Prospects for Housing Finance Reform and
A Plan for Eliminating Fannie Mae and Freddie Mac without Legislation

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Link to Event Presentation: Eliminating Fannie and Freddie
Link to Event Paper: Eliminating Fannie and Freddie
Link to video of event: http://www.aei.org/events/eliminating-fannie-mae-freddie-mac/

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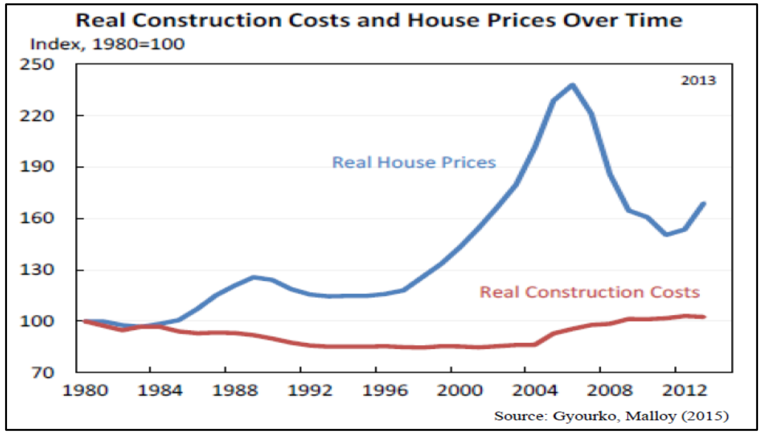
Proposals for Housing Finance Reform

- The MBA, “Promising Road”, and Milken proposals keep and expand the current government-centric housing finance system, similar to last session’s Johnson-Crapo Senate proposal
- All will ultimately become economics-free zones and leave the taxpayer on the hook
- Reforming or eliminating the GSEs and decreasing the risk of taxpayer-funded bailouts through legislation will be difficult
- Policy disagreements in the Senate, and between the Senate and the House, make it unlikely that there will be financial reform legislation in 2018
  - Once again the battle will be over amount of cross-subsidies in the “’Affordable Housing’ cookie-jar”
- Solution: eliminate Fannie Mae and Freddie Mac without legislation
  - The Trump administration could create a stable housing finance market by:
    - Eliminating the GSEs over time and reforming the FHA
    - Shift from government-dominated US housing finance system to one based on market principles
    - These steps can be taken by FHFA as conservator (not as regulator) of the GSEs.
    - In January 2019, President Trump will have an opportunity to appoint a new FHFA director who will be able to take these steps
  - The Plan is unique:
    - No other reform proposal creates a safer and more stable housing market, gets the taxpayers off the hook, and helps Treasury reduce the debt by billions of dollars annually
    - A measured approach which relies on the private market to provide both investment and risk capital
    - A limited government role consisting of on-budget assistance for narrowly targeted groups of borrowers and focused on sustainable wealth building

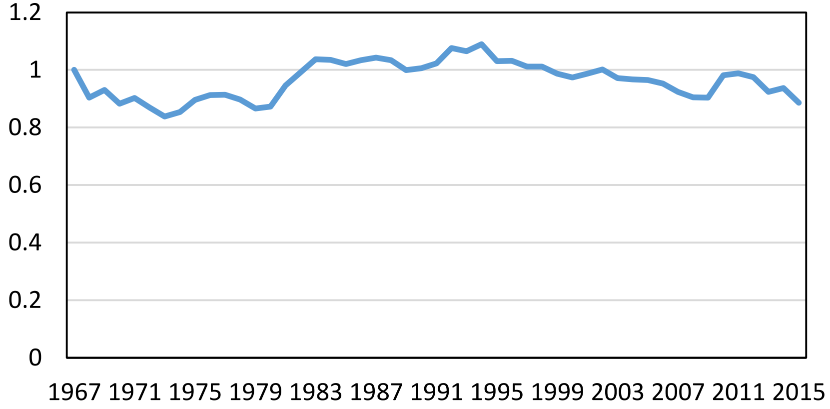
Government Policies Have Distorted the Housing Market

In large markets where effective bargaining occurs, prices remain stable, but not for housing market where government policies distort prices



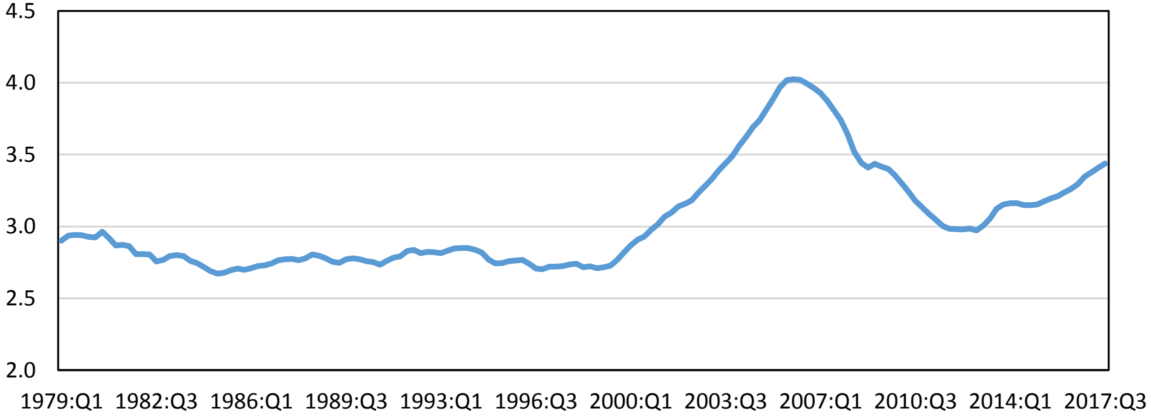
Source: White House Housing Development Toolkit, October 2016

Average Real New Car Price/Real Household Median Income (With 1967=1)



Raff, D.M.G. & Trajtenberg, M. (1995), "Quality-Adjusted Prices for the American Automobile Inc
National Bureau of Economic Research, Inc.; Gordon, R.J. (1990), The Measurement of Durable G
National Bureau of Economic Research, Inc. and U.S. Department of Commerce, Bureau of Econ

Median Home Price-to-Median Household Income Ratio*



* Calculated as median house price divided by median household income.
Source: Zillow.

