



Housing Finance Recommendations

Background: In 2013, out of 1,622,000 conventional purchase mortgage loans, African Americans got only 36,903 loans and Hispanics got 71,013 loans. This represents 2.2% and 4.3% of loans respectively, compared to these two groups being only 13.2% and 17.1% of the U.S. population. This mortgage availability crisis is not expected to improve in 2014 and 2015. (*Source: Center for Responsible Lending Policy Brief, September 2014, based on HMDA data.*)

High-Level Asks:

- Support families by setting strong housing goals, completing the “Duty to Serve” rulemaking, and moving forward with reforms in other areas such as servicing, loss mitigation, and REO properties.
- Lock in and enhance permanent funding for the Housing Trust Fund and the Capital Magnet Fund by restoring Fannie and Freddie’s safety and soundness.
- Re-build capital at Fannie Mae and Freddie Mac by allowing them to keep their profits and raise additional capital to support their affordable housing mandates, secondary market function, and further expansion of the underwriting “credit box” to benefit all Americans.

Discussion

Before the end of the Obama Administration, there is a unique opportunity to help disadvantaged communities and to build a lasting legacy of affordable housing. This can be done by providing a true helping hand to those who have an uphill battle accessing the American dream of home ownership. Permanent funding of the Housing Trust Fund and Capital Magnet Fund can be achieved, without any further action or appropriation by Congress, by ensuring the continued existence and recapitalization of Fannie Mae and Freddie Mac. Ensuring the GSEs’ safety and soundness would allow them to continue their mandated affordable housing goals. Maintaining these goals has been, and will continue to be, crucial to supporting social stability, social mobility, and economic growth. The GSEs’ current undercapitalized state jeopardizes long-term housing access to significant portions of the U.S. population, those unable to access private credit due to tighter lending standards.

The use of the word recapitalization is in no way meant to suggest that Fannie Mae and Freddie Mac will (or should) go back to their prior positions of market dominance and taxpayer risk. Building capital inside the enterprises not only protects taxpayers, but actually expands options for future reforms.

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1. Regulatory and structural issues:

Oversight of the mortgage sector by the CFPB, FHA, FHFA, and other regulatory bodies has reduced the predatory lending and foreclosure practices of the past that have painfully impacted urban communities and constituencies. However, the “credit box” remains unnecessarily tight, and significant issues remain with the servicing and disposition of troubled mortgages. To address this, we need regulatory changes that make it easier for mortgage credit to flow to underserved home buyers and that strengthen the neighborhoods in which they live. For example:

A. FHFA should release a strong “housing goals” rule and should complete the long-overdue “duty to serve” rulemaking. FHFA has not yet issued a final rule setting strong housing goals for Fannie Mae and Freddie Mac, and it should do so immediately. It should set strong single- and multi-family benchmarks, including a 27% goal for low-income home purchase lending, take enforcement actions that consider the performance of the overall market when the GSEs fail to meet housing goals, establish sub-goals for small multifamily properties, and create reporting requirements for single-family rentals. In addition, the HERA statute requires FHFA to promulgate a duty-to-serve rule to encourage responsible innovation and give the GSEs strong incentives to serve broadly and lead the market. We need Fannie and Freddie to provide new mortgage products, flexible underwriting, affirmative outreach, and other activities including grants to and partnerships with high-performing nonprofits in the housing space.

B. FHFA should direct the GSEs to update their credit score models to include more creditworthy borrowers. Currently, Fannie Mae and Freddie Mac require the use of a FICO 04 credit score in their automated underwriting systems. However, newer scoring models, such as VantageScore, have made critical changes that improve the reliability of the resulting scores and/or allow the scoring of the 30 to 35 million consumers that could never get a credit score under the FICO 04 system because of their limited credit history or “thin files.” Proposed newer scoring models no longer consider paid collection items, including medical debt collections, and give less weight to unpaid medical debts. FHFA should direct the GSEs to modernize their underwriting systems and to permit use of scores resulting from these new models.

