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Policy Thoughts about Single-Family Mortgage Social Bonds

Laurie Goodman and Janneke Ratcliffe

March 2023 (corrected March 27, 2023)

The housing market has historically been the main way Americans build wealth. The nationwide homeownership rate is 65.9 percent; far more Americans have housing wealth than wealth in any other asset. Homeownership rates for low- and moderate-income (LMI) households lag their higher-income counterparts, and homeownership rates for households of color lag those of white households, but many mortgage loans are being made to LMI borrowers and borrowers of color. It is only natural that as investors focus more on environmental, social, and governance issues, investors would want more disclosure on the characteristics of the loans they own. Against this backdrop, there has been considerable discussion about policies regarding social bonds in the single-family mortgage market.

The government-sponsored enterprises (GSEs) and Ginnie Mae have both taken action or are taking action to increase their disclosures to help investors meet their environmental, social, and governance mandates. Meanwhile, the Federal Housing Finance Agency has put out a request for input (RFI) on social bonds (hereafter, “S-lending”). The RFI states, “An Enterprise-labeled social bond should positively impact borrower sustainability, affordability and/or equity” (DHMG 2023, 5).

Fannie Mae and Freddie Mac do not currently issue single-family mortgages that are labeled as social bonds, though they do so on the multifamily side. But the GSEs do provide disclosures that would increase transparency into S-lending. This is done through two mechanisms:

- **Issue special bonds.** Fannie Mae and Freddie Mac already issue single-family affordable pools solely composed of loans originated under their principal affordable lending products—Fannie Mae’s HomeReady and Freddie Mac’s Home Possible—as well as limited issuance under other affordability programs (e.g., housing finance agency programs and refinance programs).

- **Provide social disclosures on regular bonds.** Fannie Mae and Freddie Mac both recently introduced Social Index disclosures. This index is designed to measure the amount of socially oriented lending in a mortgage pool.

The Purpose of Social Bond Programs

It is important to ask what the purpose of a social bond program should be or, equivalently, what increased disclosures on mortgage pools should be. The general thought is that investors should be willing to "pay up" for S-mortgages and that, as the Federal Housing Finance Agency noted, this value can benefit the borrower, such as by reducing costs and increasing affordability. Many investors are unwilling to pay up for S-bonds just because of the label, as they have a fiduciary responsibility to their investors to maximize returns. But in mortgage bonds, S-lending is generally expected to have more valuable prepayment characteristics. That is, investors value mortgages that prepay slower when mortgage interest rates are low, as investors can earn their above-market coupon longer; or they value mortgages that prepay more quickly when rates are high, which gives investors the ability to reinvest more funds at a higher rate. Investors are willing to pay up for bonds with superior prepayment characteristics. Note that investors are generally interested only in prepayment characteristics, as the credit is guaranteed by a quasi-governmental organization.

The mortgage market is currently paying up for pools that are entirely composed of loans with such characteristics as smaller loan sizes and lower credit scores. The market is also paying up for the single-family affordable pools. This reflects the fact that lower-balance (smaller) loans, for example, tend to prepay much less quickly when rates are low, as (1) refinancing costs are higher relative to the loan amount and (2) if originators are capacity constrained, as they often are when rates fall, smaller-balance loans are not prioritized to offer refinancing, as they are less profitable to originate.

Although the pay-ups for prepayment protection are almost always applicable, pay-ups are market dependent. Investors will pay up more in a market that is conducive to refinancing. An organized system for trading these "specified pools" has evolved—the pay-ups are quoted as a spread (in 32nds of a percent; 8 ticks would entail a pay-up of $0.25 per $100 par) over generic product. Generic product is the to-be-announced (TBA) market, where the investor does not know exactly which mortgages will be delivered. The pay-ups can never go negative, as these "spec pools" are good delivery into TBA pools. That is, generic product sets a TBA floor on pricing, assuring these mortgages of liquidity under all market conditions.

The hope is that a spec pool market will develop around broader S-lending. A few items will help this market develop. First, it is important to be able to quantify these products' prepayment benefits. Second, the more homogenous the specified pool, the more likely investors are going to be comfortable making the spec pool pay-up, as they can be confident they will receive the prepayment benefit. Third, the more homogenous the specified pool, the more likely the borrower will actually receive the benefits of this more favorable pricing. That is, the originator will know, when they give the mortgage quote, that they can sell the loan at a pay-up and will hence be more likely to pass some of that on to the borrower.

