Reform of the Housing Finance System

by John Weicher

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Submitted as part of public input on
Reform of the Housing Finance System
TREAS-DO-2010-0001-0001

TO: The U.S. Department of the Treasury
The U.S. Department of Housing and Urban Development
c/o www.regulations.gov

Re: Public Input on Reform of the Housing Finance System
eDocket Number: Treas-DO-2010-001
eDocket Number: HUD-2010-0029

Dear Sirs or Mesdames:

Thank you for the opportunity to comment on the important policy issue of the reform of the United States housing finance system. I am submitting comments on the first two of the seven questions raised in your invitation. These responses are based on my experience with the regulation of Fannie Mae and Freddie Mac.

I have had a substantial role in GSE regulation on two occasions. As Assistant Secretary for Policy Development and Research at the U.S. Department of Housing and Urban Development during 1989-1993, I created and managed a staff to support Secretary Jack Kemp in his responsibilities as sole regulator of Fannie Mae and Freddie Mac between the passage of FIRREA in 1989 and FHEFSSA in 1992. Later, as Assistant Secretary for Housing at HUD during 2001-2005, I received the delegation of regulatory authority from Secretaries Mel Martinez and Alphonso Jackson, to serve as "mission regulator," including the affordable housing goals, new program approval, and related matters. My comments will focus on two issues, one from each of those periods, which are relevant to the first two questions on which you have solicited public input.

My responses to these questions begin on the next page. Thank you again for the opportunity to comment. I will be very happy to respond to any further questions or provide any further comments that may be helpful to you.

Sincerely,

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Question 2: GSE Safety and Soundness – Stress Testing in 1991

My first comment concerns safety and soundness and capital adequacy and is relevant to question 2: What role should the federal government play in supporting a stable, well-functioning housing finance system and what risks, if any, should the federal government bear in meeting its housing finance objectives?

The Secretary of HUD became the regulator of Fannie Mae when it was chartered as a privately managed corporation in 1968. In 1984, the Secondary Mortgage Market Enhancement Act required the Secretary to submit annual reports on Fannie Mae's activities (Section 309(h) of the FNMA Charter Act). FIRREA transferred regulatory authority for Freddie Mac to the Secretary of HUD in 1989, and also required annual

them AA in the absence of their implicit government guarantee. The outcome was that S&P pulled back from its rating. But the GSEs did not want this issue raised again.

The HUD analysis was based on the assumptions that the GSEs would continue to buy mortgages for two years after the economic downturn started. After two years they would stop buying mortgages, but they would lose money on the mortgages they owned, including the mortgages they bought after the start of the downturn, and eventually they would go bankrupt, in about seven years. The HUD analysis also assumed that the GSEs would maintain their fee structure throughout the ten-year period.

The GSEs argued that they would stop buying mortgages immediately – as soon as the downturn started. In addition, they would raise their guarantee fees and their service charges. And they would therefore survive for the full ten years.

HUD responded that the beginning of an economic downturn is generally not recognized until some time has passed: "like many other businesses and observers of the

Question 1: Federal Housing Objectives – Affordable Housing Goals

My second comment concerns the affordable housing goals and is relevant to question 1: How should federal housing finance objectives be prioritized in the context of the broader objectives of housing policy?

FHEFSSA assigned a continuing role in GSE regulation to the HUD Secretary. He or she retained responsibility for issues other than safety and soundness. In 1993, Secretary Henry Cisneros delegated that responsibility to the Assistant Secretary for Housing, and that delegation remained in place until GSE regulation was consolidated within the new Federal Housing Finance Agency, under the Housing and Economic Recovery Act of 2008. As Assistant Secretary for Housing during 2001-2005, I therefore was responsible for managing the GSE regulatory process within HUD.

