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Housing Finance Reform and the Future of the Latino Homeowner

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Absract

The future of Government Sponsored Entities ("GSEs") has a central, yet contentious role in maintaining the sustainability of the housing market recovery. GSE's serve as intermediary pseudo-financial firms, chartered by the US Congress, that either purchase or guarantee the financial obligations of mortgages and mortgage products that banks sell to investors. This results in a significant risk to the American taxpayer, as they face exposure to financial losses from the GSE investment portfolio. This occurred during the 2008 recession, resulting in a taxpayer bailout reaching upward of tens of billions of dollars. This taxpayer exposure in the housing market must be diminished in a manner that sustains and promotes the overall economic recovery, allowing private equity to enter the market, and transitioning the role of the government to serve as a backstop for only a catastrophic economic loss, rather than serve as the first loss guarantor. Additionally, GSE reform must promote affordable access to mortgage capital to the population segments most devastated by the economic downturn. Furthermore, the reform must address financial inclusionary measures to ensure that the future of the housing market flourishes in the decades to come, stabilizing the American economy and providing access to the middle class and homeownership for millions of Latino homeowners.

PART I — Background on Housing Market & Housing Finance Reform

Housing Market Brief History & Current State

Around 2003, an increasing amount of financial firms began to serve the subprime mortgage market at an escalating rate. In the years leading up to the financial crisis the major banks in the mortgage market did not readily or efficiently serve minority communities and low-income borrowers. More specifically, Latino and immigrant borrowers tend to have a greater frequency of unique credit profiles, including a lack of traditional credit and payment history, multiple co-borrowers on single assets/property, and primarily a cash income, credit qualities that label them unattractive to lenders who utilize automated underwriting processes and formulaic credit scoring evaluation. Although prime lenders, the Federal Housing Administration (FHA), and the Veteran's Administration (VA) offered loans designed to accommodate these non-traditional credit profiles, the vast majority of private sector lenders referred these applicants to their subprime affiliates or simply did not engage these consumer populations whatsoever. This market vacuum was quickly filled by profit driven, high–risk, subprime and predatory lenders, resulting in the eventual unprecedented foreclosure rate in Latino and minority communities during the downturn. When compared to Whites, Latinos were 30% more likely to receive high-cost loans at the height of the housing bubble when purchasing their homes.[1] Financial firms such as Countrywide Financial and Lehmann Brothers, ultimately brought down by their involvement in this sub prime market, began to exponentially accelerate the rate at which they pooled subprime mortgages and issued mortgage-backed securities to international investors. These firms had four major buyers of their mortgage-backed securities, with the heaviest demand coming from Fannie Mae and Freddie Mac- the GSEs. The GSE demand was driven by the goals of the *Community Reinvestment Act* requirements put forth by HUD. The GSEs, to meet this requirement, accounted for the purchase of nearly half of all subprime Mortgage backed securities — more than 5 times the share they held in 2002. By the first quarter of 2007, GSEs backed or purchased virtually all of subprime originations (usually in the form of adjustable rate mortgages). The unprecedented collapse of the housing market began in 2007, after catastrophic economic and asset losses began to cripple the liquidity and equity markets as capital all but disappeared. Housing prices were in free-fall—having fallen every month for 30 straight months by 2008, and home equity had been slashed in half—losing $6 trillion total—which wiped out wealth for many families, accompanying an average loss of 753,000 jobs every month.[2]

The housing market has been on a slow and steady path of recovery, defined as decreased foreclosure rates, and rising housing prices. This recovery, while moving forward, is at a cross roads for reform.

The financial repercussions of the housing downturn are still rippling though the economy today, as millions of families have lost their homes, and trillions of dollars in household wealth and equity has been eradicated, and countless neighborhoods and cities remain marred by historically unprecedented foreclosure rates, abandonment and neglect. The bailout of Fannie Mae and Freddie Mac, the institutions established by Congress to ensure a stable supply of mortgage financing and ensure a viable housing market has cost taxpayers tens of billions of dollars to date. [3]