It is hard to quantify whether current spec pool pay-ups get back to borrowers, but we know they partially do. That is, for example, borrowers with small loan balances do not realize lower rates, even when the spec pool pay-ups are large. But small-balance loans are more expensive to originate; absent these pay-ups, the loans either would not be originated or would be originated at much higher rates.

The Current Social Index Is Less Well Suited to Spec Product

The Social Index, as currently designed, looks across three dimensions—income, borrower, and property—and scores on eight criteria: low-income borrowers, underserved minorities, first-time homebuyers, low-income areas, minority tracts, high-needs rural, designated disaster area, and manufactured housing (table 1).[1]

TABLE 1

Proposed Social Index Dimensions and Criteria

Dimensions	Criteria
Income	Low-income borrowers
Borrower	Underserved minorities First-time homebuyers
Property	Low-income areas Minority tract High-needs rural Designated disaster area Manufactured housing

Source: Fannie Mae.

The GSEs then disclose two numbers on each pool:

- **The social criteria share,** or a number reflecting the share of the pool (by loan count) meeting any of the social criteria. So if 20 of 30 loans in the pool have at least one social characteristic, the social criteria share would be 66.67 percent.
- **The social density score,** or an aggregate average of the number of socially oriented lending activities. If there are 30 loans in the pool, and 10 have three of the social attributes listed above, 10 have two of the attributes, and 10 have only one attribute, the social density score is 2.

It is a real contribution to lay out the social attributes where enhanced disclosure is warranted. These social attributes also align with the GSEs' Duty to Serve and housing goals. But the issues with this index are highlighted in the letter that the Structured Finance Association sent to Fannie Mae on behalf of its investor members.[2] In particular, the investor members uniformly believe that "the way the Social Index measures, aggregates, scores and reports the Social factors…provides limited utility." In particular, each social factor is very different and has different implications for projecting prepayments.

For example, manufactured homes may prepay far more slowly than LMI loans. First-time homebuyers may not exhibit prepayment characteristics all that different than other homebuyers, after correcting for loan size and credit characteristics. Minority borrowers may prepay more slowly than white borrowers after correcting for loan size and credit characteristics.

The more granular the information, the more investors can attribute value and decide which characteristics they are willing to pay up for. Aggregation of characteristics makes it more difficult for investors and makes it more difficult for the pay-up to be directed back to the borrower. If a loan originator does not know what the characteristics of the other loans in their pool will be, they cannot pass any of the spec pool pay-up back to the borrower.

Yes, a few impact investors value the social characteristics. But these investors will value more granular disclosure even more, as they can more easily see how they are optimizing their fund's social mission.

The GSEs' reason for constructing an index, rather than disclosing the data, is data privacy concerns. Fannie Mae states, "Mortgage-related disclosures may present data privacy concerns, specifically a potential risk that certain disclosed information can be combined with other publicly available data, potentially enabling third parties to identify the specific individuals—in our case individual borrowers."[3] We think there are alternatives that protect privacy while still providing environmental, social, and governance investors the insight they need to more precisely value the prepayment (or other social) attributes.

Alternative Approaches

Another way to construct social disclosures would be to release limited information at the pool level on a characteristic-by-characteristic measure, rather than aggregating the characteristics. An example is shown in table 2. The market would be able to figure out the prepayment characteristics of LMI pools and would price appropriately. If an originator knew that a pool would command a pay-up, they could pass back some of the savings to the borrower.

For table 2, we have largely adapted the GSE construct but have suggested adding a category for 80 to 100 percent of the area median income.

TABLE 2

Social Disclosures: A Pool-Level Alternative

Criteria	Percentage in pool
LMI borrowers	
< 80% of the AMI	
80–100% of the AMI (not 120%)	
Underserved minorities	*
First-time homebuyers	
Low-income areas	
Minority tract	*
High-needs rural	
Designated disaster area	
Manufactured housing	

Source: Urban Institute, based on Fannie Mae's criteria shown in table 1.

Notes: AMI = area median income; LMI = low- and moderate-income. Asterisks indicate the value is capped. These disclosures would apply if the pool has at least 25 loans. If the pool has less than 25 loans, there is no social disclosure.

Addressing Privacy Concerns

We agree that data privacy is a valid concern. But data privacy concerns can be addressed by (1) disclosing each characteristic separately and including no cross-tabulations and (2) disclosing information at the pool level, not the loan level. If there is a concern about small pools, one could disclose the information for pools with at least 25 loans. For pools with less than 25 loans, there would be no social disclosures.

