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The Role of a Duty to Serve in the Secondary Mortgage Market

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INTRODUCTION

A particularly difficult challenge in moving forward with housing finance reform legislation is resolving differences over the idea of a duty to serve (DTS) as a policy with which to support affordable housing. The idea behind the DTS is to impose an obligation on the secondary market institutions of Fannie Mae and Freddie Mac or their successors to ensure that adequate lending occurs in specified segments of the primary market. Today, there is a DTS on three areas of housing: manufactured housing, rural housing, and affordable housing preservation. These obligations were enacted in 2008 as part of the Housing and Economic Recovery Act (HERA).[1] In the policy debate over housing finance reform, there is discussion of the creation of a DTS that would encompass a broader part of affordable housing, rather than just these three targeted areas. This paper first discusses the DTS as it exists now and then turns to a discussion of this broader conception of a DTS in housing finance reform.

The DTS differs from the affordable housing goals. The DTS requires Fannie and Freddie to bring about an expansion of lending from firms operating in the primary market, while the affordable housing goals generally require Fannie and Freddie to purchase loans to meet benchmarks set by the Federal Housing Finance Agency (FHFA). While the affordable housing goals are meant to bring about an expansion of lending, in principle, the requirements can be met by taking away market share from other segments of the secondary market such as by moving mortgages from bank balance sheets into products insured by government-sponsored enterprises (GSEs), or from the Federal Housing Administration (FHA) to the GSEs. With the DTS, Fannie and Freddie are required to ensure that firms in the primary market make mortgages as required.

[1] 12 U.s. Code § 4565 - Duty To Serve Underserved Markets and Other Requirements. https://www.law.cornell.edu/uscode/text/12/4565

INTRODUCTION

In the parlance of the DTS, the GSEs are required to act under the view that firms in the primary market are collectively underperforming relative to the requirements for specified segments of the housing market. An important consideration for a DTS is to identify the borrower segments, loan types, and geographies that are considered underserved and define what success might look like. In the DTS now in statute, lawmakers have specified the market segments, while allowing the regulator to determine which requirements GSEs must follow to be compliant with their duty.

What makes an affirmative DTS thornier than other affordable housing reform issues is that it imposes an obligation on secondary market institutions to boost lending in the primary market. Imposing a responsibility to take affirmative action, rather than to reflect primary market lending activities, could require costly changes to secondary market firms' business strategies and economic performance to bring about requisite changes in the primary market. An attraction for the left of DTS is that it ensures that the goal of increased lending is reached. There is not merely an incentive for firms in the primary market to make more loans, but instead a requirement that the GSEs make it economically attractive for them to do so—a situation preferred by advocates who worry that market mechanisms alone will not bring about the desired changes in affordable housing. However, this requirement is precisely a concern on the right—for whom the preferred approach to supporting affordable housing is through explicit and transparent subsidies. This approach would improve the economics of affordable lending, but not institute an outright requirement for private firms to make certain loans—or in the case of the DTS—impose a requirement on Fannie and Freddie to make sure that other firms make the loans.

INTRODUCTION

Fannie and Freddie, to fulfil their quantitative requirement, will put economic incentives in place. The two GSEs do not make the loans themselves and so must devise strategies that lower costs or risks for originators—in effect, indirect subsidies—in the primary market to act in a way that fulfills the duty. Economic incentives will be at play; the issue is how the mechanisms work, in which parts of the market they work, and how success is gauged. Even so, this more nuanced concept of the DTS makes the legislative debate surrounding this issue among the more divisive and ideologically driven aspects of housing finance reform.

We next turn to a discussion of the obligations of the GSEs under the current DTS. We then discuss DTS rulemaking efforts to implement the statute under successive FHFA leaders. A comparison of the two DTS regimes illustrates the importance of regulatory discretion and provides a lesson on how differences in worldviews can translate into dramatically different interpretations of legislation, which in turn translate into differences in the specified GSE obligations. Section three highlights elements of Fannie Mae and Freddie Mac's respective underserved markets plans (UMPs) setting out the business strategies they will use to meet their DTS requirements. These plans illustrate the challenges involved in relying on secondary market entities like the GSEs to bring about desired results in the primary mortgage market. Next, we discuss FHFA's multistep process to evaluate the GSEs' performance in meeting the objectives with respect to underserved markets identified in the DTS. We close with housing finance reform lessons from our analysis of the DTS regime.

HOW THE HOUSING AND ECONOMIC RECOVERY ACT LEGISLATION DEFINES DUTY TO SERVE

In policy discussions surrounding housing finance reform, DTS typically refers to a proposed policy lever intended to ensure broad access to affordable mortgages, especially for low- and moderate-income (LMI) households. This use of this term is sensible in the context of the housing finance reform debate and consistent with the obligations in the GSEs' charters to promote access to mortgage credit "throughout the nation, including central cities, rural areas, and underserved areas," even if doing so involves earning "a reasonable economic return that may be less than the return earned on other activities."[2] However, the legislation enacted in 2008 had a narrower scope for the DTS imposed on the GSEs. The idea in the Housing and Economic Recovery Act (HERA) was that despite existing requirements of the GSEs, such as the affordable housing goals, certain segments of housing markets remained especially underserved. Section 129 of HERA identifies three underserved markets (manufactured housing, affordable housing preservation, and rural housing) in which the GSEs are required to not just increase the liquidity of existing mortgage investments in underserved markets, but also "improve the distribution of investment capital available for mortgage financing in these segments."[3] This has been interpreted since enactment to mean that the DTS requires the GSEs to increase the volume of primary market lending in underserved markets.