The housing market has been on a slow and steady path of recovery, defined as decreased foreclosure rates, and rising housing prices. This recovery, while moving forward, is at a cross roads for reform. The GSEs are in conservatorship, funneling money to the US Treasury, but their place as government guarantors is still not certain, which is the single most determinant to housing market stability, investment and growth. At these cross roads, Congress has significant decisions to make. A new system could provide credit to a broad and diverse population, offer safe investment opportunities to a wide range of investors, and result in a larger, more stable housing market; or alternatively, it could create an environment in which credit and housing choices are more costly, more limited, and less sustainable, especially for minority and low- and moderate-income households, and where there are fewer opportunities for investors who do not seek credit risk. [4]

There is more at stake than providing access to credit and increasing the rate of homeownership. In reality, any housing finance proposal will not only determine the course, speed, and efficiency of the macroeconomic housing recovery, but also serve as the foundation for decades to come for the sustainability of achieving the American dream of homeownership as a means of entry into the middle class for millions of Americans. The new system must account for the realities of a changing demographic, changing consumer profiles, including the rapid growth of communities of color, ever-increasing student debt burdens, rising demand among rural Americans, and increased economic insecurity among all but the wealthiest American families.[5] The current state of the housing market is not a strong one. Homeownership rates have plummeted, in the later half of 2013 approximately two thirds of mortgages are refinanced mortgages rather than new originations, and many home purchases are investor funded rather than homeownership mortgages.[6] Delimited access to credit, high down payments and increased excess credit standards have all but shut out first-time homebuyers, young homebuyers and homebuyers of color, who serve as the main drivers for the future of American homeownership.[7] The evolving demographic of the United States has put further importance on the need for housing finance reform. Due to natural increases in birthrates and immigration, the US has trending growth in population. By mid century, the Census Bureau projects that the US population will exceed 400 million, an almost 33% increase from the current population estimate of 310 million. As the population surges so will the demand for housing, and the modern demographics will define the *new* homebuyer, who will in turn shape the modern housing market.[8]

The Importance of the Hispanic Homeowner

The Hispanic population in the U.S. is expected to grow at a faster pace than the general population for the next several decades.[9] Hispanic household income is also trending upward and more Hispanics are attending college than ever before. Hispanics are also a much younger demographic averaging a full ten years younger than the overall population. As a result the role that Hispanics will play in the housing market is expected to positively correlate with the burgeoning population. [10] In terms of challenges, the most significant barriers to Hispanic ownership in the short term are investor shortages. Access to affordable, low down payment mortgages are the key to driving affordable capital. The over restrictive credit tightening, and lack of low down payment loans prevent this affordable access. Naturalized Hispanics tend to become homeowners at a higher rate than the US born Hispanics. [11] Hispanics continue to lead population growth in America. Hispanics have accounted for more than half of the population increase over the past decade, with 50,000 young Hispanics reach the age of 18.[12] Hispanics dominate household growth. Over one million Hispanics households were formed in 2012, compared to a decrease of 704,000 non-Hispanic households. [13] Hispanics are achieving educational milestones as well, composing the largest minority group on the nation's campuses.[14] Hispanics are dominating the growth of the nation's workforce. In 2012, Hispanic job growth accounted for approximately half of the total U.S. job growth. Hispanics are earning more as well, with 40% of Hispanic household's earning more than $50,000, and this income bracket is growing at a faster rate than non-Hispanic groups. The overall purchasing power of Hispanics is over $1 trillion, growing to $1.5 trillion by 2015.[15] This growth stems from the projections that 4 out of every 10 households will be Hispanic owned by 2020, and are expected to be about 50% of all new homebuyers by 2020.[16] Hispanics are expected to account for 40% of an estimated 12 to 14 million new households within the next

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10 years.[17] Hispanics, culturally are passionate about homeownership, with 56% of Hispanics saying a major reason to buy a home was because it represents a symbol of success or achievement, compared to only 32% of all Americans.[18]

With a cultural impetus to strive for homeownership, coupled with trillion dollar buying power and increased employment, housing finance reform cannot afford to ignore the Hispanic homeowner. More importantly, it would be unjust for reform to ignore the Latino homebuyer; a consumer group suffering the brunt of the recession as a result of the financial industry's ill placed investment bets.

