CHAPTER IV

BENEFITS AND MARKET EFFECTS OF THE HOUSING GOALS: SINGLE-FAMILY-OWNER MORTGAGES

A. Introduction

The benefits of a well-developed secondary market for mortgage loans have long been recognized. Congress, in authorizing the National Housing Act of 1934, hoped a system of private secondary mortgage associations would develop to bring the benefits of lower capital costs to homebuyers and renters. In 1938, after none had formed, Congress chartered Fannie Mae to buy and hold mortgages with capital from bond issues. Since 1970, with the added chartering of Freddie Mac, the Government Sponsored Enterprises (GSEs) have helped to channel lower cost capital to the housing markets, expanding the benefits of homeownership and improving the condition of renter households.[1]

As a result of the development of the secondary market, the nation's housing finance system is, on the whole, highly efficient, enabling most homebuyers to obtain long-term funding at relatively small spreads above the lender's borrowing costs and with relatively small amounts of up-front cash. Unfortunately, this system does not work everywhere or for everyone. There exists evidence that many low-income and minority families and their neighborhoods are not receiving the full benefits of the nation's highly developed housing finance system. Congress was especially concerned about these gaps in access to mortgage credit when it passed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. This act called for HUD to take actions to enhance the GSEs' role in providing mortgage finance to these historically underserved borrowers and neighborhoods. Thus one purpose of the housing goals established by HUD for the GSEs is to encourage the development of customized mortgage products, underwriting, and outreach by the GSEs so that the secondary market's benefit for households can grow with the inclusion of the families who have historically not been served with traditional products, underwriting, and marketing.

The remainder of this section presents the main findings of the chapter. Section B characterizes the benefits derived from secondary market support of single-family housing markets, identifies unmet needs, and discusses the range of potential beneficiaries with the housing goals. As background for an analysis of the impact of the housing goals, Section C discusses the market for affordable loans, with an emphasis on the role that the GSEs play in this market.[2] Section D and compare the affordable lending performance of the GSEs with the primary market. Section E and examine the market share of the GSEs in important market

[1] For a fuller discussion of the benefits of the secondary mortgage market, see U. S. Department of Housing and Urban Development, Office of Policy Development & Research, *Privatization of Fannie Mae and Freddie Mac: Desirability and Feasibility, A HUD Report*, July 1996.

[2] In this chapter "affordable lending" is used as a generic term to include loans to lower-income and minority borrowers and their neighborhoods.

segments such as first-time homebuyers. Sections F and G summarize the qualitative impacts of the housing goals, and Section H examines potential market effects of the housing goals. Appendices A and B to this chapter present a detailed analysis of the affordable lending performance of the GSEs in the single-family market between 1992 and 2002.

This chapter focuses on the benefits of the GSE housing goals in the single-family-owner mortgage market. Chapter V discusses the single-family rental and multifamily markets. In certain instances, results from Chapter V are noted here in order to provide a complete discussion of impacts.

The qualitative discussion of benefits and impacts in this chapter complements the more quantitative analyses of the final goals in Section C of Chapter III. Chapter III examines some of the direct impacts of the final goals on GSE mortgage purchases for important groups such as first-time homebuyers.

This chapter relies heavy on the analysis of the single-family market reported in Appendix A of the Final GSE Rule. Readers interested in a more complete discussion of several of various topics are referred to that appendix.

B. Main Findings

This Regulatory Analysis identifies the Final Rule's benefits as facilitating homeownership, especially among lower-income families; reducing affordability problems; reducing search and transaction costs; overcoming credit shortages in underserved areas; supporting rental housing; and bringing the efficiencies of the secondary market to certain market segments that in the past have not benefited from an active secondary mortgage market. These benefits have long been recognized as contributions of the secondary market justifying Federal charters for the GSEs. The appendices to the Final Rule discuss problems in the single-family mortgage market such as income and racial disparities in mortgage lending and homeownership, and how GSE and lender initiatives—such as outreach, prudent underwriting changes, and new affordable lending products—can contribute to solving these problems. In fact, there is growing evidence that affordable lending initiatives, such as those encouraged by the housing goals, are paying off—lending to underserved borrowers and neighborhoods has increased rapidly in recent years.

Under the housing goals, the GSEs have increased their purchases of loans for low-income families and underserved neighborhoods and therefore they have played an important role in the recent upsurge in affordable lending. However, both HUD's analysis and other studies have shown that the GSEs generally have lagged the overall market in providing funding for first-time homebuyers and those groups who suffer low levels of homeownership and who would benefit from the low-cost financing offered by the secondary market. The higher targets for the housing goals and the new home purchase subgoals are intended to encourage the GSEs to further increase their purchases of affordable loans and to move into a leadership position in the single-family conventional conforming market.

The main findings of this chapter, organized by major topics, are presented below.

Homeownership Benefits and Gaps

- While difficult to quantify, the public and private benefits of homeownership are nonetheless real, particularly when judged by the degree of planning, sacrifice, and endurance households expend to become homeowners. Recent studies have provided statistical evidence of the benefits from homeownership.

- Despite the record national homeownership rate of 69.2 percent in the second quarter of 2004, much lower rates prevailed for minorities, especially for African-American households (50.1 percent) and Hispanic households (47.4 percent), and these gaps are only partly accounted for by differences in income, age, and other socioeconomic factors.

- Some households desire to own a home but cannot raise enough cash for a down payment, cannot afford the monthly mortgage payment, or have a poor record of meeting their credit obligations. Others are unable to obtain financing due to inflexible underwriting standards or lender discrimination. Others may reside in neighborhoods that are not adequately served by mainstream lenders.

Mortgage Market Disparities and Problems

- There is evidence that some households and neighborhoods experience problems accessing credit and are not well served by the mortgage markets. There is a substantial literature on disparities in mortgage lending, which indicates that low-income and minority borrowers and their neighborhoods have problems accessing mortgage credit.

- Pervasive and widespread disparities in conventional mortgage lending by race continued across the nation in 2002, when the loan denial rate was 7.8 percent for white mortgage applicants, but 20.0 percent for African Americans and 15.5 percent for Hispanics.[3]

- Despite recent industry efforts to increase the flexibility of mortgage underwriting guidelines, there remains a concern that overly strict underwriting standards remain a barrier to some low-income and minority families becoming homeowners. Despite the widespread use of automated mortgage scorecards and their recognized ability to accurately predict the likelihood of default, there also remain concerns about the potential negative impacts of these automated mortgage-scoring systems on low-income and minority borrowers.

Potential Beneficiaries

- There is a significant pool of lower-income, low-risk potential homebuyers that would benefit from affordable initiatives offered by the GSEs.

[3] The market definition is the conventional conforming market. Lenders that specialize in manufactured housing loans are excluded from this analysis.

- Numerous surveys by Fannie Mae and other industry organizations show that current renters have a strong desire to become homeowners and hope to do so in the near future.

- Changing population demographics will result in a need for primary and secondary mortgage markets to meet nontraditional credit needs, respond to diverse housing preferences, and overcome information and other barriers that many immigrants and minorities face. Growing housing demand from immigrants (both those who are already here and those projected to come) and non-traditional homebuyers will help to offset declines in the demand for housing caused by the aging of the population. Immigrants and other minorities—who accounted for nearly 40 percent of the growth in the nation's homeownership rate over the past five years—will be responsible for almost two-thirds of the growth in the number of new households over the next ten years. As these demographic factors play out, the overall effect on housing demand will likely be sustained growth and an increasingly diverse household population from which to draw new renters and homeowners.

Affordable Lending Market

- The housing goals are consistent with and were likely one factor behind recent developments in the market for affordable loans. Since 1993, the mortgage industry has offered new low-down-payment and other special products for low-income families, has introduced greater flexibility into their underwriting standards, and has entered into numerous partnerships with local governments and nonprofit groups to extend their outreach into historically underserved markets. Some have characterized these efforts as a "revolution in affordable lending." As this chapter explains, HMDA data suggest these programs of the GSEs, private mortgage insurers, and lenders are paying off in terms of more mortgages for low-income and minority borrowers. It also appears that these new programs are being implemented in a prudent fashion to attract creditworthy homebuyers.

- The primary affordable lending market appears to have an underlying strength. For example, special affordable loans (i.e., loans to very-low-income families and low-income families living in low-income census tracts) increased significantly between 1992 and 1994, from 10.4 percent to 14.1 percent of the home purchase market. The additional years since the 1995 GSE Rule have seen the special affordable market rise to an even higher level. Over the four years 1995 through 1998, the special affordable share of the market averaged 15.1 percent. Then it averaged over 16 percent between 1999 and 2003. While lending patterns could change due to shifts in the economy and interest rates, the fact that there have been several years of strong affordable lending suggests that the mortgage market has changed in fundamental ways since the early 1990's.

