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Most mortgage backers have done little about crisis

Damage from Ian, a Category 5 hurricane in 2022, at Fort Myers Beach, Fla., on Feb. 9, 2023. Fannie Mae and Freddie Mac, which backstop most U.S. mortgages, know that floods and fires are a growing problem, but little action has yet been taken to mitigate future risk. SCOTT MCINTYRE — NEW YORK TIMES FILE

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As sea levels rise and natural disasters become more intense, homes in low-lying coastal areas or tinder-dry mountains are starting to lose value. *

That's a problem for the finances of Fannie Mae and Freddie Mac, the government-sponsored enterprises that back half of the nation's outstanding mortgages — and keep the residential real estate market liquid by buying mortgages from banks and repackaging them into securities. *

In the first year of the Biden administration, financial regulators seemed to recognize the risk, identifying the mortgage market as one of the main channels through which climate change could destabilize the financial system. *

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Since then, reports have been published, comments gathered and summits held. But when it comes to insulating the two enterprises and borrowers from climate-related catastrophe, the Federal Housing Finance Agency — which regulates Fannie and Freddie — has issued only vague guidance.

"It came out and I thought, where's the rest of it?" said Carlos Martín, director of the Remodeling Futures Program at the Harvard Joint Center for Housing Studies.

The issue comes with risk for taxpayers as well, since the federal government took Fannie and Freddie into conservatorship in 2008 after the financial crisis. Fannie and Freddie have reserve capital buffers, but large losses could force the government to intervene.

Interviews with former housing officials, researchers and advocates for borrowers and climate action point to one primary reason for the lack of movement: concerns about raising housing costs when homeownership is already out of reach for many, especially for the low-income households that disproportionately live in areas of higher risk.

The White House referred questions to the Federal Housing Finance Agency, which declined to comment and did not respond to detailed questions. Freddie Mac and Fannie Mae also declined to comment.

Evidence of risk in Fannie's and Freddie's portfolios has been mounting for years.

One report has estimated that homes in places at risk of flooding were collectively overpriced by at least $187 billion; in some counties in Appalachia and coastal Louisiana, that amounts to more than 10% of the total property value. Last year, the Congressional Budget Office found that federally backed mortgages covered properties that were likely to sustain about $190 billion in flood damage over 30 years. That's not counting the peril of wildfires or drought.

While banks are becoming more careful about extending credit in areas that might flood, and homeowners are responding to flood risk disclosures on property search websites, the government-sponsored enterprises do not formally take such risks into account when underwriting loans. Studies have found that banks are more likely to sell mortgages in risky areas to the secondary market, and to Fannie and Freddie specifically after hurricanes (a conclusion that economists funded by Fannie Mae have disputed).

Fannie and Freddie have generally relied on insurance to deal with climate risk management: Flood coverage is required in special flood hazard areas.

That has become a riskier gambit in recent years, however, as disasters have also hit places far beyond where federal flood maps say they're supposed to. At the same time, extreme weather has driven up insurance costs nationwide. Recent research has found that those rising costs can drive homeowners into delinquency, even if the house avoids damage.

Unexpectedly large losses could undermine Fannie's and Freddie's profits and threaten their ability to keep the mortgage market liquid, said Susan Crawford, a senior fellow at the Carnegie Endowment for International Peace who wrote a book last year about the impact of sea-level rise in Charleston, S.C.

"This is all about the safety and soundness of the enterprises," Crawford said. "We've got this mortgage-generating machine that is just moving blindly on without taking into account these risks."

Historically, officials at Fannie and Freddie have banked on their mortgage portfolio's being diversified across so many markets that even when delinquencies and defaults spike after disasters, they wouldn't cause significant losses. In recent years, any climate impact on home values in sunny locales like South Florida has been masked by strong demand. And so far, investors are not valuing these risks in the market for mortgage-backed securities.

But the coming decades will look different. Repeated major flooding events could prompt employers to exit, and a loss of tax revenue could hurt the ability of local governments to borrow, setting off a downward spiral. And continuing to subsidize mortgages in those places could set buyers up for grief.

