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Racial Justice and the Mortgage Market: Recommendations to the Biden Administration Regarding the Future of the GSEs

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Homeownership is the dominant housing tenure for white America, in which almost three out of four households own their own home.¹ But this is not the case for Black America, in which more than one-half of households are renters. The difference between white and Black homeownership rates has generally persisted, growing significantly in the wake of the subprime crisis. By 2018, the white-Black homeownership gap reached over 30 percentage points, its highest level in 50 years (McCargo and Choi, 2020). Black homeownership fell more than 5 percentage points following the subprime crisis. The racial difference in homeownership rates is a key contributor to the racial wealth gap, in which median white household wealth is almost eight times median Black wealth (Bhutta et al., 2020).

Although homeownership is not necessarily the best tenure choice for any one household at any one time, homeowners in the U.S. generally benefit from favored treatment in their local housing markets. While affluent homeowners benefit from the federal mortgage interest deduction, for lower-to-middle-income households the largest advantages to homeownership tend to be the greater housing stability and security it provides; the ability to fix most future housing costs (via long-term, fixed-rate mortgages) and avoid unpredictable rent increases; and the capacity to leverage a modest amount of forced savings into an asset that can provide some critical wealth-building over time. In many parts of the U.S., being a renter means being subject to a landlord-friendly rental market with few tenant protections and no rent stabilization laws.

In many metropolitan areas, rental housing is disproportionately concentrated in a relatively small number of neighborhoods. As of 2018, neighborhoods with high levels of rental housing (over 80 percent rental) had a median household income of less than half those with high owner-occupancy levels (over 80 percent ownership), with mixed-tenure neighborhoods falling in the middle (Joint Center for Housing Studies, 2020). Given this segregation by tenure within many metropolitan areas, the ability to choose between buying a home and renting may also provide families with a greater variety of neighborhood options, including those where rental housing is relatively scarce (Immergluck, 2015; Levitin, 2020).

Of course, homeownership entails financial risks that must be considered seriously. On the other hand, in most cases, especially after the regulatory changes adopted in the Dodd-Frank Act, mortgage

1 The homeownership rate for non-Hispanic white households was 73.7% in the first quarter of 2020. It was 44.0% for Black households. <https://www.census.gov/housing/hvs/files/currenthvspress.pdf>. Note, the Census Bureau's estimates of homeownership rates after the first quarter of 2020 are generally considered not reliable due to COVID-19 issues.

borrowers are far better protected from being rapidly displaced via foreclosure than tenants are from eviction, and low down-payment programs can reduce the amount of savings that homeowners need to put at risk.

For homeownership to be accessible in a racially just way, discrimination (including both disparate treatment and disparate impact) in access, pricing, and terms must be minimized. One way to ensure this is through rigorous enforcement of fair lending laws and the Community Reinvestment Act. But there are two additional necessary components to providing a fair and just system of housing finance: 1) a robust Federal Housing Administration (FHA) that provides affordable, low down-payment mortgages to families with less wealth and lower credit scores; and 2) a large, robust, and equitable secondary market that will improve upon the current government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac and that maintains a strong and central federal role in housing finance. This paper focuses primarily on the latter, especially in the context of single-family mortgage finance. While not a subject of this paper, any future federally-backed secondary market must also play a critical role in providing financing for affordable rental housing.²

Black Wealth, White Wealth

Differences in homeownership rates are a major contributor to the Black-white racial wealth gap. There is a paradox here because, although homeownership comprises a greater share of the Black wealth than it does white wealth, white families have historically benefited from larger home values and often greater wealth accumulation via homeownership than Black families (McCoy and Choi, 2020; Perry et al. 2018). Historically, appreciation rates of Black-owned homes have often lagged those of white-owned homes, especially when spanning the 2007-2011 subprime crisis, which hit Black neighborhoods especially hard (Immergluck et al., 2019). On top of this, subprime lending, risk-based pricing, and other features of racialized mortgage markets left many Black homeowners with high-cost, often predatory loans, which frequently turned what otherwise could have been beneficial home purchases into disasters (Immergluck, 2011a).

Despite the median white homeowner's having approximately double the home equity that the median Black homeowner had in 2019 (\$130,000 vs. \$66,800), home equity comprises nearly 60 percent of the net worth of Black homeowners, while comprising only 43 percent of the net worth of white homeowners (McCargo and Choi, 2020). Thus, access to affordable homeownership can be critical to the wealth prospects of Black households.