The Affordable Housing Goals

Among its regulatory responsibilities, HUD was required to formulate the affordable housing goals for the GSEs, and to monitor their performance. These goals were established and specified by FHEFSSA (Part 2, Subpart B). They were intended to codify one of the public purposes of the GSEs, namely, "to provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities)." (This statement of purpose appears in Section 301(3) of both the Fannie Mae Charter Act and the Freddie Mac Corporation Act)

Within HUD, the process of formulating the affordable housing goals involved four offices: the Office of General Counsel, the Office of Housing, the Office of Policy Development and Research, and the Office of Fair Housing and Equal Opportunity. The goals were established through formal rulemaking, following the procedures required under the Administrative Procedures Act: a proposed rule, a comment period, a review of comments by the Department, and a final rule. As with all rules, both the proposed rule and the final rule were also reviewed by the Office of Management and Budget, which also circulated the rule to other interested federal agencies and coordinated their responses

The rule was always painstakingly developed, with extensive supporting analyses as required by both the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA) and the Administrative Procedures Act. The rule and analyses issued in 2004 were more than half the length of *War and Peace*. Like other rules, they could be challenged, and must be able to withstand a challenge.

There are three statutory goals:

(1) The Low- and Moderate-Income Housing Goal: loans to borrowers with incomes at or below the median income for the market area in which they live;
(2) The Special Affordable Goal: loans to very low-income borrowers (those with incomes at or below 60 percent of the area median income), or to low-income borrowers living in low-income areas (borrowers with incomes at or below 80 percent of the area median income, living in census tracts in which the median income of households is at or below 80 percent of the area median income);
(3) The Underserved Areas Goal: loans to borrowers living in low-income census tracts (tracts in which the median income of residents is at or below 90 percent of the area median income) or high-minority tracts (tracts in which minorities comprise at least 30 percent of residents, and the median income of residents in the tract does not exceed 120 percent of the area median income).

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Table 1
GSE Affordable Housing Goals, 1993-2008
(share of mortgage purchases by GSEs)

Years	Goals		
	Low- and Moderate-Income	Special Affordable	Underserved Areas
1993-1995	30%	NA	30%
1996	40%	12%	21%
1997-2000	42%	14%	24%
2001-2004	50%	20%	31%
2005	52%	22%	37%
2006	53%	23%	38%
2007	55%	25%	38%
2008	56%	27%	39%

NA – Not Applicable: goals were set in dollar amounts for each GSE rather than percentages

The Underserved Areas goal was determined on the basis of 1990 Census tract geography from 1993-2004, and on the basis of 2000 Census tract geography from 2005-2008.

The numerical targets are determined partly on the basis of activity in that part of the mortgage market which the GSEs serve – the "conventional conforming market."

The conventional conforming market excludes

established by HUD. Analysis during the process leading up to the 2000 rule found that the GSEs were making "A-minus" and "Alt-A" loans.

The Goals in Relation to the Conventional Conforming Market

Table 2
GSE Affordable Housing Goals Compared to Market Shares
(Percentages of the Conventional Conforming Market Served by the GSEs)

Year	Low- and Moderate-Income		Special Affordable		Underserved Areas	
	Goal	Market	Goal	Market	Goal	Market
1993	30%	NR	NA	NA	30%	NR
1994	30	NR	NA	NA	30	NR
1995	30	57%	N.A.	29%	30	34%
1996	40	57	12	29	21	33
1997	42	57.5	14	29	24	34
1998	42	54	14	26	24	31
1999	42	58	14	29	24	34
2000	42	59	14	30	24	35
2001	50	55	20	26.5	31	33
2002	50	50.0	20	23.5	31	34
2003	50	53	20	24.5	31	34
2004	50	58	20	28	31	42
2005	52	57	22	28	37	44
2006	53	55	23	27.5	38	44
2007	55	52	25	24.7	38	40
2008	56	54	27	26.5	39	42

NOTE: Market shares reported to nearest percent except where the share is halfway between two percents (e.g., 57.5%), or where the market share is within one percent of the goal.

