

GSE Reform and Affordable Housing

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Overview

- Over 90 percent of originations today are funded by the GSEs or FHA
 - FHA's market share rose from 3 to 30 percent in the past two years
- The GSEs have significantly tightened their underwriting standards, making FHA the primary funding source for:
 - First time homeowners
 - Low downpayment mortgages
 - Borrowers with weaker credit scores
- The private market is not expected to recover any time soon
 - Portfolio lending is capital-constrained
 - Private label securitization has virtually disappeared
- Challenge: How to reduce the government's role in the mortgage market without threatening the fragile recovery

Outline of Presentation

- GSEs
 - Current status
 - Options for Reform
 - Affordable Housing Goals
- FHA
 - Current Status
 - Recent Underwriting Changes

GSE Update

- Conservatorship has made the GSEs wards of the state
 - CBO now contends that the GSEs should be “on budget”
- GSEs have cost the US Treasury \$110 billion thus far, with another \$65 billion projected
 - December 24th Treasury announcement indicated unlimited federal support through the end of 2012
- Marked-to-market losses account for most of the GSEs’ losses to date. However, credit losses continue to rise on both their “traditional” and “non-traditional” books.
 - Alt-A mortgages represent about 10 percent of the GSEs’ book but account for 40 percent of credit losses
- The precarious state of the GSEs—and their importance to the housing recovery—make the timing and direction of reform uncertain.

Perspectives on GSE Reform

- Securitization needs to be part of any solution
- The mortgage market must be built to withstand periodic shocks
 - This requires a government guarantee
- Reform should be accomplished without a major overhaul to the existing infrastructure of the mortgage industry

GSE Mission

- Create a liquid and stable secondary market for residential mortgages
- Respond to the needs of the capital market
- Improve the distribution of affordable mortgage credit

GSE Accomplishments

- Standardization
- Liquidity
- Stability
- Improved Access
 - Regional differences eliminated
 - Lower mortgage rates—25 to 50 bps
 - Low downpayment, 30 year FRM