- Considering the total mortgage market, the FHA sector stands as the major provider of affordable loans, particularly for African-American and Hispanic families seeking their first home. Between 1996 and 2001, FHA insured more than two out of every five African-American and Hispanic first-time homebuyers, even though FHA accounted for only one out of every six home loans.

- Studies have found that the conventional market, on the other hand, has done a relatively poor job providing mortgage funds for minority families. This chapter presents data showing that African-American borrowers account for only a small percentage of loans originated in the conventional market. Over the 1996 to 2003 period, African-American borrowers accounted only 5.5 percent of conventional conforming home loans originated in metropolitan areas, compared with 7.7 percent of all home loans (including FHA and VA loans). Along with conventional lenders, the GSEs also need to improve their funding of mortgages for minorities, particularly those seeking their first home (see below).

GSE Performance Within the Conventional Conforming Market

- This chapter includes a comprehensive analysis of each GSE's performance in funding home purchase mortgages for borrowers and neighborhoods covered by the three housing goals—special affordable and low- and moderate-income borrowers and underserved areas. In addition, the role of the GSEs in the first-time homebuyer market is examined.

- While Freddie Mac has improved its affordable lending performance in recent years, it has consistently lagged the conventional conforming market in funding affordable home purchase loans for special affordable and low-moderate-income borrowers and underserved neighborhoods targeted by the housing goals. In 2003, its performance on the underserved areas goal was particularly low relative to both the performances of Fannie Mae and the market; in that year, underserved area loans accounted for only 24.0 percent of Freddie Mac's purchases compared with 26.8 percent of Fannie Mae's purchases and 27.6 percent of market originations.

- In general, Fannie Mae's affordable lending performance has been better than Freddie Mac's. But like Freddie Mac, Fannie Mae's average performance during past periods (e.g., 1993-2003, 1996-2003, 1999-2003) has been below market levels. However, it is encouraging that Fannie Mae markedly improved its affordable lending performance relative to the market during 2001, 2002, and 2003, the first three years under the higher housing goal targets that HUD established in the GSE Final Rule dated October 2000. Over this three-year period, Fannie Mae led the primary market in funding special affordable and low-mod loans but lagged the market in funding underserved areas loans. In 2003, Fannie Mae's increased performance placed it significantly above the special affordable market (a 17.1 percent share for Fannie Mae compared with a 15.9 percent share for the market) and the low-mod market (a 47.0 percent share for Fannie Mae compared with a 44.6 percent share for the market). However, Fannie Mae continued to lag the underserved areas market in 2003 (a 26.8 percent share for Fannie Mae compared with a 27.6 percent share for the market). In this case, which is referred to in the text as the "purchase year" approach, Fannie Mae's performance is based on comparing its purchases of all loans (both seasoned loans and newly-originated mortgages) during a particular year with loans originated in the market in that year. When Fannie Mae's performance is measured on an "origination year" basis (that is, allocating Fannie Mae's purchases in a particular year to the year that the purchased loan was originated), Fannie Mae also led the 2003 market in funding special affordable and low- and moderate-income loans, and lagged the market in funding underserved area loans.

- Both Fannie Mae and Freddie lag the conventional conforming market in funding first-time homebuyers, and by a rather wide margin. Between 1999 and 2001, first-time homebuyers accounted for 27 percent of each GSE's purchases of home loans, compared with 38 percent for home loans originated in the conventional conforming market.

- The GSEs have accounted for a significant share of the total (government as well as conventional) market for home purchase loans, but their market share for each of the affordable lending categories (e.g., low-income borrowers and census tracts) has been less than their share of the overall market.

- The GSEs also account for a very small share of the market for important groups such as minority first-time homebuyers. Considering the total mortgage market (both government and conventional loans), it is estimated that the GSEs purchased only 14 percent of loans originated between 1999 and 2001 for African-American and Hispanic first-time homebuyers, or one-third of their share (42 percent) of all home purchase loans originated during that period. Considering the conventional conforming market and the same time period, it is estimated that the GSEs purchased only 31 percent of loans originated for African-American and Hispanic first-time homebuyers, or about one-half of their share (57 percent) of all home purchase loans in that market.

The GSEs' small share of the first-time homebuyer market could be due to the preponderance of high (over 20 percent) downpayment loans in their mortgage purchases.

Impacts of the Housing Goals

- This chapter discusses specific areas where the existing housing goals have had favorable impacts on the single-family mortgage market.[4] As noted above, Fannie Mae and Freddie Mac have improved their affordable lending performance under the housing goals. Based on experience with the interim (1993-95) goals, the 1996-2000 goals, and the current (2001-04) goals, the final higher housing goal targets and the new home purchase subgoals are expected to encourage the GSEs to further improve their ongoing affordable lending efforts and to reach out to markets that have not been adequately served by the secondary market. Some examples of past and potential impacts of the housing goals are given next:

    1. **Leadership position in the home loan market.** As noted earlier, the GSEs have not led the primary market in funding goals-qualifying loans. Given that single-family home purchase lending is their "bread and butter" business, there is no reason these entities can not lead the primary market for home loans. Under the new home purchase subgoals, the GSEs will be in such a leadership position.

    2. **More flexible purchase and underwriting guidelines.** The GSEs have introduced

[4] Impacts on the multifamily market are discussed in Chapter V.

more flexibility into their standard underwriting and appraisal guidelines since the early 1990s, and they have also developed affordable underwriting guidelines to serve borrowers who may not qualify for mortgages under their standard guidelines. An important impact of the new housing goals and home purchase subgoals will likely be further pursuit by the GSEs of more customized mortgage products, underwriting, and outreach. In this manner, the net benefits resulting from the secondary market's lower-cost financing can be extended to additional creditworthy households who have low incomes or live in neighborhoods that have not been adequately served with traditional products, underwriting, and marketing.

3. **Increased purchases in underserved neighborhoods.** This chapter and Appendix B of the Final GSE rule document the serious credit problems faced by families living in the low-income and high-minority neighborhoods covered by HUD's underserved area definition. An important impact of the housing goals will be to increase further the GSEs' purchases in these historically underserved neighborhoods, which should increase the attractiveness of the neighborhoods to mainstream lenders. Additional capital is important to maintain a vibrant housing market in underserved neighborhoods

4. **Increased purchase of loans for first-time homebuyers.** First-time homebuyers qualify for the housing goals at a higher rate than repeat homebuyers. As noted above, there are ample opportunities for the GSEs to increase their purchases of loans for first-time homebuyers. Within the conventional conforming market, about 60 percent of first-time homebuyer loans are available for them to purchase, as are 70 percent of the first-time homebuyer loans of African Americans and Hispanic borrowers. (See Section C of Chapter III for some illustrative estimates of increased first-time homebuyer loans that could be purchased by the GSEs under the final goals and subgoals.)

5. **Increased purchases of seasoned CRA loans.** Studies have documented the increased lending in minority and low-income communities by banks and thrifts as part of their commitments under the 1977 Community Reinvestment Act (CRA). Evidence shows that seasoned loan purchases contributed significantly to Fannie Mae's performance on all three of the housing goals. Thus, increased purchases of seasoned CRA loans will likely be one strategy that the GSEs can use to meet their housing goal and subgoal targets.[5] The GSEs' purchases of seasoned CRA loans frees up capital of banks and thrifts so they can make new loans of this type.

6. **Entry into, and continued growth in new single-family-owner market segments.** The GSEs have been experimenting in several market segments that provide funding for low-income and minority families. The GSEs have introduced programs to

[5] Section C below summarizes a recent report by the Treasury Department on the growth in CRA lending. See Robert E. Litan, Nicolas P. Retsinas, Eric S. Belsky, and Susan White Haag, *The Community Reinvestment Act After Financial Modernization: A Baseline Report*, U.S. Department of Treasury, April 2000. Also see the report by Temkin et al (2000).

purchase A-minus loans on a flow basis. The GSEs' entry into the subprime market could help standardize that market and thus encourage prime lenders to increase their activity in those low-income and high-African-American neighborhoods that are currently relying upon subprime lenders for refinancing credit. Depending on the magnitude and success of the GSEs' new programs, their efforts could lead to more market competition and lower interest rates. In addition, both GSEs have developed programs aimed at the urban home improvement and rehabilitation market, which is a market that would benefit from new program innovations. The final new housing goal targets and home purchase subgoals will encourage the GSEs to further step up their activity in these markets that typically serve low-income families. As noted earlier, most of these markets could benefit from a more active secondary market.