The bottom line in terms of the impact of homeownership on the racial wealth gap is perhaps best summarized by some findings of a 2016 study from the Institute for Assets and Social Policy and Demos. Sullivan et al. (2016) estimated that, if racial and ethnic disparities in homeownership rates were eliminated, the Black-white wealth gap would shrink 31 percent. They also estimated that, if the

2 For more discussion of the GSE's roles in the financing of multifamily rental housing, see J. Griffith and A. Jakobovics (2017).

financial returns to homeownership were equalized for Black and white homeowners, this would decrease the racial wealth gap by another 16 percent.

Notwithstanding the critical impact that differences homeownership can have on the racial wealth gap, it is important to note that the evidence suggests that most homeowners are not motivated by expected financial returns when choosing to buy a home.³ Many, if not most, are seeking a sense of control over their home, including an ability to resist displacement by market forces or landlord whims and to plan on a more predictable housing future.

Racial Disparities in Housing Finance

Historically, Black homeowners have often faced higher mortgage costs and worse financing options than white owners. Both historically and recently, predatory financial practices such as contract-for-deed selling have targeted Black neighborhoods and communities (Immergluck, 2018; Satter, 2009). Predatory home finance has often thrived in more heavily segregated metropolitan areas (Hyra et al., 2013).

During the subprime boom, Black homeowners were more likely to receive higher-cost, higher-risk loans (Bayer et al., 2018; Faber, 2013). These loans often featured predatory, risk-inducing terms, including prepayment penalties, yield-spread premiums, and balloon payments. While regulation following the subprime crisis reduced the incidence of predatory and toxic loan products, risk-based pricing, where borrowers with lower credit scores and lower down-payments pay higher interest rates, continues to be widely used by the GSEs.

When Black mortgage applicants receive higher-cost mortgages than white borrowers, regardless of the cause, it creates at least four types of possible problems. First, pushing some applicants over maximum debt-to-income thresholds will result in more Black families' being denied homeownership altogether. Second, the financial rate of return on homeownership will be reduced for Black families. Related to this, buying a home may become financially unwise as compared to renting a comparable home. And finally, the higher cost of the loan may actually increase the risk of default and foreclosure (Levitin, 2020).

In fact, targeting Black and Latinx borrowers with subprime loans led to these groups being disproportionately harmed by foreclosure during the foreclosure crisis (Reid et al., 2017). The geographical clustering of subprime lending also meant that vacant, foreclosed homes accumulated in many Black neighborhoods harming not just the borrowers themselves but entire neighborhoods, depressing local property values and pushing many homeowners into negative equity (Immergluck, 2015; Raymond, 2018).

3 Drew and Herbert (2012) and other research on surveys suggests that financial reasons are typically not the ones given as the top reasons for buying versus renting. In Fannie Mae's National Housing Survey, the top four cited reasons for wanting to buy were nonfinancial vs. financial, including "provides good place to raise children," "provides a safe place to live," "can have more space for family," and "have control over living space."

Due to legacies of discrimination and systemic disadvantage in credit, housing, labor and other markets, Black households tend to have lower credit scores than white households (McCargo and Choi, 2020). In addition, over one in five Black consumers is “credit invisible,” that is, lacking a credit score, compared to only 12 percent of white consumers. And, on top of these differences, lower earnings, less secure employment, and less access to generational wealth are important barriers to affordable homeownership.

Extremely tight mortgage markets in the wake of the subprime crisis meant that millions fewer Black families were able to buy a home than could have if mortgage markets had been functioning normally (Goodman et al., 2015; Immergluck et al., 2019). This occurred precisely when it would otherwise be a particularly good time to purchase a home, while home values were low and about to begin a more than eight-year run of appreciation. As a result, the collapse of an under-regulated and heavily-privatized mortgage market slammed Black homeowners and neighborhoods on the way down; afterwards, too many Black households were locked out of the benefits of the broad national recovery (Immergluck et al., 2019; McCargo and Choi, 2020)

Institutionalizing a Strong Federal Role in Housing Finance

From its creation in 1938 through to the late 1960s, Fannie Mae was not a “government sponsored” private enterprise, but a government agency, and later a corporation owned jointly by the federal government and private investors. Then, faced with political pressures over budget deficits growing as a result of the Vietnam War, Johnson effectively privatized Fannie Mae, turning it into a “government-sponsored” private firm. Shortly afterwards, Freddie Mac was created in the same government-sponsored enterprise (GSE) model.