With respect to manufactured housing, HERA allows the FHFA director to decide whether to grant DTS credit for GSE purchase of loans secured by personal property (chattel loans, which represent the majority form of manufactured housing financing today) or to limit DTS credit to traditional mortgage financing (loans backed by real property).

[2] Michael A. Stegman, "A Framework for Improving Access and Affordability in a Reformed Housing Finance System," the Bipartisan Policy Center, May 2017.

[3] 12 U.s. Code § 4565 - Duty To Serve Underserved Markets and Other Requirements. https://www.law.cornell.edu/uscode/text/12/4565

HOW THE HOUSING AND ECONOMIC RECOVERY ACT LEGISLATION DEFINES DUTY TO SERVE

For affordable housing preservation, HERA focuses on improving liquidity for properties subsidized under an enumerated list of federal rental assistance and development programs. These were predominantly programs in which, at the time HERA was enacted, subsidies were scheduled to expire or the underlying mortgages on affordable rental properties would soon be running to term, ending rent restrictions that had been in place through various programs. HERA also provides DTS credit for GSE financing that provides liquidity for comparable programs to support affordable housing from state and local governments. Rural populations in sparsely populated and persistently poor communities historically have found it relatively difficult to obtain mortgage credit save for direct or guaranteed federal loans, which explains the inclusion of rural housing in the DTS requirement.

In imposing a DTS on Fannie and Freddie, lawmakers had in mind that the GSEs would develop new loan products, make changes to underwriting guidelines, and take other steps to increase primary lending volumes in these targeted markets over what lending would be in the absence of a DTS mandate.[4] In the legislation, the GSEs were encouraged to develop and strengthen their relationships with nonprofit and for-profit housing development organizations, including state housing finance agencies; to assist primary lenders to make credit available in areas with concentrations of low-income and minority families; and help develop the institutional capacity to finance housing for first-time homebuyers.[5] HERA also expects the GSEs, as part of DTS, to help depository institutions meet their Community Reinvestment Act (CRA) obligations, including developing "appropriate and prudent underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures."[6] A potential complication here is that the DTS and CRA income thresholds are not wholly compatible.[7]

Three other statutory provisions are worth noting. In assessing the GSEs' overall DTS performance, HERA does not allow FHFA to set

[4] 12 U.s. Code § 4565 - Duty To Serve Underserved Markets and Other Requirements. https://www.law.cornell.edu/uscode/text/12/4565

[5] The statute uses the auxiliary verb "shall" when specifying each of the foregoing activities. However, HERA precedes the list of activities the GSEs shall take with the clause "In General…" Taken together, we interpret the intent of the legislative drafters to mean that in carrying out their duty to serve, the GSEs are encouraged rather than required to adopt the specified means listed in the statute.

[6] 12 U.s. Code § 4565 - Duty To Serve Underserved Markets and Other Requirements. https://www.law.cornell.edu/uscode/text/12/4565

[7] Comments on the Proposed Rule to Implement the Duty to Serve. March 16, 2016. https://ncrc.org/wp-content/uploads/2016/03/ncrc_fhfa_duty_to_serve_web.pdf.

numerical targets or mortgage purchase requirements in underserved markets, in contrast to the practice in setting and evaluating their affordable housing goal activities.[8] As will be discussed later, this prohibition has led FHFA to develop a DTS regulatory assessment regime that more closely resembles that used by financial regulators to evaluate banks' CRA performance. Also, by statute, no affordable housing funded in whole or in part with monies raised from FHFA's affordable housing assessment can receive DTS credit,[9] although such housing may count toward a GSE's affordable housing goals. Finally, while Fannie and Freddie remain in conservatorship, FHFA denies DTS credit for activities funded by grants from the GSEs, which were common features of pre-crisis GSE affordable housing business strategies.

A DECADE-LONG PATH TO A FINAL RULE

The rulemaking process to develop DTS guidance began a year after Congress imposed a DTS obligation on the GSEs, took place over nearly seven years, and involved the release of two different proposed rules directed by two FHFA leaders with different views of the appropriate role of government in the secondary mortgage market. FHFA, under the leadership of Acting Director Ed DeMarco, put out a proposal for the GSEs' underserved markets obligations for comment in June 2010,[10] but the rule was never finalized. With the transition to Director Mel Watt in January 2014, FHFA withdrew and replaced DeMarco's proposal with a new proposed rule in late 2015[11] that was finalized in December 2016.[12]

Highlighting a few key differences between DeMarco's narrowly tailored proposal and Watt's more expansive final rule illustrates the role and importance of regulatory discretion in rulemaking and how the philosophical orientation of the FHFA director can affect the breadth and depth of the GSEs' underserved market obligations. Such changes in regulatory emphasis are familiar—indeed, it would be natural to expect further changes following the appointment of a new (and presumably more conservative) director after Watt's five-year term ends in January 2019.