More persuasively, Ginnie Mae has the same data privacy concerns and has begun disclosing information about the number and share of LMI borrowers in a pool.[4] To make this possible, it has signed memorandums of understanding with the Federal Housing Administration (FHA) and the Veterans Administration (VA). LMI information will be aggregated from FHA and VA loans pools into single-family mortgage-backed securities originated in 2012 or later and will be disclosed monthly. The following data points will be included:

- the number of underlying loans made to LMI borrowers
- the share of LMI loans to overall loans in the pool
- total unpaid principal balance (UPB) among LMI loans in a pool
- the share of LMI UPB to overall pool UPB

Table 2 proposed disclosing only the second item, the share of LMI loans to overall loans in the pool.

Our approach would allow an originator to put together a 100 percent LMI pool or a 100 percent rural pool should they choose to. But two categories in the Social Index dimensions (table 1) disclosures are particularly sensitive, as they relate to protected classes: the shares of the pool going to underserved minorities and to minority tracts. If the share was 100 percent, it would be possible to identify the borrowers of the specified loans as underserved minorities or as living in minority tracts. It would hence be necessary to cap the share of these in a single pool.

Disclosing the S-dimensions in a more granular fashion is more likely to create a liquid market that better recognizes, and pays for, the latent prepayment value in S-lending.

Social Bond Designation?

Several questions in the RFI deal with the designation of social bonds. The social bond designation does not substitute for enhanced disclosure. The worst outcome of this RFI would be a simple, one-size-fits-all designation of social bonds. In and of itself, without better disclosure, a social bond designation would do little. There are a minority of investors who would value this designation, as it would allow them to use it to fill certain social impact mandates. But a bond with a social mission and without superior prepayment characteristics would likely not command a pay-up. Moreover, it would rob the market of the spec pool market that could develop with better disclosure. For example, if Home Possible and HomeReady pools lost their disclosures and were lumped in with other social bonds, they would lose much of their pay-up. Finally, the social bond designation is not without its costs to the issuer; these costs include better transparency and annual reporting.[5]

The question is whether a social bond designation, in conjunction with better disclosures, would be desirable. We think probably so, but it will require a great deal of thought as to how to define a social bond so it does not interfere with the market decisions that better disclosure would provide.

First, it is critical that the mortgages always be deliverable into TBA pools. This will preserve liquidity under every set of market conditions; an investor will be more comfortable paying up for a specified pool if the pool can never sell for less than TBA.

Second, any social designation should not interfere with market forces. As the new disclosures are released, more data will become available for investors to look at prepayment behavior. This will determine the pay-up structure. Characteristics that are valued by the market may change. For example, some of the characteristics that offer prepayment protection may actually prepay more slowly in a high-rate environment. In a low-rate environment, the spec pool pay-up will be primarily determined by borrowers' responsiveness to refinancing. In a higher-rate environment, such as what we have now, where few borrowers can refinance, the spec pool pay-up will be determined by prepayments because of mobility and cash-out refinancing. Letting the market figure out what social characteristics should be priced is the key; this may be different in different market environments (high rates versus low rates). And if the originators know the social characteristics that are valued in that market environment, it will maximize the chance that the borrower can benefit from the enhanced disclosures.

Finally, it is important for the FHA and the GSEs to be flexible enough to add extra disclosures over time. For example, as special purpose credit programs gain critical mass, the GSEs may want to disclose the share of loans in each pool that benefit from these programs. If a social bond designation were used in conjunction with increased disclosures, it would need to be updated over time.

Conclusion

The mortgage market is currently paying up for such characteristics as smaller loan sizes and lower credit scores. They are also paying up for the single-family affordable pools. The S-mortgages introduce additional pool-level disclosures, giving investors the opportunity to pay up for combinations such as LMI borrowers, underserved minority borrowers, first-time homeowners, minority census tracts, rural census tracts, designated disaster areas, and manufactured housing. But what set of disclosures would maximize these pay-ups?

S-lending disclosures and designations aim to achieve two separate, if related, goals: to allow investors to identify these bonds and to allow borrowers to benefit from the pay-ups investors pay. Certainly, the more granular the disclosure, the better the information investors will be able to use to analyze the prepayment characteristics of these bonds, and the more likely they will pay up for these bonds. That is, if there is no disclosure, LMI and minority borrowers cannot possibly benefit from their more desirable prepayment characteristics. But the mechanism by which borrowers benefit from these pay-ups is more amorphous and difficult to measure.