The Effect of the Housing downturn on the Hispanic Population

The differential impact of the downturn highlights a key concern with homeownership as a means for reducing racial wealth disparities.[19] Namely, if the downside risks associated with owning a home are distributed unequally by race, increased rates of delinquency and default may ultimately exacerbate rather than diminish the racial wealth gap. In the downturn, blacks and Hispanics were more than twice as likely to have a delinquent mortgage compared to their white counter parts. [20] Researchers have documented the greater exposure of minority households to income and health shocks time and time again[21] To the extent that wealth and liquidity gaps leave minority households especially vulnerable to negative economic shocks, some research implies that those minority households drawn into homeownership following a major expansion of credit are especially likely to default in a subsequent downturn.[22] Research indicates that black and Hispanic households are more likely to become delinquent and default on their mortgages than white households with similar credit scores, house type, neighborhood, and loan characteristics, especially for mortgages originated for new home purchases in 2005-06. [23] The effects of the downturn are unequivocal- Latinos bared the brunt of the economic recession in terms of wealth building and housing.

Some 28% of Latino homeowners owe more on their home than what they could sell it for in today's market, compared with about 14% of homeowners in the general public.[24] About 45% of Latino homeowners have delayed or cancelled plans to buy a home or make major home improvements over the past 2 years.[25] For Latinos, after reaching a high of 49.8% in 2006, the homeownership rates fell to 47.4% in 2001, matching declines in similar groups.[26] Decreasing house values hit Latino homeowners more than any other group. In 2005, Latinos derived nearly two-thirds of their net worth from home equity however, because many Latinos live in places where housing values increased the most prior to the housing crisis, and have fallen the most, the housing bust had a greater impact on Latino household wealth than any other group.[27] With 40% of Latino homeowners (who purchased their home from 2000–2011) are now underwater, meaning all equity has been eradicated, Latino wealth has suffered irreversible damage. This compares with 22% of Latinos with an underwater mortgage that bought a home a decade earlier (1900–1999), and only 15% who bought a home between 1980–1989).[28] Hispanic families lost 44% of their wealth between 2007 and 2010; by contrast, Black families lost 31% and White families lost 11%.[29] From 2005 to 2009, the median level of home equity held by Latino homeowners declined by half—from $99,983 to $49,145.[30] At the same time, homeownership rates among Hispanics also fell, from 51% to 47%.[31] A disproportionate share of Hispanics live in California, Florida, Nevada, and Arizona, the states that experienced the steepest declines in housing values during the crisis.[32] Today the market is not serving communities of color significantly better. Even though housing prices are on the rise, the market remains flawed. Housing prices in many urban markets with concentrated minority populations are once again outpacing income. At the same time, credit standards continue to tighten. Creditworthy, low-income potential homebuyers cannot adjust to the overcorrection in today's lending standards reacting to the housing collapse. As a result, mortgage credit is currently available to only the strongest credit customers with FICO scores over 760, with down payments above 20%, and with the capacity to buy jumbo loans.[33] These trends point to an unsustainable housing market that has not yet fully recovered.[34] Similarly, when it comes to underwriting, there has been an overcorrection in underwriting standards. Although it has been widely acknowledged that tightening credit standards to prevent harmful products, and originating loans to unworthy credit borrowers, today the regulations are overly restrictive. The majority of loans to low- and moderate-income families since 2007 have been FHA or GSE-backed loans due to lack of private capital. Since 2009, the typical GSE-issued loans have a loan-to-value (LTV) ratio under 80% with FICO scores over 760[35] However, despite being the hardest hit demographic in the housing bust, 75% of Latinos agree that buying a home is the best long-term investment a person can make, compared with 81% of the general population who say the same, even among underwater households with three-in-four say buying a home is the best long-term investment.

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PART 2: Elements of Housing Finance Reform

The Role of Private Capital

One of the main goals for the transition from a GSE run housing market to a sustainable efficient one is the return of private capital. Private capital is not meant to completely supplant the role of the government, but rather, support the housing market (and secondary market), without overexposing American taxpayers unnecessarily to the inherent risks of financial markets. A government role, targeted correctly, and with the right protections for taxpayers, should remain an important component of any future system, but it should be limited. [36] In the aftermath of the financial crisis, there has been a discernable absence of private capital from the marketplace, largely due to the ambiguity, if not the lack, of housing finance reform, leaving Fannie Mae, Freddie Mac, FHA, and Ginnie Mae to insure or guarantee more than nine out of every ten new mortgages. Under normal market conditions, the essential components of housing finance — buying houses, lending money, determining how best to invest capital, and bearing credit risk — should be private sector activities. [37] It is ultimately in the best interest of the economy and the country to wind down Fannie Mae and Freddie Mac in a strategic and responsible manner. The Department of Treasury estimates show that the net cost of our support for Fannie and Freddie will total approximately $73 billion through 2021, 44 percent lower than the $134 billion in net investments requested or drawn to date.[38] It is important to keep in mind that private capital has always been the source of all funding for home mortgages, the central issue is how much of the capital, or to what extent should that capital, be insured by the government.[39]