[8] Comments on Duty to Serve Proposed Rule. March 17, 2016. https://www.mba.org/Documents/MBA%20Comments%20on%20FHFA%20Duty%20to%20Serve%20-%203-17-16.pdf.

[9] 12 U.s. Code § 4565 - Duty To Serve Underserved Markets and Other Requirements. https://www.law.cornell.edu/uscode/text/12/4565

[10] United States. Federal Housing Finance Agency. Enterprise Duty to Serve Underserved Markets Proposed Rule. June 7, 2010. https://www.gpo.gov/fdsys/pkg/FR-2010-06-07/pdf/2010-13411.pdf.

[11] United States. Federal Housing Finance Agency. Enterprise Duty to Serve Underserved Markets Proposed Rule. December 18, 2015. https://www.fhfa.gov/SupervisionRegulation/Rules/Pages/Enterprise-Duty-to-Serve-Underserved-Markets-Proposed-Rule.aspx.

[12] United States. Federal Housing Finance Agency. Enterprise Duty to Serve Underserved Markets Final Rule. December 12, 2016. https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/2016%20Duty%20to%20Serve%20Final%20Rule_For%20Web.pdf.

THE POWER OF REGULATORY DISCRETION

In addition to differences in philosophical perspectives, varying expectations about how long the GSEs would remain in conservatorship may have influenced the contours of the DTS rules put out by DeMarco and Watt. DeMarco formulated his proposed DTS rule in 2010, two years after the GSEs were put into conservatorship with an expectation that the Obama Administration and Congress would soon agree on a plan for the future of the nation's housing finance system "that [would] include a proposal for the ultimate resolution of the Enterprises in conservatorship."[13] Given this short horizon, it made sense that DeMarco limited the proposed DTS rule to the GSEs' core business activities and did not allow them to engage in new lines of business.[14] Watt came into office in the midst of a divisive political debate and a failing legislative attempt at GSE reform, and it likewise makes sense that his DTS proposals reflect the possibility of the GSEs remaining in conservatorship for an extended period. Watt's DTS rule makes clear that "FHFA expects the Enterprises to continue to fulfill their core statutory purposes while they are in conservatorship, which include their support for affordable housing and underserved markets."[15]

The most significant exercise of regulatory discretion by FHFA in the rulemaking process is reflected in Watt's creative interpretation of Congressional intent resulting in an addition in the final rule of two new classes of DTS activities not mentioned in the DTS statute: so-called "regulatory activities" and "extra credit-eligible activities." Prominent regulatory activities that Watt makes eligible for DTS credit as part of the affordable housing preservation requirement are GSE support for financing energy or water-efficiency improvements on single-family and multifamily properties, with the requirement that the improvements are projected to result in savings of at least 15 percent over their expected life and that the savings exceed the cost of installation.

[13] United States. Federal Housing Finance Agency. Enterprise Duty to Serve Underserved Markets Proposed Rule. June 7, 2010. https://www.gpo.gov/fdsys/pkg/FR-2010-06-07/pdf/2010-13411.pdf.

[14] Ibid.

[15] United States. Federal Housing Finance Agency. Enterprise Duty to Serve Underserved Markets Final Rule. December 12, 2016. https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/2016%20Duty%20to%20Serve%20Final%20Rule_For%20Web.pdf.

FHFA justifies DTS preservation credit for GSE financing of cost-effective energy improvements under the view that "savings in utility consumption that reduce utility expenses may help maintain overall affordability."[16] Skeptics might point to research, such as that by a former economic adviser to President Obama who finds that, for residential energy efficiency investments, "the cost to deploy the efficiency upgrades was about double the energy savings."[17] Both Fannie Mae and Freddie Mac are planning to invest significant resources in the refinement and creation of green financing tools and products not mentioned in the HERA statute.[18] It is easy to imagine that a future FHFA director might pause and then do away with these aspects of the rule on the grounds that GSE support for solar panels and the like diverts support away from the affordable housing preservation activities specified in the HERA statute.