Government Housing Policy Creates an Economics Free Zone

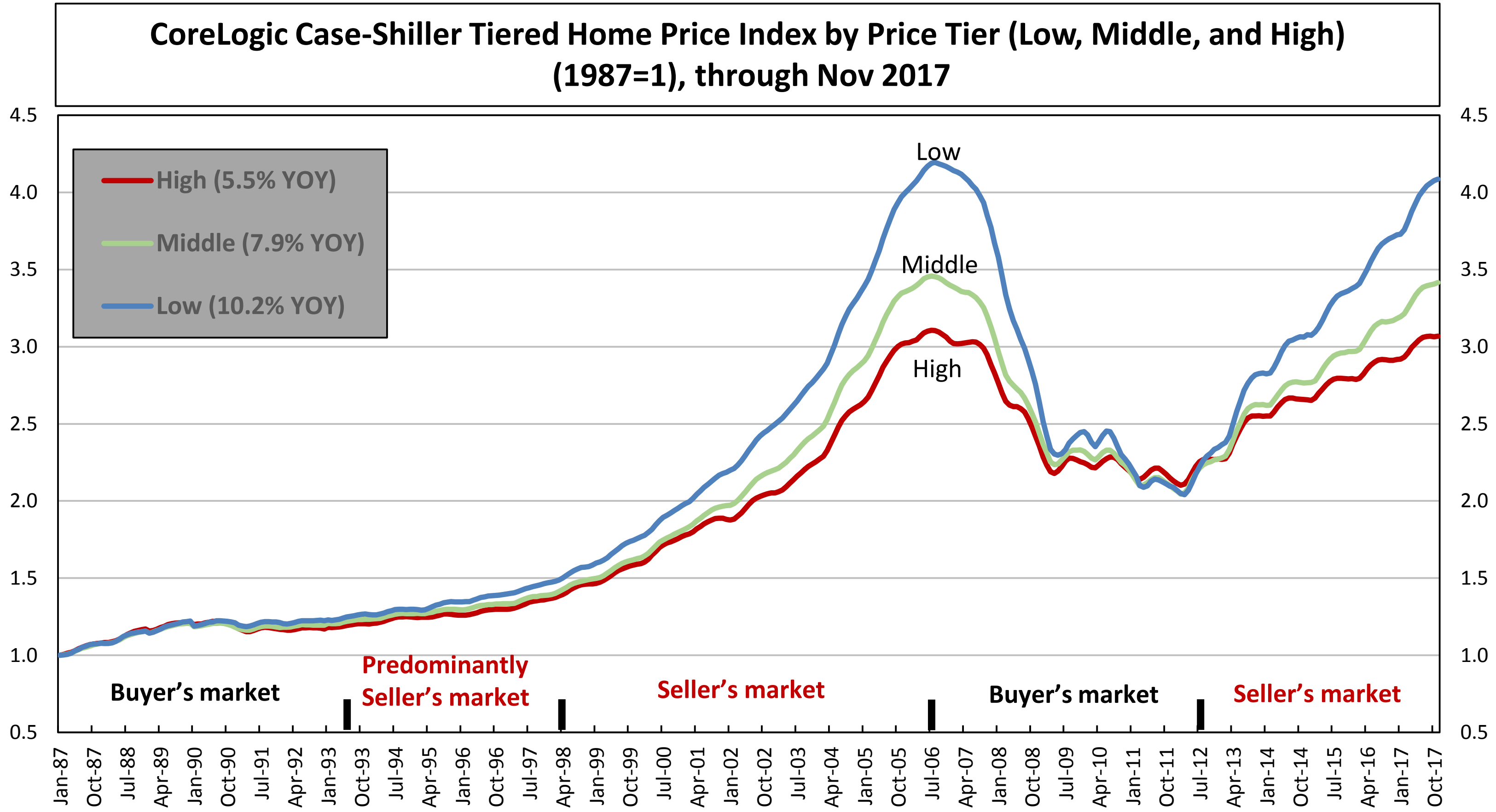
- **Law of the Marginal Buyer:** In a seller's market, prices rise faster than incomes as long as marginal buyer, who sets the price for all, has access to higher leverage.
  - Determines not only price level, but also degree of instability, as price is not necessarily equal to value.
- **Fisher's Law:** [I]n a seller's market, when choice is restricted and the seller virtually dictates sales terms, more liberal credit is likely to be capitalized in price.*
- **Law of Ignorance:** Policy makers ignore principles of supply, demand, and housing finance, resulting in an economics free zone. Cross-subsidies and expanded access to credit push up demand against a regulation-constrained supply.

