The Path to Equitable Housing Finance:
U.S. Lessons for the Global Market

Karen Petrou
Managing Partner
Federal Financial Analytics, Inc.
Author, *Engine of Inequality*

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- Residential mortgage finance is inherently domestic despite cross-border demand for MBS and related instruments.
- Monetary-policy and political solutions are thus challenging to export.
- However, the global regulatory regime is considerably more homogeneous. Thus, equitable finance can be advanced by regulatory-capital and similar changes that create incentives for affordable-housing finance without allowing undue risk-taking.
- Examples include new capital rules for internal securitizations, effective credit-risk transfers, and the real risk inherent in loans to lower-income households for home purchase versus many other mortgages.

You have sent me a difficult task: using the U.S. experience to lay out solutions to increase global financing for affordable housing that enhances both equality and equity. As I'll briefly discuss, this is hard because much about U.S. mortgage finance is unique to U.S. law, rule, institutional bias, and market configuration. However, some of the most important determinants of who gets a mortgage are to be found in the global rulebook governing banks in the U.S., the U.K., Europe, and many other nations. There are answers in this rulebook that we can apply across borders. Where these are to be found and what might best be done about them is thus the topic of this talk.

Land of the Refi, Home of the HELOC

The U.S. is distinct in many ways from other residential-mortgage markets in terms of both institutional structure and the way monetary policy transmits through this vital sector. In brief, the U.S. has key regulators such as Director Thompson at the Federal Housing Finance Agency (FHFA) setting the course for what they call "equitable finance,"[1] but these solutions are specific to Fannie Mae and Freddie Mac, our key government-sponsored enterprises (GSEs) and official mortgage guarantors including the Federal Housing Administration (FHA) and Veterans Administration (VA). No other nation has such entities and thus these affordable-housing solutions are challenging to export.

The role of the GSEs and official guarantors also results in a very different approach to the secondary market for residential mortgages. In sharp contrast to covered bonds, U.S. originators need have no balance sheet to originate loans and sell them into an $11 trillion secondary market.[2] Nonbank originators are thus major market forces, accounting for 90% of FHA loans and over half of Fannie and Freddie lending.[3] The role of the GSEs also affects the CMBS market because, again, one need not be a bank with a balance sheet to enjoy a major market presence.

Another vital difference has to do with the U.S. central bank. My book, *Engine of Inequality: The Fed and The Future of Wealth in America*,[4] lays out monetary-policy solutions advancing equitable mortgage finance, but these too are hard to extrapolate. For one thing, monetary policy most directly transmits through banks but much of the U.S. mortgage market now depends on non-banks.

Further, the U.S. is by and large a realm of thirty-year fixed-rate mortgages (FRMs), meaning that low interest rates do not automatically translate into lower-cost mortgage loans as they do across Europe. Mortgage refinancing (refis) are widely available, but the process of taking one FRM and turning it into another remains cumbersome and, often, costly. Worse, refis are disproportionately available to more affluent white and Asian borrowers, with their Black and Hispanic counterparts far less likely to be able to obtain a refi[5] and often paying more[6] for one when they do.

Finally, there are unique attributes to the U.S. regulatory and capital regime that adversely affect affordable housing where solutions are less applicable in other nations. These include a punitive capital charge on mortgage servicing rights that accelerated the transformation of mortgage finance into a nonbank preserve. Relatively recent changes by U.S. regulators have reduced the MSR capital requirement,[7] but the very largest banks remain under the very toughest regulatory capital standards for mortgage-servicing assets and thus eschew the business for all but the loans – usually very large, "jumbo" ones – they retain on portfolio. The largest banks are also subject to annual stress tests that include conservative capital add-ons for reliance on private mortgage insurance (MI) and the risk that mortgages sold into the secondary market will be "put back" to the originating lender for failure to adhere to GSE or FHA underwriting requirements.[8] The limit on recognizing MI reduces bank willingness to portfolio the high loan-to-value (LTV) loans key to affordable housing or to return to loan origination because many banks remain wary of a significant cost that adversely affects competitiveness given the inapplicability of like-kind capital charges to nonbank originators.