To put the role of the government guaranty, and the exposure to the American taxpayer into perspective, currently about 90% of the mortgages for the finance of home purchases rely on the government guarantee of the GSEs, namely that in case of default on the mortgages, the GSE's would remit payments to investors of the security pools on time and for the full amount of the original security. This, in effect, means that the taxpayers, through the funding to the GSEs, remain entirely liable for the losses that exceed the capital reserves of the GSEs in the case of an housing downturn. This loss can (and was) in the billions. Transitioning the government's role to a backdrop only for monumental catastrophes (to avoid national recessions), and placing private capital in front of the government guaranty is a protection that American taxpayers need. There are other advantages to having private capital fill the first loss position as well, outside of the reasonableness that private capital should absorb some of the risk associated with mortgage investing. Additionally, there is the argument that the private sector is better able than the public sector to accurately price the risk of mortgage risk.[40] It is useful to keep in mind the amount of private capital that is needed to support the amount of risk in the GSE market. Currently there is about $11 trillion dollars of mortgages outstanding. GSEs (Fannie Mae and Freddie Mac) currently bear the credit risk of about half of that amount, almost 50% of those loans, and issue about $1 trillion dollars a year in new commitments. [41]

When private capital is utilized in the first loss position of a mortgage backed security, the risk to the taxpayer decreases as the quality of the loans increases, and as the amount of private capital increases. The big issue is however, private capital comes at a cost, and as private investors and mutual funds demand certain returns on the level of risk they absorb, the riskier, or longer the debt maturity, the more the cost of capital will be. Prior to conservatorship, GSEs shareholders bore this credit risk of the GSE portfolio.

Cost of Credit

Credit costs vary significantly based on factors such as borrower credit scores (FICO) and Loan-TO-VALUE (LTV) ratios. For example, the credit cost for loans with FICO greater than 750 and LTV below 80% would be less than 25 basis points a year, while the credit cost for loans with FICO below 700 and LTV greater than 90% would be more than 10 times higher and exceed 250 basis points a year. Policy resolutions to widen or narrow the "credit box" could greatly impact down payment amounts, monthly payments and/or credit access overall. During times of economic downturn and/or depressed housing pricing affordable credit becomes scarce. It would be useful for reform to allow for a diversity of sources of funding for housing, and for private capital to come in a number of forms and through a variety of mechanisms, this will help make the future housing finance system more resilient to economic and market events that affect particular parts of financial markets and thus impinge on the availability of funds for housing.[42] At the level of the individual loan, capital for conforming individual mortgages will continue to flow from a combination of down payments, private mortgage insurance, and the capital of originators that carry out balance sheet lending.[43]

To Be Announced Market (TBA)

The major element of the housing finance reform is the preservation of the To-Be-Announced (TBA) market, where Fannie and Freddie "pass-through" Mortgage

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Backed Securities (MBS). Most of the finance community agrees that this highly liquid secondary market is essential to the functioning of an efficient housing finance market, and it is primarily responsible for the liquidity and efficiency of buying and selling Mortgage Backed Securities. The loss of this market, or curtailing it, would spike the cost of capital and jeopardize availability of affordable, fix rate long-term mortgages. It is important that, as discussed above, the influx of private capital is compatible with this secondary market in terms of the availability of the buying and selling in the TBA mortgage.[44] The TBA market allows packages of mortgages to be sold at a later date, up to 90 days, where both parties agree on limited loan components (such as loan amount, coupon rate, collateral type, etc.). This allows a buyer to contract with a seller to deliver x amount of mortgages (meeting the core agreed upon characteristics) at a certain future date, and the buyer agrees to pay x amount for said mortgages. This allows the seller to fill an "order" for mortgages, lock in a rate for the borrower for 90 days and select the mortgages for delivery at the future date giving flexibility to which mortgages will be packaged and delivered, allowing banks to lock in interest rates for borrowers. Current legislation The major bill that directly seeks housing finance reform is listed below , and is currently being considered by the Senate Banking Committee. The Senate bill seeks to transition from a GSE dominated housing market to one shared with private capital over the course of several years.