* Fisher, *Financing Home Ownership*, NBER, 1951 (FHA's first chief economist)

Since Early 1990s Government Housing Policies Have Resulted in Higher and More Volatile Home Prices Trends, Particularly at the Entry Level

These trends have developed since the advent of aggressive "affordable housing" efforts that began in 1992

As a result, government policies have made it more difficult –not easier—for low-and moderate-income families to buy homes

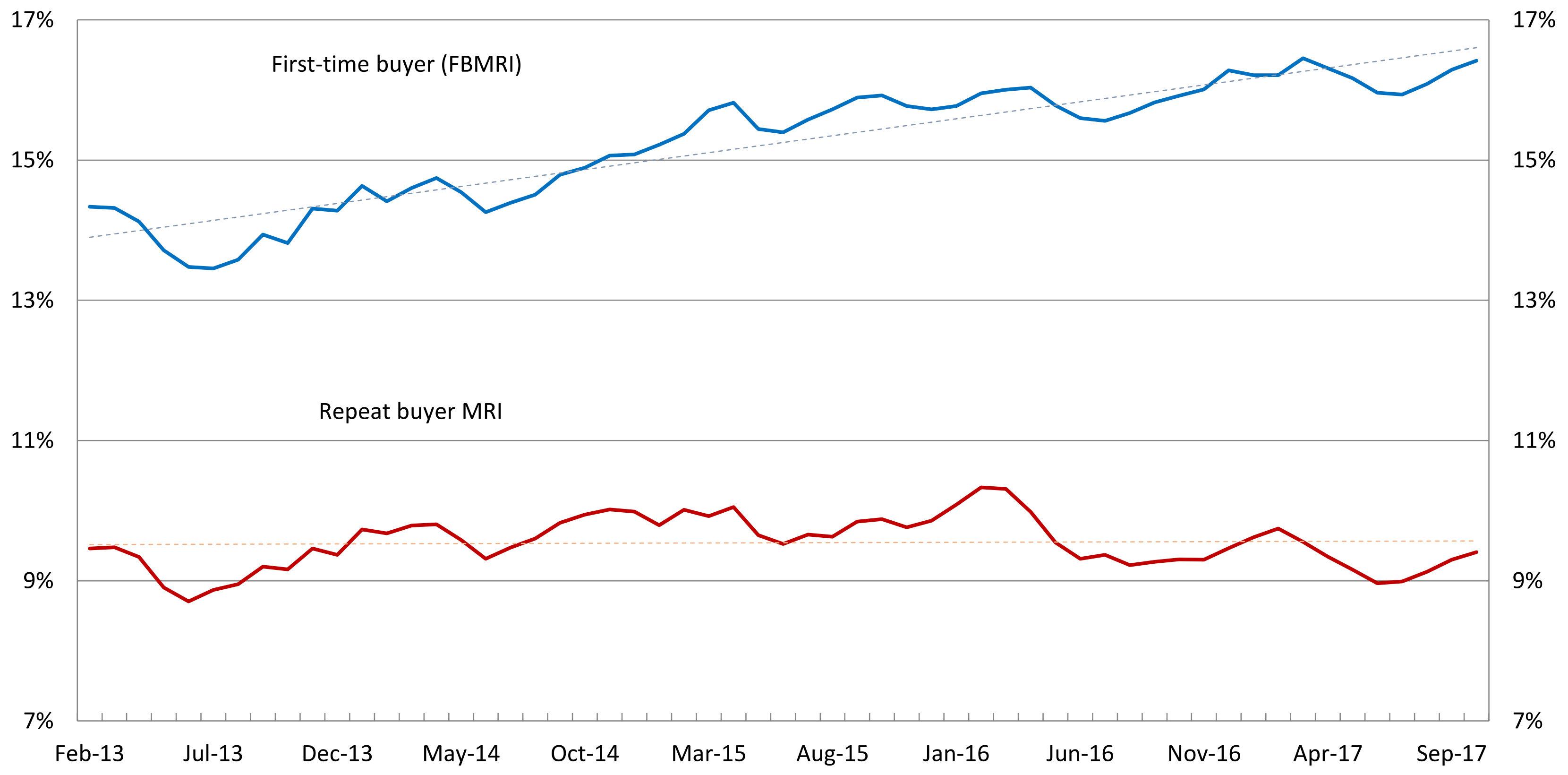


*** A seller's market: an economic situation in which goods are scarce and sellers can keep prices high. (Google.com)**

****A buyer's market: an economic situation in which goods are plentiful and buyers can keep prices down. (Google.com)**

Source: CoreLogic Case-Shiller (Data: Nov-17, Pub: Jan-18), compiled by John Burns Consulting and AEI Center on Housing Markets and Finance (www.HousingRisk.org)

Government Polices Are Hurting First time Home Buyers by Driving up Prices and Forcing Them to Take on More Risk



Source: National Mortgage Risk Index, AEI Center on Housing Markets and Finance

Historically "Affordable Housing" Mandates Have Eased Credit and Promoted Price Instability

- 1950s: National Housing Act amendments result in 30-year and minimal down payment loans becoming commonplace
- 1960s: Congress expands FHA to lower-income families unable to meet normal FHA credit requirements
- 1977, 1995: Community Reinvestment Act requires use of innovative and flexible lending practices to address LMI buyers
- 1992: Congress mandates GSE affordable housing goals
- 2008: Congress makes GSE affordable housing goals tighter and adds duty-to-serve