DeMarco's proposal, with respect to the underserved market for affordable housing preservation, focused on liquidity in the subsidized low-income rental market, while Watt extended the concept of affordable preservation from the rental market to the homeownership sector by emphasizing the preservation of long-term affordability (regardless of tenure). For affordable homeownership, says Watt, "there are no regulatory agreements similar to those with affordable rental properties that expire after certain regulatory periods, such as 15 years, 20 years, or 30 years. Rather, preservation for affordable homeownership entails ensuring that the price of the home is affordable over a long-term period to initial and subsequent purchasers."[19] He sees certain types of shared equity programs as offering this type of sustainable, affordable homeownership through a new preservation regulatory activity. The final rule grants the GSEs' DTS affordable preservation credit for activities that support "single-family properties under shared equity programs administered by a community land trust, a nonprofit organization or a state or local government agency. Eligible shared equity programs must ensure affordability for 30 years, monitor the units to ensure affordability is preserved over resales, and support the homeowners to promote successful homeownership."[20]

[16] United States. Federal Housing Finance Agency. Enterprise Duty to Serve Underserved Markets Final Rule. December 12, 2016. https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/2016%20Duty%20to%20Serve%20Final%20Rule_For%20Web.pdf.

[17] "Energy Efficiency Upgrades Cost Double the Projected Benefits." UChicago News. June 23, 2015. https://news.uchicago.edu/story/energy-efficiency-upgrades-cost-double-projected-benefits-0.

[18] Fannie Mae. Federal Housing Finance Agency. January 1, 2018. https://www.fhfa.gov/policyprogramsresearch/programs/documents/fannie-mae_final-ump.pdf.

Freddie Mac. Federal Housing Finance Agency. January 1, 2018. https://www.fhfa.gov/PolicyProgramsResearch/Programs/Documents/Freddie-Mac_Final-UMP.pdf.

[19] United States. Federal Housing Finance Agency. Enterprise Duty to Serve Underserved Markets Final Rule. December 12, 2016. https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/2016%20Duty%20to%20Serve%20Final%20Rule_For%20Web.pdf.

[20] Ibid.

In allowing the GSEs to obtain DTS affordable preservation credit for certain types of single-family owner-occupied homes rather than just multifamily rental properties, Watt argued that "the multifamily and single-family business units in both Enterprises are sufficiently distinct from each other that establishing a Regulatory Activity for affordable homeownership preservation should not materially detract from Enterprise efforts to preserve the affordability of multifamily rental housing."[21]

Watt made extra DTS credit available for GSE activities that promote economic integration, an activity not specified in HERA. The final rule defines these as activities that "reduce the economic isolation of very low-, low-, and moderate-income households by promoting residential economic diversity." A residential economic diversity activity is defined as a GSE activity "in connection with mortgages on (1) affordable housing in a high opportunity area or (2) mixed-income housing in an area of concentrated poverty."[22]

With the GSEs in conservatorship, regulatory actions that require the GSEs to undertake activities not specified in statute could be seen as akin to spending taxpayer money without a vote of Congress, if the activities involve costs that translate into lower profits transmitted to the Treasury through the GSE net profit sweep. Moreover, these actions set a precedent for future FHFA directors to require the GSEs to undertake other activities (perhaps including some that might not seem worthwhile to advocates of Watts' initiatives).

In the following section, we turn our attention to Fannie Mae's and Freddie Mac's plans to deepen their presence in the corners of the housing market in which their footprints are currently only inches deep.

[21] United States. Federal Housing Finance Agency. Enterprise Duty to Serve Underserved Markets Final Rule. December 12, 2016. https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/2016%20Duty%20to%20Serve%20Final%20Rule_For%20Web.pdf

[22] Ibid.

THE HEART OF DUTY TO SERVE: UNDERSERVED MARKET PLANS

How the GSEs plan to mobilize capital and increase liquidity in underserved markets and the resource-intensive strategies they will pursue to deepen their footprints in targeted markets are spelled out in their respective underserved market plans (UMPs).

The challenge in meeting their collective DTS obligations is clear: the GSEs must figure out how to expand affordable lending in targeted primary markets in ways that ultimately can then be sustained using their secondary market tools of loan pooling, purchase, and securitization. In the words of one GSE, "our authority to purchase and securitize loans can provide stability and liquidity in the underserved markets, but we cannot purchase and securitize loans unless and until they have been originated." Similarly, "we can support affordable multifamily apartments by providing them permanent financing, but we cannot undertake their construction."[23] Both UMPs feature GSE commitments to fund research and data collection where there is inadequate knowledge and lack of reliable market information. GSEs are also required to create product standards where none exist because certain types of mortgages that are held on individual lender balance sheets (and not destined to be securitized and sold into the capital markets) had no need to adhere to a uniform standard. The UMPs also explain how the GSEs plan to address the lack of infrastructure and lender presence in markets covered by the DTS by developing partnerships and strategic alliances with for-profit and nonprofit lenders and technical assistance providers and to do a number of other things to help mitigate the problems that discourage primary market lenders from extending sufficient credit to low-income consumers in the targeted markets to meet a much larger share of demonstrated need.

[23] Fannie Mae. Federal Housing Finance Agency. p. Intro 3. January 1, 2018. https://www.fhfa.gov/policyprogramsresearch/programs/documents/fannie-mae_final-ump.pdf.