7. **More partnership activities.** Both GSEs, but especially Fannie Mae, have formed partnerships with a wide variety of organizations to increase mortgage availability for historically underserved borrowers and their neighborhoods. For example, Fannie Mae has opened 54 local (or state) partnership offices around the nation. Freddie Mac has also stepped up its partnership initiatives in the past few years. The final new housing goals will likely encourage both GSEs to continue looking for ways to coordinate and leverage their outreach activities with local community groups and local governments.

- The above summarizes a few of the avenues that the GSEs could take to meet the new housing goal and subgoal targets. While it is not possible to identify specifically the actions the GSEs will take to meet the new targets, most industry observers believe that the housing goals have played a significant role in these various aspects of the operations of Fannie Mae and Freddie Mac and in the improvement they have made in purchasing targeted loans.

- In most of the aforementioned areas, Fannie Mae has taken more initiative than Freddie Mac. The Urban Institute (1999) reported that lenders felt that Fannie Mae had shown more flexibility in its underwriting guidelines than Freddie Mac, that Fannie Mae had developed a more comprehensive partnership program than Freddie Mac, and that Freddie Mac had not targeted seasoned loans to lower-income families for purchase. The Department does not attempt to micromanage either GSE's activities, and the enterprises are free to adopt whatever strategies they wish to meet HUD's housing goals. But these final new goals may challenge both GSEs to develop more innovative approaches to reach the housing goals for 2005-2008.

- It is difficult to quantify the anticipated effects of the final new housing goals on important housing market dimensions such as mortgage availability in underserved neighborhoods and homeownership rates. However, to provide some sense of the magnitudes involved, HUD has estimated, under several illustrative purchase scenarios, the number of additional, goal-qualifying dwelling units that the GSEs would have to finance in order to meet the new housing and subgoal targets. These estimates are presented in Section C of Chapter III, along with a breakdown by important policy dimensions such as first-time homebuyer.

Other Market Effects of the Housing Goals

- This chapter presents data showing that there is ample room in the non-GSE portion of the market for the GSEs to purchase any additional goal-qualifying loans. Between 1999 and 2002, the GSEs' single-family-owner purchases accounted for 61 percent of all loans originated in the conventional conforming market, 57 percent of the low-mod loans, 56 percent of the underserved area loans, and 52 percent of the special affordable loans. As noted earlier, the GSEs' current share of the first-time homebuyer segment of the conventional conforming market is only 40 percent. The GSEs have an even smaller presence in the rental market. Between 1999 and 2002, the GSEs' purchases of mortgages for single-family and multifamily rental units represented only 37 percent of that market. Thus, there is ample room for the GSEs to increase their purchases in the remainder of the goal-qualifying markets.

- As noted above, the housing goals appear to be in line with trends in the broader market for housing finance. The recent affordable housing initiatives by the GSEs and others suggest that there is room for expansion in the affordable lending market without compromising the business base of non-GSE portfolio lenders.

- Chapter 3 provided estimates of the additional single-family-owner loans that the GSEs will purchase under the new housing goal targets. That analysis highlights the extent to which the GSEs will have to move deeper into the lower-income-end of the market in order to meet the new housing goals. Section I.2 of this chapter summarizes the main findings from that analysis, as background for examining the market effects of the housing goals.

- This chapter briefly discusses the effects of the higher housing goals on the FHA market. Some FHA loans could be redirected to the GSEs, but probably not many, given that FHA borrowers typically do not meet the GSEs' underwriting standards; specifically, FHA borrowers have very little cash, so they require very low-downpayment loans, and they often have credit blemishes.

Conclusions. To summarize, there is evidence from recent studies that the GSEs have been increasing their purchases of goals-qualifying loans and have been offering customized mortgage products, underwriting, and outreach that are expanding homeownership opportunities for low-income families. In many areas, however, while the GSEs have improved their purchases of affordable loans, they need to make more effort if they are going to lead the market in providing funding for low-income borrowers and underserved neighborhoods, as well as for first-time homebuyers. These efforts could involve more flexibility in their programs and guidelines as well as other initiatives such as those mentioned above. The new housing goal targets and the new home purchase subgoals are designed to encourage both GSEs to continue improving their affordable lending performance, especially with regard to home purchase loans, including loans for first-time homebuyers. The increase in the low-income proportion of GSE business over the last several years suggests that creditworthy households can be found through

GSE outreach efforts, affordable housing programs, and refinement of their underwriting guidelines and procedures.

Credit Risk. This chapter and Chapter VI on credit risk discuss various activities—such as outreach and marketing efforts, pre-purchase credit counseling, close default monitoring, and intensive loss mitigation—that are involved in lending to low-income and traditionally underserved borrowers. It is recognized that affordable lending can be more labor-intensive and costly than other types of lending. It is also recognized that low-income borrowers generally have limited assets and less ability to deal with financial adversity—factors that could lead to higher mortgage default rates. However, as discussed in Chapter VI, there is evidence that the credit risks associated with low-income lending programs can be managed by the GSEs and private lenders. This is because the underwriting flexibilities that characterize recent affordability efforts involve prudent changes to traditional underwriting guidelines and rely heavily on compensating factors and techniques such as automated mortgage scoring to control borrower default risk.[6] It might further be noted that in 1992 Congress added a provision to the GSEs' Charter Acts that mortgages on housing for low- and moderate-income families should involve a reasonable economic return that "may be less than the return earned on other activities."[7]

C. Identification and Characterization of Benefits[8]

This section lays the foundation for examining the housing goals by discussing the benefits that low-income families can gain from owning a home. It also presents evidence indicating that there is a significant unmet demand for homeownership and that disparities in credit availability continue to exist in the mortgage market. Finally, this section concludes that the size of the pool of potential low-income and minority homeowners that could benefit from affordable lending programs is quite large. Appendices A and B of the Final Rule provide a more detailed discussion of the issues examined here.

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[6] As noted in Chapter VI, this type of prudent underwriting is to be contrasted with "relaxed" underwriting that involves multiple and layered risk dimensions (such as a low down payment combined with a high debt-to-income ratio) that are not offset by compensating factors (such as a good credit history). Thus, while relaxed underwriting might lead to the excessively high defaults, prudent underwriting should not, as evidenced by an analysis by Freddie Mac. See "Revisiting Targeted-Affordable Lending: Fresh Evidence Finds Lower Default Rates" by Michael K. Stamper, published in *Secondary Mortgage Markets: A Freddie Mac Quarterly*, October 1997. This paper concludes that affordable lending is viable when done well.

[7] Section 301(b)(3) of the Freddie Mac Corporation Act and Section 301(3) of the Fannie Mae Charter Act.

[8] For a review of economic research on the benefits of homeownership, see U.S. Department of Housing and Urban Development, "Homeownership and Its Benefits," *Urban Policy Brief*, #2 (Office of Policy Development and Research, August 1995).

C.1. Benefits of Homeownership

Homeownership has long been a key aspiration of Americans and, as such, a basic concern of government. The private and public benefits of homeownership have justified government encouragement and support.

Homeownership has expanded the range of individual choice permitting households to tailor more carefully or customize their living arrangements to their particular situation. It improves access to the larger homes and better neighborhoods particularly needed by families with children. Larger households or households on the periphery of the mainstream are more apt to be able to have housing built or adapted to their specific needs when they own the property.

Because homeownership places households in the position of property management, such that they must negotiate financing and provide for the operation, maintenance, and repair of the property, it cultivates responsibility and self-reliance, which engender both private and public benefits. Recent research noted below also associates homeownership with lower neighborhood mobility, greater participation in voluntary and political activities, positive impacts on children, and links to entrepreneurship.[9] To the extent that development and reinforcement of these qualities improve prospects for individual economic opportunities, both private and public benefits are increased; and to the extent that broader distribution of these qualities serve by way of example to reinforce their development and maintenance throughout society, public benefits are further augmented.

The view that homeownership provides public or social benefits to communities in addition to individual homeowners is quite pervasive and has long been thought to include improved outcomes for children, increased civic involvement, better maintenance of homes and greater neighborhood stability, a better sense of well-being, increased savings and wealth, and many other beneficial outcomes. Until recently, these social benefits to homeownership were simply taken as given because there was no empirical evidence either supporting or discrediting these long-held claims. Of late, a large number of academic studies conducted by demographers, sociologists, psychologists, and economists have been published that have consistently corroborated the view that the benefits of homeownership extend to the greater community. Taken together, the studies and findings reported below, the weight of the evidence, the breadth of the disciplines, the variety of data sets, and the many time periods studied strongly suggest that intuition was right and that the benefits of homeownership do indeed extend beyond individual homeowners to society at large.

