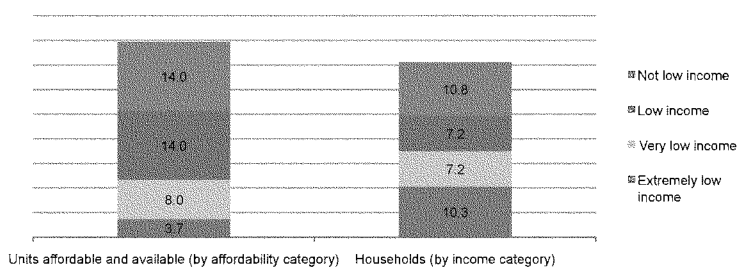
"Worst case needs" for rental housing—a statistic HUD uses to keep track of renters who do not receive housing assistance, and either pay half of their income for housing or live in severely substandard housing—grew 20 percent

Chart 4-1: Housing Cost Burdens Among U.S. Renters, 2009



Source: Steffen, Barry et al. *Worst Case Housing Needs 2009: Report to Congress.* (Washington, D.C.: U.S. Department of Housing and Urban Development, Office of Policy Development and Research, 2011), 28.

Chart 4-2: Rental Units and Renters, by Affordability and Income Categories (in millions, 2009)



Source: Steffen, Barry et al. *Worst Case Housing Needs 2009: Report to Congress.* (Washington, D.C.: U.S. Department of Housing and Urban Development, Office of Policy Development and Research, 2011), 55. Based on a chart in Danilo Pelletiere. *A Preliminary Analysis of the 2009 and 2007 Rental Affordability Gaps.* (Washington, D.C.: National Low Income Housing Coalition, 2010), 4.

between 2007 and 2009. But renter problems were on the rise before then as well, with the number of households with worst case needs growing 18 percent between 2001 and 2007. Renters paying excessive shares of income for rent and utilities often have insufficient income available to meet their basic needs for food, health care, education, and transportation—undermining child and adult health and contributing to residential instability that can, among other things, impair educational achievement and employment potential.[102]

Compounding their difficulties, low-income households are often employed in low-wage or temporary jobs that are vulnerable to layoffs and reduced work hours. One study found that about 20 percent of households with children in the lowest-income quintile experience a loss of more than 50 percent of their income in any given year, with only about half of these households fully recovering the lost income within the same one-year period.[103] Unpredictable income shocks can lead to household stress and inability to plan for the future, and income volatility has been cited as a causal link to homelessness.[104] Without an ability to cushion the impact of this temporary loss of income, households may experience severe residential instability.

Factors Driving Increases in Renter Cost Burdens

Housing cost burdens for renters have risen dramatically in recent years, and the factors driving these increases are neither novel nor difficult to identify. Unemployment, stagnating incomes, and volatile wages for those at the low end of the income spectrum greatly compromise families' buying and saving power, leaving them with limited resources to meet basic needs such as shelter. At the same time, the supply of rental housing affordable to these families falls well short of demand, driven by the loss of affordable rentals to conversion, demolition, or other factors and an insufficient supply of rental subsidies that reduce renters' monthly housing costs. In the absence of government support, high land prices and construction costs make it difficult for the private sector to develop non-luxury, market-rate housing.[105] While much of the unsubsidized yet affordable stock of privately owned housing consists of older structures that have become more affordable over time, strong competition for these units leads to higher rents and—in many markets—the upgrading of these older units to meet the needs and preferences of higher-income households.

In the past, the development of new apartments could lead renters with higher incomes to move on to updated units with more amenities, allowing older units to filter down to households lower on the income ladder. However, one of the problems inhibiting the filtering down of older rental units today to levels affordable to low-income households is the proliferation of barriers to new development or redevelopment that either prohibit certain types of development entirely or raise development costs to levels that make it economically infeasible. These barriers include local land-use regulations that restrict density directly or indirectly through the use of parking and other requirements, impose lengthy permitting or environmental review processes that may entail additional expenses in return for permits to build, or require a zoning variance to build multifamily housing developments. Other barriers include local restrictions on innovative and efficient reuse of existing properties, such as the development of accessory apartments (sometimes known as "granny flats") or the rental of excess rooms to boarders. In some cases, these regulations are the result of Not in My Backyard, or NIMBY, sentiment, which adds uncertainties and obstacles to development.[106]

While many of these regulations may strive to advance important policy goals, in the aggregate they increase the cost of housing and inhibit the development of new affordable rental housing by extending the development timeframe and increasing the risks associated with development.[107] These regulations also prevent the construction of non-luxury rental housing that could help meet the needs of moderate-income households and allow older developments to filter down to rent levels affordable to low-income households. In addition, both federal and local regulations often discourage or inhibit the development of economically diverse, mixed-use neighborhoods that can help support educational achievement and economic mobility for low-income families.

Current Limits of Federal Rental Assistance

In all, federal rental assistance programs currently help approximately five million American households afford housing, providing critically needed shelter and stability for older adults, persons with disabilities, families with children, and other low-income individuals.[108] However, because of the lack of resources, only about one in four renter households eligible for federal rental assistance receives it,[109] resulting in an inequitable system in which housing subsidies are allocated by lottery or through ever growing waiting lists. Many of the lottery losers become residentially unstable and move frequently—at great expense to their health and their children's educational prospects. Some even become homeless.

Existing federal housing assistance programs do a good job achieving the overarching goal of reducing housing costs to levels families can afford. But given the significant remaining unmet need for rental assistance and today's fiscal challenges, the nation's rental assistance programs must achieve a higher level of performance. These programs must also more fully realize the potential of rental assistance to substantially improve the life opportunities of assisted households—for example, helping older adults to lead independent lives and work-capable households to make progress toward economic self-sufficiency, and enabling families to move to neighborhoods with greater opportunities.

Available data suggest that affordable rental housing is likely to become even more scarce in the coming years, with the production of rental housing failing to keep pace with demand.[110] Looking ahead, the nation's demographic trends indicate that the number of renter households will increase dramatically over this decade, as Echo Boomers begin to form their own households and as Baby Boomers seek to downsize from their existing homes and into living situations with less upkeep and fewer maintenance requirements. It is estimated that the construction of at least three million new multifamily rental units will be necessary over the next ten years to meet this growing demand,[111] a target unlikely to be met without a concerted focus to help stimulate new production by the private sector. Absent this focus, rents are likely to continue to rise faster than incomes, exacerbating the nation's already significant housing affordability challenges. And without subsidies, the private sector will not be able to provide housing at a cost that extremely low-income households can afford.

Historical Context: How We Got Where We Are Today

In 1937, the federal government began to provide rental assistance to the nation's low-income households in a targeted way through the establishment of a public housing program as part of the U.S. Housing Act.[112] This Act established a new federal agency focused on housing, the U.S. Housing Agency (a precursor to HUD), and required the establishment of local public housing authorities to build, own, and operate housing using debt financing guaranteed and paid for entirely by the federal government. Tenants occupying the new public housing units were obligated to pay rents that covered building operating expenses, but not construction expenses.

Following World War II, the shortage of adequate housing, particularly for returning veterans, caught the nation's attention. The 1949 Housing Act, along with setting a national housing objective of "a decent home and a suitable living environment for every American family," authorized funding for nearly one million additional units of affordable public housing.

The late 1950s and early 1960s ushered in a wave of innovation in affordable housing, including the establishment of new programs that created incentives for private developers and investors to produce and own assisted housing with the government's support, such as the Section 202 program for housing the elderly and the Section 23 Leased Housing Program to provide leased affordable housing in privately owned properties. The Section 236 Program, created by Congress in 1968, offered subsidies to reduce the interest rate paid on mortgages insured by the FHA in return for rent limits.

As a result of a combination of factors—including the energy crisis of the early 1970s, which drove up costs in many privately owned, federally subsidized properties; corruption; and incompetent management—in 1973 the Nixon administration declared a moratorium on all subsidized production in both HUD and the USDA rural-housing programs. The Nixon administration then followed up the moratorium with a series of proposals to overhaul the federal government's role in rental housing assistance. Congress responded by adopting the Housing and Community Development Act of 1974, which created the Section 8 program, as a more flexible means of delivering rental housing assistance to the lowest-income households by focusing on rental subsidies to or on behalf of tenants rather than subsidies directly paid to developers. Through this program, funds were made available to support new construction, rehabilitation, and tenant-based rental assistance in existing properties. Although the 1974 Act helped to retain existing public housing units, approvals for new development were scaled back. The stock of public housing that had grown from about 150,000 units in the 1950s to over one million units in the 1970s began to decline. The 1974 Act also called for the consolidation and restructuring of a number of federal housing programs.[113]

During this period, increases in rents due to escalating operating and maintenance costs and declining resident incomes meant that many residents of public housing were spending upwards of 75 percent of their incomes on rent and utilities. In response, Congress adopted, in 1969, the so-called "Brooke Amendment," championed by Massachusetts Republican Senator Edward W. Brooke, which limited a tenant's rent to 25 percent of income in public housing. This action, while benefiting tenants, had the effect of lowering the amount of operating capital available to cover the costs of an affordable property. HUD therefore had to provide additional capital to agencies for the maintenance and operation of public housing properties, spurring adoption of annual operating subsidies as well as separate modernization (or "capital") funding to restore aging stock. Through the Omnibus Budget Reconciliation Act of 1981, Congress raised the minimum tenant payment required from 25 to 30 percent of income, in part to help cover operating costs.[114] The Brooke Amendment that established the 25 percent of income limit is responsible for the income-based rent structure that exists to this day in federal housing programs.

In 1986, the Low Income Housing Tax Credit (LIHTC) program was created as part of the Tax Reform Act with bipartisan support, replacing a series of other tax subsidies that had been in place for decades to encourage investment in affordable housing. LIHTC created a new and more efficient means of developing rent-restricted, affordable housing using tax subsidies and became the primary means by which the federal government supports the development and preservation of affordable housing.

During the severe recession of the early 1980s, the problem of large-scale homelessness appeared in America's cities for the first time since the Great Depression. In 1988, Congress passed the Stewart B. McKinney Homeless Assistance

Act (later the McKinney-Vento Act) to put homeless assistance on the national housing agenda. Funding for homeless initiatives grew rapidly thereafter through the 1990s and 2000s, and numerical goals were put in place to end chronic homelessness through coordinated and comprehensive approaches that combine housing assistance with specialized services where necessary.

In the 1990s, the devolution of federal authority in rental assistance programs that began with the 1974 Act was further reinforced through the creation of the HOME Investment Partnerships (HOME) program. This program introduced a flexible block grant to states and municipalities that builds on the existing infrastructure and partnerships between HUD and the public agencies, nonprofits, faith-

History of Homeless Assistance

For many years, homelessness was thought to be a temporary recession-related problem exacerbated by factors such as the deinstitutionalization of people with mental illness and the emerging AIDS epidemic. As a result, the interventions funded were largely short term: shelter, food, and transitional housing. HUD was the major funder, but targeted services funding was provided through a collection of homeless-specific programs at the Departments of Health and Human Services, Veterans Affairs, Labor, and Education, among others.

It soon became clear, however, that the real driver in homelessness was the lack of affordable housing and that persons with disabilities were simply the first to face the problem. By the end of the 1980s, despite a robust recovery, mass homelessness had increased and had come to affect non-disabled adults, families, and even youth. Accordingly, over time and with strong support from both Republicans and Democrats, homeless assistance was altered to include more permanent solutions, particularly housing. The first focus was on single-room occupancy housing for single adults, and this later shifted to permanent supportive housing (subsidized housing with services) for people with disabilities, based on strong research showing its cost-effectiveness.

More recently, a new housing strategy, called rapid re-housing, has emerged to assist the 80 percent of homeless people whose problem is largely economic. By negotiating with landlords; providing deposits, move-in money, and short-term rental assistance; and connecting people with services in the community, rapid re-housing helps households that have lost their housing.

Both permanent supportive housing and rapid re-housing use an approach labeled "Housing First"—helping the homeless person to get in to housing immediately then following up with employment assistance, mental health treatment, or whatever other kinds of services are necessary to ensure that the housing is stabilized.

While HUD provides most of this funding, the VA has become increasingly involved. In partnership with HUD, it now provides permanent housing subsidies linked to services offered by the VA to high-need homeless veterans. In its new Supportive Services to Veteran Families program, it also funds rapid re-housing.

Through these programs, and in conjunction with other financing sources (including LIHTC), a significant amount of housing assistance is now being provided via homeless programs. In recent years, HUD has expanded the number of permanent supportive housing opportunities by approximately 20,000 per year.[115] There are now some 275,000 units of permanent supportive housing.[116] Well over one million households have been assisted with rapid re-housing funds. Republican and Democratic administrations have made commitments to solve all or parts of the homeless problem, the most recent being the Obama administration's pledge to end chronic and veteran homelessness by 2015 and family homelessness by 2020.

based organizations, and private entities in the affordable housing field. States and local governments are given wide discretion over how to use the funds to benefit low- and moderate-income households.

More recently, two federal housing initiatives—HOPE VI and Choice Neighborhoods—have helped transform the nation's housing stock by bringing the operating practices of the 20th century to public housing in order to establish a more effective approach to supporting the lowest-income households. HOPE VI emerged from the recommendations of the National Commission on Severely Distressed Public Housing, and was first funded by Congress in 1993. HOPE VI followed a series of earlier initiatives launched by former HUD Secretary Jack Kemp, which he hoped would increase resident empowerment and quality of life in public housing. The program worked to demolish and rebuild the existing distressed public housing stock that had become synonymous with concentrated poverty and substandard conditions with lower-rise, higher-quality homes connected to services and amenities. Residential empowerment was central to the aim of the HOPE VI program, as was reducing density and promoting mixed-income communities. The Choice Neighborhoods Initiative, proposed by the Obama administration and authorized by Congress in 2011, built upon the success of HOPE VI. It aims to transform distressed communities into mixed-income places tying the importance of increased access to jobs, supportive services, and economic and educational opportunity into housing developments.

Recommendations for a Reformed Rental Assistance System

The commission strongly endorses the 1949 Housing Act goal of a "decent home and a suitable living environment for every American family." We note that the poorest households among us are suffering tremendous burdens. Increasing levels of poverty—particularly among children, elderly, and working families—give us a strong sense of urgency about our recommendations. Working to address these critical needs and achieve the goal laid out in 1949 is, of course, an ongoing enterprise requiring a sustained policy commitment and the dedication of adequate resources.

At this moment in our nation's history, as our leaders work to put the federal government's fiscal affairs in order, we believe there must be a rebalancing of federal expenditures on housing to ensure a greater focus on helping our most vulnerable households—homeless people and those with extremely low incomes—and those who are suffering a temporary loss of income or a short-term crisis that may jeopardize their housing stability. We do not believe our nation's most impoverished families should be subject to a lottery system or spend years on a waiting list to obtain access to federal rental assistance.

Our recommendations to improve the inadequate affordable rental housing system are presented to respond to specific and urgent needs that are deeply interconnected. Implementation of the entire package of proposals put forth by the commission would be the most effective and enduring way to respond to the challenges faced by our nation's most vulnerable households. We estimate that these recommendations, fully implemented, would help meet the needs of an additional five million vulnerable renter households—through production, preservation, and rental assistance. However, the commission recognizes that a transition period will be necessary to fully realize the specific reforms identified. These are fiscally constrained times where the resources are not readily available to fully support the needs of unassisted households, and calling for any additional spending in the current fiscal environment has its practical limits. We therefore recommend that our approach for meeting the needs of the nation's most vulnerable households be phased-in over time, although we make these recommendations with a strong sense that action is both possible and necessary.

In order to meet the affordable housing needs of the nation's most vulnerable households and to ensure the overall quality of the housing stock, we recommend that the following five objectives guide federal housing policy:

Focus long-term rental assistance on the households with the greatest needs to help them afford decent homes.

Increase the supply of suitable, decent, and affordable homes to address both current and projected demand.

Provide short-term emergency rental assistance to assist families who suffer temporary setbacks that threaten to force them out of their homes and from which recovery can be difficult.

Reform existing rental assistance programs to improve accountability and flexibility within the delivery system, as well as outcomes for participating households.

Advance innovative programs that connect housing to other sectors like employment and education, health and human services, and transportation.

Each of these objectives is discussed in more detail below.

Focus long-term rental assistance on households with the greatest needs

We recommend the federal government increase support for the nation's most vulnerable households, in order to make progress toward the 1949 Housing Act goal of a "decent home and a suitable living environment" for all American families. More specifically, we recommend that federal rental assistance be made available to all eligible households with incomes at or below 30 percent of AMI who apply for such assistance. At the national level, 30 percent of the annual median family income ranges from $13,650 for a one-person household to $19,500 for a family of four.[117] In most areas of the country, renters with incomes below this threshold simply cannot afford private-market housing. As a result of their limited financial resources and the limited availability of federal rental assistance, nearly 80 percent of extremely low-income renters spend more than 30 percent of their income for housing and almost two-thirds spend more than half of their income for housing.