If the goal is to lower the cost of borrowing to certain groups of borrowers, explicitly doing so through GSE pricing (e.g., by lowering loan-level pricing adjustments) is more direct. We realize that the GSEs have already brought loan-level pricing adjustments to zero for some borrowers, but there is no reason they could not be negative—that is, cash back at the closing table. Stated differently, using the capital markets' pay-ups to subsidize the borrower is a less efficient form of subsidy than changing GSE pricing. But with social disclosures, it is important to realize that the market, not the GSEs, is providing the subsidy to the borrower. It would require more granular disclosure for the borrower to benefit from the spec pool pay-up. That is, the lender needs to be able to count on the pay-up being there when the loan is closed.

Notes

1 Laurel Davis, Devang Doshi, and Nick Sapirie, "A Proposed Methodology for Single-Family Disclosure," *Perspectives* (blog), Fannie Mae, August 17, 2022, https://www.fanniemae.com/research-and-insights/perspectives/proposed-methodology-single-family-social-disclosure.

2 Michael Bright, chief executive officer of the Structured Finance Association, letter to Fannie Mae and Freddie Mac, January 5, 2023, https://structuredfinance.org/wp-content/uploads/2023/01/SFA-Letter-to-GSEs-on-Social-Index-website.pdf.

3 Davis, Doshi, and Sapirie, "A Proposed Methodology."

4 Ginnie Mae, "Ginnie Mae Announces Low-to-Moderate Income Disclosure, Enhancing ESG Social Metrics," press release, February 9, 2023, https://www.ginniemae.gov/newsroom/Pages/PressReleaseDispPage.aspx?ParamID=272.

5 The International Capital Market Association framework for social bonds can be found at The Social Bond Principles (2021).

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DHMG (Division of Housing Mission and Goals). 2023. "Enterprise Single-Family Social Bond Policy: Request for Input." Washington, DC: Federal Housing Finance Agency, DHMG.

The Social Bond Principles. 2021. "Social Bond Principles: Voluntary Process Guidelines for Issuing Social Bonds." Paris: The Social Bond Principles.

Errata

We corrected this brief on March 27, 2023, to change "specific pools" to "specified pools" on pages 2 and 6.

About the Authors

Laurie Goodman is an Institute fellow and founder of the Housing Finance Policy Center at the Urban Institute. The center provides policymakers with data-driven analyses of housing finance policy issues that they can depend on for relevance, accuracy, and independence. Before joining Urban, Goodman spent 30 years as an analyst and research department manager at several Wall Street firms. From 2008 to 2013, she was a senior managing director at Amherst Securities Group LP, a boutique broker-dealer specializing in securitized products, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of global fixed income research and manager of US securitized products research at UBS and predecessor firms, which were ranked first by *Institutional Investor* for 11 straight years. Before that, she held research and portfolio management positions at several Wall Street firms. She began her career as a senior economist at the Federal Reserve Bank of New York. Goodman was inducted into the Fixed Income Analysts Hall of Fame in 2009. Goodman serves on the board of directors of MFA Financial, Arch Capital Group Ltd., and Home Point Capital Inc. and is a consultant to the Amherst Group. She has published more than 200 journal articles and has coauthored and coedited five books. Goodman has a BA in mathematics from the University of Pennsylvania and an AM and PhD in economics from Stanford University.

Janneke Ratcliffe is vice president for housing finance policy at the Urban Institute. She joins the Housing Finance Policy Center's leadership team to manage execution of the center's mission. Over a career that spans industry, the nonprofit sector, academic research, and the federal government, her work focuses on increasing access to financial systems that foster economic security and prosperity. Ratcliffe came to Urban from the Consumer Financial Protection Bureau, where she served as assistant director, leading its Office of Financial Education. Previously, she was the executive director of the University of North Carolina Center for Community Capital, leading "transformative research on how mortgage markets and financial services can better promote financial security and economic opportunity." Ratcliffe has also served at GE Capital Mortgage, the Center for American Progress, and Self-Help, where she was instrumental in high-impact programs in affordable and Community Reinvestment Act mortgages and community development finance. Ratcliffe serves on the Consumer

Affairs Advisory Council of the Mortgage Bankers Association, and she is a member of the National Community Stabilization Trust Board of Managers. She is a graduate of the University of North Carolina at Chapel Hill, where she studied economics and French.

Acknowledgments

This report was supported by the Housing Finance Innovation Forum, a group of organizations and individuals that support high-quality independent research that informs evidence-based policy development. We are grateful to them and to all our funders, who make it possible for Urban to advance its mission.

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500 L'Enfant Plaza SW
Washington, DC 20024
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