NA – Not Applicable: goals were set in dollar amounts for each GSE rather than percentages

NR – market shares not reported

The Underserved Areas goal was determined on the basis of 1990 Census tract geography from 1993-2004, and on the basis of 2000 Census tract geography from 2005-2008.

Sources: 1993-1994, FHEFSSA, Sections 1332, 1333, 1334; 1995-2001, "2005 Proposed Rule," *Federal Register*, May 3, 2004, p. 24468.; 2002-2008, Federal Housing Finance Agency, "The Housing Goals of Fannie Mae and Freddie Mac in the Context of the Mortgage Market: 1996-2009," Mortgage Market Note 10-2, February 1, 2010, Appendix B.

GSE Performance Vis-à-vis the Goals and the Market

In fact, that is what the GSEs did, annually from 1995 to 2005. Their performance is shown in Table 3, which repeats the goals and the actual market share from Table 2, and adds the actual purchases of each GSE toward each goal.

GSE performance was consistently above the goal, but below the share of the GSE market that qualified for the goal.

(1) For the Low- and Moderate-Income Goal, both GSEs' purchases exceeded the goal but fell short of meeting the market from 1995 through 2005;
(2) For the Special Affordable Goal, Fannie Mae's purchases exceeded the goal but fell short of meeting the market from 1995 through 2005, and Freddie Mac's purchases exceeded the goal but fell short of meeting the market from 1995 through 2006;
(3) For the Underserved Areas goal, both GSEs' purchases exceeded the goal but fell short of meeting the market from 1995 through 2006, with the exception of 2002, when Freddie Mac fell just short of the goal.

Freddie Mac's failure to meet the Underserved Areas goal in 2002 occurred because it double-counted loans which it had purchased in 2001 toward the goals in both 2001 and 2002. These loans covered 22,424 housing units. Correcting for the double-counting, Freddie Mac fell short of the 31 percent Underserved Areas goal by 90 loans, or 0.002 percent. There was a similar double-counting of 22,371 units toward the Low- and Moderate-Income Goal, but correcting this error did not affect Freddie Mac's performance; it continued to meet that goal in 2002. (This matter is described in the final rule for 2005-2008, which appears in the *Federal Register* for November 2, 2004, on p. 63587 and in Table 6.)

In 2006, both GSEs' purchases met the Low- and Moderate-Income Goal and also met the market. This was also true with respect to Fannie Mae's performance on the Special Affordable Goal in that year.

Table 3

What this means is that lenders other than the GSEs – lenders without the various special privileges that gave the GSEs "agency status" and the ability to borrow at preferential rates in the capital markets – consistently did a better job of serving households in each of these goal categories than did the GSEs. Since loans to low- and moderate-income borrowers, for example, were a smaller share of GSE purchases than they constituted in the conventional conforming market, other lenders must have been buying a larger share of loans to low- and moderate-income borrowers than the GSEs. Those loans were a larger share of their portfolios than they constituted in the portfolios of the GSEs.

In short, the concern expressed by the GSEs that they could not meet the goals for 2005 and later because they were "too high" was not borne out by the actual market shares available to meet each goal, or by their purchases, during 2005 and 2006. .

The situation was different in 2007, and the GSEs responded to it differently, as will be discussed later.

The Goals and the Subprime Mortgage Market

It has sometimes been asserted that the affordable housing goals established in 2005 are substantially responsible for the GSEs' collapse in 2008. For example, former Fannie Mae senior officials expressed this view in recent testimony before the Financial Crisis Inquiry Commission, and as did the former CEO of Freddie Mac earlier.

There is direct evidence on the extent to which the GSEs were buying subprime mortgages, both before and after the 2005 rule went into effect. This evidence indicates that the affordable housing goals had little if any impact on GSE activity in these markets. Instead, it appears that the GSEs were responding to the same factors in the mortgage market as other lenders.