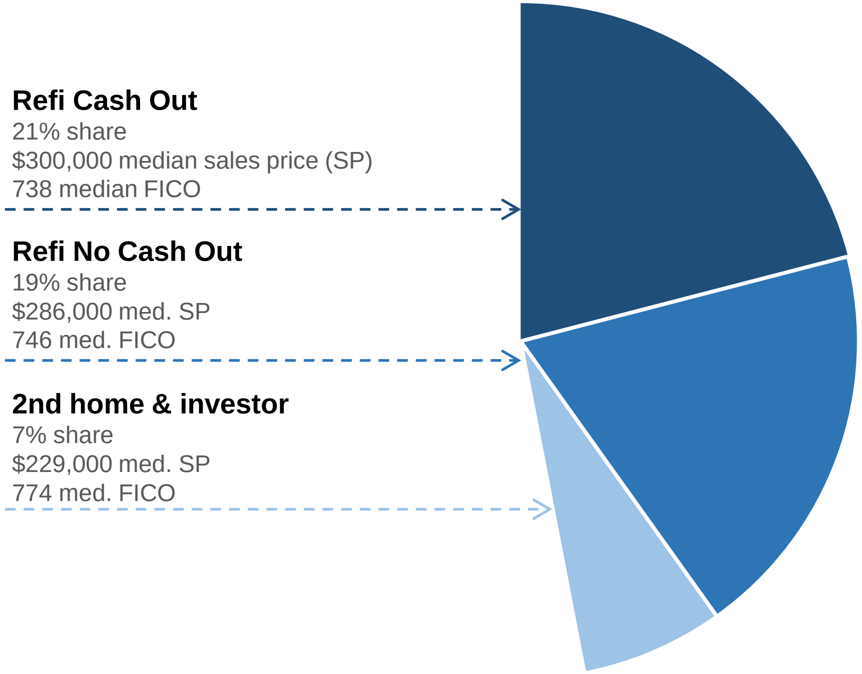
Today: recent drafts and plans, including the Corker draft, are no different

- Promote and ensure access to affordable mortgage credit and affordable housing, including to underserved borrowers
- "Market Access Fund", "Market Access Plan", "Market Access Agreement"
- "Access" appears 62 times in 80 pages and yet garnered no Democratic sponsors

Such mandates seek to provide a "free lunch", but ignore the fact that the marginal buyer determines not only price levels, but also their degree of instability, because price does not necessarily equal value.

Principle: the only plausible reason for government to back the housing market is to help low- or moderate income families buy homes

An evaluation of the GSEs 2017 business shows that the GSEs fail to meet this simple test



Almost half of the GSEs' 2017 volume wasn't even related to buying a primary residence. These borrowers could be served by the private sector

Source: AEI Center for Housing Markets and Finance. All share percentages based on dollars (YTD Aug. 2017)

Another 41% went to help well-to-do buyers

Of which 25 percentage points went to well-to-do repeat buyers of primary residences and 16 percentage points went to well-to-do first-time buyers.

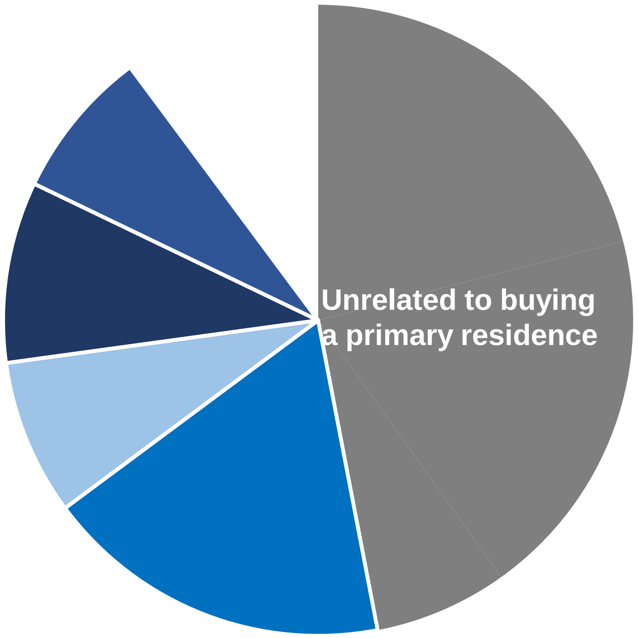
These buyers could be served by the private sector

First-time buyer (FTB) w.>85% CLTV & loan>$250,000
8% share
$353,000 med. SP
746 med. FICO

