URBAN INSTITUTE · ELEVATE · THE · DEBATE

October 27, 2014

The Honorable Melvin L. Watt
Director, The Federal Housing Finance Agency
Constitution Center
400 7th Street, SW
Washington DC, 20014
Attn: RIN 2590-AA65

Re: 2015-2017 Enterprise Housing Goals

Dear Director Watt:

The Federal Housing Finance Agency issued a proposed rule with request for comments regarding the 2015-2017 Enterprise Housing Goals on August 29, 2014. Please find attached our response to your request. We appreciate the opportunity to provide this input.

Sincerely yours,

Jim Parrott, Senior Fellow

Laurie Goodman, Center Director, Housing Finance Policy Center

Ellen Seidman, Senior Fellow

Wei Li, Senior Research Associate

Jun Zhu, Senior Financial Methodologist

2100 M Street NW
Washington DC 20037

urban.org

URBAN INSTITUTE

Assessing the Proposed Housing Goals

Jim Parrott, Laurie Goodman, Wei Li, Ellen Seidman, and Jun Zhu

October 2014

The Federal Housing Enterprises Financial Safety and Soundness Act requires the Federal Housing Finance Agency (FHFA) to establish annual housing goals for mortgages purchased by Fannie Mae or Freddie Mac (the enterprises or GSEs). The purpose of single-family housing goals,[1] the focus of this commentary, is to motivate Fannie Mae and Freddie Mac to provide secondary market support for lending to creditworthy borrowers who have low incomes or live in traditionally underserved communities. Absent such support, many lenders would be unwilling to make these loans, and those that did would tend to do so at significantly higher cost to the borrower.

Though this objective is straightforward in theory, it is challenging in practice. If the goals are set too aggressively, then in order to comply the enterprises will be forced to support lending to borrowers who are poorly positioned for sustainable homeownership. If the goals are set too conservatively, then they will not motivate the enterprises to expand their lending meaningfully to all who are well-positioned for homeownership. In setting the goals, the FHFA walks a fine line.

On August 29, 2014, the FHFA issued a proposed rule updating these goals for 2015 through 2017. We provide our comments below, focusing on three issues central to their effort:

1. How do these goals interact with other policy issues?
2. Should the FHFA apply both benchmark (prospective) and market (retrospective) goals?
3. Does the FHFA set its benchmark goals appropriately?

How the Goals Interact with Other Policy Issues

It is important to keep in mind that many factors will together determine how adequately the enterprises serve low-income borrowers. While the goals could help at the margins, they will help only where these factors together create a more hospitable environment for lending to these borrowers.

As we have discussed elsewhere (http://www.urban.org/publications/412910.html and http://www.urban.org/publications/413000.html), uncertainty over the GSEs' enforcement of their underwriting representations and warranties and servicing rules has led lenders to apply credit overlays to their GSE lending. This has drastically constrained lending to those with lower credit scores, which has in turn limited access to credit for the very populations the goals are intended to serve. If the enterprises do not address this problem, then it is difficult to see how they could meaningfully open up access to credit for those targeted in the goals.

Similarly, their pending decisions on the new private mortgage insurance eligibility requirements (PMIERs) and where to set their guarantee fees and loan-level price adjustments could significantly affect how affordable lending through the GSEs is for those with lower credit scores and down payments. If they set these policies in a way that significantly increases pricing, then many of these borrowers will find the Federal Housing Administration the more affordable execution, again making it difficult for the enterprises to reach the populations targeted in the goals.

The influence can, of course, work the other way as well. The goals, if well designed, should motivate the GSEs to work harder to resolve the uncertainty that drives lenders' overlays, think more creatively about ways to make low-income borrowers sustainable loans, and price these loans competitively. But the bottom line is that what will determine whether these borrowers are adequately served will ultimately be whether lenders are comfortable making GSE-backed loans at competitive prices. The goals may help improve these factors, but they will not overcome them.

Applying Both Prospective and Retrospective Goals

For the single-family goals, the FHFA currently sets both prospective and retrospective measures in four categories: (1) low-income home purchase loans; (2) very low income home purchase loans; (3) low-income areas home purchase loans, with a subgoal that excludes loans to moderate-income families in disaster areas; and (4) low-income family refinance loans.

