

# ISSUE BRIEF

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## GSE Reform: Affordable Housing Goals and the “Duty” to Provide Mortgage Financing

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As Congress considers legislation to eliminate the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, advocacy groups are pressuring financial institutions to adhere to a “duty to serve” their markets rather than to meet specific affordable housing goals.

The “duty to serve” is a nebulous concept that codifies the idea that the GSEs (and lenders) have a “duty” to provide mortgage financing to the entire market. Thus mortgage market participants would no longer have to make sure a certain percentage of their business serves a low-income segment, but they would have to fulfill their *duty to serve* that segment. A regulatory regime such as this one leaves so much discretion in the hands of regulators that it effectively replaces the market with a government directive. There is no doubt that less private capital will be available when financial institutions have to do whatever regulators determine on a case-by-case basis.

This approach is misguided and it presents a serious danger for taxpayers, potential homebuyers, and ultimately all consumers. All of these people will be harmed if lawmakers ignore the following facts:

- The “duty to serve” regime will almost certainly be a regulatory framework with added confusion

for lenders and an enhanced ability for regulators to use politics to pressure financial institutions into making imprudent lending decisions.

- Market economies provide benefits to people when business owners earn profits, not when they have a specific “duty” to serve government mandates. Finally, affordable housing goals tend to encourage people with low wealth to get into an enormous amount of debt—a point that seems to be getting lost in this debate.

**Brief Background on Affordable Housing Goals.** Prior to the early 1990s, Fannie and Freddie were regulated by the Department of Housing and Urban Development (HUD). During this time, the HUD Secretary only had the authority to “encourage” Fannie and Freddie to purchase mortgages in low-income markets. In 1992, Congress required Fannie and Freddie to finance fixed percentages of mortgages from clearly specified low-income and underserved markets.<sup>1</sup>

These affordable housing goals remain at the center of the GSE reform debate because mortgage defaults and foreclosures among higher risk mortgages were a contributing factor to the recent financial crisis. At the very least, the affordable housing goals encouraged financial institutions to lend to high-risk borrowers because lenders knew the GSEs would purchase the loans.

Thus, newly proposed legislation in both the House and the Senate eliminates the housing goals. The legislation in the Senate, though, expands a new regulatory approach—one that began in 2008—that is much worse than the specific goals the bill eliminates.

This paper, in its entirety, can be found at <http://report.heritage.org/ib4083>

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### Legislative Background on “Duty to Serve.”

The Housing and Economic Recovery Act of 2008 introduced language that allowed for a shift away from affordable housing goals. It explicitly acknowledged a “duty to serve” role for the GSEs in the U.S. mortgage market and assigned the task of writing regulations to the GSEs’ new regulator, the Federal Housing Finance Agency (FHFA). In 2010, the FHFA completed rules that require the GSEs to “serve” various “underserved markets.” For example, the FHFA regulations charged the GSEs with a duty to provide

leadership to the market in developing loan products and flexible underwriting guidelines to facilitate a secondary market for mortgages on housing for very low-, low- and moderate-income families with respect to manufactured housing, affordable housing preservation and rural markets.<sup>2</sup>

Thus, the nebulous “duty to serve” language replaced the prior focus on “affordable housing goals” in the GSE regulations. This concept is now an integral component to legislation working through Congress.

**Corker–Warner Extends Duty to Serve.** In the Senate, S. 1217, co-authored by Senators Bob Corker (R–TN) and Mark Warner (D–VA), eliminates both the GSEs and the affordable housing goals. However, the bill replaces the GSEs with a new government agency called the Federal Mortgage Insurance Corporation (FMIC) and gives the FMIC a vague set of “duties” instead of explicit goals. Section 201 of the bill states that one of the principal duties of the FMIC shall be to “provide leadership to the housing finance market to help ensure that all geographic locations have access to mortgage credit.”

This language closely mirrors the wording of the recent FHFA regulations, but housing advocacy groups are criticizing the Corker–Warner bill for failing to “articulate a key public policy goal that any

proposals to rebuild the home finance market must embody: Broad access to affordable mortgage credit for all credit-worthy borrowers.”<sup>3</sup> More specifically, these groups have called for legislation “to include an explicit duty to serve credit-worthy borrowers protected by civil rights laws.”<sup>4</sup>

This euphemistic language replaces “housing goals” with “duty to serve,” and it potentially does more harm to markets because regulators will have more leeway to craft rules without any specific reference points. Lenders, for example, will constantly operate under the threat of a regulatory agency accusing them of failing to live up to their “duty” regardless of how many loans they make in underserved markets. The end result will almost certainly be a regulatory framework with added confusion for lenders and an enhanced ability for regulators to use politics to pressure financial institutions into making imprudent lending decisions.

Simply put, regulating the housing market with “housing goals” is distinct from doing so with a “duty to serve,” but they are both bad policy, and the latter is much worse because of the added uncertainty and increased potential for political influence.

### Recommendations.

- Neither “duties to serve” or “affordable housing goals” should be imposed by policymakers on the GSEs or any successor agencies.
- New laws should not bias the market toward homeownership because a free market allows people to choose between renting and owning a home.

**A Bad Euphemism.** Proposed legislation focuses on mandating a *duty to serve* various markets so that borrowers in all types of communities will be guaranteed “access” to credit. However, when it comes to regulatory policy, the more vague “duty to serve” is much worse than specific goals. Duty to serve is

1. See Norbert Michel and John L. Ligon, “Fannie and Freddie: What Record of Success?,” Heritage Foundation *Backgrounders* No. 2854, November 7, 2013, <http://www.heritage.org/research/reports/2013/11/fannie-and-freddie-what-record-of-success>.

2. *Federal Register*, Vol. 75, No. 108 (June 7, 2010), p. 32100.

3. James H. Carr and Lisa Rice, “Hensarling Bill Moves Further Away From Housing Finance Reform,” TheHill.com, July 26, 2013, <http://thehill.com/blogs/congress-blog/economy-a-budget/313529-hensarling-bill-moves-further-away-from-housing-finance-reform-> (accessed October 28, 2013). Carr and Rice are affiliated with the Center for American Progress and the National Fair Housing Alliance, respectively.

4. *Ibid.*

simply a bad euphemism for “housing goals,” and it is bad economic policy.

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