FTB w.<=85% CLTV
9% share
$280,000 med. SP
752 FICO

Repeat buyer w. >85% CLTV & loan >$250,000
8% share
$365,000 med. SP
755 FICO

Repeat buyer w. <=85% CLTV
18% share
$327,000 med. SP
774 med. FICO

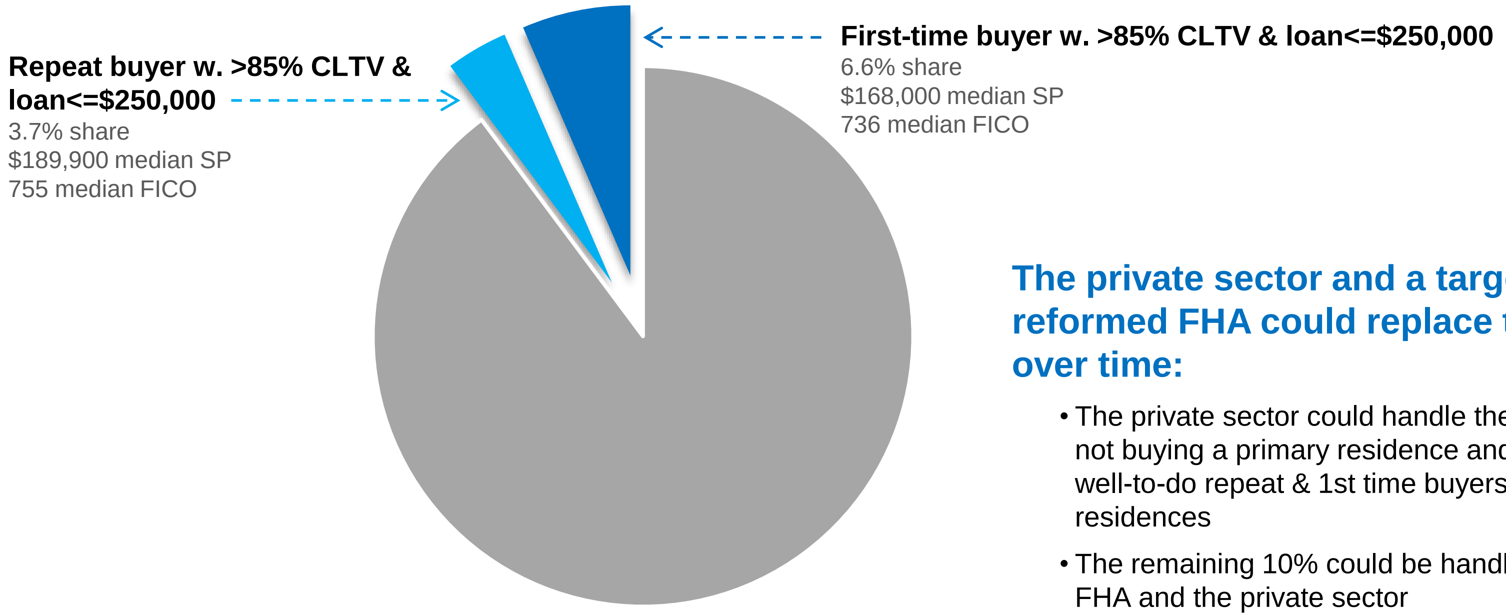


Source: AEI Center for Housing Markets and Finance. All share percentages based on dollars (YTD Aug. 2017)

Only 1 in 10 GSE dollars went to buyers of more modest homes

Only 6.5% (1 in 16) GSE Dollars went to first-time buyers of more modest homes and only 3.7% (1 in 30) GSE Dollars went to repeat buyers of more modest homes.

The GSEs "spend" an estimated $3 billion/year on cross-subsidies to higher credit risk borrowers, most of whom are not low- or moderate income



The private sector and a targeted and reformed FHA could replace the GSEs over time:

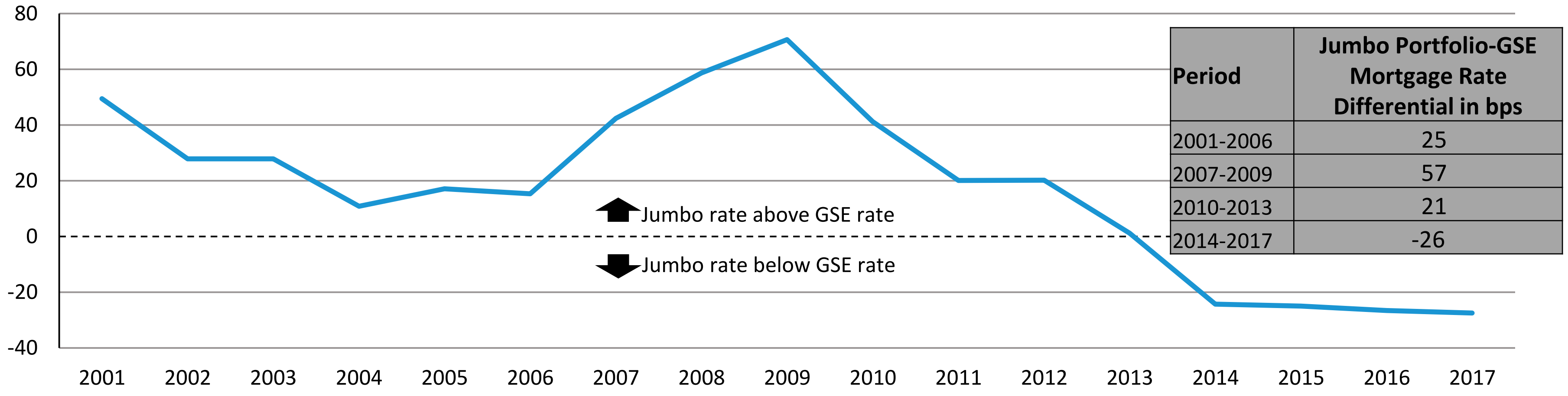
- The private sector could handle the 50% who are not buying a primary residence and the 40% well-to-do repeat & 1st time buyers of primary residences
- The remaining 10% could be handled by the FHA and the private sector

Source: AEI Center for Housing Markets and Finance. All share percentages based on dollars (YTD Aug. 2017)

Jumbo Portfolio-GSE Mortgage Rate Differential

Before the financial crisis, the GSEs reduced mortgage rates by taking risks for which they were not compensated

- Since 2009, the GSEs have been required to recognize risk in their pricing of mortgages, driving up their mortgage rates
- Since 2014, mortgage rates for private portfolio whole loans have been below GSE rates — after controlling for the risk characteristics of the mortgages