The absence of reliable and consistent data on mortgage originations in DTS markets means that a GSE's DTS activities cannot be evaluated solely against primary market data or FHFA forecasts as is the practice in evaluating the firms' performance in meeting single family affordable housing goals. Instead, FHFA's DTS assessment process starts with each GSE establishing its own mortgage purchase baseline against which annual progress in ramping up volume will be measured. The baseline generally will be set as the average level of income-qualified mortgage purchases a GSE has made in each underserved market over the 2014-2016 period. FHFA then bases the amount of DTS credit it will provide to each GSE on the extent to which it brings about annual increments of mortgage originations above its baseline over each of the three years covered by its plan (2018-2020). The greater the increment over baseline, the more DTS credit a GSE will earn. The UMP lays out in considerable detail the strategies a GSE plans to pursue in each underserved market, along with major activities including research, outreach, investments in market infrastructure, capacity building of local partners, and so on, that each GSE will use to ultimately increase mortgage purchases relative to baseline.

The nature of the UMP means that the DTS process is a marathon and not a sprint. Meaningfully expanding GSE secondary market presence in corners of the housing finance system where the primary lending market is underdeveloped will take substantial time and resources. Two examples follow, taken first from Fannie Mae's and then Freddie Mac's UMP, to illustrate why this is so.

OVERCOMING CHALLENGES IN THE MANUFACTURED HOUSING MARKET

The vast majority of manufactured homes purchased with financing are financed with a chattel or personal property loan rather than a mortgage. With a chattel loan, the home is titled as personal property with the lender taking a security interest in the home, but not in the land on which the home sits (as is the case with a traditional mortgage loan). Since chattel loans are not mortgages, few of the federal consumer protections familiar to conventional home buyers who finance their homes with a mortgage apply; instead, state-by-state regulations apply in the chattel loan market.

Neither GSE has an active chattel loan purchase and guaranty program, but both have made the design and implementation of a chattel loan pilot program a central element of their UMP to bring greater liquidity to the low-income manufactured housing loan market. Our sense is that improvement in the lending market for manufactured homes has the potential to be an important element in a program aimed at increasing the affordability of housing.

Creating a chattel loan program involves overcoming myriad challenges including expanding the number of primary market lenders who operate in this market.[24] Chattel loan products lack the consistency and standardization necessary for pooling and securitizing; the chattel loan market involves a handful of originators that generally hold their loans in portfolio, reflecting the absence of a secondary market. With fewer consumer protections applying in this market, GSE programs to purchase chattel loans could involve a new requirement that lenders looking to sell loans into the secondary market must agree to attach consumer protections to their loans. There is also much legal work and credit risk analysis to be done before a GSE can structure and properly price and manage the risks associated with a chattel loan product, as well as a need for new forms of credit enhancement for low-down payment chattel loans since private mortgage insurance companies do not currently offer such a product. This process will take substantial time and resources—about two years in total—which is why Fannie Mae does not expect to roll out its chattel loan pilot program until 2020 (the third year of its inaugural UMP). The rollout of Freddie Mac's potential chattel pilot is along a similar timeline.

OVERCOMING CHALLENGES IN RURAL UNDERSERVED MARKETS

The second example is from Freddie Mac's rural UMP. Relative to its baseline of an annual average of 22,642 income-qualifying rural single family home loans purchased from 2014-2016, Freddie Mac will strive to boost its annual rural housing mortgage purchases by a total of about 4,000 loans by the end of 2020.[25]

[24] Fannie Mae. Federal Housing Finance Agency. January 1, 2018. https://www.fhfa.gov/policyprogramsresearch/programs/documents/fannie-mae_final-ump.pdf.

[25] Freddie Mac. Federal Housing Finance Agency. January 1, 2018. https://www.fhfa.gov/PolicyProgramsResearch/Programs/Documents/Freddie-Mac_Final-UMP.pdf.

