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The Leadership Conference

Preserving Access and Affordability in Housing Finance:
Questions and Answers on the Role of Fannie Mae and Freddie Mac

Why are Fannie Mae and Freddie Mac vital in promoting mortgage lending?

Fannie Mae and Freddie Mac (government-sponsored enterprises, or GSEs) were created and chartered by Congress to expand access to mortgage credit throughout the country. Prior to the New Deal, many areas of the country faced limited access to mortgages and homeownership. Fannie Mae, along with the Federal Housing Administration, or FHA, were created to provide more uniformity and liquidity for mortgage lending nationwide. Several decades later, Freddie Mac was created and now plays a role similar to Fannie Mae.

Fannie and Freddie play a distinct and important role in promoting mortgage lending, in both the single-family and multi-family housing markets. They do this by purchasing and guaranteeing mortgages originated by other lenders, allowing those lenders to take the loans off their books and use the proceeds for other purposes, including the origination of additional mortgages. This practice is especially important to small, community-focused lenders, who would otherwise face challenges in making additional loans. Fannie and Freddie can securitize the mortgages they purchase and sell them to investors, or they can retain loans in their own portfolios. (Ginnie Mae, another GSE, plays a similar role in the securitization of mortgages directly backed by the federal government, such as FHA or VA loans.)

Because Fannie and Freddie provide a guarantee of payment to investors, their mortgage-backed securities have long been viewed as an attractive and safe product. As a result, throughout most of their history, Fannie and Freddie have attracted significant funds across the globe for U.S. home loans, making them profitable while at the same time promoting mortgage lending that would otherwise not occur. While a number of banks have followed a similar model, purchasing and securitizing mortgages in what are known as private-label securities (or PLSs), Fannie and Freddie remain the two largest entities that provide liquidity to the housing finance system.

More specifically, why are Fannie Mae and Freddie Mac vital in promoting access to, and affordability of, mortgage lending for underserved communities, such as low-income and minority borrowers?

As a part of their unique relationship with the federal government, Fannie Mae and Freddie Mac have certain obligations with respect to underserved communities. Fannie and Freddie are authorized to engage in secondary mortgage market "activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities." In addition, they are obligated to "promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas)." This access is promoted in several ways.

First, the laws creating Fannie Mae and Freddie Mac require them to meet certain affordable housing goals. These are specific numerical goals for the purchase of mortgages from low-income borrowers and low-income areas, measured by the aggregate share of loans made by year and across time. There are

goals set for single family home mortgages, with benchmarks set for the purchase of loans made to low-income families (=< 80% area median income), very low-income families (=< 50% area median income), and low-income areas. In addition, benchmarks are set with respect to refinance loans made to low-income families, and for loans made to purchase multifamily housing for low-income and very low-income families. As Fannie and Freddie demonstrated in their multifamily businesses through the financial crisis, while such mortgages are typically less attractive to lenders and to investors who purchase mortgage securities, when they are carefully underwritten, they can generate positive returns.

Second, as a result of the Housing and Economic Recovery Act of 2008 (HERA), Fannie Mae and Freddie Mac have a statutory "duty to serve" underserved markets. Specifically, the GSEs must ensure that they include mortgages for manufactured housing, affordable housing preservation, and rural areas in their purchase and securitization practices. This "duty to serve" is met by developing special loan products and underwriting guidelines that are tailored to these unique markets, and by participating in other Federal affordable housing programs.

Third, HERA also calls upon Fannie Mae and Freddie Mac to contribute a small portion of their proceeds to create and maintain a "Housing Trust Fund" and a "Capital Magnet Fund." The Housing Trust Fund is an affordable housing production program that complements existing federal, state, and local efforts to increase and preserve the supply of affordable housing for extremely low- and very low-income households, including those who are currently homeless. The Capital Magnet Fund provides grants, on a competitive basis, to community development financial institutions (CDFIs) and nonprofit housing organizations to develop affordable housing in highly underserved communities. HERA requires Fannie Mae and Freddie Mac to contribute a total of 4.2 basis points (.042 percent) of their fee income from new business purchases to these two programs. Shortly after the enactment of HERA, however, these contributions were suspended when the GSEs entered conservatorship under the Federal Housing Finance Agency (FHFA), the agency created under HERA to oversee the two corporations. In December 2014, thanks to the improved financial condition of the GSEs, the FHFA directed them to resume these contributions – but only if doing so would not create the risk of further draws from the Treasury (*i.e.* a further bailout).[1] In other words, the contributions to these two funds are not guaranteed; rather, they depend on continued positive earnings by Fannie and Freddie.

