



October 2014

HOUSING FINANCE SYSTEM

A Framework for Assessing Potential Changes

GAO Highlights

Highlights of [GAO-15-131](#), a report to congressional addressees

Why GAO Did This Study

Housing finance played a major role in the 2007-2009 financial crisis, and the housing sector continues to show considerable strains. The federal government's role in the single-family housing finance system has also grown substantially. As a result, policymakers and others have made proposals to change the system. To help policymakers assess various proposals and consider ways to make it more effective and efficient, this report (1) describes market developments since 2000 that have led to changes in the federal government's role in the single-family housing finance system; (2) analyzes whether and how these market developments have challenged the housing finance system; and (3) presents an evaluation framework for assessing potential changes to the system.

GAO reviewed literature on housing finance and housing market developments as well as prior GAO reports presenting frameworks for reform in the financial sector and criteria for improving government performance. GAO also met with officials from a number of federal agencies. Based on the literature review and interviews, GAO developed a draft framework that it shared with seven discussion groups composed of government officials, experts from academia and research organizations, and interested parties such as consumer advocates and industry representatives. The discussants provided input on market developments and the framework.

View [GAO-15-131](#). For more information, contact Matt Scire` at (202) 512-8678 or sciremj@gao.gov.

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What GAO Found

Developments in the single-family housing finance market from 2000-2013 led to changes in the federal government's role in the housing finance system and ultimately to a significant increase in that role. For example,

- Before the 2007-2009 financial crisis, the market share of nonprime mortgages—loans often made to borrowers with high-risk characteristics and funded by mortgage backed securities (MBS) issued by private institutions without a federal guarantee (private-label MBS)—grew but fell dramatically during the crisis.
- As this market segment grew the share of new mortgage originations (refinances and purchase loans) insured by federal entities—the Federal Housing Administration and the Departments of Veterans Affairs and Agriculture—fell from 11 percent in 2000 to less than 3 percent of the value of new originations in 2006 but, with the onset of the crisis, the market share of these mortgages rose as high as 25 percent before declining to 20 percent of the market in 2013.
- The market share of new mortgages backing MBS guaranteed by Fannie Mae and Freddie Mac (the enterprises) fell from 36 percent in 2000 to 27 percent in 2006 but stood at 61 percent in 2013.
- In 2008, when the enterprises' weakened financial condition led to their being placed into conservatorship, the federal government's support for them became explicit.
- In 2013 the federal government was providing support either directly or indirectly for 81 percent of the value of all new mortgages. In addition, during the crisis, the Federal Reserve System and the Department of the Treasury began purchasing MBS issued by the enterprises. The Federal Reserve System began reducing these purchases in January 2014, and Treasury completed the sale of its MBS investments in fiscal year 2012.

Developments in mortgage markets since 2000 have challenged the housing finance system and revealed or led to weaknesses in that system including misaligned incentives, an overall lack of reliable information or transparency, and excessive risk taking. For example

- Originators' and private-label securitizers' incentives were not aligned with those of borrowers and investors, because originators and private-label securitizers generally did not retain credit risk.
- Some borrowers lacked reliable and relevant information to adequately understand the risks of mortgage products because originators were not required to share certain information.
- A loosening of underwriting standards prior to the financial crisis likely led to excessive risk taking by borrowers.

Limitations in federal oversight of housing market participants exacerbated these weaknesses, though Congress has taken some steps designed to address these limitations. The Federal Housing Finance Agency and Bureau of Consumer Financial Protection (known as the Consumer Financial Protection Bureau) were

created to address regulatory gaps, including oversight of the enterprises and consumer protection. These agencies have taken steps designed to oversee the enterprises, protect consumers, and provide better information to the public. However, representatives of market participants said that they faced uncertainties because some regulations had not been implemented, and Congress was considering further changes to the system.

In light of the substantial increase in federal support of the single-family housing finance system and weaknesses revealed during and after the financial crisis, some experts believe the U.S. housing finance system warrants reform. In addition, GAO has identified the federal role in housing

finance as a high risk area. GAO is providing a framework to help assess proposed changes in the housing finance system. This framework is comprised of nine elements (see table), and certain characteristics—transparency, accountability, aligned incentives, and efficiency and effectiveness—need to be addressed throughout the elements. Applying the elements of this framework should help reveal the relative strengths and weaknesses of any proposal for change and identify what are likely to be significant trade-offs among competing goals and policies. Similarly, the framework could be used to craft new proposals. Finally, the framework should help policymakers understand the risks associated with transitioning to a new housing finance system.

Element	Description
Clearly defined and prioritized housing finance system goals	Broad goals for the housing finance system should be clearly articulated and relevant so that government and market participants can effectively conduct activities to implement their missions. Additionally, market and government performance can be assessed against those broad goals. These goals should recognize broader housing policy objectives, as well. Where trade-offs among the broad goals exist, the goals should be prioritized.
Policies and mechanisms that are aligned with goals and other economic policies	Housing finance policies and mechanisms should be aligned with the broader goals of housing finance. Changes in housing finance should consider the full range of options for government actions—such as direct participation in markets through government guarantees, oversight and regulation, data collection and dissemination, and tax or other federal incentives to promote greater private market participation—and show how policies and mechanisms interact to achieve the goals on a comprehensive basis, while minimizing fragmentation, overlap, and duplication. In light of weaknesses exposed during the financial crisis these policies and mechanisms should help to align incentives, provide more information and transparency, and restrain excessive risk-taking. Proposals should also reflect how these mechanisms will interact with broader economic policies.
Adherence to an appropriate financial regulatory framework	In 2009, GAO proposed a framework for a financial regulatory system that included some of the elements listed here as well as ensuring that regulation was appropriately comprehensive, consistent, flexible, adaptable, and had a systemwide focus (GAO-09-216). A regulatory system should also ensure that regulators have independence from inappropriate influence; have sufficient resources, clout, and authority to carry out and enforce statutory missions; and are clearly accountable for meeting regulatory goals.
Government entities that have capacity to manage risks	Government entities will need adequate skills and resources to understand, price, and manage risks. These entities would also need the capacity to ensure that their counterparties in the private sector have the capacity to manage the risks inherent in their activities.
Mortgage borrowers are protected and barriers to mortgage market access are addressed	Borrowers need consistent, useful information, as well as legal protections, including disclosures, sales practice standards, and suitability requirements, over the mortgage life cycle. Any barriers facing creditworthy borrowers in accessing mortgage markets should be addressed. Key issues will be to encourage innovation to reduce barriers while ensuring that products are easily understood, such as through standardization and developing better tools to assess creditworthiness.
Protection for mortgage securities investors	Investors in the secondary market require adequate, reliable information to assess secondary-market risks. This would include providing clear information on securitizer and trustee responsibilities as they relate to investors. As with borrower protection, some standardization may be useful; however, care must be taken to ensure that certain protections do not discourage beneficial innovation.
Consideration of cyclical nature of housing finance and impact of housing finance on financial stability	Housing finance has been characterized by cycles that have alternated between loose credit standards and those that are tight. Because housing is a significant part of the economy, these cycles may pose risks to financial and economic stability. Government should determine whether actions related to housing finance are procyclical or countercyclical and consider making actions less procyclical. Government may also want to consider the appropriateness of countercyclical measures. Actions also should address the threat housing finance poses for financial stability when there are incentives for excessive risk taking.
Recognition and control of fiscal exposure and mitigation of moral hazard	Choices about policies and mechanisms will result in different levels of fiscal exposure. Wherever possible, exposures should be made explicit and costs recognized. Actions should be taken to minimize unexpected costs and to mitigate any moral hazard created by government policies and support.
Emphasis on implications of the transition.	Because changing the housing finance system may lead to substantial changes in the marketplace, issues related to transitioning from the current system to a new one will should be emphasized in any proposal for change. Any action that would severely limit market liquidity during the transition should be of particular concern.

Source: GAO. | GAO-15-131

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Abbreviations

ABS	asset-backed securities
ARM	adjustable-rate mortgage
CDO	collateralized debt obligations
CFPB	Consumer Financial Protection Bureau
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
DOJ	Department of Justice
ECOA	Equal Credit Opportunity Act
enterprises	Fannie Mae and Freddie Mac
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FHLBank	Federal Home Loan Bank

FICO	Fair Isaac Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
GPRA	Government Performance and Results Act
HERA	Housing and Economic Recovery Act of 2008
HELOC	home equity line of credit
HOLC	Home Owners' Loan Corporation
HUD	Department of Housing and Urban Development
LTV	loan-to-value
MBS	mortgage-backed securities
OCC	Office of the Comptroller of the Currency
OFHEO	Office of Federal Housing Enterprise Oversight
OTS	Office of Thrift Supervision
QM	qualified mortgage
QRM	qualified residential mortgage
RESPA	Real Estate Settlement Procedures Act of 1974
RHS	Rural Housing Service
SEC	Securities and Exchange Commission
TBA	to-be-announced
TILA	Truth in Lending Act
Treasury	Department of the Treasury
USDA	U.S. Department of Agriculture
VA	Department of Veterans Affairs

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October 7, 2014

Congressional Addressees

Housing finance played a major role in the 2007-2009 financial crisis, and the housing sector, which is an important part of the overall U.S. economy, continues to show considerable strains.¹ In the years since the crisis began, mortgages supported by the federal government, directly or indirectly, have accounted for over three-quarters of the value of new originations in the single family housing market.² Mortgages receiving support included loans guaranteed or insured by the Federal Housing Administration (FHA) and the U.S. Departments of Veterans Affairs (VA) and Agriculture (USDA) and those securitized by Fannie Mae and Freddie Mac (the enterprises), which guarantee the timely payment of principal and interest on those mortgage-backed securities (MBS). The federal government also provides support for mortgages through Ginnie Mae, which guarantees the timely payment of principal and interest of MBS supported by pools of loans insured by FHA, VA, and USDA. Recognizing the large role played by the federal government in the housing finance market and continuing challenges that were not addressed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), we have placed the housing finance system on our high-risk list.³ In part, as a result of concerns about the government's role in housing finance, many proposals have been introduced, both in Congress and elsewhere, to change the single-family housing finance system.

¹In 2010, after a severe decline in home prices, primary residences still accounted for 29.5 percent of total family assets in the United States according to a Federal Reserve analysis of the 2010 Survey of Consumer Finances. At that time, 14.4 percent of American households also owned other residential real estate, such as second homes. The value of these assets contributes not only to the well-being of the individual family but also has an impact on consumption activity, which makes up about two-thirds of the U.S. Gross Domestic Product. In addition, residential construction contributed about 18 percent to the investment component of the Gross Domestic Product in 2012—a smaller percentage than prior to the financial crisis.

²Federal government-supported mortgages include the value of those insured or guaranteed by the full faith and credit of the United States and those mortgages that back mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac while they are in conservatorship.

³Pub. L. No. 111-203, 124 Stat. 1376 (2010); see GAO, *High-Risk Series: An Update*, [GAO-13-283](#) (Washington, D.C.: Feb. 14, 2013).

To help policymakers assess various proposals for changing the single-family housing finance system and consider ways in which the system could be made more effective and efficient, we prepared this report under the authority of the Comptroller General. Specifically, this report (1) describes market developments since 2000 that have led to changes in the federal government's role in single-family housing finance; (2) analyzes whether and how these market developments have challenged the housing finance system; and (3) presents an evaluation framework for assessing potential changes to the housing finance system.

To meet these objectives, we reviewed literature, including prior GAO reports, on housing finance and housing market developments, as well as prior GAO reports presenting frameworks for reform in the financial sector and reports that contain criteria for improving government performance. We also met with officials from the Bureau of Consumer Financial Protection known as the Consumer Financial Protection Bureau (CFPB), Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA), Board of Governors of the Federal Reserve System (Federal Reserve), Office of the Comptroller of the Currency (OCC), Securities and Exchange Commission (SEC), and Departments of Housing and Urban Development (HUD), Treasury (Treasury), USDA, and VA. Based on our literature review and meetings with officials, we developed a draft framework, which we shared with seven discussion groups to gather input on market developments and the framework. The groups were comprised of government officials, experts from academia and research organizations, and other relevant parties, such as consumer advocates and industry representatives. The experts and interested parties were chosen because they had made reform proposals, written or testified before Congress on housing finance reform issues, or been recommended by government officials. We also reviewed proposals for changing the housing finance system including legislative proposals and those made by groups that participated in our discussion groups. We used examples from these proposals to show how the framework elements can be used to assess potential changes. See appendix I for more information on the scope and methodology for this report.

We conducted this performance audit from August 2013 to October 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

The U.S. markets for single-family housing finance are complex and have numerous public and private participants. The housing finance markets include a primary market, in which lenders make loans to borrowers, and a secondary market, in which mortgage loans are purchased from lenders and packaged into securities that are sold to investors. Thus, a single mortgage is often owned or held by many different parties before the mortgage terminates. Figure 1 provides an overview of the lifecycle of a mortgage. The federal government participates in the primary and secondary mortgage markets as both an actor and a regulator, to promote home ownership and stabilize housing markets.⁴ The federal government also regulates certain aspects of mortgage servicing.

⁴The federal government's roles in housing finance markets have changed substantially over time. For more detail on these developments, see appendix II.

Interactive graphic

Figure 1: Mortgage Lifecycle

Directions: [Click on any of the boxes below for more detail on each of the phases of a mortgage.](#)

Source. GAO. | GAO-15-131

The Primary Mortgage Market Connects Borrowers and Lenders

When individuals purchase residential real property with borrowed funds, they usually enter into a contractual agreement, typically called a promissory note, in which they agree, among other things, to make principal and interest payments to the originating lender for a period of time. To secure their debt, lenders obtain a lien on the underlying property as collateral against borrower default, which grants the holder of the lien the right to seize, and usually sell, the property should the borrower fail to pay.⁵ In other words, what may be commonly referred to as a mortgage consists of both a promissory note evidencing the debt to be paid by the borrower and the lien or security interest in the underlying property, which generally is provided for in a deed of trust or a mortgage document. Equity is a homeowner's financial interest in a property, or the difference between the value of a property and the amount owed on the mortgage. Borrowers may make an initial down payment as a means of building equity. Home equity can increase over time if the mortgage balance is paid down or the value of the home appreciates. Borrowers who owe more on their mortgages than their properties are worth (negative equity) are commonly referred to as "underwater."

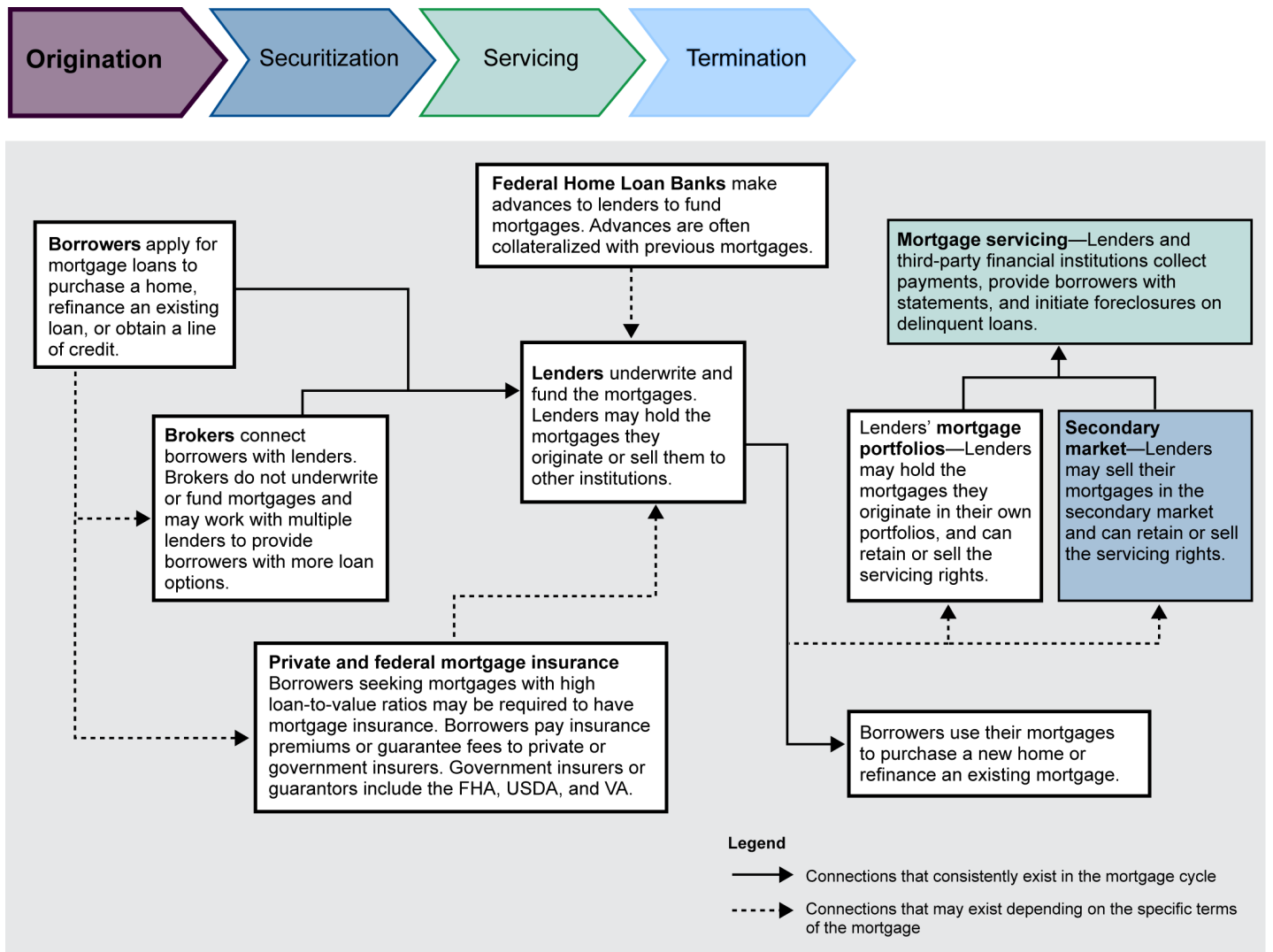
In the primary market, lenders originate mortgages for borrowers to purchase homes, refinance existing mortgages, or to extend loans or lines of credit to borrowers based on the amount of equity the borrower has accumulated (called home equity loans or home equity lines of credit, known as HELOCs).⁶ Mortgages vary in terms of the interest rates charged and terms of the loan. Prime mortgages have the most competitive interest rates and terms and have generally been reserved for borrowers with strong credit histories and the ability to make required down payments. Nonprime mortgages include subprime and Alt-A loans,

⁵Some mortgage contracts may also provide the owner of the mortgage with recourse to collect any remaining debt if the value of a foreclosed property is less than the amount owed by a delinquent borrower. The ability of a lender to pursue a deficiency judgment may depend on state law.

⁶These are all types of forward mortgages, which are mortgages where loan payments made to the lender generally add to the borrower's home equity and decrease the loan balance. (Some types of forward mortgages, such as interest-only loans, allow borrowers to defer principal payments during some periods of the mortgage's term, and a borrower's equity would not increase during these periods). A reverse mortgage is a loan that converts the borrower's home equity into payments from a lender, and the loan balance increases as the home equity decreases over time. Reverse mortgages are available to homeowners aged 62 and older and typically do not require any repayments as long as the borrower continues to live in the home and continues to make all property tax and insurance payments associated with the home.

which have higher interest rates and fees than prime loans. Historically, subprime mortgages have been offered to borrowers who do not qualify for a prime loan, while Alt-A loans have been offered to borrowers who have some higher-risk characteristics, such as limited documentation of income or assets. However, prior to the financial crisis some borrowers who qualified for prime mortgages also were steered toward nonprime loans. Borrowers may be eligible for federally insured or guaranteed mortgages, which have interest rates that are similar to those of prime loans, but require borrowers to pay insurance premiums (FHA) or guaranty fees (USDA and VA). Some borrowers who do not qualify for prime loans, such as those unable to meet down payment or credit history requirements, may qualify for these loans. The most common mortgage length is 30 years, but mortgages can have shorter or longer terms in some cases. Borrowers with equity in their homes can refinance their mortgages (pay off the current loan early by taking out a new mortgage loan) in order to lower their interest rate, change the length of their mortgage, or get more favorable terms. However, some lenders charge a prepayment penalty if a mortgage is paid off early. If the equity in the home has increased since the loan was originated, homeowners may be able to take out a loan larger than the principal balance, sometimes called a cash-out refinance mortgage. Figure 2 provides additional information about mortgage originations.

Figure 2: Mortgage Origination



Source: GAO. | GAO-15-131

Mortgage originators offer a range of loan products to borrowers in the primary market, but most mortgages fall into one of two categories:

- Fixed-rate mortgage loan—the interest rate does not change over the life of the loan. Fixed-rate loans generally have fully amortizing payment schedules, where equal monthly payments pay off the full principal balance over the term of the loan.

-
- Adjustable-rate mortgage loan (ARM)—the interest rate changes periodically over the life of the loan based on changes in a specified index. Initial interest rates are generally lower on these mortgages than for fixed-rate loans but can rise or fall over the course of the term. Typically, an ARM's interest rate will adjust at agreed-upon intervals, adjustments to the interest rate will be based on a specific index rate, and the adjusted rate will fall within a maximum and minimum range. Prior to the financial crisis, the nonprime market began to offer a number of nontraditional products with adjustable rates that had previously been available only in the prime market. For example, the interest rates on hybrid ARM loans are fixed during an initial period and then become adjustable for the remaining term of the loan. Another type of loan, payment-option ARM loans, allowed borrowers to defer payment of the principal or the accrued interest, meaning that the balance of the loan could increase over time.

Mortgages create a number of risks for market participants including:

- Credit risk is the risk that a borrower will default on the mortgage by failing to make timely payments. Credit risk can vary based on borrower characteristics and the terms of the mortgage. For example, the lower the down payment made by a borrower relative to the value of the house, the higher the credit risk associated with the loan.
- Interest-rate risk is the risk that an increase in interest rates will reduce the value of a loan. For example, if a mortgage lender is funded by short-term deposits, and interest rates rise, the cost of the lender's funds increase. If the lender had previously made a long-term fixed-rate mortgage at a lower rate, the difference between the interest the lender receives from the mortgage payments and the interest the lender pays its depositors decreases. Fixed-rate loans have greater interest rate risk for lenders than ARMs.
- Prepayment risk is the risk that mortgage borrowers will pay off the principal of the loan before the term of the mortgage ends. Prepayment of some or all of the principal balance reduces or eliminates future interest payments, and requires lenders to relend or reinvest the principal that was prepaid. Prepayment may be a result of borrowers refinancing when interest rates decrease, and in these cases, the lender may have only lower-interest options for lending or investing the funds.

Mortgage lenders evaluate the creditworthiness of potential borrowers (called underwriting), and make mortgage loans using funds raised from

deposits, securitization, and other sources. Borrowers generally access mortgage lenders through three major channels—mortgage brokers, loan correspondents, and retail lenders.⁷ Lenders, such as credit unions, banks, and thrifts, can fund their mortgages with deposits, but also may receive funding from the secondary market, discussed in greater detail later in this report, and the Federal Home Loan Bank (FHLBank) System. The FHLBank System is a government-sponsored enterprise that consists of 12 FHLBanks and the Office of Finance, the FHLBanks' fiscal agent. Each FHLBank is cooperatively owned by member financial institutions, typically commercial banks and thrifts. The FHLBanks borrow funds by issuing debt securities in capital markets and provide low-cost, long- and short-term advances (loans) to member institutions, which use the loans to fund mortgages and maintain liquidity for their operations. Member institutions provide the FHLBanks with mortgages or other qualifying loans and securities, as collateral for the advances. If a member institution fails, the FHLBank generally gets repaid before many other creditors; depending on the agreement, the FHLBank may be able to draw on the majority of the financial institution's assets in addition to the collateral provided for the advances for repayment.

Private financial institutions and the federal government facilitate mortgage lending by insuring mortgages that meet certain criteria against default or guaranteeing lenders payment of principal and interest.⁸ Generally, lenders require borrowers to purchase private mortgage insurance when the initial loan-to-value (LTV) ratio of the mortgage (the amount of the mortgage loan divided by the value of the home) exceeds 80 percent. The enterprises require that loans they purchase with LTV ratios in excess of 80 percent have a credit enhancement mechanism, such as private mortgage insurance. Generally, loans with higher LTV ratios have a greater risk of default and may experience greater loss severity in the event of a default.⁹ FHA operates the largest federal

⁷Mortgage brokers are independent contractors that originate loans for multiple lenders. Mortgage brokers are funded through fees paid by borrowers and originators. Loan correspondents are generally smaller lenders that underwrite and originate loans, but immediately sell them to other lenders. Retail lenders, such as credit unions, banks, and thrifts, underwrite and originate loans directly.

⁸Programs offered by different federal agencies are described in some cases as mortgage insurance and in others as mortgage guarantees, but these programs operate in fundamentally similar ways.

⁹Generally, loss severity is the loss amount, which is the loan balance less net liquidation proceeds, as a ratio of the original loan balance.

mortgage insurance program, which is backed by the full faith and credit of the federal government. FHA insures the full value of mortgages made by private lenders for borrowers making down payments of at least 3.5 percent.¹⁰ The purpose of FHA's mortgage insurance is to encourage lenders to make mortgages available to borrowers, including those who would not otherwise qualify, such as low-income and first-time homebuyers. Congress has set limits on the size of loans eligible for FHA insurance, and these limits have varied over time. For example, when the recent financial crisis and economic recession set in and other segments of the mortgage market contracted, Congress increased the loan amounts eligible for FHA insurance. In 2014, FHA's mortgage limits for single-family houses ranged from the national standard of \$271,050, to \$625,500 for other higher cost areas, and to \$938,250 for certain areas outside of the 48 contiguous states such as Alaska, Hawaii, and Guam. Borrowers pay up-front and ongoing insurance premiums that go to FHA's Mutual Mortgage Insurance Fund to cover the estimated long-term costs of the program. In fiscal year 2013, FHA reported that it insured more than 1.3 million new mortgages representing approximately \$240 billion in mortgage insurance coverage on forward mortgages. This brought the total loans insured to more than 7.8 million, and FHA reported that its total amortized insurance-in-force on mortgages at the end of fiscal year 2013 was \$1.09 trillion.¹¹

The federal government also administers two other mortgage insurance programs, through VA and USDA. The VA Home Loan Guaranty program provides financial incentives for private lenders to offer eligible servicemembers and veterans of the U.S. armed forces mortgages with certain favorable terms, such as not requiring a down payment or private mortgage insurance. Depending on the size of the loan, VA guarantees between 25 and 50 percent of the mortgage loan in the event that a borrower defaults, providing lenders with protection against some of the losses that may be associated with making these loans.¹² Most veterans

¹⁰FHA pays claims to reimburse mortgage servicers for their interest expenses, the lost principal on outstanding mortgage balances, and maintenance costs. For more information see [GAO-02-305](#).

¹¹Amortized insurance-in-force is the remaining principal balance on all insured loans outstanding. This represents FHA's potential risk because FHA's insurance covers 100 percent of the loan balance.

¹²Loan amounts lower than \$144,000 carry a higher percentage of guaranty than do loans above this threshold.

receiving guaranteed loans pay a funding fee of up to 3.3 percent of the loan amount, but the program also receives funding through federal appropriations.¹³ As of September 30, 2013, the outstanding principal of VA's guaranteed loans was \$339 billion, but VA had only guaranteed \$89 billion of that amount. USDA administers the Section 502 Guaranteed Rural Housing Loan Program, which is designed to serve rural residents who have low or moderate incomes and are able to afford mortgage payments but are unable to obtain adequate housing through conventional financing, by guaranteeing loans made by commercial lenders. In 2013, the principal of new loans supported by USDA guarantees was \$22.3 billion and the outstanding principal of all guaranteed loans was \$89.7 billion.¹⁴

Borrowers can also take advantage of tax exclusions and deductions (including the mortgage interest deduction) to facilitate the purchase of a home. Because of the total dollar amounts provided, these tax expenditures represent a major element of the federal government's role in the markets for housing finance. The most significant of these tax expenditures is the deduction for mortgage interest, through which taxpayers who itemize deductions may deduct the interest they pay on loans secured by qualified homes—either their primary residence or their primary residence and a second home.¹⁵ Generally, taxable income may be reduced by the amount of interest paid on first and second mortgages of up to \$1 million, plus home equity indebtedness of up to \$100,000.¹⁶

¹³Exemptions to the funding fee are granted for certain veterans and service members receiving, or eligible to receive, VA disability compensation, and for certain surviving spouses.

¹⁴USDA's guarantee provides coverage for eligible losses of up to 90 percent of the original principal, including unpaid principal and interest; principal and interest on USDA-approved advances for protection and preservation of the property; and the costs associated with selling the foreclosed property. USDA and VA also make direct mortgage loans, though the total amount of loans made under these programs is far lower than the amount of loans that are guaranteed.

¹⁵Boats and recreational vehicles may qualify as homes if they have sleeping, cooking, and toilet facilities.

¹⁶Taxpayers may deduct all of the interest paid on acquisition debt incurred on or before October 13, 1987, known as grandfathered debt.

The mortgage interest deduction has been estimated to result in \$67.8 billion in forgone tax revenue in 2014.¹⁷

The federal government has established regulatory standards, which are enforced by federal regulators, for mortgage lending in the primary market. CFPB and the federal banking regulators are involved in the examination and enforcement of these regulatory requirements.¹⁸

Significant examples of federal statutes in the mortgage market include:

- The Truth in Lending Act (TILA), which was designed to provide consumers with accurate information about the cost of credit.¹⁹ Among other things, TILA requires lenders to disclose information about the terms of loans—including the amount financed, the finance charge, and the annual percentage rate—that can help borrowers understand the overall costs of their loans. The Dodd-Frank Act reformed mortgage lending by amending TILA to include, among other things, provisions affecting (i) underwriting (for example, the ability of borrowers to repay their loans); (ii) servicing; (iii) loan originator compensation; and (iv) escrows and appraisals.²⁰
- The Real Estate Settlement Procedures Act of 1974 (RESPA), which was enacted to provide more effective advance disclosure regarding mortgage loan settlement costs to homebuyers and sellers, requires lenders to provide consumers with certain disclosures during the mortgage application and closing transaction.²¹ These disclosures previously included a Good Faith Estimate form given within three days after a mortgage application is received and a uniform settlement statement given at the loan closing. Regulations

¹⁷The Joint Committee on Taxation has estimated that in 2014, tax expenditures for the deduction of property taxes and the exclusion of capital gains on sales of primary residences will result in \$31.9 billion and \$24.1 billion, respectively, in forgone revenue.

¹⁸The federal banking regulators are the Federal Reserve, FDIC, National Credit Union Administration, and OCC.

¹⁹Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. §§ 1601-1667f).

²⁰Pub. L. No. 111-203, §§ 1403-1433, 1461-1475, 124 Stat. 1376, 2139-63, 2178-2200 (2010).