C. FHFA should work with the GSEs to institute other reforms aimed at keeping borrowers in their homes, and at preserving neighborhoods when foreclosure is the only option. For years, The Leadership Conference and other groups have called for the use of principal reduction and other key loss mitigation reforms. Only some of these reforms have been put into place. Meanwhile, Fannie and Freddie have a significant number of REO properties under their control that must be managed properly and put back on the market in a way that fosters neighborhood stability. In many instances, however, this is not happening – as evidenced by the fact that recently, the National Fair Housing Alliance filed a complaint against Fannie Mae

for maintaining foreclosed properties in minority neighborhoods more poorly than in white neighborhoods. Last year, we presented a detailed set of recommendations (attached) to the FHFA calling for reforms to policies that govern access & affordability, servicing, non-performing loans, REO disposition, and other key issues. It will be important to discuss these areas in greater depth as we move forward.

2. Restructuring GSEs in and after conservatorship to enhance financial resources available for affordable housing:

On the subject of financial resources put towards greater mortgage availability, we need these funds more secure, we need them faster, and we need more of them. To make progress on each of these goals, we can and should recapitalize Fannie Mae and Freddie Mac – and use that process to generate and improve the quality of these financial resources.

To map out this process, FHFA should figure out exactly how to recapitalize Fannie Mae and Freddie Mac, either internally or by hiring a well-qualified advisor. Once the recapitalization process starts, it will be effectively irreversible by future administrations. The immigration issue illustrates why – just as a decision by the Obama Administration to let people stay in the United States will not be changed by a new president who would have to confront the horrible political optics of making these people leave, a decision by the Obama Administration to support safety and soundness would not be reversed except by a new president who wants to be seen as supporting recklessness and risk to taxpayers.

The recapitalization process can deliver major financial benefits to low-income and minority communities by securing financial resources and adding new ones to support affordable housing.

A. Regular contributions to affordable housing funds by Fannie Mae and Freddie Mac.

At the Financial Services Committee hearing with Director Watt on January 27, 2015, House Republicans argued that FHFA’s decision to turn on the GSEs’ contributions to the Housing Trust Fund and the Capital Magnet Fund is on uncertain legal ground so long as the GSEs are undercapitalized. Section 1131(b) of HERA says that FHFA “*shall temporarily suspend allocations... by an enterprise upon a finding... that such allocations (1) are contributing, or would contribute, to the financial instability of the enterprise; (2) are causing, or would cause, the enterprise to be classified as undercapitalized; or (3) are preventing, or would prevent, the enterprise from successfully completing a capital restoration plan....*” We believe Director Watt’s interpretation of this provision is sound, but it will remain especially contentious under the current status of the GSEs.

When Fannie Mae and Freddie Mac lose money during a quarter – and this will happen eventually over the housing cycle given their complex financial accounting – the enterprises’ lack

of capital to absorb those losses will lead them to draw on the Treasury financing lines once again. The timing of a draw on Treasury may be in question, but the likelihood of this happening is not. If this occurs during this Administration, that will lead to political attacks on the White House for having promised “no more bail-outs.” Regardless of the timing of a draw, Republicans will use the opportunity to call for, and to try to force, suspension of affordable housing funding by the GSEs making a draw. Our communities will be at risk from this eventuality, so Fannie and Freddie should be allowed to rebuild capital to protect both our people and the Administration.

The GSEs’ contributions to affordable housing can produce roughly \$300-400 million per year, but this flow of funds must be secured against political interference during and beyond this Administration. Future administrations may not be as sympathetic as this one to the need to maintain this important source of funding for affordable housing.

B. Affordable housing contributions from GSE shareholders as part of the recapitalization process. Private parties can do things that are not within the legal or fiscal power of the government, as we saw earlier in this Administration in bank settlements over mortgages and mortgage-backed-securities. As part of settling lawsuits with the Department of Justice, major banks agreed to provide mortgage relief and make contributions to affordable housing funds benefiting constituencies in serious need of help.

Similarly, as part of recapitalizing Fannie Mae and Freddie Mac, the Administration has to deal with the litigation between private GSE shareholders and the Treasury Department which has claimed virtually all the enterprises’ earnings through a “net worth sweep.” In exchange for recognizing the private GSE shareholders’ claims and allowing them to recover value, the Administration could require shareholders to contribute a portion of their securities to the Housing Trust Fund, the Capital Magnet Fund, or other affordable housing efforts. We believe a settlement could be reached in a way that (a) would involve no payment to shareholders or harmful admissions by the government, (b) could deliver substantial value to communities in need of support, and (c) could be structured, packaged and announced in a way that makes it a political win for this Administration rather than a problem left for the next one.