Homeownership results in higher levels of housing maintenance and property price appreciation. Property values not only measure the utility and condition of a structure for residential purposes, but also the value of the location in terms of community and neighborhood. Studies have found homeowners spend both more in dollar terms and personal labor on

[9] See: Robert Dietz and Donald Haurin. "The Social and Private Consequences of Homeownership" (May 2001), p. 51; William M. Rohe, George McCarthy, and Shannon Van Zandt. "The Social Benefits and Costs of Homeownership" (May 2000), p. 31; and U.S. Department of Housing and Urban Development. "Economic Benefits of Increasing Minority Homeownership", p. 8-9.

maintaining their residences than do landlords of comparable rental properties.[10] The empirical literature is generally supportive of a relationship between homeownership and greater investment in property.[11] Moreover, areas with higher rates of homeownership also witness greater rates of property value appreciation.[12] (See Section B.2 of Chapter 6 for a summary of evidence on property appreciation rates by the race and income of the homeowner and neighborhood.)

Homeownership has a positive impact on children. Several researchers have reached the conclusion that, holding all else equal, homeownership has a positive impact on children within the household. These benefits include an improved cognitive stimulation and emotional environment, an increased educational attainment for children (i.e., higher math and reading scores), fewer behavior problems, a lower teen-age pregnancy rate for daughters living in an owned home, and a higher lifetime annual income for children raised in an owned home.[13] While the household, and the children in particular, reap the bulk of these benefits, society benefits in several ways, such as the benefit to the economy of an educated work force and the reduction in assistance payments that results from increases in employment and decreases in out-of-wedlock births.

Homeowners are more involved in their communities. Although the level and benefits of community involvement are hard to measure, several researchers have found, using a wide variety of measures, that owners tend to be more involved in their communities and local governments than renters. For instance, owners participate in a greater number of non-professional organizations, have higher church attendance, and higher voter participation rates.[14] While it is hard to put a dollar value on something like church attendance, it is clear that these factors generally make a neighborhood a more pleasant place to live. In addition to higher civic participation, owners also tend to remain in their homes longer, adding stability and familiarity to the neighborhood.[15]

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[10] Rohe, W., and L. Stewart, "Homeownership and Neighborhood Stability," *Housing Policy Debate*, 7 (1996) #1: 37-82. Galster, G., "Empirical Evidence on Cross-Tenure Differences in Home Maintenance and Conditions," *Land Economics*, 59(1983) #1:107-113.

[11] Robert Dietz and Donald Haurin, "The Social and Private Consequences of Homeownership," May 2001, p. 51.

[12] Rohe, W., and L. Stewart, "Homeownership and Neighborhood Stability," *Housing Policy Debate*, 7(1996) #1:37-82.

[13] See Haurin, D. R., T. Parcel, and R. J. Haurin, R. J., "The Impact of Home Ownership on Child Outcomes," Unpublished manuscript, 2000; Green, R., and M. White, "Measuring the Benefits of Homeowning: Effects on Children," *Journal of Urban Economics*, 41(1997)#3:441-461; Kane, T. "College Entry by Blacks since 1970: The Role of College Costs, Family Background, and the Returns to Education," *Journal of Political Economy*, 102(1994)#5: 879-911; and Boehm, T., and A. Schlottmann, "Does Homeownership by Parents Have an Economic Impact on their Children?" Unpublished manuscript, 1998.

[14] DiPasquale, D., and E. Glaeser, "Incentives and Social Capital: Are Homeowners Better Citizens?" *Journal of Urban Economics,* 45(1999) #45:354-384; also see Rossi, P., and E. Webb. "The Social Benefits of Homeownership: Empirical Evidence from National Surveys," *Housing Policy Debate,* 7(1996) #1:1-36. For additional discussion of the greater participation of homeowners in voluntary and political activities, William M. Rohe, George McCarthy, and Shannon Van Zandt, "The Social Benefits and Costs of Homeownership," May 2000, p. 31.

[15] Rohe, W., and L. Stewart, "Homeownership and Neighborhood Stability," *Housing Policy Debate,* 7(1996)#1:37-

Homeowners are more satisfied with their homes and neighborhoods. The American Housing Survey (AHS) collects information on current resident's satisfaction with their home and neighborhood. According to an analysis conducted using the 1999 AHS, owners on average rated their satisfaction with their home at 8.0 (on a scale of 1 to 10), compared to 7.2 for renters. Among single-family home residents, owners rated their neighborhoods at 7.9, while renters rated their neighborhoods at 7.3.

Homeownership helps to build wealth and savings. Research shows that, holding all else equal, homeowners save more than renters and also keep a higher percentage of their savings in safer assets.[16] Homeownership is an important way to accumulate wealth and savings for retirement. Home equity is also a significant share of households' net worth. As reported above, home equity accounts for about 72 percent of net household wealth of lower income homeowners and approximately 55 percent for homeowners with incomes between $20,000 and $50,000.[17]

Homeowner equity provides an important link to entrepreneurship. Home equity serves as one method of enabling potential new business owners to gain access to the credit markets. Home equity tends to be one of the largest sources of collateral for bank loans to start new businesses.[18] Homeowners are almost three times as likely to hold direct ownership in business ventures than renters. The 1998 Survey of Consumer Finances reports that 14.5 percent of owners held some form of nonstock business equity, compared to only 5.4 percent of renters. Moreover, a typical owner also held almost two-and-a-half times the dollar value of business equity as a typical renter. The median nonstock business equity holding for owners was $75,000 in 1998, compared to $31,000 for renters.[19]

Homeownership is one of the most common forms of property ownership and sources of saving in society. As such, it is thought to promote social or community stability by way of increasing the number of stakeholders and reducing disparities in the distribution of wealth and income. Historically, home equity has been the largest source of wealth for most Americans**,** and wealth gains in housing have been more widely distributed among the population than gains in the stock market.[20] In recent years, stock equity exceeded home equity as a share of total

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82.

[16] Fratantoni, M., "Homeownership and Investment in Risky Assets," *Journal of Urban Economics*, 44(1998)#1:27-42.

[17] Retsinas, N. P., and E. S. Belsky, *Low-Income Homeownership: Examining the Unexamined Goal*, Washington, D.C.: Brookings Institution Press, 2002, p. 201.

[18] Over 740,000 businesses in 1992 reported a mortgage or home equity loan as a source of start-up capital for their business, helping to create millions of new jobs. See US Bureau of the Census, *Characteristics of Business Owners, 1992*. Economic Census CBO92-1. US GPO, Washington, DC. September 1997.

[19] Also see U.S. Department of Housing and Urban Development, "Economic Benefits of Increasing Minority Homeownership," 2002, pp. 8-9.

[20] Todd Buchholz, "Safe At Home: The New Role of Housing in the U.S. Economy," a paper commissioned by the

household wealth; however, was once again a more significant asset in the household balance sheet than stocks in 2001.[21] The Joint Center on Housing Studies of Harvard University estimated that even with stocks appreciating faster than home prices over most of the past decade, 59 percent of all homeowners in 1998 held more than half of their net wealth in the form of home equity.[22] Among low-income homeowners (household income less than $20,000), home equity accounted for about 72 percent of household wealth. Median net wealth for low-income homeowners under 65 was twelve times that of a similar renter.[23] Thus a homeownership gap translates directly into a wealth gap.

For this reason, President Bush issued the "Homeownership Challenge" in June 2002 to increase minority homeownership by 5.5 million by the end of the decade. By December of 2003, the Census estimated that the number of minority homeowners had increased by 1.53 million. This meant that in the fourth quarter of 2003, for the first time ever, the majority of minority households are now homeowners

Increasing homeownership among groups for which it has not traditionally been an option has importance throughout a wide spectrum of public policy issues. High rates of homeownership support economic stability within housing and related industries, sectors that contributed nearly one-third of the total gain in real GDP since the beginning of the decade.[24] In addition to economic benefits such as jobs and residential investment, the current literature substantiates that the benefits of homeownership extend beyond individual homeowners and their families to society at large, as has been summarized above. In addition, more than half of the refinancing mortgages in the first two years of the decade were cash-out, defined as refinancing procedures by which the mortgage balance is increased by more than five percent in order to tap into home equity. Cash-outs have injected more than $300 billion into the economy since 2000 and are responsible for one-fifth of real GDP growth since late 2000.[25] More recent figures confirm that refinancing remained steady in first quarter of 2004 with Freddie Mac estimating that $114 billion will be pumped into the economy in 2004 from equity extraction, which the consumer can devote to other uses.[26]

Homeownership Alliance, 2002.

[21] Mark Zandi. "Housing's Rising Contribution" (June 2002), p. 5.

[22] Joint Center for Housing Studies of Harvard University. *State of the Nation's Housing 2000*. (2000), p. 9.

[23] U.S. Department of Housing and Urban Development. "Economic Benefits of Increasing Minority Homeownership", 2002, p. 7.