²¹Pub. L. No. 93-533, 88 Stat. 1724 (codified at 12 U.S.C. §§ 2601-2617; 12 U.S.C. § 1831b).

implementing RESPA were revised in 2008.²² The Dodd-Frank Act also made significant changes to RESPA, including transferring rulemaking authority for RESPA from HUD to CFPB and requiring CFPB to issue rules to integrate the disclosures required by TILA and RESPA.²³

The Secondary Market Provides Liquidity and Reduces Risk for Mortgage Lenders

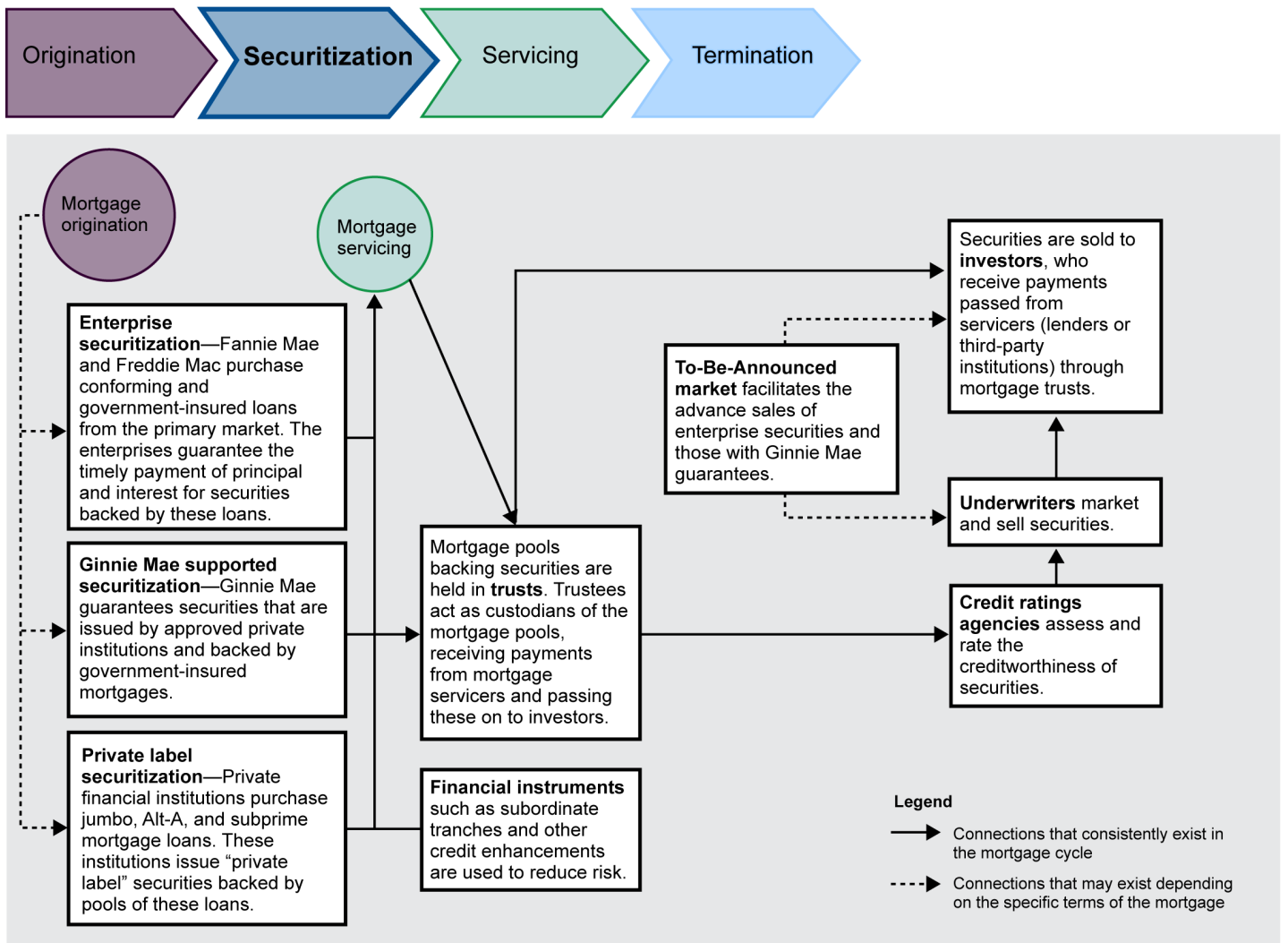
In the secondary market, institutions purchase loans from primary market originators and then either hold the loans in their own portfolios or bundle the loans into MBS that are sold to investors. Mortgage originators may sell their loans to transfer risk (especially interest rate risk in the case of fixed-rate mortgages) or to increase liquidity. When loans are sold, they are generally packaged together into pools and held in trusts pursuant to terms and conditions set out in an underlying pooling and servicing agreement. Pools of loans are the assets backing securities that are issued and sold to investors, who are entitled to the cash flow generated by loans in the trust. The terms of the contracts defining the rights associated with MBS typically include representations and warranties about the mortgage loans that have been securitized.²⁴ The investors assume the interest rate, prepayment, and credit risk associated with the loans (to the extent that credit losses are not covered by mortgage insurance or guarantees of MBS). The enterprises are the two largest participants in the secondary market. Other participants include Ginnie Mae (a federal agency within HUD that guarantees the timely payment of principal and interest on MBS backed by government-insured mortgages), issuers of Ginnie Mae-backed MBS, issuers of private label MBS, and investors. (Fig. 3 provides an overview of mortgage securitization in the secondary mortgage market.)

²²See Real Estate Settlement Procedures Act (RESPA): Rule To Simplify and Improve the Process of Obtaining Mortgages and Reduce Consumer Settlement Costs, 73 Fed. Reg. 68204 (Nov. 17, 2008).

²³The CFPB issued those rules in November 2013. See Integrated Mortgage Disclosures Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z); Final Rule, 78 Fed. Reg. 79730 (Dec. 31, 2013).

²⁴Representations and warranties typically include statements that each of the loans bundled into the security has met all applicable federal, state, and local laws, including laws regarding truth-in-lending, consumer credit protection, required disclosures, and predatory and abusive practices. If a loan is found to violate the representations and warranties, it must be repurchased by the seller, according to the terms of the contract between the seller and the securitizing entity.

Figure 3: Mortgage Securitization



Source: GAO. | GAO-15-131

The enterprises are congressionally chartered, for-profit, shareholder-owned companies that have been under federal conservatorship since 2008.²⁵ Generally the enterprises purchase mortgage loans that meet certain criteria for size, features, and underwriting standards known as

²⁵On September 6, 2008, FHFA placed the enterprises into conservatorship, due to a substantial deterioration in the enterprises’ financial condition.

“conforming” loans.²⁶ However, prior to the crisis, the enterprises purchased a large volume of loans that did not meet these standards. After purchasing mortgages, the enterprises create MBS and guarantee investors in these securities that they will receive timely payments of principal and interest. These bonds have generally paid a lower rate of interest than corporate bonds that posed comparable risks, in part, because investors generally believed that these bonds had an implicit guarantee by the federal government. Prior to being placed into conservatorship in 2008, the enterprises raised capital through the issuance of common and preferred stock. In conjunction with the conservatorships, Treasury entered into agreements to provide capital support to the enterprises to enable them to continue to provide liquidity and stability to the mortgage market. As of March 31, 2014, Treasury had outlays of \$187.5 billion to the enterprises through purchases of senior preferred stock. Through its Senior Preferred Stock Purchase Agreements, Treasury collects dividend payments from the enterprises, which have reported paying \$202.9 billion in dividend payments from 2008 through March 31, 2014.²⁷

Private institutions are also involved in the creation of MBS. These institutions, primarily investment banks, purchase mortgages that do not conform to the enterprises’ purchase requirements because the mortgages are too large or do not meet specified underwriting criteria, and loans that are federally insured. Securities issued by these institutions that are backed by loans that do not meet the enterprises’ loan limits or quality standards are called “private-label securities.” Such loans may include subprime and Alt-A mortgages. Other securities issued by approved private financial institutions are backed by government-guaranteed mortgages, such as those insured by FHA, and Ginnie Mae guarantees the timely payment of principal and interest of these MBS.

²⁶The enterprises’ conforming loan limits for single-family homes in 2014 ranged between \$417,000 in the contiguous United States, District of Columbia, and Puerto Rico to \$625,000 in areas outside of the contiguous states, and up to \$938,000 in high-cost areas outside of the contiguous United States. Mortgages that are larger than the conforming loan limit are known as “jumbo loans.”

²⁷ The Senior Preferred Stock Purchase Agreements that Treasury entered into with the enterprises initially entitled Treasury to 10 percent dividend payments on its senior preferred stock investments. The agreements were subsequently amended, and since January 2013, the enterprises’ required dividend payments are equal to their positive net worth, if any, above required capital levels.

Ginnie Mae's guarantee is explicitly backed by the full faith and credit of the federal government.

MBS issued by the enterprises or guaranteed by Ginnie Mae trade in different segments of the secondary market from private-label securities. MBS issued by the enterprises or guaranteed by Ginnie Mae are typically purchased by investors through the to-be-announced (TBA) market. A TBA trade is a forward contract in which the specific mortgages in the MBS that are being purchased are not known until 2 days before the trade is settled.²⁸ TBA trades allow the enterprises and issuers of Ginnie Mae guaranteed securities to provide lenders with the sale price at which they will purchase conforming and government guaranteed loans, prior to the mortgages being originated. This allows mortgage lenders essentially to sell the loans they intend to fund even before the loans are closed. In turn this allows lenders to lock in the mortgage rate for the borrower before the loan is finalized. Private-label MBS are traded in the "specified pool" segment of the secondary market, where the exact securities to be delivered are known at the inception of the trade. Investors in MBS include financial institutions, pension funds, and other institutional investors, such as insurance companies and managers of other complex structured finance products known as collateralized debt obligations (CDO), which consist of MBS and other securities.

The federal government regulates the enterprises and private issuers of MBS are subject to federal securities laws and regulations. FHFA was created by the Housing and Economic Recovery Act of 2008 (HERA) to supervise and regulate the enterprises and the FHLBank System.²⁹ FHFA is an independent agency that took over the oversight of the enterprises from the Office of Federal Housing Enterprise Oversight, formerly an independent entity within HUD.³⁰ FHFA has a statutory responsibility to

²⁸In a forward contract, the security and cash payment for the security may not be exchanged until after the date on which the terms of the trade are contractually agreed upon. On the TBA trade date, six criteria of the securities are agreed upon: issuer, maturity, coupon, face value, price, and the settlement date. However, the particular securities to be delivered to the buyer are not specified on the trade date.

²⁹Pub. L. No. 110-289, § 1101, 122 Stat. 2654, 2661 (codified at 12 U.S.C. § 4511).

³⁰Pub. L. No. 110-289, § 1301, 122 Stat. 2654, 2794 (codified at 12 U.S.C. § 4511 note). The Office of Federal Housing Enterprise Oversight was created by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub. L. No. 102-550, tit. XIII, § 1311, 106 Stat. 3941, 3944 (codified at 12 U.S.C. § 4511).

ensure that the enterprises operate in a safe and sound manner and that the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets. FHFA is managing the conservatorship of the enterprises. FHFA also took over the responsibilities of the Federal Housing Finance Board that oversaw the FHLBanks. Private issuers of MBS must either file a registration statement that meets SEC's disclosure requirements or rely on an exemption from registration. Securities issued by the enterprises or guaranteed by Ginnie Mae are exempt from these registration requirements. Ginnie Mae has processes in place to oversee issuers of securities eligible for Ginnie Mae guarantees that include approval, monitoring, and enforcement. The Dodd-Frank Act also created new requirements for issuers of MBS related to conflicts of interest, credit risk retention, disclosures and reporting, reviews of underlying assets, and representations and warranties. SEC has proposed or finalized rules addressing these areas, jointly with other agencies when directed by the act.³¹

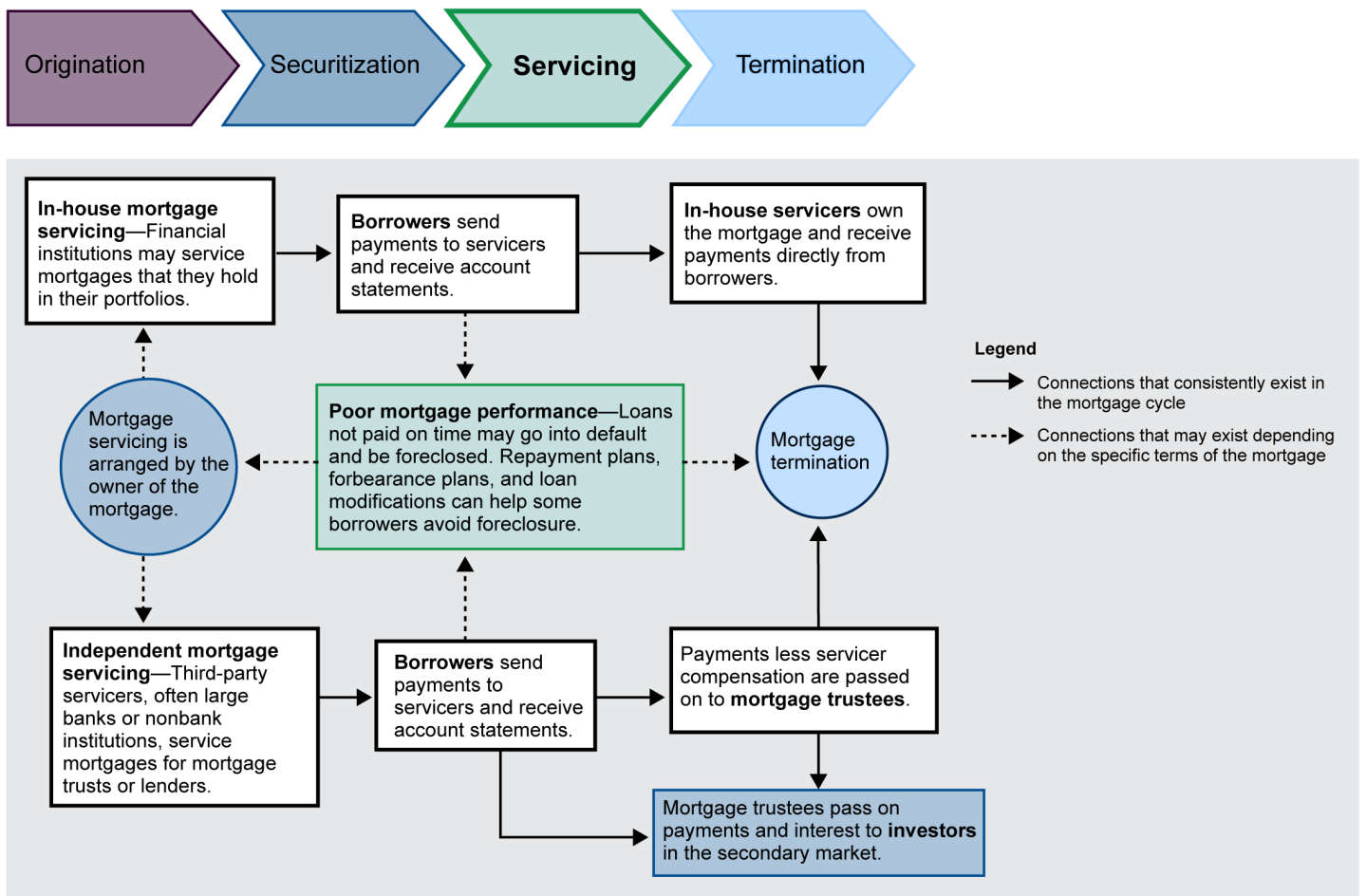
Mortgage Servicers Manage Loans After Origination

After they are originated, mortgages are serviced until they are either paid in full or closed as a result of nonpayment. Servicing can involve sending borrowers monthly account statements and tax documents, answering customer service inquiries, collecting monthly mortgage payments, maintaining escrow accounts for property taxes and hazard insurance, and forwarding proper payments to the mortgage owners. Figure 4

³¹SEC finalized rules regarding representations and warranties in asset-backed securities offerings in January 2011. Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 4489 (Jan. 26, 2011). That same month, the agency finalized rules regarding underlying asset review. Issuer Review of Assets in Offerings of Asset-Backed Securities, 76 Fed. Reg. 4231 (Jan. 25, 2011). In August 2014, SEC adopted amendments to existing rules and finalized new rules that apply to credit rating agencies. See Nationally Recognized Statistical Rating Organizations, 79 Fed. Reg. 55078 (Sept. 15, 2014) (to be codified at 17 C.F.R. pts. 232, 240, 249, and 249b). . In September 2014, SEC finalized rules regarding the offering process, disclosure, and reporting for asset-backed securities. See Asset-Backed Securities Disclosure and Registration, 79 Fed. Reg. 57184 (Sept. 24, 2014) (to be codified at 17 C.F.R. pts. 229, 230, 232, 239, 240, 243, and 249). Rules regarding risk retention by securitizers of asset-backed securities (ABS) and conflicts of interest between those who package and sell ABS and those who invest in ABS have also been proposed. See Credit Risk Retention; Proposed Rule, 78 Fed. Reg. 57928 (Sept. 20, 2013); Prohibition Against Conflicts of Interest in Certain Securitizations; Proposed Rule, 76 Fed. Reg. 60320 (Sept. 28, 2011). The credit risk retention rule was proposed jointly by SEC, Federal Reserve, FDIC, FHFA, HUD, and OCC.

provides an overview of the mortgage servicing process. In the event that a borrower becomes delinquent on their loan payments, servicers may initiate a workout option to allow the borrower to stay in the home or conduct a foreclosure to obtain the proceeds from the foreclosure sale on behalf of the owners of the loans. In some cases, the servicer is the same institution that originated the loan. However, servicers may change over the life of the mortgage, as servicers sell servicing rights to other institutions. Third-party mortgage servicers, which can be mortgage finance companies or commercial banks that are also originators, earn a fee for acting as the servicing agent on behalf of the owner of a loan. If a mortgage originator sells its loans to an institution that will securitize them, another financial institution or other entity is usually appointed as the servicer to manage payment collections and other activities associated with these loans.

Figure 4: Mortgage Servicing



Source: GAO. | GAO-15-131

The duties of servicers are specified through several means. The enterprises specify in servicing guidelines what they expect of servicers for loans backing their MBS. Also, servicing requirements for some government-backed loans are specified by the federal agencies backing the mortgages. Finally, as part of private-label securitizations, investors and servicers enter into pooling and servicing agreements that specify what investors expect of servicers. These pooling and servicing agreements can vary widely, but may mirror the servicing guidelines issued by the enterprises. However, there is no standard pooling and servicing agreement that is used for all private-label MBS. CFPB, which was created by the Dodd-Frank Act, has primary enforcement authority to assess compliance with mortgage servicing rules under TILA and RESPA with regard to large depository institutions and credit unions and their

affiliates. FDIC, the Federal Reserve, National Credit Union Administration, and OCC are responsible for enforcing the mortgage servicing rules under TILA with respect to depository institutions and credit unions that have \$10 billion or less in assets. The Federal Trade Commission and CFPB generally both have enforcement authority over nondepository institutions for mortgage servicing rules under TILA.

Mortgages Terminate When They Are Paid in Full or After They Go into Default

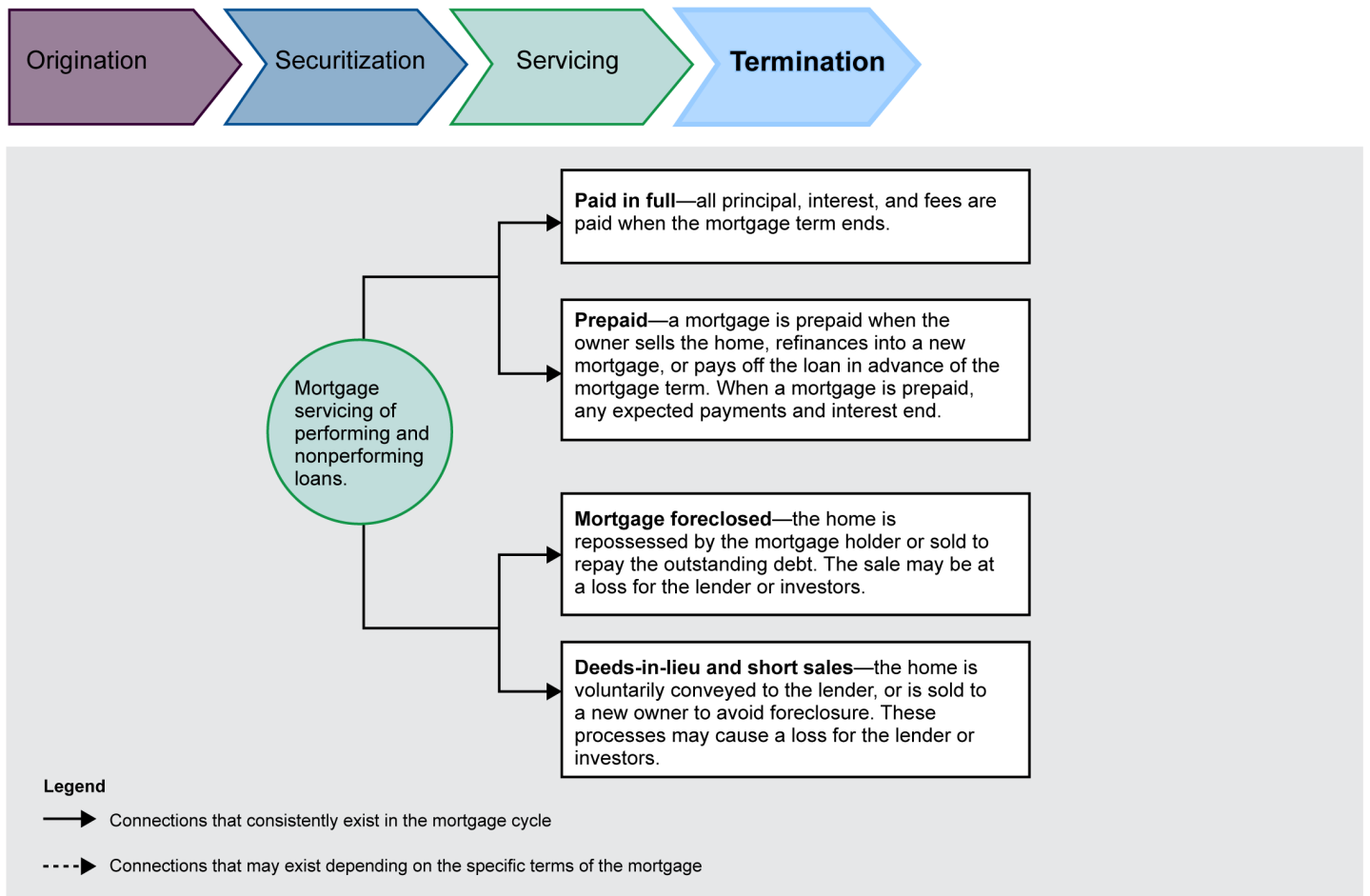
Generally, mortgages terminate when borrowers pay off their mortgage debt or after borrowers default on their loans (see fig. 5). Borrowers can pay off the mortgage debt by making payments of principal and interest or by refinancing the mortgage for a new loan, usually with lower interest rates. Generally, if a borrower fails to make a payment for 90 days, mortgage loans go into default. When a borrower defaults on a mortgage loan, the mortgage note holder is entitled to pursue foreclosure for the property, obtain title to the property, and sell it on behalf of the mortgage owner to repay the loan. However, under CFPB rules issued in 2013, servicers, with limited exceptions, cannot initiate a foreclosure until a borrower is more than 120 days delinquent.³² Once the borrower is in default, the servicer must decide whether to pursue a home retention workout or other foreclosure alternative or to initiate foreclosure.³³ Home retention workouts include loan modifications, through which temporary or permanent changes are made to the terms of the existing loan agreement, either by capitalizing the past due amounts, reducing the interest rate, extending the loan term, reducing the total amount of the loan through principal forgiveness or forbearance, or a combination of these actions. Foreclosure alternatives include short sales, in which a house is sold through a real estate agent or other means rather than through foreclosure, even if the proceeds of the sale are less than what the borrower still owes on the mortgage. Mortgage holders may agree to accept the proceeds of a short sale and may waive any deficiency. Under a deed-in-lieu of foreclosure, the homeowner voluntarily conveys the interest in the home to the lender to satisfy a loan that is in default as an

³²CFPB mortgage servicing rules now require that a servicer may not make the first notice or filing required by applicable law until the borrower is more than 120 days delinquent if the loan is a closed-end mortgage secured by the borrower's principal residence. See 12 C.F.R. § 1024.41(f)(1).

³³CFPB's mortgage servicing rules also prohibit servicers from filing for foreclosure while a borrower's complete loss mitigation application is being evaluated. 12 C.F.R. § 1024.41(f)(2).

alternative to foreclosure proceedings. Mortgage holders may opt to accept ownership of the property in place of the money owed on the mortgage and may waive any deficiency. Deeds-in-lieu will generally not be accepted by a mortgage holder if there are other liens on the property, as foreclosure may be necessary for the mortgage holder to gain clear title.

Figure 5: Circumstances under Which Mortgages Terminate



Source: GAO. | GAO-15-131

Market Developments since 2000 Have Changed the Government's Role in Housing Finance

Since 2000, home prices have fluctuated dramatically, in part reflecting developments in the underlying housing finance market such as the growth of nonprime mortgages. These developments led to changes in the government's role throughout the period and ultimately to a significant increase in that role. In 2000, the federal government directly supported about \$118 billion (11 percent) of the estimated value of new mortgage originations for home purchase and mortgage refinancing through government-insured or -guaranteed loans in the primary market.³⁴ In that same year, the enterprises supported about \$376 billion (36 percent), of the estimated value of new mortgage originations through their guarantees on MBS they issued. These roles declined in the years just prior to the 2007-2009 financial crisis when government-insured or -guaranteed mortgages made up about 3 percent of the market and those supporting enterprise MBS about 27 percent. During the crisis, the government's role in supporting mortgage originations expanded and has remained relatively high. The share of the primary market insured or guaranteed by the federal government grew and the share of mortgages backing MBS securitized by the enterprises also grew, reaching highs in 2009 of about 25 and 67 percent, respectively. As mentioned earlier in this report, the federal government also placed the enterprises into conservatorship in 2008. As a result, by 2009, mortgages supported by the federal government, directly or indirectly, reached a peak of about \$1.7 trillion (93 percent) of the total value of new originations. By 2013, the market share of those mortgages supported by the federal government had dropped to 81 percent—about 20 percent guaranteed or insured directly by the government and about 61 percent backing enterprise MBS. However, the percentage of loans supported by the federal government was still well above the 47 percent of the value of new mortgage originations supported by government-guaranteed or -insured loans and those backing enterprise MBS in 2000. In addition, in response to the financial crisis, the Federal Reserve has provided additional support for the mortgage market by becoming one of the largest purchasers of enterprise MBS.

³⁴This calculation includes the value of new mortgages insured or backed by FHA or VA. Ginnie Mae securities were not included in this calculation because they pool government-insured or -guaranteed mortgages.

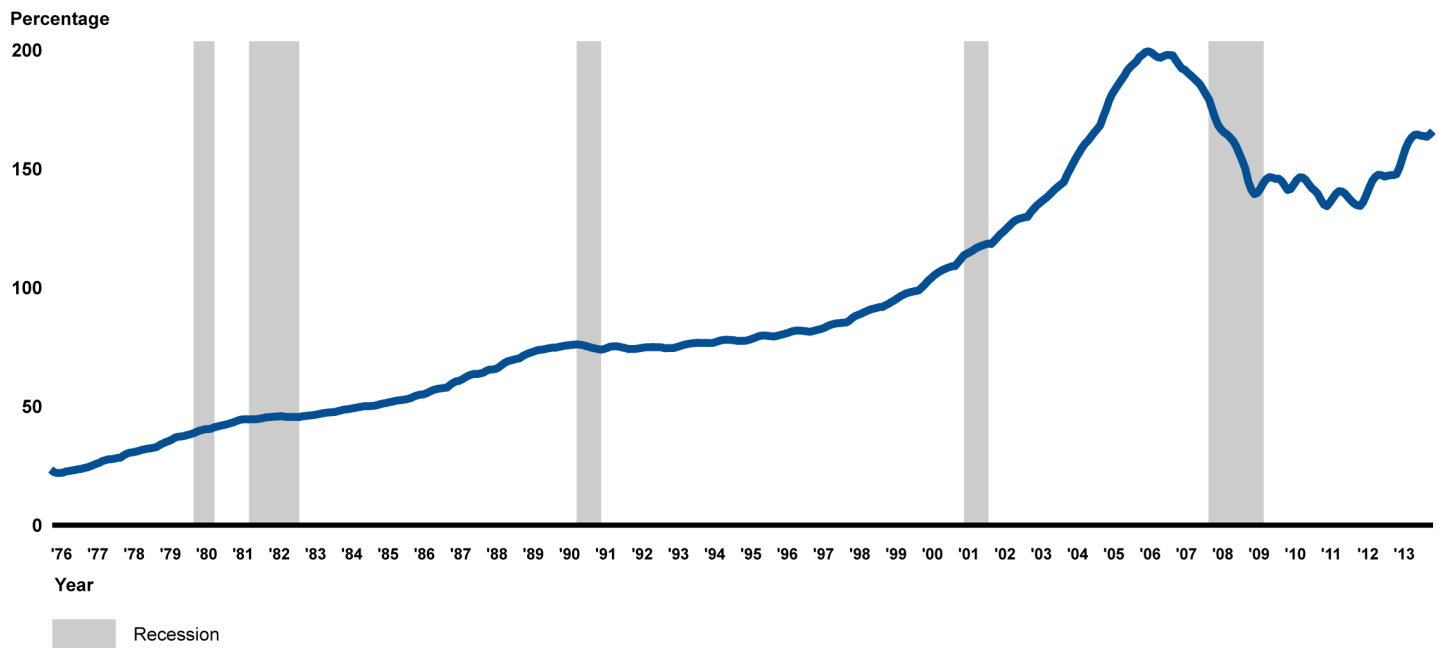
Home Prices and Homeownership Rates Fluctuated since 2000

Nationally, U.S. home prices nearly doubled between January 2000 and their peak in April 2006 (see fig. 6). However, price changes varied across local markets. For example, home prices rose by more than 174 percent in the Los Angeles metropolitan area and by 27 percent in the Detroit metropolitan from 2000 to their respective peaks in 2006 and 2005, according to data from the S&P/Case-Shiller Home Price Indexes.³⁵ The volume of home sales rose rapidly during this period as overall homeownership rose and many people purchased homes other than their primary residences, some for investment purposes. Researchers and others have noted that the increases in house prices prior to the financial crisis may have reflected an asset bubble.³⁶ Beginning in May 2006, however, prices began falling, and across the country tumbled by nearly 33 percent from peak to trough. Prices fell even further in some areas such as the Los Angeles metropolitan area, which experienced a 42 percent decline from peak to trough. National average home prices began rising in 2011 and continued rising through 2013, bolstered by low interest rates and housing inventories as well as improving economic factors.

³⁵The S&P/Case Shiller National Home Price Index is a composite of single-family home price indexes for the nine U.S. Census divisions and is calculated quarterly. S&P/Case Shiller also calculates indexes for various metropolitan areas including Los Angeles and Detroit. The methodology used to calculate these indexes is described in *S&P/Case Shiller Home Price Indices Methodology* (March 2014).

³⁶An asset bubble is characterized by a rise in asset prices unsupported by market fundamentals.

Figure 6: CoreLogic National Home Price Index, 1976-2013



Source: CoreLogic House Price Index and National Bureau of Economic Research. | GAO-15-131

The homeownership rate generally increased between 2000 and 2004 but has fallen steadily since the financial crisis due to fewer potential homeowners entering the market and an increase in home foreclosures. In the fourth quarter of 2000 the homeownership rate was 67.5 percent. The rate peaked in the fourth quarter of 2004 at 69.2 percent and has fallen steadily since. As of the end of 2013, the homeownership rate was 65.2 percent. According to *The State of the Nation's Housing 2013*, the declines in homeownership rates have been more pronounced among certain groups, in particular, families with children and within the African-American and Hispanic communities.³⁷

³⁷Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing 2013* (Cambridge, Mass: June 26, 2013).

Home prices and homeownership rates are influenced, in part, by demographic and economic trends.³⁸ According to some housing market experts, some of the demographic and economic trends influencing the housing market in 2013 include later household formation, stagnant incomes, and changes in the demand for rental housing. However, an FDIC official noted that the timing of household formation and demand for rental housing may be the result of changes in the for-sale market. Experts also suggest that longer demographic trends, such as increases in the proportion of the population that is 65 or over and those classified as minorities, may affect homeownership rates in the future. For example, minorities will make up an increasing share of young households but face greater constraints than other groups due to lower income and wealth.³⁹ As a result, demand for first homes may decrease. A former Chairman of the Federal Reserve also noted in 2012 that some potential minority borrowers also may face discrimination either because lenders discriminate against minority neighborhoods or charge minorities higher loan prices than they would comparable nonminority borrowers. Other factors such as high unemployment and student loan debt could also have an impact on the housing market and homeownership. The U.S. average unemployment rate rose to over 9 percent in 2009 and 2010 before beginning to decline; in 2013, the average unemployment rate was 7.4 percent. The percentage of students with student debt as well as the average size of that debt has increased over the period since 2003, potentially making it more difficult for younger borrowers to qualify for a mortgage loan or afford to own a home.⁴⁰

³⁸Housing finance market developments can also influence home prices and home ownership rates. For more information, see the next section of this report.

³⁹See for example *The State of the Nation's Housing 2013* and Lesley Frieman, Selma Hepp Dowell Myers, and Rolf Pendall, *Demographic Challenges and Opportunities for U.S. Housing Markets*, Prepared for the Bipartisan Policy Center (Washington, D.C.: March 2012).

⁴⁰According to the Federal Reserve Bank of New York, the share of 25-year-olds with student debt has increased from 25 percent in 2003 to 43 percent in 2012 and the average student loan balance grew from \$10,649 in 2003 to \$20,326 in 2012.