We recommend providing the expanded assistance through a reformed housing voucher program. To reduce costs, we further recommend that, as families currently enrolled in the housing voucher program turn back their subsidies due to rising household income or other factors, all newly available vouchers be issued to extremely low-income households, ensuring that voucher assistance is deeply targeted to the households with the greatest needs.[118] Households who qualify for the program and subsequently experience increased income would not immediately lose assistance; however, these households would be expected to make an increased payment that is proportionate to their increase in income.

Helping to narrow this gap between incomes and housing costs not only directly benefits millions of extremely low-income households, it is also a practical necessity to sustain private investment in the supply of rental housing. If tenants cannot afford the economic costs of their housing, landlords may be forced to choose between two equally undesirable outcomes: defer maintenance and withhold capital investments, or "volunteer" to support the tenants by foregoing a reasonable return on their investments. The latter choice is unreasonable and unrealistic. The former can lead to deteriorated homes and distressed communities. While rental assistance is usually categorized as a social program designed to help meet the basic needs of low-income families, it is also a large-scale investment in the physical infrastructure of our communities. By closing the gap between the cost of owning and operating decent housing and the rent that extremely low-income tenants can afford to pay, rental assistance programs sustain a valuable component of our physical infrastructure that otherwise would be jeopardized.

According to an analysis prepared for the commission by Abt Associates, the estimated annual cost of providing this increased coverage is approximately $22.5 billion.[d] This is the estimated cost of providing a Housing Choice Voucher type subsidy to currently unassisted, cost-burdened renter households with incomes at or below 30 percent of AMI who would be expected to participate in such a program were it available. The estimated cost takes into consideration resources that are projected to become available, over time, as the existing voucher program shifts from serving households up to 80 percent of AMI to serving households with incomes that do not exceed 30 percent of AMI.[119]

These estimates do not take into account any potential savings resulting from fewer families becoming homeless or reduced health care costs. Further research should be conducted to assess the budgetary savings that could be generated through reductions in the number of households in need of homeless or emergency care services.

At a time when there is enormous pressure and competition for existing federal resources, we know this is an ambitious goal; however, it is one we feel is necessary to support the needs of our nation's most vulnerable households. By placing a floor under the most vulnerable households, this recommendation would have a number of immediate and profound impacts. It could, in effect, end homelessness for the vast majority of those experiencing it. Virtually all households experiencing homelessness have incomes under 30 percent of AMI, and 80 percent of those who become homeless do so almost exclusively for economic reasons.[120] For the approximately 20 percent of homeless persons with disabilities,[121] stable housing would need to be combined with treatment and other services, but the affordability of the housing would effectively end their homelessness. All vulnerable persons with disabilities and elderly households would be able to count upon stable housing. The most vulnerable and extremely low-income families with children would not face disruptions in employment or their children's education because of the lack of an affordable home.

Increase the supply of suitable, decent, and affordable homes

Our nation has developed a stock of nearly five million subsidized rental homes that provide quality affordable housing, including units funded through the LIHTC, the project-based Section 8 program, the Section 202 and 811 supportive housing programs for the elderly and persons with disabilities, public housing, and the rental housing programs at the U.S. Department of Agriculture.[122] In the coming years, these properties will play an even more vital role in housing the growing population of low-income adults over age 65, many of whom are aging in place in affordable rental units that were not initially designed to meet their current needs. Many of these properties are aging and not only need repair, but are operating inefficiently, resulting in crippling energy costs. With adequate funding for maintenance and modernization, this stock can provide decades of additional service, helping millions of households obtain and remain in stable, affordable housing.

To increase the supply of suitable, decent, and affordable homes, the commission recommends:

Protect and expand the Low Income Housing Tax Credit as the bedrock of the nation's efforts to preserve and increase the supply of affordable rental housing.

The LIHTC[123] is a capped federal tax incentive that is allocated to developers through state housing finance agencies. Developers compete for credit awards through applications that are scored based on how closely the proposed development would meet the affordable housing

d. Abt Associates has prepared a memorandum on this topic that provides the details of their analysis. See *Projections for 10-year Costs of Deep-Subsidy, Voucher-Type Program Offered to Unassisted Renter Households Below 30 Percent of AMI* found on the BPC Housing Commission website at www.bipartisanpolicy.org/housing.

priorities of the state as laid out in an annual qualified allocation plan, or QAP. The properties must be rented to tenants with incomes at or below 60 percent of AMI at rents that are capped for a period of at least 30 years. Federal law requires that states give preference to properties that target lower incomes; as a result, about 41 percent of LIHTC residents have incomes at or below 30 percent of AMI, and 80 percent have incomes below 50 percent of AMI, according to a recent study conducted by the Furman Center at New York University that found that many of these residents were benefitting from other subsidies like Section 8, as well.[124]

It is not economically feasible to develop affordable housing at restricted rents, so a subsidy is needed to make up the difference between what a property costs to develop and the income that can be generated to support such development costs. The LIHTC plays that role. Because rental income is limited, affordable housing properties are not able to support sufficient levels of debt to finance development of the property. This contrasts with other real estate—both residential and nonresidential—which typically is substantially financed by debt. Developers use the tax credits to raise equity capital from investors in the property that serves as a substitute for higher levels of debt. Equity investors receive a stream of tax credits for ten years that reduces their tax liability on a dollar for dollar basis.

The program has a number of features that have made it a successful tool in affordable housing development. Most importantly, the program is administered at the state level by housing finance agencies that go through an annual process to develop allocation plans based on the housing needs of the state. These QAPs ensure that affordable housing investment is aligned with the housing needs within the state. This structure also builds flexibility into the system that enables states to continually tailor their plans to address evolving housing needs.

Another key feature of the program is the means by which it engages market forces to build affordable housing. This engagement occurs at a number of levels. First, developers compete against each other to obtain an award of credits. In most states, the number of applications far exceeds the available credits, causing developers to structure their applications to earn the most points possible under the state allocation plan. Second, investors compete against each other to invest in properties, a process that maximizes the prices they are willing to pay for the credits, resulting in greater taxpayer efficiencies. Third, profit margins for the companies that provide syndication services to raise equity capital and purchase LIHTC properties are driven down as they compete against each other, also benefiting the taxpayers.

A final feature that has made the LIHTC so successful is the minimization of risk to the federal government. The LIHTC is a pay-for-performance program in which the private sector, not the government, bears the full real estate risk of the investment. If for any reason the property falls out of compliance within the first 15 years, stringent IRS recapture rules require the investor to pay back a portion of the tax credits claimed in previous years.

The positive results are evident in the program's track record. Over the first 24 years of the LIHTC program's existence, it financed more than 16,000 properties, or 1.2 million units, across the country. During that period only 98 properties experienced foreclosure, an aggregate foreclosure rate of just 0.62 percent.[125] This record is unmatched by any other real estate class, including residential and nonresidential real estate.

In recent years, the LIHTC has been called upon to carry a larger load in serving the affordable housing priorities of federal and state governments. The use of the program to create new affordable housing has declined as a greater share of credits has been used to preserve the stock of existing affordable housing, including both the federally assisted inventory of housing and older LIHTC properties that are in need of recapitalization. As HUD expands its efforts to revitalize an aging public housing stock by tapping the private capital markets, Housing Finance Agencies will undoubtedly be asked to allocate an increasing share of housing credits for the conversion of public housing units.

The commission strongly believes the LIHTC must be preserved. Furthermore, to help address the growing demand for rental housing, we recommend that the annual LIHTC allocation be increased by 50 percent, as the resources are identified, to support a higher level of affordable housing development. We estimate a 50 percent increase in the allocated credit would support the preservation and construction of 350,000 to 400,000 additional affordable rental housing units over a ten-year period at an average annual cost of $1.2 billion over the first ten years.

An increase in the credits available would provide an opportunity to refine the targeting of credits to ensure the program is meeting the most critical rental housing needs. One approach might be to allocate additional credits based on a formula that measures a state's share of cost-burdened renters; another approach might be to base allocation on the relative size of a state's renter population. Either would be an improvement over the existing allocation formula, which is based on a per capita calculation and does not reflect differences from state to state in the share of the overall population who rents or has a rent burden.[126]

We strongly endorse the use of LIHTC resources to preserve existing affordable rental properties at risk of loss, particularly in the high-opportunity and gentrifying neighborhoods where owners of these units are most likely to exit the program when affordability requirements expire. However, we recommend leaving the decision on how to best prioritize any new LIHTC resources up to the states.

Provide gap funding sufficient to support an expansion of the LIHTC.

To help ensure effective utilization of the expanded LIHTC, the commission recommends the provision of gap funding at a level sufficient to support this expansion. In most markets, the costs to produce or preserve an affordable rental housing development exceed the funds available through the equity raised by the LIHTC and the debt that can be supported by projected rents. For both current allocations and an expansion of the LIHTC to be most effective, some level of additional funds is needed to cover this gap.

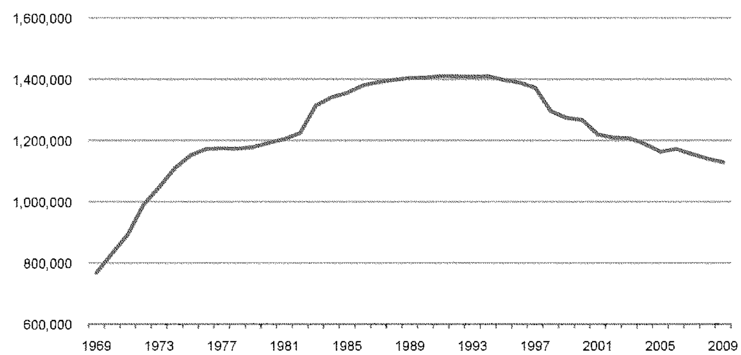
We estimate that $1.0 billion in gap funding would help to support the new development financed though the suggested incremental increase to the LIHTC program. Beyond this funding, an additional $1.0 billion (for a total of $2.0 billion annually) would help support existing LIHTC allocations that have been impacted by the substantial reduction in federal appropriations for the HOME program in FY 2012. The new gap funding should be authorized through the HOME program and restricted for use in conjunction with the LIHTC.

Address the capital backlog and ongoing accrual needs in public housing to preserve the value of prior investments and improve housing quality for residents.

The nation's stock of public housing is deteriorating and shrinking and is in need of basic maintenance and modernization. This slow death-by-attrition wastes valuable federal housing assets and risks the loss of both high-quality and deteriorating units alike. In addition, it penalizes residents.

Accordingly, we recommend an overhaul of the public housing system to (1) introduce market discipline; (2) improve access to private capital; (3) incentivize public/private partnerships; (4) preserve the public investment in properties that have been well-maintained and are located

Chart 4-3: Number of Public Housing Units, 1969 to 2009



Source: Ingrid Gould Ellen, "Rental Housing Policy in the United States: Key Facts and Critical Trade-Offs" (presentation, *The Next Generation Housing Policy Convening on Rental Policy,* Washington, D.C., October 13, 2010), using estimates prepared by the Joint Center for Housing Studies of Harvard University.

in areas of opportunity; and (5) facilitate the transfer of subsidies from properties that are in very poor condition or are located in areas of highly concentrated poverty to newer properties with longer lifecycles and better locations.

While the commission stops short of endorsing HUD's Rental Assistance Demonstration program, we endorse its overall objectives of incentivizing public/private partnerships and facilitating access to private sources of capital by public housing authorities to support the revitalization and modernization of public housing.

The preservation of existing public housing is estimated to cost an additional $4.0 billion annually.[127] Though this additional investment is not likely to increase the overall number of units in the public housing stock, we estimate it would help revitalize and prevent the loss of the existing stock of 1.2 million public housing units over the next ten years. Moreover, where possible, as part of a capital improvements program, steps to improve the energy efficiency of existing public housing structures should be undertaken. By reducing the utility costs associated with the operation of these units, improved energy performance would result in cost savings over time that could be used to support the ongoing maintenance and preservation of the stock.[128]

Encourage the removal of local and state barriers to the development of rental housing.

The nation's housing affordability challenges can be exacerbated by barriers imposed by local and state zoning, permitting and other policies that raise the costs of producing new units or restrict the effective and efficient use of existing ones. While it is not the federal government's role to require local or state governments to adopt specific land-use policies, there are measures that can be taken to encourage better policies. Federal efforts should (1) ensure that communities employing highly restrictive zoning and building code policies that substantially drive up the cost of housing are not rewarded with larger allocations of federal housing funds; and (2) educate local and state leaders about the negative effects of regulatory barriers on affordable rental housing and highlight promising approaches for removing these barriers.

Provide short-term emergency rental assistance

While the incomes of extremely low-income renters are generally insufficient to afford private-market rents without ongoing rental assistance, households with somewhat higher incomes can afford private-market housing on their own in many communities. However, the loss of a job, the death or departure of a working household member, or a major medical crisis can lead to short-term affordability crises that can jeopardize the residential stability of these households, leaving some homeless and others consigned to making multiple unwanted moves. This instability can undermine educational achievement and create or exacerbate health problems. Short-term, targeted funding for security deposits, back rent, temporary rental assistance, and other limited forms of assistance, such as utility payments, could improve residential stability and help prevent homelessness for these renters.

The commission recommends dedicating supplemental funding to the HOME program to deliver one-time, emergency assistance to households with incomes between 30 and 80 percent of AMI. The HOME program currently allows tenant-based rental assistance to be provided to special needs groups—the homeless or those at risk of homelessness. This authority should be broadened to include any low-income household with income between 30 and 80 percent of AMI who demonstrates a need for temporary assistance. Many of the eligible uses described above—security deposits and utility payments—are already allowable expenses through the HOME program and should be continued. Data currently collected through the HOME program does not sufficiently capture the level of detail necessary to demonstrate the effectiveness of this short-term assistance. Grantees receiving this incremental funding should therefore be subject to additional data collection requirements.

According to the analysis prepared for the commission by Abt Associates, the estimated annual cost of providing flexible, one-time emergency assistance to eligible renter households expected to participate is around $3.0 billion, assuming assistance levels up to $1,200 per household.[129] These households would be ineligible to receive assistance under the expanded housing voucher subsidy program for extremely low-income households outlined above, but nonetheless have modest incomes, may live in overcrowded conditions, and experience housing emergencies for which a temporary rental supplement could be beneficial.

This type of program would help to reduce pressure on homeless shelters, lowering the number of temporarily displaced households seeking assistance and generating offsetting savings in programs serving those populations. HUD has experience operating larger-scale programs of homelessness prevention, particularly the three-year Homelessness Prevention and Rapid Re-Housing Program (HPRP) that was part of the 2009 economic recovery legislation. HPRP is widely regarded as having been instrumental in preventing the large increase in homelessness that was expected to result from the Great Recession.[130]

Further study of other mechanisms for delivering temporary emergency assistance could be helpful. For example, a rental insurance program may be a promising way to help households with temporary emergency needs. A rental insurance program would require tenants to make an initial payment upon occupancy of a unit toward an insurance policy that would cover payment of rent and utilities in the event of an emergency. The insurance program would be set up to provide a fixed payment amount to the landlord for a fixed number of months. Though rental insurance programs are promising, they still require rigorous testing to assess their overall effectiveness in preventing homelessness for low-income, unassisted renters; discouraging discrimination against lower-income households; and decreasing the average length of stay in longer-term assistance programs.

Reform existing rental assistance programs

The changes we have proposed above will enable more households to access affordable rental housing. However, we recognize that additional benefits could be achieved if we also improved how housing assistance is delivered. This section describes improvements to the process of delivering rental assistance, providing an important complement to our recommendations for expanding availability.

While HUD's rental assistance programs generally do a good job reducing to affordable levels the rents that households pay, there are a number of significant challenges that must be overcome in order for the programs to more fully realize their potential to improve the life outcomes of assisted households. To address these challenges, the commission proposes a major overhaul of the incentives' structure for all HUD rental assistance programs, creating stronger incentives for housing providers[e] to improve efficiency and housing quality among other desired outcomes. This

e. We use the term "housing providers" to refer to any entity that administers a housing assistance program, including both housing authorities and private owners of multifamily assisted housing.

A Renters Tax Credit

While the commission recommends that rental assistance be delivered through an improved voucher program, a renters' tax credit is another vehicle that illustrates how tax credits could be used to deliver rental assistance and may warrant additional consideration.