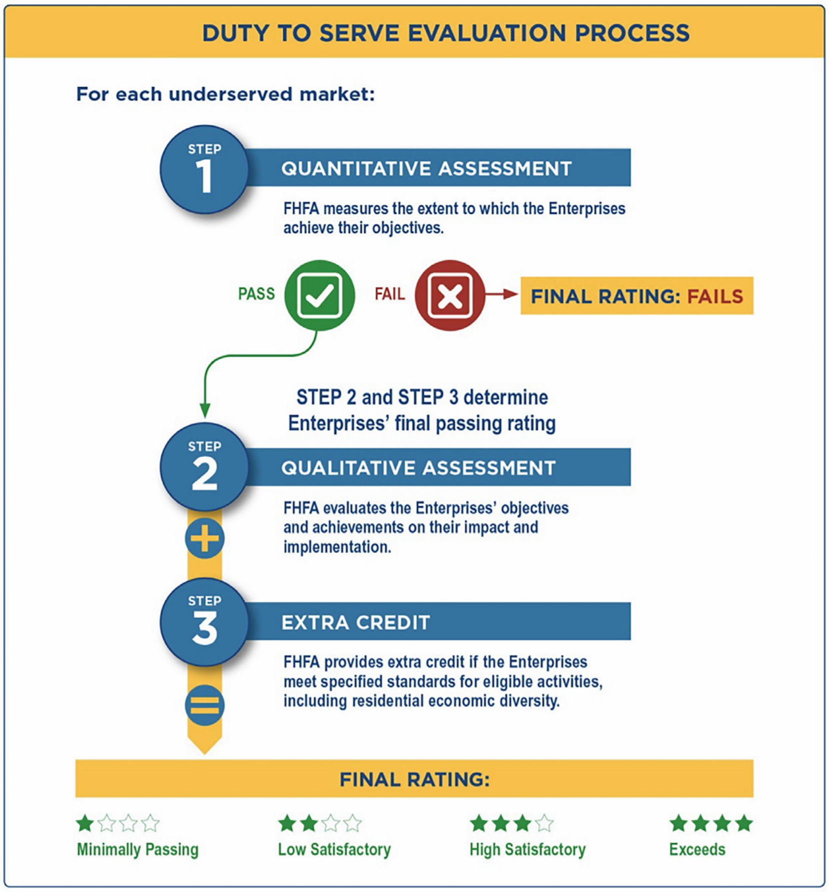
While seemingly not a large increment, Freddie notes that modest levels of primary lending in rural markets prevent the ready use of pooling and securitization. Among the challenges are that the rural areas to be targeted are sparsely populated and persistently poor with declining employment opportunities and limited access to financial services. In rural areas with few primary lenders, a particular challenge is that there can be too few similar properties within acceptable distances from each other to create suitable "comparables" for appraisal purposes. The need to strengthen primary market lending means that Freddie Mac expects progress to be slow in meeting this aspect of their UMP.[26]

[26] Freddie Mac. Federal Housing Finance Agency. January 1, 2018. https://www.fhfa.gov/PolicyProgramsResearch/Programs/Documents/Freddie-Mac_Final-UMP.pdf.

THE DUTY TO SERVE EVALUATION PROCESS

In contrast to the purely quantitative standards by which GSE performance is measured on the affordable housing goals, FHFA's DTS assessment regime is a complex multistep process that employs a mix of quantitative and quantitative metrics similar to how financial regulators evaluate banks' performance in meeting their Community Reinvestment Act (CRA) obligations. FHFA's starts its annual DTS evaluation with Fannie Mae's and Freddie Mac's UMPs discussed above. As the graphic of the evaluation process illustrates below (from FHFA), FHFA first assesses the extent to which a GSE has achieved the objectives identified in its UMP.

Figure 1: Duty to Serve Evaluation Process



Source: Federal Housing Finance Agency.

THE DUTY TO SERVE EVALUATION PROCESS

The first step is to look at the numbers with which FHFA evaluates how each GSE has done relative to its quantitative targets. This assessment translates into a performance evaluation that will be used to determine whether a GSE is eligible for a passing rating or has failed its statutory DTS responsibilities. If eligible for a passing rating, FHFA will determine its final rating through the second and third steps of the evaluation process. In the second step, FHFA will evaluate the GSE's performance under its UMP from a qualitative perspective, assessing the extent to which the GSE has had a meaningful impact in achieving its objectives and the extent to which the programs were implemented skillfully. In the third step, FHFA may award extra DTS credit for eligible residential economic diversity activities undertaken by the GSE, as well as for other activities eligible for extra credit.

A rating of exceeds, high satisfactory, low satisfactory, or minimally passing will constitute compliance with the DTS in each of the three underserved markets. A rating of fails will constitute noncompliance with the DTS. The results of the evaluation are reported to Congress. The same limited enforcement authorities sometimes referred to as "shame and blame" that Congress gave to FHFA for dealing with a GSE's failure to meet one or more of its annual affordable housing goals also apply to DTS, which includes development of a plan to remedy performance deficiencies. Presumably, FHFA would also require additional effort from a GSE that fails to achieve its DTS target, and of course FHFHA could exercise its powers as conservator.

IMPLICATIONS FOR HOUSING FINANCE REFORM

We have three takeaways from our deep dive into the existing DTS process that are relevant to the nexus between affordable housing and housing finance reform.

1. DTS is not the same as providing broad access to affordable mortgage credit.

Imposing a statutory DTS on the GSEs or their successors is about deepening their presence in a limited number of targeted parts of the housing market that lack threshold levels of primary market lending necessary for meaningful secondary market engagement. This differs from the primary way that the current system provides broad access to affordable mortgage credit to a wide range of creditworthy borrowers, which is by charging less for the insurance on mortgages to lower credit quality borrowers than would be indicated by pure risk-based pricing. This reflects the fact that the levers that "most affect mortgage pricing are required rates of return on capital, overall capital requirements, and the degree to which costs are either distributed or pooled."[27] The GSEs target a lower rate of return on mortgages made to low- and moderate-income (LMI) household borrowers as part of a complex and opaque system of multiple billions of dollars in subsidies overseen and approved by FHFA that reduce guaranty fees for higher risk borrowers offset by charging higher guaranty fees to lower risk borrowers (relative to what these borrowers would be charged without the cross subsidy, based on their modeled losses). The scale and deployment of these subsidies are documented elsewhere;[28] we note in particular that it is possible to improve the targeting of these cross-subsidies to focus on LMI families that most need assistance to become homeowners.[29]

[27] Calhoun, Mike, and Sarah Wolff. "Who Will Receive Home Loans, and How Much Will They Pay?" Urban Institute. June 2, 2016. https://www.urban.org/policy-centers/housing-finance-policy-center/projects/housing-finance-reform-incubator/mike-calhoun-and-sarah-wolff-who-will-receive-home-loans-and-how-much-will-they-pay.

