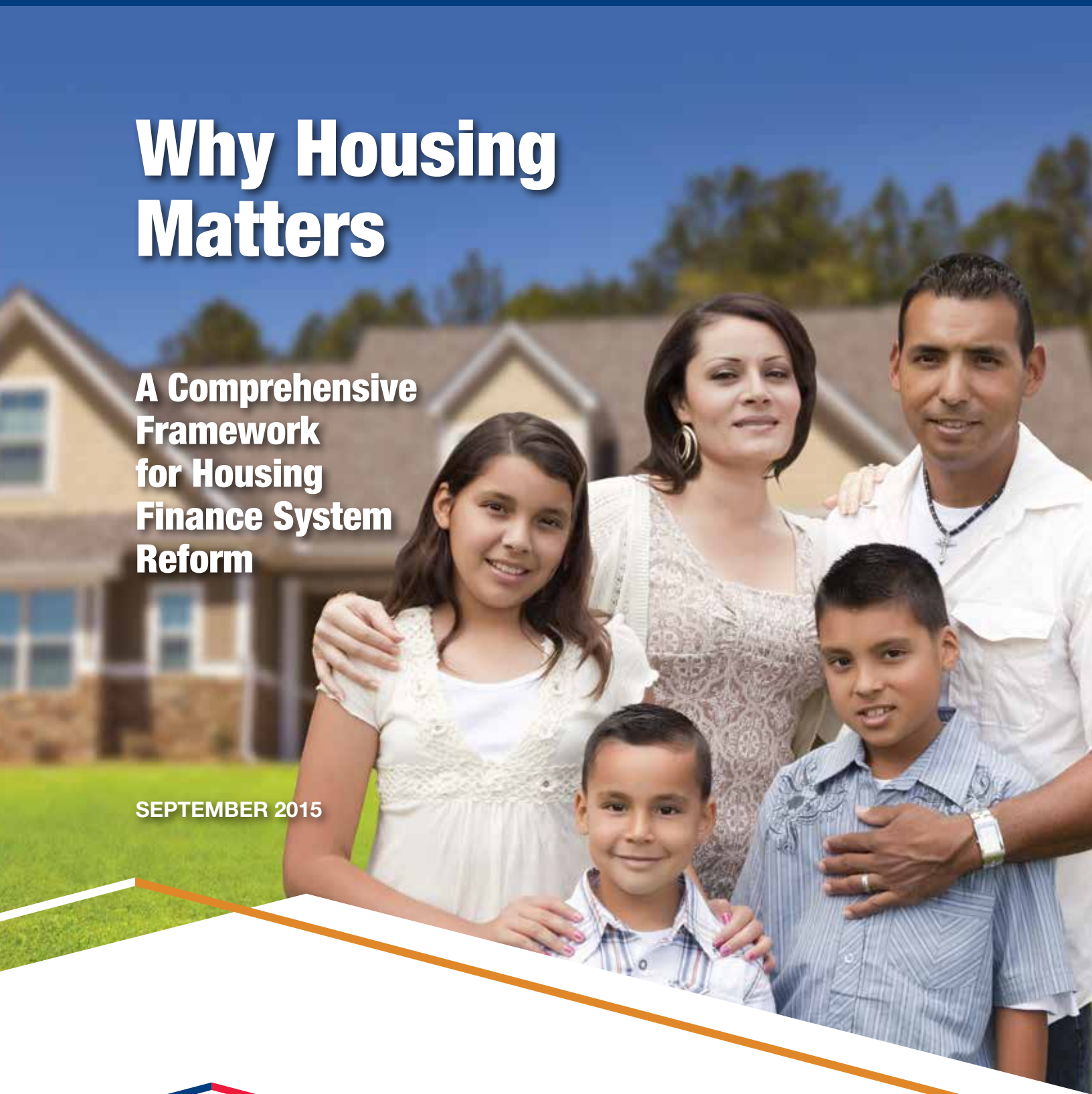
National Association of Home Builders

# Why Housing Matters

## A Comprehensive Framework for Housing Finance System Reform



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NAHB®

# WHY HOUSING MATTERS

## A COMPREHENSIVE FRAMEWORK FOR HOUSING FINANCE SYSTEM REFORM

***SEPTEMBER 2015***


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# WHY HOUSING MATTERS

# A COMPREHENSIVE FRAMEWORK FOR HOUSING FINANCE SYSTEM REFORM

## Executive Summary

While it is self-evident to some, at the outset it is important to answer the following questions:

**"Why Housing Matters…and Why a comprehensive Housing Finance System Reform Policy is necessary now?"**

While there are many reasons, some stand out as compelling:

1. The Housing Act of 1949 pledged a "decent home and a suitable living environment for every American family." That principle remains a bedrock for Americans, although delivering on the promise is more difficult in 2015 and beyond.
2. Homeownership has been the most effective step on the ladder into the middle class and to create wealth for most Americans since the 1950s, and continues to fill that role while also fulfilling the promise of the Housing Act of 1949.
3. Excessive unemployment and underemployment has occurred and continues from the negligence and mismanagement in the financial industry, a principal cause of the Great Recession. Millions in the U.S. suffered and continue to suffer from loss and impairment of income which also increased the burden on the national government from lower tax revenues and the need to extend unemployment benefits and other backstops.
4. Homebuilding is USA manufacturing. The jobs it creates cannot be shipped overseas. Reigniting and supporting homebuilding directly correlates to American manufacturing jobs at all levels.
5. A reformed National Housing Finance Policy supports the Housing Act of 1949's goals, but, just as importantly, will reduce the probability of another Great Recession caused by a lack of effective financial systems for the housing sector of the economy.
6. "Decent, affordable, and accessible housing fosters self-sufficiency, brings stability to families and new vitality to distressed communities, and supports overall economic growth…[while indirectly reducing the] enormous strains on the nation's education, public health, social service, law enforcement, criminal justice and welfare systems."[1] This is especially so in inner city and redeveloping communities.

The nation's housing market continues to suffer eight years since the severe upheaval in world financial markets, retarding economic and job market recovery in the U.S. While some steps have been taken to address weaknesses in the framework for mortgage and broader financial transactions, no meaningful progress has occurred in implementing comprehensive reforms to

[1] Bipartisan Millennial Housing Commission Report, *Meeting Our Nation's Housing Challenges,* (Washington, DC: Government Printing Office, 2002), *p.10*.

the housing finance system to ensure that housing credit is available and affordable in the future and is delivered though a competitive, efficient, sound, safe and stable system. A healthy housing market is a cornerstone of a durable and strong U.S. economy and a vibrant and reliable housing finance system is essential to fulfilling the mandate of the Housing Act of 1949.

The National Association of Home Builders (NAHB) believes the U.S. housing finance system should be multifaceted with both competing and complementary components, including private, federal and state sources of capital liquidity. The following are summaries of specific policy positions covering funding for both single family and multifamily housing, which are detailed more fully in the body of the white paper.[2]

**Establish a new secondary market system for conventional mortgages with a federal government backstop for catastrophic circumstances.**

It is essential to have an efficient and stable secondary market where conventional single family and multifamily mortgages are aggregated and placed into diversified pools for securitization and sale to investors all over the globe. The securities would have an explicit federal government guarantee, but the federal support to the conventional mortgage market of the future should be limited to catastrophic situations where carefully calibrated levels of private capital and insurance reserves are depleted before any taxpayer funds are employed to shore up the mortgage market. This would be done by creating a privately funded insurance pool for conventional mortgage-backed securities (MBS) that would be similar to the insurance fund that secures savings deposits through the Federal Deposit Insurance Corporation (FDIC).

Banks and other lenders do not have the capacity, business model or dedication to adequately service the nation's demand for housing credit by keeping all loans in their portfolios. Further, the fact that the private market has not stepped in since the start of the Great Recession, coupled with the support and good performance from Fannie Mae and Freddie Mac (except for the transgressions leading up to the Great Recession), provide compelling arguments for an explicit last resort government backstop in a reformed conventional mortgage market.

Under this approach, private Housing Finance Entities (HFEs) would be authorized to purchase mortgages from loan originators and to package the loans into securities. The originators and HFEs would be required to maintain capital to cover a portion of the credit risk on the pooled mortgages, with private mortgage insurance required on higher loan-to-value mortgages. The HFEs and originators also would pay premiums into the insurance fund that would provide additional protection to MBS investors. The federal government would ensure the fund is actuarially sound and would stand behind the insurance fund in a catastrophic last tier position. This would provide securities investors a guarantee similar to the successful Government National Mortgage Association (Ginnie Mae) model.

HFEs could take on a range of forms. One possibility would be to bring Fannie Mae and Freddie Mac (the Enterprises) out of conservatorship and restructure them as HFEs. The

[2] On February 9, 2012, the Board of Directors of the National Association of Home Builders (NAHB) adopted policy outlining a comprehensive framework for housing finance system reform. This paper incorporates updates based on a review of that policy by the 2015 Housing Finance Committee in light of developments since the original policy was adopted.

Enterprises would be subject to the same rules, including safety and soundness and capital requirements, as all HFEs and be provided the protection and opportunities of the federal catastrophic backstop. Most important, the Enterprises' infrastructure should be utilized one way or another regardless of the ultimate future of Fannie Mae and/or Freddie Mac.

To the extent that the Federal Home Loan Bank System could adapt to the HFE system and desires to do so, one or more of the Federal Home Loan Banks (FHLBanks) could serve as HFEs. Most FHLBanks also have operated or participated in mortgage purchase programs, buying mortgages from member institutions to hold in portfolio. The FHLBanks also have been cautiously expanding their role in the housing finance system through pilot programs developed to help their members sell mortgage loans in the secondary mortgage market. FHLBanks could expand their mortgage programs by aggregating loans for sale to HFEs if the FHLBank desired. Alternatively, one or more FHLBanks could be restructured as HFEs, subject to the same requirements and protections of all HFEs.

The HFE conventional mortgage securitization system should operate under the oversight of a strong independent regulatory agency to ensure all aspects of safety and soundness. The agency also would oversee the federal conventional MBS insurance fund. The regulatory agency should be governed by a board similar to the body governing the FDIC with extensive expertise in the housing capital markets and housing finance needs.