Fourth, there are additional programs and policies that enable Fannie Mae and Freddie Mac to promote homeownership in underserved communities. For example, they engage in affordable housing partnerships with state housing finance agencies. Recently, the FHFA permitted the GSEs to purchase mortgages for up to 97 percent of a home's price, if loans are accompanied by careful underwriting, borrower counseling, and other safeguards – a policy that will greatly benefit first-time homebuyers. We have also urged the FHFA to allow the use of improved and modernized credit scoring systems, to identify people who are good credit risks but whose histories have not been accurately captured by the traditional scoring model.

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[1] Under the terms of the "Preferred Stock Purchase Agreements" (PSPAs) with Fannie Mae and Freddie Mac, the Treasury Department provided funds to the GSEs so they could meet their capital requirements and avoid insolvency. In exchange, Treasury got a warrant for 79.9 percent of the common stock plus an immediate $1 billion in preferred equity, plus a dollar of preferred equity for every dollar it put in. This is an important point, because Treasury did get something from the company in return for its money. Recapitalizing and privatizing the GSEs would provide a path for Treasury to get even more for its investment.

To be clear, these access and affordability policies have not resulted in the levels of minority homeownership and affordable housing that we would like to see. Those levels were disappointing before the 2008 crisis, and in recent years they have been even worse. Some programs, such as the newly-funded Housing Trust Fund, obviously need more time before we can assess their results. Yet with the right leadership in place at FHFA, we believe the potential for improvements across the board is there.

If Fannie and Freddie are eliminated, on the other hand, that potential disappears with them. Low-income individuals and areas will lose vital access to affordable mortgages altogether, and middle-class borrowers will find it more difficult to obtain loans as well. Small, community-focused lenders will find it far more difficult to provide loans, giving big banks a huge competitive edge in the market. While the FHA could be somewhat helpful in the absence of Fannie and Freddie, its narrow mandate and limited resources would prevent it from filling the void in any meaningful way.

Why did the housing market crash in 2008, and what role did Fannie Mae and Freddie Mac play in the downturn?

The causes of the 2008 housing market crash, and the involvement of Fannie Mae and Freddie Mac, have long been the subject of widespread misunderstanding and frequent misrepresentation. Some in Congress and the media have tried to pinpoint most of the blame on Fannie and Freddie (or even more wrongly, the Community Reinvestment Act) for causing the crisis, when the truth is that the entire financial regulatory system had broken down, and the market was plagued with unrealistic expectations that housing prices would continue rising indefinitely and prevent losses from taking place.

In short, risky mortgage practices such as subprime and Alt-A lending proliferated in the 2000s because too many people believed at once that there were fortunes to be made. Low interest rates in the years following the 2001 recession led many investors to look for higher-yield products in which to grow their money. The relatively high interest rates promised by subprime and Alt-A mortgage securities fit the bill perfectly. The problem was that few investors realized that the bulk of the loans backing these securities had been very poorly underwritten. Many loans were based on the "stated" – but not verified – income of borrowers. Many loans gave borrowers a low teaser rate, only to reset to much higher and unaffordable payments after several years (borrowers were often assured that they could simply refinance or sell the house for a gain). Many houses were appraised at highly unrealistic values, leading borrowers to take out larger loans and artificially inflating housing prices even further. As long as there was investor demand for high-yield mortgages, lending companies such as Countrywide and Ameriquest were more than happy to oblige, quickly making loans and selling them off to banks and other investors as fast as they could. Meanwhile, the risks of many loans were grossly misjudged or misrepresented by credit rating agencies, which slapped "AAA" ratings on mortgage-backed securities regardless of their underlying quality.

It is important to point out that much of this lending and securitization took place outside of the GSE system. In fact, as subprime and Alt-A lending were booming, Fannie and Freddie were losing market share. The critical mistake they made was that they tried to regain it, and did so with exceptionally poor timing. They, too, loosened their underwriting standards and increased their purchases of more risky mortgages. As the cracks in the system became evident, the banks, investors, and the GSEs all began facing catastrophic losses, leading to the 2008 enactment of HERA and a massive bailout of banks that were deemed "too big to fail."