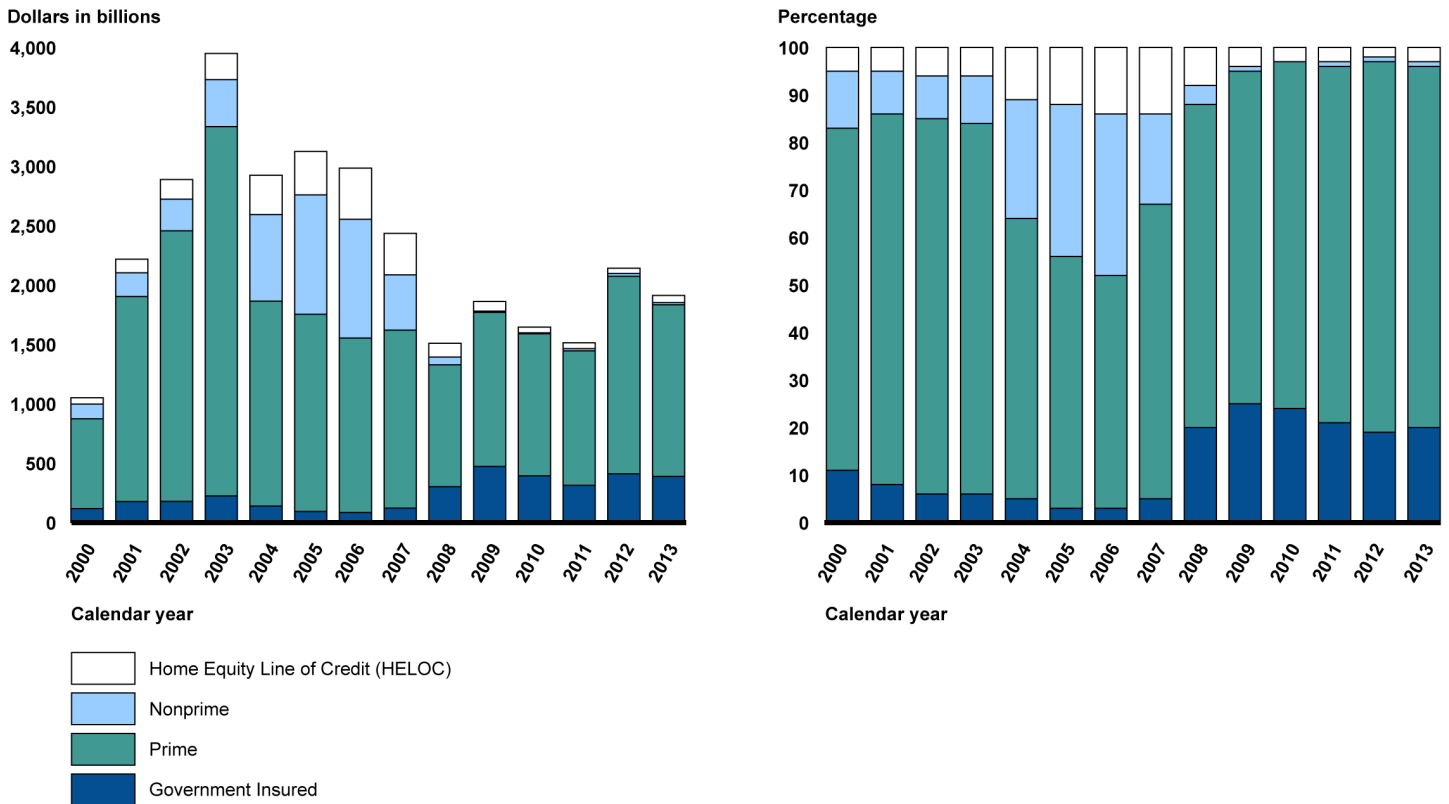
Developments in the Primary Market since 2000 Have Affected the Government's Role in Housing Finance

Changes in home prices and changes in the housing finance market have affected the government's role in housing finance. Changes in the primary market generally fell into three time periods: 2000-2003, 2004-2006, and 2007 and thereafter (see fig. 7). In the first period, a period of low interest rates, prime mortgages made up the vast majority of all mortgages. However, in the second period the market share of nonprime mortgages increased dramatically to a peak of 34 percent of all mortgage originations in 2006, including purchases and refinancing. The value and market share of mortgages insured or guaranteed by the U.S. government also fell during this period, largely due to the availability of nonprime mortgages.⁴¹ Specifically, the share of government-insured or -guaranteed mortgages—those directly supported by the government—fell from 11 percent in 2000 to less than 3 percent of the value of all new mortgage originations in 2006. From 2008 through 2013, average total originations declined to around \$1.7 trillion per year from more than \$2.7 trillion per year on average between 2000 and 2006. However, prime and government insured or -guaranteed mortgages have dominated the market since 2008. In 2013, prime mortgages accounted for 76 percent of the value of all mortgage originations and government-insured mortgages for 20 percent of the value of all mortgage originations.⁴²

⁴¹For more information on the decline in market share of FHA mortgages during this period, see GAO, *Federal Housing Administration: Decline in the Agency's Market Share Was Associated with Product and Process Developments of Other Mortgage Market Participants*, [GAO-07-645](#) (Washington D.C.: June 29, 2007).

⁴²According to data from Inside Mortgage Finance, jumbo loans represented 14 percent of the approximately \$1.9 trillion in prime originations during 2013.

Figure 7: Value of Mortgage Loan Originations by Product Type and Distribution of Market Share, 2000-2013



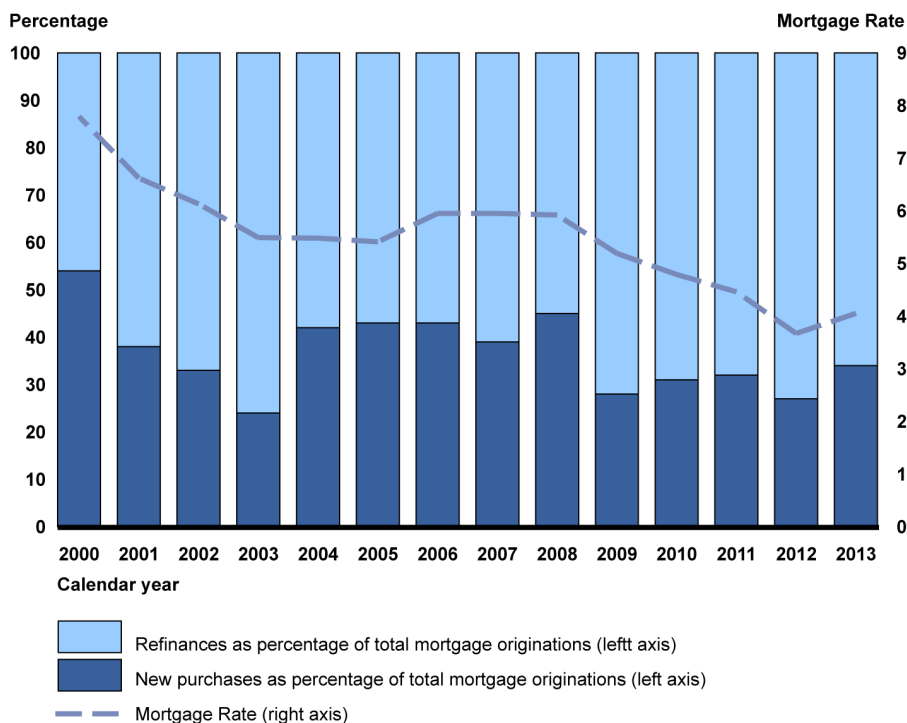
Source: GAO analysis of Inside Mortgage Finance and USDA Rural Housing Service data. | GAO-15-131

Note: For purposes of this figure, we include direct loans made by federal agencies in “government insured.”

In addition to changes in the market shares of mortgage products, the overall size of the mortgage market and the division between loans for new mortgages and those that were refinancing existing mortgages shifted between 2000 and 2013. Early in the period, the overall value of mortgages rose because, from 2000 through 2003, many homeowners refinanced their existing mortgages to take advantage of falling mortgage rates (see fig. 8). As the decline in mortgage rates slowed, and then began to rise, refinances declined and purchase loans for new homes grew as a percentage of the value of all originations. After 2007, the overall value and number of mortgage originations declined. To encourage spending, the Federal Reserve lowered interest rates, which in turn lowered mortgage rates and spurred refinancing activity. In 2013, refinancing volumes decreased as mortgage rates rose. However, refinances continued to represent the majority of origination activity,

accounting for about 43 percent of the value of FHA originations and about 71 percent of the value of originations securitized by the enterprises in 2013.

Figure 8: Refinance and Home Purchase Rates and Mortgage Rates, 2000- 2013



Source: GAO analysis of Bloomberg and Inside Mortgage Finance data. | GAO-15-131

Note: Mortgage rate is the 30-year conventional fixed-rate mortgage rate.

Before the financial crisis, many borrowers withdrew equity from their homes. HELOCs, which draw down the home’s equity when borrower’s use them, were popular (see fig. 7), and some borrowers refinanced with cash-out refinance mortgages with which they converted increased equity into cash by taking out a loan larger than the remaining loan balance. Data from Freddie Mac for a sample of loans retained in their portfolio show that between 2004 and 2007, homeowners cashed out approximately \$966 billion in home equity and that in 2006, cash-out refinances accounted for nearly 30 percent of all refinances in Freddie

Mac's portfolio.⁴³ At the same time, many new nonprime mortgages had features that made it more difficult to accumulate home equity and to refinance with new loans.⁴⁴

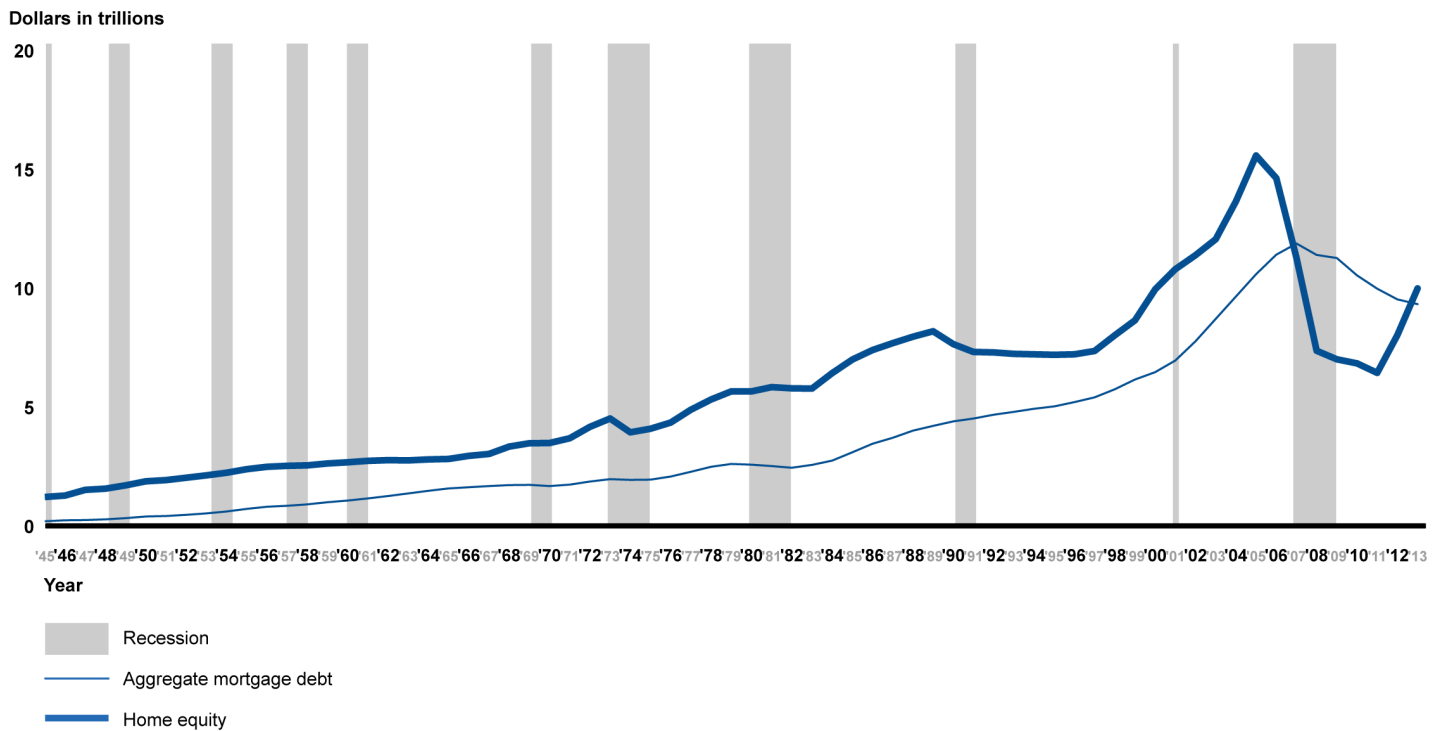
The years from 2008 through 2011 were the first in which aggregate home mortgage debt exceeded home equity since the data were first collected in 1945 (see fig. 9). During this period a significant number of homeowners found themselves underwater on their mortgages—in a situation in which they owed more than the home was worth—because of the substantial decline in home prices and trailing declines in mortgage debt. The fall in mortgage debt since 2009 has been attributed to defaults on existing mortgage loans by financially distressed borrowers, consumers generally paying down debt, and tightened lending standards that contributed to a decline in home purchases and less accumulation of debt.⁴⁵ As of December 2011, national home equity (the difference between aggregate home value and mortgage debt owned by homeowners) was approximately \$3.7 trillion less than total home mortgage debt. In 2013 home equity rose past home mortgage debt again, and, as of the end of 2013, aggregate home equity exceeded aggregate home mortgage debt by approximately \$655 billion.

⁴³According to data from Freddie Mac, cash out refinances increased from 2.8 percent in 2012 to 3.7 percent in 2013. The percentage of cash out refinances in 2012 was the lowest amount recorded for data available from 1993 to 2013.

⁴⁴We have found that many nonprime products that offered interest-only or payment options that allowed for negative amortization (deferred interest payments are added to the loan balance) can result in borrowers building less home equity than they would with a traditional loan. For more information see GAO, *Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments*, [GAO-08-78R](#) (Washington, D.C.: Oct. 16, 2007).

⁴⁵Meta Brown, Andrew Haughwout, Donghoon Lee, and Wilbert van der Klaauw, *The Financial Crisis at the Kitchen Table: Trends in Household Debt and Credit*, Federal Reserve Bank of New York Staff Report, no. 480 (New York, NY: 2010) and Neil Bhutta, *Mortgage Debt and Household Deleveraging: Accounting for the Decline in Mortgage Debt Using Consumer Credit Record Data*, Federal Reserve Board Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board (Washington, D.C.: March 2012).

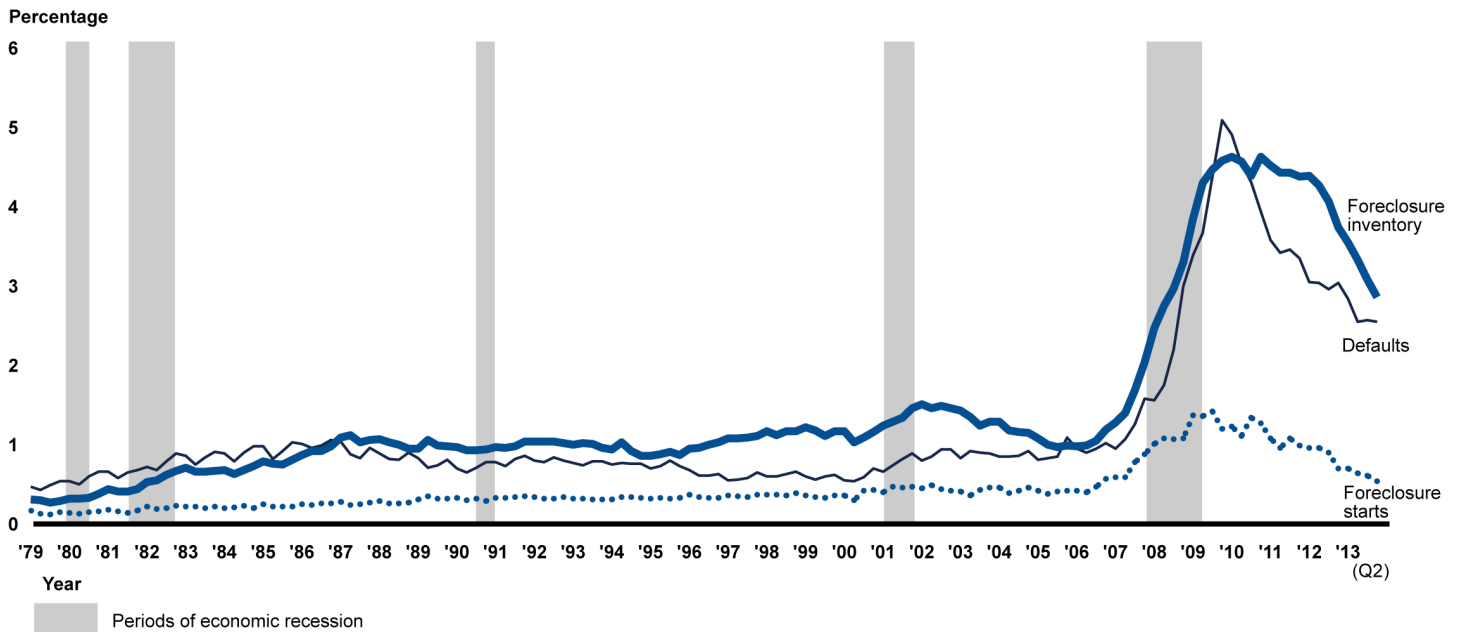
Figure 9: Value of Home Equity and Aggregate Mortgage Debt and Recession Periods, 1945-2013



Source: Federal Reserve, Flow of Funds Accounts of the United States; Bureau of Labor Statistics; and National Bureau of Economic Research. | GAO-15-131

The financial crisis resulted in increased mortgage defaults and foreclosures. From 1979 until 2007, mortgage performance had been relatively stable and the rates of default and foreclosure inventory—the percentage of total mortgage loans in foreclosure—were below 1 or 2 percent, respectively (see fig. 10). But after the financial crisis, the rates of default and foreclosure rose to historic levels—defaults peaked at 5 percent of mortgages at the end of 2009 and the foreclosure inventory peaked at 4.6 percent of mortgages in the first quarter of 2010—before beginning to decline. While defaults and foreclosures have declined, more than 1.15 million homes were in foreclosure at the end of 2013, according to data from the Mortgage Bankers Association.

Figure 10: Percentage of Mortgage Loans in Default 90 Days or More or in Foreclosure and Recession Periods, 1979-2013

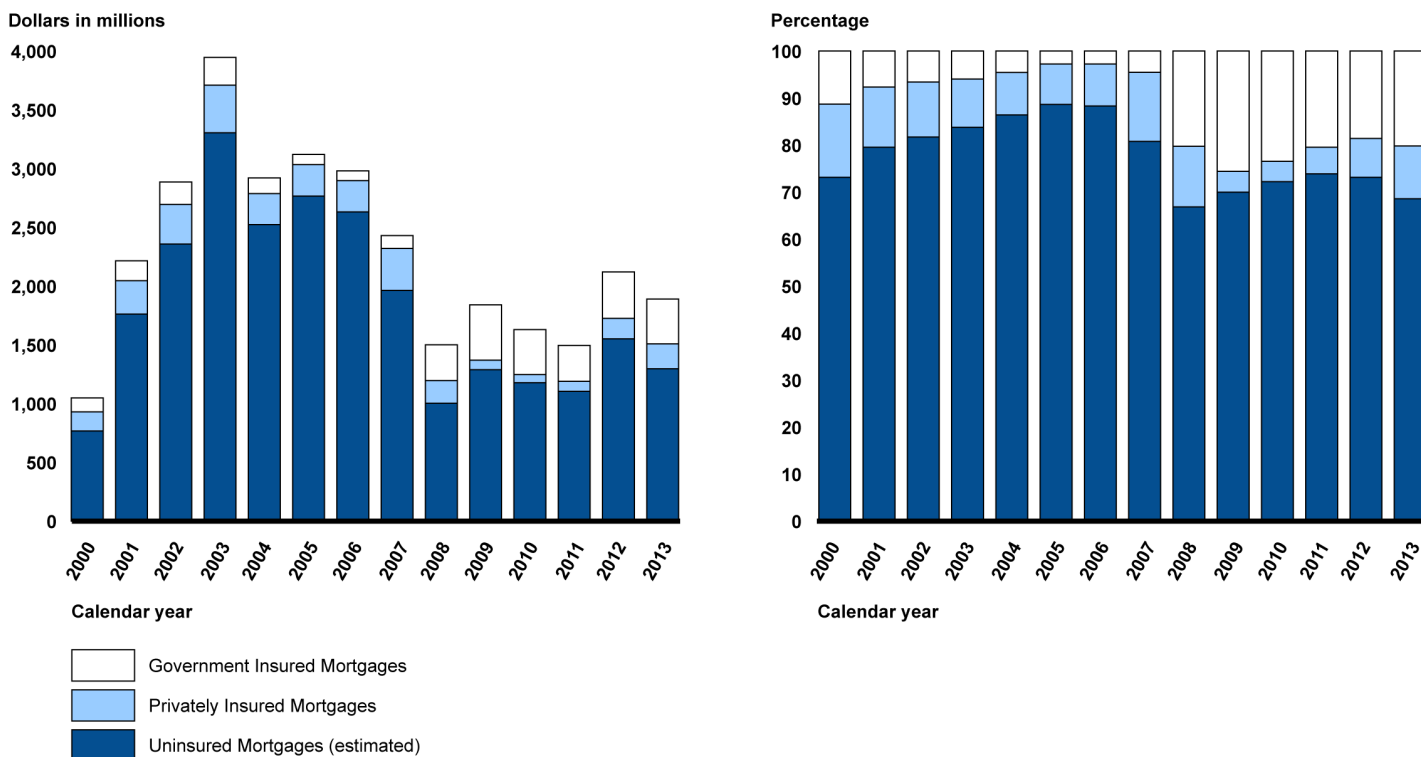


Source: GAO analysis of Mortgage Bankers Association data, National Bureau of Economic Research. | GAO-15-131

Although the government’s role in the primary market had declined between 2004 and 2006, reaching a low of less than 3 percent of originations in 2006, the 2007-2009 financial crisis and the accompanying rapid increase in foreclosures reversed this trend. The government took steps to mitigate the effect of the economic downturn and increase access to mortgage credit by increasing loan limits for FHA-insured mortgages and mortgage loans eligible for securitization by the enterprises. Considering only new mortgage originations, the share of mortgages that were federally insured grew relative to those that were privately insured or uninsured from 2007 to 2009 (see fig. 11). By 2009, over 85 percent of all new insured mortgages were insured by FHA or guaranteed by VA and USDA. In an effort to help troubled homeowners and stem the increase in foreclosures, the government also introduced several emergency programs, including the Home Affordable Modification

Program.⁴⁶ As of November 2013, about 1.3 million borrowers had entered into a permanent loan modification through this program, and, to increase participation, the program deadline has been extended through December 2016. As of the end of 2013, defaults and foreclosure rates were continuing to improve, but many homeowners continued to be at risk for foreclosure, and government-guaranteed and -insured mortgages and mortgages eligible for securitization by the enterprises continued to be the primary options for borrowers.

Figure 11: Value of New Insured Mortgage Originations and Distribution of Market Share, 2000-2013



Source: GAO analysis of Inside Mortgage Finance data. | GAO-15-131

⁴⁶For more information on the Home Affordable Modification Program and other foreclosure mitigation efforts, see GAO, *Troubled Asset Relief Program: More Efforts Needed on Fair Lending Controls and Access for Non-English Speakers in Housing Programs*, [GAO-14-117](#) (Washington, D.C.: Feb. 6, 2014) and *Foreclosure Mitigation: Agencies Could Improve Effectiveness of Federal Efforts with Additional Data Collection and Analysis*, [GAO-12-296](#) (Washington D.C.: June 28, 2012).

Developments in the Secondary Market Have Also Affected the Government's Role in Housing Finance

Until 2009 the securitization rate of mortgage originations generally had been increasing. Over the period from 2000 through 2013, the rate began at 50 percent in 2000, peaked at 84 percent in 2009, and ended at 79 percent in 2013 (see fig. 12).⁴⁷

Figure 12: Distribution of Mortgage Originations between Securities and Held-in Portfolio, 2000-2013



Source: GAO analysis of Inside Mortgage Finance data. | GAO-15-131

Note: Originations held in portfolio were estimated from data on the value of mortgages originated and the value of mortgages securitized.

Over that same period, FHLBank advances, which can be an alternative to securitizations as a source of liquidity for mortgage originations, also

⁴⁷We estimated the percentage of originations held in portfolio based on the value of mortgages originated and the value of mortgages securitized by year as reported by Inside Mortgage Finance.

varied.⁴⁸ According to the FHLBanks' financial statements, advances, which had been rising prior to the financial crisis, rose by over 35 percent between 2006 and 2007 and continued to rise into 2008, reaching an end of year value of about \$929 billion. Since the crisis, advances have generally declined to levels consistent with those in the early 2000s. At the end of 2013 advances were almost \$500 billion. According to the Council of Federal Home Loan Banks, outstanding advances rose during the crisis to meet liquidity needs. However, since the height of the economic crisis, advances have declined as reduced loan demand and excess liquidity have reduced members' need for advances.

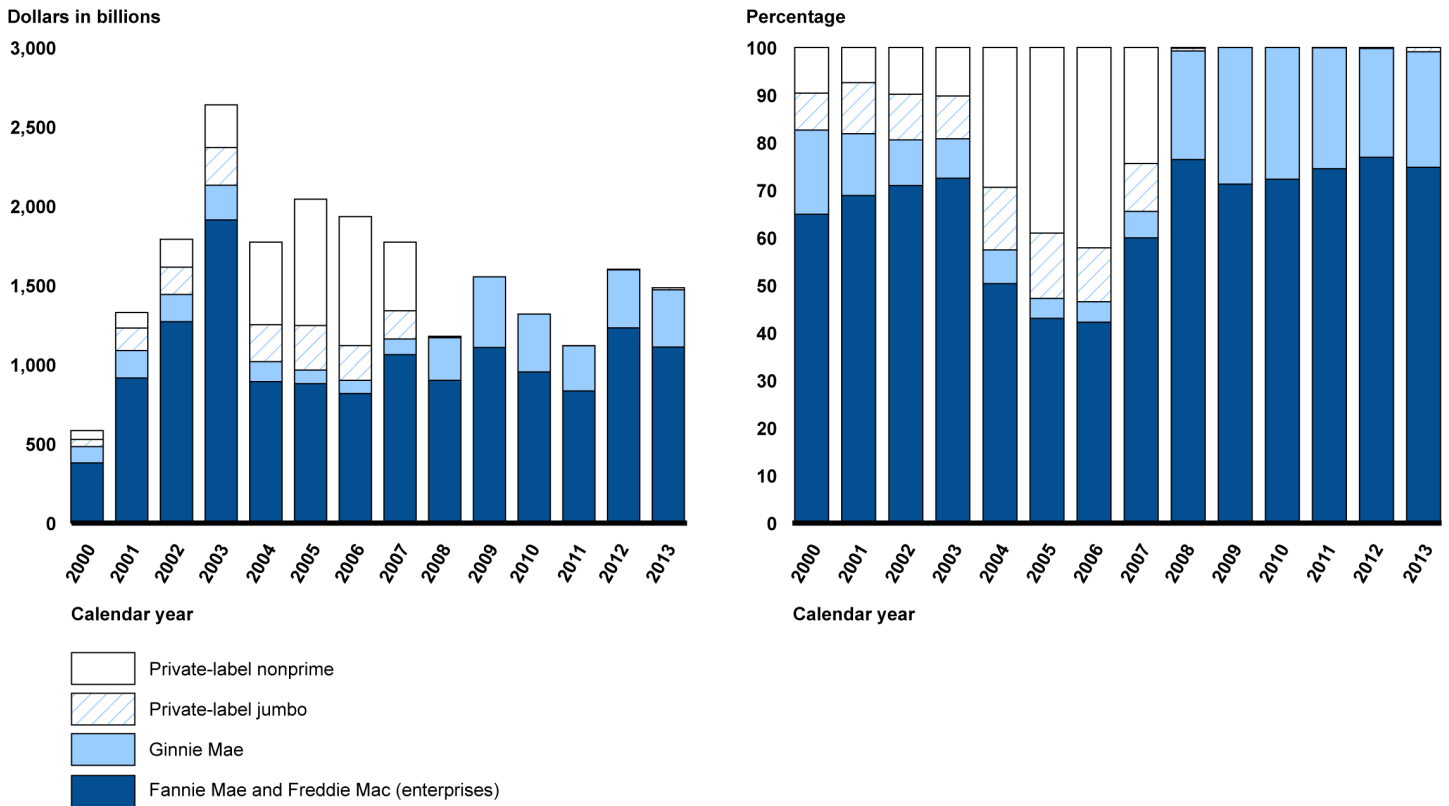
The rapid expansion of nonprime lending and private-label MBS contributed to the increase in securitization between 2000 and 2009 (see fig. 13). Specifically, the market share of private-label MBS, which typically pool jumbo and nonprime mortgages, grew rapidly from 2004 to 2006.⁴⁹ During this time, the market share of the enterprises' MBS, which pool eligible prime mortgages, and MBS guaranteed by Ginnie Mae decreased. However, there have been almost no new issuances of private-label MBS since the onset of the financial crisis.⁵⁰ As illustrated in figure 13, since 2008, the market shares of the enterprises, which were in conservatorship, and Ginnie Mae have increased. Thus, the government supported almost all of the value of new MBS securities issued in 2008 and continued to do so through 2013.

⁴⁸The FHLBanks provide liquidity by providing advances to members to originate loans to hold, including those that members are not willing or able to sell in the securitization market. The FHLBanks also operate mortgage purchase programs in which the FHLBanks may purchase eligible mortgage loans and MBS from member institutions.

⁴⁹Private-label MBS had existed for sometime before 2000, but they were a small part of the market. Private-label MBS were used primarily to securitize jumbo and nonprime mortgages. Jumbo mortgages are generally considered prime mortgages and are not Alt-A or subprime (i.e., nonprime) mortgages. Between 2001 and 2003, jumbo mortgage originations represented more than 60 percent of the value of jumbo and nonprime originations, this decreased to between 32 and 43 percent from 2004 through 2007. Since 2009, jumbo mortgage originations have represented more than 90 percent of the value of jumbo and nonprime originations.

⁵⁰According to data from Inside Mortgage Finance, there continues to be a small market for jumbo private-label securities; in 2013 about \$13.1 billion of these securities were issued or less than 1 percent of all MBS issuances.

Figure 13: Value of Mortgage-Backed Securities Issued and Distribution of Market Share, 2000-2013



Source: GAO analysis of Inside Mortgage Finance data. | GAO-15-131

The increasing reliance on securitization that began around 1980, the rapid increase and subsequent decline in private-label securities that reasserted the market dominance of the enterprises and Ginnie Mae, and the change in the status of the enterprises combined to increase the government’s role in the secondary market. The percentage of the secondary market controlled by Ginnie Mae and the enterprises has grown since the onset of the crisis, in part, because Congress increased loan limits for FHA-insured loans and loans eligible for enterprise securitization. The government’s role has also changed as a result of placing the enterprises into conservatorship in 2008. The Senior Preferred Stock Purchase Agreements, which provide capital support from the Treasury to the enterprises, are the federal government’s single

largest risk exposure remaining from its emergency actions to assist the financial sector after the financial crisis.⁵¹ Given the government investment in the enterprises and variations in the secondary market over the period, the government supported almost all of the value of new MBS issued in 2013.⁵² Because of this support, the government indirectly supports the mortgages backing the MBS. In response to the financial crisis, the Federal Reserve and Treasury have provided additional support for the mortgage market by purchasing MBS issued by the enterprises and those that have Ginnie Mae guarantees.⁵³ As of the end of 2013, the Federal Reserve, which was one of the largest purchasers of enterprise and Ginnie Mae MBS, held approximately \$1.5 trillion of these securities, but announced in January 2014 that it planned to decrease purchases due to improvements in the economy.⁵⁴ Treasury had completed the sale of its MBS investments in fiscal year 2012.

Market Developments since 2000 Have Challenged the Single-Family Housing Finance System

Market developments since 2000 have challenged the single-family housing finance system and revealed some key weaknesses in that system, including misaligned incentives, an overall lack of reliable information or transparency, and excessive risk taking. These developments are evident throughout the phases of the mortgage lifecycle—origination, securitization, and mortgage servicing.

⁵¹Through the purchase of senior preferred stock, Treasury has provided \$187.5 billion to the enterprises. However, since the second quarter of 2012, neither enterprise has needed additional funding from Treasury. Under the current terms of the Senior Preferred Stock Purchase Agreements, Fannie Mae and Freddie Mac must pay to Treasury all of their quarterly positive net worth (if any) over a specified capital reserve amount.

⁵²This includes securities issued by the enterprises and guaranteed by Ginnie Mae.

⁵³According to data from Inside Mortgage Finance, the Federal Reserve System was the largest investor in this market, followed by commercial banks, in 2013. The Federal Reserve System is self-funded and independent but its revenues are transferred to the General Fund of the U.S. Treasury and therefore profits or losses from its investments in the housing market indirectly impact the U.S. budget.

⁵⁴These data were from the Federal Reserve announcement for the week ending January 1, 2014.

Key Weaknesses in the Housing Finance System Have Been Revealed since 2000

Some market developments that occurred prior to the financial crisis may have contributed directly to it, revealing weaknesses in the housing finance system. However, some weaknesses—in particular those related to mortgage servicing—were revealed only after the onset of the crisis when mortgage defaults and foreclosures rose. These interrelated weaknesses include misaligned incentives, lack of information or transparency, and excessive risk taking (See table 1).

Table 1: Some Weaknesses in the Housing Finance System Revealed Since 2000

Weakness	Definition	Examples
Misaligned incentives	Individual interests or interests of some groups do not align with the interests of other groups or a system; often long- and short-term interests of individuals or groups differ, as well. Misaligned incentives are closely tied to a lack of accountability.	<ul style="list-style-type: none"> • Originators' incentives were not aligned with those of borrowers because the former tended to sell mortgages in the secondary market and did not retain credit risk. This may have led to the origination of mortgages with higher potential default rates. • The structure of the enterprises as for-profit entities provided them with incentives that were not well-aligned with their public missions. • Because private-label securitizers generally did not retain credit risk their incentives may have differed from those of investors. • Individual compensation for originators and securitizers that were focused on the short term was often misaligned with the longer terms interests of firms, investors, and borrowers.
Lack of information or transparency	Adequate information to weigh risks related to products is not shared between one party and another or parties do not have information that would allow them to respond effectively to adverse market developments.	<ul style="list-style-type: none"> • Some borrowers lacked reliable and relevant information to adequately understand risks associated with nonprime loans because originators were not required to disclose certain features to borrowers in a readily understandable manner. • Investors may have lacked reliable and relevant information to adequately assess credit risk because they did not receive adequate data and relied on MBS credit ratings that may not have represented actual risk levels.
Excessive risk taking	When the costs of the risk taking do not fall solely on or are not well understood by the person or entity taking the risk. Excessive risk taking can occur when checks on such risk taking, such as internal controls or regulation, are lacking.	<ul style="list-style-type: none"> • Lenders loosened underwriting standards during the housing bubble, likely leading to excessive risk taking by borrowers. • The enterprises structures provided them with incentives to engage in potentially profitable business practices that were risky without taking precautions such as holding capital commensurate with those risks.