Any changes to the housing finance system should be undertaken with extreme care and with sufficient time to ensure that U.S. home buyers, owners, and renters are not placed in harm's way and that the mortgage funding and delivery system operates efficiently and effectively as the old system is wound down and a new system is put in place. Every effort should be made to reassure borrowers and markets that credit will continue to flow to creditworthy borrowers and that mortgage investors will not experience adverse consequences as a result of changes in process.

**Restart a carefully regulated fully private mortgage-backed securities system.**

HFEs would operate alongside a fully private MBS system. Key prerequisites to restarting the private-label MBS market include increasing transparency and disclosure around the collateral and structure of private label securities, ensuring all participants operate under adequate regulation and have a stake in the performance of the mortgages that are originated and sold. The credit ratings process must be reformed to address conflicts of interest and provide investors assurance that their interests and rights are protected.

**Continue the roles of the federal government housing agencies.**

The housing finance support roles of the Department of Housing and Urban Development (HUD), Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), the Department of Agriculture (USDA) and Ginnie Mae should be preserved. Efforts should continue to make the operations of these agencies more efficient and effective.

**Enhance the activities of state and regional sources of housing funding.**

State and local housing finance agencies (HFAs) utilize tax-exempt bonds and taxable securities as well as state and federal resources to offer a range of single family for sale and multifamily funding programs. Further, given the unique position of HFAs to assess community housing needs, these agencies should play an even more prominent housing finance role, including through new programs involving partnering with federal and private providers of housing capital.

The FHLBanks should continue their current activities to serve as an ongoing key liquidity source for institutions providing housing credit. Existing programs, such as the FHLBanks' mortgage purchase programs should be enhanced by allowing the FHLBanks to have greater options for managing their balance sheets, consistent with safety and soundness. Further, the FHLBanks should develop additional programs to leverage their strong understanding of regional housing conditions and needs.

**Correct other flaws in the mortgage markets that contributed to the causes of the Great Recession and resolve excessive unnecessary negative impacts on current credit availability for homebuyers.**

It is extremely important to continue and complete steps to close the gaps in standards and oversight that allowed and facilitated the improper and illegal activities in financial and mortgage markets which caused the Great Recession. Today's mortgage market is more stringently regulated than in the time leading up to the financial crisis. A new mortgage lending framework has been established to prevent excessive risk taking which led to the severe and prolonged housing crisis and ensure the safe and sound operation of the entire housing finance system. However, the pendulum has swung too far and home buyers are currently confronting challenging credit conditions, in many cases beyond what should be needed to ensure safety and soundness in mortgage products and underwriting. The negative consequences of today's tight lending conditions must be addressed.

In short, "one size fits all" does not describe the needs of a vibrant, efficient and effective, safe and sound housing finance system in America today and in the future. What follows is a more detailed discussion of what such a comprehensive housing finance system could look like, one which is neither completely private nor excessively public but which addresses real needs across the spectrum with a balanced and nuanced approach. Such a system would function effectively in both boom and bust cycles to provide all deserving Americans with the reasonable opportunity to realize the American dream of homeownership.

# Why Housing Matters

## Overview:

"Securing access to decent, affordable housing is fundamental to the American Dream. All Americans want to live in good-quality homes they can afford without sacrificing other basic needs."[3]

"Decent, affordable, and accessible housing fosters self-sufficiency, brings stability to families and new vitality to distressed communities, and supports overall economic growth. Very particularly, it improves life outcomes for children. In the process, it reduces a host of costly social and economic problems that place enormous strains on the nation's education, public health, social service, law enforcement, criminal justice, and welfare systems. Housing very much matters—to the individual, to the family, to the neighborhood, and to the nation,"[4] and most importantly in inner city and renewing communities.

The Housing Act of 1949 pledged a "decent home and a suitable living environment for every American family." This principle remains a bedrock for Americans even though delivering on the promise is more difficult in 2015 and beyond. Surveys confirm homeownership remains a goal for a majority of American families. Even among millennials age 35 and younger, there is a strong preference for owning a home.[5] To be faithful to the Housing Act of 1949 and the present aspiration of most Americans, Congress and the Administration must make housing finance a major policy priority.

Since the 1950s, homeownership has been the most effective step on the ladder into the middle class and in the creation of wealth for most Americans. Today, it continues to serve that vital function while also fulfilling the promise of the Housing Act of 1949. A December 2014 study by the National Bureau of Economic Research determined that housing generated 63 percent of household wealth in 2013 for middle-class families, defined as the middle three-fifths of Americans. That compares with just 8.7 percent of household wealth generated from housing for the top 1 percent of Americans.

Today's housing finance system is in a state of uncertainty, which is never good for the economy and presents potential downside risk. A consensus has not formed yet on a clear path for reform and its components. Legislation and regulation to address the past abuses should be designed to ensure transparency as well as safety and soundness in the future housing finance system and support economic growth, but not be so restrictive as to prevent a return of home buyers, lenders, and investors to the marketplace.

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[3] Bipartisan Millennial Housing Commission Report, *Meeting Our Nation's Housing Challenges,* (Washington, DC: Government Printing Office, 2002), *p.10*
[4] Ibid.
[5] A Place to Call Their Own, US News and World Report, Robert Dietz, April 8, 2015

NAHB supports policies designed to ensure that the United States is the best- and most-housed nation in the world. The American dream of homeownership, as well as the availability of decent, safe and affordable rental housing, should continue to be supported by federal policy within reasonable, safe, and sound parameters. In May 2015, 66 percent of respondents to Fannie Mae's monthly National Housing Survey, which assesses consumer sentiment toward owning and renting a home, said they would buy a home if they were to move. Respondents who said they would rent if they were to move comprised 27 percent of the total, down from 32 percent in April 2015.

The U.S. housing finance system should be multifaceted with both competing and complementary components, including private, federal and state sources of capital liquidity. The system should support a reasonable menu of sound mortgage products for both single family and multifamily housing, governed by prudent underwriting standards and adequate oversight and regulation. This white paper contains recommendations covering:

- Establishing a new secondary market system for conventional mortgages with a federal government backstop for catastrophic circumstances.
- Restarting a fully private mortgage-backed securities market.
- Continuing the role of federal government housing agencies.
- Enhancing the activities of state and regional sources of housing funding.
- Correcting other flaws in the mortgage markets that contributed to the causes of the Great Recession and resolving excessive unnecessary negative impacts on current credit availability for home buyers.

## Background: Status of Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac (the Enterprises), prior to the excesses leading to the Great Recession and since conservatorship, have a solid record of supporting the mortgage finance market. The Enterprises were established as government-sponsored enterprises (GSEs) with a public mission to provide stability, liquidity and affordability to the housing finance market in return for benefits from the federal government.

Historically, Fannie Mae and Freddie Mac have been extremely successful in meeting their charter mission to establish a secondary market for mortgages and maintaining a liquid and efficient mortgage market to increase homeownership for the middle-class home buyer by allowing banks to make more mortgage loans to American homebuyers. The success has been attributed, in part, to the “implied” federal government guarantee of the mortgage-backed securities (MBS) they issue. Their ties to the government through their charters led investors to assume the government would never let them default on their obligations and allowed them to borrow to fund their portfolio holdings at much lower interest rates than those paid by fully private financial institutions and to support the staple 30-year mortgage.

The downturn in the housing market hit Fannie Mae and Freddie Mac hard. As house prices fell, defaults and foreclosures increased dramatically. Fannie Mae and Freddie Mac suffered enormous losses on their MBS and on investments held in their retained portfolios. The

organizations were determined to be insolvent in 2008 and they were placed into conservatorship by their regulator, the Federal Housing Finance Agency (FHFA).

To prevent collapse of the mortgage market and extreme damage to the nation's financial system, the Enterprises were bailed out by the U.S. Department of Treasury (Treasury). This certainty allowed the market to continue to function. Beginning in 2007, as private mortgage market participants fled the market, the Enterprises continued to support the secondary mortgage market. Without the Enterprises, the mortgage market would have come to a halt. In the years 2000 through 2014, Fannie Mae and Freddie Mac had a combined market share of new MBS issuance ranging from a low of 39.9 percent in 2006, when private label MBS reached a peak of 56 percent of the market, to a high of 77 percent in 2008, when private label MBS fell to 5 percent market share. Private label MBS issuance fell to 1 percent or less of the market by 2012 while the Enterprises and Ginnie Mae were issuing 99 percent of MBS.

In September 2008, Treasury gave each of the Enterprises $1 billion to meet their outstanding obligations and Preferred Stock Purchase Agreements (PSPAs) were signed with Treasury to provide market participants confidence in the Enterprises' debt and MBS obligations. In August 2012, the PSPAs were modified to require the Enterprises to pay all their profits, with the exception of a small capital buffer, to Treasury on a quarterly basis.

Today, both Enterprises have been profitable for more than three years. The Enterprises have paid a combined $230.8 billion to Treasury which is $ 41.4 billion more than Treasury lent in the bailout to the Enterprises. However, by the wording of the PSPAs, the $230.8 billion is essentially a profit to the taxpayers not a repayment of the monies lent by Treasury to support the Enterprises during the Great Recession financial system and economic meltdown. Thus, a no doubt unintended negative consequence of the PSPAs is that the Enterprises will never be able to get out of debt to Treasury. In light of the urgent need to reform the housing finance system, this consequence should be revisited.

Under the PSPAs, Treasury has a remaining outstanding commitment of $258.1 billion available to the Enterprises to draw down. Treasury representatives believe this is what gives the market confidence that the Enterprises will remain solvent even though they are prevented from building capital reserves by the terms of their PSPAs.

The Housing and Economic Recovery Act of 2008 (HERA), the Act that created FHFA, granted the agency authority to place the Enterprises in conservatorship and to bring them out of conservatorship. Treasury has the authority to make additional amendments to the PSPAs. There does not appear to be any language in the PSPAs that specifically prohibits FHFA from releasing the Enterprises from conservatorship, which could allow the Enterprises to recapitalize with reformed safe and sound charters and resume business operations or be recast into new secondary mortgage market entities.