Up until then, most regulators and members of Congress had been asleep at the switch. Meanwhile, for years before the crash, The Leadership Conference and many of its coalition partners had been sounding the alarms, to no avail. Among other things, we worked with former Representatives Barney Frank (D-MA), Mel Watt (D-NC), Brad Miller (D-NC) and others on legislation to curtail abusive practices in subprime lending,[2] including through the imposition of stronger underwriting standards. Our efforts were rebuffed by the industry and their Congressional allies.[3] In late 2006, well ahead of its time, the Center for Responsible Lending issued a report predicting that millions of subprime mortgages would end in foreclosure.[4] The organization was criticized for its dire warning. It was not until 2010, with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, that stronger "ability to repay" requirements were imposed on lenders. Even those have come under attack by some in Congress.

Since Fannie Mae and Freddie Mac entered conservatorship in 2008, what kinds of reforms have taken place? How effective have those reforms been?

It is clear that Fannie Mae and Freddie Mac did not singlehandedly cause the mortgage crisis, but they did contribute to it – and they were certainly to blame for the condition in which they found themselves by 2008. In a misguided effort to regain market share and boost profits at a time when the entire mortgage industry was spinning out of control, they took on massive amounts of risk without the capital buffers necessary to withstand the subsequent downturn. Reforms to these two entities and their regulatory structure were critical.

When Fannie Mae and Freddie Mac were placed in conservatorship in 2008, those reforms were able to begin taking place in earnest. The underwriting requirements of the GSEs were drastically strengthened (unfortunately, we believe an overcorrection took place, shutting many creditworthy borrowers out of the mortgage market). The FHFA made numerous changes to improve mortgage servicing and reduce foreclosure-related losses (we believe further improvements here are also necessary, particularly to allow the use of principal reduction in the case of "underwater" mortgages). Risky investment practices have been curtailed, by shrinking the GSE portfolios and changing their composition. In an effort to recoup losses, the FHFA has pursued legal action against a number of banks that sold fraudulent mortgage securities to the GSEs, resulting in large fines and "putback" (buyback) settlements.

Without overstating the case, the results of these and other reforms have been positive. The massive losses faced by the GSEs in the first several years of the housing crisis have been reversed, and both Fannie and Freddie have become – from an operational standpoint – profitable. The rub here is that since 2012, when the Preferred Stock Purchase Agreements (effectively, the bailout) were last amended, nearly

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[2] H.R. 1182, the "Prohibit Predatory Lending Act," 109th Cong. (2005). For example, Section 3(c) prohibited "Lending Without Due Regard to Ability to Repay." The bill had 67 cosponsors.

[3] In June 2007, more than a year before the widespread housing and banking crisis, Leadership Conference President & CEO Wade Henderson testified before the Senate Banking Committee regarding the widespread problems in the housing finance industry, their impact on communities of color, and the resistance his organization had faced in pushing for more effective regulation. "Hearing on Ending Mortgage Abuse: Safeguarding Homebuyers," Senate Banking Subcommittee on Housing, Transportation and Community Development, 110th Cong. (June 26, 2007) (testimony of Wade Henderson, available at http://1.usa.gov/1zdnlRo.

[4] Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, "Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners," Center for Responsible Lending, Dec. 2006, at http://bit.ly/1LCDKny.

all of Fannie's and Freddie's profits have been paid directly to the U.S. Treasury.[5] It is important to note that these payments are construed as an ongoing "fee" for the bailout, not a repayment of the bailout itself. Under the current terms of the agreements, the Treasury continues to own a controlling interest in both corporations. While this arrangement maintains the leverage that the Treasury and FHFA have over the GSEs to continue making vital reforms, it also raises questions about the ultimate end game strategy.

In recent years, lawmakers have proposed the elimination or "wind down" of Fannie Mae and Freddie Mac. What would the consequences of this be? In the absence of such legislation, what risks do the GSEs currently face?

Many members of Congress, as well as some Obama administration officials, believe that Fannie Mae and Freddie Mac should be wound down, through the legislative process, and replaced with an entirely new mortgage finance system. In the 113th Congress, we saw two proposals to this end.

We had significant concerns with both approaches. In the House, the Financial Services Committee approved H.R. 2767, the "Protecting American Taxpayers and Homeowners Act." We feared it would drastically shrink the mortgage market, and eliminate the *potential* access and affordability benefits that the GSEs can provide. The bill was never brought to the House floor for a vote. In the Senate, the Banking Committee approved S. 1217, the "Housing Finance Reform and Taxpayer Protection Act." While less troubling than the House approach, this bill would have presented enormous execution risks, and as drafted would also have likely shrunk the market and limited access and affordability. It also never moved beyond the committee stage.