[28] Stegman, Michael A., Jim Parrott, Phillip Swagel, and Mark Zandi. "Access and Affordability in the New Housing Finance System." Economy.com. February 2018. https://www.economy.com/getlocal?q=dfbce7de-80b3-4d64-88fb-9b33d00c9ac9&app=eccafile.

[29] Stegman, Michael A., Eric Kaplan, Ted Tozer, Laurie Goodman, and Jim Parrott. "A Conversation about Housing Finance Reform." Milken Institute. March 6, 2018. https://assets1c.milkeninstitute.org/assets/Publication/Viewpoint/PDF/WP-An-Affordable-Housing-Fee.pdf.

DTS effectively requires Fannie Mae and Freddie Mac to change the economics of housing market decisions in a way that gets primary lenders to undertake the desired activities. There is an irony here in the juxtaposition of the relatively narrow DTS requirements in HERA alongside the broader DTS considered during previous policy debates over housing finance reform. Proponents of a broad interpretation of DTS preferred this mechanism over the alternative of explicit subsidies to make mortgages more available and affordable because of concerns about the political vulnerability of subsidies over the longer term,[30] and out of a mistrust of market mechanisms more generally—advocates wanted an assurance that mortgages would be made to communities they saw as underserved and not merely an incentive for that to happen. However, as discussed above, Fannie Mae and Freddie Mac, as firms in the secondary market, are prohibited by law from operating in the primary market to which the DTS applies. To meet the requirements of the DTS (even the narrow ones in HERA, let alone the broader DTS envisioned by affordable housing advocates), the GSEs must put in place financial incentives that lead to actions by firms participating as mortgage originators in the primary market. That is, financial incentives ultimately must still be at play for the DTS to work, but these incentives are carried out within the scope of the GSEs (rather than directly by the government).

The desire to impose a DTS at the secondary level is understandable in another dimension as well, in that there is a federal "touchpoint" on Fannie Mae and Freddie Mac through both regulation and direct control of the firms in conservatorship. Non-bank originators that are especially important in certain areas of the housing market are generally regulated at the state level and thus somewhat removed from federal oversight and obligations. While the Consumer Financial Protection Bureau (CFPB) has some authority over these firms (including with respect to fair lending obligations), this authority is more in terms of ensuring that primary lenders observe the rules (that they do not discriminate, for example), rather than requiring them to affirmatively make loans to certain groups.

[30] Gelzinis, Gregg, and Sarah Edelman. "5 Features of Successful Housing Finance Reform." Center for American Progress. December 14, 2017. https://www.urban.org/policy-centers/housing-finance-policy-center/projects/housing-finance-reform-incubator/mike-calhoun-and-sarah-wolff-who-will-receive-home-loans-and-how-much-will-they-pay.

The DTS mechanism requiring Fannie Mae and Freddie Mac to get firms in the primary market to undertake the desired actions might be awkward, but is necessary under this view because of shortcomings in the federal government's principal lever to require action by originators—the Community Reinvestment Act (CRA)—which is discussed more fully below.

In the other direction, concerns from the right over the DTS requirements are likewise understandable, since these mandates interfere with private firms' business judgements (the federal government is looking to induce loans to be made that might not otherwise happen). In a sense, opposition to the DTS reflects a concern over having the incentive mechanisms to support affordable housing buried within Fannie Mae and Freddie Mac. Under this view, it would be better to make affordable housing subsidies explicit and transparent.

In summation, both conceptions of DTS discussed here are important to the housing finance reform debate and should not be confused or conflated. We do not seek to bridge this divergence of views, but simply to explain it and to note that it constitutes a formidable impediment to making progress in housing finance reform.

2. There is a new level of transparency.

FHFA's DTS regime has introduced a new level of transparency to the GSEs' affordable housing activities—a contrast that can be seen by considering that FHFA does not track the housing activities subsidized with Housing Trust Fund dollars from the GSEs' affordable housing fee (the focus of our previous paper).[31] While FHFA seeks public input in setting the GSEs' annual affordable mortgage purchase requirements, and the results of FHFA's housing goals performance assessment are made public, the costs and business strategies that the GSEs employ in pursuit of their annual housing goals remain proprietary.

[31] Stegman, Michael A., and Phillip Swagel. "An Affordable Housing Fee in the Context of GSE Reform." June 2018. https://assets1c.milkeninstitute.org/assets/Publication/Viewpoint/PDF/WP-An-Affordable-Housing-Fee.pdf.