A renters' tax credit, developed by the Center on Budget and Policy Priorities, could be administered by states working in public-private partnerships with lenders and/or property owners. This approach is similar to that taken by the LIHTC program and the Section 8 voucher program. States would receive an annual allocation of credits determined by either population or a need-based formula. Credits allocated to each state could be used by low-income renters to reduce rents at a property of their choosing, by property owners offering affordable rental units for low-income households, or by lenders underwriting affordable rental properties. Property owners could either claim the tax credit based on the rent deduction provided, or pass the benefit along to the property's lender in return for reduced mortgage payments.

States would have the flexibility to set their own preferences for how to allocate and use the credits, including in combination with the LIHTC, consistent with federal income eligibility and targeting requirements. The program could also be used to advance identified state policy goals that benefit low-income households. States would be responsible for the program's administrative costs.

Such a program could help increase the ability of low-income households to pay prevailing rents in high-opportunity neighborhoods, as well as help stimulate production and preservation of affordable rental housing for low-income households and reduce homelessness. Renters benefitting from the tax credit would be required to pay no more than 30 percent of their income toward rent with the tax credit making up the gap between what a tenant could pay and the actual rent charge.

proposed system would reward high-performing housing providers with substantial deregulation, providing greater freedom to innovate and depart from standard HUD practices. At the same time, providers who fail to achieve acceptable results should lose the right to administer the programs, with new administrators chosen through competitions held among providers. The end result of these proposed changes would be more efficiency, better outcomes for residents, and more freedom for providers to innovate.

There are important differences among the various HUD rental assistance programs. The outcome-based system we articulate will therefore need to be tailored to the specific characteristics of each program. Nevertheless, the fundamental transformation in the delivery system—a shift in emphasis toward outcomes rather than process, combined with increased accountability for results and greater flexibility for high performers—would benefit all of HUD's rental assistance programs. We propose to apply this new system initially to the three main HUD rental assistance programs: housing vouchers, public housing, and project-based Section 8, followed by adaptations for other more specialized programs, such as Section 202 and 811 supportive housing for the elderly and persons with disabilities, as well as eventually to rental assistance funded through USDA. States could also be encouraged to align the housing priorities articulated in their QAPs with the outcomes we outline below, allowing residents of LIHTC properties to benefit from this outcome-based approach.

A transition period will be necessary during which time various approaches to applying an outcome-based measurement system are considered and evaluated. This transitional period will provide a valuable opportunity to engage stakeholders in conversation—informed by the close analysis of program data—on how to improve the outcomes of our nation's rental assistance programs.

Problems with the Current Delivery System

Overall, the nation's rental assistance programs do a good job of ensuring that participating families have access to affordable rental units. At the same time, however, it is clear that the system can be improved in ways that benefit participants while improving efficiency and reducing administrative burden. High-capacity housing providers and other stakeholders administering HUD's rental assistance programs regularly express a number of concerns with the current delivery system, including:

Overly prescriptive and burdensome rules. The laws and regulations governing HUD's rental assistance programs have, over time, evolved into a set of highly prescriptive rules, which some housing providers believe make it difficult to effectively adapt the programs to meet local needs and generate substantial compliance costs that reduce the ability of agencies to focus resources on improving outcomes for residents. These rules generally were shaped by experience, often a scandal in program administration, and were designed to prevent its repetition and provide essential protection for taxpayers and program participants. Others are the result of congressional mandates or court rulings issued in response to lawsuits over management problems. Whatever their provenance, however, there is widespread agreement among housing providers that many of these prescriptive rules are hindering rather than fostering efficiency.

One specific concern raised by some housing providers is that the rules governing HUD's rental assistance programs do not pay adequate attention to differences among local real estate markets. Providers argue that solutions must be crafted in the context of local real estate markets and the local economy. In this vein, providers argue for more flexibility, for example, to adjust voucher payment standards to account for local variations in rents and more flexibility to adjust inspection standards to account for neighborhood quality (such as safety and/or concentration of vacant homes).

Insufficient accountability for results. A historical focus on process, rather than outcomes, has allowed housing providers in HUD's performance management systems to receive high scores even if their outcomes are mediocre. For example, in HUD's housing voucher program, the performance measurement system examines the extent to which agencies re-inspect properties found to have had a deficiency in an initial inspection, but does not directly assess the quality of the units that residents occupy.[131] Perhaps as a result, HUD data raise serious concerns about the quality of housing occupied by assisted households.[132]

Failing to realize the potential of housing as a platform. Today, many housing practitioners recognize that rental assistance can serve as a platform for attaining broader social outcomes related to resident health, educational achievement, economic opportunity, independent living for older adults and persons with disabilities, and the de-concentration of poverty. HUD has not set up a performance management structure that strongly incentivizes these outcomes, in part because of concerns by housing providers that they have neither full control over their achievement nor the ability to collect data measuring results in these areas. Nevertheless, some stakeholders argue that HUD should place more emphasis on these broader social outcomes through its performance management system and through enhanced partnerships with other relevant federal agencies.

Insufficient support for measuring outcomes and cross-site learning. Even as HUD invests resources in regular audits of local programs to make sure all the procedures are being followed, providers receive little assistance in measuring program outcomes or identifying promising approaches for achieving them. To its credit, HUD has stepped up its research program in recent years to help identify successful approaches for achieving a range of objectives, but providers need even more assistance tracking real-world outcomes and impacts on assisted households, as well as opportunities to learn from the experiences of other providers facing similar challenges.

Remedying these concerns will require a shift in HUD's general approach to managing federal housing programs—from a rigid focus on compliance with program rules to a focus on achieving key outcomes, while providing support for innovation, entrepreneurship, and flexible administration. In this regard, it is important to acknowledge that additional staff, training, or other resources may be needed at HUD to ensure they can effectively manage these reformed programs. Staffing levels at HUD today are about one-half what they were in the 1980s.[133] It is not reasonable to layer more requirements for the programs HUD administers, or demand higher outputs and outcomes, without providing adequate tools and staff, or enabling flexibility in staffing and administration to support the agency's ability to carry out such mandates.

An Improved Approach

To address these challenges and strengthen HUD's rental assistance programs, we propose a fundamental shift in the incentives' structure for HUD-funded housing providers to a system marked by the following characteristics:

A focus on outcomes, rather than process. We propose establishment of a performance management system that measures resident outcomes across all rental assistance programs, focused on creating incentives for greater efficiency and improved housing quality, as well as ensuring that rental assistance meets its full potential to serve as a platform for the achievement of other social outcomes.

Expanded deregulation for high performers. As an incentive for providers to achieve strong outcomes, we propose to reward high-performing providers with substantial devolution, giving them broad latitude to depart from HUD program rules akin to the flexibility currently provided to housing authorities enrolled in the Moving to Work demonstration.[134]

Increased accountability through competition. At the same time, providers that consistently fail to deliver an acceptable level of performance should be held accountable for inadequate results by having the right to administer their housing subsidies taken away and assumed by a higher-performing agency selected through a competitive process.

Real-time learning environment. To support the outcome-based performance measurement system and stronger performance by housing providers, HUD (either directly or through contractors) should expand its role providing data, evaluating promising approaches, and facilitating the exchange of information among providers.

Greater focus on interagency partnerships. To more fully realize the potential of rental assistance to advance goals related to healthy housing, economic opportunity, independent living for older adults and persons with disabilities, and the de-concentration of poverty, we recommend the development of more robust interagency partnerships between HUD and other agencies that can help align performance management systems and resources to achieve these goals.

In addition to instituting and supporting this new performance measurement system, we recommend that HUD consider other opportunities to reduce the burden of regulatory compliance, particularly among small public housing agencies that lack staff capacity. A number of models have been advanced to address the concerns of small agencies.[135] Additional ideas for simplifying the administrative process, including ideas for streamlining the property inspection and income-verification processes have been developed and have bipartisan support. While the commission stops short of addressing any specific legislation, we urge HUD to work collaboratively with the full range of stakeholders to consider these and other solutions for reducing the burden on housing providers, while ensuring the continuation of essential protections for residents.

Learning from Other Outcome-Based Measurement Systems

Stewards for Affordable Housing in the Future—an association of affordable housing developers with members who have properties throughout the country—has begun an initiative to track outcomes in areas which their members see as critical to helping low-income households help themselves. This system includes measures related to: work, income, and assets; youth and education; housing stability; community engagement; and health and wellness.

Likewise, NeighborWorks America has an outcome-based measurement system, known as the "Success Measures Data System," that measures outcomes related to affordable housing, community building, and economic development.

In translating our recommendations into practice, it would be useful to consider the experiences of these and similar measurement systems developed by high-performing nonprofit organizations.

Key Desired Outcomes of HUD-Funded Rental Assistance

To more effectively achieve the full potential of rental assistance to improve participants' life opportunities, the commission recommends that a new accountability system be established to achieve the following key outcomes:

1. **Improve housing quality.** All units funded through the housing voucher program must pass an inspection to ensure they meet basic housing quality standards. Public

housing authorities and owners of assisted rental housing are similarly responsible for maintaining acceptable levels of housing quality. These rules help to direct scarce federal resources to high-quality housing and should be strengthened in a reformed system that seeks the best outcomes for tenants. Federal resources should not be dedicated to supporting substandard housing.

2. **Increase the efficiency with which housing assistance is delivered.** The rising cost of rental assistance requires significant budget increases each year to continue serving the same number of households and puts pressure on funding levels for other important HUD programs. There is a tension between the goal of lowering costs and achievement of other policy objectives, such as improving access to neighborhoods of opportunity. But all things being equal, lower costs would help HUD stretch scarce budget resources further. In particular, we recommend focusing on reducing administrative costs and on ensuring that rents are set at levels that are at or below market, and not inflated.

3. **Enable the elderly and persons with disabilities to lead independent lives.** The population that receives federal housing subsidies is aging and growing increasingly frail. While many of these households can live independently without additional services, many cannot—particularly the frail elderly and persons with severe or multiple disabilities. Given the great expense and disruption of moving these households to nursing homes, the preferred alternative is to ensure that these households have access to the services that may be needed to enable them to live independent lives within HUD-assisted housing, such as coordination of health care, preparation of meals, and assistance with transportation. *See Chapter 6, Aging in Place: A New Frontier in Housing.*

4. **Promote economic self-sufficiency for households capable of work.** Evidence indicates that housing assistance by itself is not enough to boost employment and earnings.[136] Research on the Jobs Plus and Family Self-Sufficiency programs—two promising housing-based self-sufficiency initiatives—suggests that a combination of work-promoting services and financial incentives can help households with rental assistance increase adult employment and earnings.[137] Higher earnings, in turn, lead to higher rent payments by residents, reducing federal expenditures and enabling many households to transition off of assistance.

5. **Promote the de-concentration of poverty and access to neighborhoods of opportunity.** Both research and practice confirm the harmful effects of concentrated poverty on the well-being of low-income households and the health and educational benefits of accessing neighborhoods with better schools and lower poverty rates.[138] While preserving individual choice, housing policy should strive to increase opportunities for households to find affordable housing in areas of opportunity and avoid concentrated poverty.[139]

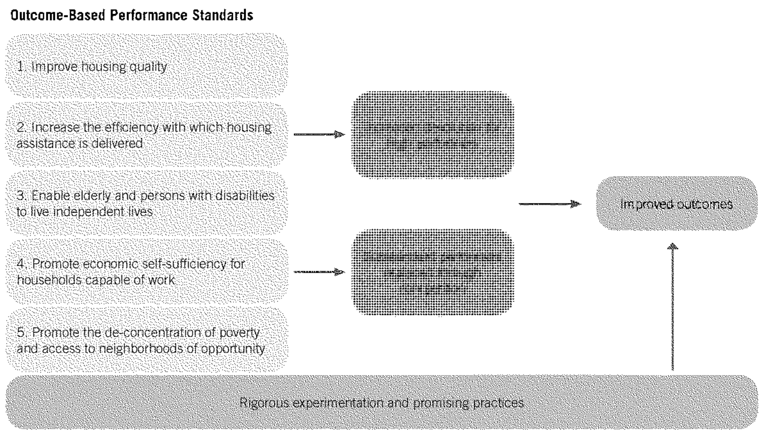
   Among other strategies for achieving this goal are: (a) mobility counseling to help voucher-holders with children access available housing in high-opportunity neighborhoods with good schools, (b) the use of project-based vouchers to secure affordable housing opportunities for older adults in walkable neighborhoods near planned or existing transit stations, and (c) the redevelopment of public housing or project-based Section 8 housing in a manner that facilitates a greater mix of incomes.

Explanations of each system component follow:

Outcome-based performance standards.

By establishing an outcome-based measurement system, HUD could determine which providers are excelling in achieving key housing outcomes and which are not. Of course, providers also need to be competent in administering basic program functions and fulfilling basic requirements efficiently and effectively. But given the potential of affordable housing to lead to meaningful and

Figure 4-1: How the Proposed System Would Work



measurable improvements in the lives of individuals, we recommend moving beyond a focus on rule compliance to a focus on outcome-based results.

For the most part, HUD's current rating systems fall short of this charge. HUD has established separate systems for rating the performance of local providers of Section 8 housing voucher programs, public housing programs, and multifamily assisted properties. The current rating system for Section 8 housing vouchers—the Section 8 Management Assessment Program, or SEMAP—focuses largely on compliance with basic program mechanics (such as full utilization of vouchers and prompt follow-up on quality deficiencies identified during housing quality inspections) and stops well short of identifying truly excellent programs. HUD's assessment systems for public housing and multifamily assisted housing include a somewhat greater focus on outcomes—particularly housing quality [140] —but stop short of identifying programs that excel in achieving the five programmatic outcomes the commission has identified.[141] Providers also note that HUD's rating and reporting systems do not work effectively for agencies with Moving to Work authority, leading to complications and administrative burdens.

A new rating system will be challenging to implement, with providers likely to argue that they lack direct control over the outcomes that will be measured. The rating systems will also need to account for differences in housing markets, as well as differences between rental assistance programs. For example, it will be much easier to promote the de-concentration of poverty in a tenant-based program like the housing voucher program than in a project-based program like public housing or project-based Section 8, where the physical location of a property is fixed. Despite these challenges, measures of program excellence need to be developed as the prerequisite for a system designed to promote better outcomes for participating households.

Some housing providers have expressed a preference for having a third party administer the rating system, rather than HUD. We do not express a specific opinion about who does the evaluation but rather emphasize the importance of ensuring that outcomes are measured effectively and objectively.

Increased devolution for high performers.

HUD should provide greater flexibility to agencies that have demonstrated their competence by excelling in achieving the outcomes measured by the new accountability system we propose. This flexibility should be broad—similar to that provided to public housing agencies participating in the Moving to Work demonstration. At the same time, this shift should be closely monitored to ensure that program beneficiaries are not inadvertently hurt. Special care should be taken to ensure that increased flexibility does not adversely impact the elderly and persons with disabilities.

Providers receiving this flexibility should continue to be monitored to ensure continued excellence, with penalties imposed if their performance declines sharply. The following are examples of the kind of flexibility that high-performing providers could use to better achieve key programmatic outcomes:

- **The ability to modify rent rules to promote economic self-sufficiency** - In Portland, Oregon the housing authority has used its Moving to Work authority to offer participants in its Opportunity Housing Initiative a financial reward for higher earnings. Participants continue to pay income-based rents, but all amounts above $300 per month go into an escrow account that the family can access once it has met the program requirements (which include employment and graduation from housing assistance). Among other benefits, the housing authority believes this variation on the traditional Family Self-Sufficiency program model is more likely to be cost-neutral or even revenue positive, allowing it to offer the incentive more broadly.
- **The ability to extend housing quality standards to incorporate neighborhood quality** - In Atlanta the housing authority decided that the use of a housing voucher to rent a unit in a dangerous neighborhood was not an acceptable outcome, even if the unit itself would meet traditional HUD housing quality standards. Accordingly, Atlanta has modified the standards that it uses to determine whether to approve a rental opportunity—offered to a family with a housing voucher—to include such issues as the extent of vacant and abandoned property nearby, as well as signs of suspicious illegal activity.[142]
- **The ability of owners of multifamily assisted properties to achieve economies of scale by operating on a portfolio basis.**[143] - Current housing policies and programs drive affordable housing owners to manage each housing development as a separate stand-alone entity with its own financing, compliance, and reserves. For mission-oriented owner/operators who have large portfolios of properties, this approach needlessly raises operating and compliance costs, makes it difficult or impossible to raise capital at the enterprise level, and prevents deployment of capital and excess cash proceeds to achieve better outcomes for the people they serve. The commission supports consideration of policy changes that allow and

encourage the strongest, performance-oriented providers to manage their properties at a portfolio level to increase the impact of these resources. *See Text Box, Entity-level Finance and Operations.*

Entity-level Finance and Operations

Equity, excess reserves, and residual receipts associated with a property that is operating well are now locked in that property. If portfolio owners could move resources to a weaker property in the portfolio to improve its operating performance or preserve it as affordable housing over a longer period of time, the overall quality of the housing would be maintained and costly deferred maintenance avoided. Entity-level finance would enable owners or property managers to provide HUD and state housing officials with a single audit for a portfolio of properties rather than pay for an audit of each property as required under current practice. Flexible management of portfolios would also allow organizations to more efficiently raise larger amounts of capital at the enterprise level and then deploy this capital to those places in their portfolios with the greatest needs and the greatest return on the investment dollar. Finally, the management of rental assistance contracts at a portfolio level would make the system more efficient and effective by allowing owners to reposition the rental assistance on other properties in their portfolios or to new properties.