Source: GAO. | GAO-15-131

Developments in the Mortgage Origination Process Revealed Many Weaknesses

A number of developments in the mortgage origination process for home purchases and mortgage refinancing may have contributed to the housing bubble and, therefore, to the financial crisis. These market developments challenged the housing finance system and revealed weaknesses in that system. For example, prior to the financial crisis:

- Originators' incentives were not aligned with the long-term interests of borrowers because originators did not retain credit risk. Mortgage originators lowered underwriting standards, enabling less-qualified borrowers to access mortgage credit.⁵⁵ These changes included reducing or eliminating requirements for documentation of borrowers' incomes and assets. Originators lowered underwriting standards, in part to respond to demand for new mortgage originations in the secondary market. In addition, originators and brokers may have focused on increasing loan volume in the short-term, and thereby their fees, rather than originating loans more suitable for borrowers.
- Similarly, with the ability to pass on credit risk and compensation structures that rewarded them in the short term, mortgage originators offered nonprime mortgages that included high-risk features. Features of nonprime mortgages, such as loans with high LTV ratios and interest-only payments, have been found to increase the likelihood of default.⁵⁶ However, during periods of rapid house price appreciation, such as that experienced during the housing bubble, these risks were mitigated. Some mortgage originators may have steered borrowers who were qualified for less risky products to these nonprime mortgages. Some mortgage brokers received yield spread premiums (bonuses or extra compensation) for referring borrowers to high-interest loans. Some consumer advocates have noted that compensating brokers this way may have resulted in some borrowers receiving loans with higher interest rates and fees.⁵⁷ These mortgages were not in the best interest of some borrowers.
- Many borrowers may have lacked information or may not have fully understood the risks associated with the features of nonprime loans.

⁵⁵For more information on lowered underwriting standards, see [GAO-08-78R](#).

⁵⁶For more information on risky loan features associated with defaults, see GAO, *Nonprime Mortgages: Analysis of Loan Performance, Factors Associated with Defaults, and Data Sources*, [GAO-10-805](#) (Washington, D.C.: Aug. 24, 2010).

⁵⁷For more information see GAO, *Consumer Protection: Federal and State Agencies Face Challenges Combating Predatory Lending*, [GAO-04-280](#) (Washington, D.C.: Jan. 30, 2004).

Prior to the crisis, because mortgage originators were not required to disclose completely all of the features of nonprime loans, some mortgage originators may not have disclosed some high-risk features, contributing to borrowers assuming excessive risk. For example, borrowers may have agreed to such loans without understanding the potential for substantial increases in monthly payments.⁵⁸ A Treasury official noted that many lenders expected that these loans would be refinanced and fees would be paid for by extracting expected increases in equity before the loans got into trouble.

- Borrowers took on excessive risk, and when house prices fell, foreclosures rose and homeowners, communities, the housing market, and the overall economy experienced adverse effects. The *Financial Crisis Inquiry Commission Report* suggested that the relatively inexpensive mortgage credit available during the housing bubble and expectations that home prices would continue to rise may have caused borrowers to take on more debt than they would have otherwise. Some borrowers may have taken on excessive risk by investing in homes they planned to sell for a profit or by withdrawing equity from their homes.

Developments in the mortgage market prior to the financial crisis also revealed gaps in the financial regulatory system. As we have previously found, the activities of nonbank mortgage lenders were generally subject to little or no direct oversight by federal regulators.⁵⁹ We also found that nonbank mortgage lenders played a substantial role in the nonprime mortgage market and contributed to a dramatic loosening in underwriting standards leading up to the crisis. Although these lenders were subject to certain federal consumer protection and fair lending laws, they generally have not been subject to the same routine monitoring and oversight by federal agencies that their bank counterparts were. In addition, the complexity and expanded use of nonprime mortgage products made it difficult for the current regulatory system to adequately protect individual consumers and investors.

⁵⁸GAO, *Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved*, [GAO-06-1021](#) (Washington, D.C.: Sept. 19, 2006).

⁵⁹GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated Financial Regulatory System*, [GAO-09-216](#) (Washington, D.C.: Jan. 8, 2009) and [GAO-04-280](#).

The financial crisis also resulted in new challenges for FHA. During the crisis, FHA's market presence expanded as private sector lenders exited nonprime markets and tightened credit standards. In response, Congress increased the limits on the size of mortgages available for FHA insurance in 2008. With increased demand for FHA-insured mortgages and higher-than-expected insurance claims and losses, FHA has not met its 2 percent statutory minimum capital ratio for its insurance fund since 2009. In addition, in 2013, FHA needed funding from the Treasury to ensure it had sufficient resources for all future insurance claims on its existing portfolio. This funding reflected updated estimates of cash flows into and out of the fund over the term of the mortgages in its portfolio, rather than an inability to pay current claims. We have found previously that tightening underwriting standards, enhancing enforcement powers, and improving loss mitigation efforts are among options that could help strengthen FHA's financial condition.⁶⁰ Consistent with recommendations we made in a 2001 report, we stated in our 2013 high-risk update that Congress or FHA needed to specify the economic conditions that FHA's insurance fund would be expected to withstand without drawing on the Treasury.⁶¹ We concluded that implementing this prior recommendation would be an important step not only in addressing FHA's long-term financial viability but also in clarifying FHA's role. The 107th Congress considered this matter and did not enact legislation. HUD has not implemented our recommendation, but it has adopted modeling techniques that can better predict the soundness of the insurance fund.

While national average home prices began to increase in 2011, challenges to the primary market remain. In particular, after the crisis hit, mortgage originators tightened underwriting standards, which had weakened during the crisis, reducing credit availability and limiting opportunities for some borrowers, and constraints for some borrowers persist. According to *The State of the Nation's Housing 2013*, Ellie Mae reported that lenders have denied mortgages to many applicants who had good credit scores but would have been required to purchase mortgage

⁶⁰For more information on options to improve FHA's financial condition, see GAO, *Federal Housing Administration: Analysis of Options for Modifying Its Products, Market Presence, and Powers*, [GAO-13-682](#) (Washington, D.C.: Sept. 9, 2013).

⁶¹[GAO-13-283](#). A matter was raised for Congress's consideration and a recommendation made to FHA in GAO, *Mortgage Financing: FHA's Fund Has Grown, but Options for Drawing on the Fund Have Uncertain Outcomes*, [GAO-01-460](#) (Washington, D.C.: Feb. 28, 2001).

insurance because their LTVs were above 80 percent. Some government agencies have also acknowledged constraints facing some creditworthy borrowers. FHA imposed minimum underwriting standards in September 2010 requiring that new borrowers have a minimum Fair Isaac Corporation (FICO) credit score of 580 to qualify for its 3.5 percent down payment program.⁶² However, in its May 2014 *Blueprint for Access*, FHA expressed concern about credit continuing to be constrained for borrowers with credit scores between 580 and 680. Similarly, in its strategic plan for the conservatorship of the enterprises, issued in May 2014, FHFA expressed concern about access for some creditworthy borrowers. FHFA noted that some originators and private mortgage insurers require higher minimum credit score requirements than would be required by the enterprises, resulting in the rejection of many loans that would otherwise meet enterprise credit standards. The FHFA Director acknowledged that these higher credit standards were the result of lender uncertainty about having to repurchase these loans in the future. Nonetheless, the enterprises reported data in 2014 showing that while average FICO scores remained higher for acquired mortgages than before the financial crisis, average origination LTV ratios have steadily increased or stayed steady since 2009, indicating that opportunities for borrowers with less equity might be improving.⁶³

⁶²Since September 2010, those with credit scores between 500 and 579 are required to put down at least 10 percent of the value of the property, and those with credit scores below 500 do not qualify for FHA-insured mortgage financing. Prior to that time, FHA did not have a minimum required credit score.

⁶³According to Fannie Mae acquisition data, in 2013 the weighted average credit score was 753 and the average origination LTV was 75.7 percent, whereas in 2005 the average credit score was 719 and the average origination LTV was 72 percent; average credit scores reached a high of 762 in 2010 and 2011 and LTV reached a low of 66.8 percent in 2009. According to separate acquisition data from Freddie Mac, in 2013 the average credit score was 755 and the average original LTV ratio was 71 percent, whereas from their pre-2005 books of business the average credit score was 711 and the average origination LTV was 72 percent; the average credit score reached a high of 761 in 2012 and the average LTV was 69 percent between 2009 and 2012.

The Secondary Market Helped Fuel Nonprime Mortgage Originations and Spread Risks through Complex Products

Increases in demand for private-label MBS, which occurred primarily between 2004 and 2006, helped fuel the housing bubble and the spike in nonprime mortgage originations. In addition, complex financial products such as credit default swaps, which were designed to reduce the risk associated with MBS for investors, spread risk throughout the financial markets and contributed to the onset of the financial crisis. Developments prior to the financial crisis also highlighted similar weaknesses in the secondary market, such as misaligned incentives, lack of transparent information, and excessive risk taking. In addition, markets were challenged by gaps in regulation. For example:

- The enterprises' structures included misaligned incentives and led to excessive risk taking. We concluded in 2009 that the enterprises' structures as for-profit corporations with government sponsorship provided them with incentives to engage in potentially profitable business practices that were risky and not necessarily supportive of their public missions.⁶⁴ For example, prior to conservatorship, the enterprises' retained mortgage portfolios that were complex to manage and exposed them to losses resulting from changes in interest rates. Further, the enterprises made substantial investments in private-label MBS, and the enterprises' management did not hold capital commensurate with this additional risk. These investments in private-label MBS contributed to losses that led to the conservatorship. In addition, the enterprises had a lower cost of capital than other for-profit corporations, including private-label MBS issuers, because market participants assumed that the federal government would support the enterprises if they experienced financial distress. This kind of support, referred to as a perceived implicit guarantee, likely contributed to the enterprises' taking of excessive risk.
- Similar to the misaligned incentives of lenders and borrowers, incentives of issuers of private-label MBS and investors were also misaligned because the former generally did not retain the increased credit risk associated with lower quality loans. These increased risks were passed onto investors who may not have been aware that they were taking on increased risk. A lack of information on the part of investors likely contributed to their taking on this excessive risk.

⁶⁴For more information see GAO, *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-term Structures*, [GAO-09-782](#) (Washington, D.C.: Sept. 10, 2009).

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- Increased competition may have led issuers of MBS to accept lower quality mortgages for securitization, resulting in higher risk securities. Historically, the enterprises issued the vast majority of MBS, and we have found that this led to their underwriting guidelines becoming the industry standard. Research has suggested that the enterprises were able to maintain tighter control over underwriting standards for the loans they purchased because of their market share.⁶⁵ The rapid growth of nonprime mortgage lending and private-label MBS in the early part of the decade led to increased market competition among private-label issuers and the enterprises. Competition for market share led issuers of private-label MBS and the enterprises to relax underwriting standards and accept riskier mortgages.
 - Investors may not have understood the risks of MBS, ultimately leading them to take on excessive risk. Prior to the financial crisis, investors seeking higher yields invested in private-label MBS because these securities offered higher returns than other highly rated assets, such as enterprise MBS. While increased yields over other highly rated securities should have indicated increased risk, the use of complex financial instruments such as credit default swaps allowed investors to transfer the credit risk of these investments, and led to excessive risk taking.⁶⁶ Further, some researchers and industry representatives have noted the lack of appropriate data made it difficult for investors to analyze complex private-label securities. In addition, the common expectation that home prices were expected to continue to rise further minimized any perceived risks associated with MBS.
 - The risks related to private-label MBS also may not have been fully understood because most of these securities had received investment grade ratings from independent credit ratings agencies that did not adequately reflect the risk that these products ultimately posed. We have found that leading up to the crisis, some investors had come to rely heavily on these ratings rather than conducting independent analyses on the quality of assets.⁶⁷ Further, we found that although

⁶⁵Michael Simkovic, "Competition and Crisis in Mortgage Securitization," *Indiana Law Journal*: vol. 88: Iss. 1, Article 4, 2013.

⁶⁶Credit default swaps are bilateral contracts that transfer credit risks from one party to another. In return for a periodic fee, the seller agrees to compensate the buyer if a specified credit event, such as default, occurs. For more information on credit default swaps see [GAO-09-397T](#).

⁶⁷[GAO-09-216](#).

ratings downgrades for investment grade securities are generally infrequent, many of the private-label MBS issued with investment grade ratings were later downgraded. In addition, others have found that credit-rating agencies used models based, in part, on periods of relatively strong credit performance and did not consider the possibility of dramatic declines in home prices. We have also noted that concerns have been raised over the way in which ratings of some private-label MBS may have been influenced by compensation arrangements between the issuers and ratings agencies—that is, the issuers paid the rating agencies to rate the securities. Prior to the crisis, investors who viewed ratings agencies as independent evaluators of securities may not have appreciated the potential impact on credit ratings posed by apparent conflicts of interest created by the relationship between private-label MBS issuers and ratings agencies.

- Incentives provided to individual employees of the enterprises and issuers of private-label MBS were often based on short-term results and were not well-aligned with the longer term interests of the firms that employed them or investors. Prior to the crisis, some employees received bonuses based on the volume of MBS issued, which were not related to the long-term performance of the securities. This gave these employees the incentive to take on excessive risk, and when home prices began to fall, firms failed and investors experienced losses.
- We have previously found that there were gaps in the regulatory system related to the secondary market for private-label MBS and that market participants and regulators did not fully understand the complex financial instruments that were intended to transfer risk.⁶⁸ The complexity and expanded use of these products made it difficult for the regulatory system to oversee risk management at financial institutions. Many of these institutions, including large commercial and investment banks, appeared to have underestimated the amount of risk and potential losses that they could face from creating and investing in private-label MBS and more complex financial instruments. For example, among other factors, the variation and complexity of CDO structures, and the underlying assets they contain, may explain why institutions—and regulators—did not effectively monitor and limit the risk that CDOs represented.

⁶⁸GAO-09-216.

The High Number of Defaults and Foreclosures Revealed Weaknesses in Mortgage Servicing

Mortgage securitization, in general, relies on mortgage servicers to manage individual mortgages, but the financial crisis revealed the mortgage servicing industry's lack of capacity to respond adequately to the increased number of mortgage defaults and foreclosures. We have reported previously on challenges in mortgage servicing after the crisis, such as improper documentation used in foreclosures and the difficulty of implementing government foreclosure mitigation programs.⁶⁹ For example, we previously found there were pervasive problems with servicer document preparation and oversight of foreclosure processes. We also found that servicers faced challenges related to implementing the government's first and second lien modification programs and that investors were concerned about the lack of transparency of modifications.

In addition, the increase in defaults and foreclosures also revealed misaligned incentives, as well as gaps in regulatory oversight that might have addressed such weaknesses. For example:

- Research suggests that while loan modifications can be in the financial best interest of investors and borrowers, it can be in the financial best interest of servicers to foreclose rather than modify mortgages.⁷⁰ Thus incentives for borrowers, investors, and servicers were not always aligned. While servicers were entitled to reimbursement of costs related to foreclosures, they may not have been entitled to the reimbursement of all costs related to pursuing foreclosure alternatives, creating the incentive for servicers to pursue foreclosure. Further, servicer reimbursement of costs related to foreclosures took precedence over investor claims. In addition, servicers had an incentive to charge borrowers additional fees related to defaulted loans and, if homeowners lacked the equity to cover these fees, proceeds for investors would be decreased to cover the fees.
- Similarly, the securitization system created additional misaligned incentives between servicers and borrowers, and borrowers had little

⁶⁹See GAO, *Mortgage Foreclosures: Documentation Problems Reveal Need for Ongoing Regulatory Oversight*, [GAO-11-433](#) (Washington, D.C.: May 2, 2011) and *Troubled Asset Relief Program: Treasury Continues to Face Implementation Challenges and Data Weaknesses in Its Making Home Affordable Program*, [GAO-11-288](#) (Washington, D.C.: Mar. 17, 2011).

⁷⁰Adam J. Levitin, J. and Tara Twomey, *Mortgage Servicing*, Georgetown Public Law and Legal Theory Research Paper No. 11-09, 2011.

ability to hold servicers accountable. As CFPB has noted, mortgage servicers that are hired by the owners of mortgage loans face competitive pressure to reduce the costs of servicing, and, as a result, some servicers provided limited customer service.⁷¹ For example, some servicers did not provide information on fees imposed in borrowers' billing statements. Further, servicers earned revenue from fees assessed on borrowers and, as a result, had an incentive to look for opportunities to impose fees on borrowers to enhance revenues. Borrowers generally did not have the ability to change mortgage servicers, unless they refinanced their mortgages.

- Some breaches of representations and warranties in pooling and servicing agreements may not have been identified because of mortgage servicers' potential conflicts of interest. Pooling and servicing agreements contain representations and warranties that require originators to repurchase loans from issuers of MBS if the loans do not meet underwriting requirements or in some cases default within a certain time period. These representations and warranties are one mechanism for aligning the incentives of originators, investors, and servicers. However, in some cases, when servicers and originators were affiliated, servicers may have had a disincentive to identify loans that breached representations and warranties because such loans would need to be repurchased by the affiliated originators.
- Although not directly related to the role of servicers, SEC has noted that transaction agreements typically have not included specific mechanisms to identify breaches of representations and warranties or to resolve a question as to whether a breach of the representations and warranties has occurred. Thus, these contractual agreements have frequently been ineffective because without access to documents relating to each pooled asset, it can be difficult for the trustee, who typically notifies the responsible party of an alleged breach, to identify a breach. In addition, addressing representation and warranty breaches can require that a minimum percentage of investors act together. However, investors have noted that it is difficult for them to locate other investors so they can jointly exercise their rights.
- Industry representatives and researchers have noted that although loss mitigation actions taken by servicers affect investors, investors do

⁷¹Mortgage Servicing Rules Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 10902, 10905 (Feb. 14, 2013); Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10696, 10700 (Feb. 14, 2013).

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- not receive adequate and consistent information from servicers that would allow them to compare servicer performance in these areas.
- Oversight of servicers' foreclosure activities and of nonbank servicers was limited prior to and during the financial crisis. We previously found federal agencies' past oversight of servicers' foreclosure activities had been limited and fragmented.⁷² Similarly, nonbank mortgage servicers, especially those that were not affiliated with banks or other regulated financial institutions, were historically subject to little or no direct oversight by federal regulators. Prior to and during the financial crisis, state banking regulators generally oversaw independent mortgage servicers by requiring business licenses that mandated meeting net worth, funding, and liquidity thresholds. Nonetheless, according to VA officials, when borrowers in its Home Loan program are experiencing financial hardship, VA provides direct oversight of entities servicing those loans to ensure that all reasonable effort has been made to help those veterans avoid foreclosure.

The Government Has Taken Some Steps to Address Housing Finance Market Challenges through Regulation and Enforcement

The federal government revised guidance and regulations and enacted legislation designed to address adverse developments or weaknesses related to the housing finance market that contributed to the financial crisis. For example, in 2006 to better protect borrowers and address the safety and soundness of banks, the bank regulators issued *Interagency Guidance on Nontraditional Mortgage Product Risks*. In 2008, HUD revised the rules implementing RESPA so that the required forms would provide additional disclosures, including clear summaries of loan terms and conspicuous information about yield spread premiums designed to make it easier for potential borrowers to compare originators when shopping for a mortgage loan. Also in 2008, Congress passed HERA, which created FHFA to address the safety and soundness issues and weak oversight at the enterprises.⁷³ HERA also gave FHFA responsibility for overseeing the FHLBank System.

To address challenges related to limitations on mortgage information, HERA required FHFA to collect market data.⁷⁴ To fulfill this requirement,

⁷²[GAO-11-433](#).

⁷³Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1101, 122 Stat. 2654, 2661.

⁷⁴§ 1125, 122 Stat. at 2693-94.

in 2012, FHFA and CFPB announced an agreement to partner on the creation of a National Mortgage Database to include detailed loan information. In addition, the Dodd-Frank Act amended the Home Mortgage Disclosure Act of 1975, the main mechanism for collecting loan origination data prior to the financial crisis, to require additional reporting of loan level mortgage data.⁷⁵ The act transferred Home Mortgage Disclosure Act rulemaking authority from the Federal Reserve to CFPB on July 21, 2011. Although these data are not yet being collected by CFPB, officials at CFPB noted that the agency has taken steps in the rulemaking process. On February 7, 2014, CFPB convened a panel to discuss potential changes in the Home Mortgage Disclosure Act, and in July 2014, the agency issued a notice of proposed rulemaking regarding new and revised mortgage disclosure reporting requirements.⁷⁶

The Dodd-Frank Act includes many other provisions to address market challenges in the areas of consumer protection, mortgage underwriting, and investor protection.⁷⁷ For example:

- To protect consumers, the act established CFPB and authorized it to supervise certain nonbank financial companies including mortgage servicers and brokers, regardless of size, and large banks and credit unions for consumer financial protection purposes.⁷⁸ The act transferred to CFPB rulemaking and enforcement authority over many

⁷⁵Pub. L. No. 111-203, § 1094, 124 Stat. 1376, 2007 (2010). Consistent with recommendations we have made, the Dodd-Frank Act calls for collecting additional information including mortgage applicants' credit scores as well as information on the mortgage product and terms and property purchased or refinanced. In addition to those items, the National Mortgage Database will include information about the ongoing payment history of the loan. In addition to CFPB's and FHFA's efforts, OCC has been publishing mortgage-related data in its quarterly Mortgage Metrics Report since 2008. However, this report is limited to mortgage data from national banks and federal savings associations—the depository institutions over which OCC has regulatory authority.

⁷⁶Home Mortgage Disclosure (Regulation C); Proposed Rule, 79 Fed. Reg. 51732 (Aug. 29, 2014).

⁷⁷Pub. L. No. 111-203, 124 Stat. 1376 (2010). For additional information on the impact of the Dodd-Frank Act on the mortgage and financial markets see GAO, *Mortgage Reform: Potential Impacts of Provisions of the Dodd-Frank Act*, [GAO-11-656](#) (Washington, D.C.: July 19, 2011) and [GAO-13-180](#).

⁷⁸§§1024-1026, 124 Stat. at 1987-95. Before the Dodd-Frank Act, responsibility for administering and enforcing consumer financial laws for these entities was spread across several federal agencies.

previously enacted consumer financial protection laws and requires that CFPB track consumer complaints.⁷⁹

- To protect mortgage borrowers, the act requires, among other things, that servicers take timely action to respond to borrower requests to correct errors in connection with payment allocation, final balances, or avoiding foreclosure, or other standard servicer duties. The act also requires that servicers provide notices in advance of initial interest-rate resets for adjustable-rate mortgages. Further, the act requires that servicers credit mortgage payments promptly. CFPB has issued rules to implement these provisions as well as to address other weaknesses in servicing standards. Specifically, CFPB adopted rules to address servicers' obligations to correct errors raised by borrowers; provide certain information requested by borrowers, including loss mitigation options available to delinquent borrowers; and provide borrowers with continuity of contact with appropriate servicer personnel. CFPB also adopted rules to require servicers to provide borrowers with enhanced information, including notices regarding interest rate adjustments. The new rules took effect January 10, 2014.
- To improve mortgage underwriting and protect borrowers, the act amended TILA by prohibiting creditors from making mortgage loans without regard to a consumer's ability to repay the loan.⁸⁰ According to the act, a lender is presumed to have satisfied the ability-to-repay requirement when it originates a "qualified mortgage" (QM).⁸¹ CFPB had the responsibility to define QM generally and has included a

⁷⁹§§ 1011, 1012, § 1013(b)(3), 124 Stat. at 1964-66, 1968-69. In July 2013, CFPB reported that 48 percent of its over 175,000 consumer complaints were related to mortgages.

⁸⁰§ 1411, 124 Stat. at 2142-45 (codified at 15 U.S.C. § 1639c(a)).

⁸¹§ 1412, 124 Stat. at 2145 (codified at 15 U.S.C. § 1639c(b)). The act specifies nine criteria that a loan must meet to be a qualified mortgage (QM). These include, but are not limited to, criteria specifying that the loan be a loan with regular, amortizing payments for a term of no more than 30 years; the lender have verified and documented borrower income and financial resources; the loan complies with established guidelines or regulations relating to total monthly debt to monthly income ratios or alternative measures of ability to pay regular expenses; and that the loan's points and fees do not exceed 3 percent of the loan amount. 15 U.S.C. § 1693c(b)(2)(A). In addition, there are criteria specifying when ARMs, balloon payments, and reverse mortgages can qualify as a QM. CFPB's final QM rule went into effect January 10, 2014—Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z); Final Rule, 78 Fed. Reg. 6408 (Jan. 30, 2013). The final rule specified a 43 percent threshold for the maximum total monthly debt to monthly income ratio with respect to the definition of qualified mortgages, although the rule provided more flexibility for loans that were originated by small creditors or in compliance with enterprise and Ginnie Mae standards. 12 C.F.R. § 1026.43(e).

requirement that loans not guaranteed or insured by the government not exceed a debt-to-income ratio of 43 percent. However, this requirement does not apply to small creditors.⁸² HUD had responsibility to define QM for loans insured by FHA. Both CFPB's and HUD's QM-definition rules went into effect on January 10, 2014. In May 2014, to comply with the requirements of the Dodd-Frank Act, VA published an interim final rule amending its loan guaranty regulations that implement provisions to define QM for VA-guaranteed loans for the purpose of the new ability-to-pay provision of TILA. In this rule, VA defines the types of VA-guaranteed loans that are qualified mortgages for the purpose of the new ability-to-pay provision of TILA. USDA also has authority under the Dodd-Frank Act to define QM for its loans, but has not yet done so. The Dodd-Frank Act also prohibits mortgage originators from "steering" borrowers to mortgages that exhibit certain predatory features, restricts the use of prepayment penalties, and requires increased consumer disclosures related to certain mortgage features. In addition, the act established appraisal independence requirements to reduce conflicts of interest between appraisers and parties of interest in the transaction. Further, the act required that HUD establish an Office of Housing Counseling, which, according to HUD officials, began operating in October 2012.

- To protect investors, the act includes provisions related to new disclosures for asset-backed securities (ABS) including MBS.⁸³ The act requires SEC to prescribe regulations to require ratings agencies to disclose in their ratings the use of representations and warranties and enforcement mechanisms available to investors. The act also requires ABS issuers filing a registration statement to review the securities' underlying assets and disclose the nature of the review in the registration statement.⁸⁴ It also requires SEC to adopt regulations for MBS issuers to make additional disclosures of loan-level or asset-level data if such data are necessary for investors to independently

⁸²Small creditors are defined as those with no more than \$2 billion in assets that (along with affiliates) originate no more than 500 first-lien mortgages covered under the ability-to-repay rules per year. See Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z); Final Rule, 78 Fed. Reg. 35430, 35431 (June 12, 2013).

⁸³§942(b), 124 Stat. at 1891-97 (codified at 15 U.S.C. § 77g(c)). Some of these provisions apply to ABS, in general, and MBS are a subset of ABS.

⁸⁴§ 943, 124 Stat. at 1897 (codified at 15 U.S.C. § 78o-7); § 945, 124 Stat. at 1898 (codified at 15 U.S.C. §77g(d)(1)). This rule became effective on March 28, 2011.

perform due diligence. Such data are to include, among other things, the amount of risk retention by the originator and the securitizer of such assets.⁸⁵ In addition, the act prohibits conflicts of interest between individuals responsible for developing ABS and investors.⁸⁶ The act also requires that SEC, among other things, issue regulations requiring credit rating agencies registered with SEC to address conflicts of interest arising from sales and marketing and to disclose performance statistics.⁸⁷

- To protect investors further, the act generally includes provisions related to risk retention requiring MBS securitizers to retain a financial exposure of no less than 5 percent of the credit risk of any securitized residential mortgage that does not meet criteria associated with a lower risk of default.⁸⁸ Securitized mortgages meeting the criteria—referred to as a “qualified residential mortgages (QRM)—are exempt from this risk retention requirement; the QRM criteria are to be defined

⁸⁵§ 942(b), 124 Stat. at 1897 (codified at 15 U.S.C. § 77g(c)(2)(B)(iii)).

⁸⁶§ 621(a), 124 Stat. at 1631-32 (codified at 15 U.S.C. § 77z-2a(a)). Regulations implementing section 621 have been proposed by SEC but not yet finalized. See Prohibition Against Conflicts of Interest in Certain Securitizations; Proposed Rule, 76 Fed. Reg. 60320 (Sept. 28, 2011).

⁸⁷§ 932(a), 124 Stat. at 1872-1880 (codified at 15 U.S.C. § 78o-7). Pursuant to section 932’s amendments to the Securities Exchange Act of 1934, SEC revised its nationally recognized statistical rating organizations conflict-of-interest rule, 17 C.F.R. § 240.17g-5. Nationally Recognized Statistical Rating Organizations, 79 Fed. Reg. 55078 (Sept. 15, 2014).

⁸⁸§ 941(b), 124 Stat. at 1892. Government-insured or -guaranteed residential mortgage loans and loans eligible for securitization by the enterprises would be excluded from this requirement for so long as the enterprises are in receivership or conservatorship with capital support from Treasury. Credit Risk Retention; Proposed Rule, 78 Fed. Reg. 57928, 58033 (Sept. 20, 2013). In addition, although the act contains a minimum 5 percent requirement, it gives the rule-writing federal regulators the flexibility to specify different risk retention requirements for securitizers of different classes of assets, including residential mortgages, commercial mortgages, commercial loans, auto loans, and other classes of assets that the agencies deem appropriate, subject to certain underwriting standards established by federal banking agencies. A joint agency final rule for the risk retention requirements and the definition of qualified residential mortgage (QRM) has yet to be issued. However, the relevant agencies have proposed two rules. In March 2011, the agencies issued their original proposed rules, including a QRM definition that included loans with back-end debt-to-income ratios of no more than 36 percent, minimum 20 percent down payments, and minimum credit history requirements. Credit Risk Retention; Proposed Rule, 76 Fed. Reg. 24090, 24096 (Apr. 29, 2011). In August 2013, the agencies repropose the credit risk retention rules, which, as revised, would equate the definition of QRM with the definition of QM adopted by CFPB. Credit Risk Retention; Proposed Rule, 78 Fed. Reg. 57928, 57934, 57992 (Sept. 20, 2013).

jointly by several agencies. The risk retention provision is designed to protect investors by providing an incentive for securitizers of non-QRMs to ensure that the assets underlying a securitization transaction are well-underwritten.

Since many of the regulatory actions required by the Dodd-Frank Act and other legislative actions are not yet complete or have been recently implemented, their impact on the marketplace remains to be seen. Representatives of market participants have said that they faced uncertainties because some regulations had not been implemented and that these uncertainties could limit the return of private capital to the secondary market.

In addition to legislative changes, federal and state agencies have taken action to enforce consumer protections including legal and regulatory enforcement actions against mortgage servicers and other industry participants. The Department of Justice (DOJ) has pursued a number of mortgage securities and mortgage fraud cases. For example, a settlement was reached in February 2012 between DOJ, HUD, Treasury and 49 state Attorneys General, with the nation's five largest mortgage servicers to address mortgage servicing and foreclosure abuses.⁸⁹ A large share of the \$25 billion settlement is dedicated to financial relief for homeowners including mortgage principal reduction and refinancing for underwater homeowners.⁹⁰ In addition, SEC has pursued a number of enforcement actions related to, among other areas, improper disclosure of investor risks related to CDOs, mortgage-related risks and exposure, and concealment of the extent of mortgage-related risks in mutual funds and other investment products. For example, in August 2012 SEC charged Wells Fargo's brokerage firm and a former vice president with

⁸⁹*United States v. Bank of America Corp.*, No. 1:12-CV-00361 (D.D.C. Apr. 4, 2012). The settling servicers were Ally (formerly GMAC), Citi, Bank of America, JPMorgan Chase, and Wells Fargo. The settlement, known as the National Mortgage Settlement, established nationwide servicing reforms for the participating servicers, including establishing a single point of contact for borrowers, standards for communication with borrowers, and expectations for fee amounts and the execution of foreclosure documentation. The settlement also established an independent monitor to oversee the servicers' execution of the agreement, including their adherence to the mortgage servicing standards.

⁹⁰The Federal Reserve and OCC also concluded their Independent Foreclosure Review by entering into payment agreements with 15 servicers in 2013 to provide \$3.9 billion in direct cash payments to borrowers and approximately \$6.1 billion in foreclosure-prevention assistance.

selling investments tied to mortgage-backed securities without fully understanding their complexity or disclosing the risks to investors. Wells Fargo agreed to pay SEC more than \$6.5 million to settle the charges; this settlement will go to an SEC fund for harmed investors.

A Framework for Assessing Potential Changes to the Housing Finance System

We have identified the role played by the federal government in the housing finance system as a high-risk area for the government and have also noted that the Dodd-Frank Act did not fully address weaknesses in the housing finance system.⁹¹ Attention has now turned in Congress and elsewhere to considering other significant changes to the housing finance system (see app. III for a list of legislative proposals introduced in the 113th Congress). Some experts and interested parties believe that the current system is unsustainable and warrants reform, while others believe that certain features of the current system should be maintained because they have served the United States well.