There are many other issues that would need to be considered prior to ending the conservatorships. Among the most critical questions to be addressed are:

- How much capital should the Enterprises be required to have in reserve prior to being released from conservatorship?

- How would ongoing minimum and risk-based capital requirements be established post conservatorship?
- Would the Enterprises' pre-conservatorship charters be immediately reactivated and allow for a return of private stockholders and resumption of federal government benefits?
- How would this action impact the "explicit" versus "implicit" guarantee?
- Would Treasury release the Enterprises from their obligation, per the PSPAs, to repay the total outstanding balance of federal funds loaned to them?

Pending the resolution of the conservatorships, FHFA has directed the Enterprises to implement changes to their securitization process that should ease the transition to a new securitization system for conventional mortgages. The Enterprises are experimenting with increased use of private capital to reduce credit risk to taxpayers on the mortgage-backed securities they issue and also are developing a common securitization platform. Both efforts incorporate concepts that have been generally accepted as beneficial industry reforms.

Since 2013, FHFA has directed the Enterprises to use multiple types of private capital credit risk transfers on pools of single family mortgages to reduce taxpayer risk. During 2014, the Enterprises executed credit risk transfers on single-family mortgages with a combined unpaid principal balance of over $300 billion. In each transaction, the Enterprises retained a small first-loss position in the underlying loans, sold a significant portion of the risk beyond the initial loss and then retained the catastrophic risk in the event losses exceeded the private capital support.

FHFA also tasked the Enterprises with building the Common Securitization Platform (CSP) that would replace the Enterprises' individual proprietary platforms. The CSP is designed to serve both Enterprises and a post conservatorship mortgage market with multiple future issuers, including the issuance of private label securities. Additionally, the Enterprises are establishing the operational and systems capabilities necessary to issue a single or common agency security within the CSP with the goal of improving the liquidity of the Enterprises' securities.

Finally, regardless of the resolution of the conservatorships, any legislative or regulatory efforts to require the Enterprises to raise their guarantee fees and apply the monies to costs unrelated to housing should be resisted. Guarantee fees are meant solely to cover the credit risk inherent in the Enterprises' business model; other uses could impact future housing finance system reform.

## A New Securitization System for Conventional Mortgages

The housing finance system currently is under a cloud of uncertainty. The federal government, through the Federal Housing Administration (FHA), Fannie Mae and Freddie Mac, is currently accounting for nearly all mortgage credit flowing to home buyers and rental properties. Fannie Mae and Freddie Mac continue to operate under conservatorship with a lifeline to Treasury, an arrangement that greatly limits their ability to respond to market developments and needs. Even with the current heavy dose of federal support, fewer mortgage products are available and these loans are being underwritten on much more stringent terms. Many believe these terms are excessively restricting credit for creditworthy borrowers, especially in the middle class and among the millennial generation of first time home buyers. There is no clear picture of the future shape of the conventional mortgage market.

The uncertainty of today's temporary housing finance system is not desirable and cannot continue indefinitely. Policy discussions are underway on what should become of Fannie Mae and Freddie Mac following the current, still-indefinite conservatorship period. A key consideration is how to get from the current structure to a future arrangement without disrupting the operation of the housing finance system.

Mortgage-backed securities are an essential component of the housing finance system and a stable and reliable conventional secondary mortgage market requires a federal government backstop.

A reliable and adequate flow of affordable funds is necessary in order to achieve the nation's housing and economic goals. Establishing a finance system that provides liquidity for the housing sector in all markets throughout the economic cycle is a prerequisite to achieving housing policy objectives. A high priority should be assigned to creating an efficient, vibrant and stable secondary market for conventional mortgages. Securitization is key to meeting the housing finance needs of a healthy and growing economy. Banks and thrifts should continue to play a mortgage finance role through portfolio lending, but these institutions do not have the capital capacity, business model or dedication to adequately service the nation's mortgage credit requirements by holding all of their loans on their books. It is important to have a highly reliable method of attracting funds to the U.S. mortgage market from investors throughout the world via securitization.

NAHB has concluded that an effective system for securitizing conventional mortgages requires a federal government backstop for catastrophic last tier losses. Investors, particularly those beyond our borders, require such a promise to secure the obligations they purchase. This fact is amply demonstrated by the need for federal government support to maintain the flow of mortgage money during the recent housing recession. While NAHB agrees that private capital must be the dominant source of mortgage credit, the future housing finance system cannot be left entirely to the private sector. The historical track record clearly shows that the private sector is not capable of providing a consistent and adequate supply of housing credit without a government backstop.

A federal backstop is needed to ensure that 30-year fixed-rate mortgages are available at reasonable interest rates and terms.

Federal support is particularly important in continuing the availability of the 30-year, fully amortizing, fixed-rate mortgage (FRM), which has been a staple of the U.S. housing finance system since the 1930s. Borne out of the Great Depression, the 30-year FRM has played a pivotal role in helping to increase the national homeownership rate so that today more than 60 percent of Americans own a home of their own.

The 30-year FRM has become an industry standard for several reasons:

- **Affordability.** These loans are geared toward affordability; 30-year terms lock in low monthly payments, allowing households with average incomes to comfortably budget for their home loan.

- **Inflation protection.** Knowing their monthly housing costs will remain the same year in and year out regardless of whether interest rates rise provides households with a sense of financial security and also acts as a hedge against inflation.

- **Long-term planning.** Many young buyers know that as their incomes rise, their housing costs will stay constant and become less of a burden, enabling them to prepare for other long-term obligations, such as college tuitions and retirement savings.

- **Tax advantages.** In most instances, all of the interest and property taxes borrowers pay in a given year can be fully deducted from their gross income to reduce taxable income. These deductions can result in thousands of dollars of tax savings, especially in the early years of a 30-year mortgage when interest makes up most of the payment.

The key to the sustainability of the 30-year FRM is a securitization outlet because originators (banks and thrifts) have limited capacity to hold such long-term assets which are funded with short-term deposits. Fannie Mae and Freddie Mac provided the securities vehicle along with an implicit government guarantee for investors. It is not clear whether a private housing finance system would be capable of supporting this type of product without some government backing. At a minimum, the cost of 30-year FRMs would increase under a private system and mortgage underwriting requirements would likely be far more stringent, locking out larger segments of creditworthy borrowers from homeownership and its clear benefits.

As the private market transitions to assume a greater role, a strong federal backstop is necessary to maintain a stable and adequate supply of credit for home buyers and to ensure that the 30-year FRM remains readily available to first-time home buyers and working American families. Otherwise private financial institutions will turn the 30-year mortgage into a luxury product, with high interest rates, fees and downpayments that would price millions of middle-class households out of the market.

**NAHB supports a securitization system for conventional mortgages backed by private capital and a privately funded federal mortgage-backed securities insurance fund with a federal government backstop in the event of catastrophic circumstances.**

The fact that in the eight (8) years since the start of the Great Recession the private market has not stepped in, coupled with the Enterprises' good performance, provides a compelling argument for an explicit last resort government backstop in a reformed conventional mortgage market. The needed bailout of the Enterprises provides an equally compelling argument that the future mortgage finance system should assess and provide for credit risk at an appropriate level with the federal government backstop for explicit and catastrophic circumstances only.

Federal support to the conventional mortgage market of the future should be limited to catastrophic situations where carefully calibrated levels of private capital and reserves are depleted before any taxpayer funds are employed to shore up the mortgage market.
This would be done by creating a privately funded insurance fund for conventional mortgage-backed securities (MBS) that would be similar to the insurance fund that secures savings deposits through the Federal Deposit Insurance Corporation (FDIC.) The FDIC fund is

capitalized by the financial institutions benefitting from the deposit insurance but the federal government is committed to ensuring that the fund is solvent regardless of economic conditions.

Housing Finance Entities (HFEs) should assume the function of securitizing single family and multifamily conventional mortgages.

Under this approach, various private market participants would originate, insure and service conventional single family and multifamily mortgage loans. Originators would sell mortgages to private Housing Finance Entities (HFEs) that would be authorized to purchase conventional single family and multifamily mortgages. HFEs would aggregate and package the loans into securities for sale to investors worldwide. All MBS issued by the HFEs would be issued through a common platform to preserve and ensure liquidity.

A government-backed insurance fund (IF) capitalized with fees from the HFEs and originators would provide an explicit government full faith and credit guarantee on the timely payment of principal and interest on the securities, not the underlying mortgages. The federal government would stand behind the insurance fund to ensure that the fund was actuarially sound, similar to the successful Government National Mortgage Association (Ginnie Mae) model. The federal government would backstop the IF and would only expend funds to continue payments to MBS investors in a catastrophic event where private market participants (originators and HFEs) have reached their pre-determined level of loss and the insurance fund is depleted. The intent is for the government to be in a limited loss position and to be the insurer of last resort in order to reduce the risk to taxpayers.[6] The originators and HFEs also would be required to maintain capital to cover a portion of the credit risk on the pooled mortgages, with private mortgage insurance required on higher loan-to-value mortgages.

HFEs could take on a range of forms.

*Fannie Mae and Freddie Mac could be recast as HFEs alone or with other participants.*

One possibility would be to bring the Enterprises (Fannie Mae and Freddie Mac) out of conservatorship and restructure them as HFEs. The Enterprises would be subject to the same rules, including safety and soundness and capital requirements, as all HFEs and be provided the protection and opportunities of the federal catastrophic backstop. Either one or both of the Enterprises, individually or combined, could become HFEs.

Most important, the Enterprises' infrastructure should be utilized regardless of the ultimate future of Fannie Mae and/or Freddie Mac. During the more than four decades of their existence prior to conservatorship, the Enterprises developed sophisticated infrastructures of products, programs, and processes, including underwriting and servicing requirements. These should be used to form the foundation of an HFE system. This would also ensure less market disruption in the transition to the new system.

[6] The attached analysis of NAHB's 2012 proposal by RiskSpan, an independent consulting firm, provides further explanation of NAHB's proposal and financial modeling of the loss coverage, capitalization and estimated increase in mortgage costs.