***Substandard performers replaced through competition.*[144]**

The prospect of competition should promote stronger performance among providers, while the competition process itself would strengthen administration by bringing in proven providers to run struggling programs. To protect residents, the competition should be limited to providers with a track record running the program in other locations. To gain experience, prospective providers who are not already operating a program could start out acting as sub-contractors to existing program providers.

In many cases, neighboring housing authorities or other local providers will be strong candidates for winning these competitions. Given the benefits of consolidating administration of smaller voucher programs, HUD may elect to make consolidation an explicit goal of the competition process.

In developing new accountability policies, it will be essential to recognize the impact of inadequate and uncertain funding on providers' ability to meet their responsibilities and run excellent programs. Public housing authorities, for example, report receiving funding at levels well below those necessary to operate their programs effectively, leading to reductions in housing quality and numbers of households served. Owners of project-based Section 8 developments raise similar concerns. The sweeping of provider reserve funds could likewise jeopardize provider flexibility to meet changed circumstances and adversely affect the ability of providers to attract talent and implement innovation.

Rigorous experimentation and promising practices.

Flexibility in program rules can create incentives for high performance. But flexibility also may lead to new approaches that yield better outcomes for households. When new approaches are tried and proven to be successful, without causing hardship or undermining other programmatic goals, they should be made available as options for all providers, including standard performers that may not have Moving to Work–type authority.

Rigorous evaluation of new approaches can help provide the data necessary to determine if a particular approach is effective, and HUD and Congress should invest in the data collection and evaluation tools needed to track and confirm the costs and benefits. The new approaches taken by high-performing providers through devolution provide a natural testing ground for evaluating new ideas. By tracking outcomes and constructing and executing research frameworks built around these ideas,[145] HUD can ensure that new ideas are thoroughly studied before being incorporated into the program rules applicable to standard agencies.

A number of current studies by HUD's Office of Policy Development and Research (PD&R) illustrate the potential of rigorous evaluation to generate the evidence base needed to determine whether new program options should be made broadly available to all administrating agencies. For example, PD&R is studying the effect of applying Small Area Fair Market Rents (FMRs) in six metropolitan regions across the country. In these trial areas, public housing authorities are able to use FMRs calculated at the zip-code level rather than the metropolitan or Core Based Statistical Area level, as is currently the case. One purpose of this effort is to provide assisted households accessibility to a broader range of neighborhoods, including high-opportunity areas that might otherwise be prohibitively expensive for low-income families. Early evidence from a Dallas case study suggests that significant shares of voucher-holders are moving to safer neighborhoods after a year of the Small Area FMRs being in effect. Additional research is needed to determine the fiscal impact of these changes and their impact in other study sites.

More robust efforts are needed to facilitate the documentation of innovative approaches and sharing of promising practices among program providers. With multiple providers trying new approaches for achieving similar objectives, strong lines of communication will be needed to ensure they have opportunities to learn from each other both about approaches that appear to lead to better outcomes and approaches that do not generate the expected benefits or lead to unexpected costs or other problems. Rather than asking each local agency to investigate and evaluate the practices of other providers on its own, it would be much more efficient and effective to assign this function to a single entity or consortium of entities with complementary expertise funded centrally by HUD.

This would not be a regulatory function—no local housing agency will be forced to adopt any of the policies highlighted in these reviews—but rather a support function designed to provide timely and relevant information to local providers to help them develop more effective rental assistance programs. The practices covered by this documentation and information-sharing process will include both the details of program administration (e.g., how to increase utilization of housing vouchers or improve the accuracy of income verification) as well as practices to better achieve key programmatic outcomes.

Many details will need to be worked out in order to fully implement an accountability system that improves the delivery of rental assistance. A transition period will help to appropriately identify and phase in the relevant metrics for measuring the identified outcomes. During the transition process, well-accepted measures of outcomes or outputs could be adopted and implemented on a phased-in basis, even as new measures are developed and existing ones are strengthened. In developing the new measures, it will be important to identify those that apply both to agencies operating under standard rules and the high-performing agencies that have received opportunities to depart from these rules.

The commission hopes to encourage a data-driven debate about what the nation ultimately wishes to achieve through its rental assistance programs, beyond the core value of affordability. As a transition period proceeds, it will be important to ensure that the debate itself does not undermine progress in developing and implementing the new system. The new performance measures should be thoroughly vetted and tested, but we cannot let the perfect be the enemy of the good. The perfect accountability system may be unattainable, but a much improved, reformed system is definitely achievable and will lead to stronger outcomes for the millions of households participating in federal rental assistance programs.

Advance innovative programs that connect housing to other sectors

There is much that local housing providers can do on their own initiative to make progress in achieving goals such as increased economic self-sufficiency for residents and an increased ability of older adults and persons with disabilities to lead independent lives. However, the likelihood of achieving these goals will be increased substantially if housing providers can count on the active collaboration of partner agencies working at the local level on issues like education, workforce development, human services, health, aging and disability, and transportation.

Accordingly, HUD should continue to build strong relationships with other federal agencies to develop coordinated guidance at the federal level to promote the more efficient use of existing resources at the local level. Federal interagency efforts should be designed to generate guidance on specific actions that local agencies can take to advance shared goals.

In the area of economic self-sufficiency, for example, interagency partnerships among HUD, the Department of Labor (DOL), and the Department of Health and Human Services (HHS) could focus on coordinating the services offered by DOL and HHS grantees with family self-sufficiency programs administered by local housing providers to expand the number of families benefitting from a comprehensive array of services that can together help boost earnings and employment: stable affordable housing, economic incentives to increase earnings and build assets, work-promoting case management or coaching, and access to work-promoting services.

Similarly, an already-established partnership between HUD and HHS is focused (among other things) on maximizing the access of older adults and persons with disabilities with rental assistance to the services needed for them to live independently. If implemented robustly, this partnership could, for example, facilitate the use of Medicaid for services that help older adults remain in HUD-assisted housing, rather than transitioning to nursing homes. Research is now underway to test the extent to which service-enriched housing can help reduce Medicaid and Medicare expenses; to the extent this research demonstrates savings, there will be additional benefits to this type of interagency collaboration. *See Chapter 6, Aging in Place: A New Frontier in Housing.*

Other promising areas of interagency collaboration include: combating homelessness, meeting the housing needs of veterans, promoting healthy homes, improving energy efficiency, and ensuring that families of all incomes have access to emerging areas of opportunity near public-transit stations, job centers, and other areas with low transportation costs. The commission applauds the federal government for its efforts to date in building partnerships between federal agencies and recommends that these efforts be continued and strengthened to more effectively meet the cross-sectoral challenges of housing, poverty, health, aging, and economic growth.

Summary of Recommendations

Table 4-1 summarizes the commission's recommendations for affordable rental assistance and provides estimated annual costs for each recommendation.

The commission is aware of the difficult issues that will need to be addressed in the coming years to balance federal budget priorities. The federal government currently provides substantial resources in support of housing, the majority of which is in the form of tax subsidies for homeownership, as set forth in Figure 4-2 below. The commission supports the continuation of tax incentives for homeownership—

recognizing the importance of this tax policy to homeowners in the United States today. The commission notes that various tax benefits provided to homeowners, including the mortgage interest deduction, have been modified over the years. In the ongoing debate over tax reform and budget priorities, all revenue options must be evaluated. In that context, the commission recommends consideration of further modifications to federal tax incentives for homeownership to allow for an increase in the level of support provided to affordable rental housing. Any changes should be made with careful attention to their effect on home prices and should be phased in to minimize any potential disruption to the housing market. A portion of any revenue generated from changes in tax subsidies for homeownership should be devoted to expanding support for rental housing programs for low-income populations in need of affordable housing.

In addition, the commission recommends retaining in a reformed housing finance system the fee adopted by Congress in the Housing and Economic Recovery Act of 2008 (HERA) and intended to be collected by the GSEs, to apply only to mortgages guaranteed by the Public Guarantor. Revenue generated should be used to fund the National Housing Trust Fund and the Capital Magnet Fund, with eligible activities to include housing counseling for first-time homebuyers and support for affordable rental housing.

The commission strongly opposes using fees imposed on mortgages to finance governmental expenditures outside of the housing sector. In 2011, Congress enacted a supplemental 10 basis point fee on single-family mortgages guaranteed by Fannie Mae and Freddie Mac to cover a portion of the cost of extending Social Security payroll tax relief. Proceeds from this fee are included in the cost of new mortgages guaranteed by the companies and the proceeds deposited in the general Treasury. In November 2012 the

Table 4-1: Estimated Annual Costs and Potential Impact

	Estimated Annual Costs (in billions)	Estimated Number of Units Produced/ Preserved or Households Served
[illegible]	[illegible]	[illegible]
Short-term assistance to households experiencing residential instability	$3.0	2.4 million
Protect and expand the LIHTC program	$1.2	35,000 – 40,000
Gap financing to support an expansion of the LIHTC program	$1.0 – $2.0	N/A
Capital backlog and ongoing accrual needs in public housing	$4.0	110,000

Notes: In all cases, the dollar amount listed and units produced are incremental, on top of what is currently being spent and produced. Estimated annual cost for rental assistance to households with incomes at or below 30 percent AMI is based on participation rates in the Supplemental Nutrition Assistance Program (SNAP) among households with incomes below 30 percent of AMI. Average annual cost of Protect and expand the LIHTC program is over ten years—annual costs would range from $0.26 billion in year three to $2.9 billion by year 10 after enactment. (Because of lag time between allocation and production, no increases in tax expenditures would be experienced in the first two years.) The difference between the estimated accrual need and the actual accrual need in public housing will continue to grow if the capital backlog is not addressed. Addressing the capital backlog in the near future will decrease accrual needs in the long term. The estimates do not include administrative costs.

House of Representatives approved legislation to extend this fee for a year beyond its October 21, 2021, expiration to finance immigration reform legislation. There is no policy justification for requiring that the single-family mortgage finance system bear the burdens of programs that have no relationship to housing.

However, the adoption of fees to support targeted expenditures is well-established in Social Security, Medicare, transportation, and airport funding. HERA established a 4.2 basis point mortgage fee on new single-family mortgages guaranteed by Fannie Mae and Freddie Mac. The funds were allocated specifically to the National Housing Trust Fund to finance affordable housing for very low-income households, and the Capital Magnet Fund in the U.S. Treasury for CDFIs carrying out affordable housing and community and economic development lending. No fees were ever collected because shortly thereafter Fannie Mae and Freddie Mac were put into conservatorship and collection of the fees was suspended by the Federal Housing Finance Agency.

Affordable Housing Program: Making the Connection

The Federal Home Loan Banks' Affordable Housing Program (AHP) is a working example of a federal housing policy that promotes access to private capital. Created by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the AHP requires each Federal Home Loan Bank to set aside 10 percent of its net income each year for assistance to low- and moderate-income families and individuals. Awards made through the program may be provided as grants or loans and can serve a variety of purposes related to affordable housing, including acquisition, construction, or rehabilitation of rental and owner-occupied housing. Set-asides may also be provided for homeownership assistance and housing counseling. Eligibility for AHP is limited to the member institutions of each Home Loan Bank, which partner with local housing developers and community organizations to submit applications and benefit from the opportunity to earn credit toward their community investment goals.

Notes: Summing tax expenditures can lead to an overestimate of the total tax benefit. Each estimate, in isolation, treats itemization separately. This can result in an over count of the total estimate. See: Altshuler, Rosanne and Robert Dietz, "Reconsidering Tax Expenditure Estimation," *National Tax Journal* 64, no. 2, part 2 (2011), 459-489.

Other tax expenditures - owner includes exclusion of interest on government qualified private activity bonds for owner-occupied housing ($1.1 billion) and exclusion of income attributable to the discharge of principal residence acquisition indebtedness ($1.3 billion); *Other appropriations - owner* includes block grant programs (HOME and CDBG) owner activities ($1.5 billion) and USDA programs ($1.0 billion); *Other tax expenditures - renter* includes deferral of gain on like-kind exchanges ($2.5 billion - includes all real estate transactions that utilize the section 1031 like-kind exchange rules and assumes that the exchange of apartment buildings is approximately 40 percent of the total of both corporate and individual deferrals), exclusion of interest on government qualified private activity bonds for rental housing ($0.8 billion), and credit for rehabilitation of structures ($0.9 billion); *Other appropriations - renter* includes homeless assistance and other HUD programs ($3.6 billion), block grant programs (HOME and CDBG) rental activities ($2.7 billion), and USDA Section 521 rental assistance and other USDA programs ($1.1 billion).

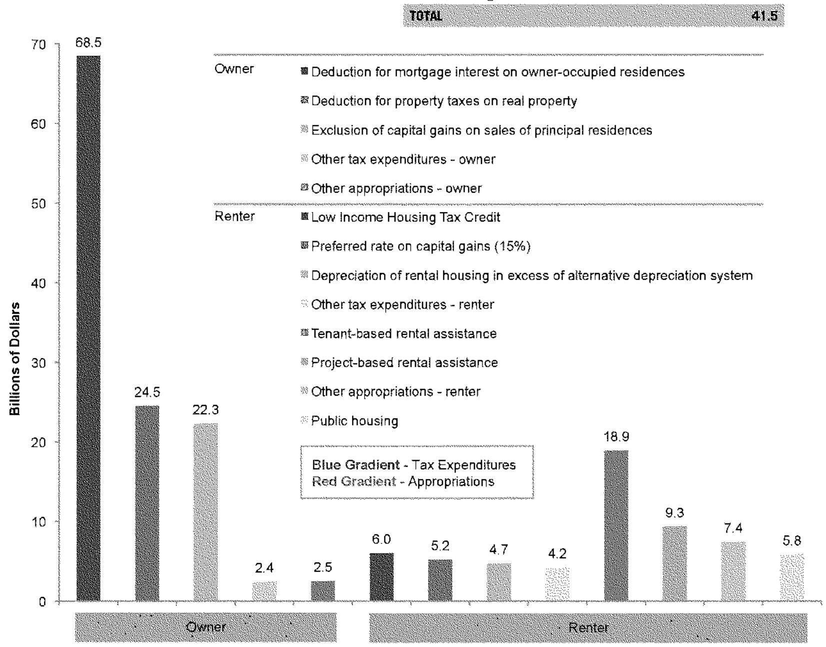
Preferred rate on capital gains estimate based on Joint Committee on Taxation estimate of the tax expenditure for the preferred tax rate on gains and dividends, assuming 4 percent of the value is due to residential rental property, consistent with the share of gains income found in the 2007 IRS Sales of Capital Assets (SOCA) data.

Sources: Tax expenditure numbers from the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017* (Washington, D.C.: U.S. Government Printing Office, 2013). Appropriations numbers from McCarty, Maggie and David Randall Peterman, *Transportation, Housing and Urban Development, and Related Agencies (THUD): FY2013 Appropriations* (Washington, D.C.: Congressional Research Services, 2012).