Table 4 reports the dollar values of subprime and Alt-A mortgage purchases by the GSEs during 2001-2007. As mentioned earlier, the GSEs had been buying A-minus and Alt-A loans since the later 1990s, but they began buying subprime mortgage-backed securities (MBS) heavily in 2002. Their subprime MBS purchases doubled between 2002 and 2003, and doubled again in 2004 – from $38 billion to $81 billion to $176 billion. All this of course happened before the housing goals were changed in 2005. After the new goals went into effect, their subprime MBS purchases actually declined slightly, to $169 billion, and then dropped sharply to $110 billion for 2006. Their share of the subprime MBS market rose from 19 percent in 2002 to 33 percent in 2004; then it declined to 27 percent in 2005 and further to 18 percent in 2006, after the new goals were in place.

Essentially, what happened is that the market for subprime MBS took off in the early years of the decade, and the GSEs became active in that market for a couple of years. Then they began pulling back, at the same time that the affordable housing goals were increased.

Table 4
Subprime and Alt-A Purchases by the GSEs, 2001-2006
(Dollar amounts in billions)

Year	Subprime Loans and MBS		Alt-A loans
	Dollar amount	Share of Market	Dollar Amount
2001	N.A.	N.A.	$ 15
2002	$ 38	19%	$ 66
2003	$ 81	26%	$ 77
2004	$176	33%	$ 64
2005: new affordable housing goals go into effect			
2005	$169	27%	$ 77
2006	$110	18%	$157
2007	$ 59	31%	$178

Sources: loan data, OFHEO annual reports, "Mortgage Markets and the Enterprises;" size of subprime market, Inside Mortgage Finance Publications, "The Rise and Fall of the Subprime Market," 2009.

The loan data come from a series of annual reports by the Office of Federal Housing Enterprise Oversight (OFHEO), the GSE safety and soundness regulator, entitled "Mortgage Markets and the Enterprises." Also, it appears that OFHEO did not think that these purchases posed a risk. In each report, the discussion of subprime purchases was followed immediately by a section on overall single-family mortgage credit risk in which OFHEO concluded that the risk was not great. Indeed, in the report for 2007, issued July 21, 2008, a week after the Bush Administration offered a plan to rescue the GSEs and nine days before HERA was enacted, the discussion was entitled, "Enterprises Continue to Manage Single-Family Credit Risk." In the 2006 report, issued June 25, 2007, four months after subprime mortgage problems were widely reported, the discussion of subprime purchases was followed by a section entitled, "Enterprise Single-Family Credit Risk Remains Low." Similar discussions appeared in earlier reports, going back to 2001.

Table 4 also reports on Alt-A mortgages – loans where the borrower does not supply full documentation in support of the application. Often the borrower does not provide income data. Traditionally these were loans to higher-income borrowers with

GSE purchases of subprime mortgages. The GSEs began retreating from the subprime market, at the same time that the affordable housing goals were increased.

Underwriting Changes and the Affordable Housing Goals

Further evidence on GSE behavior comes from an analysis by HUD staff economists, published in the August 2008 issue of HUD's periodical, "U.S. Housing Market Conditions." This study reports the distribution of mortgage-to-income ratios for the GSEs and other lenders during 2001-2006. Higher ratios indicate greater risk of default – mortgage payment burdens that will be a particularly large share of the borrower's income. The data are shown in Table 5, for loans in the 90th percentile of the mortgage-to-income ratio – close to the most risky loans being made. To illustrate more directly the effect of the changes, the table also shows comparable mortgage principal amount for a family with an income of $60,000, close to the median family income for mortgage borrowers during 2004-2006.

Table 5
Risk-Taking by the GSEs and Other Lenders, 2001-2006
(for the 90th percentile of the distribution of home purchase loans)

Panel A – ratio of mortgage principal to income

	Before the housing goals were increased:				New goals:	
	2001	2002	2003	2004	2005	2006
GSEs	335%	356%	383%	390%	397%	380%

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The GSEs began making significantly more risky loans to homebuyers beginning in 2002, offering larger loans to families with a given income level; they took still more risk in 2003. Beginning in 2004, their appetite for increased risk subsided, but their mortgage-to-income ratios remained high, and very nearly constant, through 2006.