Across both GSEs, there is roughly \$33 billion face value of preferred stock outstanding and tens to hundreds of billions of dollars of potential value to common stock. The Administration should consider asking the holders of that stock to support the GSEs’ public mission by contributing some of that value to affordable housing efforts as part of recapitalization. Such one-time contributions could dwarf annual contributions from Fannie Mae and Freddie Mac.

C. Contribution of Treasury’s warrants for common stock of Fannie Mae and Freddie Mac to the affordable housing funds. Often lost in public discussion of the GSE conservatorships is the fact that the Treasury Department currently owns warrants for 79.9% of the common stock of each of Fannie Mae and Freddie Mac. While it may not be widely appreciated, these warrants are extremely valuable. In recapitalizing the GSEs, the government should maximize the warrant value and use that value in support of affordable housing.

The value of the warrants could easily exceed \$100 billion. If the Administration were to contribute a portion or all of these warrants to affordable housing, that would ensure funding of necessary assistance to our communities for a generation. It is important to note, however, that this value is only achievable to the extent that a recapitalization allows value to flow over time to the Fannie and Freddie common stock to which these warrants are tied. The warrants cannot easily be sold in the market, or exercised with the common stock received then sold in the market, before the end of this Administration. But the Administration can keep this value in the housing sector and devote its use to constituencies that need help. The huge amount of value in the warrants can make this a “top 10” or even “top 5” legacy item for President Obama. Of course, future administrations may not have the same priorities, and they may use this substantial long-term value for other purposes, unless it is contributed to the trusts.

D. In conservatorship, FHFA should continue its work to de-risk the GSEs so they need less capital to achieve safety and soundness. Keeping Fannie Mae and Freddie Mac safe and sound ensures the flow of affordable funds through their direct contributions to the trust funds and through their securities. FHFA should continue “de-risking” the GSEs by reducing risk away from the balance sheets and to mortgage insurers and capital market investors. HERA has already mandated the near-total elimination of the GSEs’ portfolios for other than liquidity purposes. Whatever operational reforms are enacted should be matched by full exercise of the safety-and-soundness regulatory power that HERA gave FHFA as regulator. That statute is not just about conservatorship, it is about systemic stabilization.

E. Post-conservatorship: after sufficient capital is raised and safety and soundness are ensured, a portion of Fannie and Freddie economic returns should be recycled back into affordable housing. While the two largest financial institutions in the United States need to be strongly regulated for safety and soundness, and dividends may be necessary to attract private capital into the GSEs and lessen their dependence on the Treasury Department, all profits above capped rates of return being required to be contributed to affordable housing will both ensure long-term assistance to communities in need and deprive the GSEs of the “deep pockets” with which to lobby legislators, avoiding much of the basis for regulatory capture.

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Fannie Mae and Freddie Mac are as essential to the mortgage market as water and power companies are to daily life across the United States, and the GSEs could similarly be regulated going forward as public utilities. While FHFA as conservator can regulate Fannie and Freddie's guarantee fees while they are in conservatorship, after the conservatorship is over a public utility commission could be responsible for determining allowable rates of return. This particular item will likely require legislation, which could address any additional problems with the charters.

Political benefits to the Administration

- Secures the existing affordable housing benefits provided by Fannie Mae and Freddie Mac for future generations, preventing their elimination or inadequate replacement by Republicans.
- Maintains and builds this Administration's legacy with low-income and minority communities as the champion of their economic interests on the housing front.
- By unlocking and channeling financial resources to affordable housing, ensures millions of Americans will be able to buy homes for decades beyond this Administration.
- Protects taxpayers against future GSE draws against the Treasury Department by putting substantial private capital in the first-loss position.
- Completes financial sector reform (clean-up after 2008 financial crisis) begun with Dodd-Frank and continued with mortgage regulations protecting homeowners, by acting on the last item of unfinished business – Fannie and Freddie reform.

Almost all of this can be done without further legislation from Congress.

None of this takes away from Congress' ability to pass housing finance reform in the future or to fix any problems with the charters of Fannie Mae and Freddie Mac. In fact, the more capital there is in the GSEs, and with reforms including (but not limited to) those described above, the more likely it is that future Administrations and Congresses will have to carry out reform in ways that are supportive of and responsive to the interests of the President's base.