Retention of the Enterprises' successful infrastructure is especially critical in the multifamily market. The Enterprises' multifamily businesses remained profitable throughout the housing crisis, while most private market players simply left the market. Both of the Enterprises' multifamily businesses involve risk-sharing with private capital and both businesses have practiced disciplined underwriting as evidenced by the very low default rates on multifamily loans held or guaranteed by Fannie Mae and Freddie Mac. The Enterprises' multifamily programs form the core of multifamily debt financing provided by major financial institutions. In addition, because of the range of products and business lines employed by the Enterprises, a wide range of multifamily rental properties that provide housing for very-low to middle income households can be financed in the conventional market.

In the single family for sale area, the Enterprises recent risk-sharing initiatives should be retained and enhanced. Under these arrangements, private capital is absorbing significant credit risk on Fannie Mae and Freddie Mac's new purchases, thereby substantially reducing risk to taxpayers from these purchases. As part of a comprehensive reformed housing finance system these arrangements would be absorbed as appropriate.

*Other types of HFEs*

To the extent that the Federal Home Loan Bank System could adapt to the HFE system and desires to do so, one or more of the Federal Home Loan Banks could serve as HFEs. The eleven Federal Home Loan Banks (FHLBanks) currently operate by making collateralized loans to, and mortgage purchases from, member financial institutions, funded by debt offerings. Each FHLBank is a cooperative enterprise, which is owned by the commercial banks, thrift institutions, credit unions and insurance companies that utilize the FHLBank as a source of funds.

The principal business of the FHLBanks is extending to their members loans, called advances, which are collateralized by mortgages and other eligible assets in the portfolios of borrowing institutions. Most FHLBanks also have operated or participated in mortgage purchase programs, where the FHLBanks buy mortgages from member institutions to hold in portfolio. FHLBank advances and mortgage purchase activities are funded by debt offerings for which all eleven FHLBanks are responsible on a joint and several basis and which are managed by an Office of Finance.

The FHLBanks have been cautiously expanding their role in the housing finance system through pilot programs developed to help their members sell mortgage loans in the secondary mortgage market. Through the Mortgage Partnership Finance (MPF) programs, FHLBs aggregate members' loans and sell these into the secondary market programs. The MPF Xtra program provides a channel to sell fixed-rate conforming loans to Fannie Mae; MPF Government and MPF Government MBS provide a channel to sell fixed-rate mortgage loans insured or guaranteed by government agencies through Ginnie Mae; and MPF Direct is a program that allows FHLB members to sell eligible jumbo mortgage loans to a subsidiary of Redwood Trust. So far, the pilot programs have shown promise; however, the nature of the FHLBank System does not mean all FHLBanks in the System will or must participate, and not all have, leaving a continuing need for other players in the very large securitization marketplace.

FHLBanks could expand their MPF programs by aggregating loans for sale to HFEs if the FHLBank desired. Alternatively, one or more FHLBanks could be restructured as HFEs, subject to the same requirements and protections of all HFEs.

HFEs should deal only with well understood and well-tested mortgage products.

HFEs would deal in mortgages with well understood and reasonable risk characteristics. Single family mortgage products could be required to meet the Consumer Financial Protection Bureau's (CFPB) Ability to Repay and Qualified Mortgage (QM) Rules; generally this would include standard 30-year FRMs and adjustable rate mortgages (ARMs). (See discussion of the QM rules under "Other Mortgage Lending Reforms" below.) HFEs also would have the flexibility to establish underwriting criteria beyond the baseline QM requirements for other mortgage products that may be beneficial to consumers, including mortgages with shorter maturities, but also to ensure safe and sound loan terms and fully documented and reasonably soundly underwritten credit criteria.

In the multifamily market, as noted, Fannie Mae's and Freddie Mac's multifamily platform, including mortgage loan products and underwriting standards, should be retained and transferred to the new HFE framework. The Enterprises' successful approach to risk management in the multifamily area should not be lost in the transition.

Strong regulatory oversight is required.

The HFE conventional mortgage securitization system should operate under the oversight of a strong independent regulatory agency to ensure all aspects of safety and soundness. The regulatory agency should be governed by a board with a structure modeled on that of the FDIC, where members would be required to have extensive experience in and/or knowledge of housing capital market transactions and issues and housing finance needs. An Advisory Committee would also be established to advise the Board on broad market conditions. One member of the Advisory Committee would be required to be a representative of the home building industry.

This agency would oversee the federal conventional MBS insurance fund and ensure the actuarial soundness of the fund, which would provide investors an explicit federal government guarantee of timely payment of principal and interest on HFE-issued MBS. In addition, the agency would establish approval standards for originators, servicers and HFEs as well as underwriting standards, capitalization levels, loss coverage requirements and guarantee fees.

The agency also would establish a single platform for the issuing, trading and tracking of MBS. The single securitization platform would serve as the securitization framework for HFE-issued MBS and eventually support multiple issuers, including issuers of private label MBS. Development of the platform would build on the intellectual and technical work currently underway by the Enterprises on the common securitization platform.

The regulatory agency should be established as an independent, wholly-owned government corporation. As such it would be a self-supporting institution not reliant on federal appropriations, but funded through assessments on market participants. The agency should operate independent of any existing federal department which will allow it to respond quickly to

changing market conditions and to operate more efficiently with respect to staffing, procurement and budgeting decisions.

Rather than creating a new agency, the HFE regulator could build on capabilities of existing regulatory agencies. For example, Ginnie Mae or FHFA could assume the role of the HFE regulator. In either case, these existing agencies would have to be restructured under a Board framework and given the necessary authorities of the HFE regulator. In the case of Ginnie Mae, it would also have to be removed from HUD and spun out as a separate and independent institution.

<u>The transition to the new conventional mortgage market should be carefully planned and executed.</u>

Activity in the housing sector remains below normal levels and therefore is not fully contributing to a recovery in economic output and jobs. The current environment is rife with instability and uncertainty. Many markets throughout the country, however, have returned to a position where consumers are shopping for new homes and housing production can begin to move back to more normal levels.

It is critical that the housing finance system facilitate this recovery rather than stifle it. Under these circumstances, finding a means of moving to a new secondary market framework may be as great, or greater, a challenge as developing the new conforming conventional secondary market structure. Congress should carefully consider and address the short-term, unintended consequences that could occur during the transition to a new housing finance system.

Any changes should be undertaken with extreme care and with sufficient time to ensure that U.S. home buyers, owners and renters are not placed in harm's way and that the new mortgage funding and delivery system operates efficiently and effectively as the old system is abandoned and a new system is put in place. Every effort should be made to reassure borrowers and markets that credit will continue to flow to creditworthy borrowers and that mortgage investors will not experience adverse consequences as a result of changes in process.

*Transition process should be dynamic and flexible*

Congress could mitigate market disruptions by enacting a dynamic, flexible transition to a new conventional mortgage market. A dynamic problem-solving approach where design of the new securitization system for conventional mortgages is based on lessons learned during the transition will ensure policy choices evolve in response to changing market conditions. Transition to the new system could be facilitated through continued utilization of the Enterprises' existing infrastructure, either by re-chartering the Enterprises as HFEs or transferring their single family and multifamily infrastructures to new HFEs.

The transition process should specify a timeline and specific milestones that will need to be achieved before the new system could become operable. Importantly, the impact of the transition on the mortgage and housing markets should be of paramount concern. The transition process should provide for extension of the timeline if a milestone cannot be met or if implementing it would have an adverse market impact. Finally, the old system should not be abandoned before the new system is fully functioning.

## Renewal of a Private Mortgage-Backed Securities System

HFEs would operate alongside a fully private MBS system. A robust market for private label MBS (or PLS) will be critical to the availability of mortgage products that do not conform to the underwriting and credit guidelines of mortgage loans that will be eligible for purchase by HFEs or insured or guaranteed by the Federal Housing Administration (FHA), the Department of Agriculture (USDA), and the Department of Veterans Affairs (VA). The government guaranteed and non-guaranteed market segments can and should complement each other by specializing in distinct market niches while also competing on price and product for overlapping market segments.

**NAHB supports restarting as quickly as possible a carefully regulated, fully private mortgage-backed securities system.**

In the years leading up to the financial crisis, PLS issuance increased steeply and steadily – growing from just over $400 billion in 2002 to a peak of just under $1.2 trillion in 2005 or 55 percent of total residential MBS issued. Private label securities were collateralized primarily by jumbo prime, subprime, and Alt-A mortgages. When the housing bubble burst in late 2007, rising defaults and increasing investor losses in PLS essentially led to the demise of new PLS issuance. In 2008, PLS issuance barely hit $50 billion and did not include any subprime or Alt-A loans – the most significant components of PLS at the peak of the housing market. Between 2008 and 2014, PLS issuance dropped from 5 percent to less than 1 percent in 2012 before beginning to grow to approximately 4 percent of the market in 2014.

There is broad agreement that the continued lack of interest of investors in PLS is having a detrimental impact on the housing market and holding back a robust recovery. The return of private investors to the mortgage market would benefit home buyers by increasing competition and mortgage choice.

The mortgage crisis exposed unsound mortgage practices and vulnerabilities within the structural and disclosure components of PLS that contributed to the severity of the market deterioration and significant losses for investors. The issue of trust appears to be the underlying cause for the overall apprehension of investors. The investor community lacks the trust that the flaws have been resolved to the degree necessary for them to return to the market. Though some regulatory and legislative reforms have been implemented, and others will take effect in the future, investors lack the conviction the market will not again fail them.

Before investors will be willing to support a substantial level of PLS issuance again, there are many issues to consider and barriers to overcome. Key prerequisites to restoring investor confidence and restarting the PLS market include increasing transparency and disclosure around the collateral and structure of PLS, ensuring all participants operate under adequate regulation and have a stake in the performance of the mortgages that are originated and sold. Reforms that provide investors with loan-level information about the underlying collateral, disclose the structure of the securities, enhance and clarify the contractual obligations of all parties to the transaction, encourage standardization, and align the financial incentives of all parties will significantly reduce the many barriers that are preventing investors from reengaging

in the PLS market. For issuers and originators, uncertainty regarding regulatory compliance and costs are paramount concerns.