The FHFA first sets a prospective goal for each category based on estimates of market composition. If the GSE hits these levels, they are deemed to have satisfied their goals. If the GSE doesn't meet one of these benchmarks, however, they get a second chance in a retrospective assessment of their performance relative to the market over the same period. In this assessment, the FHFA looks at the annual data disclosed under Home Mortgage Disclosure Act (HMDA) to determine whether the share of the GSE's business that was done in the category exceeded the share of loans eligible for GSE support that fell into that category. If it did, then they have met the goal, even if they did not meet the prospective benchmark. Essentially, the GSEs meet the goals if they meet the lower of the prospective "benchmark level" or the retrospective "HMDA market share." Table 1 shows how these goals have worked in practice from 2010 to 2012.

TABLE 1

How the GSEs Have Done Historically

	Fannie Mae		Freddie Mac	
	Prospective	Retrospective[a]	Prospective	Retrospective[a]
1. Low-income purchase goals				
2013	1	N/A	0	N/A
2012	1	0	1	0
2011	0	0	0	0
2010	0	0	0	0
2. Very low income purchase goals				
2013	0	N/A	0	N/A
2012	1	0	1	0
2011	0	0	0	0
2010	0	0	0	0
3.1. Low-income area home purchase: subgoal				
2013	1	N/A	1	N/A
2012	1	0	1	0
2011	0	1	0	0
2010	0	1	0	0
3.2. Low-income area home purchase: subgoal				
2013	1	N/A	0	N/A
2012	1	0	1	0
2011	0	1	0	0
2010	1	1	0	0
4. Low-income refinance goal				
2013	1	N/A	1	N/A
2012	1	0	1	0
2011	1	0	1	0
2010	0	0	1	1
Score	**55%**	**27%**	**45%**	**5%**
# passes with both prospective and retrospective	**74%**		**53%**	

Source: FHFA 12 CFR Parts 1282, RIN 2590-AA65, 2015–2017 Housing Goals, appendix tables 6–9, tabulated by the Urban Institute.

Note: 1 = goal is met, 0 = goal is not met, N/A = inadequate information.

[a] Information on the 2013 retrospective goals was not available when the FHFA put out this request. It is calculated from the 2013 HMDA data, released in late September. To the best of our knowledge, the results have not been publicly disclosed.

We believe it is important to retain the current hybrid system, as both sets of goals serve important purposes. With the prospective goals, the GSEs know what they are striving for and can plan accordingly. If the GSEs are considerably behind on their goals, they can adjust pricing and policies in order to catch up. These prospective goals are inevitably imperfect, however, projecting market composition years out. So the retrospective look provides an important safety valve, protecting the GSEs from large, unpredictable market movements for which it makes little sense to hold them accountable.

Both tests are thus critical to providing the GSEs with the right incentives and predictability to maximize access to credit for creditworthy borrowers.

Setting Appropriate Benchmarks

The next question is whether the FHFA is setting appropriate benchmarks. Put differently, is the FHFA pushing the GSEs enough to maximize access to credit for creditworthy, low-income borrowers without pushing them to support lending to those who aren't in a position for sustainable homeownership?

The FHFA has proposed the following benchmarks for the GSEs' single-family business:

- 23 percent of their guarantee business in a given year must be for mortgages made to those with incomes no greater than 80 percent of area median income (AMI).
- 7 percent of their guarantee business must be for those with incomes no greater than 50 percent of AMI.
- 14 percent of their guarantee business must be to those in census tracts with an average income of no greater than 80 percent of AMI *or* those with no greater than 100 percent of AMI in census tracts of no greater than 100 percent of AMI *and* minority shares of greater than 30 percent.
- 27 percent of their refinance business must be to those with incomes no greater than 80 percent of AMI.

The first two goals are the same as those in place now, but because the FHFA projects a decline in the general market share of loans in these categories, the GSEs will actually have to perform better relative to the market than they do now. The second two goals are increases over those in place today, but because the FHFA projects increases in the general market shares of loans in these categories, it's actually unclear whether the new goals will require an improvement of the GSEs' performance relative to the market.

Whether with these goals the FHFA has struck the right balance between pushing the GSEs to maximize access without pushing them into undue risk depends on a great many factors. For example, if either FHA or non-agency lending naturally fills the demand in these markets, or demand among low-income borrowers remains soft in large part due to credit stress or other risk-heightening economic factors, the enterprises will have to move into a riskier pool of borrowers to meet their goals. Similarly, if the FHA pulls back and the non-agency market fails to rise to fill the demand, or demand among these groups begins to build coming out of the recession, then the GSEs will be able to meet their goals with relatively lower-risk borrowers, perhaps failing to maximize access to sustainable credit as intended.

Whether the FHFA has chosen the right goals thus depends a great deal on how effectively it has modeled the behavior of the markets in which the GSEs will be pursuing these goals. We can see several problems with the modeling, giving us pause over whether the FHFA has, in fact, struck the right balance.