[24] Homeownership Alliance, "The Economic Contribution of the Mortgage Refinancing Boom," December 2002, pg. 2.

[25] Homeownership Alliance, "The Economic Contribution of the Mortgage Refinancing Boom," December 2002, pp 4-5.

[26] Freddie Mac, "Share of Cash-Out Home Refinancings Remain Steady in First Quarter 2004," Press Release May 3, 2004.

C.2. Benefits of Primary and Secondary Market Financing

It was concluded above that both the individual and society benefit from homeownership. If the benefit were simply viewed as additive over individuals, then the aggregate benefit would depend on the number of individual homeowners, which in turn, would be limited by the range of financing arrangements available. If homebuyers had to self-finance their purchases with accumulated wealth, the proportion of homeowners would indeed be small, as would the aggregate benefit from homeownership. The number of homebuyers and aggregate benefit will expand with (1) the extent to which long-term, fixed-rate debt financing is available to replace equity financing and (2) reductions in the cost of debt financing.

Long-term debt financing, which has become readily available through primary market lenders and the support of the GSE secondary market, has: (1) increased the number of primary market competitors (reducing both home search and dollar costs); (2) lowered the direct cost of debt financing by enhancing liquidity and investor security; and (3) generally evened capital flows, directing it to where it is most desired. Thus, the GSE secondary market has helped to reduce (in terms of both equity requirements and monthly payments) the cost of financing homeownership nationwide and has thereby significantly expanded the number of individual homeowners and aggregate benefit from homeownership.[27]

Unfortunately, as discussed in the next two sections, not everyone is benefiting from the highly efficient mortgage market that the GSEs and other industry participants have created. Significant disparities in homeownership and mortgage lending continue to exist, often preventing low-income and minority families from taking advantage of the lower financing costs offered by the secondary market. As discussed in Section D below, there is evidence that the housing goals have encouraged the GSEs to offer more customized mortgage products, underwriting, and outreach. The higher housing goals seek to extend even further the secondary market's benefit of low-cost financing to those families who historically have not been well served by traditional mortgage programs.

C.3. Unmet Demands for Homeownership

In 1980, 65.6 percent of Americans owned their own home, but due to the unsettled economic conditions of the 1980s, this share fell to 63.9 percent by 1989.[28] However, major

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[27] In a recent study, Passmore (2003) argues that (1) the federal government's implicit subsidy of Fannie Mae and Freddie Mac has resulted in a funding advantage for the GSEs over private sector institutions, (2) the actions of GSEs result in slightly lower mortgage rates for some homeowners, (3) the government's ambiguous relationship with Fannie Mae and Freddie Mac imparts a substantial implicit subsidy to GSE shareholders ($72 billion after tax), (4) the implicit government subsidy accounts for much of the GSEs' market value (60% of market value with variation in estimates between 42% and 81%), (5) the GSEs would hold far fewer of their mortgage-backed securities in portfolio and their capital-to-asset ratios would be higher if they were purely private, and (6) the GSEs' implicit subsidy does not appear to have substantially increased homeownership or homebuilding. Of course, as argued by HUD (1996) in its 1996 privatization study, the purpose of the housing goals is to enable more lower-income families to receive the benefits of the low interest rates offered by the GSEs in the prime conventional market. See Section A.2 of Chapter III for further discussion of the Passmore paper.

[28] Historically high interest rates, low price appreciation, and a series of deep regional recessions caused the decline

gains in ownership have occurred over the last few years, due mainly to solid economic growth, low interest rates, house price stability, and new affordability lending initiatives by the mortgage industry. The homeownership rate reached a record level of 67.9 percent in 2002, when the number of households owning their own home was 10.6 million greater than in 1994.

While the gains in homeownership have been widespread over the last eight years, wide differences in ownership rates have persisted by race.[29] In 2003, 75.4 percent of non-Hispanic whites were homeowners, compared with only 48.8 percent of blacks and 46.7 percent of Hispanics. These differentials persist even when differences in income and age are controlled.[30]

Barriers to Homeownership. As noted above, economic expansion and lower mortgage rates have substantially improved homeownership affordability in recent years. Many young, low-income, and minority families who were closed out of the housing market during the 1980s have re-entered the housing market. However, many of these households still lack the financial resources and earning power to take advantage of today's home buying opportunities. As discussed in Appendix A of the Final Rule, insufficient income and savings, high debt burdens, and limited access to credit are obstacles to homeownership for these families.

Since the early 1980s, earnings growth has been slow for blue collar and less educated workers. African Americans and Hispanics, who have lower average levels of educational attainment than whites, are especially disadvantaged by the erosion in wages among less educated workers.[31] Slow income growth hampers the ability of these families to raise enough cash to meet the down payment requirements, closing costs, and monthly mortgage payments associated with owning a home.

A study by the U.S. Census Bureau showed that low-income and minority households have found it difficult to accumulate cash for required down payments and closing costs or to make monthly mortgage payments. According to the 2003 Fannie Mae National Housing Survey,

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in homeownership during the 1980s. During this period, homeownership was particularly elusive for low- and moderate-income families. Declines in ownership rates were most pronounced for younger, lower income households, particularly those with children. Between 1980 and 1991, the total ownership rate fell about 1 percentage point, from 65.6 percent to 64.1 percent, while the rate fell 7 percentage points for families with children, from 70.4 percent to 63.4 percent. The decline was even greater for young households, from 43.3 percent to 33.1 percent between 1980 and 1992. These declines were concentrated among single-parent households and married couples with children.

[29] The homeownership rate for non-Hispanic African-Americans increased from 42.0 percent in 1993 to 47.3 percent in 2002 and that for Hispanics, from 39.4 percent in 1993 to 48.2 percent in 2002. Homeownership rates prior to 1993 are not strictly comparable with those beginning in 1993 because of a change in weights from the 1980 Census to the 1990 Census.

[30] US Housing Market Conditions, 1st Quarter 2004, Table 29.

[31] Several trends have contributed to the reduction in the real earnings of young adults without college education over the last 15 years, including technological changes that favor white-collar employment, losses of unionized manufacturing jobs, and wage pressures exerted by globalization. Over 42 percent of the nation's population between the ages of 25 and 34 have no advanced education and are therefore at risk of being unable to afford homeownership. (U.S. Census Bureau, Current Population Survey, March 2000.)

46 percent of English-speaking Hispanics viewed not having enough money for a down payment or upkeep as an obstacle to buying a home versus 41 percent of all Americans.[32] In addition, a study by Gyourko, Linneman, and Wachter (1999) found significant racial differences in homeownership rates in "wealth-constrained" households while finding no racial differences in homeownership rates among households with wealth sufficient to meet down payment and closing costs.[33]

In addition to low incomes, high debts are a primary reason households cannot afford to purchase a home. About 48 percent of renter families have both insufficient income and excessive debt problems that may cause difficulty in financing a home purchase.[34] High debt-to-income ratios frequently make potential borrowers ineligible for mortgages based on the underwriting criteria established in the conventional mortgage market.

Furthermore, some potential low-income and minority homebuyers have not established and maintained a good credit history. Fannie Mae reported that nearly a third of African-American respondents said their credit rating would be an obstacle to buying a home, versus 23 percent of all Americans. Poor credit ratings can be the result of unexpected and uninsured events like hospital bills, which often times are unpaid because of a lack of medical insurance. Another cause of poor ratings is the lack of budgeting skills. As discussed in Appendix A of the Final Rule, a major concern about the industry's shift to automated underwriting and credit scoring systems relates to the impact of these systems on low-income and minority borrowers.

An additional barrier to homeownership is fear and a lack of understanding about the buying process and the risks of ownership. A study using focus groups with renters found that even among those whose financial status would make them capable of homeownership, many felt that the buying process was insurmountable because they feared rejection by the lender or being taken advantage of.[35] Also, many feared the obligations of ownership, because of the concerns about the risk of future deterioration of the house or the neighborhood. In addition, the 2002 Fannie Mae National Housing Survey revealed that erroneous beliefs about down payment requirements and other aspects of the mortgage process are widespread and disproportionately affect minority Americans.[36] While often misinformed and discouraged, a significant number of minorities aspire to be homeowners. This is particularly true for Spanish-speaking Hispanics. Though they are the least informed group, they have high hopes for someday being homeowners. This has important implications for the future; because their numbers are expected to increase by 75% in the next two decades, this group, if steered toward homeownership, can do much to help

[32] Fannie Mae. 2003 Fannie Mae National Housing Survey. (2004), p. 9.

[33] Boehm, Thomas P. and Alan M. Schlottmann, "Housing and Wealth Accumulation: Intergenerational Impacts," in *Low-Income Homeownership: Examining the Unexamined Goal*. Brookings Institution Press (2002), p. 408.