U.S. Solutions with a Global Footprint

As this brief discussion demonstrates, one reason nonbanks are as significant in U.S. mortgage finance is regulatory asymmetry regarding capital, liquidity, and many other safety-and-soundness standards. These make banks more resilient than most nonbanks, and this is to some extent a reasonable result because banks have unique government-afforded privileges. However, this regulatory asymmetry has become problematic given that massive Fed rescues blurred the distinctions between banks and nonbanks and, regardless of this policy debate, it has a clear and adverse impact on the supply of affordable-housing finance.

In nations where banks essentially have a market lock, these competitive consequences are not a significant concern, but the inevitably increased cost associated with tough regulatory standards that adversely affect the cost of housing finance still has a direct and adverse affordable-housing impact. Thus, regulatory requirements that are disproportionate to real risk in mortgage finance on which equality depends warrant careful review.

There are in fact several ready fixes to the Basel framework which could quickly make a material difference increasing the supply of affordable financing around the world. In the balance of my time, I'll sketch several of these out for further discussion and, I hope, action.

First, one problem all nations share when it comes to home financing is the indisputable fact that lower-income households can prudently afford only lower-price housing. However, the cost of originating each home loan is largely fixed, as is the cost of loan servicing. As a result, low-balance loans are considerably less profitable than higher-balance loans, a problem that looms even larger when central banks set interests rates with low or even negative real returns that sharply compress the spread which a lender or servicer needs to gain a bit of net interest margin to compensate for operational and capital costs.

In the U.S., government agencies are working on ways to reduce the underwriting costs of low-balance loans, but this will only work within the confines of the government market. That's a start, but capital and other safety-and-soundness regulatory revisions could deepen this market and make it portfolio-possible.

Current capital rules now distinguish between portfolio loans – for which capital is considered on an asset-by-asset basis – and securitizations where capital benefits reflecting complex credit risk mitigation and portfolio diversification are reflected to at least some extent. A portfolio of low-balance loans converted into a single asset – i.e., what I call an internal securitization – should get the best of both capital charges by creating a single on-portfolio asset with lower risk-based capital reflecting the significant diversification benefit afforded by many small-balance loans in geographically-diverse markets.

Importantly, this structure retains the risk alignment of balance-sheet lending with the sophistication of securitization capital requirements. Further, ready action to increase affordable lending requires little to no operational build-out by banks already active in mortgage finance – they know how to originate and service loans as well as how to create asset-backed financial instruments. There's clearly a way here – what we need is will that can only be generated by a regulatory willingness to innovate in this equality, growth, and competitiveness arena.

Another regulatory capital fix with global implications is included in the capital rules recently finalized for the GSEs.[9] These do two equality-essential things not yet recognized by the Basel Committee or national bank regulators.

First, these rules differentiate mortgage risk-based capital by the purpose of the loan rather than, as is now generally the case, treating any loan secured by a one-to-four-family house with like-kind financial features as a loan with the same risk. As was learned the very hard way in the U.S., even loans considered "subprime" before 2008 had lower default rates than seemingly prime loans if the mortgage was one for home purchase, not for refinancing or for an investment or second-home property.[10] We also know that equity extraction is highly procyclical; regulatory capital should also reflect this with higher capital rates for cash-out refinancing and seemingly first-lien loans, not just for home equity lines of credit or other equity extraction tools.

Secondly, the GSE capital rules encourage credit-risk transfer in structures other than traditional securitizations. Reviewing covered bonds with these structures in mind and expanding secondary-market constructs more broadly could create additional affordable-housing capacity for both single- and multi-family finance. I have long been troubled by GSE credit-risk transfer structures dependent on first loss GSE tranches and the value of the implicit federal guarantee that deepens secondary markets for these instruments, but the absence of federal support for private-lender structures suggests considerable scope for innovation without undue risk as long as an additional concern – illiquidity under market stress – is also taken carefully into consideration for capital-reduction purposes.