We are providing a framework consisting of nine elements that Congress and others can use to assess or craft proposals as they consider changes to the housing finance system (see table 2). Similar elements appear throughout the literature we analyzed on the housing finance system, including our prior reports (see related list of reports at the end of this report) and, to some extent, in proposals to change the system. We sought the input of a broad range of government officials, experts from academia and research organizations, consumer advocates, and industry representatives on this framework and have included their comments related to the nine elements as appropriate. We believe each element in the framework is critically important in establishing the most effective and efficient housing finance system. Applying the elements of this framework would help policymakers identify the relative strengths and weaknesses of any proposals they are considering. Similarly, the framework can be used to craft proposals or to identify changes to existing proposals to make them more effective and appropriate for addressing any limitations of the current system. However, any viable proposal for change will involve choices that recognize that sometimes trade-offs will exist among and within the nine elements. In addition, proposals will need to take into consideration certain characteristics—transparency, accountability,

⁹¹See [GAO-13-283](#) and GAO, *Financial Regulatory Reform: Regulators Have Faced Challenges Finalizing Key Reforms and Unaddressed Areas Pose Potential Risks*, [GAO-13-195](#) (Washington, D.C.: Jan. 23, 2013).

aligned incentives, and efficiency and effectiveness—associated with appropriate controls and high-quality government performance that run through each element.

Table 2: Elements of a Housing Finance Framework

Element	Description
Clearly defined and prioritized housing finance system goals	Broad goals for the housing finance system should be clearly articulated and relevant so that government and market participants can effectively conduct activities to implement their missions. Additionally, market and government performance can be assessed against those broad goals. These goals should recognize broader housing policy objectives, as well. Where trade-offs among the broad goals exist, the goals should be prioritized.
Policies and mechanisms that are aligned with goals and other economic policies	Housing finance policies and mechanisms should be aligned with the broader goals of housing finance. Changes in housing finance should consider the full range of options for government actions—such as direct participation in markets through government guarantees, oversight and regulation, data collection and dissemination, and tax or other federal incentives to promote greater private market participation—and show how policies and mechanisms interact to achieve the goals on a comprehensive basis, while minimizing fragmentation, overlap, and duplication. In light of weaknesses exposed during the financial crisis these policies and mechanisms should help to align incentives, provide more information and transparency, and restrain excessive risk taking. Proposals should also reflect how these mechanisms will interact with broader economic policies.
Adherence to an appropriate financial regulatory framework	In 2009, GAO proposed such a framework for a financial regulatory system that included some of the elements listed here as well as ensuring that regulation was appropriately comprehensive, consistent, flexible, adaptable, and had a systemwide focus (GAO-09-216). A regulatory system should also ensure that regulators have independence from inappropriate influence; have sufficient resources, clout, and authority to carry out and enforce statutory missions; and are clearly accountable for meeting regulatory goals.
Government entities that have capacity to manage risks	Government entities will need adequate skills and resources to understand, price, and manage risks. These entities would also need the capacity to ensure that their counterparties in the private sector have the capacity to manage the risks inherent in their activities.
Mortgage borrowers are protected and barriers to mortgage market access are addressed	Borrowers need consistent, useful information, as well as legal protections, including disclosures, sales practice standards, and suitability requirements, throughout the lifecycle of a mortgage product. Any barriers facing creditworthy borrowers in accessing mortgage markets should be addressed. Key issues will be to encourage innovation to reduce barriers while ensuring that products are easily understood, such as through standardization and developing better tools to assess creditworthiness.
Protection for mortgage securities investors	Investors in the secondary market require adequate, reliable information to assess secondary-market risks. This would include providing clear information on securitizer and trustee responsibilities as they relate to investors. As with borrower protection, some standardization may be useful; however, care must be taken to ensure that certain protections do not discourage beneficial innovation.

Element	Description
Consideration of cyclical nature of housing finance and impact of housing finance on financial stability	Housing finance has been characterized by cycles that have alternated between loose credit standards and those that are tight. Because housing is a significant part of the economy, these cycles may pose risks to financial and economic stability. Government should determine whether actions related to housing finance are procyclical or countercyclical and consider making actions less procyclical. Government may also want to consider the appropriateness of countercyclical measures. Actions also should address the threat housing finance poses for financial stability when there are incentives for excessive risk taking.
Recognition and control of fiscal exposure and mitigation of moral hazard	Choices about policies and mechanisms will result in different levels of fiscal exposure. Wherever possible, exposures should be made explicit and costs recognized. Actions should be taken to minimize unexpected costs and to mitigate any moral hazard created by government policies and support.
Emphasis on implications of the transition.	Because changing the housing finance system may lead to substantial changes in the marketplace, issues related to transitioning from the current system to a new one should be emphasized in any proposal for change. Any action that would severely limit market liquidity during the transition should be of particular concern.

Source: GAO | GAO-15-131

Element 1: Clearly Defined and Prioritized Housing Finance System Goals

For some time, we have noted the importance of having clearly articulated goals when considering federal intervention in and regulation of market activities, and such requirements would apply to housing finance as well. In our work on the Troubled Asset Relief Program, for instance, we built on lessons learned from the financial crises of the 1970s and 1980s to identify guiding principles to help serve as a framework for evaluating large-scale federal assistance efforts and provide guidelines for assisting failing companies.⁹² As part of that work, one of the key principles we developed was that national interests should be determined and clear goals and objectives set that reflect those interests. Further, in 2009 we identified clearly defined goals and objectives as essential to reforming the financial regulatory system.⁹³ For housing finance, such goals include the general purpose of any government guarantees in housing finance markets or other rules and regulations governing activities in housing finance markets. Goals for housing finance have also included goals relative to the housing market and to the overall functioning of the financial and economic systems including maintaining financial stability or creating jobs.

⁹²GAO, *Financial Assistance: Ongoing Challenges and Guiding Principles Related to Government Assistance for Private Sector Companies*, [GAO-10-719](#) (Washington, D.C.: Aug. 3, 2010).

⁹³[GAO-09-216](#).

More generally, we have found that clear goals can help guide agency activities and establish agency accountability. For example, clear goals help agencies identify and achieve their missions, establish priorities, and define responsibility and accountability for identifying risks.⁹⁴ As part of their strategic planning, agencies are expected to link their staffing, activities, and budgets to their missions and goals.⁹⁵ In addition, in our work on government performance, we have concluded that agency missions should begin with statutory requirements and that agencies should coordinate with Congress when setting agency goals.⁹⁶ Without clearly stated goals, agency activities may lack focus and consistency. For example, the lack of clearly stated goals for FHFA that recognize the potential trade-off between bringing private capital back into the market and making mortgage credit available has led to inconsistency in its policy on the level of guarantee fees on MBS issued by the enterprises. In 2012, under an acting director, FHFA increased guarantee fees and planned further increases to encourage private capital back into the market. However, when FHFA's new director took over in 2014, he put further increases on hold expressing concern about the implications an increase would have for mortgage credit availability. FHFA has also reached out for direction on its goals. In June 2014, FHFA issued a request for public input on further changes to these fees including input on what goals FHFA should seek to meet in setting guarantee fees. Additionally, the Director noted in a speech on the strategic plan for the enterprises that Congress and the Administration, not FHFA, have the important job of deciding on housing finance reform legislation. A housing finance policy goal that clearly identifies the importance of bringing private capital back into the market relative to other goals of that system would help guide FHFA activities. In addition, we have previously found that clearly stated missions help to hold agencies accountable because they facilitate the clear statement of agency objectives and the measurement of agency performance.⁹⁷

⁹⁴[GAO-09-216](#).

⁹⁵See for example, GAO, *Results-Oriented Government: GPRA Has Established a Solid Foundation for Achieving Greater Results*, [GAO-04-38](#) (Washington, D.C.: Mar. 10, 2004).

⁹⁶GAO, *Agencies' Strategic Plans Under GPRA: Key Questions to Facilitate Congressional Review*, [GAO/GGD-10.1.16](#) (Washington, D.C.: May 1997).

⁹⁷[GAO-04-38](#) and GAO, *Executive Guide: Effectively Implementing the Government Performance and Results Act*, [GAO/GGD-96-118](#) (Washington, D.C.: June 1996).

Addressing weaknesses in the single-family housing finance system could result in conflicting goals. The 2007-2009 financial crisis left the government more involved in housing finance than it had been traditionally. As a result, one potential goal of changes to the housing finance system could be to reduce the government's role. However, doing so could conflict with a number of other potential goals, such as keeping the cost of housing finance affordable or providing liquidity and stability during market downturns. We have previously concluded that choosing clearly among potentially conflicting objectives is important. Therefore, it is important to first identify the primary objective, otherwise, deciding what steps are appropriate and judging whether a program has succeeded will be difficult.⁹⁸

Participants in our discussion groups stressed the importance of setting appropriate goals, and some participants noted that divisions among proponents of change generally stemmed from differences in goals. Several of the participants or the groups they represented had published lists of principles for or goals of housing reform prior to the meeting.⁹⁹ For example, one group's goals can be summarized as including: the market should principally function without direct government financial support; programs for assisting low-income families to become homeowners should be on budget and should limit risks to homeowners and taxpayers; and the enterprises should be eliminated. While another group's goals are that the enterprises be phased out over an appropriate period: the private sector play a far greater role; government-insured MBS play a continued but more limited role for government-insured MBS; FHA play a continued but more targeted role; and borrowers have access to safe and affordable mortgages based on sound underwriting and risk management throughout economic cycles. Some participants agreed that policymakers need to be aware of trade-offs among goals when setting priorities. However, one participant noted that having to be explicit about goals

⁹⁸GAO, *Guidelines for Rescuing Large Failing Firms and Municipalities*, [GAO/GGD-84-3](#) (Washington, D.C.: Mar. 29, 1984).

⁹⁹See for example, Bipartisan Policy Center's Housing Commission Economic Policy, *Housing America's Future: New Directions for National Policy* (Washington, D.C.: February 2013); Mortgage Finance Working Group of the Center for American Progress, *A Responsible Market for Housing Finance: A Progressive Plan to Reform the U.S. Secondary Market for Residential Mortgages* (Washington, D.C.: January 2011); and Peter J. Wallison, Alex J. Pollock, and Edward J. Pinto, *Taking the Government Out of Housing Finance: Principles for Reforming the Housing Finance Market*, An American Enterprise Institute Policy Paper (Washington, D.C.: Mar. 24, 2011).

could limit the opportunity for change. This view raises the question of how much specificity any legislation should include and how much should be left to entities responsible for implementing the rules. While having clearly articulated goals is important, in prior work we have noted that regulators also need the ability to be flexible and adaptable when implementing financial reform.¹⁰⁰ This is also important with housing finance reform because these markets also evolve over time.

Proposals have defined goals for housing finance reform as well. One set of goals includes maintaining access to the 30-year fixed-rate mortgage, protecting taxpayers, providing stability and liquidity, requiring transparency and standardization, and ensuring access to affordable rental housing. However, goals sometimes conflict and their priority is unclear. For example, one proposal includes a goal of protecting taxpayers from bearing the cost of a housing downturn and a goal of promoting a sound, stable, and liquid housing market. However, these goals may conflict during an economic downturn, and the proposal does not discuss priorities.

Element 2: Policies and Mechanisms That Are Aligned with Goals and Other Economic Policies

We have reported that aligning policies and mechanisms with the relevant goals and priorities helps to achieve accountability and efficiency. In addition, we have noted that housing reform needs to be considered on a comprehensive basis, which could better control risks and reduce any unnecessary overlap and duplication. For example, in our 2013 high-risk report we concluded that decisions about the future role of the enterprises should consider impacts on other parts of the housing finance system, including FHA's single-family mortgage insurance programs.¹⁰¹ Efforts to reduce the market presence of the enterprises could shift some borrowers currently served by that market segment to FHA, and the resulting impacts on FHA's risk exposure should be considered. Moreover, we have noted the overlap between FHA insurance programs for single-family mortgages and USDA's loan guarantee program and the potential for consolidation of these programs.¹⁰² In 2012, we noted that the administration announced in 2011 the creation of a task force to evaluate the potential for coordinating or consolidating homeownership loan

¹⁰⁰[GAO-09-216](#).

¹⁰¹[GAO-13-283](#).

¹⁰²GAO, *Housing Assistance: Opportunities Exist to Increase Collaboration and Consider Consolidation*, [GAO-12-554](#) (Washington, D.C.: Aug. 16, 2012).

programs at HUD, USDA, and VA. Although a working group that includes these agencies has been meeting and considering ways to better coordinate, it is not considering program consolidation.¹⁰³

Proposals for policy changes would need to consider the full range of options for government action, such as direct participation in markets through government guarantees, oversight and regulation, data collection and dissemination, and tax and other federal incentives to promote greater private market participation. As a first step, proposals would need to look across current policies and mechanisms to determine whether they are achieving their purpose, whether that purpose is consistent with proposed housing finance policy goals, and whether the purpose might be achieved more effectively through some alternative policy or mechanism. As this report has shown, the U.S. government uses a range of policies and mechanisms in the single-family housing finance area, including insurance and guarantees in both the primary and secondary market; tax expenditures such as the mortgage interest deduction; and data collection and dissemination, primarily under the Home Mortgage Disclosure Act.¹⁰⁴ New proposals would need to consider whether these are still viable or could be altered to produce a better result. For instance, some research suggests that rather than increasing the number of home buyers, the mortgage interest deduction provides an incentive for people to buy larger homes than they otherwise would, an outcome that may conflict with current policy goals. In addition, proposals would need to show how suggested policies and mechanisms will interact, both among themselves and with broader macroeconomic policies, to achieve goals on a comprehensive basis while minimizing fragmentation, overlap, and

¹⁰³A Joint Federal Housing Agencies Working Group, which includes CFPB, FHA, FHFA, Ginnie Mae, USDA, and VA, has been formed. According to its March 2014 minutes, the working group plans to meet monthly to discuss issues including coordination, information sharing, and development of best practices.

¹⁰⁴The Home Mortgage Disclosure Act, Pub. L. No. 94-200, 89 Stat. 1125 (codified at 12 U.S.C. §§ 2801-2810), is intended to provide the public with loan data that can be used to (1) determine whether financial institutions are serving the housing needs of their communities; (2) assist public officials in the distribution of public-sector investments so as to attract private investment to areas where it is needed; and (3) identify possible discriminatory lending patterns. 12 U.S.C. § 2801(b); 12 C.F.R. § 1003.1(b)(1).

duplication.¹⁰⁵ In light of weaknesses exposed during the financial crisis, these policies and mechanisms would help align incentives, provide more information and transparency, and restrain excessive risk taking.

Participants across the stakeholder groups at our panel discussions noted that housing finance reform should be considered as a whole. Some participants noted specifically that reforming one part of the housing finance system, such as the secondary market, could create additional risks elsewhere in the system, such as in the primary market. An official at Treasury noted that reforming the housing finance system should include a discussion of how the key risks of mortgage lending (credit, interest rate, and prepayment risk) should be distributed between households, governments, and private lenders, and investors.

One proposal for change addresses reform on a comprehensive basis including a range of policies and mechanisms. That proposal includes FHA reform along with reform of the secondary market and considers alternatives to the latter, such as developing a market for covered bonds.¹⁰⁶ That same proposal also addresses an opportunity to reduce overlap and duplication by recognizing the potential for efficiencies that could be achieved by requiring that FHA develop and maintain appropriate financial, underwriting, and operations systems that USDA can also use for its rural housing programs. Proposals also contain policies and mechanisms intended to address weaknesses exposed during the financial crisis. For example, one proposal to change the housing finance system would better align incentives and limit risk by

¹⁰⁵Fragmentation refers to those circumstances in which more than one federal agency is involved in the same broad area of national interest. Overlap occurs when programs have similar goals, devise similar strategies and activities to achieve those goals, or target similar users. Duplication occurs when two or more agencies or programs engage in the same activities or provide the same services to the same beneficiaries. In some instances, it may be appropriate for multiple agencies or entities to be involved in the same programmatic or policy area due to the nature or magnitude of the federal effort. See [GAO-12-554](#).

¹⁰⁶A covered bond is a debt obligation secured by a pool of assets, often mortgages. It differs from a securitization in that in the case of default, holders of the bonds not only have access to the collateral supporting the security, but also can draw on the issuer's other assets for repayment in case of bankruptcy or insolvency. According to the Congressional Research Service covered bonds are a relatively common method of funding mortgages in Europe, but uncommon in the United States. See Congressional Research Service, *Covered Bonds: Background and Policy Issues*, R41322 (Washington, D.C.: Apr. 26, 2013).

requiring that some lenders making FHA-insured loans take greater responsibility for errors or fraud and abuse and consider borrowers' ability to repay. To facilitate public access to more mortgage information, at least three proposals would establish new databases to store uniform loan-level data. These proposals also aim to improve transparency in market operations through uniform securitization agreements for covered securities, to include standard documents such as pooling and servicing agreements, representations and warranties, and loss mitigation procedures. To better manage risk, some proposals also would require that credit risk-sharing structures be established wherein private market participants share or assume the credit risk associated with mortgage securities.

Element 3: Adherence to an Appropriate Financial Regulatory Framework

In 2009, GAO proposed a framework for crafting or assessing proposals to modernize the financial regulatory system that included some of the elements listed here, along with others that were designed to help ensure that regulation was appropriately comprehensive, consistent, flexible and adaptable, and had a systemwide focus.¹⁰⁷ We also found that a regulatory system should ensure that regulators have independence from inappropriate influence; have sufficient resources, clout, and authority to carry out and enforce statutory missions; and are clearly accountable for meeting regulatory goals. To strengthen decision-making and accountability, regulators will need access to the best reasonably obtainable scientific, technical, economic, and other information. Given the market weaknesses we noted earlier in this report, and consistent with our previous framework, regulators under a new housing finance system should consider how their activities could better identify and address any systemic risks posed by the housing finance system. We also have previously found that any financial regulatory reform needed to address gaps, overlapping missions, and fragmentation in the regulatory system.

These elements would be applicable to any regulatory system developed to make rules and oversee the housing finance system. For example:

- **A comprehensive, systemwide focus.** Any proposed regulatory system for single-family housing finance would need to have a

¹⁰⁷[GAO-09-216](#).

systemwide focus that addresses the complexity of the housing finance system on a comprehensive basis. For example, proposals would need to consider how any new regulatory entities will interact with existing regulators, such as CFPB, FHFA, and the Financial Stability Oversight Council. A systemwide focus would also increase the attention given to the effects of incentives and constraints that regulations place on market participants' risk taking and to actions regulators can take to anticipate and mitigate any such risk taking.

- **Consistency.** Regulatory consistency across relevant federal agencies would help ensure that market participants are better able to understand the rules governing their behavior. Although there are similarities among the various rules creating safe harbors for regulatory treatment of mortgages including CFPB's QM rule, HUD's QM rule, VA's QM rule, and multiagency rules being developed for QRM, some participants in our discussions, including regulators, noted the lack of regulatory consistency. CFPB officials noted that CFPB has consulted with other agencies and given them opportunities to identify inconsistencies before issuing proposed and final QM rules. In addition, CFPB officials noted that the Dodd-Frank Act specifically allowed for differences across the agencies issuing these rules. A consumer advocate who attended our group discussions also noted possible inconsistencies in regulatory oversight that could occur as mortgage servicing moves from banks to nonbanks. This move may be driven, in part, by heightened capital and liquidity requirements for banks that engage in mortgage servicing. Nonbanks would not have these requirements, but CFPB oversees compliance with consumer financial protection regulations at nonbanks as well as banks. As noted earlier in this report, CFPB's servicing rules apply to all mortgage servicers, including non-depository institutions, regardless of size.
- **Flexibility and adaptability.** Designing a system to be flexible and proactive involves determining how much of the system would need to be dictated by law and how much would need to be left to federal entities responsible for implementing the law. Flexibility and adaptability may be particularly important during a transition from the current system to a new housing finance system.
- **Accountability.** As noted earlier, any housing finance system would need to ensure that regulators are accountable to the public and to Congress for meeting clearly stated regulatory goals. The Government Performance and Results Act (GPRA) of 1993 requires agencies to clarify their missions, set strategic and annual

performance goals, and measure and report on performance toward those goals.¹⁰⁸ Congress may also require regulators to submit annual reports, performance audits, and testify before Congress. The GPRA Modernization Act of 2010 further requires that agencies disclose more information about the accuracy and validity of their performance information in their performance plans and reports, including the sources for their data and actions to address any data limitations.¹⁰⁹ Additionally, in 2009 in our report on a regulatory framework, we concluded that policymakers may want to consider how to ensure that agencies are recognized for successes and held accountable for failures to act in accordance with regulatory goals as part of any reform effort.¹¹⁰ The housing finance system is somewhat fragmented, with multiple agencies responsible for regulating various aspects of the housing finance system. The International Monetary Fund, in its 2010 review of the U.S. bank regulatory system, found that a multiplicity of regulatory agencies can lead to overlap that dilutes accountability. When regulation and missions overlap, defining the specific responsibilities of each entity is critical for ensuring that each regulator can be accountable for its defined mission. In addition, in a fragmented system, collaboration among regulators may help ensure that agencies are accountable by helping to define the roles and responsibilities of each regulator. We also have found that fragmented regulation can make more challenging the identification of systemwide risks.¹¹¹ Therefore, all regulators under a new system for housing finance would need to consider how their activities could better identify and address any systemic risks posed by the housing finance system.

Proposals vary in the extent to which they address the regulatory elements noted above. Few proposals have a comprehensive, systemwide focus. For example, one proposal addresses changes in both the primary and secondary markets, while other proposals focus on regulation of the secondary market. At least two proposals address regulation of the broader housing finance system and how the new

¹⁰⁸Pub. L. No. 103-62, §§ 3-4, 107 Stat. 285, 286-89 (codified at 5 U.S.C. § 306, 31 U.S.C. § 1115).

¹⁰⁹Pub. L. No. 111-352, § 4, 124 Stat. 3866, 3871-72 (codified at 31 U.S.C. § 1116).

¹¹⁰See [GAO-09-216](#).

¹¹¹See [GAO-09-216](#).

regulatory entities may interact with existing regulators. For example, one proposal would establish a new independent government agency to regulate all of the participants in the housing finance system, insure eligible mortgage securities in a system similar to FDIC's deposit insurance in the banking system, and assume FHFA's seat on the Financial Stability Oversight Council, an organization created by the Dodd-Frank Act to identify risks and respond to threats to financial stability. At least one proposal calls for the director of the new regulatory agency to share information with other federal regulatory agencies regarding the financial condition and risk management practices of market participants, thereby potentially enabling federal regulators to better identify systemic risks. Consistent with existing QM underwriting standards recently established by CFPB, four proposals recommend the same QM standards for the secondary market platform. At least four proposals would require regulatory coordination among the newly established secondary market regulatory bodies and existing regulators. For example, one of these proposals specifically requires that the new regulator coordinate standards for approval of servicers and mortgage servicing standards with CFPB and the federal banking regulators, respectively. Another proposal would permit the new regulator to consult with other federal agencies as appropriate, and avoid duplication with the regulatory activities of other agencies, such as examination activities and reporting requirements. At least one proposal would create an advisory committee to provide a mechanism for stakeholders to provide input to the regulatory entity, which could potentially help the regulator adapt to developments in the primary and secondary mortgage markets. Some proposals would also establish accountability mechanisms for the regulator, including annual reporting to Congress by key agencies and officials of proposed regulatory structures including an Office of Inspector General.

Element 4: Government Entities That Have Capacity to Manage Risk

We have previously stated that government agencies should assess risks associated with both internal management factors and external sources.¹¹² We have also identified strategic human capital management as a high-risk area because for agencies to cost-effectively carry out their missions and respond to emerging challenges, they will need to take a

¹¹²See GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999).

strategic and efficient approach to acquiring, developing, and retaining individuals with needed skills.¹¹³ Government entities in the housing finance system that make loans or provide insurance or guarantees on loans or MBS will need adequate skills and resources to understand, price, and manage risks to the housing finance system. These government entities will also need the capacity to ensure that their counterparties in the private sector are able to manage the risks inherent in their activities. For example, when government entities act to insure mortgages or guarantee MBS, they need the capacity to manage their own credit and operational risks and to ensure that their counterparties, such as lenders, servicers, and investors, can manage their respective risks. We have found previously that agencies with loan insurance programs, such as FHA, face credit risks including borrower default risk, which arises as borrowers become unable to make payments on insured mortgages.¹¹⁴ Agencies also face counterparty risk. That is, an agency may suffer losses due to weaknesses or uncertainties in the work of its counterparties, including lenders and appraisers for FHA and issuers for Ginnie Mae. At the enterprises, private mortgage insurer counterparties have historically provided the main mechanism to help reduce credit risk exposure for the enterprises. Generally, we have found that private mortgage insurers experienced weakened financial conditions during the financial crisis.¹¹⁵ In May 2014, FHFA's Office of Inspector General reported that 5 of the 10 private mortgage insurers eligible to conduct business with the enterprises are considered financially weakened.¹¹⁶ And all agencies face operational risks—that is, the risk of loss resulting from inadequate or failed internal processes; deficiencies in staff numbers, training, and skills; or external events. For example, between 2002 and 2004, the enterprises were cited for failures in their accounting systems that did not adequately capture their risk-taking activities. We have made a number of recommendations aimed at improving FHA's risk

¹¹³See GAO, *Human Capital Management: Effectively Implementing Reforms and Closing Critical Skills Gaps Are Key to Addressing Federal Workforce Challenges*, [GAO-12-1023T](#) (Washington, D.C.: Sept. 19, 2012).

¹¹⁴See GAO, *Mortgage Financing: FHA and Ginnie Mae Face Risk-Management Challenges*, [GAO-12-578T](#) (Washington D.C.: Mar. 29, 2012).

¹¹⁵See GAO, *Insurance Markets: Impacts of and Regulatory Response to the 2007-2009 Financial Crisis*, [GAO-13-583](#) (Washington, D.C.: June 27, 2013).

¹¹⁶Mortgage insurers are regulated by state insurance departments which require insurers to maintain a minimum risk based capital ratio.

assessment and human capital management, as well as HUD's information technology systems.¹¹⁷

FHA and FHFA have considered risk-sharing strategies as a way to help manage risk at FHA and the enterprises. FHA officials have told us in the past that FHA would need to increase its staff and analytic capacity to safely implement risk-sharing agreements.¹¹⁸ Ginnie Mae officials told us that any FHA risk-sharing agreements that shift additional credit risk to servicers would increase the agency's counterparty risk and noted that Ginnie Mae would probably require issuers to hold more capital to mitigate this risk. They further noted that Ginnie Mae's counterparty risk would not increase if FHA shifted risk to a third party in a way that is similar to the way the enterprises shift risks to third parties. In *The 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac*, FHFA noted that the enterprises have completed several risk-sharing transactions, which support FHFA's plan to reduce the enterprises' presence in the housing finance market. Specifically, the 2014 strategic plan requires each enterprise to transfer a substantial portion of the credit risk on \$90 billion of new MBS—a three-fold increase over the amount required in 2013.¹¹⁹ FHFA's 2014 strategic plan also states, upon FHFA's direction, the enterprises would take steps to strengthen counterparty standards for private mortgage insurers to ensure that the insurers are able to fulfill their intended role of providing private capital. As part of this effort, on July 10, 2014, FHFA requested input on draft eligibility requirements the enterprises would use to approve private mortgage insurers that provide mortgage insurance on loans owned or guaranteed by the enterprises.¹²⁰ According to FHFA, these new standards are

¹¹⁷See GAO, *Federal Housing Administration: Improvements Needed in Risk Assessment and Human Capital Management*, [GAO-12-15](#) (Washington, D.C.: Nov. 7, 2011) and *Information Technology: HUD Needs to Improve Key Project Management Practices for Its Modernization Efforts*, [GAO-13-455](#) (Washington, D.C.: June 12, 2013). In response to these recommendations, FHA has taken steps, such as developing a plan for conducting an inaugural risk assessment and a workforce analysis and succession plan, and describing actions HUD would take to improve its project management practices in order to address the deficiencies identified.

¹¹⁸See [GAO-13-682](#).

¹¹⁹See FHFA, *The 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac* (Washington, D.C.: May 2014).

¹²⁰Fannie Mae and Freddie Mac Draft Private Mortgage Insurer Eligibility Requirements; Request for Public Input, 79 Fed. Reg. 42513 (July 22, 2014). The period for public input ended on September 8, 2014.

designed to ensure that approved insurers maintain sufficient financial and operational capacity to withstand a severe stress event. Any proposal for sharing risks between public and private entities requires careful consideration, not only of the capacity of these entities to understand and manage risks, but also to ensure that the risk-sharing structure does not create incentives for either party to engage in excessive risk taking.

Proposals to change the housing finance system address capacity to manage risk in a number of ways. In the primary market, two proposals would provide FHA with increased capability to manage risk. One of the proposals would allow FHA and USDA to share risk-management expertise. One proposal for changing the secondary market would authorize FHFA to regulate and examine contractual counterparties, and another proposal would require FHFA to report annually to Congress on risk-sharing structures. Proposals calling for a single government-owned independent corporation to support the secondary market recognize that the corporation's director would need technical expertise in mortgage securities and housing finance. These proposals also would establish boards of directors and advisory committees comprised of members with diverse housing finance expertise, including asset management. Some proposals for changing the primary and secondary markets would establish salary structures that are competitive with those of existing federal financial regulators for any new federal agencies overseeing the markets.

Element 5: Mortgage Borrowers Are Protected and Barriers to Mortgage Market Access Addressed

In our 2009 report presenting a framework for assessing or crafting a financial regulatory system, we found that it is important for market participants to receive consistent, useful information, as well as to have legal protections, including disclosures, sales practices for similar financial products and services, and suitability requirements.¹²¹ Similarly, a housing finance system should provide borrowers with the information to determine the loan product best suited to their needs, and the system should include borrower financial protections over the lifecycle of a mortgage loan—origination, securitization, and servicing. In September 2011, we reported that homeownership counseling could help borrowers learn about buying a home and could improve outcomes for delinquent

¹²¹See [GAO-09-216](#).

borrowers.¹²² In June 2012, we found that reaching delinquent borrowers early, when they had missed fewer payments, resulted in more successful loan modifications.¹²³ And in April 2014, we recommended that regulatory agencies strengthen oversight activities to determine the extent to which servicers are implementing foreclosure prevention principles and protecting borrowers.¹²⁴ Housing finance system reforms will also need to address any barriers that creditworthy borrowers face in accessing the housing finance market. Key issues include encouraging innovation to reduce barriers to mortgage credit while ensuring that mortgage products are suitable for borrowers, and developing alternative tools to assess creditworthiness for broader market access.

Federal agencies have taken some steps designed to better protect borrowers throughout the mortgage loan lifecycle and improve mortgage market access; many of these actions have been discussed earlier in this report. For example,

- **Origination.** CFPB, HUD, and VA have issued rules related to assessing borrowers' ability to repay their loans, which addresses some aspects of suitability. CFPB also finalized loan originator compensation rules designed to reduce incentives for loan originators to steer borrowers to unaffordable mortgages.¹²⁵ As previously noted in this report, in 2008, HUD revised the rules implementing RESPA so that the required forms would provide additional disclosures at origination. In November 2013, CFPB issued final rules consolidating the disclosures required by TILA and RESPA for applicants considering a home mortgage loan. These rules take effect on August 1, 2015. In its *Blueprint for Access* issued in March 2014, FHA outlined steps the agency is taking to expand access to credit for underserved borrowers, including encouraging broader use of housing counseling intended to ensure that borrowers are well-educated about

¹²²See GAO, *Homeownership Counseling: Although Research Suggests Some Benefits, Implementation and Evaluation Challenges Exist*, [GAO-11-925T](#) (Washington, D.C.: Sept. 14, 2011).

¹²³See [GAO-12-296](#).

¹²⁴See GAO, *Foreclosure Review: Regulators Could Strengthen Oversight and Improve Transparency of the Process*, [GAO-14-376](#) (Washington, D.C.: Apr. 29, 2014).

¹²⁵12 C.F.R. § 1026.36; see also Loan Originator Compensation Requirements Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 11280 (Feb. 15, 2013).

the home-buying and mortgage finance process. For example, in May 2014, the agency began soliciting comment on a 4-year pilot program that would provide FHA insurance pricing incentives to first-time homebuyers who participate in housing counseling and education that covers how to evaluate housing affordability and mortgage alternatives, better manage their finances, and understand the rights and responsibilities of homeownership.¹²⁶ HUD officials told us that housing counseling can divert consumers who are not ready for homeownership from entering into a contract for an unaffordable home, and also bring consumers to the housing finance system who might otherwise be afraid of being denied.

- **Securitization.** FHFA has specified the need for greater clarity about requirements for loans to be securitized by the enterprises, saying that the lack of clarity was likely restricting access for some creditworthy borrowers. FHFA noted in its 2014 Strategic Plan that some originators and mortgage insurers have been requiring higher minimum credit score requirements than would be required by the enterprises, resulting in the rejection of many loans that would otherwise meet enterprise credit standards. The FHFA Director acknowledged that these higher credit standards were the result of lender uncertainty about having to repurchase these loans in the future if they were found to violate enterprise requirements for securitization.
- **Servicing.** CFPB established new mortgage servicing rules that took effect in January 2014 requiring servicers to follow certain standards and procedures when working with troubled borrowers in an effort to avoid unnecessary foreclosures.¹²⁷ According to VA, the VA Home Loan program oversees mortgage servicers by reviewing every loan to ensure that the servicer has made all reasonable efforts to help the veteran avoid foreclosure. In cases of mortgage default, VA employees in regional offices serve as intermediaries between the veteran and servicer to negotiate a resolution to the default. FHA requires servicers to address delinquencies through an early intervention process, which could include default counseling, prior to engaging in formal foreclosure mitigation actions.¹²⁸ A 2012 HUD

¹²⁶Federal Housing Administration (FHA): Homeowners Armed With Knowledge (HAWK) for New Homebuyers, 79 Fed. Reg. 27896 (May 15, 2014).