[34] Howard A. Savage, *Who Can Afford to Buy A House in 1995?*, U.S. Bureau of the Census, Current Housing Reports H121/99-1, (August 1999), p. 5.

[35] Donald S. Bradley and Peter Zorn. "Fear of Homebuying: Why Financially Able Households May Avoid Ownership," *Secondary Mortgage Markets* (1996).

[36] Fannie Mae. Fannie Mae National Housing Survey. (2003), pp. 7, 10.

continue the boost that GDP has received through the housing sector in the past few years.[37]

Finally, discrimination in mortgage lending continues to be a barrier to homeownership. In both mortgage lending and the real estate industry, researchers have documented disparities in treatment between homebuyers of different races. These disparities are discussed in the next section.

C.4. Disparities in Mortgage Financing

As noted earlier, the nation's housing finance system is, on the whole, highly efficient, enabling most homebuyers to obtain long-term funding at relatively small spreads above the lender's borrowing costs and with relatively small amounts of upfront cash. Unfortunately, this system does not work everywhere or for everyone. Studies have shown that access to credit often depends on improper evaluation of characteristics of the mortgage applicant and the neighborhood in which the applicant wishes to buy.[38]

Disparities Between Borrowers of Different Races. There is much evidence suggesting that the current mortgage funding system does not work uniformly well for everyone everywhere.[39] Research based on Home Mortgage Disclosure Act (HMDA) data suggests pervasive and widespread disparities in mortgage lending across the Nation. For 2002, the denial rate for white mortgage applicants was 8 percent, but 20 percent of African-American and 15 percent of Hispanic applicants were denied. Even after controlling for income, the African-American denial rate was approximately twice that of white applicants. HUD-sponsored studies of the pre-qualification process conclude that African Americans and Hispanics faced a significant risk of unequal treatment when they visit mainstream mortgage lenders.

Differentials in denial rates, such as those reported above, are frequently used to demonstrate the problems that minorities face obtaining access to mortgage credit. However, an important question is the degree to which variations in denial rates reflect lender bias against certain kinds of borrowers relative to the degree to which they reflect the credit quality of potential borrowers (as indicated by applicants' available assets, credit rating, employment history, etc.). Without fully accounting for the creditworthiness of the borrower, racial differences in denial rates cannot be attributed to lender bias. Some studies of credit disparities have attempted to control for credit risk factors that might influence a lender's decision.

A major study by researchers at the Federal Reserve Bank of Boston found that mortgage denial rates remained substantially higher for minorities in 1991-93, even after controlling for

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[37] Fannie Mae. Fannie Mae National Housing Survey. (2003), p. 3.

[38] Sections B.7 and D.7 discuss additional disparities that have arisen due to predatory lending and subprime lending, respectively.

[39] HUD's analysis on this point appears in Appendix B of the Final Rule. The mortgage denial rates reported in the text exclude the effects of lenders that specialize in manufactured housing loans (see Appendix A of the Final Rule for an explanation of how specialized manufactured housing lenders are identified in HMDA).

numerous indicators of credit risk.[40] African-American and Hispanic applicants in Boston with the same borrower and property characteristics as white applicants had a 17 percent denial rate, compared with the 11 percent denial rate experienced by whites. The findings of this study have been confirmed by a reassessment and refinement of the same data by William Hunter at the Chicago Federal Reserve Bank.[41] Both studies found that denial differentials were concentrated among marginal applicants with bad credit ratings or high debt ratios. Among borrowers with good credit ratings, race did not matter.

The Boston Fed study, as well as reassessments of that study by other researchers, concluded that the effect of borrower race on mortgage rejections persists even after controlling for legitimate determinant of lenders' credit decisions. [42] Thus, these studies imply that variations in mortgage denial rates, such as those reported above, are not determined entirely by borrower risk, but reflect discrimination in the housing finance system. Partly as a result of these racial disparities in the housing and mortgage markets, the homeownership rate for minorities is 25 percentage points below that for whites.

Disparities Between Neighborhoods. There are neighborhoods that are not being adequately served by the nation's housing and mortgage industries. The existence of substantial neighborhood disparities in homeownership and mortgage credit is well documented for metropolitan areas. HUD's analysis of HMDA data shows that mortgage credit appears to be less accessible in low-income and high-minority neighborhoods. As discussed in Appendix B to the Final Rule, 2002 HMDA data also show that mortgage denial rates are nearly twice as high in census tracts with low-income and/or high-minority composition, as in other tracts (14.6 percent versus 8.0 percent). Numerous studies have found that mortgage denial rates are higher in low-income census tracts, even accounting for other loan and borrower characteristics.[43]

HUD's definition of underserved areas deserves mention here. HUD's selection of a targeted, census tract approach in defining underserved areas has the benefit of more efficiently directing mortgages to those low-income and high-minority neighborhoods that are not well-served by the mortgage market. Alternative approaches, such as including all central cities in the definition of underserved areas, would not focus GSE efforts on areas with the most severe credit problems.[44] [45] Thus, HUD's Underserved Areas Goal provides an important means of reducing

[40] Munnell, Alicia H., Geoffrey M. B. Tootell, Lynn E. Browne, and James McEneaney, "Mortgage Lending in Boston: Interpreting HMDA Data," *American Economic Review*, 86 (March 1996).

[41] See Hunter (1995). In addition, a study undertaken for HUD also found higher denial rates for minorities after controlling for credit risk. See Schnare and Gabriel (1994).

[42] For a reassessment of the Boston Fed study, see Stephen Ross and John Yinger, *The Color of Credit*, MIT Press 2002, and other studies cited there.

[43] Robert B. Avery, Patricia E. Beeson and Mark E. Sniderman. *Understanding Mortgage Markets: Evidence from HMDA*, Working Paper Series 94-21. Federal Reserve Bank of Cleveland (December 1994).

[44] An ancillary but no less important benefit is the external effect of neighborhood improvement. A current lack of mortgage credit can depress the supply of future mortgage credit because future appraisals are made more difficult. This self-reinforcing cycle can lead to neighborhood decline, as each neighbor ceases to maintain his home because the neighbor cannot sell or maintain his home for lack of credit to the area. By the same token, a loan made on a

the disparities in lending. Extending the link to lower cost capital to creditworthy households in underserved areas will increase the number of homebuyers and net benefit from homeownership.

C.5. Explanations of Lending Disparities

Discrimination. A number of possible explanations for these lending disparities have been suggested in the literature. As discussed above, studies such as the Boston and Chicago Federal Reserve studies have found evidence of lender bias. These studies found that racial disparities could not be explained by differences in creditworthiness. In other words, minorities were more likely to have their applications denied than whites with similar credit characteristics. Bias is usually perceived as an aversion to a particular group. However, a Chicago Federal Reserve study attributes the disparities to a cultural gap between white loan officers and minority applicants, and conversely, an affinity of white loan officers to white applicants. Under either explanation the net effect is the same, that is, discriminatory treatment of minorities.

In addition, if race is correlated with risk, loan officers may effectively discriminate by using race as a screening device, rather than devoting effort to distinguishing the creditworthiness of the individual applicant.[46] While the intent may not be discriminatory, the outcome is. Though racial discrimination has become less blatant in the home purchase market, studies have shown that it is still widespread in more subtle forms.

In 2002, HUD released its third Housing Discrimination Study (HDS) in the sale and rental of housing. The study, entitled *Discrimination in Metropolitan Housing Markets: National Results from Phase I of the Housing Discrimination Study (HDS)*, was conducted at the Urban Institute.[47] The results of this HDS were based on 4,600 paired tests of minority and non-minority home seekers conducted during 2000 in 23 metropolitan areas nationwide. The report showed large decreases between 1989 and 2000 in the level of discrimination experienced by Hispanics and African Americans seeking to buy a home. Although there was a downward trend since 1989, the report found that housing discrimination still exists at unacceptable levels. The greatest share of discrimination for Hispanic and African American home seekers can still be

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property has positive externalities for neighboring properties. Small lenders may be discouraged from making loans in underserved areas because they are unable to internalize these externalities. (Van Order, 1994) GSE efforts to focus mortgage lending on underserved neighborhoods can help overcome these mechanisms.

[45] Appendix B of the Final GSE Rule reviews the economic literature regarding the underlying causes of disparities in access to mortgage credit. These studies have been unable to definitively identify the causes of credit disparities, that is, the relative importance of discrimination, "redlining" of specific neighborhoods, and barriers posed by underwriting guidelines to potential minority and low-income borrowers. Nevertheless, a number of studies have found racial and income disparities to persist for individuals and neighborhoods, even after controlling for risk and demand factors. (See for example Munnell, *et al.*, 1992; Hunter, 1995; Shear, *et al.*, 1994, and Avery, *et al.*, 1994.)