The GSEs purchase mortgages from mortgage lenders, including banks and mortgage companies, and then package them into mortgage-backed securities, providing a key source of liquidity to the mortgage market. Because the loans they purchase comprise such a large share of all home loans, they effectively set loan pricing and terms for a large number of homebuyers and homeowners. While the GSEs functioned generally adequately over the next twenty-five years or so, they found themselves losing market share to unregulated, Wall Street-driven private-label securitization (PLS) that fueled the subprime booms of the late 1990s and 2000s. This subprime lending surge wreaked havoc on Black and Latinx borrowers and neighborhoods. After the federal government poured hundreds of billions into rescuing the two firms and buttressing the housing market, Fannie and Freddie recovered.

Over the last decade, speculators in Fannie and Freddie stock have lobbied for the firms to be recapitalized and then released back into private ownership and control (also known as “recap and release”), which would bring them a huge windfall. After years of frustration under the Obama Administration, speculators thought they had found their champion when the Trump Administration appointed the libertarian Mark Calabria to head of the Federal Housing Finance Agency. Calabria set a clear goal of “recap and release,” which fit his ideological view that the federal role in the housing

market should be minimized. Fortunately, some in the Treasury Department were less convinced of the wisdom of this direction (Layton, 2021).

So what should happen to Fannie Mae and Freddie Mac? First, it is important to recognize that nothing would do more damage to both the soundness of the housing market and to the affordability and fairness of housing finance than releasing Fannie and Freddie into the private market. As Adam Levitin and Susan Wachter (2020) have put it:

The combination of releasing the GSEs from conservatorship, hamstringing them with excessive capital requirements, and the loosening of underwriting standards is a recipe for disaster. It would unleash the “private label” Wall Street securitization machine that financed the junk mortgages of the housing bubble. Rolling back underwriting requirements enables Wall Street to return to dodgy mortgage products, and releasing the GSEs from conservatorship will create an uneven regulatory playing field that favors Wall Street.

The COVID-19 crisis has amplified the importance of maintaining a strong federal role in housing finance. Because the GSEs and the FHA, together, command such a dominant share of outstanding mortgages, federal policymakers were able to institute widespread mortgage forbearance programs very quickly and require servicers to offer borrowers the option to move their missed payments to the end of their loan terms. Meanwhile, in the rental market, the federal footprint is much smaller. The CARES Act eviction moratorium covered less than one-third of the rental market and so was much less effective.

During the Obama Administration, housing industry groups and generally centrist think tanks developed a number of proposals for the future of the GSEs. Most involved various complex forms of hybrid privatization, relying on different mechanisms of mortgage-backed securities issued by private players together with some form of government-backing in case of catastrophic failure. The main proposal that reached the Senate in 2014 was the Housing Finance Reform and Taxpayer Protection Act of 2014, better known as “Johnson-Crapo” (U.S. Senate, 2014).

Johnson-Crapo died in the Senate, due in part to opposition from progressives. As Ellen Seidman of the Urban Institute put it:

...the breadth of progressive opposition to Johnson-Crapo as negotiations came down to the wire came as something of a surprise. People asked why the focus was on bringing in private capital and protecting investors, rather than on ensuring that Americans are well-housed... What would this kind of reform do to access and to the price of mortgages? That’s an important issue not only for those potential homebuyers, but also for the economy, and our society as a whole. (Parrott et al., 2014)

This response is telling. The dominant discussion of the future of the GSEs by think tank specialists and housing finance insiders has frequently seemed remarkably disconnected from the

concerns of the housing needs and finances of lower-to-middle-income families and, especially, families and communities of color. Despite the greater focus on racial equity in recent discussions of housing policy, this remains a major problem.⁴

After the failure of Johnson-Crapo, and recognizing the desire among progressives to cement a stronger federal role in housing finance, some of the architects of early hybrid-privatization proposals moved to advocating a different approach, one that had been proposed years earlier (Immergluck, 2011b). Parrott et al. (2016) argue that a government-owned corporation structure offered the best path forward for Fannie and Freddie, arguing that this structure eliminates “too-big-to-fail” risk by taking the key market infrastructure out of the private market. With the government as the gatekeeper in the secondary market, smaller lenders will also be assured a level playing field compared to larger firms. Moreover, housing the operation in a government-owned corporation eliminates the need to create elaborate incentives to encourage private firms to do what they may not view as profit-maximizing.

Government ownership, via a government corporation, offers the advantages of government authority, centralization, standardization, and transparency. At the core of this corporation’s charter should be the purpose of enabling affordable homeownership and rental housing for families of all means. Given the entrenched legacies of racial discrimination in housing markets and housing finance, the new entity should also be charged with reducing racial and ethnic disparities in access to mortgage credit, loan pricing, and homeownership rates.

