GAO Highlights

Highlights of GAO-15-131, a report to congressional addressees

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HOUSING FINANCE SYSTEM

A Framework for Assessing Potential Changes

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.

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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.

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