"If you're just looking backwards, it looks like the system handled it," said Carolyn Kousky, associate vice president for economics and policy at the Environmental Defense Fund. "But that's not going to be what we have to handle in the future."

Fannie and Freddie charge fees in exchange for guaranteeing mortgages. Those fees vary according to the borrower's credit quality, but pricing based on geography has always been a third rail. When the Federal Housing Finance Agency tried a decade ago to vary fees based on state foreclosure rules that can be costly, members of Congress protested, and the proposal was scrapped.

Pricing climate risk has an additional complication: Many of the areas in most jeopardy are also populated by lower-income homeowners of color. Raising mortgage fees in those places could immediately hurt home values by making it more expensive to borrow to buy property.

"When you start doing things on a geographic-area basis, that starts to feel a little bit like redlining," said Michael LaCour-Little, who was senior director of economics at Fannie Mae from 2016 to 2023. "The charters suggest that Fannie and Freddie should be there to create a liquid market under all circumstances at all times."

Pricing risk on a property-by-property basis — which matters, since small differences in elevation and building quality can determine whether a home floods or stays dry — is also difficult with the data and models currently available.

But the bigger challenge is likely to be political opposition from representatives of districts that could be harmed if climate risk is priced in. Those representatives would come under pressure from people like Orlando Diaz, a Miami-area mortgage broker who is president of the Florida Association of Mortgage Professionals.

"We cannot change the fact that in Florida we have hurricanes, so we shouldn't be penalized for it," Diaz said, noting that high insurance costs were already pushing prospective buyers to less popular submarkets. "This is why we have the federal government." ? ?

There are ways, however, to cushion the impact for vulnerable homeowners. Fannie and Freddie could scale fees by the borrowers' income, for example, or create subsidies for people who want to relocate to safety. The two enterprises could also buy mortgages only for homes with features that protect against the worst kinds of damage, such as fireproof roofs or elevated foundations.

One model is Alabama, which has required roof improvements in coastal counties and offers grants to help finance them. Training programs for roofing contractors have fostered a workforce to do the upgrades, and Alabama has not faced the insurance crises plaguing Florida; insurers often offer discounts for participating homeowners.

Steven Rothstein is the managing director of the Ceres Accelerator for Sustainable Capital Markets, which compiles a scorecard on financial agencies' progress on climate action. He said he thinks any effort to incorporate climate risk into federal mortgage underwriting should come with a set of carrots and sticks to ease adaptation and protect the vulnerable.

"This has to be an all-society challenge," Rothstein said. "If you pulled one lever it could have unintended consequences."

The Biden administration, which for the last couple of years has focused on housing affordability, never coordinated such an effort.

At the same time, the Federal Housing Finance Agency hasn't taken other relatively simple steps. After saying this past spring that it was considering standards for energy efficiency for new homes financed by Fannie and Freddie, as two federal agencies with smaller portfolios have done, the agency has not moved forward.

Advocates of the policy say it would respond to climate change on two fronts. First, it would curb carbon emissions. Second, it would lower homeowner costs over time by guarding against extreme weather damage and cutting energy bills. That would protect Fannie and Freddie, too, by avoiding defaults.

"It's huge from a climate perspective," said Ivan Frishberg, the chief sustainability officer at Amalgamated Bank. "That they would sit on this is sort of like avoiding politics by being political and ignoring the science."

Homebuilders strongly objected, however. The initiative may now be doomed, since the incoming Trump administration has signaled hostility to anything premised on climate change. But it might not be the end of the discussion of taking climate risk into account.

During the last Trump administration, the Federal Housing Finance Agency pushed to end the conservatorship. Doing so would give Fannie and Freddie more freedom to adjust fees or take other steps to hedge their exposure.

"Given that Fannie and Freddie have some incentive to protect their own bottom line, I think you would see more willingness on their part to start to price this risk," said Mark Calabria, who led the agency during the first Trump administration and briefly under President Joe Biden. "The obstacle to pricing this really is fundamentally a political one."