First, the modeling admits of enormous ranges in the market shares projected for the categories of loans in question. For instance, though the FHFA projects that in 2015, loans made to borrowers with incomes below 80 percent of AMI will make 20.9 percent of the market, the 95 percent confidence interval (i.e., the margin of error in its forecast) is 6.7 percent. "In other words," as the FHFA puts it in the request for comment, "the model prediction is that there is a 95 percent chance that the actual market share in 2015 will be between 14.2 percent and 27.6 percent." The forecast for 2017 has a still-larger range: between 10.8 percent and 28.8 percent.

So, how aggressive the goals are is highly indeterminate and thus almost impossible to evaluate adequately. The goal chosen for the GSEs for the 80 percent of AMI and below segment is 23 percent. If they must meet that goal in a market in which these loans make up roughly a quarter of the loans done, then the goal may make good sense. If the GSEs have to do so in a market in which these loans make up only one-tenth, then the goal may make no sense at all. In any case, the same goal will function *very* differently in these two different markets, striking a *very* different balance between the push for access and the pull of prudent risk management.

Second, in its modeling the FHFA appears to have left out a few important variables in order to keep the confidence intervals from becoming even wider. The omitted variables typically average out to close to zero over the period measured, rendering them statistically insignificant to the forecast. But these variables tend to swing from strong positive numbers to strong negative ones, expanding the margin of error in any forecast that includes them. The modelers appear to have chosen to leave the variables out in order to shrink their margin of error without affecting the forecast.

The problem, of course, is that it gives the impression that the margin of error is much narrower than it actually is. So the already disconcerting 95 percent confidence interval for the 2017 market share for low-income borrowers—between 10.8 percent and 28.8 percent—actually *understates* the uncertainty of the forecast. Thus, the goal chosen for this group—23 percent—may be even further removed from the actual market share than had been initially feared, making it still more unclear whether it will eventually strike the right balance between pushing access to credit and maintaining prudent risk management.[2]

Third, the modeling is shaped significantly by the market's current unhealthy composition. By using a market dominated by the GSEs as a baseline, the FHFA runs the risk of locking into place the GSEs' current lending patterns. The GSEs largely determine today's market shares for the target groups, so setting their future goals based on these shares creates the perverse incentive for the GSEs not to push too hard to expand access over the near term. The more cautious they are today, the easier their goals will be in the years to come.

Similarly, by using as a baseline a market in which the target populations are by all accounts remarkably underserved, the FHFA is at risk of setting goals that are only ambitious in a constrained, underserved market such as this one. As the market returns to health, and these borrowers discover more channels through which to find a loan, the goals set in the current environment are likely to fall well short of what would be needed for the GSEs to keep up with the primary market, much less lead it.

Unfortunately we have more confidence in our concerns than we do in any recommendations to address them. This is in part because the FHFA has not disclosed enough in its modeling to make it clear how severe the problems are or how they might be addressed. A sensitivity analysis would be particularly useful, for example, so we could see how the model responds to changes in the values of variables, both for those used and those omitted. Absent that level of detail, it is unclear whether there is a way to reduce the margin of error while including the omitted variables.

If the problems are not resolvable, then it raises the question whether the policy should be adjusted to compensate for the modeling's inherent shortcomings. For instance, should the FHFA commit to a more frequent reassessment of market behavior and provide a transparent metric for recalculating the goals based on changes in its forecasting? This would introduce an element of uncertainty that will make it more difficult for the GSEs to plan to meet the benchmarks, but perhaps a tolerance for shortfall could be built into any goals increased through these reassessments.

In any case, the FHFA should disclose more information about its modeling to better inform the discussion. Until we have that, it is difficult not only to offer suggestions to improve upon or compensate for the modeling, but also to assess whether with the benchmarks chosen the FHFA has struck the right balance between expanding access to credit and maintaining prudent risk management.

Orphaned Two- to Four-Unit Properties

Finally, the FHFA has unfortunately defined the single-family category overly broadly, including properties that have two to four family units. This reflects the practice among the enterprises and lenders to apply similar rules and offer similar financing terms to all loans for properties of up to four units. However, the economics associated with two- to four-unit properties are quite different than those for true single-family properties, involving rental revenues, vacancy challenges, and other variables that make them function in some respects more like larger multifamily properties. The resulting mismatch leads to higher-than-necessary risk, which in turn has depressed the financing available for investing in these properties.