The operations and oversight of securities ratings firms must be reformed.

It is widely believed that improper actions of securities rating agencies played a significant role in the severe dislocations that occurred in the mortgage and financial markets leading to the Great Recession. Internal compensation incentives encouraged revenue generation over accuracy and transparency of ratings and ratings shopping by securities issuers encouraged rating agencies to compete for business by lowering rating criteria. The credit ratings process must be reformed to address conflicts of interest and provide investors assurance that their interests and rights are protected.

## Federal, State, and Regional Sources of Housing Funds

Government agencies have been an important support for housing for many years and continue to play a vital role in meeting affordable housing needs in America today. With the private market pulling back, these agencies have stepped up to fill the gap.

**NAHB recommends continuing the roles of the federal government housing agencies.**

The housing finance support roles of the Department of Housing and Urban Development (HUD), Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), the Department of Agriculture (USDA) and Ginnie Mae should be preserved. These agencies provide crucial counter-cyclical support to the housing market, expanding in downturns and contracting when the market improves. During the recent mortgage crisis, FHA demonstrated how invaluable its counter-cyclical support was in providing access to homeownership for underserved communities, primarily first-time home buyers, minorities and those with limited downpayment capabilities. As other sources of mortgage credit disappeared, FHA's share of the single family mortgage market jumped from 3 percent during the housing boom to a high of almost 30 percent early in the crisis before receding to around 15 percent of today's purchase housing market. FHA should have the ability to further expand its support in cyclical downturns by increasing loan limits, as was done in the recent housing crisis.

FHA also plays an essential role in the financing of multifamily rental housing, and it was especially important during the recent downturn. In 2008, FHA endorsed just over $2 billion in multifamily loans (excluding health care programs), which peaked at $17.6 billion (excluding health care programs) in FY 2013. This unprecedented growth in FHA multifamily loan volume occurred as private market sources of multifamily financing withdrew from the market when economic conditions worsened.

Steps should be taken to make the operations of these agencies more efficient and effective.

FHA's operations, in particular, must be modernized to allow the agency to operate more efficiently and effectively. Too many constraints have been placed upon FHA, by Congress and internally via HUD, which inhibit FHA's ability to operate in a manner that recognizes, complements and evolves with developments by the private sector. To continue its vital role in

the housing finance arena, FHA must be afforded greater freedom from external micromanagement and political influence while developing a professional, responsive, results-oriented culture and remaining accountable for achievement of its mission.

NAHB believes this can best be accomplished by restructuring FHA as an independent government corporation within HUD, separate from Ginnie Mae, which would continue its current mission of supporting liquidity, innovation and continuity in the housing finance markets by providing mortgage insurance backed by the full faith and credit of the U.S. government. The restructured FHA would be led by a chief executive officer, appointed by the President, who would report to a presidentially appointed board, chaired by the HUD Secretary.

While under general Congressional oversight, FHA should have the authority, without further Congressional action, to create or alter specific insurance programs in order to have the flexibility to react promptly to changes in market and other conditions. Hiring, salaries, personnel management, and procurement would be freed from current, confining federal government constraints in order to be more consistent and competitive with the private sector. FHA would be operated in a manner that does not require a federal subsidy and would allow FHA to retain revenues generated in excess of expenses to be used for mission purposes.

Further, NAHB urges Congress and policymakers to evaluate any changes to FHA or other government housing agencies within the context of other changes that have occurred, or may occur, within the agency and in the broader housing finance system. Changes must be assessed in terms of the cumulative impact on all components of the housing finance system, including the interplay among housing finance sectors.[7]

Finally, NAHB encourages greater coordination between FHA and the USDA Rural Housing Service (RHS) on issues related to risk management and streamlining of administrative practices and procedures in some program areas, such as FHA multifamily mortgage insurance and rental housing assistance. However, NAHB does not support the transfer of RHS programs to FHA. The RHS programs are uniquely structured to address the housing credit needs of low and moderate income persons in rural areas, which are very different than those found in urban and suburban areas.[8]

**NAHB recommends enhanced roles of state and local housing finance agencies as a source of housing funds.**

State and local housing finance agencies have proved critical in helping communities continue to meet the needs of consumers who have faced hardships in the face of less credit availability. State and local housing finance agencies utilize tax-exempt bonds and taxable securities as well as state and federal resources to offer a range of single family and multifamily funding programs.

The recent economic crisis significantly diminished investor interest in mortgage revenue bonds (MRBs) and therefore severely limited the amount of funds available to finance affordable home mortgages and multifamily loans. The stress in the economy has pressed HFAs to consider new

[7] NAHB Policy, 2013.6 No. 9, *Support of FHA*.
[8] NAHB Policy, 2011.5 No. 14, *U.S. Department of Agriculture Housing Programs*.

ways of doing business, such as alternative bond financing programs. In addition, HFAs have increasingly turned to MBS execution through Ginnie Mae as an alternative funding source. Efforts to address problems in the tax-exempt MRB market and to facilitate new HFA financing products should be encouraged.

HFAs are uniquely positioned to assess community housing needs and should play an even more prominent housing finance role through the development of new programs for new, for-sale housing and multifamily rental homes. This should include partnering with federal and private providers of housing capital.

**NAHB recommends expanding the role of the Federal Home Loan Banks in the housing finance system.**

The FHLBanks should continue their current activities to serve as an ongoing key liquidity source for institutions providing housing credit. Existing programs, such as the FHLBanks' mortgage purchase programs should be enhanced by allowing the FHLBanks to have greater options for managing their balance sheets, consistent with safety and soundness. Further, the FHLBanks should develop additional programs to leverage their strong understanding of regional housing conditions and needs. Specifically, the FHLBanks should be authorized to engage in additional activities, including purchase of multifamily mortgages, and services to support a full range of housing-related lending by their members.

Changes to the housing finance system must be undertaken in a manner that will not diminish the favorable cost of funds for the FHLBanks or impair the role of the FHLBanks in supplying liquidity to institutions providing mortgage and housing production credit, support for community and economic development, and resources to address affordable housing needs. Efforts by the FHLBanks' regulator, FHFA, or legislative proposals by Congress that would curb innovations or restrict additional lending opportunities by FHLBanks to their member banks should be opposed.

## Other Mortgage Lending Reforms

It is extremely important to continue and complete steps to close the gaps in standards and oversight that allowed and facilitated the improper and illegal activities in financial and mortgage markets which caused the Great Recession. Today's mortgage market is more stringently regulated than in the time leading up to the financial crisis. A new mortgage lending framework has been established to prevent excessive risk taking which led to the severe and prolonged housing crisis and ensure the safe and sound operation of the entire housing finance system. However, the pendulum has swung too far and home buyers are currently confronting challenging credit conditions, in many cases beyond what should be needed to ensure safety and soundness in mortgage products and underwriting. Access to mortgage credit is limited mainly to high net worth individuals or borrowers with steady income and high credit scores. Significant new regulations and lender credit overlays are major factors impacting the availability of mortgage credit.

**NAHB supports safe and sound mortgage products.**

Between the years of 2000 and 2006, nontraditional mortgage products, initially developed to meet the needs of select borrowers, were originated widely and often without adequate documentation, sound underwriting and clear disclosures to the consumer. These mortgages came to epitomize the definition of "unsound" by virtue of their dependence on unbridled inflation, inability to withstand market forces and the propensity to default at high rates when property values began to slide. The origination of unsound mortgage products had a profound impact on the housing market when borrowers began defaulting at excessive rates starting in 2007 and during the Great Recession.

Congress addressed the risk associated with these unsound products by creating the Consumer Financial Protection Bureau (CFPB) and including the Ability-to-Repay (ATR) standard and credit risk retention requirements in the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank). The ATR rule defines new lender underwriting requirements for mortgage loans and imposes expanded liabilities on lenders. The ATR rule, which went into effect on January 10, 2014, requires that a lender make a reasonable, good-faith determination before or when consummating a mortgage loan that the consumer has a reasonable ability to repay the loan. The ATR rule applies to every mortgage loan with a few exemptions.

The final ATR rule establishes standards for complying with the ATR requirement by defining a "qualified mortgage" (QM). The QM standard is intended to balance protecting consumers from unduly risky mortgages and providing lenders more certainty about potential liability. Lending outside the QM box is still allowed; however, lenders face increased litigation risk with non-QM product offerings. As required by Dodd-Frank, FHA and VA have approved separate QM definitions for loans insured or guaranteed by these agencies.

To address the risks associated with the "originate to sell" model of mortgage lending, the Dodd-Frank Act also included a requirement for securitizers to retain 5 percent of the credit risk on loans packaged and sold as securities. An exemption was allowed for qualified residential mortgages (QRM) which were not explicitly defined in the law. As directed by Dodd-Frank, six federal agencies finalized the credit risk retention regulations that included the definition of a QRM. The regulators aligned the definition of a QRM with the QM. By equating QRM to QM, the regulators have provided consistent underwriting standards for the primary and secondary mortgage markets. The new QRM regulations will go into effect on December 24, 2015.

**NAHB supports the use of prudent mortgage underwriting guidelines.**

Prudent underwriting guidelines should allow for reasonable flexibility by lenders and the acknowledgement that "one size does not fit all." A borrower's creditworthiness should be determined based upon sound, accurate data and sufficient documentation to ensure qualified borrowers are not excluded from obtaining a mortgage. These principles are essentially addressed in the ATR requirement.

Under the ATR requirement, the determination of a borrower's ability to repay must be based on the following factors: the borrower's current and expected income and other financial resources excluding equity in the dwelling which secures the loan; employment status; payment of the loan based on a fully amortizing payment schedule and the fully-indexed rate; payment of any

simultaneous liens; payment of applicable taxes, insurance and assessments; the consumer's current debt obligations; the borrower's debt-to-income (DTI) ratio or residual income; and the consumer's credit history.