At the heart of the government ownership model lies the ability to create a more just housing finance system where Black homeowners do not pay what amounts to a racial legacy tax in the mortgage market. This means reducing, and ideally eliminating, “risk-based pricing,” where borrowers with lower credit scores or who can only afford lower down-payments pay significantly higher interest rates than borrowers with higher credit scores and more wealth. The increased charges such borrowers pay are referred to as “loan-level price adjustments” (LLPAs) and can be substantial, potentially increasing one’s interest rate by well over 50 percent.⁵

There is some modest cross-subsidization in the GSEs currently, where lower-wealth and lower credit-score borrowers benefit from the higher profits made on loans to higher-wealth, higher credit-score borrowers, but it is far from sufficient and may not be targeted as well as it might be. Almost 90 percent of the existing cross-subsidies in the GSEs benefit “broad, middle-of-the-market borrowers,” while a much smaller share go to lower down-payment, moderate- and higher-credit-score borrowers (Stegman and Cooperstein, 2019). These modest cross-subsidies come from other types of loans, especially cash-out refinance loans and loans to non-owner-occupant investors.

4 For example, in a recent 8,000-plus-word paper on the future of the GSEs from the Federal Reserve Bank of Kansas City, there is not one mention of the words “Black,” “race,” “racial,” “minority/ies,” “inequality,” or “wealth” (Rappaport, 2020).

5 Fannie Mae’s loan-level pricing matrix can be found at <https://singlefamily.fanniemae.com/media/9391/display>.

There is clearly room to increase cross-subsidies from cash-out refinance and investor loans or from the borrowers with higher credit scores and greater wealth. This will allow LLPAs to be reduced or even eliminated. However, the ability to cross-subsidize requires that the government maintain a large footprint in the overall mortgage market, and efforts to reduce this footprint by investment bankers and market fundamentalist ideologues must be resisted. Such measures would drastically debilitate a more equitable housing finance system. If the new government corporation is only allowed to serve smaller borrowers, or owner-occupied properties, for example, it will have less ability to provide affordable loans to borrowers who could otherwise suffer high levels of risk-based pricing.

The racially disparate impacts of risk-based pricing are clear. By making raising effective interest rates, LLPAs directly reduce the financial benefit to homeownership precisely for those folks who are already less affluent. Moreover, as Adam Levitin (2020) writes:

LLPAs may appear race-neutral, but their structure compounds existing racial wealth disparities. Because LLPAs are higher for low-down-payment mortgages, they fall more heavily on borrowers with less savings for a down payment. And because LLPAs are more costly for borrowers with worse credit scores, they fall disproportionately on those with low and moderate incomes, who are in turn disproportionately minorities. This creates a vicious circle: Because of the racial wealth gap, LLPAs are more likely to exacerbate the racial homeownership gap, which further reinforces the racial wealth gap.

The Importance of Maintaining a Strong Federal Housing Administration

The FHA has been a critical tool to providing access to homeownership to lower-wealth and lower-credit-score households, including many first-time homebuyers and borrowers of color. Two thirds of FHA loans go to first-time homebuyers (compared to 20 percent of GSE loans) (U.S. Department of Housing and Urban Development, 2020). More than a third of FHA loans go to minority homeowners, compared to 22 percent of GSE loans. As risk-based pricing by the GSEs has increased, FHA loans have become even more important because, for borrowers with lower credit-scores and/or lower down-payments, the LLPAs imposed by the GSEs can often get quite large, making the mortgage-insurance charged by the FHA a more affordable option. An FHA borrower buying a \$250,000 house would typically pay less than \$200 a month in insurance premiums. For borrowers with low credit scores or low down payments, this could be substantially less expensive than the combination of private mortgage insurance premiums and LLPAs on a comparable GSE loan.

The FHA has also proven itself to be a critical source of countercyclical home finance, especially for Black borrowers and neighborhoods. During the subprime crisis, the agency's market share soared from less than 4 percent to approximately 25 percent within just a couple of years (U.S. Department of Housing and Urban Development, 2020). If not for the FHA, the home buying market in many Black neighborhoods, which had contracted a great deal, would have shut down completely and for a longer period of time. The Biden Administration should work to strengthen and modernize the operations of

the FHA. It should resist efforts to shrink the market footprint of the FHA in any way that could reduce its financial reserves over the long run.

Notwithstanding the importance of maintaining a strong FHA, it is critical to make the GSE circuit of mortgage finance more equitable and to institutionalize such equity, avoiding the risk that a system of mortgage markets rigidly segmented by race will seriously worsen racial wealth and housing inequality.

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