¹²⁷12 C.F.R. §§ 1024.39-1024.41.

¹²⁸See [GAO-12-296](#) for more information about FHA's servicing requirements.

study found that 69 percent of housing counseling clients enrolled in foreclosure and prepurchase counseling obtained a mortgage remedy, and 56 percent were able to become current on their mortgages with a counselor's help.¹²⁹ In *The 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac*, FHFA requires the enterprises to continue, and improve upon servicing standards and loss mitigation outcomes for borrowers.

Some participants in our discussion groups noted that CFPB's Ability-to-Repay and Qualified Mortgage Standards Rule, which went into effect on January 10, 2014, promotes borrower protection by requiring mortgage lenders to consider borrowers' ability to repay the loans before extending them credit.¹³⁰ However, some participants have noted the rule could limit access to the housing finance market for some creditworthy borrowers who do not satisfy certain QM standards, such as the 43 percent debt-to-income ratio for private loans.¹³¹ Several industry groups that participated in our discussions jointly submitted a letter to CFPB and HUD regarding their concerns about potential liability for fair lending violations based on disparate impact; they expressed concern that the QM criteria may tighten credit and inadvertently exclude a disproportionate number of

¹²⁹See *Foreclosure Counseling Outcome Study: Final Report—Housing Counseling Outcome Evaluation*. The evaluation was designed to document the circumstances of housing counseling clients enrolled in foreclosure and prepurchase counseling in the fall of 2009 at a broad sample of HUD-funded housing counseling agencies in the United States.

¹³⁰Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z); Final Rule, 78 Fed. Reg. 6408 (Jan. 30, 2013); 12 C.F.R. § 1026.43.

¹³¹Alys Cohen, National Consumer Law Center, *Housing Finance Reform: Essentials of a Functioning Housing Finance System for Consumers*, testimony before the Senate Committee on Banking, Housing and Urban Affairs, 113th Cong., 1st sess., October 29, 2013.

minorities and protected classes.¹³² In an interagency statement about fair lending compliance and the Ability-to-Repay Rule issued in October 2013, five federal agencies noted that they do not anticipate that a creditor's decision to offer only QM mortgage loans would, absent other factors, elevate a supervised institution's fair lending risk.¹³³ The agencies counseled creditors to continue to evaluate fair lending risk for QM loans as they would for other types of product selections, including by carefully monitoring policies and practices and implementing effective compliance management systems.

In our discussions, some participants expressed additional concerns about access to housing finance for some borrowers and overall access to housing. For example, two consumer advocates who attended our discussions have noted that standard underwriting criteria and down-payment thresholds reflect accumulated wealth that can differ across groups and may be a barrier to accessing housing finance.¹³⁴ Other group discussion participants noted that as a result of the financial crisis, many borrowers have lost their homes through foreclosure and experienced periods of unemployment, and consequently, they will have difficulty qualifying for loans in the future unless underwriting standards are more

¹³²The fair lending laws—the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FH Act)—prohibit discrimination in making credit decisions, among other things. Respectively, Pub. L. No. 90-321, tit. VII, as added Pub. L. No. 93-495, tit. V, 88 Stat. 1521 (1974) (codified at 15 U.S.C. §§ 1691–1691f) and Pub. L. No. 90-284, tit. VIII, 82 Stat. 81 (1968) (codified at 42 U.S.C. §§ 3601-3619). Under ECOA, it is unlawful for a lender to discriminate on a prohibited basis in any aspect of a credit transaction, including mortgage lending, and under both ECOA and the FH Act, it is unlawful for a lender to discriminate on a prohibited basis in a residential real estate-related transaction. Under one or both of those laws, a lender may not, because of a prohibited factor, vary the terms of credit offered, including the amount or interest rate, or use different standards to evaluate collateral, among other things. A lender also may not maintain a facially neutral policy or practice that has a disproportionately adverse impact on members of a protected group for which there is no business necessity that could not be met by a less discriminatory alternative. *Policy Statement on Discrimination in Lending; Notice*, 59 Fed. Reg. 18266, 18268-18269 (Apr. 15, 1994).

¹³³Interagency Statement on Fair Lending Compliance and the Ability-to-Repay and Qualified Mortgage Standards Rule, October 22, 2013. The statement was issued by the Federal Reserve, CFPB, FDIC, National Credit Union Administration, and OCC.

¹³⁴Ethan Handelman, National Housing Conference, *Housing Finance Reform: Essential Elements to Provide Affordable Housing Options*, testimony before the Senate Committee on Banking, Housing and Urban Affairs, 113th Cong., 1st sess., Nov. 7, 2013; Alys Cohen, National Consumer Law Center, *Housing Finance Reform: Essentials of a Functioning Housing Finance System for Consumers*.

flexible. One industry representative also noted that prospective first-time homebuyers who have accumulated large student debt will have difficulty qualifying for a mortgage under the debt-to-income ratios required by QM. Some participants at our discussions said that the housing finance system should promote broader market access through flexible underwriting standards that include innovations in the way creditworthiness is assessed, such as alternative credit scoring, consideration of compensating factors, and no- or low-down payment requirements. Other participants emphasized the role that small lenders play in providing credit to those who might otherwise not have access to it, and said that a housing finance system needs to include secondary market access to all lenders. For those who are not prospective mortgage borrowers, participants across our group discussions emphasized the need for affordable housing options and the importance of including financing for rental housing in any housing finance system. Consumer advocates noted specifically that a comprehensive housing finance system should include a steady, reliable, and liquid source of capital to support rental housing.

Participants at our discussion groups also noted the benefits of home ownership counseling and the need for protection for those borrowers facing mortgage default. Participants noted that homeownership counseling should be included in a new housing finance system. They said that it was helpful in educating borrowers about the risks they are assuming and which products are best suited for them. Some participants in our discussions also noted that borrower protections in any housing finance system should cover the entire mortgage lifecycle, including setting stringent loan modification requirements for servicers who had sometimes benefited from pursuing foreclosure over loss mitigation efforts.

Some participants at our discussion groups also discussed how standardization of mortgage products may promote borrower protection and access to credit, but also may limit beneficial innovation. Some participants at our discussions noted that the 30-year fixed-rate mortgage is a product that borrowers have long understood. Several participants also noted that the TBA market should be maintained as the conduit for the 30-year fixed-rate mortgage, because it makes mortgage credit widely available by ensuring a predictable path to securitization for small lenders as well as larger institutions. Other participants who attended our group discussions have proposed that in a reformed system, borrowers would have a variety of well-underwritten mortgage loan choices. As with standardized underwriting, some participants noted that standardizing

products may limit innovation that could benefit some potential homeowners. Two housing finance experts who attended our group discussions noted that certain innovations to the standard mortgage contract could increase the affordability of home ownership. For example, under a shared appreciation mortgage the borrower gives the lender a share of any increase in home value in exchange for lower interest rates and monthly mortgage payments. The Dodd-Frank Act required HUD to conduct a study to determine statutory and regulatory requirements for widespread use of shared appreciation mortgages within 6 months after the act was enacted, but as of June 1, 2014, this study had not been completed.¹³⁵

Several proposals provide for borrower protections and promote mortgage market access. One proposal calling for FHA reform would require lenders to provide each borrower at origination with a disclosure detailing the likelihood of default for a borrower with a similar risk profile and mortgage product. Some proposals would preserve the existing QM criteria, and explicitly authorize the development of standards to ensure access for affordable mortgage credit, including maintaining the 30-year fixed-rate mortgage. At least one of these proposals would explicitly preserve the TBA market. However, a press release accompanying another proposal says that it is based on a previously issued set of principles that include ensuring the continued, smooth operation of the TBA market through any transition and after, so that market participants do not lose the ability to lock in a price for securities before loans are sold. Some proposals address secondary market access by smaller lenders. For example, at least one proposal would authorize the creation of a mutually owned company to facilitate small lenders' access to the secondary market, and another proposes that the FHLBanks facilitate that access, by creating a TBA market for those lenders. Some proposals promote lending innovations to address the needs of underserved markets and populations. For example, some proposals would create a mechanism to support innovation in responsible lending products, underwriting, and servicing specifically targeted to underserved groups. Another proposal would require mortgage servicing standards to include foreclosure loss mitigation programs. Some proposals address the trade-off between consumer protection and innovation. For example, they include mechanisms whereby the impact on consumers of new mortgage

¹³⁵Pub. L. No. 111-203, § 1406, 124 Stat. 1376, 2142 (2010).

products would be evaluated during a trial period. At least one proposal preserves the Housing Trust Fund to increase the supply of affordable rental housing for extremely low-, very low-, and low-income families in rural and urban areas and the Capital Magnet Fund at Treasury to develop, rehabilitate, or purchase affordable housing for these households.¹³⁶

Element 6: Protection for Mortgage Securities Investors

In any housing finance system, investors in the secondary mortgage market require adequate, reliable information to assess risks related to mortgage-backed securities, and incentives need to be better aligned across market participants. In our 2009 report presenting a framework for assessing or crafting a financial regulatory system, we found that investors need to receive consistent, useful information as well as legal protections.¹³⁷ As we noted earlier in this report, prior to and during the financial crisis, investors lacked reliable information, and the securitization process displayed misaligned incentives between investors and other parties. For example, investors did not have access to the same information about the assets collateralizing MBS as did the originators of securitized loans. Moreover, before the crisis some investors did not independently assess asset risk but relied instead on ratings provided by credit rating agencies. As we have previously reported, some of the ratings agencies had conflicts of interest and provided ratings that did not adequately reflect the risks posed by MBS and CDOs.¹³⁸ In a study mandated by the Dodd-Frank Act, we identified seven alternative models for compensating credit rating agencies that were designed to address the conflict of interest inherent in having issuers-pay for ratings, better align credit rating agencies' interest with users of ratings, or improve

¹³⁶The Housing Trust Fund—established by the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1131, 122 Stat. 2654, 2711—is an affordable housing production program to increase and preserve the supply of affordable housing for extremely low- and very low-income households, including homeless families. The Capital Magnet Fund was established through the same act to provide grants for programs that support affordable housing and economic development activities. § 1131, 122 Stat. at 2723.

¹³⁷[GAO-09-216](#).

¹³⁸[GAO-09-216](#).

incentives credit rating agencies have to produce reliable and high-quality ratings.¹³⁹

As required by the Dodd-Frank Act, SEC, which is generally responsible for investor protection, has taken steps designed to provide investors with more information to evaluate risks. For example, in 2011, SEC adopted rules related to the disclosure of information on breaches of representations and warranties in ABS transaction documents.¹⁴⁰ Specifically, securitizers must provide the history of repurchase or replacement requests if the transaction agreements include repurchase or replacement rights for breaches of representations and warranties.¹⁴¹ The rules also require registered credit rating agencies to include in any report accompanying the credit rating information regarding the representations and warranties and enforcement mechanisms available to investors.¹⁴² SEC has also engaged in rulemakings designed to provide investors with the information they would need to compare the performance of different MBS and better evaluate investment risk. SEC officials with whom we spoke noted that providing investors with better information helps improve transparency thus enabling more effective monitoring and investor decision making. In September 2014, SEC adopted a rule governing the disclosure, reporting, and offering process for ABS, including those backed by residential mortgages.¹⁴³ Among other things, the rule requires ABS issuers to provide standardized loan-level information, such as borrowers' credit and mortgage payment terms, at the time the ABS is offered and in ongoing reports. According to SEC, providing investors with access to such information will allow them to better understand, analyze, and track the performance of ABS. The rule also provides additional time for investors to analyze the specific structure, assets, and

¹³⁹GAO, *Credit Rating Agencies: Alternative Compensation Models for Nationally Recognized Statistical Rating Organizations*, [GAO-12-240](#) (Washington, D.C.: Jan. 18, 2014).

¹⁴⁰Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 4489 (Jan. 26, 2011).

¹⁴¹17 C.F.R. § 240.15Ga-1.

¹⁴²17 C.F.R. § 240.17g-7.

¹⁴³See Asset-Backed Securities Disclosure and Registration, 79 Fed. Reg. 57184 (Sept. 24, 2014) (to be codified at 17 C.F.R. pts. 229, 230, 232, 239, 240, 243, and 249).

contractual rights for certain ABS transactions.¹⁴⁴ In August 2014, SEC also adopted a rule that addresses new requirements for credit rating agencies, which, according to SEC, is designed, in part, to increase transparency and credit rating agency accountability.¹⁴⁵ Among other things, the rule requires a number of credit rating agencies to provide certain disclosures including credit rating performance statistics and credit rating methodologies.¹⁴⁶

As required by the Dodd-Frank Act, SEC has taken some actions designed to protect investors from misaligned incentives related to credit rating agencies. In June 2012, SEC established an Office of Credit Ratings as required by the act, and completed its required study of alternative means for compensating rating agencies intended to create incentives for accurate credit ratings later that year.¹⁴⁷ In its August 2014 credit rating agency rule, SEC took actions designed to address credit rating agencies' conflicts of interest.

Regulators have taken some additional actions designed to better align incentives, as required by the Dodd-Frank Act. For example, FDIC, the Federal Reserve, FHFA, HUD, OCC, and SEC have jointly proposed a

¹⁴⁴The rule includes an asset-review provision requiring that parties to a pooling and servicing agreement must retain an asset reviewer and that underlying transaction agreements must require a review of pool assets upon the occurrence of a two-pronged trigger—first upon the occurrence of a specified percentage of delinquencies in the pool, and, if the delinquency trigger is met, then upon the direction of investors by vote. The asset reviewer would then prepare a report about the assets reviewed and provide the report to the trustee, who would then determine whether a repurchase request would be appropriate under the terms of the transaction agreements. In addition, the rule revises the eligibility criteria for ABS using an expedited registration process known as shelf registration. The rule requires ABS issuers using a shelf-registration statement to file a preliminary prospectus containing transaction-specific information at least three business days in advance of the first sale of securities in the offering. Most public offerings of ABS are conducted through expedited SEC procedures known as “shelf offerings.”

¹⁴⁵See *Nationally Recognized Statistical Rating Organizations*, 79 Fed. Reg. 55078 (Sept. 15, 2014) (to be codified at 17 C.F.R. pts. 232, 240, 249, and 249b).

¹⁴⁶*Nationally Recognized Statistical Rating Organizations; Proposed Rule*, 76 Fed. Reg. 33420 (June 8, 2011).

¹⁴⁷See SEC, *Report to Congress on Assigned Credit Ratings As Required by Section 939F of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, (Washington, D.C.: December 2012).

rule to implement credit risk retention requirements.¹⁴⁸ Specifically, the proposed credit risk retention rule would require that the securitizer retain at least 5 percent of the credit risk of the assets they securitize so they would have an incentive to exercise due care in selecting assets for securitization. The proposed rule includes an exemption for QRM loans, which are defined based on CFPB's definition for QM loans.¹⁴⁹ CFPB's QM rule also includes a temporary QM definition for loans eligible for purchase or guarantee by an enterprise. The temporary definition expires once the enterprises exit conservatorship or no later than 7 years after January 10, 2014.¹⁵⁰ In addition, the agencies responsible for the QRM rule expect to revisit and, if appropriate, modify the proposed rule after the future of the enterprises and any related statutory and regulatory framework becomes clearer.¹⁵¹ The extent of the impact of credit risk retention on housing finance market participants, however, may, depend on the final definition of QRM and the percentage of the market that is non-QRM.

To further protect investors, FHFA and others have recommended that the enterprises or any subsequent securitizer create a standard securitization platform. FHFA is developing an infrastructure for single-family mortgage securitization that it says is aimed at standardizing practices and helping achieve investor certainty and confidence through uniform contractual terms and standards for transparency. The infrastructure also includes a common securitization platform with design principles intended to help align and standardize existing practices, including issuance, master servicing, bond administration, collateral

¹⁴⁸In March 2011, the agencies issued their original proposed rules, including a QRM definition that included loans with back-end debt-to-income ratios of no more than 36 percent, minimum 20 percent down payments, and minimum credit history requirements. *Credit Risk Retention; Proposed Rule*, 76 Fed. Reg. 24090, 24096 (Apr. 29, 2011). In August 2013 proposal, the agencies re-proposed the credit risk retention rule. The re-proposal includes as the agencies' preferred approach a QRM definition that equated QRM with CFPB's definition of QM. *Credit Risk Retention; Proposed Rule*, 78 Fed. Reg. 57928, 57992 (Sept. 20, 2013). The act requires the agencies to exempt QRM from the risk retention requirement.

¹⁴⁹See *Credit Risk Retention; Proposed Rule*, 78 Fed. Reg. 57928, 57934 (Sep. 20, 2013).

¹⁵⁰See 12 CFR 1026.43(e)(4)(iii).

¹⁵¹See *Credit Risk Retention; Proposed Rule*, 78 Fed. Reg. 57928, 57992 (Sep. 20, 2013).

management, and data integration. In March 2014, FHFA and the enterprises began an initiative intended to improve and standardize the collection of mortgage servicing data.

Representatives of investors at our discussion groups noted the importance of robust, loan-level disclosure requirements and of timely and reliable information for appropriately pricing risk. One representative of investors said that risk retention was the single most important way to repair the misalignment of incentives in the securitization market and promote investor protection. As discussed earlier in this report, misalignment of incentives in the securitization market occurred when, for example, originators lowered underwriting standards but did not retain the risk and passed on the risks of these mortgage loans to the secondary market. He noted that while aligning the QRM definition with CFPB's QM definition in the proposed joint credit risk retention rule, would streamline regulatory certainty and compliance with underwriting standards, it may exempt some risky loans from risk retention requirements, including those with low down payments and high LTVs and debt-to-income ratios. Another investor representative who attended our discussions later noted at a panel on bringing private capital back to the mortgage market that including government-insured loans and loans securitized by the enterprises in the definition of QRM would result in too few non-QRM loans to make their securitization economical. As noted earlier in this report, the five agencies that have issued the proposed credit risk retention rule recognize that modifications to the proposed rule may be necessary depending on changes in the current housing finance system.

In addition to better aligning incentives through risk retention initiatives, some participants at our discussions noted that more effective resolution of representations and warranties issues would protect investors. SEC has noted that without access to documents relating to each pool asset, determining whether or not a representation or warranty relating to a pool asset has been breached can be difficult for the trustees that typically notify sponsors of alleged breaches. One investor representative at our discussions, has noted that a third party mechanism for investigating and resolving breaches of representations and warranties concerning the pool assets could help serve the interests of investors.¹⁵² The September 2014

¹⁵²Chris Katopis, Association of Mortgage Investors, *Building a Sustainable Housing Finance System: Examining Impediments to Private Investment Capital*, testimony before the House Committee on Financial Services, 113th Cong., 1st sess., April 24, 2013.

rule governing ABS disclosure includes such a third-party mechanism for reviewing pool assets and providing certain information from the review to the trustee who would decide whether to pursue actions based on a breach of the representations and warranties.¹⁵³ In May 2014 FHFA announced increased efforts to improve the enterprises' representation and warranty framework in the agency's strategic plan for the conservatorships of the enterprises. One participant at our group discussions has recognized that while standardization of securitization generally provides investors with greater protection, it may inhibit beneficial innovation in the secondary market.

Many of the proposals for changing the housing finance system include a standardized platform and some address issues of transparency in market operations, including making improvements in loan document disclosures for investors. These proposals also would require the development and adoption of standard uniform securitization agreements, which would include terms relating to representation and warranty violations and trustee responsibilities. One of these proposals requires that the secondary market regulator submit a report to Congress on any effects such trustee responsibilities would have on market liquidity and additional costs and expenses to borrowers.

Element 7: Consideration of Cyclical Nature of Housing Finance and Impact of Housing Finance on Financial Stability

We have identified financial system stability and reforms related to promoting that stability as a key issue.¹⁵⁴ We have also issued several reports on the ways the Dodd-Frank Act attempted to address market weaknesses leading up to the 2007-2009 financial crisis and the extent to which requirements of the act related to financial stability have been implemented.¹⁵⁵ However, we have found that the housing finance system, which is characterized by cyclical fluctuations, still poses risks to financial stability. We noted earlier in this report a number of weaknesses in the housing finance system including the weakening of underwriting

¹⁵³The rule also requires that the transaction agreement provide the reviewer with access to copies of the underlying loan documents.

¹⁵⁴http://www.gao.gov/key_issues/financial_system_stability_reform/issue_summary#t=0 downloaded on June 30, 2014.

¹⁵⁵See GAO, *Dodd-Frank Regulations: Agencies Conducted Regulatory Analyses and Coordinated but Could Benefit from Additional Guidance on Major Rules*, GAO-14-67 (Washington, D.C.: Dec. 11, 2013); GAO-13-195; and GAO-13-180.

standards during the economic expansion and the tightening after the onset of the financial crisis. These weaknesses contribute to cyclical fluctuations in housing finance. According to the former Chairman of the Financial Stability Oversight Council, these cycles are to some extent related to the ability of originators and securitizers who do not retain risk, to, at least in the short run, maximize their own returns by lowering loan underwriting standards in ways that investors may have difficulty detecting, thus exposing investors and the overall economy to greater risks.¹⁵⁶ Eventually, the accumulation of these risks during the housing bubble led to a downturn, with some participants leaving the market and those remaining imposing tighter credit standards. In addition, housing finance cycles may be amplified by expectations among all participants in the mortgage process that housing prices will continue to do what they have done in the recent past. When house prices have been rising, participants in the mortgage process may act on the assumption that prices will continue to rise and, thus for some time, perpetuate and amplify such increases. But if underlying factors, such as a growth in population or income, do not support the growth in the market, such increases will not be sustained. Because housing is a significant part of the economy, these cycles generally pose risks to overall financial and economic stability.

Financial regulatory actions, or inaction, can exacerbate housing finance cycles, and the potential for these actions to do so should be considered and perhaps avoided. For example, while regulators did not take sufficient actions to stem a decline in underwriting standards during the run-up in house prices preceding the financial crisis, they did require regulated financial institutions to raise their capital levels during the downturn. The Ability to Repay and QM rules may play a countercyclical role by, as CFPB notes in its official interpretations of the final rules, setting a floor to the loosening of credit to prevent the deterioration of lending standards to dangerous levels and preventing a repeat of the deterioration of lending standards that contributed to the financial crisis. Researchers and government officials participating in a conference on regional housing finance cycles in the aftermath of the savings and loan crisis said that

¹⁵⁶Timothy F. Geithner, Chairman, Financial Stability Oversight Council, *Macroeconomic Effects of Risk Retention Requirements* (Washington, D.C.: January 2011).

public policy should avoid reinforcing any speculative activity during the emergence of housing bubbles.¹⁵⁷

Government policies and practices can also be countercyclical. FHA has played a countercyclical role during the recent downturn but is sometimes criticized for doing so. For example, FHA lending standards remained relatively unchanged and its loan limits grew during the onset of the financial crisis when other market participants were tightening mortgage credit standards, resulting in the rapid growth of FHA's share of the market. Later FHA experienced higher-than-expected losses because of higher than expected defaults and, in response, tightened requirements for lender underwriting and raised its insurance premiums. As we have previously reported, mortgage industry observers have proposed options that would limit FHA's market presence as a way of either reducing FHA's liability or better ensuring that it serves a certain market—that is, low- or moderate-income borrowers and first-time homebuyers.¹⁵⁸ Other government entities have taken countercyclical actions, such as varying loan-to-value ratios over the cycle. For example, according to a paper from the Hong Kong Monetary Authority, Hong Kong has varied the loan-to-value ratios for residential loans for depository institutions in response to cyclical changes. According to the Hong Kong Monetary Authority, this policy was introduced as an instrument for strengthening the banking system's resilience to asset price volatilities and reducing the risk of cycle amplification through bank credit, rather than as a means of managing asset price cycles and market activities or targeting asset prices.¹⁵⁹ The paper also notes a number of special circumstances facing the Hong Kong Monetary authority, including that it is precluded from conducting independent monetary policy. Officials at one U.S. government agency noted that varying the loan-to-value ratio over the cycle would be less advantageous than setting these ratios at a level that would be sustainable over a cycle, and researchers have suggested that limits on

¹⁵⁷Lynn E. Browne and Eric S. Rosengren, eds., *Real Estate and the Credit Crunch* (Boston, MA: September 1992).

¹⁵⁸[GAO-13-682](#).

¹⁵⁹Hong Kong Monetary Authority, "Loan-to-Value Ratio as a Macroprudential Tool—Hong Kong SAR's Experience and Cross Country Evidence," *The Influence of External Factors on Monetary Policy Frameworks and Operations*, Bank for International Settlements Papers No. 57 (Basel, Switzerland; September 2011).

certain loan-to-value ratios in Texas, that did not vary over a cycle, may have led that state to have fewer defaults during the financial crisis.¹⁶⁰

Some participants at our discussion groups also noted that at times government actions may intensify housing finance cycles and that such actions should be avoided. For example, one participant noted that financial regulation encouraged the formation of the housing bubble and then government officials failed to act early enough to limit the impact of the crisis. Another noted that because policy responses to the crisis had been late in terms of moderating the downturn in the cycle, it would be better to rely on policies that change automatically over the cycle, such as requiring borrowers to make higher down payments on subsequent mortgage loans when they increase the number of mortgage loans they take out, rather than on discretionary government actions. Although some participants at our discussion groups acknowledged that FHA had played a countercyclical role, one participant noted that there will be lots of pressure to let the next housing bubble continue and that FHA may need flexibility, such as being able to vary down payment requirements, to provide a countercyclical force. However, one participant noted that FHA's goal of providing financing for lower-income homebuyers might lead it to use that flexibility to lower downpayments. Another participant at our discussion groups said that it would be difficult to design national countercyclical policies for the U.S. housing markets because of local variations in those markets.

In proposals for changing the housing finance system and related research, policymakers and researchers have concentrated on countercyclical policies directed at severe downturns in the market. Some proposals to change the housing finance system provide a government backstop if losses exceed some threshold. The backstop generally consists of government mortgage guarantees that would be activated

¹⁶⁰Researchers at the Federal Reserve Bank of Dallas have suggested that a regulation limiting home equity borrowing in Texas may have led that state to have fewer defaults during the financial crisis. The authors note that after purchase, mortgage debt along with any new borrowing—including home equity loans—cannot exceed 80 percent of a home's market value unless the new debt funds home improvements. However, the article notes that comparisons with the rest of the nation cannot fully disentangle the role of the home equity borrowing restrictions because states differ in many other ways. See Anil Kumar and Edward C. Skelton, "Did Home Equity Restrictions Help Keep Texas Mortgages from Going Underwater?" *Southwest Economy, Federal Reserve Bank of Dallas, Third Quarter 2013* (Dallas, Tex: 2013).

when mortgage losses reach a particular level. Those making proposals with a government backstop have said that it is unreasonable to assume that the federal government would not enter the market to soften a severe downturn in the future.

Element 8: Recognition and Control of Fiscal Exposure and Mitigation of Moral Hazard

Recognition and control of fiscal exposures depends, in part, on the treatment of these exposures in the federal budget. In a 2013 report that discussed fiscal exposures in a number of programs, including the activities of the enterprises, we noted that fiscal exposures may be explicit in that the federal government is legally required to pay for the commitment; alternatively, they may be implicit in that the exposures arise from expectations based on current policy or past practices.¹⁶¹ In that report we concluded that the federal budget has not provided complete information about some significant fiscal exposures. Therefore, we continued to support many past recommendations to improve budget recognition of these exposures, both to increase the attention given to them and also to allow for more comparable cost information for decision makers to consider when determining the best way to achieve various policy goals or to design a program. These recommendations include incorporating measures of the full cost of programs into primary budget data. We have also noted in prior reports that government actions that respond to private sector losses may contribute to moral hazard—a situation in which private market parties may make decisions that affect certain risks believing that the federal government will ultimately bear the losses, and as a result, may take on excessive risk.¹⁶² Nonetheless, we have found that the government may choose to assist private companies or markets when that assistance would reduce the impact of systemic crises and have recommended that the government take actions to mitigate the effects of weakened market discipline when it provides certain kinds of assistance.¹⁶³

¹⁶¹GAO, *Fiscal Exposures: Improving Cost Recognition in the Federal Budget*, [GAO-14-28](#) (Washington, D.C.: Oct. 29, 2013).

¹⁶²See GAO, *Federal Deposit Insurance Act: Regulators' Use of Systemic Risk Exception Raises Moral Hazard Concerns and Opportunities Exist to Clarify the Provision*, [GAO-10-100](#) (Washington, D.C.: Apr. 15, 2010); [GAO-10-719](#); and [GAO-09-216](#).

¹⁶³For the recommendation see [GAO-10-100](#).

The estimated cost for FHA, VA, and USDA direct loans and loan guarantees—generally referred to as credit subsidies—is explicitly recognized in the federal budget under the Federal Credit Reform Act of 1990.¹⁶⁴ Agencies estimate their programs' credit subsidy costs based on estimated future cash flows on their guarantees, and reestimate the credit subsidy cost each year. The subsidies are explicitly accounted for in the federal budget and fiscal exposure as measured by those estimated costs is known. However, the ultimate subsidy costs may differ from the estimates. We have previously found challenges in estimating the cost of credit programs and made a number of recommendations for improving FHA's estimates.¹⁶⁵ In addition, we found that FHA has taken actions to improve the models it uses for estimating its credit subsidy costs and other purposes.¹⁶⁶ Nonetheless, estimating credit subsidy costs for a mortgage guarantee program can be difficult, in part, because the estimates are based on long-term assumptions about house prices and interest rates that are inherently uncertain.

The activities of the enterprises have had limited transparency in the federal budget, despite a series of events that have led to significant fiscal exposure. Prior to 2008, the enterprises did not represent an explicit fiscal exposure. However, because of an assumption in financial markets of an implied federal guarantee, the enterprises were able to borrow at lower costs than other market participants. Implicit exposures can be difficult to estimate and do not appear in the federal budget. As noted earlier in this report, in 2008, FHFA placed the enterprises into conservatorship and Treasury agreed to provide temporary capital assistance under the Senior Preferred Stock Purchase Agreements, creating a new explicit exposure.¹⁶⁷ For budgetary purposes, Treasury recorded its assistance as

¹⁶⁴Pub. L. No. 93-344, tit. V, as added Pub. L. No. 101-508, tit. XIII, 104 Stat. 1388 (codified at 2 U.S.C. §§ 661-661f).

¹⁶⁵See GAO, *Mortgage Financing: FHA's \$7 Billion Reestimate Reflects Higher Claims and Changing Loan Performance Estimates*, [GAO-05-875](#) (Washington, D.C.: Sept. 2, 2005) for discussion of credit subsidy estimates and the use of models. FHA's actuarial models for predicting loan defaults and prepayments are used to estimate its credit subsidy costs, to calculate its liability for loan guarantees for its financial statements under generally accepted accounting principles applicable to federal agencies, and to estimate the economic net worth and capital ratio for the Mutual Mortgage Insurance Fund.

¹⁶⁶See [GAO-05-875](#) and GAO, *Mortgage Financing: FHA's Fund Has Grown, but Options for Drawing on the Fund Have Uncertain Outcomes*, [GAO-01-460](#) (Washington, D.C.: Feb. 28, 2001).

¹⁶⁷These activities were permitted under HERA.

budget outlays to the enterprises in the year Treasury made the actual disbursement.¹⁶⁸ As this support for the enterprises did not represent a direct loan to the enterprises or a loan guarantee, Treasury deemed that the budgetary credit subsidy accounting (consistent with the Federal Credit Reform Act of 1990) did not apply. As noted earlier in this report, since entering the Senior Preferred Stock Purchase Agreements with the enterprises in September 2008 through March 31, 2014, Treasury has disbursed \$187.5 billion to the enterprises and received dividend payments of \$202.9 billion. Treasury records these dividend receipts from the enterprises in the federal budget as reductions in budget outlays when received. While neither enterprise has needed additional funding from the Treasury since the second quarter of 2012, the remaining reported authorization available to the enterprises was about \$258 billion as of March 31, 2014. On April 14, 2014, FHFA published the results of stress tests designed to estimate fiscal exposure under a range of economic scenarios.¹⁶⁹ They found that payments to the enterprises could range from \$0 up to \$190 billion under various economic assumptions. In addition, while recognizing that the federal government is not obligated to provide additional assistance beyond the scope of the Senior Preferred Stock Agreements, its past responses may influence expectations related to future support, representing an additional implicit exposure that is difficult to estimate.

Some participants at our discussions noted the need to manage moral hazard saying that if there is another housing crisis, the government will step in. One participant said that we should admit first that there will be some type of catastrophic government backstop. The participant noted that we should define moral hazard and try to price it, saying that moral hazard is endemic, but we need to determine how to best control and manage it by determining how much capital is necessary. Another participant added that the cost of a government backstop is part of a discussion of trade-offs among the goals of the housing finance system. The participant also noted that private insurers tend to handle moral hazard better than public insurers.

¹⁶⁸At the end of any quarter in which either Fannie Mae's or Freddie Mac's balance sheet reflects total liabilities that exceed total assets, the enterprises have 15 business days to request funds, which Treasury has 60 days to provide. Such payments are referred to as "draws."