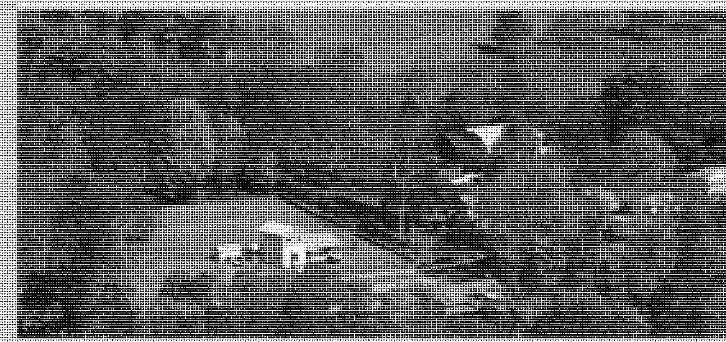
Figure 4-2: Estimates of Federal Tax and Spending Supports for Housing

[illegible]	[illegible]
Tax Expenditures	
Deduction for mortgage interest on owner-occupied residences	68.5
Deduction for property taxes on real property	24.5
Exclusion of capital gains on sales of principal residences	22.3
Other tax expenditures - owner	2.4
TOTAL	**117.7**
Appropriations	
Other appropriations - owner	2.5
TOTAL	**2.5**

[illegible]	[illegible]
Tax Expenditures	
Low Income Housing Tax Credit	6.0
Preferred rate on capital gains (15%)	5.2
Depreciation of rental housing in excess of alternative depreciation system	4.7
Other tax expenditures - renter	4.2
TOTAL	**20.1**
Appropriations	
Tenant-based rental assistance	18.9
Project-based rental assistance	9.3
Other appropriations - renter	7.4
Public housing	5.8
TOTAL	**41.5**



2012 Federal Housing Expenditures and Appropriations



Chapter 5. The Importance of Rural Housing

Although housing costs are generally lower in rural communities, lower incomes and higher poverty rates make housing unaffordable for many rural residents. Overall, the median income for rural households ($40,038) is 20 percent lower than the national median income ($50,046) and more than 20 percent lower than the median income for urban households ($51,998).[146] In 2010, the U.S. poverty rate was at its highest since 1993 at 15.1 percent;[147] yet, the rural poverty rate was even higher at 16.5 percent.[148] Many rural households live in counties classified as high poverty areas with a poverty rate of 20 percent or more.[149]

More than seven million families—or nearly 30 percent of all rural households—spend more than 30 percent of their monthly income on housing costs and are considered cost-burdened.[150] The lack of affordable housing prevents households from meeting other basic needs, such as nutrition and health care, or saving for their future.

Although rural homeownership rates are higher than the national average[151] and mortgage-free homeownership is more common in rural America than in urban and suburban areas,[152] the home values in rural parts of the country are generally lower, with more than 40 percent of rural homes valued at less than $100,000.[153] In addition, rural homes are more likely to be in a substandard condition. Nearly 6 percent of rural homes are either moderately or severely substandard, without hot water, or with leaking roofs, rodent problems, or inadequate heating systems.[154] These poor housing conditions put additional financial constraints on low-income families.

Rental housing is an important housing option in rural America. While renters from rural areas occupy 17 percent of all U.S. rental-housing units, rural renters are more likely to live in single-family homes or smaller multifamily structures (with fewer than five units) than their urban and suburban counterparts. In addition, a far larger percentage of rural renters occupy manufactured homes. Rural rental housing is also generally older than rural owner-occupied homes, with approximately 35 percent of rural rentals built more than 50 years ago.[155]

The same demographic trends that are transforming the country are also at work in rural America. While the population of rural America is generally older than that of the nation at large, rural parts of the country are graying with the aging of their Baby Boomer populations and the outmigration of younger households, many of whom are seeking employment opportunities elsewhere. In addition, Hispanics now rank as the largest minority group in rural America, with much of the population growth in rural communities attributable to the growth in the number of Hispanics who live there.[156]

Federal Role in Rural Housing

The federal role in supporting rural housing can be traced back to the Housing Act of 1949, which authorized the Farmers Home Administration to issue mortgages for the purchase and repair of rural single-family houses, as well as to provide financial support for rural rental housing. Subsequent federal legislation shifted these responsibilities to the Rural Housing Service (RHS), the agency within the U.S. Department of Agriculture that today administers the USDA's rural housing programs.

Key USDA Housing Programs

The following are brief summaries of the major rural housing programs provided by USDA.[f] These programs are often used in combination, and provide loans, grants, loan guarantees, and other support to help meet housing needs in rural America.

Homeownership programs

- Section 502 Guaranteed Loan – Guarantee of up to 90 percent of principal on mortgage loans issued by private lenders to low- and moderate-income families, in amounts up to 102 percent (including a 2 percent guarantee fee) of the home's market value or acquisition cost *(Funding in FY 2012: $24 billion)*
- Section 502 Direct Loan - Direct, fixed-interest financing in amounts up to 100 percent of the home's market value or acquisition cost to low-income individuals to purchase, build, repair, or renovate homes *(Funding in FY 2012: $900 million)*
- Section 504 Very Low-Income Rural Housing Repair Loan and Housing Assistance Grants - Direct loans up to $20,000 and, for very low-income elderly homeowners only, grants up to $7,500, for housing repairs and improvements *(Funding in FY 2012: $39.5 million)*
- Section 523 Mutual and Self-Help Grant - Grant funding for local providers to deliver technical assistance to groups of low- and very-low income families who work cooperatively to build their houses *(Funding in FY 2012: $30 million)*

Rental programs

- Section 521 Rental Assistance - Project-based rent assistance to owners of Rural Housing Service-financed projects *(Funding in FY 2012: $905 million)*
- Section 538 Multi-Family Housing Guaranteed Loans – Guarantee of up to 90 percent of principal (97 percent for nonprofit developers) on loans issued by private lenders to support construction, acquisition, and rehabilitation of multifamily housing for low- and moderate-income households *(Funding in FY 2012: $130 million)*
- Section 515 Rural Rental Housing Direct Loans - Long-term, low-interest loans to limited-profit and nonprofit developers to support the construction, acquisition, and rehabilitation of multifamily housing for low- and moderate-income renters *(Funding in FY 2012: $64.5 million)*

Other programs

- Section 514 and 516 Farm Labor Housing Loans and Grants - Loans and grants to farm owners, nonprofit organizations, and others to buy, build, improve, or repair housing for farm laborers *(Funding in FY 2012: $27.9 million)*

To be eligible for a USDA housing program, the beneficiary of the program must live in a rural area, which includes for purposes of these programs:

Any open country, or any place, town, village, or city which is not part of or associated with an urban area and which

(1) Has a population not in excess of 2,500 inhabitants, or

(2) Has a population in excess of 2,500 but not in excess of 10,000 if it is rural in character, or

(3) Has a population in excess of 10,000 but not in excess of 20,000, and (A) is not contained within a standard metropolitan statistical area, and (B) has a serious lack of mortgage credit for lower and moderate income families, as determined by the Secretaries of Agriculture and HUD.[157]

This definition of "rural area" encompasses approximately 109 million individuals, or 34 percent of the U.S. population.[158]

USDA programs have proven cost-effective and efficient at serving some of the nation's most vulnerable rural households, and support for and preservation of these programs must be given priority attention. For example, in FY 2012 the total cost to the federal government of enabling a low-income rural family to become a homeowner through the Section 502 Direct Loan program was $7,200 over the life of the loan.[159] Likewise, the annual Section 521 Rental

f. Summaries of USDA rural housing programs rely on information contained in Tadlock Cowan, *An Overview of USDA Rural Housing Programs* (Washington, D.C.: Congressional Research Service, 2010).

Assistance for households living in Section 515 Rural Rental Housing was $4,400 in 2011,[160] compared with $7,640 in the Housing Choice Voucher program.[161] In 2011, USDA housing programs helped nearly 140,000 rural families become homeowners and assisted in meeting the rental housing needs of an additional 470,000 individuals.[162] The following recommendations aim to strengthen successful programs in a way that can serve a greater number of the most vulnerable rural households.

Policy Recommendations

1. Support and strengthen USDA's role in rural housing. USDA has a presence in rural communities that is critical for administering support to vulnerable households. While increased collaboration and efficiency across agencies is important, Congress should not pursue proposals to shift USDA programs to other government agencies where they will be absorbed by other federal programs.[163] USDA is well-positioned to leverage the existing resources and infrastructure of rural service providers that understand the unique conditions of local markets.

2. Extend the current definition of rural areas through the year 2020. Any area currently classified as rural for the purposes of USDA housing programs should remain so at least until after the receipt of data from the decennial census in 2020, provided the area's population does not exceed 25,000.

Without congressional action, hundreds of rural communities are at risk of losing eligibility for funding designated for rural areas. A change in the definition would sweep up many small towns and farming communities into larger metro areas, reducing the population eligible for rural housing assistance by roughly 8 percent.[164] Extending the definition would help to ensure low-income rural families, elderly, and persons with disabilities living in these communities continue to access low-cost loans, grants, and other needed assistance, as well as provide certainty to housing developers on where they can build utilizing the resources of USDA rural housing programs.

3. Increase budget allocations to serve more households. Today, USDA holds or guarantees 944,000 loans totaling $84.4 billion, or less than 1 percent of the $9.4 trillion in U.S. mortgage debt outstanding. Since 2007, however, USDA's loan volumes have tripled. In FY 2011, the department guaranteed $16.9 billion in loans and issued $1.1 billion in direct loans.[165] Many of these loans are securitized, and Ginnie Mae guarantees the timely payment of principal and interest on these securities. Additional funding for the Section 502 Direct Loan program would enable more rural households to become homeowners at relatively low cost to the federal government. However, any additional federal appropriations for the Section 502 Direct Loan program should be contingent on an evaluation of underwriting risks associated with the program, which for the past four years has carried delinquency rates hovering around 14 percent.[166] Specifically, the program's current no-down-payment requirement should be reconsidered with a minimum down payment required on all future loans.

4. Dedicate resources for capacity-building and technology to strengthen USDA providers. A portion of the resources available for rural communities should be dedicated to providing technical assistance to nonprofit providers operating in rural communities, as well as to modernizing the technology that USDA providers use for loan processing, some of which is still done by hand. Specifically, local agencies receiving USDA funds should be incentivized to operate on compatible software to ease data and information sharing. These improvements could help USDA monitor and improve the performance of its rural housing programs.

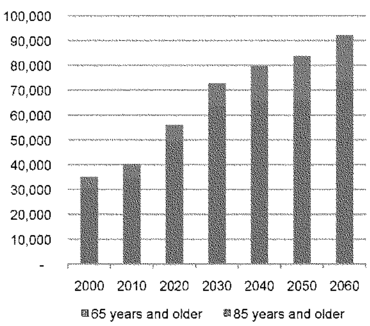
Economic Policy Program

Chapter 6. Aging in Place: A New Frontier in Housing

In 2011, the first members of the Baby Boom generation turned age 65. In the coming decades, millions more Baby Boomers will enter their retirement years. As indicated in Chart 6-1, the number of Americans aged 65 or older will rise from 35 million in 2000 to nearly 73 million in 2030 and more than 90 million in 2060. The very oldest Americans, those aged 85 and older, will increase in number from 4.2 million in 2000 to nearly nine million in 2030 and then to 18.2 million in 2060. At the same time, the ratio of working-age people to those who have reached retirement age will fall significantly.[167]

Chart 6-1: U.S. Population Aged 65 and Older

Numbers in thousands



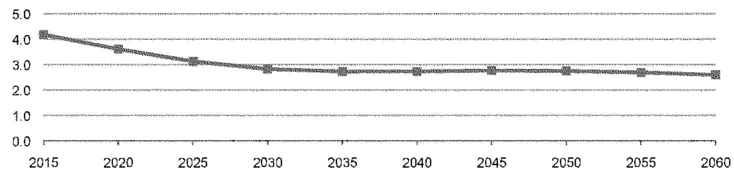
Source: 2000 and 2010 counts from U.S. Census Bureau, "Summary File 1, Matrices DP-1: Profile of General Demographic Characteristics: 2000 and 2010." *Decennial Census* (Washington, D.C.: 2001 and 2012); projections from U.S. Census Bureau, "Table 2. Projections of the Population by Selected Age Groups and Sex for the United States: 2015 to 2060," *2012 National Population Projections: Summary Tables*.

These unprecedented demographic changes will have a profound impact on American society. Cultural attitudes about aging and the role of seniors in our communities are likely to change. The graying of America, with fewer workers supporting more retirees, will strain the budgets of already overburdened state and local governments. And, as America's senior population grows, we will need to reexamine our housing priorities to determine how best to meet the needs of the overwhelming majority of seniors who wish to age in place.

"Aging in place" is defined as "the ability to live in one's own home and community safely, independently, and comfortably, regardless of age, income, or ability level."[168] Studies show that some 70 percent of Americans aged 65 and older live in single-family detached homes, and nearly 90 percent intend to age in place and remain in their homes permanently.[169] For most seniors, the desire to age at home is the most cost-effective and financially sensible housing option, so long as their physical abilities allow. Understandably, seniors wish to remain linked to their family, friends, and communities, supported by the very connections that have given meaning to their lives and provide a sense of belonging, independence, and peace of mind. For the 30 percent of seniors who are renters and typically have lower incomes than homeowners, aging in place means the ability to achieve similar goals in their apartments.

Yet, this strong desire to age in place runs into a harsh reality: Many of today's homes and neighborhoods were designed at an earlier time before the demographic changes now transforming the country were even recognized. For many seniors, their homes lack the necessary structural features and support systems that can make independent living into old age a viable, safe option. Similarly, many of our nation's communities fail to provide for adequate street lighting, accessible sidewalks and transportation options, and other services and amenities that would make aging in place in those communities a realistic choice.[170]

Chart 6-2: Projected Ratio of Working-age Americans (aged 18 to 64) to People Aged 65 and Older



Source: Bipartisan Policy Center tabulations of U.S. Census Bureau, "Table 2. Projections of the Population by Selected Age Groups and Sex for the United States: 2015 to 2060," *2012 National Population Projections: Summary Tables.*

Rising to the Challenge

This new demographic reality demands that we think creatively about how the houses in which we live affect our health, longevity, and the cost of caring for an aging population. At every stage of life, our houses and apartments are both the shelter we seek for ourselves and our families, and the platform from which we engage with nearly every other aspect of our lives. This is true to perhaps the greatest extent in promoting healthy independent lives for seniors. When we broaden our focus on housing's role in our lives—including as a vehicle for the delivery of lower-cost and more effective health care for seniors—we can begin to think more strategically about how we make housing-related investments, taking into account the full life-cycle costs of both housing infrastructure and health care expenses.

A key focus of this effort must be strengthening our nation's capacity to deliver health care and other critical services in residential and community-based settings. If implemented properly, these new approaches have the potential to empower our nation's seniors to make even greater contributions to society. And, as more seniors forego long-term care in costly institutionalized settings, they also have the potential to produce real long-term savings for cash-strapped governments at all levels. Studies of programs in Japan and the United Kingdom, for example, suggest that retrofitting existing properties to accommodate the needs of seniors could produce significant savings as the cost of medical care and other services is reduced.[171] Savings in the health care system can be used to support further extensions of these services and take advantage of the virtuous circle created by helping seniors remain in their homes.

Modifying existing single-family houses, apartments, and communities—as well as designing new ones—to support aging in place for those millions of Baby Boomers now entering their retirement years must become a far greater national priority.

Any discussion of modifying our homes and communities to accommodate the desire of seniors to age in place must take cost into account. For some seniors and their families, personal savings and retirement earnings may be sufficient to finance home modifications. Reverse mortgages and

Leadership in Practice

Numerous private and public institutions have already begun to respond to the challenges posed by the graying of the population and the desire to age in place. Organizations such as the American Association of Retired Persons (AARP), the National Association of Home Builders, the American Institute of Architects, and the American Society of Interior Designers have all initiated programs to educate professionals in their respective fields about relatively simple steps that can be taken to transform an existing home into one that is livable and safe for an elderly person. Better home lighting, use of contrasting colors on the edges of furniture and steps, strategic placement of handrails and grab bars, modest structural alterations to bathrooms and kitchens, and the removal of tripping hazards such as throw rugs and electrical cords are just some of the suggestions that can make a big difference in the living conditions of seniors. These organizations also emphasize the importance of applying universal design principles to new home construction so that a home built today has structural features, such as a zero-step entrance and wider doors and hallways, that will allow the home's initial owners to age in place if they choose.[172]

State and local governments are also beginning to respond to the challenge. All across the country, neighborhoods are naturally being transformed into concentrated pockets of older residents who are aging in place. There is even a name for these neighborhoods: Naturally Occurring Retirement Communities, or NORCs. A NORC can take a variety of forms. It can be a large multifamily rental complex or a neighborhood populated with single-family homes whose residents are growing older. NORCs exist in central cities, in suburbs, and even in rural areas. The AARP estimates there are some 5,000 NORCs throughout the United States but cautions they are "the most dormant and overlooked form of senior housing."[173]

Some states, including Georgia, Maryland, Massachusetts, Missouri, New York and Pennsylvania, encourage the use of NORCs as efficient and cost-effective venues to deliver health care and other services to senior residents.[174] In New York alone, there are more than 50,000 seniors living in NORCs and benefiting from the supportive services delivered through these communities. The federal government is also playing a role: The U.S. Department of Health and Human Services (HHS), through its Administration on Aging, helps fund the development of NORCs in some twenty-five states.[175]

Another state-level model that combines housing with supportive services is "Communities for a Lifetime." A major goal of this model is to establish neighborhoods that support aging in place and more deliberately integrate seniors into community life. Key elements of this approach include ensuring senior-friendly transportation options and land-use planning. States such as Florida, Indiana, Michigan, and North Carolina are actively promoting "Communities for a Lifetime" programs and activities.[176]

home equity lines of credit offer other financing options, particularly for seniors with little or no outstanding mortgage obligations. State and local tax benefits and grant programs may provide additional help. But for many seniors, whose earnings have fallen dramatically since leaving the workforce, financing options are more limited. In fact, 9.5 million households headed by someone over the age of 65 spend more than 30 percent of their income on mortgage or rental costs, leaving little left over to cover the cost of even basic maintenance that can greatly impact safety in the home. Even worse, some 5.1 million senior households spend more than half their income to cover housing costs.[177] These households may be forced to make difficult choices between covering housing costs and purchasing needed medication or nutritious food.