One final option: reconsidering capital requirements for multi-family loans to provide capital incentives for condominium projects targeted at lower-income households. These loans have a different risk profile than rental housing because of occupant equity stakes, which are also essential to the wealth accumulation critical to long-term financial security. However, capital rules generally treat all multi-family projects the same based on developer characteristics, not ultimate purpose and dwelling sustainability.

Conclusion

If I had more time, I'd also discuss ways to create new mortgage products that could, for example, reflect the fact that lower-income families face impossible challenges accumulating mortgage down payments when savings results in inflation-adjusted loss of principal, as has been the case now for over a decade. Rent-to-own projects that convert apartments into condominiums are one approach to this dilemma, as are embedded down payments offered by lenders to align lender incentives with those of borrowers otherwise unable to afford a first home. Where government funds or private credit enhancement supplement these subsidized down payments, so much the better.

However, constructing products along these lines is complex and none has ever advanced far in the U.S. As a result, I've focused today on a few ways to make risk-based capital rules align far better with the real risk all of us face in each of our nations: the risks that economic inequality will continue to increase at grave cost not only to economic growth, but also financial stability. Recognizing these risks and drilling down to differentiate sound affordable-housing finance from higher-risk housing obligations is not credit allocation or social engineering causing risk to bank and financial stability. It's using analytical skills focused on equality and equity to identify targets of opportunity to make the rules work for an additional, essential objective: public welfare.

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[1] Federal Housing Finance Agency (FHFA) "FHFA Strategic Plan Fiscal Years 2022-2026", (April 14, 2022), https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_StrategicPlan_2022-2026_Final.pdf.
[2] Households and Nonprofit Organizations; One-to-Four-Family Residential Mortgages; Liability, Level, retrieved from FRED, Federal Reserve Bank of St. Louis, (accessed April 25, 2022), https://fred.stlouisfed.org/series/HMLBSHNO.

[3] Karan Kaul and Laurie Goodman, Improving the Safety and Soundness of Nonbank Mortgage Servicers Will Require More Than Prudential Regulation, Urban Institute, (December 2020) https://www.urban.org/research/publication/improving-safety-and-soundness-nonbank-mortgage-servicers-will-require-more-prudential-regulation.

[4] Karen Petrou, *Engine of Inequality: The Fed and the Future of Wealth in America,* (New Jersey: John Wiley & Sons, Inc, 2020). https://fedfin.com/engine-of-inequality/

[5] See for example Consumer Financial Protection Bureau (CFPB), "Data Point: 2020 Mortgage Market Activity and Trends", (August 2021), https://files.consumerfinance.gov/f/documents/cfpb_2020-mortgage-market-activity-trends_report_2021-08.pdf.

[6] See for example Michelle Aronowtiz, Edward Golding, and Jung Hyun Choi, *The Unequal Costs of Black Homeownership*, (Massachusetts Institute of Technology, October 1, 2020).

[7] Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Final Rule, "Regulatory Capital Rule: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996," *Federal Register* 84 no. 140, (July 22, 2019) https://www.govinfo.gov/content/pkg/FR-2019-07-22/pdf/2019-15131.pdf.

[8] Board of Governors of the Federal Reserve System, Final Rule, "Regulations Q, Y, and YY: Regulatory Capital, Capital Plan, and Stress Test Rules," *Federal Register* 85 no. 53, (March 18, 2020), https://www.govinfo.gov/content/pkg/FR-2020-03-18/pdf/2020-04838.pdf.

[9] Federal Housing Finance Agency, "Enterprise Regulatory Capital Framework– Prescribed Leverage Buffer Amount and Credit Risk Transfer," *Federal Register* 87 no. 51, (March 16, 2022), https://www.govinfo.gov/content/pkg/FR-2022-03-16/pdf/2022-04529.pdf.

[10] Karen Petrou, *Engine of Inequality: The Fed and the Future of Wealth in America,* (New Jersey: John Wiley & Sons, Inc, 2020). https://fedfin.com/engine-of-inequality/