¹⁶⁹FHFA, *Projections of the Enterprises Financial Performance (Stress Tests)* (Washington, D.C.: Apr. 30, 2014).

One proposal to change the housing finance system recognizes the possible fiscal exposure and therefore does not include a government guarantee in the secondary market. However, others have asserted that the government would step in if the housing sector faced a severe downturn and try to minimize fiscal exposure by having private capital assume some level of losses before any government guarantees would be activated. In addition, these proposals attempt to offset fiscal exposure and minimize moral hazard by assessing risk-based fees for market participants. However, as is evident in other government insurance programs, such as deposit or flood insurance, assessing appropriate fees outside of a market is difficult. In addition, pressure may develop to reduce the buildup of any fund that collects such insurance payments during the upswing of a cycle. One proposal that includes changes for FHA is designed to promote controls over lenders, such as explicitly requiring that lenders—whether operating under its direct endorsement program or delegated authority—that misrepresented loans repay FHA in cases where the loans default.

Element 9: Emphasis on Implications of the Transition

Because reforming the housing finance system may represent substantial changes in the marketplace, policymakers should consider how best to ensure that the transition to any new system does not hamper the functioning of markets, individual institutions' ability to conduct their activities, and consumers' ability to access needed services. Any action that would severely limit market liquidity—negatively impacting mortgage borrower access—should be of particular concern. A transition period might allow for changes to be phased in at a pace that market participants could manage. In addition, we found in 2009 that certain critical factors, such as effective communication strategies, could help to ensure that any large-scale transitions were implemented successfully.¹⁷⁰ Further, attention should be paid to developing a sound human capital strategy to ensure that any new or consolidated agencies are able to retain and attract additional quality staff during the transition period, and policymakers should consider how best to retain and utilize the existing skills and knowledge base within agencies subject to changes as part of a transition.¹⁷¹ However, any housing finance reform policies should consider that there may be trade-offs between making smaller changes to

¹⁷⁰[GAO-09-216](#).

¹⁷¹See [GAO-09-216](#).

help ensure a smooth transition in the short run and making more significant changes that would provide greater long-term benefits but might result in a more difficult transition.

Because changes to the housing finance system may have large unintended consequences for housing finance markets, policymakers and federal officials would need to monitor the system during the transition and make any needed changes. Specifically, the impact on housing affordability would need to be monitored during the transition to ensure that effects are aligned with expectations. Such monitoring would permit adjustments to be made through flexibilities provided to government entities or legislation. No matter how the housing finance system is ultimately restructured, or even if it remains as is, mortgage rates are expected to be higher in the future. How much higher depends on numerous factors, including the sources and cost of private capital supporting the system and the extent and nature of any government guarantees. One researcher has estimated that in a new housing finance system, the cost of mortgages will rise depending on the extent of the federal role in the secondary market. Estimates of the increase in mortgage rates range from .1 to 1.8 percentage points, depending on borrower and loan characteristics.¹⁷² However, housing affordability rests on many factors other than mortgage rates, including the price of housing and the types of mortgage products available.

Agency officials, industry representatives, consumer advocates, and researchers who attended our discussions emphasized the importance of a deliberate, well-defined transition from the current housing finance system to any new one that would minimize market disruption. In particular, they noted that ongoing mortgage liquidity would have to be maintained during the transition to ensure the availability of credit. Across stakeholder groups, participants also emphasized the need to maintain the smooth functioning of the TBA market during the transition and the availability of the 30-year-fixed rate mortgage. Some participants noted that a transfer of human capital from the enterprises to any new system set up in the secondary market would be helpful. Two consumer advocates also noted that monitoring of any increasing costs to potential borrowers during a transition is critical. One of these consumer advocates

¹⁷²Mark Zandi and Cristian deRitis, *Housing Finance Steps Forward*, Moody's Analytics, March 2014.

and several other group participants noted the importance of weighing the benefits and costs involved in a transition to a new system relative to maintaining the current housing finance system.

Proposals to change the housing finance system include details on the transition to a new system, including time frames and operational issues such as the transfer of powers, personnel, and facilities from current entities to those that are proposed to replace them. At least two proposals provide for flexibility, such as allowing the enterprises to continue to operate past a proposed time limit even if certain conditions are not met. Two proposals include requirements for formal transition planning. For example, one proposal requires the new secondary market regulator to provide Congress with a plan that specifies all the legislative, administrative, and regulatory actions necessary to transition to a fully privatized secondary mortgage market. Some proposals also consider the impact of the transition on a range of other factors. For example, one proposal considers how transition options may affect housing prices and affordability, the effectiveness of borrower protections, small-lender participation in the secondary mortgage market, access to credit in rural and underserved communities, innovation among secondary market participants, and taxpayer repayment. It also provides for transition oversight, including annual testimonies before Congress on transition progress and reports to Congress on the status of the transition.

Any Changes Will Involve Trade-offs and Should Consider Characteristics Associated with Controls and Performance

One of the most difficult parts of changing the single-family housing finance system will be to make choices when there are trade-offs among and within the elements. As we have noted, trade-offs and priorities need to be considered when the goals of the housing finance system are being defined. Establishing competing goals or principles, without an indication of their relative importance, will not provide government agencies with sufficient certainty as to what is expected of them going forward. Identifying these trade-offs and defining priorities are essential to developing policies and mechanisms to achieve goals. Within the elements related to protecting borrowers and investors, for example, the benefits of standardization will need to be weighed against possible limits to beneficial innovation and access to credit for people who do not meet the criteria for standardized products.

In addition, any housing finance system should have appropriate controls and high-quality performance that are characterized by transparency and accountability and that align incentives and ensure efficiency and

effectiveness. These interconnected characteristics apply to many of the nine elements that we laid out earlier in this report.

Transparency. In prior reports, we have cited the value of transparency in such areas as improving program outcomes and strengthening oversight.¹⁷³ In those reports, we have found that transparency is essential for Congress and the public to hold government agencies accountable and that transparency includes clarity of communications. We have also recognized that an appropriate level of transparency takes into account the need to maintain confidentiality and information security and must be balanced with the need for those involved in deliberations to be able to express their views. Transparency includes clearly communicating goals and trade-offs to the public; ensuring that adequate data are disseminated; and ensuring that borrowers and investors have adequate information to assess risks. Clear communications will be especially important during any transition from the current system to a new one. As a result, any system that satisfies the elements will be one with appropriate levels of transparency.

Accountability. Clarity of responsibility and transparency of actions taken by government entities is necessary for Congress and the public to hold them accountable—a key control for promoting an efficient and effective government. In housing finance, market participants must be accountable for their actions as well. Holding market participants accountable means that those making the decisions will be the ones who benefit or lose as a result of those decisions. Such accountability would reduce the moral hazard in the housing finance system. In addition, federal agencies will need to oversee market participants and enforce rules related to preventing fraud and abuse. Further, specifying goals and trade-offs is essential to holding federal agencies and the private sector accountable. Accountability is also important in elements related to policies and mechanisms, an effective regulatory system, and the capacity of federal agencies to understand and manage risk. Any system addressing the nine elements will have accountability embedded throughout.

¹⁷³For example, see GAO, *Troubled Asset Relief Program: Further Actions Needed to Enhance Assessments and Transparency of Housing Programs*, [GAO-12-783](#) (Washington, D.C.: July 19, 2012); *Federal Reserve Bank Governance: Opportunities Exist to Broaden Director Recruitment Efforts and Increase Transparency*, [GAO-12-18](#) (Washington, D.C.: Oct. 19, 2011); and [GAO-12-886](#).

Aligned incentives. Holding the private sector accountable requires that incentives be better aligned and moral hazard minimized. As we have seen, misaligned incentives likely contributed to the financial crisis. The Dodd-Frank Act and some proposals seek to have participants in the mortgage process hold some of the risk associated with a mortgage. For example, the Dodd-Frank Act requires that, in certain circumstances securitizers retain some portion of the risk of their MBS, and some proposals want borrowers to have some equity in their property. Some proposals require market participants to pay for government insurance and guarantees, which could be used to recognize their contributions to systemic risk and reduce excessive risk taking, but determining appropriate pricing and reserving practices for providing this guarantee poses significant challenges. Aligning incentives means basing decisions, in part, on the ability of borrowers to repay rather than solely on the collateral of the house itself. Aligning incentives across the elements will help to mitigate moral hazard throughout the housing finance system.

Efficiency and effectiveness. Changes in the single-family housing finance system should be made in ways that support efficiency and effectiveness. Policymakers and interested parties should consider the benefits and costs of making various changes in policies, mechanisms, or the regulatory systems relative to other alternatives and to allowing the current system to persist. They should also consider the extent to which the missions, goals, and programs of government entities may contribute to costly fragmentation, overlap, and duplication. Finally, policymakers and interested parties should recognize that changes to the single-family housing finance system that address weaknesses in the system while preserving its strengths are likely to have costs. Weighing potential benefits and costs of changes to the housing finance system, including costs and risk for the federal government, will require careful consideration.

Agency Comments and Our Evaluation

We provided copies of this report to CFPB, FDIC, the Federal Reserve, FHFA, HUD, OCC, SEC, Treasury, USDA, and VA for review and comment. All but one of the agencies provided technical comments on the draft, and we addressed technical comments as appropriate. None of the agencies provided formal written comments on the draft. USDA, which did not provide technical comments on this draft, noted that it generally concurred with the information in the draft pertaining to its rural housing program.

Some of the technical comments raised some higher level issues including the following:

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- CFPB noted that regulators need access to timely information for effective regulation. We agree and note in the final report that to strengthen decision-making and accountability, regulators will need access to the best reasonably obtainable scientific, technical, economic, and other information.
 - In response to a statement in the draft report saying that regulators did not take actions to stem the decline in underwriting standards prior to the financial crisis, FDIC noted that regulators had taken some actions beginning in 2006 to stem the decline in underwriting standards. We agree that the regulators did take some actions, and the final report says that regulators did not take sufficient actions to stem the decline in underwriting standards.
 - HUD noted that the draft report did not discuss improvements to borrower protection made prior to the Dodd-Frank Act, specifically changes made to rules implementing RESPA. As a result, we added information on 2008 revisions requiring that RESPA forms provide additional disclosures, including clear summaries of loan terms and conspicuous information about yield-spread premiums designed to make it easier for potential borrowers to compare originators when shopping for a mortgage loan.

We will send copies of this report to the Chairs of FDIC, the Federal Reserve, and SEC; Comptroller of the Currency; Directors of CFPB and FHFA; and Secretaries of HUD, the Treasury, USDA, and Veterans Affairs; and other interested parties. In addition, the report will be available at no charge on GAO's website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or sciremj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs are listed on the last page of this report. GAO staff who made major contributions to this report are listed in appendix V.

A handwritten signature in black ink, appearing to read "Mathew J. Scire". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Mathew J. Scire
Director, Financial Markets and Community Investment

List of Addressees

The Honorable Tim Johnson
Chairman

The Honorable Mike Crapo
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Tom Coburn
Ranking Member
Committee on Homeland Security and Governmental Affairs
United States Senate

The Honorable Jeb Hensarling
Chairman
The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
House of Representatives

The Honorable Elijah E. Cummings
Ranking Member
Committee on Oversight and Government Reform
House of Representatives

Appendix I: Objectives, Scope, and Methodology

To help policymakers assess various proposals for changing the single-family housing finance system and consider ways in which it could be made more effective and efficient, we prepared this report under the authority of the Comptroller General. Specifically, this report (1) describes market developments since 2000 that have led to changes in the federal government's role in single-family housing finance; (2) analyzes whether and how these market developments have challenged the housing finance system; and (3) presents an evaluation framework for assessing potential changes to the housing finance system.

To meet these objectives, we reviewed literature, including existing GAO reports on housing finance and housing market developments, as well as prior GAO reports presenting frameworks for reform in the financial sector and reports that contain criteria for appropriate controls and high-quality government performance. These reports are referenced in footnotes throughout this report and some are included in a list of related GAO products at the end of the report. In addition to prior GAO reports, we conducted a literature review including academic and industry reports on housing finance and housing market developments; current and past financial and housing market events which have revealed limitations in our existing regulatory and housing finance system; and proposals for modifying the current housing finance system. To identify literature, other than GAO reports, included in this review, we relied, in part, on Internet and electronic database searches on housing finance. We also searched for literature written by those who had testified before Congress or participated in relevant conferences between September 1, 2013 and January 31, 2014. We also attended a number of conferences on housing finance reform. Further, we reviewed footnotes and bibliographies in the literature we reviewed to identify additional literature for review. We also relied on recommendations from GAO staff who worked in the area of housing finance and officials from other relevant government agencies. These agencies included the Board of Governors of the Federal Reserve System (Federal Reserve), Bureau of Consumer Financial Protection known as the Consumer Financial Protection Bureau, Departments of Agriculture (USDA), Housing and Urban Development, Treasury and Veterans Affairs (VA), Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Office of the Comptroller of the Currency, and Securities and Exchange Commission.

To provide input on a draft housing finance framework and key market developments, we convened seven discussion groups comprised of government officials, researchers, consumer advocates, and industry representatives. The participants were selected because they had made

reform proposals, written or testified before Congress on housing finance reform issues, or been recommended by government officials or GAO staff who had participated in prior GAO studies of housing finance issues. Although we grouped the discussions into categories such as government officials, researchers, consumer advocates, and industry representatives, we chose the participants because they had a range of views. As a result, we were not expecting to find consensus about our framework or key market developments during the discussions. A list of the participants is included in appendix IV of this report. In a few cases where key participants could not attend our discussion groups, we interviewed them separately. How these discussions and interviews were used to address issues across the objectives is further discussed below.

Specifically, to address our first objective, we identified relevant market developments from 2000 through 2013. To help identify pertinent market developments and relevant prior reports and analyses, we held an internal discussion with a broad group of GAO staff who had experience with housing finance issues. During our discussion groups with experts and other relevant parties, we also asked participants to identify the most important market development that housing finance reform would need to address. We relied primarily on prior GAO reports that identified and analyzed key national housing market indicators, including measures of home prices, loan performance, home equity, and unemployment.¹ We used data that had been collected for these reports and reviewed the data reliability assessments that had been completed for those reports to determine if the data were reliable for our purposes. Based on these reviews, we determined that the data were reliable for our purposes. To update the data and analyses, we relied on several data sources including CoreLogic's Home Price Index, the National Delinquency Survey data issued by the Mortgage Bankers Association, data issued by the National Bureau of Economic Research, the Federal Reserve's statistical releases on the Flow of Funds Accounts of the United States and the 30-year conventional mortgage rate, and consumer price index data reported by the Bureau of Labor Statistics. Generally, we updated our assessments of the reliability of these data by reviewing existing

¹See GAO, *Financial Regulatory Reform: Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act*, [GAO-13-180](#) (Washington, D.C.: Jan. 16, 2013) and *Foreclosure Mitigation: Agencies Could Improve Effectiveness of Federal Efforts with Additional Data Collection and Analysis*, [GAO-12-296](#) (Washington, D.C.: June 28, 2012).

information about data quality and corroborating key information. We determined that the data were sufficiently reliable for our purposes.

To describe changes in market participants and products in the primary and secondary markets, we calculated the percentage of the dollar value of mortgage originations supported by the Federal Housing Administration, VA, and USDA and the percentage supported by Fannie Mae and Freddie Mac from 2000 through 2013. We relied on data published by Inside Mortgage Finance on new mortgage originations and issuances of mortgage-backed securities. To determine the reliability of these data, we reviewed publicly available information on the data source and queried a knowledgeable official about the accuracy of the data. We determined the data were sufficiently reliable for our purposes, which were to provide information about how the federal role changed over the relevant time period.

To address our second objective, which describes weaknesses revealed by developments in the housing finance market beginning in 2000, we used information from our literature review and interviews. We identified developments based on available literature, interviews and discussions with external experts and other relevant parties, and internal suggestions. We determined which market developments revealed weaknesses based on which developments were most often cited as posing challenges for the market. For example, several developments were cited in our sources as contributing to the 2007-2009 financial crisis. Further, through our review of the literature, we defined certain weaknesses—misaligned incentives, lack of information or transparency, and excessive risk taking—and found that many of the identified market developments fell into these categories. In addition, we identified and described government legislative and legal enforcement responses to the identified weaknesses.

To address our third objective, we reviewed the elements of frameworks in prior GAO reports including those for modernizing the financial regulatory framework, determining when the federal government should provide assistance to the private sector, and assessing catastrophic

insurance programs.² From these, an initial review of existing proposals to change the housing finance system, and meetings with government officials, we developed a list of potential elements of a framework that could be used by Congress and others to assess proposals. We then reviewed the literature to determine if these elements were relevant, useful, and appropriate for such a framework. As a result of this analysis, we were able to develop a draft framework that included a number of elements and certain characteristics associated with good governance—appropriate controls and high-quality performance. We then shared this draft framework with government officials, researchers, and other relevant parties at our discussion groups. During the discussions, we asked participants to exchange views on the usefulness, relevance, and appropriateness of the draft framework; any priorities and trade-offs among the framework elements and characteristics; and whether any elements or characteristics of good governance had not been included in the draft framework. Based on discussions at these meetings, we determined that certain aspects of the framework needed to be clarified by separating some of the elements that had originally been combined, and by reassessing the division of the framework between its elements and the characteristics of good governance. Where possible, we used the remarks of participants to help clarify and enrich the discussion of the framework elements.

Throughout the engagement we reviewed proposals for changing the single-family housing finance system, including legislative proposals and those made by experts participating in our discussion groups. As noted earlier in this report, we used these proposals to help us develop an initial list of potential elements for our framework. We also used these proposals to help test the usefulness, relevance, and appropriateness of the elements. For each element in the framework, we used actual parts of proposals to illustrate how the element could be used to assess potential changes to the housing finance system. In addition, to help ensure that the framework was useful, relevant, appropriate, and sufficient, we applied it to a legislative proposal.

²GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated Financial Regulatory System*, [GAO-09-216](#) (Washington, D.C.: Jan. 8, 2009); *Financial Assistance: Ongoing Challenges and Guiding Principles Related to Government Assistance for Private Sector Companies*, [GAO-10-719](#) (Washington, D.C.: Aug. 3, 2010); and *Public Policy Options for Changing the Federal Role in Natural Catastrophe Insurance*, [GAO-08-7](#) (Washington, D.C.: Nov. 26, 2007).

We conducted this performance audit from August 2013 to October 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: History of Federal Involvement in Housing Finance from 1913 to 2014

Between 1913 and 2014, the federal government's role in the housing finance market has evolved, and these changes have influenced the types of mortgage products available to home buyers. The federal government employs multiple tools supporting homeownership and financing of homes. These tools include sponsorship of mortgage market entities, regulation of certain aspects of mortgage market operations, insurance and guarantees of mortgages and mortgage securities, direct lending, and favorable tax treatment.¹ In some cases, these tools, for example, the federal tax deduction for mortgage interest, apply broadly and are designed generally to facilitate mortgage lending and homeownership. In other cases, tools have been designed to facilitate home ownership and housing opportunities for targeted populations and groups. For example, programs administered by the Department of Veterans Affairs (VA) and the Department of Agriculture's Rural Housing Service (RHS) are designed to facilitate homeownership and housing opportunities for veterans and residents of rural areas respectively. This appendix provides a brief overview of the developments that over time have led to the federal government's current role in the housing finance markets, and GAO's prior reviews of these topics as noted.

First Steps

The federal government's current involvement in housing finance can be traced back to the 1913 Internal Revenue Act, which established the federal income tax. Under the Internal Revenue Act, taxpayers were allowed to deduct mortgage interest payments and property taxes from their taxable income when determining their federal tax liability. At that time, the deduction for home mortgage interest was part of the deduction allowed for any interest paid, and the deduction for property taxes was part of the deduction for all state, local, and federal taxes. The Congressional Research Service has noted that there is no evidence in the legislative history that these deductions were intended to encourage home ownership or to stimulate the housing industry when they were introduced.

Prior to the Great Depression, mortgages featured short terms (typically 3 to 10 years), and loan-to-value ratios of less than 50 percent. These loans also normally did not fully amortize, meaning that payments over the term

¹The federal government plays a significant role in regulating the mortgage markets. This appendix does not include all changes to federal regulation of housing finance and financial institutions, but does provide examples of significant rule changes.

of the loan did not reduce the principal balance to zero, and borrowers were left to pay off or refinance the balance of the loan at the end of the term. The market for mortgages was largely local, as banks and other lenders relied heavily on local deposits to fund mortgages. As a result, if savings in an area were too low to meet the local demand for mortgages, borrowers faced higher interest rates than in markets with a surplus of savings. The lack of a nationwide housing finance market created regional disparities in mortgage interest rates and credit availability. These structural features of the mortgage market made it susceptible to disruptions in the availability of funding.

The Great Depression

During the Great Depression, thousands of thrifts and banks failed due to their credit losses, and housing finance generally became unavailable. The Congressional Budget Office noted that the steep declines in incomes during the Depression resulted in a surge of mortgage delinquencies and foreclosures. By 1934, roughly half of home mortgages in urban areas were delinquent, and the annual foreclosure rate was over 13 percent.

The federal government began its response to the Great Depression housing crisis in 1932, with the enactment of the Federal Home Loan Bank Act, which created the Federal Home Loan Bank (FHLBank) System and the FHLBank Board as its regulator.² The FHLBank System was designed to increase liquidity in the mortgage market and serve as a low-cost lender to thrifts to support housing finance, and continues to operate this way today. The FHLBank System consisted of 12 FHLBanks and was cooperatively owned by its member institutions, which originally included only thrifts (also known as savings and loans) and insurers, before being expanded to include commercial banks and credit unions in 1989. The primary mission of the FHLBank System was to promote housing and community development by making loans, also known as advances, to member financial institutions, which used the funds to originate new mortgages. To raise the funds necessary to carry out its activities, the FHLBank System issued debt in the capital markets at favorable rates compared to those available to commercial borrowers. Investors were willing to purchase FHLBank bonds at these prices

²Pub. L. No. 72-304, 47 Stat. 725 (1932) (codified as amended at 12 U.S.C. §§ 1421-1449).

because they believed that the bonds were implicitly guaranteed by the federal government, because of the FHLBank System's government sponsorship.

Fixed-rate mortgages were expanded in the 1930's by the Home Owners' Loan Corporation (HOLC), as the federal government sought to refinance the large numbers of delinquent mortgages. As part of the New Deal, President Roosevelt signed into law the Home Owners' Loan Act of 1933, which established HOLC.³ The HOLC raised funds with government-backed bonds, used the funds to purchase defaulted mortgages, and refinanced the mortgages with new interest rates and terms. The HOLC often converted variable-rate, short-term, non-amortizing mortgages into fixed-rate, fully amortizing mortgages with terms as long as 15 years.⁴ Between August 1933 and June 1936, when the corporation stopped making loans, the HOLC refinanced about 1 million loans—or roughly 20 percent of the outstanding mortgages on nonfarm, owner-occupied properties. In 1934, the HOLC accounted for about 70 percent of new mortgages originated. The HOLC was dissolved in 1953.

While the HOLC addressed refinancing of existing home loans, the Federal Housing Administration (FHA) was created to encourage new lending for home purchases. FHA was established in 1934 under the National Housing Act to broaden homeownership, strengthen and protect lending institutions, and stimulate employment in the building industry.⁵ FHA's single-family mortgage insurance programs insured qualified private lenders against losses on home mortgage loans they originated. As the Federal Housing Finance Agency's (FHFA) Office of the Inspector General noted, FHA insurance gave lenders added security and expanded the pool of potential homebuyers for whom lenders were willing to underwrite loans. FHA financed its operations through insurance premiums charged to borrowers and interest earned on its reserves. The original FHA mortgage insurance contracts enabled borrowers to obtain

³Pub. L. No. 73-43, § 4, 48 Stat. 128, 129 (codified as amended at 12 U.S.C. §§ 1461-1468c).

⁴A fully amortizing mortgage is one where the principal is repaid over the life of the loan in regularly scheduled payments, so that the borrower does not face a large payment at the end of the loan.

⁵Pub. L. No. 73-479, § 1, 48 Stat. 1246 (codified as amended at 12 U.S.C. §§ 1701-1749aaa-5)).

financing with a minimum 20-percent down payment. The maximum mortgage was limited to \$16,000, which enabled families to purchase up to a \$20,000 home with a minimum down payment. FHA further expanded the use of fixed-rate, long-term mortgages and changed mortgage underwriting standards to allow for a much broader segment of American households to qualify for mortgage finance. Further, FHA created new uniform construction and appraisal standards to be used by private sector practitioners in the building and finance industries so that FHA insured mortgages were available across the country, and homebuyers would have access to the lowest cost funds available nationally rather than locally.

The National Housing Act gave FHA authority to create national mortgage associations for the purchase and sale of mortgages.⁶ In 1938, FHA established a national mortgage association, which became the Federal National Mortgage Association (Fannie Mae).⁷ Originally, Fannie Mae was a federal agency with a mandate to purchase, hold, and sell FHA-insured loans. By purchasing FHA-insured loans from lenders, Fannie Mae created liquidity in the mortgage market, providing lenders with cash to fund new home loans. Because the loans were insured by FHA, the lenders did not face credit risk, but by selling their mortgages to Fannie Mae lenders were able to pass on their interest rate risk. Further, by selling loans to Fannie Mae, lenders could now make loans with FHA insurance and replenish their funds to lend again.

World War II and Post-War Era

In response to a serious housing shortage, the federal government expanded its role in the housing finance markets during and following World War II. Researchers have noted that the return of millions of veterans at the end of the war, created an acute housing shortage. Expansions in the federal government's role in housing finance were included in provisions of the Revenue Act of 1951, the Servicemen's Readjustment Act of 1944, known informally as the G.I. Bill, and the Housing Act of 1949. The Revenue Act of 1951 introduced the concept of deferring the tax on the capital gain from the sale of a principal residence if the proceeds of the sale were used to buy another residence of equal or

⁶§ 301(a), 48 Stat. at 1252.

⁷National Housing Act Amendments of 1938, Pub. L. No. 75-424, § 4, 52 Stat. 8, 23.

greater value.⁸ This provision was modified in 1964 and again to its current form in 1997.

The Servicemen's Readjustment Act of 1944, known informally as the G.I. Bill, created VA's mortgage guarantee program, as part of larger package of benefits for returning veterans.⁹ Under the act, the maximum amount of guaranty was limited to 50 percent of the loan, not to exceed \$2,000, and loans were limited to a maximum 20 years. To be eligible, veterans must have served in active duty for at least 90 days during World War II. The program was amended in 1945 to increase the maximum guarantee to \$4,000, extend the maximum length of loans to 25 years, and make any veteran that could meet credit requirements eligible. In 1948, Congress authorized Fannie Mae to purchase VA-guaranteed mortgages to facilitate the efforts of veterans to purchase homes. The program is still in operation in 2014, and has undergone many revisions since 1944, including changes in loan terms, eligible uses, and fee structures.

The Housing Act of 1949 authorized new rural lending programs through USDA under Title V.¹⁰ These programs authorized USDA to provide direct loans to farm owners for home construction and improvement on land capable of producing at least \$400 worth of agricultural products annually. In 1965, the act was amended to authorize housing loans and grants to rural residents in general and to authorize USDA to insure loans made by private lenders to rural borrowers. Today, RHS administers direct loan and loan guarantee programs under sections 502 and 504 of the Housing Act of 1949, as amended. The section 502 program offers persons who do not currently own adequate housing, and who cannot obtain credit through conventional financing, the opportunity to acquire, build, rehabilitate, improve, or relocate dwellings in rural areas by guaranteeing loans made by commercial lenders or by directly lending to eligible home purchasers.¹¹ Loans guaranteed under the 502 program are limited to

⁸Pub. L. No. 82-183, § 318(a), 65 Stat. 452, 494.

⁹Pub. L. No. 78-346, 58 Stat. 284.

¹⁰Pub. L. No. 81-171, §§ 501-504, 63 Stat. 413, 432-35. The act updated a program created by the Bankhead-Jones Farm Tenant Act, Pub. L. No. 75-210, 50 Stat. 522 (1937), which authorized USDA to provide long-term, low-interest loans to farm tenants and sharecroppers so that they could purchase and improve farms, including homes on farms.

¹¹See 7 C.F.R. § 3550.2.

borrowers with low or moderate income, and loans made directly under the program are further limited to borrowers with low incomes (below 80 percent of the area median). The section 504 program offers direct loans of up to \$20,000 to very low-income homeowners who cannot obtain other credit to repair or rehabilitate their properties. The section 504 program also offers grants of up to \$7,500 to senior citizens without the ability to repay their loans.¹² Amendments to the Housing Act added in 1961 made nonfarm rural properties eligible for these single-family loan programs, and both continue to operate in 2014. In 2012, we found that the RHS loan guarantee programs overlapped significantly with FHA's loan guarantee program and that FHA guarantees more mortgages in rural areas than RHS.¹³

Until 1968, federal policies did not explicitly ban redlining, which is the refusal of lenders to make mortgage loans in certain geographic areas, typically minority or low-income neighborhoods, regardless of the creditworthiness of the loan applicant. Prior to that time, in its 1938 underwriting manual, FHA established criteria for rating the economic viability of property locations and neighborhoods, and required an assessment of the quality of development near the property location "to determine whether incompatible racial and social groups are present, for the purpose of making a prediction regarding the probability of the location being invaded by such groups". However, redlining was explicitly banned in the Fair Housing Act.¹⁴

Privatization of Fannie Mae and Creation of Freddie Mac

In the post-war period, as the mortgage market became more standardized, Congress transitioned Fannie Mae into a private corporation with a congressional charter.¹⁵ Congress began the process of changing Fannie Mae's ownership structure with the Housing Act of

¹²See 7 C.F.R. §§ 3550.103(b) and 3550.112(c).

¹³GAO, *Housing Assistance: Opportunities Exist to Increase Collaboration and Consider Consolidation*, [GAO-12-554](#) (Washington D.C.: Aug. 16, 2012).

¹⁴Pub. L. No. 90-284, tit. VIII, 82 Stat. 73, 81-89 (1968) (codified as amended at 42 U.S.C. §§ 3601-3619).

¹⁵Federal National Mortgage Association Charter Act, Pub. L. No. 83-560, tit. II, 68 Stat. 590, 612-622 (1954) (codified as amended at 12 U.S.C. §§ 1716-1723j).

1954.¹⁶ Banks that sold mortgages to Fannie Mae were required to purchase nonvoting common stock in Fannie Mae, but the federal government remained the enterprise's majority owner. The Housing and Urban Development Act of 1968 chartered Fannie Mae as a government-sponsored enterprise and provided for its sale to private shareholders, completing the transition to private ownership.¹⁷ The act also gave Fannie Mae the power to securitize loans, but initially Fannie Mae continued to primarily hold mortgages that it purchased in its portfolio. The act also split Fannie Mae into two corporations: Fannie Mae and the Government National Mortgage Association (Ginnie Mae). Ginnie Mae was and continues to be an on-budget, federally owned corporation within HUD that guarantees timely payment of principal and interest on privately issued mortgage-backed securities (MBS) collateralized by FHA, VA, or other government insured or guaranteed mortgages.

The Emergency Home Finance Act of 1970 created the Federal Home Loan Mortgage Corporation (Freddie Mac).¹⁸ Freddie Mac was intended to add liquidity to the secondary mortgage market and to complement the FHLBank System. Freddie Mac was initially owned by the member institutions of the FHLBanks, which were primarily thrifts, and was authorized to carry out transactions with any institution with federally insured deposits. Freddie Mac began to purchase long-term mortgages from thrifts, increasing their capacity to fund additional mortgages and reducing their interest rate and credit risk. Freddie Mac focused its business activities on purchasing loans and issuing MBS rather than holding mortgages in its portfolio. Freddie Mac issued its first MBS in 1971. The Emergency Home Finance Act of 1970 also authorized both Fannie Mae and Freddie Mac to purchase loans that satisfied certain requirements in terms of size and leverage that were not insured by the federal government, and the enterprises focused their business activities on these "conventional" mortgages.¹⁹ The secondary market for conventional loans created by the enterprises increased the liquidity of

¹⁶Pub. L. No. 83-560, 68 Stat. 590 (1954) (codified in scattered sections of 12 and 42 U.S.C.).

¹⁷Pub. L. No. 90-448, § 801, 82 Stat. 476, 536 (codified as amended in scattered sections of 12, 15, and 42 U.S.C.).

¹⁸Pub. L. No. 91-351, §303(a), 84 Stat. 450, 452 (codified at 12 U.S.C. §§ 1451-1459).

¹⁹§ 305, 84 Stat. at 454.

the primary mortgage market, allowing lenders to fund additional mortgages. In addition to providing liquidity, by purchasing mortgages that were not federally-insured, the enterprises took on the credit risk associated with the mortgages. Further, because of the ability to sell the loans, banks and thrifts had an incentive to originate mortgages that conformed to Fannie and Freddie's standards, and this made underwriting standards more uniform across the country.