The prospects for either approach, or any other comprehensive legislation, appear dim in the 114th Congress. In the absence of a legislative overhaul, Fannie Mae and Freddie Mac remain in a state of limbo. Under the terms of their current stock purchase agreements, they cannot rebuild any capital because virtually all profits are paid directly to Treasury. Without this ability to rebuild capital, they remain at great risk in any future setback in the recovery of the housing market. Instead of being able to absorb losses, they may be forced to draw additional funds from the Treasury to remain solvent. It also makes it more difficult to eventually exit their conservatorship, and to expand the "credit box" of loans they will purchase. It could also make it harder for them to make ongoing contributions to the Housing Trust Fund, the Capital Magnet Fund, and to implement other initiatives to improve homeownership among low-income and minority communities – especially if Congress seizes on any additional troubles within the GSEs, real or perceived, to build support for piecemeal legislative "potshots" at these access and affordability programs[6] and tries to include such bills in any must-pass spending measures.

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[5] Under the terms of the agreements, each entity is permitted to keep a small capital reserve ($2.4 billion as of December 31, 2014) which is reduced by $600 million each year until it reaches zero in 2018.

[6] *See, e.g.*, H.R. 574, the "Pay Back the Taxpayers Act of 2015," 114th Cong. (2005). Sponsored by Rep. Ed Royce (R-CA), this bill would prohibit the GSEs from making any contributions to the Housing Trust Fund or the Capital Magnet Fund as long as they remain in conservatorship or receivership. This would overrule the FHFA's careful decision in December 2014 to allow these contributions as long as the GSEs do not make additional draws from the Treasury.

Given the lack of a legislative consensus around an overhaul of the mortgage finance system, what can be done about Fannie Mae and Freddie Mac, in a way that expands responsible lending and promotes access & affordability for underserved communities in the housing market?

Barring the passage of a bipartisan legislative overhaul, we believe the administration should allow Fannie and Freddie to rebuild their capital and work to ultimately bring the conservatorship to an end. As discussed above, under the stock purchase agreements with Treasury, Fannie and Freddie pay a "fee" that reasonably covers the cost of the ongoing government backstop. This fee currently amounts to nearly all of the profits earned by the GSEs. However, this fee is not specified by law – rather, it is a term of the agreements themselves, which have been revised several times. We see no reason why the terms of this agreement cannot be revised, again, by the mutual consent of the parties to that agreement, in a way that either retains or eliminates the ongoing government backstop. Treasury would merely be deferring, not forfeiting, additional monetary compensation for its support, because it could ultimately sell the equity interests in the companies that it received.

Building an adequate capital buffer, and preparing the GSEs for a return to privatization, would certainly take years. But given the fragile state of the GSEs and the dim prospects for legislative reform, we believe it is best to allow that process of recapitalization to begin sooner rather than later.

At the same time, the FHFA must continue its ongoing administrative reforms of Fannie and Freddie, as the GSEs simply cannot be left to operate the way they did before 2008. Under HERA, the FHFA has significant authority over Fannie's and Freddie's access and affordability policies (as described above), capital requirements, limits on their portfolios, the representations and warranties made on mortgage securities, mortgage servicing and loss mitigation standards, mortgage insurance requirements, and other aspects of their operations.[7] We fully expect the FHFA to make the most of this authority, both before and after the conservatorship is brought to an end, to more carefully protect underserved communities and the public as a whole.

Allowing Fannie Mae and Freddie Mac to recapitalize and eventually ending the conservatorship would not preclude Congress from making more significant overhauls in the future, including their elimination and replacement with a different system. The system under HERA could certainly use improvements. But given our experience with highly complex reform efforts, such as the decade-old campaign to enact bipartisan immigration reform, we are mindful of the tremendous uncertainty of the legislative process – even when a proposal has obtained majority support both in Congress and with the American public. While those efforts continue, taking steps to recapitalize the GSEs and bringing an end to the conservatorship would fulfill the mandate that Congress provided with the enactment of HERA, and allow Fannie Mae and Freddie Mac to more effectively and safely carry out their mission to expand mortgage credit to worthwhile borrowers – including those who are not being, and under the status quo will continue to not be, adequately served by the existing housing finance system.

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[7] The FHFA is also currently working with Fannie and Freddie to establish a single security and a common securitization platform.