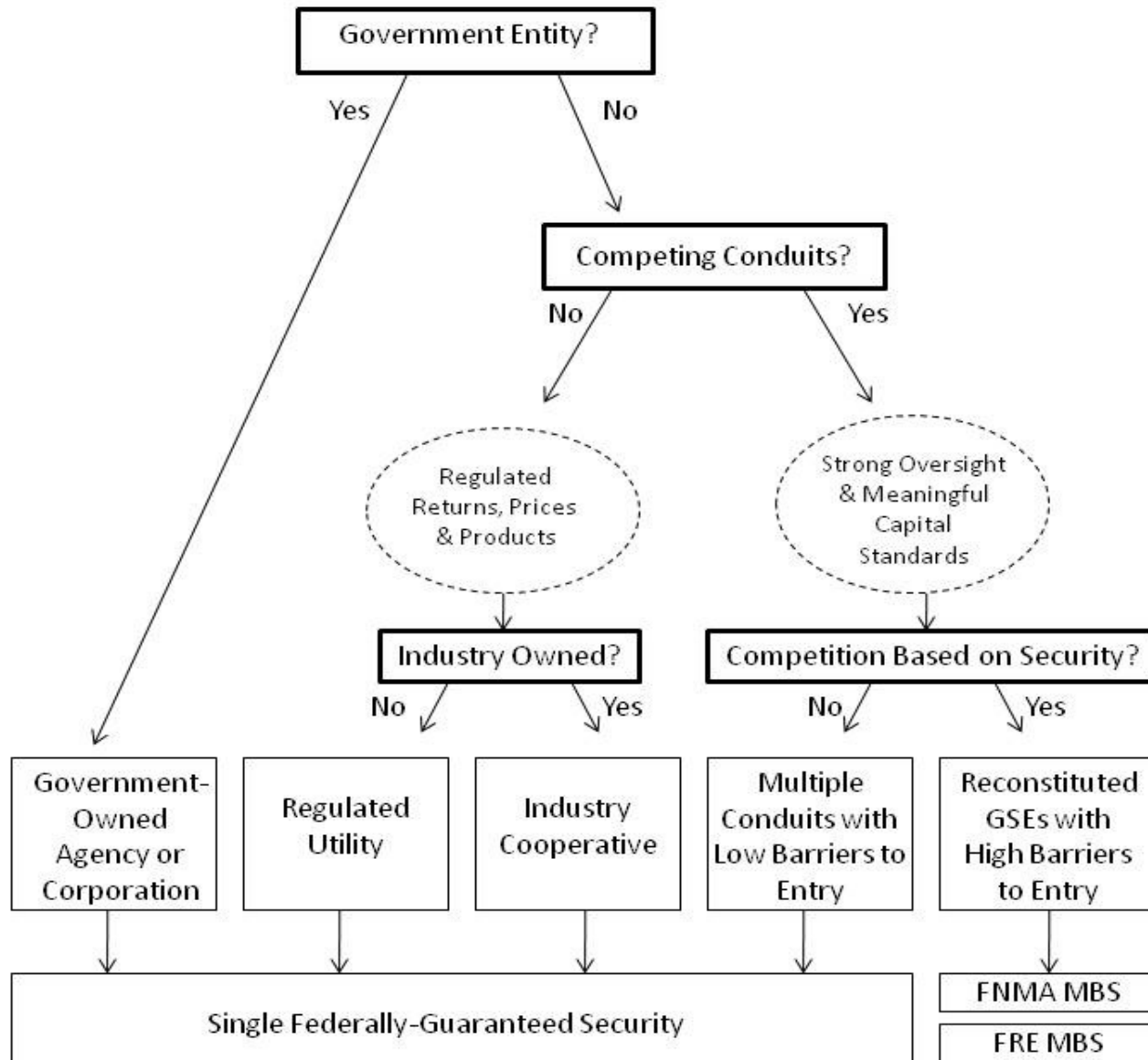
Perceived Weaknesses

- Moral hazard associated with implicit guarantee
- “Too big to Fail”
- Concentration of risk
- Inadequate capital standards
- Political Influence
- Weak regulatory oversight

Reform Proposals

- A consensus is emerging on certain aspects of reform:
 - Strong regulation
 - Higher capital requirements
 - Explicit guarantee on MBS (in exchange for a fee)
 - Limited investment portfolios, with exemptions for multifamily housing and innovative products
- However, there are significant disagreements on
 - Organizational structure and governance
 - Affordable Housing Goals/Obligations

Summary of Options



Affordable Housing Goals

- GSE track record is mixed
 - Empirical analyses have found little, if any benefit
 - Conservatives have argued that the goals supported the growth of the subprime lending and ultimately led to the housing crisis
- Goals for 2010 and 2011 to be issued shortly
- Positions differ on future goals
 - Industry groups: Any goals should be housed with FHA
 - Housing activists: Some kind of affirmative obligation should be retained
- Some are calling for a tax on future MBS issuances to create an affordable housing fund
 - This could replace or augment affordable housing goals

FHA Update

- Recent FHA audit revealed that the Fund has exhausted its reserves
 - Although the Fund is technically solvent, it no longer meets its 2% minimum capital requirement
- These projections may be optimistic
 - Delinquencies and foreclosures are at all time highs
 - While the time to foreclosure is lengthening, the probability of curing is on the decline
- FHA has tightened its underwriting requirements and increased its premiums
 - Upfront premium increased from 1.75% to 2.25%
 - Request for authority to increase annual premium from 0.50% to 0.85%
 - Minimum FICO score imposed (500)
 - 10% downpayment requirement for borrowers with weaker credit (<580)
 - Seller concessions reduced from 6 to 3%
- Treasury is currently working with HUD to apply HAMP incentive payments to FHA loan modification program

Conclusions

- Reform is unlikely to happen anytime soon, particularly in light of the GSEs weakened financial conditions.
- While affordable housing goals remain an issue, we are unlikely to return to the status quo.
 - This could change the rules of the game for advocacy groups.
- Underwriting will remain tight for the foreseeable future, with an increasing emphasis on “sustainability.”
 - Further restrictions should be expected if financial conditions at the GSEs and FHA continue to weaken.
- The respective roles of FHA and the GSEs (or their replacements) will be an issue going forward.
 - There is a real opportunity to shape the debate.