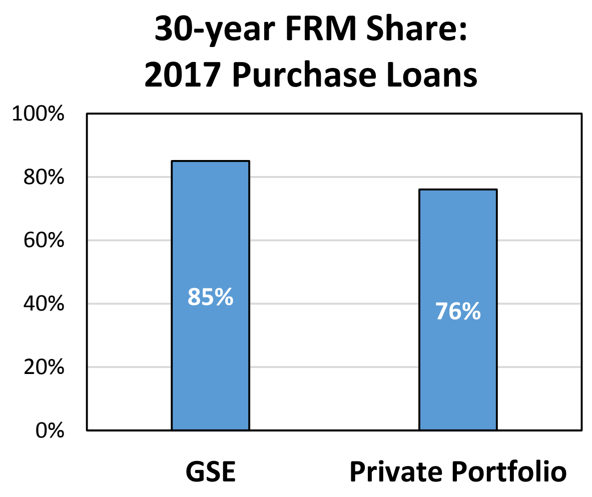
Period	Jumbo Portfolio-GSE Mortgage Rate Differential in bps
2001-2006	25
2007-2009	57
2010-2013	21
2014-2017	-26

Note. Spread pertains to 1-unit, primary owner-occupied 30-year fixed-rate home purchase loans between 90% and 110% of the applicable conforming loan limit. Data for 2017 cover January-September. Portfolio loans refer to private portfolio whole loans.
Source. Authors' calculations using data from CoreLogic©.

What Does the Purchase Loan Market Look Like Today?

- Private portfolio investors in whole loans are very active: total of 570,000 purchase loans for a total of $228 bil. originated in 2016 (HMDA data)
- Private portfolio investors, consisting largely of depositories, are active at all price points
- The 30-year FRM is widely used today – even by private portfolio investors

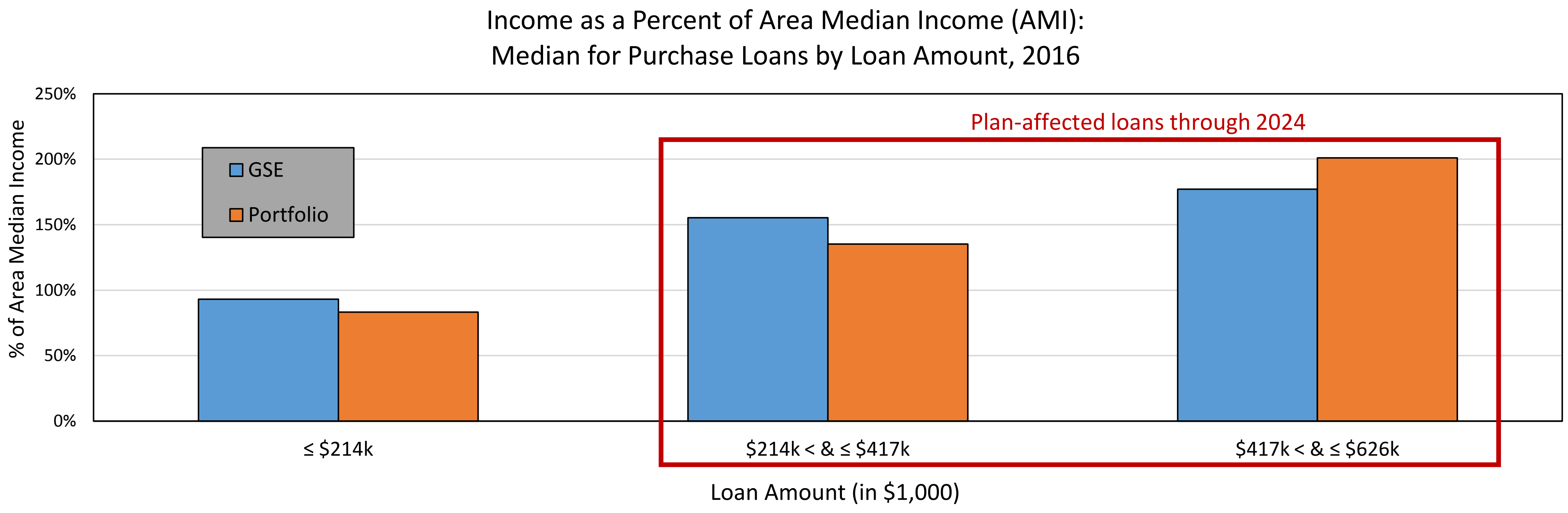
Loan Amount (in $1,000)	Distribution of 2016 Purchase Loans: by Loan Amount		Private Portfolio as a % of (GSE + Private Portfolio)
	GSE	Private Portfolio	
Total Count	1,612,000	570,000	-
≤ 214	48%	43%	24%
214 < & ≤ 417	47%	20%	14%
417 < & ≤ 626	5%	17%	56%
> 626	0%	20%	100%
Total	100%	100%	26%



Source Table: HMDA data for 1-4 unit, primary owner-occupied conventional purchase loans. GSE loan totals come from AEI's National Mortgage Risk Index (NMRI). Private portfolio loan totals are the difference between HMDA and NMRI totals. Total counts are rounded to the nearest 1,000. GSE loans in Hawaii with loan amounts greater than $626,000 are bucketed with loans in the $417,000 to $626,000 bin.
Source Chart: Authors' calculations using data from CoreLogic©.