Affordable rental housing can also be a platform for delivering services that enable aging in place, often averting high-cost institutional care. For example, Stewards of Affordable Housing for the Future, LeadingAge, and Enterprise Community Partners, with their nonprofit members, have done pioneering work to develop strategies that link senior housing with health care and supportive services. Innovative providers are not only working with traditional fee-for-services approaches and waiver-enabled programs, but also sorting out how they could work effectively with the accountable care organizations and managed care entities that are increasingly serving the low-income elderly. Multi-state providers such as National Church Residences and Mercy Housing, and smaller scale organizations such as the Cathedral Square Corporation in Vermont and Sanborn Place in Massachusetts, are using residential solutions to achieve the triple aim of improving health, improving the experience of those who are served, and reducing the per capita cost of health care. These strategies have the potential to enable low-income seniors to remain in their apartments and communities and to enhance care and coordination for the high-cost population eligible for both Medicare and Medicaid.

Finally, there is a group of older Americans for whom there are much more basic problems of affordability. While Social Security has made dire poverty among older Americans a less common phenomenon than it would otherwise be, it has not eliminated it entirely. The commission's proposal for long-term rental assistance for the most vulnerable Americans with incomes at or below 30 percent of AMI would provide a solid floor, ensuring that those older households with the lowest incomes would at least have their basic housing needs met, and providing a foundation for some of the other improvements discussed above. *See Chapter 4, Affordable Rental Housing.*

The Federal Response

The federal response to meeting the housing needs of low-income seniors historically has focused on construction and rehabilitation programs to produce or preserve housing either designated for seniors or that increasingly over time has come to serve seniors who have aged in place. The Section 202 Supportive Housing for the Elderly Program is designed exclusively to meet the needs of low-income seniors, and has taken several forms since 1959. However, funding for new Section 202 housing has been very limited since the early 1980s. In recent years, there were ten applicants on the waiting list for every unit that becomes available annually.[178] Most seniors in HUD-subsidized housing live in public or privately owned assisted housing that, in general, was not designed to house this increasingly frail population.

Other HUD programs that provide assisted housing to low-income seniors are the Section 221(d)(3) Below Market Interest Rate and Section 236 programs that offer mortgage subsidies and support properties specifically dedicated to the elderly and date back to the 1960s and 1970s. The project-based Section 8 housing programs, begun in 1974 and ended as a new construction or rehabilitation program in 1983, as well as rural housing programs administered by USDA, also support projects that serve senior households.[179] Finally, some states allocate a share of their Low Income Housing Tax Credit financing for senior housing. According to some estimates, 14 percent of LIHTC properties limit residency to tenants aged 55 or older.[180]

Table 6-1: Federal Rental Housing Programs for Low-Income Elderly Households

	Share of Units Occupied by Elderly Households	Number of Units Occupied by Elderly Households
[illegible]	[illegible]	[illegible]
Housing Choice Vouchers	19%	408,047
Public Housing	31%	346,565
USDA Section 521 Rental Assistance	59%	160,243
[illegible]	[illegible]	[illegible]
Other HUD Programs	25%	9,329
Total	**31%**	**1,546,039**

Source: Center on Budget and Policy Priorities, *Federal Rental Assistance Facts* (December 19, 2012).

In addition, HUD operates four supportive services programs for those seniors living in HUD-assisted properties. The Congregate Housing program, the Service Coordinator program, and the Resident Opportunity and Self-Sufficiency Service Coordinator program each offer meals and other forms of assistance to help seniors with the activities of daily life. The Assisted Living Conversion program makes grants to HUD-assisted properties for purposes of converting some or all units into assisted living facilities.[181] Other programs, such as the Community Development Block Grant and HOME Investment Partnerships programs, support multiple, and sometimes competing, housing priorities but could be used to help finance local aging-in-place initiatives.

These efforts are all worthwhile, but except for the LIHTC program, none is producing new units. In addition, many of the remaining federally assisted units, especially in public housing, need modernization and rehabilitation. Moreover, aging senior properties typically house the oldest and frailest residents, yet they often lack the necessary features to meet these residents' needs, such as hand rails, barrier-free entrances, or roll-in showers.

Many of the recommendations presented in Chapter 4, Affordable Rental Housing, will help to address these challenges. The following are some additional policy recommendations that can help provide a more dedicated focus on responding to the housing challenges of a growing senior population.

Policy Recommendations

1. Better coordination of housing and health care. HUD and HHS should jointly identify and remove barriers to the creative use of residential platforms for meeting the health and long-term care needs of low- and moderate-income senior residents and seniors who live in the surrounding community. HUD and HHS should encourage accountable care organizations, medical homes, federally qualified health centers, and other managed care entities to partner with housing providers to create more integrated systems of services to meet the needs of residents, enable them to age in place, and achieve cost savings for the Medicare and Medicaid programs. In evaluating the costs of housing programs that serve frail seniors, Congress and the Office of Management and Budget should identify and take into account savings to the health care system made possible by the use of housing platforms with supportive services.

Many public housing and multifamily assisted properties already provide services designed to help older adults and persons with disabilities live independent lives. Working in partnership with states and localities, nonprofit providers such as Mercy Housing and National Church Residences, have already made great strides in improving coordination of housing, health care, and supportive services for low-income seniors, including through co-location of housing with health care and fitness centers, social programming, and assisted living for residents who need a higher level of care. At the state level, the Vermont Support and Services at Home (SASH) demonstration is another promising approach that bears close attention. The initiative uses multifamily assisted housing as a platform for providing integrated health services, with funding from Medicaid and Medicare.[182] As evaluation results come out in the coming years, the SASH program may serve as a model for similar programs in other states.

In states and localities that do not yet have an aging-in-place strategy, the proposed reforms to existing federal housing programs described in Chapter 4—particularly those related to the goal of enabling the elderly and persons with disabilities to live independent lives—will help providers measure the effectiveness of these services and encourage adoption of best practices to improve quality of life for assisted residents.

2. Support initiatives to retrofit homes and apartments for energy conservation and aging in place. The Energy Department's Weatherization Assistance Program helps low-income families permanently reduce their energy bills by taking simple steps to make their homes more energy efficient, such as sealing leaks around windows and doors and installing insulation. Under the program, the federal government provides funding to states and Indian tribal governments, which in turn support local community action agencies, nonprofit organizations, and local governments that provide weatherization services. The Energy Department estimates that the program has provided weatherization services to more than 6.4 million low-income households since inception, reducing annual energy bills for these households by an average of $437.[183] Weatherizing homes to reduce energy costs and improve living conditions and health outcomes is an important element of any aging-in-place strategy.[184] Funding for the program should continue and its scope expanded to include home assessments and modifications for aging in place.

Energy conservation retrofits are equally important for senior apartments, although unique challenges in multifamily properties call for a different strategy.[185] Modest retrofits can produce material energy and cost savings, especially in older buildings, and can be funded in large part with borrowed money that is repaid from savings on utility costs. In subsidized properties, most of the eventual savings will flow to the federal government. Working with affordable housing providers, technology firms, and others, HUD has already started to explore approaches to jump-starting these approaches[186] and should continue work to take them to scale.

3. Better integration of aging-in-place priorities into existing federal programs. Existing housing programs such as the Community Development Block Grant (CDBG) and the HOME Investment Partnerships programs should place greater emphasis on supporting local aging-in-place strategies. Many states and communities already use a portion of these flexible funds on senior households—for example, by allocating CDBG funds to local Area Agencies on Aging and other community groups to offer home rehab services for low-income homeowners aged 62 and older or to provide in-home services—but there is room for even further support for aging-in-place priorities. In addition, the federal Partnership for Sustainable Communities—a collaborative project of HUD, the U.S. Department of Transportation (DOT), and the U.S. Environmental Protection Agency—should reinforce the importance of affordable senior housing and senior-friendly transportation planning in its outreach, education, and grant-making activities. Policy makers should also consider integrating aging-in-place priorities into a broader range of federal programs, such as programs under the Older Americans Act and the federal transportation reauthorization.

4. Reverse mortgages and other home equity access products. For seniors who have spent a lifetime making mortgage payments, their home is typically their most valuable asset. In 2009, for example, half of homeowners aged 62 and older had at least 55 percent of their net worth tied up in home equity.[187] Currently, reverse mortgages are the main option for homeowners to tap into this equity to fund retirement needs and to support their desire to age in place. However, in a recent report to Congress, the Consumer Financial Protection Bureau concluded that few consumers fully understood the financial mechanics of these loans and that the increasingly complex product choices in the reverse mortgage market were making it much more difficult for housing counselors to provide effective guidance to their clients.[188]

With limited retirement savings among some aging Baby Boomers, and a shrinking social safety net, consumer interest in this type of mortgage product is likely to increase significantly, and it will be imperative that older homeowners have access to low-cost and effective reverse mortgage counseling so they can learn about the risks and potential benefits of these mortgage products before they face a financial crisis. Congress should also promote the development of alternative, low-cost home equity access products, particularly for seniors and family caregivers who face substantial out-of-pocket long-term care expenses.

In December 2012, FHA, which currently insures virtually all reverse mortgages through its Home Equity Conversion Mortgage (HECM) program, announced a moratorium on a popular lump-sum reverse mortgage option, due to disproportionately large losses to the FHA's insurance fund stemming from the program. Looking ahead, other FHA-insured reverse mortgage products will continue to be available, although they may be more difficult to obtain as the FHA makes further changes to its loan programs. Efforts to develop safe new home equity products would help to ensure the effective use and orderly draw-down of this valuable asset to manage financial risk in retirement.

5. Convene a White House conference on aging in place. The White House Conference on Aging is a once-in-a-decade conference sponsored by the Executive Office of the President. The first such conference was held in 1961 and the last in 2005. To draw national attention to the issue of senior housing and provide a high-level forum for the sharing of ideas and best practices, the President should convene a White House Conference on Aging with a focus on aging in place. Participants in this conference should include representatives of all levels of government—mayors, county executives, governors, as well as top federal officials such as the secretaries of HUD, HHS, DOT, USDA, and the VA. Other participants should include housing practitioners, community planners, and health care providers from across the country with substantial experience serving the needs of the elderly, and representatives of the homebuilding, architecture, remodeling, and interior design industries.

In advance of the conference, HUD should convene a series of meetings with members of the housing community to share best practices and identify innovative private-sector solutions that could be brought to scale. These innovations include prototype homes, new appliances and accessories, and creative market options such as co-housing and live/work flex housing that allows seniors to continue to pursue careers while working at home. Moreover, these meetings should highlight innovative efforts to weave together community services in support of the elderly, such as the Virtual Village-to-Village Network. To ensure broad dissemination of this information, HUD should develop a publicly available catalogue of best practices related to accessible home modification and new construction and home assessment tools.

Chapter 7. Concluding Thoughts: A Call to Action

Our nation's housing system is broken. Homeownership remains out of reach for far too many families who stand prepared to assume its financial and other obligations, while limited access to affordable mortgage credit impedes our nation's economic recovery and future growth. The country's lowest-income households continue to suffer under the crushing burden of high rental housing costs that are rising even more as rental demand increases. And we are not equipped to respond to the desires of millions of Americans who wish to stay in their own homes and age in place during their senior years.

The commission hopes that this report provides some valuable guidance on how best to respond to these challenges and will serve as a catalyst for action. This report has proposed:

- A responsible, sustainable approach to homeownership that will help ensure that all creditworthy households have access to homeownership and its considerable benefits.
- A reformed system of housing finance in which the private sector plays a far more prominent role in bearing credit risk while promoting a greater diversity of funding sources available for mortgage financing.
- A more targeted approach to providing rental assistance that would direct scarce resources to the lowest-income renters while insisting on a high level of performance by housing providers.
- A more comprehensive focus on meeting the housing needs of our nation's seniors that responds to their desire to age in place and recognizes the importance of integrating housing with health care and other services.

The problems we face in housing are so significant and so urgent today that inaction is no longer a viable option. In responding to these problems, we have an opportunity to improve the lives of millions and make America a stronger and more economically vibrant country, today and well into the future. It is therefore the commission's hope that 2013 will be the year that Congress and the administration finally elevate housing to the top of the national policy agenda and give housing the dedicated attention it deserves. The commission's 21 members, Democrats and Republicans, stand ready to help in this effort.

Appendix: Commission Structure and Process

Regional Housing Forums

The Bipartisan Policy Center (BPC) Housing Commission in partnership with the Jack Kemp Foundation hosted four regional forums to solicit input on key housing issues and best practices from stakeholders across the country. Public input was an integral part of the commission's process to craft a package of realistic and actionable recommendations for improving the nation's housing policy. All forums were open to the public and available by live webcast.

- San Antonio, Texas — March 6, 2012
- Orlando, Florida — April 17, 2012
- St. Louis, Missouri — June 5, 2012
- Bar Harbor, Maine — July 25, 2012

Research Undertaken by the Commission

Four research papers were prepared by consultants to the BPC as background for the deliberations of the commission. These papers were presented and discussed during the regional forums, and made available to the public on the BPC website, www.bipartisanpolicy.org/housing.

- *Demographic Challenges and Opportunities for U.S. Housing Markets*
  By Rolf Pendall, Lesley Freiman, Dowell Myers, and Selma Hepp
- *A Comparative Context for U.S. Housing Policy: Housing Markets and the Financial Crisis in Europe, Asia, and Beyond*
  By Ashok Bardhan, Robert Edelstein, and Cynthia Kroll
- *Housing Programs in the United States: Responding to Current and Future Challenges*
  By Diane Levy, Rolf Pendall, Marty Abravanel, and Jennifer Biess
- *The State of the Residential Construction Industry*
  By Carlos Martín and Stephen Whitlow

Additional research and analysis was conducted to inform the commission's deliberations, including contributions by Norman K. Carleton, former Director, Office of Federal Finance Policy Analysis, U.S. Department of Treasury; Robert D. Dietz, Assistant Vice President, Tax and Policy Issues, Economics and Housing Policy, National Association of Home Builders; Richard K. Green, Professor, Director and Chair of the USC Lusk Center for Real Estate; Ann B. Schnare, Principal, AB Schnare Associates, LLC; Kristin Siglin, Vice President-Policy, Housing Partnership Network; Eric Toder, Institute Fellow, Urban Institute and Co-director, Urban-Brookings Tax Policy Center; and Paul Weech, Executive Vice President-Policy and Member Engagement, Housing Partnership Network.

Key partners who assisted the commission with roundtable discussions include Vicki Been, Boxer Family Professor of Law at New York University School of Law, Associate Professor of Public Policy at NYU's Robert F. Wagner Graduate School of Public Service, and Director of the Furman Center at NYU; Mark Willis, Resident Research Fellow, the Furman Center at NYU; Janis Bowdler, Director, Wealth-Building Policy Project, National Council of La Raza; Marcie Chavez, Vice President, Community Development Commission/Housing Authority of the County of Los Angeles; Terry Gonzalez, Director, Community Development Block Grant Division and Intergovernmental Relations, CDC/HACLA; Sean Rogan, Executive Director, CDC/HACLA; Elisa Vasquez, Intergovernmental Relations/Public Information, CDC/HACLA; Eve O'Toole, Senior Policy Advisor, Holland & Knight; Daniel D. Clute, Senior Vice President, Federal Home Loan Bank of Des Moines; Curt Heidt, Vice President, External Relations, Federal Home Loan Bank of Des Moines; Gary Kain, President and Chief Investment Officer, American Capital AGNC Management, LLC and American Capital Mortgage MTGE Management, LLC; Sarah Mickelson, Policy Associate, Rapoza Associates; Robert A. Rapoza, President and Principal, Rapoza Associates; Mary White Vasys, President, Vasys Consulting Ltd.; and Susan M. Wachter, Richard B. Worley Professor of Financial Management, Professor of Real Estate and Finance, Co-Director - Institute for Urban Research, The Wharton School, University of Pennsylvania.

Housing Expert Forum

On a monthly basis, the commission collected responses to questions on pressing housing policy issues from experts across the industry. The expert responses were shared on the commission's website in an effort to help educate the public and policy makers, as well as to add to the commission's own research.