The general ATR rule does not ban any particular loan features or transaction types, as long as the creditor makes a reasonable, good-faith determination that the consumer has the ability to repay. However, "stated income" or "no documentation" mortgages (a significant factor contributing to questionable underwriting leading to the Great Recession) are no longer allowed since a consumer's income or assets and employment must be verified in order to comply with the ATR rule. Also, the new lender liabilities are likely to discourage the origination of loans with inherently unsafe features, such as interest-only or negative-amortization periods.

To further encourage prudent underwriting, the qualifications for QM status are more stringent. QM requirements generally prohibit certain risky loan features and practices, such as negative amortization periods and loan terms longer than 30 years. Also, specific underwriting criteria are included in the QM definition, such as a total DTI of 43 percent or less and a cap on points and fees to no more than 3 percent of the total loan amount.

Credit Availability Challenges

*Credit Overlays and Buyback Risk*

During and since the Great Recession, lender overlays in the mortgage credit process have been a major factor in the greater difficulty potential home buyers are having in obtaining financing as lenders are imposing credit underwriting standards that are more restrictive than FHA, VA, Fannie Mae and Freddie Mac require. These credit overlays are employed due to heightened lender concerns over forced loan buybacks on mortgages sold to Fannie Mae and Freddie Mac and/or greater required indemnifications on FHA-insured and VA-guaranteed loans.

When lenders sell loans to entities, such as Fannie Mae and Freddie Mac, and through the FHA/VA/Ginnie Mae securities process, they are required to make assurances that they have performed the appropriate level of due diligence on the loan application, and the lenders agree to buy back a loan if it is discovered that they were at fault in their underwriting process. These representations and warranties ("reps and warrants") have been a standard practice in mortgage lending.

In the aftermath of the collapse in the housing market, the underwriting of delinquent loans was alleged not to meet the established criteria of FHA, the Enterprises, and other secondary market entities. As a result, lenders have faced a protracted fight with these agencies about the buyback of loans that have been deemed ineligible for Enterprise guarantees or government insurance based on the finding of faulty due diligence practices. Lenders contend that the criteria triggering buyback demands by Fannie Mae and Freddie Mac and insurance claims rejections by FHA and VA are unclear and inconsistent. The resulting uncertainty has caused lenders to employ underwriting standards that are more restrictive than those required by FHA, VA, Fannie Mae and Freddie Mac. These lender "overlays" have closed the credit window to many aspiring home buyers who actually meet the loan qualification requirements established for these programs. This, no doubt unintended, negative consequence must be reversed.

*Credit Scores*

Credit Scores have become an important focus in the discussion on access to mortgage credit. Lenders have used credit scores in evaluating the credit worthiness of a borrower for years. However, in the aftermath of the financial crisis, lenders have become very cautious about extending mortgage credit, and credit scores have become a more prominent factor in determining loan eligibility.

Lenders often rely on the FICO score to predict a borrower's likelihood of default. NAHB is concerned there is too much reliance on FICO – an algorithm that is not clearly understood by consumers, lenders and regulators, and which has been seen as sometimes causing onerous inaccuracies for some potential borrowers. A borrower's creditworthiness should be determined based upon sound, accurate data and sufficient documentation to ensure qualified borrowers are not excluded from obtaining a mortgage. The use of alternative credit data other than scores could offer lending opportunities to borrowers currently lacking access to mortgage credit due to a low, inaccurate, or unavailable FICO credit score. This approach has a solid track record especially in the data from Housing Finance Agencies (HFAs).

The Consumer Financial Protection Bureau (CFPB) oversees the credit reporting market and has been actively engaged on credit history and credit scores conducting outreach with stakeholders, publishing research papers, accepting consumer complaints about credit reporting, providing consumers with individual-level complaint assistance, and taking enforcement actions.

The CFPB recently released a report, "Data Point: Credit Invisibles" which found that 26 million consumers (11 percent of U.S. adults) were credit-invisible as of 2010. The CFPB defines "credit invisibles" as consumers that do not have credit records maintained by the nationwide credit reporting agencies. The CFPB also found that an additional 19 million consumers (8.3 percent of U.S. adults) had credit records that were treated as unscoreable due to insufficient or lack of recent credit history, and that blacks and Hispanics are more likely than whites or Asians to be credit invisible or to have unscored credit records. This adds to the effect of reduced lender involvement in inner city and other minority dominated communities.

Federal regulators have directed Fannie Mae, Freddie Mac and FHA to explore the use of new credit scoring models that use non-traditional factors, such as rent and utility payments, to determine creditworthiness. The potential use of alternative credit scoring models by FHA and the Enterprises could help to open the credit box.

**NAHB supports efficient and effective mortgage servicing processes.**

Beginning in 2008, an unprecedented number of home owners defaulted on their mortgages exposing significant flaws in mortgage servicing processes and prompting a wave of litigation and regulatory actions. Updated mortgage servicing rules, which were finalized by the CFPB and went into effect in January 2014, were established to address many of the problems and require servicers to implement practices to be more responsive to distressed borrowers. The new rules have very specific requirements and timelines regarding periodic billing statements, notices on interest rate adjustments, payoff statements, force-placed insurance, error resolution, early intervention with delinquent borrowers and loss mitigation procedures.

In addition, FHFA and FHA have their own requirements and time frames for handling non-performing loans which may differ from CFPB-issued rules and make compliance challenging for servicers subject to more than one agency's requirements. Regulators should work to align servicing guidelines for non-performing loans to ensure that consumers are treated fairly while establishing a consistent procedure for servicers to follow.

**NAHB supports improvements to loan modification/foreclosure procedures.**

Since the financial crisis began in 2008, about 5.6 million foreclosures have been completed. The effect lingers even today with over 2 million U.S. households either in foreclosure or delinquent on their mortgages. The Obama Administration responded to the crisis with several loan modification and foreclosure prevention programs which have had some success. Almost 1.5 million home owners received a permanent modification through the Home Affordable Modification Program (HAMP) as of April 2015 and 3.3 million home owners were able to lower their monthly payments through the Home Affordable Refinance Program (HARP) as of March 2015. The private sector also implemented modification programs helping an additional 4.4 million borrowers as of March 2015.

Principal reductions, although touted by some as the most effective tool to prevent foreclosures, are very controversial and have been implemented in only a limited number of cases. Many communities hard hit by the housing crisis have looked for ways to force principal reductions by using eminent domain to seize underwater, performing loans from private label mortgage-backed securities. Proponents of the plan assert it would help residents shed debt loads that restrain economic growth, while preventing foreclosures. Opponents, including NAHB[9], contend that the initiative would have a severe adverse impact on the MBS markets because investors, fearful that such actions could become widespread, would be unwilling to continue to invest in the MBS market or require much higher yields to do so.

NAHB supports improving foreclosure processes and practices, such as loan modification programs and requiring principal reductions when net present value tests support this option. NAHB also supports persuading America's financial institutions to take more effective loan modification actions to help home owners who are in financial need avoid foreclosure if they have behaved responsibly in handling their mortgage and other financial obligations. Furthermore, alternatives to foreclosure, such as short sales and deed-in-lieu of foreclosures, should be made more efficient.[10]

**NAHB recommends reforming the appraisal system.**

Extended stress in the housing and mortgage credit markets brought greater focus to the importance of accurate appraisals. In response to criticism that lax appraisals contributed to the financial crisis, more restrictive appraisal policies were implemented by lenders, federal banking regulators, the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), the United States Department of Agriculture (USDA), and Fannie Mae and Freddie Mac (the Enterprises).

[9] NAHB Policy, 2012.9 No. 1, *The Use of Eminent Domain in Mortgage Restructuring*
[10] NAHB Policy, 2012.2 No. 6, *Foreclosures.*

However, these steps did not address fundamental flaws and shortcomings of the U.S. residential appraisal framework. The problem has been exacerbated by improper appraisal practices, a shortage of experienced appraisers and inadequate oversight of the appraisal system. Inaccurate appraisals are an ongoing impediment to the flow of mortgage credit and the housing recovery. NAHB is not advocating that appraisals should be higher than the real market. Rather, our goal is to establish an appraisal system that produces accurate values through all phases of the housing cycle.

The appraisal process went seriously wrong during the Great Recession when some appraisers used distressed sales – many of which involved properties that were neglected and in poor physical condition – as comparables in assessing the value of brand new homes, without accounting for major differences in condition and quality. Without such adjustments, the two housing types are not comparable. The inappropriate manner in which distressed sales were utilized has distorted home valuations. Use of the cost and income approaches in conjunction with a true comparable sales approach could mitigate such distortions.

The dramatic increase in the use of Appraisal Management Companies (AMCs) is another factor contributing to inaccurate appraisals. Some AMCs have shortened turnaround times for valuations and reduced appraiser compensation, which has led to more activity by appraisers with less training and experience. These changes have had a significant adverse effect on appraisal quality.

Other challenges facing the appraisal industry include shortcomings in appraiser training and experience in dealing with new construction and green building. Additionally there is insufficient new construction, energy efficient and green building data available to appraisers and current valuation practices do not provide a process for expedited appeals of inaccurate or faulty appraisals.

It is difficult to come to a conclusion other than appraisal standards are not clear, best practices have not been well communicated, and enforcement is not occurring in a consistent manner. For all sectors that interact with appraisers – consumers, home builders, realtors, lenders, the Enterprises, mortgage insurers – appraisal quality and appraiser competence remain tremendous challenges. The problem is an urgent one, yet during the extended housing recession little attention was focused on the fundamental problems in the appraisal process.

NAHB has been a leading advocate for correcting the valuation process and has undertaken a number of actions to raise awareness and address the adverse impacts inaccurate appraisals are having on the housing sector. In 2013, NAHB released a white paper, *A Comprehensive Blueprint for Appraisal Reform*, which included several recommendations for appraisal reform.

Specifically, NAHB believes it is urgent to implement reforms in the following areas of the appraisal process:[11]

[11] NAHB policy, 2012.2 No. 4, *Improving the Accuracy of New Construction Appraisals.*

- Strengthen education, training and experience requirements for appraisers of new home construction.
- Improve the quantity and quality of data for new construction.
- Develop new appraisal standards and best practices for conducting appraisals in distressed markets.
- Develop a process for expedited appeals of inaccurate or faulty appraisals.
- Strengthen oversight of appraisal activities.

