Financial Regulation and Housing Challenges for the 21st Century

Increased global interdependency and rapid technological advancement in the financial services industry pose significant challenges to U.S. regulatory institutions charged with ensuring well-functioning markets and to government agencies charged with managing loan guarantee or mortgage insurance programs that, to some extent, compete with the private sector. Globalization has become increasingly prevalent as technology allows money to be moved around the world literally at the push of a button, challenging regulators whose authority is defined by national borders. Households can invest in companies worldwide and can be defrauded or have their identities stolen from almost anywhere. The financial services sector has been and continues to be one of the most technologically sophisticated, whether in adapting technology to new uses or providing incentives to develop state-of-the-art products to solve a range of risk management problems. Lastly, immigration patterns, demographic trends, and a range of quality-of-life issues are important factors pushing up housing prices and related rents in certain regions and local real estate markets, which quickly outpace wage growth and put increasing strain on housing affordability in those areas.

The following challenges and illustrative questions provide a framework for thinking about these issues in the future.

The present federal financial regulatory structure evolved largely as a result of periodic ad hoc responses to crises such as financial panics. In the last few decades, however, the financial services industry, especially as represented by the largest firms, has evolved, becoming more global, more concentrated, complex, and consolidated across sectors, and increasingly converging in terms of product offerings. Multiple specialized regulators bring critical skills to bear in their areas of expertise but have difficulty seeing the total risk exposure at large conglomerate firms or identifying and preemptively responding to risks that cross industry lines.

- *Is it time to modernize our financial regulatory system by consolidating various federal regulatory agencies to promote a more coherent and integrated structure, specify goals more clearly, and provide sufficient resources along with the flexibility and incentives to prospectively target resources to risk? To what*

extent can specialized or consolidated regulators effectively address companywide and systemic risks that arise from the potential failure of large, diversified financial firms?

The need to improve consumers' financial literacy—their ability to make informed judgments and effective decisions about the management of money and credit—has become increasingly important. Consumers are faced with an increasingly complicated array of options for managing their personal finances and selecting investments and credit products. In addition, available data show that many consumers are not adequately saving for their retirement, despite concerns about the adequacy of Social Security, private pensions, and retiree health benefits. At the same time, unsecured consumer debt (especially credit card debt) has grown rapidly in the past two decades, bankruptcy filings have increased substantially, and predatory lending has become a growing concern.

▶ *What role should the federal government take in improving financial literacy among consumers, and what are the most effective strategies for doing so? Where are there gaps or overlaps in federal financial literacy programs? How many agencies should be involved? Can disclosures be improved and what are the limitations of improved disclosures in protecting consumers?*

Government-sponsored enterprises (GSE) were created throughout the 20th century to address perceived market imperfections in financing housing, agriculture, and higher education. With the federal benefits they have been provided, the GSEs have linked local lending markets and national capital markets. Two of the housing GSEs, Fannie Mae and Freddie Mac, have played a critical role in establishing a nationwide secondary mortgage market and increasing efficiency through greater standardization of mortgage products. However, with rapid developments spurred by technical change, the private marketplace has evolved dramatically. While one GSE, Sallie Mae, has undergone privatization, the other GSEs have used their special federally provided status and related benefits to expand into new activities. These entities are also taking on more risk and using more sophisticated and less transparent risk management strategies. The public benefits and potential risks to

taxpayers from such expansion, as well as from the continued existence of the GSEs, are a subject of great debate.

▶ *Is the current federal GSE regulatory framework appropriately structured, and do the regulators have the necessary authorities to address the risks of the GSEs? For example, should the Office of Federal Housing Enterprise Oversight be combined with the other housing GSE regulators into one comprehensive housing GSE regulator? What is the GSE track record in achieving homeownership goals, especially for low-income and protected groups? Do the GSEs continue to serve an important public policy purpose? Should their mission focus be restrained to limit expansion into new activities, or adjusted in any way? Should they be privatized?*

New information-based technologies are transforming the credit markets at a rapid pace. Private sector financial institutions have been using credit scoring and other tools to make finer distinctions among potential risks, allowing them to measure and price risk more effectively. Government lenders, loan guarantors, and insurers have been slower to adopt similar tools for their decision making. While federal credit programs can adopt some of the new technologies to better measure risk, lags in such adoption increase the prospect of adverse selection—if the private sector and GSEs take a larger share of lower risk customers, government programs will be left to take on the less well understood and potentially riskier remainder.

▶ *Do federal lending programs need to be reexamined to address the increased risks and potential costs to the government? For example, should the Federal Housing Administration (FHA) continue to fully guarantee mortgages or move to a partial guarantee? If the cost of credit is linked more closely with risk, what role might the federal government play in reducing the cost of borrowing for those borrowers with little or no credit history? For example, should FHA focus more of its activities on those with little or no credit history?*

Homeownership continues to be one of the primary means for many families to accumulate wealth in this country, and is also thought to contribute to stable and vital communities. While the overall homeownership rate is at a historic high, in certain subpopulations the rate lags behind. Numerous tools have been applied to increase home ownership in the United States. Some of

these tools are broadly based, such as the tax deduction for home mortgage interest and GSEs and their effect on mortgage interest rates. Both of these attract capital away from other sectors of the economy and toward the housing sector. Other tools are more narrowly focused on particular areas or populations, such as the FHA mortgage insurance program and other loan programs administered by the U.S. Department of Housing and Urban Development (HUD) and USDA's Rural Housing Service (RHS). In addition, lenders and others have developed mortgage products that permit households to become homeowners sooner than would be the case otherwise.

▶ *To what extent do the tools and incentives increase spending on housing rather than promote affordable housing? Can the tools and incentives provided to homeownership be better targeted toward increasing home ownership among selected groups with less capacity to access credit markets? For example, should the cap on the mortgage interest deduction be more precisely targeted?*

▶ *What are the potential risks of recent homeownership initiatives for borrowers, financial institutions, and taxpayers? Are the recent increases in the home ownership rate sustainable; i.e., how will families and financial markets cope with increases in mortgage interest rates and slower growth in home equity?*

A number of programs provided by HUD, RHS, and other agencies, as well as other tools and incentives, are designed to provide decent rental housing affordable to target populations. Over the years, the emphasis of these incentives has shifted from the supply side (production subsidies) to the demand side (vouchers). In recent years, most construction of federally financed affordable rental housing has resulted from tax provisions. In addition, a number of federally assisted units are eligible to leave some older subsidy programs in the next two decades. Finally, the costs of HUD's housing choice voucher program continue to grow, driven in part by the difference between the eligible population's income growth and the cost of privately owned rental housing; this gap is increasing rapidly in certain markets. HUD and its public housing agency partners have struggled to balance the competing demands of maintaining assistance for a specified number of households while controlling the increasing costs of doing so.

- *What are the advantages and disadvantages of demand-based subsidies (vouchers) versus supply-based incentives (production or financing subsidies) for providing affordable housing to target populations? To what extent are these advantages and disadvantages dependent on local housing market conditions? To the extent that market forces drive the housing voucher's program cost, how might the Congress best reconcile the competing demands of continued assistance to a targeted number of households while addressing the long-term budget implications?*