The GSEs were not alone, as Table 5 shows. Beginning in 2002, other lenders were also taking more risk by relaxing underwriting standards. These lenders – both

This is particularly relevant because refinances are less likely to count toward the affordable housing goals; in general, homebuyers have lower incomes than homeowners who are refinancing, and homebuyers are more likely to live in "underserved" areas. If the GSEs were being driven by the new affordable housing goals, they would have relaxed their standards more for home purchase loans and less for refinances. Instead, they did the opposite. Again, other lenders, not subject to the goals, followed the same pattern as the GSEs.

The increase in leveraging between 2001 and 2004 is far too large to be accounted for by the decline in mortgage rates over those years. The decline in rates was about 110 basis points, which is enough to permit about a 30-basis point increase in the mortgage-to-income ratio without increasing the risk of default. For both home purchase loans and refinances, the increase in the ratio for the GSEs was about 55 basis points during those years. In addition, GSE mortgage-to-income ratios for refinances increased from 2004 to 2005 even though interest rates were stable; and they remained at about the 2005 level even though mortgage rates increased by over 50 basis points in 2006.

The GSEs relaxed their underwriting standards and began investing heavily in subprime mortgage-backed securities well before the goals were increased in 2005. After the goal increase, the GSEs maintained about the same underwriting standards, at least for home purchase loans, the most likely to count toward any of the housing goals. Despite the increase in the goals, the GSEs did not take further underwriting risk in order to meet them.

What Happened in 2007?

By the beginning of 2007, problems in the housing and mortgage markets were becoming evident. New home construction began to contract in mid-2006, and house prices as measured by the Case-Shiller Index started to drop at about the same time. Prices as measured by the OFHEO repeat-sales index – an index based on the homes on which the GSEs had actually bought the mortgages – were still rising, but more slowly than they had been prior to 2006; the OFHEO index began to decline in the second quarter of 2007. At the same time, there were growing problems in the subprime market. In early February, HSBC and New Century reported unexpectedly large losses on subprime mortgages; they were the subjects of front-page stories in the *Wall Street Journal* on consecutive days. From that point, subprime mortgage problems were

concern about the "heightened risks" to lenders as well as borrowers from subprime ARMs with teaser rates such as 2/28 and 3/27 loans, loans with very high or no payment or rate caps, low-doc and no-doc loans, and substantial prepayment penalties, and stated that institutions should develop strong control systems in order to manage the risks.

This guidance also applied to Fannie Mae and Freddie Mac, but with a lag. OFHEO notified Fannie Mae and Freddie Mac in December 2006 that they were required to comply with the guidance on non-traditional mortgage product risks, but the GSEs did not agree to comply until July 2007, and even then indicated that they would continue to buy non-traditional mortgages until September 2007. Similarly, OFHEO told the GSEs in March 2007 that they must follow the later statement on subprime mortgage lending, but the GSEs did not agree to comply until September.

The actions of OFHEO and the other financial regulators would have been a perfect opportunity for the GSEs to ask HUD for relief from the 2007 affordable housing goals. The subprime market was in the process of shrinking by almost 70 percent from the 2006 level, and the safety and soundness regulator was telling the GSEs that they should get out of that market. The section of FHEFSSA establishing the housing goals states that the Secretary of HUD must consider "the need to maintain the sound financial condition of the enterprises." (This appears as Section 1332 (b)(6), Section 1333 (a)(2)(E), and Section 1334 (b)(6).) HUD could hardly have insisted that the GSEs continue to buy A- subprime loans – the top half of the subprime market – as the total subprime market shrank, even if house prices were not dropping.

But the GSEs apparently did not make such a request to HUD, nor did they ask OFHEO to do so. The OFHEO director at that time told the FCIC that he had no knowledge of any such request by either GSE directly to HUD.