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ATTACHMENT


# NAHB'S Comprehensive Framework for Housing Finance System Reform

Financial Modeling and Analysis
September 14, 2012

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# Agenda

RiskSpan
Insight | Solutions | Results

- Project Background and Program Structure Overview
- Program Collateral Credit Quality
- Analysis
- Summary of Results

# Project Objectives and Program Framework

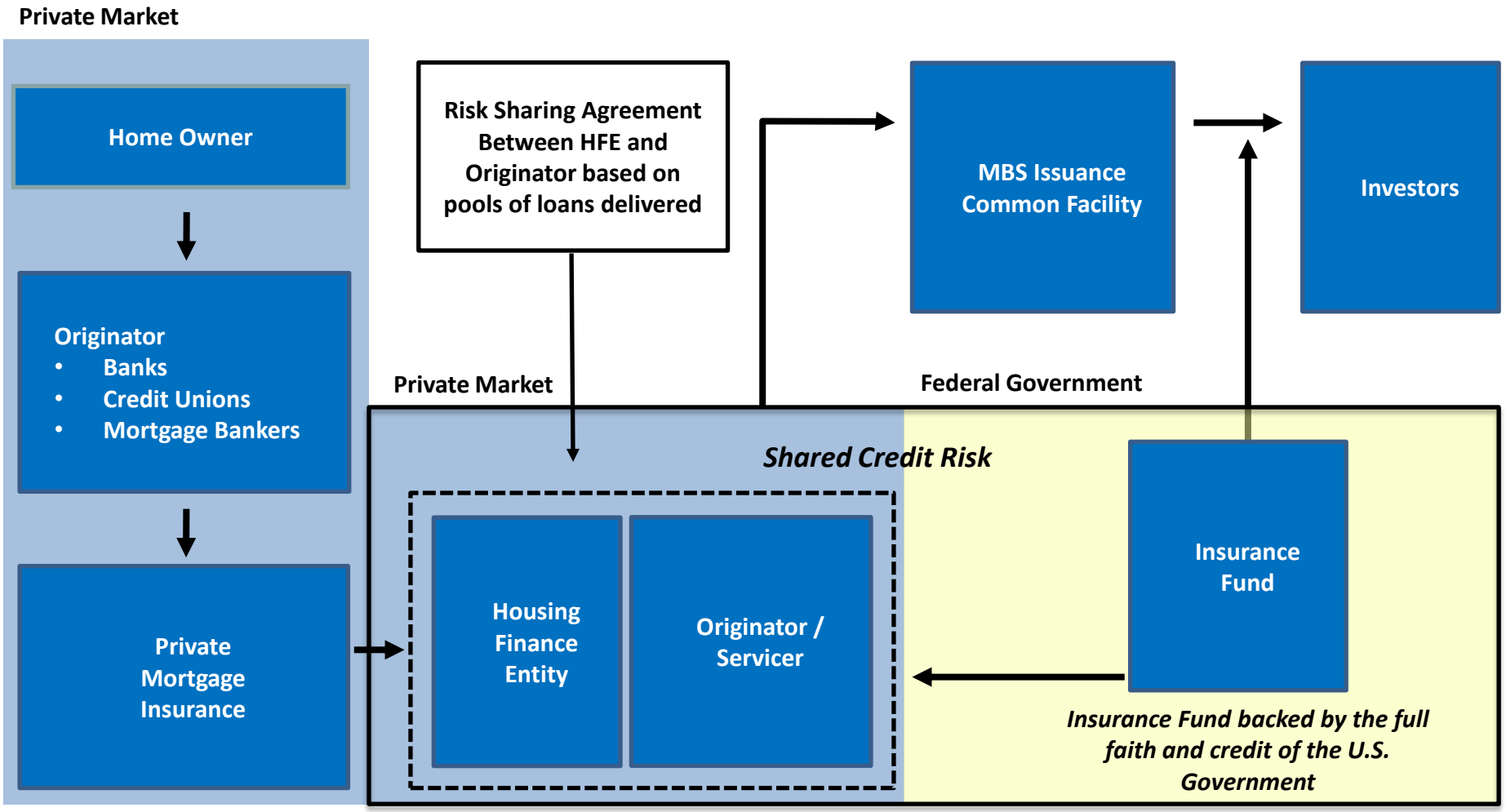
The project's stated objective is to quantify and model certain provisions of the NAHB proposed framework for Single Family Housing Reform.

**NAHB assumptions provided:**

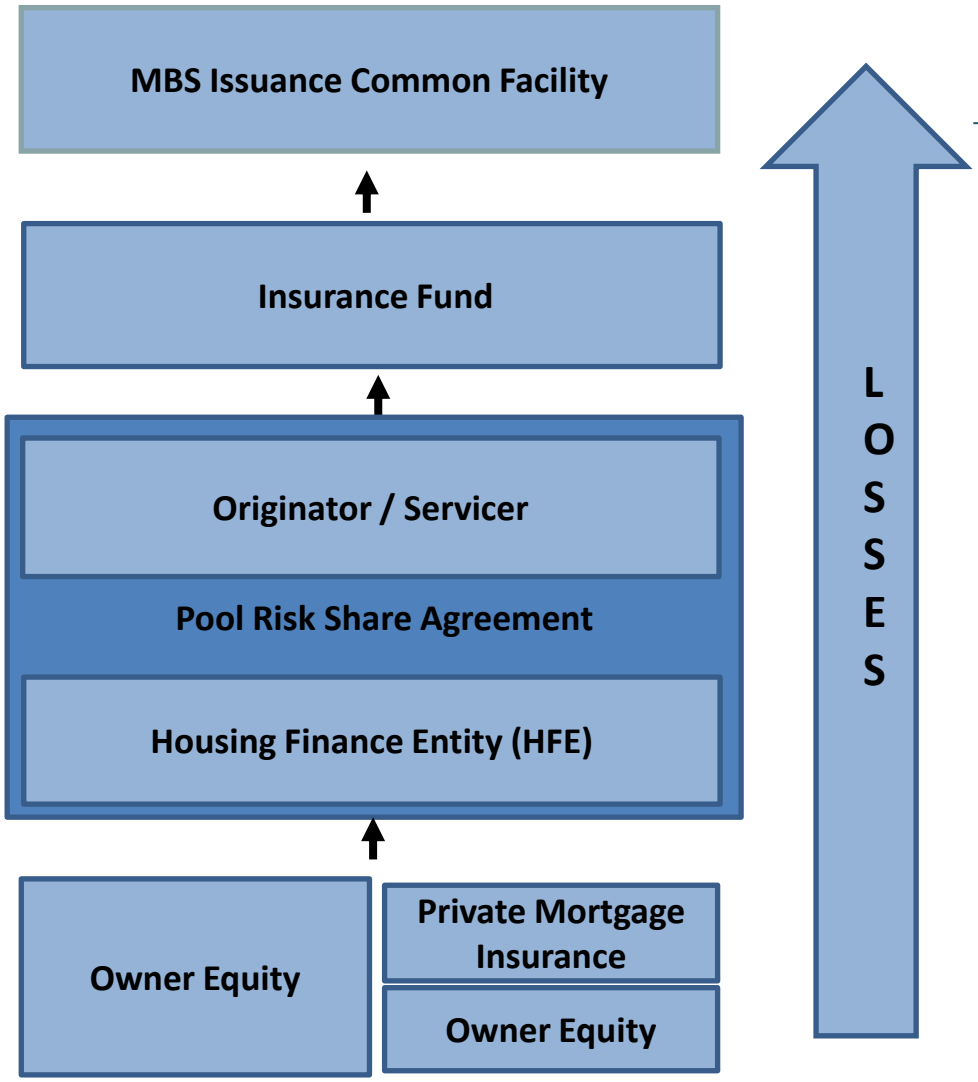
- Economic environment is stable (housing activity and price stability)
- Similar capacity to Fannie Mae and Freddie Mac (GSEs) current annual purchases
- Conventional Mortgage Products
- Structure of the Secondary Market includes the following key players:
  - ***Originators*** - Banks, thrifts, credit unions and mortgage bankers
  - ***Housing Finance Entities (HFE)*** – Takes the place of GSEs in pricing, underwriting credit risk, establishing servicing standards
  - ***Insurance Fund*** - Acts as a backstop to fully guarantee HFE issued mortgage securities
  - ***Federal Government*** - Stands behind the Insurance Fund in catastrophic loss scenarios to ensure it is fiscally sound; Insurance Fund would be backed **explicitly** by the full faith and credit of the United States Government

# Proposed Framework for Housing Finance

***HFE is a privately capitalized, federally chartered institution that would guarantee the timely payment of interest and principal on securities***



# Proposed Framework Credit Loss Coverage




✓ Provides Catastrophic Government Guarantee on RMBS

***Insurance Fund***

- ✓ Insurance Fund oversight by Federal Regulator
- ✓ Fiscally Solvent
- ✓ Provides support in event of higher than expected losses
- ✓ Funded by Originators / Servicers

***Originator/ Servicer***

- ✓ Originator / Servicer 'takes on' credit risk after "expected" losses are absorbed by HFE
- ✓ Loss limit applied to pool of mortgage deliveries
- ✓ Is compensated for shared credit risk
- ✓ HFE absorbs losses in event of non-performance of Originator / Servicer / Mortgage Insurance Company

***HFE***

- ✓ HFE oversight by Federal Regulator
- ✓ Privately capitalized insurance fund for
- ✓ Establishes underwriting criteria, quality assurance, servicing criteria, reps & warrants
- ✓ Monitors counter-party risk
- ✓ Collects Guarantee Fee and Commitment Fee
- ✓ Right to take mortgage servicing rights