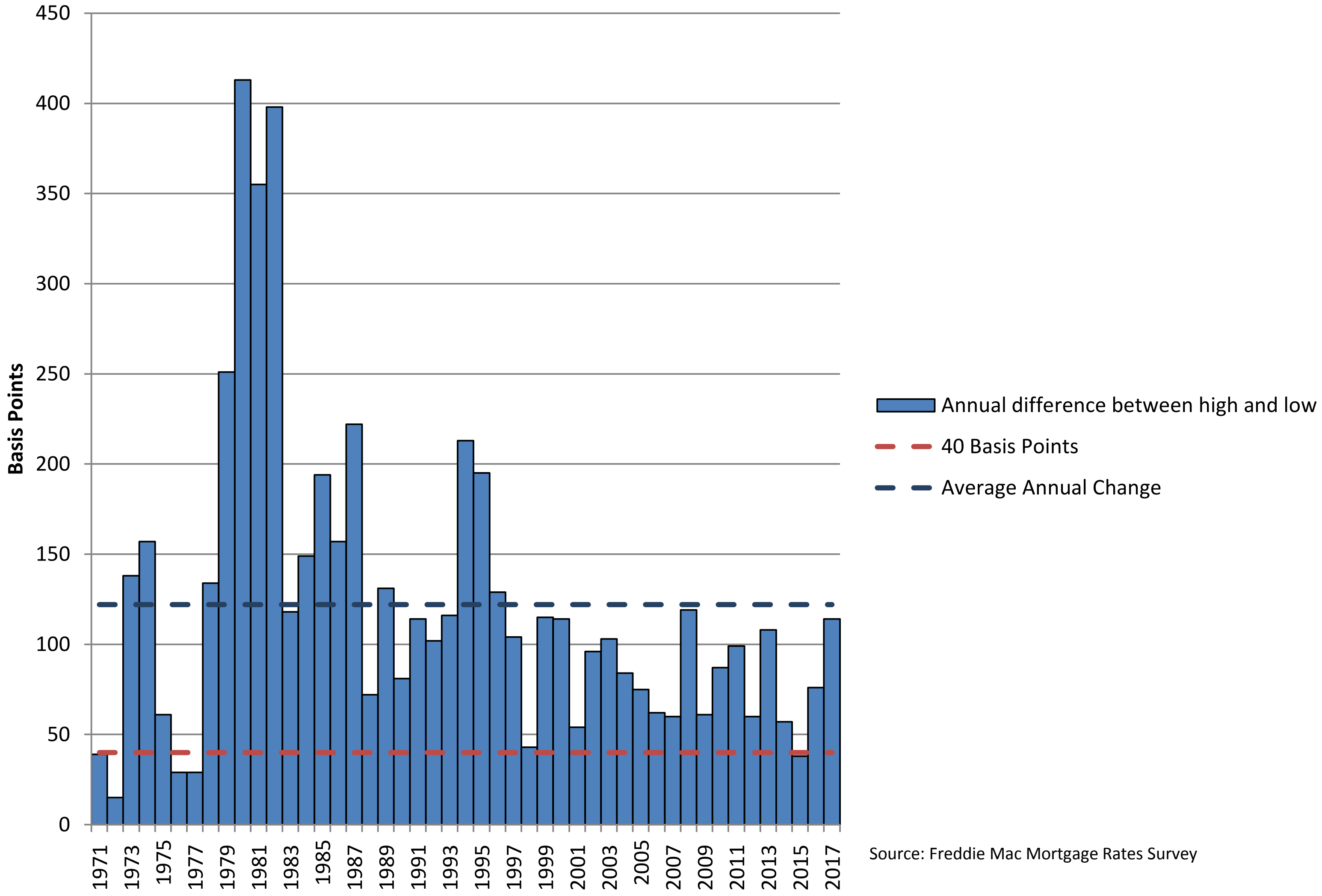
Characteristics of Affected GSE Purchase Loans in 2016

- Plan-affected borrowers served by the GSEs are generally affluent – median income of about 160% of AMI
- Borrowers served by private portfolio investors with loan amounts at or below $417,000 are somewhat less affluent than GSE borrowers