Contributors included:

- Angela Antonelli, Former Chief Financial Officer (CFO), U.S. Department of Housing and Urban Development
- Joseph N. Belden, Deputy Executive Director, Housing Assistance Council
- Michael Bodaken, President, National Housing Trust
- Mark A. Calabria, Director of Financial Regulation Studies, Cato Institute
- Robert J. Cristiano, President, L88 Investments LLC
- Conrad Egan, Senior Advisor, Affordable Housing Institute
- Eileen Fitzgerald, CEO, NeighborWorks America
- Kevin Igoe, Owner, IGOE/Associates
- Bill Kelly, President & Co-Founder, Stewards of Affordable Housing for the Future
- James Kemp, President, Jack Kemp Foundation
- Jeffrey Lubell, Executive Director, Center for Housing Policy
- Lora McCray, Manager, Housing Opportunity, National Association of Realtors
- Brian Montgomery, Chairman, The Collingwood Group
- Jeremy Nowak, former President and CEO, William Penn Foundation
- Jonathan T.M. Reckford, Chief Executive Officer, Habitat for Humanity International
- Barry Rutenberg, Immediate Past Chairman, National Association of Home Builders
- Barbara Sard, Vice President for Housing Policy, Center on Budget and Policy Priorities
- Dennis Shea, Founder and Principal, Shea Public Strategies, LLC
- David A. Smith, Founder and Chairman, Recap Real Estate Advisors
- Ali Solis, Senior Vice President, Public Policy and Corporate Affairs, Enterprise Community Partners
- Frank J. Vaccarella, President, Vaccarella & Associates, Consulting, LLP
- Joseph M. Ventrone, Vice President, Regulatory and Industry Relations, National Association of Realtors
- Kent Watkins, Chairman, National Academy of Housing and Sustainable Development
- Paul S. Willen, Senior Economist and Policy Advisor, Federal Reserve Bank of Boston

Website

The commission's website provided a platform for the commission to discuss its work, as well as for housing leaders to gain insight into the issues the commission considered throughout its year of deliberation. Some of the features of the website, www.bipartisanpolicy.org/housing, include:

- Housing by the Numbers: an interactive dashboard of key housing market indicators.
- Infographics: visual representations and explanations of trends that affect housing policy.
  - o *Household Formation and Demographic Trends*
  - o *Housing's Impact on the Economy*
  - o *Rental Housing Market Trends*

- What We're Reading: a review of top news stories that address critical developments in housing policy.
- Housing Visualized: a compilation of useful graphic and multimedia resources that explain economic indicators and statistical trends.
- Commission in the News: an aggregator of news articles and multimedia featuring commission members.

Commission Meetings

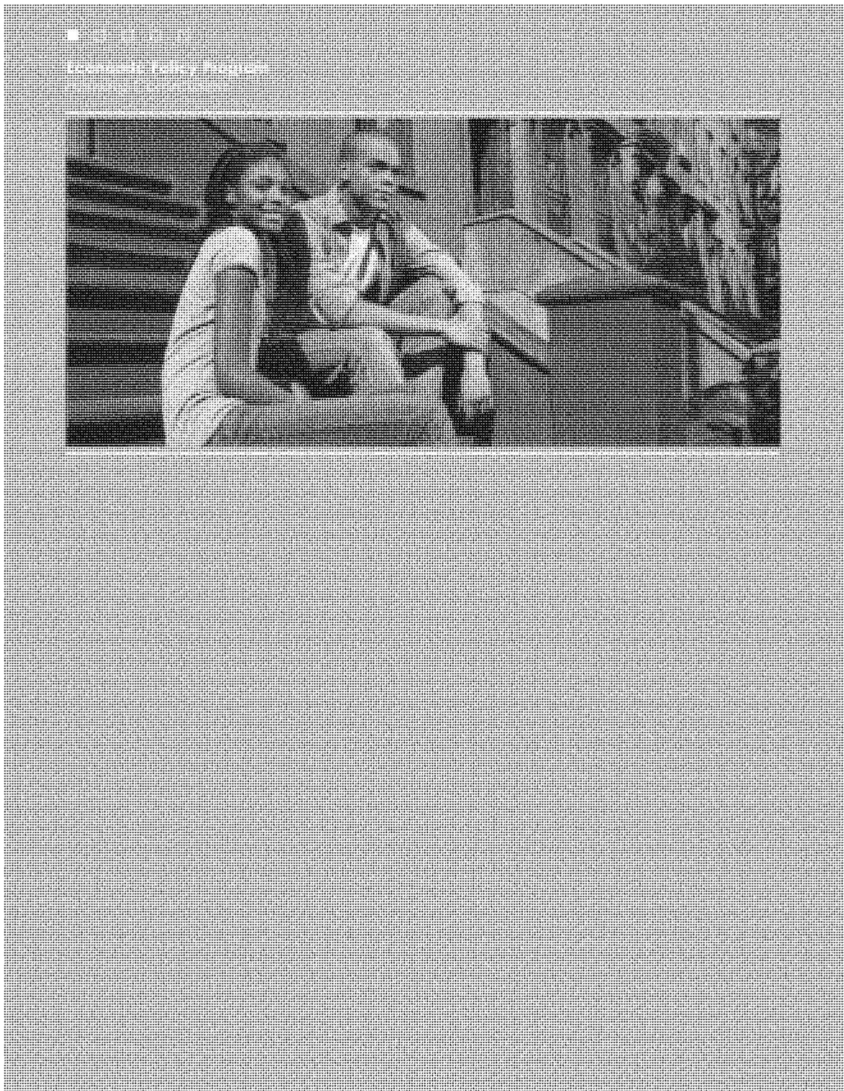
The full commission met regularly throughout the past year. In addition to these meetings, smaller groups of commissioners met frequently to focus on specific topics, such as single-family finance, multifamily finance, affordable rental housing, and homeownership. Full commission meeting dates were as follows:

- December 14/15, 2011
- February 13/14, 2012
- May 14/15, 2012
- July 25/26, 2012
- October 16, 2012
- November 27/28, 2012
- January 10, 2013

Roundtable Discussions with Invited Housing Practitioners

The commission held a number of roundtable discussions with practitioners in various areas of the housing field to solicit ideas about the appropriate role of the federal government in the housing sector, the need for reforming specific housing-related programs and funding mechanisms, as well as to get preliminary reactions to the commission's proposals. These gatherings throughout the past year were as follows:

- Roundtable on Affordable Rental Housing — February 3, 2012
- Roundtable on Affordable Rental Housing — February 10, 2012
- Roundtable on Affordable Rental Housing — April 2, 2012
- Capital Markets — April 4, 2012
- Community Lending Roundtable — June 4, 2012
- Multifamily Housing Finance Industry Roundtable — June 11, 2012
- Addressing Challenges in the Small Rental Stock, in partnership with the John D. and Catherine T. MacArthur Foundation — August 14, 2012
- Roundtable Discussion on Section 8 — August 17, 2012
- Obstacles, Costs, and Opportunities for Bringing More Private, Credit Risk-taking Capital into the Housing Market, in partnership with the Furman Center at NYU — September 19, 2012
- Accessibility and Affordability in the Mortgage Market, in partnership with the National Council of La Raza — September 25, 2012
- Positioning the Federal Role in the Future U.S. Multifamily Housing Finance System, in partnership with the Wharton School, University of Pennsylvania — September 27, 2012
- Housing Commission Discussion with Rural Housing Providers — October 18, 2012
- Housing Commission Discussion with Community Development Commission/Housing Authority of the County of Los Angeles — December 3, 2012



Endnotes

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75. An independent audit released in November 2012 found that for the first time in its history, the FHA's expected losses over the next 30 years are projected to exceed revenues. If projections prepared by the White House find similar results, FHA will need a draw from the Treasury to bring its capital reserve ratio (which measures reserves in excess of the levels needed to cover projected losses over a 30-year period) back to the statutorily required level.
76. "First loss risk" is a term that is often used to reflect the idea that the private sector will take the majority or the primary portion of the credit loss risk, leaving the "catastrophic risk" to the government. However, the term "first loss" can be misunderstood. Since it actually refers to the predominant portion of the loss (not just the first loss), this paper will use the term "predominant loss" when referring to the primary credit risk borne by the private sector.
77. If the private credit enhancer becomes insolvent and is unable to reimburse servicer losses due to default, the Public Guarantor will make those reimbursements.
78. Private credit enhancements themselves are no guarantee against failure. Rigorous capital standards, continuing oversight, and flexible regulation will be required to ensure the long-term stability of a system that relies on such private credit enhancements in order to protect taxpayer interests. Moreover, the reliance on private credit enhancers could potentially limit smaller lenders' ability to obtain insurance at reasonable prices. It will be critical for the Public Guarantor to monitor how the reliance on private credit enhancers affects smaller lenders' market access and, if necessary, to propose steps to remedy any disadvantageous outcomes that may result.
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87. Kim Betancourt, *Multifamily Market Commentary – January 2012* (Washington, DC: Fannie Mae, Multifamily Economics and Market Research, 2012).
88. In 2011, bank funding for apartment buildings increased by 60 percent, or $40 billion, from 2010. See Brian Browdie, "Apartment Lending Jumped 60% in 2011," *American Banker*, October 9, 2012.
89. Between 2008 and the third quarter of 2011 Fannie Mae and Freddie Mac's multifamily operations brought in $7 billion in revenue with default rates consistently under one percent. See Federal Housing Finance Agency, Office of the Inspector General. *Semiannual Report to the Congress: October 1, 2011, through March 31, 2012.* (Washington, DC: FHFA-OIG, 2012). Fannie Mae and Freddie Mac have taken very different approaches to managing their risks in multifamily mortgages. Fannie Mae has relied mostly on risk-sharing on a loan-by-loan basis with approved Delegated Underwriting and Servicing (DUS) lenders. DUS lenders share in all losses on multifamily rental mortgages, typically on a *pari passu* basis, with the DUS lender covering up to one-third of losses and Fannie Mae two-thirds. DUS lenders are required to maintain specified levels of net worth, liquidity and reserves with respect to their risk-sharing obligations. Freddie Mac has relied on underwriting multifamily mortgage loans directly without risk-sharing, although it recently began to share risk by issuing subordinated debt to support its guaranteed senior tranches under its K-series CMBS program.

90. The purpose of the affordability requirement is to provide liquidity for projects that will continue to serve low- and moderate-income households over time. As such, safeguards should be adopted to prevent those transactions where the underwriting indicates intent to increase rents to levels above the affordability threshold from having access to the guarantee in cases where this adjustment would shift the balance of the loan pool above the affordability threshold. This means that the pro-forma financing of the property could not count on rent increases phased in over time to satisfy underwriting criteria. That is, owners of properties financed with a government guarantee enjoy the flexibility to raise rents but not to finance a property with low initial rents just to qualify for the guarantee.

91. The exception is limited availability under the FHA multifamily program of 15 percent down payments.

92. In this new system, the issuer would be in the position to decide how it shares the predominant risk of credit losses, provided it retained some of this risk as required of it by the Public Guarantor. The Public Guarantor would provide a list of acceptable and approved vehicles for issuers to share the predominant risk with other private investors.

93. A brief and unsuccessful experience sharing risk with private counterparties under the FHA co-insurance program in the late 1980s underscores the importance of assuring that counterparties have the capital and liquidity needed to make good on their commitments.

94. Shear, William B., et al., *Fannie Mae and Freddie Mac's Multifamily Housing Activities Have Increased.*

95. For calendar year 2012, per-unit mortgage limits for Section 207/223(f) Mortgage Insurance for Purchase or Refinance of Existing Multifamily Rental Housing ranged from $47,553 for studio apartments in non-elevator buildings to $106,719 for 4+ bedroom units in elevator buildings, and from $47,325 for non-elevator studios to $101,195 for 4+ bedroom elevator units for Section 221(d)(4) Mortgage Insurance for Rental and Cooperative Housing. See Federal Register notice docket number FR-5592-N-01 for more details. In addition to these core programs, FHA also provides mortgage insurance for a host of other housing types, including multifamily manufactured home parks, rental housing for the elderly, and hospitals and residential care facilities.

96. The 2001 Residential Finance Survey is the most recent dataset of housing on a property basis (generally defined as a building or buildings under a single mortgage or contiguous properties owned debt free by the same owner and construed as a property). By contrast, there are more recent datasets that report on the number of housing units by structure type. By this measure, in 2009, 37 percent of rentals were in single-family buildings or manufactured homes, 20 percent in two- to four-unit buildings, 25 percent in buildings with five-19 units, and 9 percent in buildings with 20-49 units. Many 50-plus-unit properties are composed of multiple buildings with fewer than 50 units. Hence, for example, while in 2001 there were only 3.1 million buildings with 50 or more units, there were 10.6 million properties with 50 or more units.

97. Owners of just a single-unit property intended for rent should probably still be underwritten like homeowners in the sense that the decisions should be based on the borrowers' credit score and ability to carry the mortgage debt without relying on rental income. If the owner holds more than one such property, then policy makers should give consideration as to whether incremental additions should be handled under the multifamily system and take a portfolio view of the two or more separate properties owned.

98. The Board of Governors of the Federal Reserve System, among many others, have underscored the importance of helping support land banks -- quasi-governmental entities set up to help own and manage low-value properties that markets might otherwise leave unrehabilitated and abandoned, dragging down property values in neighborhoods. See the Federal Reserve's 2012 White Paper entitled "The U.S. Housing Market: Current Conditions and Policy Considerations."

99. CDFI membership in the FHLB system was authorized in the Housing and Economic Recovery Act of 2008, with final regulations issued by the Federal Housing Finance Agency in 2009. But the Act did not designate CDFIs as Community Financial Institutions (CFIs), limiting the ability of certain CDFIs to pledge nontraditional collateral allowed CFIs to secure advances from the FHLBs.

100. American Community Survey, 1-Year Estimates. *Median Household Income the Past 12 Months by Tenure* (U.S. Census Bureau, 2011).

101. Steffen, Barry, et al., *Worst Case Housing Needs 2009: Report to Congress.* (Washington, DC: U.S. Department of Housing and Urban Development, Office of Policy Development and Research, 2011), 28.

102. See Rebecca Cohen, *The Impacts of Affordable Housing on Health: A Research Summary* (Washington, DC: Center for Housing Policy, 2011); Maya Brennan, *The Impacts of Affordable Housing on Education: A Research Summary* (Washington, DC: Center for Housing Policy, 2011).

103. Acs, Gregory, Pamela J. Loprest, and Austin Nichols, *Risk and Recovery: Documenting the Changing Risks to Family Incomes* (Washington, DC: The Urban Institute, 2009).

104. Been, Vicki and Ingrid Gould Ellen, *Challenges Facing Housing Markets in the Next Decade: Developing a Policy-Relevant Research Agenda* (New York, NY: NYU Furman Center for Real Estate and Urban Policy, 2012).

105. J. Ronald Terwilliger, *America's Housing Policy-the Missing Piece: Affordable Workforce Rentals* (Washington, DC: Urban Land Institute, 2011).

106. For the first comprehensive examination of local regulatory barriers to affordable housing, see Advisory Commission on Regulatory Barriers to Affordable Housing, *"Not in My Backyard": Removing Barriers to Affordable Housing* HUD-5806 (Washington, DC: U.S. Department of Housing and Urban Development, 1991); see also U.S. Department of Housing and Urban Development Office of Policy Development and Research, *"Why Not in Our Community?" Removing Barriers to Affordable Housing* (Washington, DC: 2004).

107. A wealth of research confirms that regions with restrictive regulatory regimes tend to have higher housing costs than regions with fewer regulatory restrictions. See Pendall, Rolf, Robert Puentes, and Jonathan Martin, *From Traditional to Reformed: A Review of the Land Use Regulations in the Nation's 50 Largest Metropolitan Areas* (Washington, DC: The Brookings Institution, 2006); Glaeser, Edward L. and Joseph Gyourko, "The Impact Of Building Restrictions On Housing Affordability," *FRBNY Economic Policy Review* (June 2003), 21-39; Michael H. Schill, "Regulations and Housing Development: What We Know," *Cityscape: A Journal of Policy Development and Research* 8, no. 1 (2005), 5-19.