# Outstanding Balance of GSE Securities

RiskSpan
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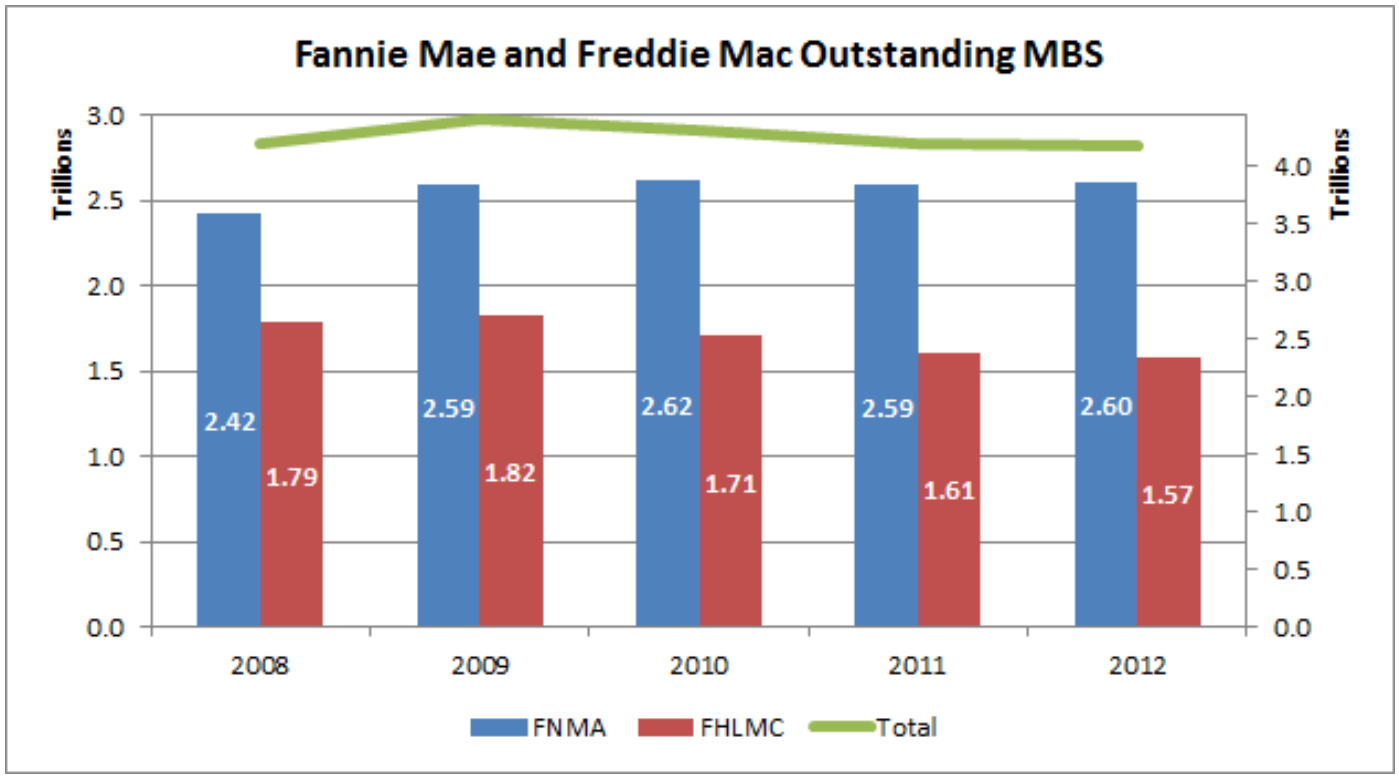
- Approximately $4.1T in GSE MBS Outstanding
- Majority of Outstanding MBS issued by Fannie Mae
- Under NAHB proposal, HFE would need similar capacity



# Assumptions applied in the NAHB Program Analysis

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**Sensitivity Analysis Performed**

- Modeled sensitivity to changes in the waterfall structure ( e.g., threshold for credit loss participation of Insurance Fund and Federal Government)

- Assumed collateral would have relatively high credit quality. Model assumed approximately 72% of loans have greater than 740 FICO and approximately 73% of loans have an LTV of 70 or lower

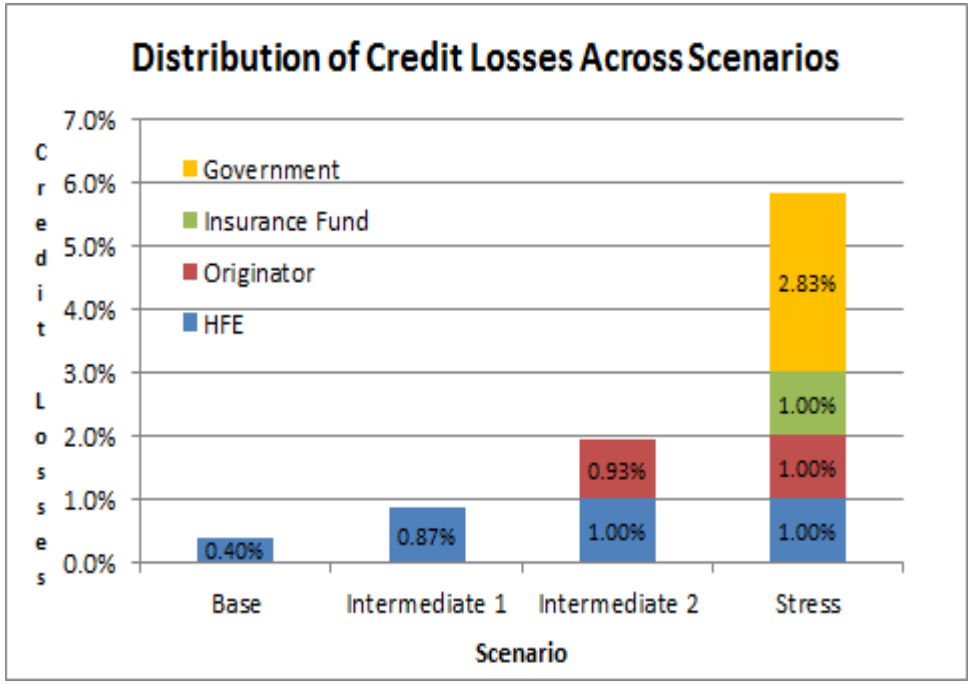
- Modeled House Price Appreciation (HPA) and sensitivity to capital and ROE requirements for the participants

  - *'Base Case' scenario* used in analysis of NAHB Program has default projections similar to the Freddie Mac 2004 vintage experience; Housing Prices appreciate at 3% per year

  - *Intermediate scenarios* - Intermediate scenario #2 Housing Prices decline 5% over 3 years then appreciate at 3% per year; Intermediate scenario #2 – Housing Prices decline 20% over 8 years then appreciate 3% per year

  - *'Stress Case' scenario* used in analysis of NAHB Program has default projections similar to Fannie Mae 2006 – 2007 vintage experience; Housing prices decline 45% over 10 years (follows 2007 scenario)

# Loss Sharing Rules and Distribution of Losses Across Parties




- Capital adequacy and pricing/fees for each of the entities depend on explicit specifications of the loss-sharing rules
- HFE absorbs cumulative losses up to 1% of commitment amount
- Originator retains losses between 1% and 2% of cumulative loss amount
- Insurance Fund guarantees losses between 2% and 3% of cumulative loss amount
- Federal Government guarantees losses above the 3% cumulative loss amount

# Initial and Long-term Capital Requirements

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- Required capital for each participating entity is a function of expected loss and credit related fees earned
- Each Market Participant will expect a reasonable return on capital
- Model assumes participating entities will require approximately 3.0% capital system-wide to support mortgage assets originated over the long-term
- Assuming a market size of $4.1T, $123B in capital will be needed to support the market at steady state
- HFE and Originator are assumed to need 70% of the required long-term capital as initial support or approximately $57.4B in capital
- Insurance Fund capital would build over time as mortgages are securitized and would not need initial capital
- Amount of capital required may cause market to establish multiple HFEs to obtain capital

| | HFE | Originator | IF | Total |
|---|---|---|---|---|
| Credit losses in "Stress' scenario | 1.00% | 1.00% | 1.00% | 2.83% |
| **CAPITAL: LONG-TERM REQUIREMENTS** | | | | |
| Capital requirement as percent of mortgage assets | 1.00% | 1.00% | 1.00% | 3.00% |
| Dollars of capital at steady state (billions) | $41.00 | $41.00 | $41.00 | $123.00 |
| ROE requirement | 15% | 15% | 10% | |
| **CAPITAL: INITIAL REQUIREMENTS** | | | | |
| Capital requirement as percent of mortgage assets | 0.70% | 0.70% | 0.00% | 1.40% |
| Dollars of capital at steady state (billions) | $28.70 | $28.70 | $0.00 | $57.40 |
| ROE requirement | 15% | 15% | 10% | |

# Credit Fees

- Under the Loss Sharing Arrangement outlined by NAHB the total credit costs in the system would be expected to be 66 bps
- Assuming GSEs will be charging approximately 48 bps g-fee in 2013, the new housing finance structure would increase costs to the consumer by approximately 18 bps
- HFE would require approximately a 31 bps credit fee for the 1st loss position
- Originator would retain / receive a 25 bps credit fee for the 2nd loss position
- Insurance Fund would require approximately 10 bps to support catastrophic risk

| | HFE | Originator | IF | Total |
|---|---|---|---|---|
| **CAPITAL: LONG-RUN REQUIREMENTS** | | | | |
| Capital requirement as percent of mortgage assets | 1.00% | 1.00% | 1.00% | 3.00% |
| **GUARANTEE FEES** | | | | |
| Annualized credit losses | 0.06% | 0.00% | 0.00% | 0.06% |
| Capital Cost/NI requirement | 0.25% | 0.25% | 0.10% | 0.60% |
| Guarantee Fees | 0.31% | 0.25% | 0.10% | 0.66% |

# Summary of Results

- Modeled NAHB program assumed 1% of credit losses are absorbed by each of three entities: 1) HFE, 2) Originator and 3) Insurance Fund
- Modeled scenarios had system-wide losses ranging from .40% in the base case scenario up to 5.83% in the stress case scenario
- The stress scenario modeled results in 2.83% of losses beyond the NAHB program entities that would be absorbed by the U.S. Federal Government
- Required capital in a “steady state” modeled is $123 billion system-wide or $41 billion for each NAHB program entity
- Guaranty fees modeled approximate .66% system-wide and are shared by the parties that assume credit risk

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