[46] See Calomiris, Kahn, and Longhofer (1994) for more discussion of this phenomenon, which is called “statistical discrimination.”

[47] Margery Austin Turner, Stephen L. Ross, George Galster, and John Yinger, *Discrimination in Metropolitan Housing Markets*, The Urban Institute Press, November 2002.

attributed to being told units are unavailable when they are available to non-Hispanic whites and being shown and told about fewer units than a comparable non-minority. Although discrimination is down in most areas for African American and Hispanic homebuyers, there remain worrisome upward trends of discrimination in the areas of geographic steering for African American and, relative to non-Hispanic whites, the amount of help agents provide to Hispanics with obtaining financing.

Underwriting Rigidities. Underwriting guidelines may fail to accommodate the special circumstances of creditworthy low-income and minority applicants or of older properties located in inner-city neighborhoods. For example, under both traditional underwriting procedures and the new automated mortgage scoring systems, applicants who have conscientiously paid bills on time but have never used credit would be penalized for having no credit record. Applicants who have remained steadily employed, but have changed jobs frequently, would also be penalized. Over the past few years, lenders, private mortgage insurers, and the GSEs have started adjusting their underwriting guidelines to take into account these special circumstances of lower-income families. Many of the changes recently undertaken by the industry to expand homeownership have focused on finding alternative underwriting guidelines to establish creditworthiness that do not disadvantage creditworthy minority or low-income applicants.[48]

With the enhanced roles of credit scoring and automated underwriting in the mortgage origination process, it is unclear to what degree the reduced rigidity in industry standards will benefit borrowers who have been adversely impacted by the traditional guidelines. Some industry observers have expressed a concern that the greater flexibility in the industry's underwriting guidelines may not be reflected in the numerical credit and mortgage scores which play a role in the automated underwriting systems that the GSEs and other have developed. Thus lower-income and minority loan applicants may be dependent on the willingness of lenders to take the time to look beyond such credit scores and consider any appropriate "mitigating" factors.

Neighborhood Redlining. HUD's analysis of geographic disparities in mortgage lending in Appendix B of the Final Rule shows clearly that low-income and high-minority neighborhoods receive substantially less credit than other neighborhoods and fit the definition of being underserved by the nation's credit market. While the economics literature has not definitively concluded that these lending disparities are due to discrimination, or redlining of neighborhoods, by lenders, the disparities are definitely substantial and certainly impact the development of urban neighborhoods. Studies reviewed in Section B of Appendix B found that the racial and income composition of neighborhoods influence mortgage access even after

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[48] However, because of the enhanced roles of credit scoring and automated underwriting in the mortgage origination process, it is unclear to what degree the reduced rigidity in industry standards will benefit borrowers who have been adversely impacted by the traditional guidelines. Some industry observers have expressed a concern that the greater flexibility in the industry's written underwriting guidelines may not be reflected in the numerical credit and mortgage scores which play a major role in the automated underwriting systems that the GSEs and others have developed. Thus lower-income and particularly minority loan applicants, who often have lower credit scores than other applicants, may be dependent on the willingness of lenders to take the time to look beyond such credit scores and consider any appropriate "mitigating factors," such as the timely payment of their bills, in the underwriting process.

accounting for demand and risk factors that may influence borrowers' decisions to apply for loans and lenders' decisions to make those loans.

These lending disparities could be the result of cost factors, such as the difficulty of appraising houses in these areas because of the paucity of previous sales of comparable homes. Sales of comparable homes may also be difficult to find due to the diversity of central city neighborhoods. The small loans prevalent in low-income areas are less profitable to lenders because up-front fees to loan originators are frequently based on a percentage of the loan amount, although the costs incurred are relatively fixed. As noted above, the disparities could also be due to neighborhood redlining by lenders, a topic analyzed in some detail in Appendix B of the Final Rule. Overall, the income and minority composition of an area is a good measure of whether that area is being underserved by the mortgage market.

While the literature has not resolved the issue of why the observed disparities exist, the GSEs and others in the lending community have recently begun to search for responsible ways to reduce these disparities. The initiatives they have undertaken are linked to the factors described above, which contribute, in varying degrees, to lending disparities. For example, recent counseling and outreach efforts by the industry are aimed at alleviating the concerns about the buying process mentioned above. Section C discusses these industry initiatives.

As mentioned at the end of the last section, it is difficult to quantify precisely the benefits of homeownership. Estimates of unrealized homeownership resulting from discrimination, redlining, externalities, and inadequate outreach would have to be made, and estimates of associated costs would have to be developed. However, with the presumption that current homeowner beneficiaries add to net benefit, the outer bound to the qualitative addition of similar net benefit may be assessed by examining the potential for additional beneficiaries requiring no significant increase in credit risk. The next section discusses this.

C.6. Size of Potential Homeownership Population

While the growth in affordable lending and homeownership has been strong in recent years, further increasing this Nation's homeownership rate will not be possible without tapping into the vast pool of potential homebuyers. Due to record low interest rates, expanded homeownership outreach, and new flexible mortgage products, the homeownership rate reached an annual record of 68.3 percent in 2003**,** reaching 68.6 percent in the fourth quarter of 2003**.**[49] This section discusses the potential for further increases in homeownership, given current demographic trends and attitudes about becoming a homeowner. The pool of potential homeowners could be quite large. Numerous surveys have indicated renters have a preference for homeownership and many plan to become homeowners in the near future. As explained below, the changing population demographics will result in a need for primary and secondary mortgage markets to meet nontraditional credit needs, respond to diverse housing preferences, and overcome information and other barriers that many immigrants and minorities face.

The Urban Institute estimated in 1995 that there was a large group of potential

[49] US Housing Market Survey, 1st Quarter 2004, Table 28.

homebuyers among the renter population who were creditworthy enough to qualify for homeownership.[50] Of 20.3 million renter households having low- or moderate-incomes, roughly 16 percent were better qualified for homeownership than half of the renter households who actually did become homeowners over the sample period. When one also considered their likelihood of defaulting relative to the average expected for those who actually moved into homeownership, 10.6 percent, or 2.15 million, low- and moderate-income renters were better qualified for homeownership, assuming the purchase of a home priced at or below median area home price. These results indicate the existence of a significant lower-income population of low-risk potential homebuyer households that might become homeowners with continuing outreach efforts by the mortgage industry.

The potential homeowner population over the next decade will be highly diverse, as growing housing demand from immigrants (both those who are already here and those projected to come) and non-traditional homebuyers will help to offset declines in the demand for housing caused by the aging of the population. As noted in the above discussion of CRA, many of these potential homeowners will be located in urban areas. Immigrants and other minorities—who accounted for nearly 40 percent of the growth in the nation's homeownership rate over the past five years—will be responsible for almost two-thirds of the growth in the number of new households over the next ten years (between 2000 and 2010), as well as over the next 25 years (between 2000 and 2025).[51] By 2025, non-family households will make up a third of all households. Non-Hispanic white and traditional households will contribute only one-third and one-tenth of the growth in new households, respectively. Fannie Mae staff report that between 1980 and 1995, the number of new immigrant owners increased by 1.4 million; and between 1995 and 2010, that figure is expected to rise to by more than 50 percent to 2.2 million. These trends do not depend on the future inflow of new immigrants, as immigrants don't enter the housing market until they have been in this country for eleven years, on average. As noted by Fannie Mae staff, "there are enough immigrants already in this country to keep housing strong for at least six and perhaps even 10 more years".[52] As these demographic factors play out, the overall effect on housing demand will likely be sustained growth and an increasingly diverse household population from which to draw new homeowners.

Surveys indicate that these demographic trends will be reinforced by the fact that most Americans desire, and plan, to become homeowners. According to the 2003 Fannie Mae Foundation annual National Housing Survey, Americans rate homeownership as the best investment they can make, far ahead of 401Ks, retirement accounts, and stocks. Two thirds of Americans said now was a good time to buy a home**,** which is down from 75 percent in 2002 but up 13 percentage points since May 2001.[53] In addition, the survey found that 57 percent of

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[50] George Galster, Laudan Y. Aron, Peter Tatian and Keith Watson. *Estimating the Size, Characteristics, and Risk Profile of Potential Homebuyers*. Washington: The Urban Institute, (1995). Report Prepared for the Department of Housing and Urban Development.

[51] This section draws from "Immigration Changes Won't Hurt Housing," *Nation Mortgage News*, January 27, 2003, p. 8.

[52] *Ibid.*

[53] Fannie Mae, 2003 *Fannie Mae National Housing Survey*, 2004, p. 3.