S. 1217, "Housing Finance Reform and Taxpayer Protection Act of 2013" (Corker-Warner)	
Subject	**Corker-Warner (S. 1217)**
1. Wind-down of Fannie Mae and Freddie Mac (the GSEs	As of the date of enactment, the FHFA is directed to begin the wind down of the GSEs and the liquidation of their assets.
1.2. Charter Repeal	The federal charters of the GSEs are repealed when the Federal Mortgage Insurance Corporation (FMIC) is able to perform the insurance functions authorized in the bill (the FMIC Certification Date) In in no event may the repeal take place later than 5 years after the date of enactment. (§ 501(a))
I1.3. Treatment of Outstanding GSE Debt and Mortgage Securities During Transition	Rights of Existing Investors The charter repeal would not impair pre-existing rights of investors who hold GSE debt or mortgage backed securities (MBS). (§ 110) Federal Guarantee GSE debt and MBS issued prior to the charter repeal would be fully guaranteed by the federal government. (§ 110)
1.4 Treatment of Dividends and G-Fees During Transition	Between the date of enactment and charter repeal all dividends and g-fees would go to the Treasury Department. (§ 110)

PART 3 Legislation Analysis

The Corker-Warner reform plan is quite straightforward, the GSE would be unwound over the course of time it would take for private capital to replace it, or at least occupy the first lost position. This government backstop would take the form of a fee charged to the sellers, but would only "kick in" in the case of financial catastrophe. Short of an economic catastrophe, private institutions and investors would absorb losses on the securities before the government assumed responsibility for payment. Therefore, the government would still provide a guaranty, allowing for lower end costs to the borrower, enabling mortgage backed securities to leverage the credit of the US Government, but would alleviate the ominous amount of risk currently bore by the American taxpayer. The bill would establish The Federal Mortgage Insurance Corp., a new independent government agency, would serve as the main regulator ensure fair market competition among all the constituents. [45]

An essential component of this bill is the recognition that a catastrophic government backstop to the housing finance system is necessary element if 30-year fixed rate loans are to remain an option for potential homebuyers, and that without this essential second position guaranty, private investors will be unwilling to take on both the credit risk and interest rate risk inherent in long-term, fixed-rate loans, or if they did, it would out price the vast majority of potential homebuyers.[46] It is important to point out that even if the government does not provide an explicit backstop for the housing finance system, it will do so implicitly. The difference is that mortgage borrowers will pay for the explicit backstop created by the Corker-Warner reform; the implicit one will be covered by taxpayers, at a higher cost, when a crisis eventually strikes.[47] The legislation recognizes that the housing finance system will be more stable and provide more mortgage loan choices to homeowners at a lower cost in different housing and economic environments if it is based on multiple sources of private capital. [48] Arguably the most significant concern with Corker-Warner is the impact it would have on mortgage interest rates.[49] Moving from the current system to Corker-Warner would increase the interest rate for the average mortgage borrower by 50 to 75 basis points. To be more precise, this would be the average increase in mortgage rates for the typical borrower in the first 15 years after Corker-Warner became law; the increase would drop to between 35 and 55 basis points after that. The principal cost of requiring such a high 10% capitalization is ultimately a higher mortgage rate for borrowers. For example, an increase of only 50 basis points monthly mortgage payments for the *average* mortgage borrower would rise by $75. For subprime, or more risky borrowers that amount would be double.[50] Additionally, this excess capitalization represents a misallocation of about $250 billion dollars that could be used more productively in the national economy.

Conclusion

Although homeownership is not the best option for everyone, it should be a policy priority to ensure opportunities be available to Americans with the financial capacity to own a home.[51] Ensuring credit worthy borrowers have access to affordable credit for housing finance to ensure the macro level economic recovery and to ensure the future of the housing market flourishes in the decades to come, stabilizing the American economy and providing access to the middle class and homeownership for millions of Latino homeowners. The Corker-Warner Bill is on the right track, ensuring affordable credit, but also removing the unreasonable and dangerous exposure of the American taxpayer in the mortgage finance system. On this path of greater economic recovery, the Latino community can slowly recuperate from the devastating wealth loss from the 2008 recession.

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