108. Based on American Housing Survey data as tabulated by Abt Associates. July 16, 2012, memo to BPC staff.

109. There are different ways of calculating this statistic. One approach compares the number of renters with incomes below 80 percent of area median income (AMI) reporting receipt of rental assistance (4.6 million) with the total number of renters with incomes below 80 percent of AMI who either: spend 30 or more of their income for housing (14.3 million) or report receipt of rental assistance (4.6 million). This generates an assistance percentage of 24.3 percent, based on numbers reported in the 2009 American Housing Survey, as tabulated in Steffen, Barry, et al., *Worst Case Housing Needs 2009: Report to Congress.*

110. Historically, from the late 1970s to the early 1990s, multifamily housing starts made up 34 percent of all housing starts. From the early 1990s to late 2000s, however, the overall share of new housing starts that were multifamily was less than 18 percent. Production of both affordable and market rate rental housing fell precipitously with the recent economic downturn, with production of multifamily rental units dropping by nearly 41 percent between 2009 and 2011 alone. Though the number of multifamily housing starts has begun to rise again, recently close to 29 percent of all new starts on average, overall multifamily production is still nearly 150,000 units short of where the average production levels were from 1994 to 2008.

111. Terwilliger, *America's Housing Policy-the Missing Piece: Affordable Workforce Rentals.*

112. Lawrence L. Thompson, *A History of HUD* (Washington, DC: 2006), 4.

113. Thompson, *A History of HUD*, 4-5.

114. Heinz, John, et al., *Omnibus Budget Reconciliation Act of 1981: An Information Paper prepared by the Special Committee on Aging, United States Senate* (Washington, DC: U.S. Government Printing Office, 1981), 19.

115. *The 2011 Annual Homeless Assessment Report to Congress* (Washington, DC: U.S. Department of Housing and Urban Development, 2012), 71.

116. *The 2012 Point-in-Time Estimates of Homelessness* (Washington, DC: U.S. Department of Housing and Urban Development, 2012), 18.

117. U.S. Department of Housing and Urban Development, *FY2012 State Income Limits* (Washington, DC: 2012).

118. Today, public housing agencies may issue up to 25 percent of vouchers to households earning up to 80 percent of AMI.

119. This shift in eligibility is expected to make available for the lowest-income households, on average, about $3.3 billion per year over a ten-year period - ranging from $0.7 billion in the first year to upwards of $5.6 billion by the tenth year of the program.

120. Burt, Martha, et al., *Homelessness: Programs and the People They Serve: Findings of the National Survey of Homeless Assistance Providers and Clients* (Washington, DC: The Urban Institute, 1999).

121. Kuhn, Randall and Dennis P. Culhane, "Applying Cluster Analysis to Test a Typology of Homelessness by Pattern of Shelter Utilization: Results from the Analysis of Administrative Data," *American Journal of Community Psychology* 26, no. 2 (1998), 207-232.

122. Ingrid Gould Ellen, "Rental Housing Policy in the United States: Key Facts and Critical Trade-Offs" (presentation, *The Next Generation Housing Policy Convening on Rental Policy*, Washington, DC, October 13, 2010), using estimates prepared by the Joint Center for Housing Studies of Harvard University.

123. In addition to the allocated tax credit program, the LIHTC includes a multifamily tax-exempt bond program which is awarded under a state's private activity bond cap and which includes lower valued tax credits.

124. O'Regan, Katherine M. and Keren M. Horn, "What Can We Learn about the Low Income Housing Tax Credit Program by Looking at the Tenants?" Forthcoming, *Housing Policy Debate* (New York, NY: NYU Furman Center for Real Estate and Urban Policy, Moelis Institute for Affordable Housing Policy, 2012).

125. CohnReznick LLC (formerly "Reznick Group"), *The Low-Income Housing Tax Credit Program at Year 25: A Current Look at Its Performance* (New York, NY: CohnReznick LLC, 2011).

126. By contrast, the LIHTC is currently allocated based on overall population. Allocating the 50 percent increase in LIHTC by renter population will help to increase the credit allocation to states with a greater use for them.

127. The Council of Large Public Housing Authorities and the Public Housing Authorities Directors Association, FFY 2013 PHADA/CLPHA Public Housing and Section 8 Funding Needs, February 1, 2012. Calculation based upon the *Abt Associates, Inc. 2010 Capital Needs Assessment* average accrual number (adjusted for inflation).

128. U.S. Department of Housing and Urban Development Office of Policy Development and Research, "Quantifying Energy Efficiency in Multifamily Rental Housing." *Evidence Matters*, Summer 2011.

129. This number is based on a tabulation of the average emergency assistance made available per household by grantees of the Homelessness Prevention and Rapid Re-Housing Program as tabulated by Abt Associates. For reference, 18 percent of HPRP grantees provided average grants at this level or lower. September 28, 2012, memo to BPC staff.

130. National Alliance to End Homelessness, *Ending Family Homelessness, National Trends and Local System Responses* (Washington, DC: 2011), 6.

131. HUD measures housing quality directly in the public housing and project-based Section 8 programs. See below for further discussion.

132. Internal HUD data from the 2000 to 2003 period indicate that about 22 percent of units assisted through the housing voucher program had 8 or more defects of the type measured by HUD's Housing Quality Standards (which include minor defects as well as major ones) while roughly 13 percent had one or more critical problems sufficient to warrant an identification as severely inadequate under the standards used in the American Housing Survey. See Gray, Robert W. et al., *Tell Us About Your Home: Three Years of Surveying Housing Quality and Satisfaction in the Housing Choice Voucher Program*, U.S. Department of Housing and Urban Development, Draft, 2009. NOTE: More recent housing quality data are expected to be available early in 2013 once HUD releases an enhanced version of the 2011 American Housing Survey, which includes identifiers for participation in HUD programs.

133. When founded in 1965, HUD employed 13,700 people and grew to 17,100 employees by 1980. In the late 1980s, abusive management practices triggered the 1989 HUD Reform Act, which ushered in a review of HUD's mission and goals. Secretaries Henry Cisneros (1993-1997) and Andrew Cuomo (1997-2001) proposed and implemented reductions in HUD staff levels. By 2012, HUD employed roughly 9,200 people. See data from the Office of Management and Budget as cited in Thompson, *A History of HUD*, 40; U.S. Department of Housing and Urban Development, "Cuomo Announces Historic Management Reforms for HUD to Stamp Out Waste, Fraud and Abuse and Improve Performance," press release, June 26, 1997; HUD, "Fiscal Year 2013 Budget, Full-Time Equivalent (FTE) Employment," A-1 (2012).

134. The Moving to Work Demonstration provides participating providers with broad flexibility to depart from statutory and regulatory requirements related to HUD-funded rental assistance. Originally authorized in 1996, the Demonstration currently applies to 35 housing authorities administering public housing and/or Section 8 housing vouchers. Participating agencies enter into a Moving to Work agreement with HUD that specifies the terms under which they will be funded by HUD as well as the nature of any waivers of legal requirements and a set of protections for residents.

135. See the Small Housing Authority Reform Proposal, jointly sponsored by the National Association of Housing and Redevelopment Officials and the Public Housing Authorities Directors Association.

136. See, for example, Mills, Gregory, et al., *Effects of Housing Vouchers on Welfare Families* (Washington, DC: U.S. Department of Housing and Urban Development, Office of Policy Development and Research, 2006).

137. See Bloom, Howard S., et al., *Promoting Work in Public Housing: The Effectiveness of Jobs-Plus* (New York, NY: MDRC, 2005); De Silva, Lalith, et al., *Evaluation of the Family Self-Sufficiency Program: Prospective Study* (Washington, DC: U.S. Department of Housing and Urban Development, Office of Policy Development and Research, 2011).

138. See, generally, Wilson, William Julius, *The Truly Disadvantaged: The Inner-City, the Underclass and Public Policy* (Chicago, IL: University of Chicago Press, 1987).

139. HUD's voucher program rating system already includes a "bonus" de-concentration measure that examines the extent to which voucher-holders have gained access to low-poverty neighborhoods. This measure could be evaluated and improved if necessary to ensure it effectively measures the success of the voucher program in helping families access neighborhoods of opportunity. Because public housing and project-based rental assistance units are not portable like vouchers, other approaches will be needed to measure access to opportunity in these programs.

140. While HUD already measures housing quality in the public housing and multifamily assisted housing programs, it will be important during the standards-setting process to consider whether the current quality standards could be strengthened to better reflect the latest research on how housing promotes health -- for example, with respect to ventilation, moisture and pests. See, generally, Jacobs, David E. and Andrea Baeder, *Housing Interventions and Health: A Review of the Evidence* (Columbia, MD: National Center for Healthy Housing, 2009).

141. A number of proposals have been made to reduce the frequency of HUD's inspections of public housing and assisted units and/or of housing authority inspections of voucher-funded units. We would support such streamlining so long as the change in frequency of inspections does not lead to a measurable deterioration in housing quality.

142. See "Housing Choice: Is your property ready?" Atlanta Housing Authority, accessed January 7, 2013, http://www.atlantahousing.org/housingchoice/landlords/index.cfm?fuseaction=checklist.

143. According to one representative of large multifamily property owners, "owners could achieve improved operating efficiencies and reduce subsidy costs if they had greater flexibility to (i) merge entities and use pooled financing, (ii) access accumulated equity and reserves, and (iii) make partial or full transfers to other properties of section 8 rental assistance and operating support for section 202 properties now tied down by regulatory agreement. The ability to build capital at the parent or portfolio level would enable an owner to cross-subsidize its weaker properties and to have working capital to innovate." July 3, 2012 statement submitted to the BPC Housing Commission by Stewards of Affordable Housing for the Future.

144. The middle group of providers that have an acceptable level of performance but do not rank as excellent will be exempt from competition but also will not have access to the regulatory flexibility provided to high performers.

145. To ensure the results can be interpreted effectively, it will also be necessary to utilize a control group and/or to compare a proposed new approach with other similar interventions. For example, if a high-performing agency wants to try a new intervention that combines financial incentives for increased work with case management to promote work, it may make sense to also examine the impacts of each of these components in isolation, and to compare the results to a control group that is not offered the opportunity to participate in the program.

146. DeNavas-Walt, Carmen, et al., *Income, Poverty, and Health Insurance Coverage in the United States: 2010*. U.S. Census Bureau, Current Population Reports, P60-239 (Washington, DC: U.S. Government Printing Office, 2011).

147. Housing Assistance Council ("HAC"), *Poverty in Rural America* (Washington, DC: HAC, 2011).

148. DeNavas-Walt, Carmen, et al., *Income, Poverty, and Health Insurance Coverage in the United States: 2010*, 18.

149. Tracey Farrigan, *Rural Income, Poverty, and Welfare: Poverty Geography* (Washington, DC: U.S. Department of Agriculture, Economic Research Service, 2010).

150. 2011 American Housing Survey, *Housing Costs -- All Occupied Units (National)* (U.S. Census Bureau, 2011).

151. Housing Assistance Council ("HAC"), *Homeownership in Rural America* Rural Research Note (Washington, DC: 2012), 1.

152. HAC, *Taking Stock: Rural People, Poverty, and Housing in the 21st Century* (Washington, DC: 2012), 35.

153. Ibid.

154. HAC, *Housing in Rural America* (Washington, DC: 2010).

155. HAC, *Taking Stock*, 36-37.

156. HAC, *Taking Stock*, 3.

157. See U.S. Code 42USC 1490. For purposes of this subchapter, any area classified as "rural" or a "rural area" prior to October 1, 1990, and determined not to be "rural" or a "rural area" as a result of data received from or after the 1990 or 2000 decennial census shall continue to be so classified until the receipt of data from the decennial census in the year 2010, if such area has a population in excess of 10,000 but not in excess of 25,000, is rural in character, and has a serious lack of mortgage credit for lower and moderate-income families.

158. See Housing Assistance Council ("HAC"), *Estimating Potential Changes to USDA-RD's Eligible Area Designations* (Washington, DC: HAC, 2011), 3. By comparison, about 16 percent of the population resides outside OMB-designated Metropolitan Areas, and 23 percent of the population is located in Census Bureau-defined Rural Areas.

159. October 23, 2012 letter submitted to the BPC Housing Commission by Robert Rapoza, National Rural Housing Coalition.

160. January 29, 2013 email communication with Donn Appleman, U.S. Department of Agricultural Development - Rural Development.

161. January 24, 2013 email communication with Barbara Sard, Center on Budget and Policy Priorities.

162. House Appropriations Committee, *Rural Development before the Subcommittee on Agriculture, Rural Development, Food and Drug Administration and Related Agencies*, 112th Congress (2012) (statement by Tammye Treviño, Administrator, Rural Housing Service).

163. Scirè, Mathew and James White, *Housing Assistance: Opportunities Exist to Increase Collaboration and Consider Consolidation*. GAO-12-554, (Washington, DC: U.S. Government Accountability Office, 2012).

164. Housing Assistance Council, *Estimating Potential Changes to USDA-RD's Eligible Area Designations*. Rural Housing Research Note (Washington, DC: 2011), 1.

165. In Fiscal Year 2011, the U.S. Department of Agriculture guaranteed $16.9 billion in loans and issued $1.1 billion in direct loans. See Ruth Simon, "USDA is a Tough Collector When Mortgages Go Bad," *Wall Street Journal*, May 24, 2012.

166. Bipartisan Policy Center and Housing Assistance Council tabulations of U.S. Department of Agriculture data.

167. Henry Cisneros, "New Visions for Aging in Place," in *Independent for Life: Homes and Neighborhoods for an Aging America*, ed. Henry Cisneros, Margaret Dyer-Chamberlain, and Jane Hickie (Stanford, CA: Stanford Center on Longevity, 2012), 8.
168. Centers for Disease Control and Prevention, *Healthy Places Terminology* (Washington, DC: Centers for Disease Control and Prevention, 2010).
169. Farber, Nicholas, et al., *Aging in Place: A State Survey of Livability Policies and Practices* (National Conference of State Legislatures and AARP Public Policy Institute, 2011), 1.
170. Henry Cisneros, "New Visions for Aging in Place," in *Independent for Life: Homes and Neighborhoods for an Aging America*, 8.
171. Green, Richard K. and Gary D. Painter, "Housing Finance," in *Independent for Life: Homes and Neighborhoods for an Aging America*, 238-239.
172. Esther Greenhouse, "The Home Environment and Aging," in *Independent for Life: Homes and Neighborhoods for an Aging America*, 88-97; and Greg Miedema, "A Contractor's Perspective," in *Independent for Life: Homes and Neighborhoods for an Aging America*, 113-122.
173. Elinor Ginzler, "From Home to Hospice: The Range of Housing Alternatives," in *Independent for Life: Homes and Neighborhoods for an Aging America*, 57.
174. Farber, Nicholas, et al., *Aging in Place: A State Survey of Livability Policies and Practices*, 48-50.
175. Elinor Ginzler, "From Home to Hospice: The Range of Housing Alternatives," *Independent for Life: Homes and Neighborhoods for an Aging America*, 57.
176. Farber, Nicholas, et al., *Aging in Place: A State Survey of Livability Policies and Practices*, 50.
177. Center for Housing Policy tabulations of the 2009 American Housing Survey. For an analysis of these data by age and income cohorts, see Lipman, Barbara, Jeffrey Lubell, and Emily Salomon, *Housing an Aging Population: Are We Prepared?* (Washington, DC: Center for Housing Policy, 2012).
178. Andrew Kochera, *Developing Appropriate Rental Housing for Low-Income Older Persons: A Survey of Section 202 and LIHTC Property Managers* (Washington, DC: AARP Public Policy Institute, 2006), 4.
179. Shirley Franklin and Jane Hickie, "A Political Strategy," in *Independent for Life: Homes and Neighborhoods for an Aging America*, 248-249; see also: Libby Perl, *Section 202 and Other HUD Rental Housing Programs for Low-Income Elderly Residents* (Washington, DC: Congressional Research Service, 2010), 1.
180. Andrew Kochera, *Developing Appropriate Rental Housing for Low-Income Older Persons: A Survey of Section 202 and LIHTC Property Managers.*
181. Ibid.
182. For more information, see Center for Housing Policy, "Meeting the Health Care Needs of Aging Residents of Affordable Multifamily Housing." Case study prepared for the How Housing Matters Conference, Washington, DC, November 2011.
183. U.S. Department of Energy. *Fiscal Year 2011 Summary of Performance and Financial Information* (Washington, DC: 2012), 16.
184. Keith Wardrip, *Strategies to Meeting the Housing Needs of Older Adults*, 3-4.
185. Government Accountability Office, *States' and Localities' Uses of Funds and Actions Needed to Address Implementation Challenges and Bolster Accountability* GAO-10-604 (Washington, DC: 2010), 121.
186. U.S. Department of Housing and Urban Development, "HUD Awards $23 Million to Test New Energy-Saving Approaches in Older Multi-Family Housing Developments," press release, March 8, 2012.
187. Consumer Financial Protection Bureau. *Reverse Mortgages: Report to Congress* (Washington, DC: 2012), 5.
188. Consumer Financial Protection Bureau. *Reverse Mortgages: Report to Congress* (Washington, DC: 2012), 111.

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