Two- to four-unit properties are a sizable segment of the market, making up 8 percent of the nation's properties. They are a particularly important segment of the market for many of the families the FHFA should be focusing on most with their goals. Two- to four-unit properties have long provided an important entry point to homeownership and make up a significant share of the rental units in which low-income families live. As of 2009, three in four units being rented without government assistance for less than $400 a month were in properties with fewer than five units, and 58 percent of the unassisted units being rented for between $400 and $599 were in these properties.[3]

To the degree that the goals are intended to improve housing options for low-income families, then, they suffer from a blind spot in failing to address the unique challenges of this segment of the market. The FHFA's proposal to increase reporting about this segment is a good beginning, and the challenges of this segment cannot be addressed through goals alone. However, an important next step would be to establish a subgoal for this segment of the market, as part of a broader reassessment of the policies most appropriate for these properties.

Notes

1. The FHFA has also proposed multifamily lending goals, which we do not address here.
2. These omissions also lead to a somewhat arbitrary mix of variables determining the goals. The goals for the low-income borrower home purchases are driven by mortgage rates, interest rates, the unemployment rate, median home prices, and home sales; yet very low income home purchase goals are driven by home prices, core consumer price index, and the unemployment rate.
3. "America's Rental Housing: Meeting Challenges, Building on Opportunities," Joint Center for Housing Studies at Harvard University, 2011, pages 22, 25, available at http://www.jchs.harvard.edu/research/publications/americas-rental-housing-meeting-challenges-building-opportunities.

About the Authors

Jim Parrott is a senior fellow with the Housing Finance Policy Center at the Urban Institute and also advises financial institutions on housing policy. Before joining Urban in 2013, Parrott served for several years in the White House as a senior advisor at the National Economic Council, where he led the team of advisors charged with counseling President Barack Obama and the cabinet on housing issues. He was on point for developing the Obama administration's major housing policy positions; articulating and defending those positions with Congress, the press, and the public; and counseling White House leadership on related communications and legislative strategy. He was previously counsel to Secretary Shaun Donovan at the Department of Housing and Urban Development, advising on a range of housing finance issues.

Laurie Goodman is the center director of the Housing Finance Policy Center at the Urban Institute. Before joining Urban in 2013, Goodman spent 30 years as an analyst and research department manager at a number of 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 was ranked first by *Institutional Investor* for 11 straight years. She has also held positions as a senior fixed income analyst, a mortgage portfolio manager, and a senior economist at the Federal Reserve Bank of New York.

Wei Li is a senior research associate in the Housing Finance Policy Center at the Urban Institute, where his research focuses on the social and political aspects of the housing finance market and their implications for urban policy. He is also a quantitative research methodologist with a deep understanding of cost-benefit analysis, program evaluation, and causal inference in social and political science. Before joining Urban, Li was a principal researcher with the Center for Responsible Lending, where he wrote numerous publications on the housing finance market and created and managed the nonprofit organization's comprehensive residential mortgage database.

Ellen Seidman is a senior fellow with the Housing Finance Policy Center at the Urban Institute, focusing on housing finance and community development. She is also a visiting scholar with the Community Development Department of the Federal Reserve Bank of San Francisco and a research fellow at the Filene Research Institute.

From 2002 through 2010, Seidman held various positions at ShoreBank Corporation and its affiliates. From 1997 through 2001, she was the director of the Office of Thrift Supervision, and concurrently served on the board of directors of the Federal Deposit Insurance Corporation and as chair of the board for the Neighborhood Reinvestment Corporation. Seidman has also served as senior counsel to the Democratic Staff, House Financial Services Committee (2001–02); been special assistant to the President for Economic Policy (1993–97); and has held senior positions at Fannie Mae, the Department of the Treasury, and the Department of Transportation.

Jun Zhu is a senior financial methodologist in the Housing Finance Policy Center at the Urban Institute. She designs and conducts quantitative studies of housing finance trends, challenges, and policy issues. Before joining Urban, Zhu worked as a senior economist in the Office of the Chief Economist at Freddie Mac, where she conducted research on the mortgage and housing markets, including default and prepayment modeling. While at Freddie Mac, she also served as a consultant to the Treasury Department on housing and mortgage modification issues.

ABOUT THE URBAN INSTITUTE

The nonprofit Urban Institute is dedicated to elevating the debate on social and economic policy. For nearly five decades, Urban scholars have conducted research and offered evidence-based solutions that improve lives and strengthen communities across a rapidly urbanizing world. Their objective research helps expand opportunities for all, reduce hardship among the most vulnerable, and strengthen the effectiveness of the public sector.

2100 M Street NW
Washington, DC 20037

www.urban.org