Response to Savings and Loan Crisis

The savings and loan crisis required a large financial intervention by the federal government and led to changes in the FHLBank System. Prior to changes made in the early 1980s, thrifts were limited by regulation in both the amount of interest they could pay on deposits and the types of loans they could offer. In 1979, the Federal Reserve System (Federal Reserve) substantially increased interest rates in an effort to reduce inflation. Thrifts were not able to offer depositors market rates on deposits due to the regulatory limitations, and lost substantial funding as depositors withdrew funds. As numerous thrifts became insolvent and were at risk of failure, the federal government's initial response was to remove some of the regulations that restricted thrifts, increase deposit insurance limits, and decrease capital requirements for thrifts. The two primary pieces of legislation in this response were the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn–St Germain Depository Institutions Act of 1982.²⁰ Together these acts removed limits on the amount of interest that could be charged on deposits and allowed certain banks and thrifts to provide many new types of products, including adjustable-rate mortgages. However, the crisis deepened and the federal government ultimately provided more than \$100 billion in direct outlays to resolve more than 700 failed thrifts. Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which placed thrifts under Federal Deposit Insurance Corporation (FDIC) insurance, created the Office of Thrift Supervision (OTS) as a new regulator for thrifts, and made changes to the FHLBank System.²¹ For example, the act allowed commercial banks and credit unions, to become members of the FHLBank System.

²⁰Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 U.S.C.); Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 12 U.S.C.).

²¹Pub. L. No. 101-73, 103 Stat. 183 (codified in scattered sections of 12 U.S.C.).

Regulation of the Enterprises

During the 1990s the federal government continued to restructure the enterprises and put in place a new regulatory structure for them. FIRREA restructured Freddie Mac as a publicly traded corporation, with a similar corporate structure as Fannie Mae. With this change Fannie Mae and Freddie Mac's structures and strategies were very similar. Both of the enterprises issued MBS that included their own guarantees to investors against credit risk on the securitized mortgage pools, and both held mortgages and MBS on their respective balance sheets. By 1992, Congress concluded that the enterprises posed potential safety and soundness risks, and regulations that had been in place since 1968 were inadequate to manage such risks. Through the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of the Housing and Community Development Act of 1992), Congress fundamentally revised regulation of the enterprises and took steps to clarify Fannie Mae's and Freddie Mac's roles within the housing finance system and better define their public housing mission responsibilities.²² The act expanded the enterprises' previous housing mission responsibilities, requiring a percentage of the loans they purchased to be mortgages serving low or moderate-income families; special affordable housing for families (that is, low-income families in low-income areas, and very low-income families); and housing located in central city, rural, and other underserved areas.²³ HUD was given responsibility for regulating the enterprises compliance with these goals. Recognizing the potentially large financial costs that the enterprises posed to the federal government, the act also established the Office of Federal Housing Enterprise Oversight (OFHEO) as an independent office within HUD whose mission was to help ensure the enterprises' safety and soundness.²⁴ One of OFHEO's most important means of helping to ensure the enterprises' financial soundness was to establish capital requirements that are related to potential risks that the enterprises face. In 1992, Fannie Mae and Freddie Mac became subject to a statutory 2.5 percent equity capital charge against mortgages or MBS that were funded on their balance sheets and a 0.45 percent equity capital charge against the MBS that they had issued to investors. Both of these capital requirements were

²²Pub. L. No. 102-550, tit. XIII, 106 Stat. 3672, 3941-4012 (codified in scattered sections of U.S.C.).

²³§§ 1331-1334, 106 Stat. at 3956-61 (codified at 12 U.S.C. §§ 4561-4564).

²⁴§§ 1311-1317, 106 Stat. at 3944-49 (codified at 12 U.S.C. §§ 4511-4517).

lower than the requirements for depository institutions, which were bound by the 4.0 percent minimum Basel I requirement.

However, in 2008, we found that the regulatory structure for the enterprises was fragmented and not well equipped to oversee their financial soundness or housing mission achievement.²⁵ We reported that OFHEO lacked key statutory authorities needed to fulfill its safety and soundness responsibilities as compared to the authorities available to federal bank regulators. For example, OFHEO was not authorized to limit the asset growth of housing enterprises if capital falls below predetermined levels. Moreover, HUD, which had housing mission oversight responsibility for the enterprises, faced a number of challenges in carrying out its responsibilities. In particular, HUD may not have had sufficient resources and technical expertise to review sophisticated financial products and issues. The Housing and Economic Recovery Act of 2008 (HERA) created FHFA to oversee the enterprises and the FHLBanks.²⁶ The law gave FHFA such new regulatory authorities as the power to regulate the retained mortgage portfolios, to set more stringent capital standards, and to place a failing entity in receivership. In addition, the law also combined the regulatory authorities that were previously distributed among OFHEO; the Federal Housing Finance Board, which had replaced the FHLBank Board in 1989; and HUD.

Response to Financial Crisis

The 2007-2009 financial crisis, which according to many researchers, was triggered by losses in the mortgage market, led the federal government to significantly increase the federal role in the housing finance markets. On October 3, 2008, the Emergency Economic Stabilization Act of 2008 was signed into law. The act authorized the Troubled Asset Relief Program, a \$700 billion program designed to restore liquidity and stability to the financial system and to preserve homeownership by assisting borrowers struggling to make their mortgage payments.²⁷ Troubled Asset Relief Program funds supported a variety of

²⁵GAO, *Housing Government-Sponsored Entities: A Single Regulator Will Better Ensure Safety and Soundness and Mission Achievement*, [GAO-08-563t](#) (Washington, D.C.: Mar. 6, 2008).

²⁶Pub. L. No. 110-289, § 1101, 122 Stat. 2654, 2661 (codified at 12 U.S.C. § 4511). Previously the Federal Housing Finance Board was the safety and soundness and housing mission regulator of the Federal Home Loan Banks.

²⁷Pub. L. No. 110-343, § 101, 122 Stat. 3765, 3767 (codified at 12 U.S.C. § 5211).

mortgage- and nonmortgage-related programs, including programs to make capital investments in shares of financial institutions.²⁸ Treasury estimates several of the programs over their lifetimes will provide income to the government while others will incur a cost.

Another significant response to the crisis was enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act.²⁹ The act is intended, among other things, to reform residential mortgage lending and securitization practices that contributed to the financial crisis. The act provides some liability protection for lenders originating mortgages that meet nine specified criteria, as applicable, associated with a borrower's ability to repay ("qualified mortgages").³⁰ The act also requires securitizers of mortgages that do not meet the definition of a qualified residential mortgage to retain at least 5 percent of the credit risk, though federal rulemaking agencies may adopt exemptions from this 5 percent requirement for certain classes of institutions or assets.³¹ A number of the act's other provisions seek to reform the mortgage market—for example, by authorizing CFPB to supervise nonbank mortgage lenders and by prohibiting certain mortgage lending practices, such as issuing mortgage loans without making a reasonable and good faith effort to determine that the borrower has a reasonable ability to repay. The act also eliminated the OTS and transferred its regulatory authorities to OCC, the FDIC, and the Federal Reserve.³²

Financial Crisis Impact on FHA's Financial Position

As housing prices began to decline in April 2006 and conventional mortgage lenders tightened their underwriting standards, more homebuyers began taking advantage of FHA-insured loans, which tend to have less strict underwriting standards and require lower down payments, as compared with conventional loans. Additionally, the Economic

²⁸For more information on Troubled Asset Relief Program see *Troubled Asset Relief Program: Treasury Sees Some Returns as it Exits Programs and Continues to Fund Mortgage Programs*, GAO-13-192 (Washington, D. C.: Jan. 7, 2013).

²⁹Pub. L. No. 111-203, 124 Stat. 1376 (2010).

³⁰§ 1412, 124 Stat. at 2145-46.

³¹§ 941(b), 124 Stat. at 1892.

³²The transfer of powers from OTS to other federal regulators was completed on July 21, 2011, and OTS was officially dissolved 90 days later (Oct. 19, 2011).

Stimulus Act of 2008 increased the limits of loans eligible for FHA insurance to 125 percent of the median house price in each area.³³ As a result, FHA's share of the market increased. In 2006, FHA insured approximately 4.5 percent of purchase mortgages. At its peak in 2009, it insured 32.6 percent of purchase mortgages. As FHA's market share grew, the economic value of FHA's insurance fund declined dramatically. Specifically, it declined from about \$21 billion at the end of 2007 to less than \$4 billion by the end of 2009. At the end of 2012, the fund's economic value was negative. As a consequence, the insurance fund's capital ratio fell to negative 1.44 percent in 2012, below its statutory minimum of 2.0 percent. As the capital ratio declined, the insurance fund's condition also worsened from the federal budgetary perspective. In recent years, FHA has taken several actions intended to strengthen its financial position and minimize defaults, such as increasing down-payment requirements for certain loans in 2010 and raising premiums on insured mortgages multiple times. (FHA proposed its most recent premium increase in January 2013.) However, on September 27, 2013, FHA notified Congress for the first time that the agency would require \$1.68 billion in Treasury funds to ensure that at the end of FY 2013, the mutual mortgage insurance fund would have sufficient funds in its capital reserve account to pay for all expected future losses.

Public Conservatorship of the Enterprises

Prior to the financial crisis, the enterprises made changes to their practices that increased their risk. For example, in 2009 we noted that during the late 1990s and early 2000s, we had raised concerns about the rapid growth of the enterprises' retained mortgage portfolios, which reached about \$1.6 trillion by 2005.³⁴ We found that although increasing the size of their mortgage portfolios may have been more profitable than issuing MBS, it also exposed the enterprises to significant interest-rate risk. Additionally, in 2004 and 2005, the enterprises embarked on

³³Subsequent to the enactment of the Economic Stimulus Act of 2008, HERA established new statutory limits of 115 percent of area median home prices for FHA loans. See Pub. L. No. 110-289, § 2112, 122 Stat. 2654, 2830. A few months later, the American Recovery and Reinvestment Act of 2009 set the floor for FHA loan limits at the 2008 levels; FHA loan limits for 2009 were set in each county at the higher dollar amount when comparing loan limits established under the Economic Stimulus Act of 2008 requirements and the 2009 limits under HERA Pub. L. No. 111-5, § 1202, 123 Stat. 115, 225.

³⁴ *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises Long-Term Structures*, [GAO-09-782](#) (Washington, D. C.: Sept. 10, 2009).

aggressive strategies to purchase mortgages and mortgage assets with questionable underwriting standards. For example, they purchased a large volume of Alt-A mortgages, which typically did not have documentation of borrowers' incomes and had higher loan-to-value ratio or debt-to-income ratios. The enterprises also increased their purchases of private-label MBS from 2003 through 2006. By the end of 2007, the enterprises collectively held more than \$313 billion in private-label MBS. According to FHFA, while these questionable mortgage assets accounted for less than 20 percent of the enterprises' total assets, they represented a disproportionate share of credit-related losses in 2007 and 2008.

During 2007 and the first half of 2008, Fannie Mae's and Freddie Mac's financial condition deteriorated, which prompted congressional and Executive Branch efforts to stabilize the enterprises and minimize associated risks to the financial system. The enterprises incurred substantial credit losses on their retained portfolios and their guarantees on MBS. These credit losses resulted from pervasive declines in housing prices, as well as specific enterprise actions such as their guarantees on MBS collateralized by questionable mortgages (mortgages with limited or no documentation of borrowers' incomes), and investments in private-label MBS collateralized by subprime mortgages. According to FHFA and Treasury officials, their ongoing financial analysis of the enterprises in August and early September 2008, as well as continued investor concerns about the financial condition of each enterprise, resulted in FHFA's imposition of the conservatorships on September 6, 2008, to help ensure the enterprises' viability, that the enterprises fulfill their housing missions, and stabilize financial markets. Concurrently, Treasury made investments in the enterprises' senior preferred stock and MBS through authorities provided in HERA in an effort to ensure that the enterprises could maintain a positive net worth. The Senior Preferred Stock Purchase Agreements that Treasury entered into with the enterprises initially entitled Treasury to 10 percent dividend payments on its senior preferred stock investments. The agreements were subsequently amended, and since January 2013, the enterprises' required dividend payments are equal to their positive net worth, if any, above required capital levels.

Appendix III: Legislative Proposals to Change the Housing Finance System-March 2013 to July 2014

This appendix discusses the legislative proposals that were introduced in the U.S. Senate and the House of Representatives between March 2013 and July 2014. These proposals are discussed accordingly from the most recent to those introduced earlier in the period.

Senate Bills

Housing Finance Reform and Taxpayer Protection Act of 2014, S.1217 (Johnson-Crapo Bill), a draft of the bill was released by Senate Banking Committee Chairman and Ranking Member on March 16, 2014. The Senate Banking Committee approved the bill with amendments on May 15, 2014. The proposed legislation addresses secondary market reform by winding down the enterprises and creating a federal mortgage insurer to protect mortgage backed securities (MBS) investors against catastrophic loss, establishing a regulatory structure to oversee the secondary market, and imposing secondary market fees that would provide a funding stream to address low-to-moderate homeownership and rental housing needs.

- *Structure* – The Federal Housing Finance Agency (FHFA) would become an independent office in the Federal Mortgage Insurance Corporation (FMIC), and FHFA would continue to be responsible for supervision and regulation of the Federal Home Loan Banks and the enterprises as they wind down. The enterprises would be dissolved over a five-year transition period with flexibility allowing for extensions if necessary to prevent market disruptions and increases in borrowing costs. FMIC is to maintain a re-insurance fund, the Mortgage Insurance Fund (MIF), to fund insurance claims on the principal and interest of FMIC-backed securities in certain circumstances. FMIC would have a 5-member bipartisan board of directors. The proposal would create an advisory committee with diverse housing finance expertise to facilitate housing finance system stakeholder interaction with the board of directors.
- *Activities* – FMIC is to establish a securitization platform to develop standardized securitization documents for all FMIC-guaranteed securities. MIF would fund claims on the principal and interest of FMIC-backed securities if losses exceed a required private market first loss position. The MIF would be funded initially by assessments on the enterprises and sustained in the future by fees on FMIC-backed securities. FMIC is to impose user fees to fund affordable homeownership and rental housing through the Housing Trust Fund, Capital Magnet Fund, and the proposed Market Access Fund. The MIF is to have a capital reserve ratio of 1.25 percent of the outstanding principal balance of FMIC-backed securities within 5

years, and 2.5 percent within 10 years and thereafter. FMIC must establish underwriting standards to mirror the definition of “qualified mortgage,” and the bill sets the down payment requirement at 3.5 percent for first-time homebuyers and at 5.0 percent for other homebuyers (this rate is established after a phase-in period). FMIC is authorized to establish and capitalize a mutually owned company to facilitate access to the secondary market by smaller lenders.

Once the new mortgage finance system is fully operational, FMIC is required to submit annual reports to Congress with detailed information including, among other things, a report on MIF’s financial condition, the exposure of the MIF to economic conditions, and an estimate of the resources needed for the MIF to operate. The bill also establishes an Office of the Inspector General of FMIC and requires GAO to submit a report on the transition within 18 months of the system becoming fully operational and, within 8 years after the date of enactment, and a report on the feasibility of transitioning to and creating a fully privatized secondary mortgage market.

FHA Solvency Act of 2013, S.1376, introduced by the Senate Banking Committee, which addresses primary market reform—in particular, the Federal Housing Administration (FHA). The bill was reported out by the Senate Banking Committee on July 31, 2013. The bill makes several changes to current law aimed at improving the financial safety and soundness of FHA’s Mutual Mortgage Insurance Fund.

- *Structure* – The bill would maintain FHA’s current structure as part of HUD. The bill includes a statutory requirement for a Deputy Assistant Secretary and Chief Risk Officer with specific duties, including an annual report to Congress on the lowest performing loans.
- *Activities* – FHA would be required to issue a single resource guide to inform lenders and servicers of all policies, processes, and procedures applicable to FHA mortgages and make it publicly available on the Internet. The bill would require an increase in the capital reserve ratio from 2 percent to 3 percent within 10 years. FHA must conduct an annual review of mortgagees underwriting or originating single family mortgages and FHA would have authority to terminate approval of a mortgagee if it determines that the mortgage loans originated by the mortgagee present an unacceptable risk to the insurance fund. FHA is given authority to issue rules requiring an underperforming servicer to contract with a specialty subservicer for a single mortgage or any pool of mortgages. FHA is required to evaluate and revise as necessary FHA’s underwriting standards using criteria similar to the criteria used by CFPB for Qualified Mortgages. FHA is required to develop an alternative stress test scenario to help

assess the financial status of the MMF. FHA would be required to submit a capital restoration plan to Congress when the MMI Fund is undercapitalized and to assess annual premium surcharges on new business.

Housing Finance Reform and Taxpayer Protection Act of 2013, S.1217 (Corker-Warner Bill), introduced by a bipartisan group of Senators, including Senators Bob Corker (R-TN), Mark Warner (D-VA), and some members of the Senate Banking Committee, on June 24, 2013. The proposal addresses secondary mortgage market reform by winding down the enterprises and creating a federal mortgage insurer to protect MBS investors against catastrophic loss, establishing a regulatory structure to oversee the secondary market, and imposing secondary market fees that would provide a funding stream for to address low-to-moderate homeownership and rental housing needs.

- *Structure* – The bill would create a new agency, the Federal Mortgage Insurance Corporation (FMIC), transfer the functions of FHFA to the new agency, and wind down the enterprises in no more than 5 years. FMIC would have a five-member bipartisan board of directors composed of individuals, each with expertise in a different area, including asset management, insurance, community banking, and multifamily housing. The bill would establish a Mortgage Insurance Fund (MIF) to cover insured losses when losses exceed the first loss position absorbed by private market holders. FMIC must create the FMIC Mutual Securitization Company, to be owned by credit unions, community and mid-size banks, and non-depository mortgage originators, to securitize member mortgages. The bill would also establish an Office of Federal Home Loan Bank Supervision within FMIC to oversee the Federal Home Loan Banks and the Federal Home Loan Bank System and would create an Office of Underwriting within FMIC to ensure that mortgages that underlie FMIC-guaranteed securities meet certain standards.
- *Activities* – FMIC would be required to develop standard risk-sharing mechanisms, products, and contracts within 5 years of enactment. MIF insurance would have full-faith-and-credit government guarantee. To be eligible for a guarantee by FMIC, the mortgage loan amount would have to be below conforming loan limits set by the bill and the mortgage would need to meet the requirements of the qualified mortgage rule. The Housing Trust Fund in HUD and Capital Magnet Fund in Treasury are to be funded with a 5-10 basis-point fee on MBS insured by FMIC (80 percent to HUD/20 percent to Treasury). MIF would be required to maintain at least a 2.5 percent capital ratio after 10 years.

The FMIC is to present reports to Congress on various topics, including the MIF and the secondary mortgage market. The bill would require GAO to conduct an annual financial audit of FMIC and to issue a study on the feasibility of a fully privatized secondary market no later than 8 years after the date of enactment. Six months later, the FMIC director would be required to submit a report to Congress that describes all the legislative, administrative, and regulatory actions necessary to carry out a transition to a fully private secondary market.

House Bills

Partnership to Strengthen Homeownership Act of 2014, (H.R. 5055).

Introduced by Congressman Delaney and referred to the House Committee on Financial Services on July 10, 2014. The bill addresses secondary market reform by winding down the enterprises and creating a federal mortgage insurer to protect mortgage-backed securities investors against catastrophic loss, establishing a new regulatory structure to oversee the secondary market, and imposing secondary market fees to fund low-income housing initiatives.

- *Structure* – Ginnie Mae is removed from HUD, established as an independent entity, and replaces FHFA six months after enactment of the act. All FHFA’s functions property and personnel are transferred to Ginnie Mae, which would have supervisory and regulatory authority over secondary market participants. Ginnie Mae is to establish a securitization platform and reinsurance fund. The bill winds down the enterprises over five years with 2-year extensions.
- *Activities* – Ginnie Mae is to establish and oversee a securitization platform and provide backstop insurance through the newly established insurance fund with catastrophic government guarantees for losses above 5 percent on MBS after private capital takes first loss position. The new insurance fund is to have a capital reserve ratio of 1.25 percent of the outstanding principal balance of backed securities within 5 years, and 2.5 percent within 10 years and thereafter. The bill requires that the Ginnie Mae, through the platform, establish uniform standards for MBS, including servicing and pooling requirements and underwriting guidelines. The bill also requires that Ginnie Mae set standards for secondary market participants, including credit rating requirements, and capital and related solvency standards intended to ensure safety and soundness of market participants and minimize risk to the insurance fund. The bill proposes that FHLBanks maintain a TBA market for small lenders. The bill requires the director of the new regulatory agency to share information with other federal regulatory agencies regarding the financial condition and risk management practices of market participants. The bill also requires the new

regulator to avoid duplication with the regulatory activities of other agencies, such as examination activities and reporting requirements. The bill preserves the Housing Trust Fund and the Capital Magnet Fund, and establishes a Market Access Fund to increase the supply of affordable housing for extremely low-, and very low-, and low-income families.

Housing Opportunities Move the Economy (HOME) Forward Act of 2014. Released by House Financial Services Committee Ranking Member Maxine Waters on March 27, 2014. The proposal addresses secondary mortgage market reform by winding down the enterprises and creating a new lender-owned issuer of government-guaranteed securities, creating a federal mortgage insurer to protect MBS investors against catastrophic loss, establishing a regulatory structure to oversee the secondary market, and imposing secondary market fees that would provide a funding stream for affordable rental housing.

- *Structure* – The bill would establish the National Mortgage Finance Administration (NMFA) to replace FHFA. The bill would also establish the new lender-owned Mortgage Securities Cooperative (MSC) to replace the enterprises, which would be wound-down over a five-year period. The Secretary of the Treasury may extend the transition period for no more than one year. The bill specifies that the director shall serve on the Financial Stability Oversight Council. The proposal establishes the Mortgage Insurance Fund (MIF), which would be funded by private companies and modeled after the Deposit Insurance Fund managed by FDIC.
- *Activities* – NMFA would oversee the securitization platform established by the GSEs and provide backstop insurance through the MIF funded by private companies—catastrophic government guarantees for losses above 5 percent on MBS after private capital takes first loss position. The proposal gives the MIF up to 7 years to reach a reserve of 1.25 percent of the outstanding principal balance of guaranteed securities and 12 years to reach 2.25 percent capital reserve ratio. The NMFA may reduce these percentages if a determination is made that the level of reserves is adequate to cover losses at least equal to any experienced in the housing markets over the last 100 years. In addition to overseeing the MIF, NMFA would have oversight responsibilities over the Federal Home Loan Banks (FHLBank) and the FHLBank System and counterparties to the MSC. The bill also would establish underwriting standards for mortgages to be guaranteed by the MIF to mirror the definition of “qualified mortgage,” and would set the down payment requirement at 3.5 percent for first-time homebuyers and at 5.0 percent for other

homebuyers. The draft bill preserves the Housing Trust Fund to increase the supply of affordable housing for extremely low-, and very low-, and low-income families in rural and urban areas. The draft bill also preserves the Capital Magnet Fund at the Department of Treasury to develop, rehabilitate, or purchase affordable housing for these households and would establish a Market Access Fund to promote innovation in housing finance and affordability.

The proposal also would establish an Inspector General with responsibilities to evaluate the programs of the agency and report on the adequacy of guarantee fees and the MIF, effectiveness of the placement of credit risk and capital requirements, and the extent to which the government is protected from loss. The NMFA Director would be required to provide a report and testimony to Congress annually. GAO would be required to conduct annual financial audits of the agency.

Protecting American Taxpayers and Homeowners (PATH) Act, H.R. 2767, introduced by Rep. Scott Garrett. The bill was reported out of committee with amendments on July 24, 2013. H.R. 2767 consists of four separate titles, which, combined, address the primary and secondary mortgage markets. Together, the legislation would move FHA out of HUD, limit its activities, and increase its capital requirements; wind down the enterprises; authorize FHFA to establish a charter for a national mortgage market utility to be owned by the private sector; establish FHFA as the regulator of the national mortgage market utility, and FHA and Rural Housing Service (RHS) programs; establish regulation of covered bonds by financial regulators and standards setting by Treasury.

- *GSE Bailout Elimination and Taxpayer Protection Act*. This title terminates enterprise conservatorship 5 years after enactment and requires FHFA director to act as receiver of the enterprises after their charters are revoked.
 - *Structure* – The bill would revoke the enterprises’ charters 5 years after the date of enactment, unless the FHA director determines that market conditions warrant a temporary extension; no new business may be conducted thereafter.
 - *Activities* – The bill would impose limitations, requirements and prohibitions on the enterprises’ activities until their charters are repealed. The bill would reduce conforming loan limits in high-cost areas, reduce the size of the enterprises’ retained portfolios, and prohibit the purchase and guarantee of mortgages that do not meet the criteria for qualified mortgages in the Dodd-Frank Act.

The bill repeals the enterprises' affordable housing goals and the Affordable Housing Trust Fund.

- *FHA Reform and Modernization Act of 2013*. The bill would establish FHA as an independent agency to provide single-family homeownership to first-time homebuyers and rental housing opportunities.
 - *Structure* – FHA would become an independent government corporation with a nine-member board composed of the HUD secretary, the Secretary of Agriculture and 5 individuals with expertise in mortgage finance and 2 individuals with expertise in affordable housing. The bill provides for a transition to independence ending no sooner than 2 years after the date of enactment or on the date FHA says it is ended, with OMB agreement or after the expiration of 5 years from the date of enactment. The bill would create positions for Chief Risk and Technology Officers with specified powers and duties. FHA would be required to use Generally Accepted Accounting Principles applicable to the private sector.
 - *Activities* – The bill would limit mortgage insurance to first-time and low- and moderate-income homebuyers and those experiencing countercyclical markets or disasters. With some delay, FHA would be required to establish credit risk-sharing on at least 10 percent of new business—FHA insures part of a mortgage and private insurers the rest. FHA insurance coverage would be reduced over 5 years from 100 percent to 50 percent of the original value of the loan. The agency would be required to engage in research, development, and testing of new mortgage products designed to make housing credit available to hard-to-serve markets. The director of FHFA would be required to evaluate the safety and soundness of FHA and RHS. The minimum capital adequacy ratio of the Mutual Mortgage Insurance Fund would be raised from 2 percent to at least 4 percent of outstanding insurance obligations with restrictions on new insurance commitments when the ratio falls below certain thresholds. The director would be required to develop a risk-based capital model and conduct stress tests to ensure capital adequacy during periods of stress. However, upon a joint determination with the Chief Risk Officer, the director may temporarily lower capital ratios under certain stressful conditions. Lenders would be required to repurchase mortgages that are more than 60 days delinquent within the first two years of the loan, and borrowers may not obtain FHA mortgage insurance within seven years of a completed foreclosure.

- *National Mortgage Market Utility Act of 2013*. The bill would require the FHFA Director to charter the National Mortgage Market Utility (Utility) to own and operate the securitization platform currently being developed by the enterprises, and the Utility is to organize and operate a national repository for mortgage data.
 - *Structure* – The Utility would be a not-for-profit entity and would be governed by a board of directors. The FHFA director would choose the Utility’s organizational form. Initial funding through appropriations is to be repaid within 10 years out of user fees. The Utility would be regulated by FHFA.
 - *Activities* – The Utility would operate a securitization platform for private issuers of residential mortgage-backed securities (RMBS) and establish standards for RMBS. The Utility would not be permitted to originate, service, insure, or guarantee any mortgage or financial instrument associated with a mortgage and may not provide a government guarantee on MBS. All users of the platform would be required to resolve all representations and warranties disputes through mandatory arbitration. The FHLBanks would be authorized to serve as loan aggregators to compile pools of mortgages originated by any of their members for securitization through the platform.
- *United States Covered Bond Act of 2013*. The bill would create a legislative framework for financial institutions to issue covered bonds, which would be an alternative to securitization as a way to finance mortgage lending. Eligible assets would include residential mortgages; federal, state, and local government securities; and auto, student, credit card, and Small Business Administration loans. The amount of covered bonds issued would be limited to a percentage of the issuer’s total assets. Treasury would be required to establish standards for and registry of covered bond programs that would be overseen by federal financial regulators.

FHA Emergency Fiscal Solvency Act of 2013, (H.R. 1145). Introduced by House Financial Services Committee Ranking Member Maxine Waters on March 13, 2013. The bill addresses primary market reform by directing HUD to establish and collect annual mortgage insurance premiums beyond current levels, expanding HUD’s indemnification authority over mortgagees, and establishing a program to review the cause of early delinquencies—defined as a mortgage that becomes 90 or more days delinquent within 24 months of origination—on mortgages that are the obligation of the Mutual Mortgage Insurance Fund (MMIF) and to report on the financial impact on the MMIF of related indemnifications.

- *Structure* –The bill maintains FHA’s current structure at HUD, including the Mutual Mortgage Insurance Fund. The bill establishes a Deputy Assistant Secretary for Risk Management and Regulatory Affairs position at FHA and a Chief Risk Officer for Ginnie Mae.
- *Activities* – The bill requires HUD to increase annual premium payments from not more than 1.5 percent to between 0.55% to 2% of the remaining insured principal balance for the first 11 years of HUD-insured mortgages, and to increase from 1.55 percent to 2.05 percent the 30-year annual premium for an insured mortgage whose original principal obligation exceeds 95% of the remaining principal balance. The bill revises the conditions under which HUD would exercise its indemnification authority to include instances where the mortgagee knew, or should have known, of serious or material violations of HUD’s mortgage requirements, irrespective of whether such violations caused a mortgage default. HUD’s indemnification authority is also revised to include fraud or misrepresentation with origination or underwriting of which the mortgagee knew or should have known. The bill directs HUD to establish an appeals process for mortgagees in indemnification cases. The bill authorizes HUD to terminate the approval of the mortgagee to originate or underwrite mortgages if the mortgagee has an excessive rate of early defaults and claims.

The bill requires HUD to establish programmatic reviews and reporting on early period delinquencies, defined as mortgages that become 90 or more days delinquent within 24 months of origination. The bill also requires HUD to estimate annual costs to the MMIF since 2008 resulting from mortgage servicers’ noncompliance with National Housing Act guidelines governing loan servicing, loss mitigation, and insurance claim submission. The bill would also add to HUD’s existing obligation to conduct and report on an annual independent actuarial study of the MMIF’s financial position a requirement that HUD conduct and report on the study semiannually during periods of capital depletion of the MMIF. The bill directs GAO to provide, within 60 days of enactment, third-party review of the financial safety and soundness of HUD mortgage insurance programs and funds and the extent of their loan loss reserves and capital adequacy.

Appendix IV: List of Participants in Discussion Groups

This appendix includes a list of the government officials, researchers, consumer advocates, and industry representatives who participated in our discussion groups on a draft housing finance framework. We also spoke with officials at the Credit Union National Association, the Council of Federal Home Loan Banks, and Treasury who were unable to attend our discussion groups about the draft framework. Researchers listed here spoke for themselves rather than for the institutions with which they are affiliated.

Sonny Abbasi, Structured Finance Industry Group
Robert Avery, Federal Housing Finance Agency
Richard Brown, Federal Deposit Insurance Corporation
Mark Calabria, Cato Institute
Richard S. Carnell, Fordham University
Jim Carr, Center for American Progress
Alys Cohen, National Consumer Law Center
Rob Couch, Bradley Arant Boult Cummings, Bipartisan Policy Center
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Laurie S. Goodman, Urban Institute
Daniel D. Gray, Nationstar Mortgage, LLC
Rohit Gupta, Genworth Mortgage Insurance, Inc., U.S. Mortgage Insurers
Ethan Handelman, National Housing Conference
Ron Haynie, Independent Community Bankers of America
Carrie Johnson, Center for Responsible Lending
Chris Katopis, Association of Mortgage Investors
Chris Killian, Securities Industry and Financial Markets Association
Jed Kolko, Trulia, Inc.
David Ledford, National Association of Home Builders
Paul Leonard, Financial Services Roundtable Housing Policy Council
Adam Levitin, Georgetown University
Jeff London, Department of Veterans Affairs
Enrique Lopezlira, National Council of La Raza
David Min, University of California at Irvine
Richard Nisenson, Office of the Comptroller of the Currency
Alessandro Pagani, Loomis Sayles & Company, L. P., Association of Institutional Investors
Joseph Pigg, American Bankers Association
Ed Pinto, American Enterprise Institute
Alex Pollock, American Enterprise Institute
Janneke Ratcliffe, University of North Carolina Center for Community Capital
Nicolas Retsinas, Harvard Business School, Bipartisan Policy Center

**Appendix IV: List of Participants in Discussion
Groups**

Garth Rieman, National Council of State Housing Agencies
Kathleen Ryan, Consumer Financial Protection Bureau
Ellen Seidman, Urban Institute
Hilary Shelton, National Association for the Advancement of Colored
People
Shane Sherlund, Federal Reserve Board of Governors
Robert Shiller, Yale University
Michael Simkovic, Seton Hall University
Phillip Swagel, University of Maryland
Sandra Thompson, Federal Housing Finance Agency
Theodore W. Tozer, Ginnie Mae
Joseph Tracy, Federal Reserve Bank of New York
Joaquin Tremols, U.S. Department of Agriculture
Joe Ventrone, National Association of Realtors
Susan M. Wachter, University of Pennsylvania
Lawrence J. White, Stern School of Business, New York University
Kyle Williams, National Urban League
Mitria Wilson, National Community Reinvestment Coalition
Andrew Winkler, American Action Forum

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Staff Acknowledgments

In addition to the individual named above, Andrew Pauline (Assistant Director), Nancy S. Barry (Analyst-in-Charge), Farah Angersola, Bethany Benitez, Emily Chalmers, Jeremy Conley, John Karikari, Colleen Moffatt Kimer, Jena Sinkfield, Andrew Stavisky, and Jim Vitarello made major contributions to this report. Janet Eackloff, Paige Smith, and Heneng Yu also contributed to this report.

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