In the affordable housing goals process there is no counterpart to the GSEs' public UMPs. The DTS process revolves around a GSE's customized strategic plan that describe the objectives, activities, and business strategies it will pursue in the targeted markets. FHFA requires the draft plans to be posted for public review and comment prior to being finalized, while performance will be reviewed annually by FHFA according to detailed evaluation guidance that was also posted for public review and comment.

The strategic planning framework at the center of the DTS process is also worth a closer look by lawmakers. What the current affordable housing goals and DTS regimes have in common is that they are both about getting the government-supported secondary market to do a better job of serving challenging markets and populations where costs may be higher and economic returns lower than in easier-to-serve and more profitable parts of the housing market. Because of this shared objective between the affordable housing goals and the DTS, it makes sense to harmonize the requirements within a single affordable housing regulatory framework. Strategies for meeting all affordable housing obligations would be spelled out in an UMP. As is the case with the DTS process, each secondary market entity would be required to identify objectives that are "strategic, measurable, realistic, time-bound, and tied to an analysis of market opportunities."[32]

The current DTS process is not transparent with regards to the economics of DTS. Even a cursory reading of the GSEs' UMPs reflect commitments of serious financial resources in pursuit of carrying out their respective DTS strategies. Because we are so early in the DTS process, it remains unclear whether expanding and deepening the GSE presence in hard-to-reach corners of the housing market will make good business sense, or instead will correspond to a use of resources purely in furtherance of social goals. The good news here is that lawmakers will have empirical data to inform their DTS discussion next time around.

[32] Stegman, Michael A. "A Framework for Improving Access and Affordability in a Reformed Housing Finance System." May 2017. https://cdn.bipartisanpolicy.org/wp-content/uploads/2017/05/BPC-Housing-Improving-Access-and-Affordability.pdf.

3. The Community Reinvestment Act (CRA) reform should go hand in hand with housing finance reform.

It is natural to ask whether the burden of carrying out a DTS should be exclusively shouldered by the GSEs, since the point of the DTS in the first place is ostensibly to address inadequacies in primary lending markets—which the Community Reinvestment Act (CRA) was enacted to address. CRA was enacted in 1977 to encourage banks to meet the credit and deposit needs of communities that they serve, including LMI persons and communities, consistent with safe and sound operations.[33] As the Treasury explained in its April 2018 report on CRA, the program was enacted in response to concerns about disinvestment and redlining as well as out of a desire to have financial institutions play the leading role in providing the capital required for local housing and economic development needs.[34] The Treasury calls for modernizing CRA to reflect the major organizational and technological changes the banking industry has experienced over the last 40 years, including interstate banking, mortgage securitization, and internet and mobile banking.

It makes sense to coordinate CRA modernization and housing finance reform because the CRA obligations of covered banks extend not just to mortgage lending to low-income households and in underserved communities, but also to providing access to affordable financial services and investments in underserved LMI markets.[35] Indeed, banks covered by CRA are better positioned than GSEs to provide these services in markets covered by the DTS. Since the administration has put both GSE and CRA reform on the table, it would be worthwhile to coordinate efforts on these related policy areas.

Among the most important CRA reforms identified by the Treasury, and relevant to our discussion of the GSEs' DTS, are recommendations to revisit the approach of determining CRA assessment areas and the treatment of banks' financial education activities.

[33] United States. Department of the Treasury. Community Reinvestment Act - Findings and Recommendations. April 3, 2018. https://home.treasury.gov/sites/default/files/2018-04/4-3-18 CRA memo.pdf.

[34] Ibid.

[35] Ibid.

With respect to the former, the Treasury proposes that “the concept of community should account for the current range of alternative channels that exist for accepting deposits and providing services arising from the ongoing evolution of digital banking. Ideally, this framework would allow banks to receive credit for CRA activity within their branch and deposit-taking footprint, and would also enable them to receive credit for investments in other LMI communities and identified areas as well.”

Notwithstanding differing views on how banks can and should contribute to financial knowledge and skill building, the Treasury notes, “there is agreement that financial education is important to community reinvestment and that banks can and should play an important role in this work.” Therefore, the Treasury recommends that CRA regulators should provide greater guidance on “how these activities will be considered under the Service Test, and that guidance should encourage banks to support high quality financial education that leads to real impacts.”

CONCLUSIONS

The GSEs only began executing on their respective UMPs at the beginning of this year, so it is too early to assess outcomes or to discuss the costs and benefits of the current DTS regime. Nevertheless, because the concept of DTS has been subject to different interpretations in housing finance reform debates, as well as to how such a provision might affect business judgments and business models of private firms in a future system, we think it is important to have a thorough understanding of how the current DTS regime works. We hope that this understanding can be helpful to inform future legislative housing finance reform debates.

[36] United States. Department of the Treasury. Community Reinvestment Act - Findings and Recommendations. April 3, 2018. https://home.treasury.gov/sites/default/files/2018-04/4-3-18 CRA memo.pdf.

[37] Ibid.

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