Instead, the GSEs continued to buy subprime mortgages. In 2007, their share of the subprime market increased to 31 percent, close to the 2004 level.

The GSEs made the decision to continue buying subprime mortgages, despite the efforts of their regulator to compel them to get out of that market. They did not seek relief from the affordable housing goals. They apparently thought there were profits in the subprime market, and they stayed in it.

The Affordable Housing Goals Relative to the Broader Objectives of Housing Policy

Question 1 asks how policy objectives such as the affordable housing goals should be prioritized in the context of overall federal housing policy. The history of the affordable housing goals since FHEFSSA carries two lessons.

First, while public policy goals can be advanced in the context of broader housing policy objectives, the process is complicated and probably not the most effective way to achieve the policy goals. The evidence indicates that the affordable housing goals had

little if any impact on the credit risk problems of the GSEs. But at the same time, the goals were set "below the market," meaning that lenders other than the GSEs were buying more loans that met the goals than did the GSEs themselves. The extent to which the goals achieved public policy purposes is therefore somewhat problematical.

Second, the affordable housing goals exemplify a basic conflict between public purpose and private profit. The GSEs were privately-owned corporations whose stockholders expected that they would be profitable; in fact, they were told to expect high and rising returns by GSE management. At the same time, they were required to devote resources to achieving public policy objectives. In that tug-of-war between those objectives, private profit consistently won. This was the case for both the affordable housing goals and the capital requirements

Conclusion

If the affordable housing goals do not account for the GSEs' purchases of high-risk subprime mortgages, what does? The best explanation is the simplest. The GSEs badly misjudged the risk of subprime and Alt-A mortgages. They thought there were large profits to be made in the growing subprime market, and they sought to maintain and expand their share of the home mortgage market. They were not alone in misjudging the risks of subprime mortgages; so did other lenders. Indeed, the GSEs were by no means the first lenders to run into problems with their non-prime portfolios; as mentioned earlier, HSBC and New Century were front-page news in February 2007. But the GSEs, because they were bigger – and were required to hold less capital – took the biggest risks and had the most spectacular problems.

The GSEs have made other misjudgments than threatened their solvency. Economists have often analyzed risk for financial institutions along three dimensions: interest rate risk, credit risk, operations risk. The GSEs have experienced all three, often spectacularly.

In the early1980s, as mentioned earlier; Fannie Mae faced enormous interest rate

The credit risk problems leading to the conservatorship of 2008 are the most recent example. The GSEs bought risky loans that went bad, not understanding the risks they were taking. When their financial position became precarious, it was much more convenient for the GSEs to blame the affordable housing goals, than to admit to mistakes made by their own choice.

Many years ago in graduate school I studied economic history under a distinguished expert in the history of banking and finance, the late Earl J. Hamilton. He once observed that financial reform in the United States had occurred under three circumstances: during wars, during depressions, and during the first term of President Woodrow Wilson. Since then, he would have found it necessary to add another circumstance: during inflations, to account for the collapse of the housing finance system as a result of the unprecedented peacetime inflation of the late 1960s and 1970s. The common feature of all these circumstances is that they were periods of extreme economic stress. (The reforms under President Wilson were a reaction to the severe depression of 1907 and the recognition that the National Banking System had outlived its ability to serve the economy effectively.)

The extraordinary collapse of the GSEs does not fit into this pattern. It occurred during a period of economic growth, with low inflation. This is a unique experience in our history.

It occurred because the GSEs were able to build up substantial political clout, as witnessed by the weak regulatory structure established in FHEFSSA. A significant component of that regulatory structure concerned the capital standard; the GSEs did not have to hold capital to the same extent as other mortgage lenders. The GSEs were politically strong enough to stave off financial reform legislation after their accounting problems were identified, and even after they became bywords for incompetence.

Fundamentally, the structure of the mortgage market after FIRREA - two large institutions sponsored by the federal government with competitive advantages over other lenders – generated the problems that we confront today.

Public policy should not make the same mistakes again.