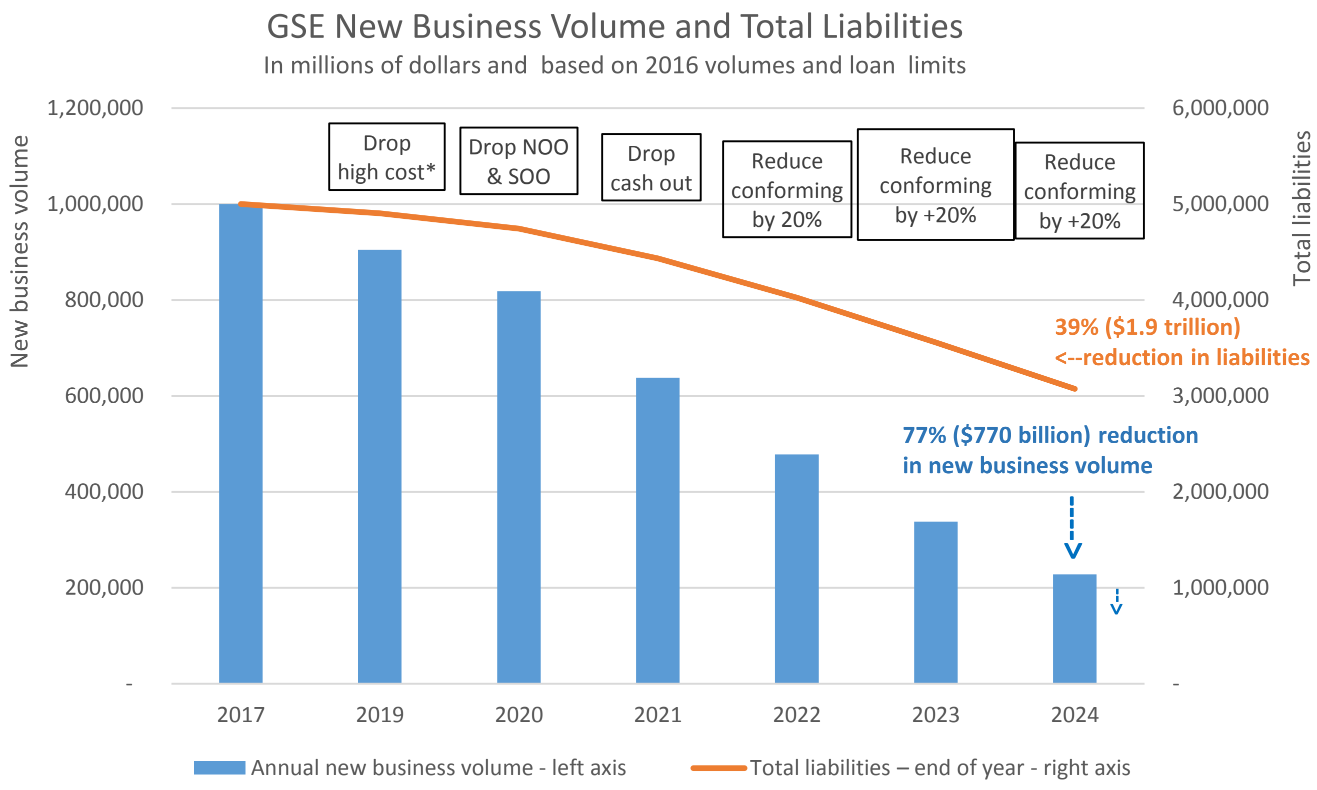
Source: 2016 HMDA data for 1-4 unit, primary owner-occupied purchase loans. GSE loans in Hawaii with loan amounts greater than $626,000 are bucketed with loans in the $417,000 to $626,000 bin.

Average variation in conforming 30-year mortgage rates for the period 1971 to 2017



Source: Freddie Mac Mortgage Rates Survey

A Largely Privatized Market, While Gradually Winding Down the GSEs



* The high cost area limits were put in place in 2008 to cover areas of the country where home prices were especially high, mostly east and west coasts. They are now about $200,000 higher than the standard limit of $417,000 ($424,100. and $453,100 in 2017 and 2018 respectively)

** NOO: Non-Owner Occupied or investment properties and SOO: Secondary Owner Occupied or second homes.

FHA Lending for Sustainability and Wealth-Building

- To prevent a flow of mortgages to the FHA as the GSEs' footprint is reduced, HUD Secretary should make commensurate reductions in FHA's loan limits
- Focus the FHA on sustainable and wealth-building home purchases by low and moderate income families
  - Limit to buyers of existing homes with incomes less that 3 times area median income (AMI) and new homes with incomes less that 4 times AMI
  - To incent a supply increase in economical new homes, limit loans on new construction to a floor area of <1800 sq. ft.
  - Provide consumer disclosure of loan's likelihood to default under stress conditions
  - Ensure that FHA's underwriting standards do not:
    - Result in higher concentrations of delinquencies & claims in low- and moderate-income neighborhoods
    - Promote higher real home prices during extended periods of a seller's market

FHA Lending for Sustainability and Wealth-Building - continued

- Additional steps to focus the FHA on sustainable and wealth-building home purchases by low and moderate income families
  - Revert to historical techniques for mortgagee risk sharing
  - Set capital plan targets during boom conditions
  - For 30-year loans:
    - Implement an Ability-to-Repay (total debt-to-income ratio or DTI) standard that limits DTI to <=43%, unless residual income test used, in which case DTI limit is 50%
    - Limit the maximum seller concession to 3%
    - Adopt mortgage insurance pricing and underwriting changes so as to crowd in loan terms of 20 years or less and crowd out 30 year loans
- HUD secretary has authority to implement these changes

Reliable Wealth Building as Central Focus of Federal Homeownership Policy

- Low-Income, First-Time Homebuyer (LIFT Home) Tax Credit
  - A transparent, targeted, on-budget, upfront tax-credit more effective than today's system based on high risk lending to marginal buyers and opaque cross-subsidies.
  - Over 10 years, places some 4 million first-time, low-income home buyers on the path to wealth building, with a fifty percent reduction in default risk
    - Frees up an estimated 1.2 million low-income rentals
  - To incent a supply increase in economical new homes, limit size of eligible newly constructed homes to less than 1800 sq. ft.
  - Limit to private loans not guaranteed by a government mortgage guarantee
    - FHA, VA, RHS, Fannie, and Freddie already benefit from housing subsidies
  - Limit to loans of <=20 years
    - One-time, refundable credit used to buy down a loan's interest rate for at least 5 years
  - Cost estimated at $4 billion/year (400,000 x $10,000 average credit)
    - An estimated 120,000 low-income rental units would be expected to be freed up annually as low-income renters purchase homes
    - Funding
      - Eliminate mortgage interest deduction on second homes--savings of about $2 billion/yr.
      - Identify and repurpose $2 billion/year in HUD funding
      - Reduce LIHTC funding by $2 billion/year