Americans report they are likely to buy in the next three years.[54]

Further increases in the homeownership rate depend on whether or not recent gains in the home owning share of specific groups are maintained. Minorities accounted for 17 percent of owner households in 2001, but the Joint Center for Housing Studies reports that minorities were responsible for more than 40 percent (a total of 5.2 million) of the net growth in homeowners between 1993 and 2002.[55] As reported by the Fannie Mae survey, 42 percent of African-American families reported that they were "very or fairly likely" to buy a home in the next three years, up from 38 percent in 1998 and 25 percent in 1997. Among Hispanics and Hispanic immigrants, the numbers reached 37 percent and 34 percent respectively. The 2002 survey also reports that more than half of Hispanic renters cite homeownership as being "one of their top priorities". In addition, nearly a third (31 percent) of baby boomers said they are "very or fairly likely" to buy a home in the next three years.

In spite of these trends, potential minority homebuyers see more obstacles to buying a home, compared with the general public. Typically, the primary barriers to ownership are credit issues and a lack of funds for a downpayment and closing costs. But Freddie Mac staff emphasize that "immigrants and minorities face additional hurdles, including a lack of affordable housing, little understanding of the home buying process, and continuing financial obligations in their home countries." [56] In the Fannie Mae survey, minority groups reported misconceptions about the difficulty of becoming a homeowner such as beliefs about the amount of down payment required and mortgage lending practices, a lack of confidence about the home buying process, poor credit ratings, and language barriers. In addition, there are continuing concerns about the limited education and low-income levels of recent immigrants and other minorities.

Thus, the new group of potential homeowners will have unique needs. To tap this potential homeowner population, the mortgage industry will have to address these needs on several fronts, such as expanding education and outreach efforts, introducing new products, and adjusting current underwriting standards to better reflect the special circumstances of these new households.

D. The Single-Family Market for Affordable Loans

The housing goals must be considered in terms of what is happening in the overall market, for three reasons. First, understanding the performance of other actors in the market provides some context for evaluating the GSEs' performance, for example, how does their funding support for low-income borrowers compare with that of depositories? Second, understanding current market funding patterns provides some sense of the feasibility of the housing goal targets, for example, are there portions of the low-income market that have not yet been penetrated by Fannie Mae and Freddie Mac. Third, in the past, there have been various concerns raised about the potential market effects of the housing goals, for example, concerns

[54] *Ibid.*

[55] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2003*, p. 15.

[56] "Immigration Changes…." *Op. cite.*

have been expressed about whether additional good quality loans satisfying the housing goals remain to be made or whether the goals might only be satisfied at the cost of reducing the volume of loans that would otherwise be made by non-GSE portfolio lenders.

As background for examining these issues, this section reviews recent trends in the affordable lending market and finds that the housing goals appear to be in line with what is happening in the broader market for housing finance. The recent affordable housing initiatives supported by lenders, private mortgage insurers (PMIs), and the GSEs suggest that there is room for expansion in the affordable lending market. In some cases, those being served by the industry's new special affordable programs may have qualified under conventional standards but did not know that the opportunity existed. Such outreach efforts can be expected to continue as mortgage originators seek new ways to expand business and to improve their CRA performance, and as the GSEs seek to meet their housing goals and develop new profitable markets.

The GSEs are well positioned to act as catalysts for primary lenders to create these benefits, given their dominant position in the mortgage finance industry. Furthermore, as explained below, there is room for the GSEs to improve their affordable lending performance in important market segments such as first-time homebuyers.

After providing a brief overview of the recent affordable lending initiatives, Subsection C.3 compares the major market sectors in terms of their focus on affordable lending. To place the GSEs in the context of the overall market, this section examines data for government (FHA, VA) loans as well as conventional conforming loans. The important role of FHA in the affordable lending market is highlighted and questions are raised about whether the conventional conforming market could be doing a better job helping low-income and minority borrowers obtain access to mortgage credit. With this general background, Section D will evaluate the GSEs' performance within the conventional conforming market, and Section E will estimate the market share of the GSEs in important market segments such as first-time homebuyers.

D.1. Recent Affordability Initiatives

During the 1990s, the mortgage industry began offering a wide range of affordable lending programs designed to attract those who had not been adequately served through traditional programs. While the details of these affordable loan programs vary, they generally have four distinct elements: targeted groups, special marketing and outreach, the application of flexible underwriting, and the use of risk mitigation activities.[57] Targeted groups are usually defined with eligibility criteria tied to borrower or neighborhood income, loan-to-value ratios, homebuyer status (e.g., first-time homebuyers), and other factors. Borrower or neighborhood income is typically the most important eligibility criterion, with eligibility restricted to lower-income families or census tracts.

[57] This description of affordable lending programs is taken from Avery *et al.* (1996). Also see Rutgers University (1998), The Urban Institute (1999), and HUD (2000a,b) for other descriptions of the rise in affordable lending during the 1990s.

Special marketing typically includes homebuyer education programs and outreach through nonprofit and community groups that are active in targeted neighborhoods. In fact, partnership efforts are quite common with local community groups often responsible for screening the applicants and making recommendations to lenders. In addition, lenders sometimes pool their resources and operate their affordable programs through lender consortia.

Flexible underwriting is perhaps the most important attribute of special lending programs. Flexible underwriting can have the following characteristics: low-down-payment loans, high debt-to-income ratios, reduced cash reserve requirements, and use of alternative credit history (such as payment of rent and utilities). To reduce the applicant's costs, lenders sometimes offer below-market interest rates and waive private mortgage insurance requirements. As noted above, these underwriting changes are often accompanied by homeownership and credit counseling to ensure homeowners are ready for the responsibilities of homeownership. A recent study by Freddie Mac suggests that homeownership counseling can reduce delinquent mortgage payments (Hirad and Zorn, 2001).

The industry has also engaged in intensive loss mitigation to control any extra default risks associated with their special lending programs. This can include quick follow-up calls to borrowers who miss a monthly payment as well as use of automated models that assist servicers in determining which loss mitigation strategy should be pursued for different situations involving a delinquent borrower. The industry's efforts to control the default risks of their special lending programs and the early default performance of these programs are both discussed in HUD (2000a).

Fannie Mae and Freddie Mac have each been playing an active role in these market initiatives[58]. During 1998, Fannie Mae introduced its "Flexible 97" and Freddie Mac introduced its "Alt 97" low downpayment lending programs. Under these programs borrowers are required to put down only 3 percent of the purchase price. The downpayment, as well as closing costs, can be obtained from a variety of sources, including gifts, grants or loans from a family member, the government, a non-profit agency and loans secured by life insurance policies, retirement accounts or other assets. The GSEs have recently started programs for "A-minus" borrowers (i.e., those with blemished credit) that offer interest rate reductions for those borrowers who are not delinquent on their mortgage payments for a period of two years.

In addition to developing new affordable products, the GSEs and lenders have been entering into partnerships with local governments and nonprofit organizations to increase mortgage access to underserved borrowers. Fannie Mae's partnership offices in over 50 central cities, serving to coordinate Fannie Mae's programs with local lenders and affordable housing groups, are an example of this initiative.[59] Freddie Mac does not have a partnership office structure similar to Fannie Mae's, but it has undertaken a number of initiatives in specific metropolitan areas.

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[58] For information on the GSEs' affordable lending initiatives, see the various Annual Housing Activities Reports that they have submitted to HUD since 1993. Examples include Fannie Mae (2001, 2002, 2003) and Freddie Mac (2001, 2002, 2003).
[59] See Boxall and Silver (2001) for the functions of Fannie Mae's partnership offices.

The GSEs have also been modifying their underwriting standards to attempt to address the needs of families who find qualifying under traditional guidelines difficult. The changes to underwriting standards include, for example: using a stable income standard rather than a stable job standard, which particularly benefits low-skilled applicants who have successfully remained employed, even with frequent job changes; and allowing pooling of funds for qualification purposes, which benefits applicants with extended family members.

D.2. 1993-2002 Lending Trends

HMDA data suggest that the industry and GSE initiatives are increasing the flow of credit to underserved borrowers. Between 1993 and 2003, conventional loans to low-income and minority families increased at much faster rates than loans to higher income and non-minority families. As shown below, conventional home purchase originations to African Americans more than doubled between 1993 and 2003 and those to Hispanic borrowers more than tripled. Home loans to low-income borrowers and to low-income and high-minority census tracts also more than doubled during this period.

	1993-2003 Growth Rate: All Home Loans	1993-2003 Growth Rate: Conventional Home Loans
African-American Borrowers	106%	206%
Hispanic Borrowers	235%	357%
White Borrowers	44%	64%
Low-Income Borrower (Less than 80% of AMI)	101%	150%
Upper-Income Borrower (More than 120% of AMI)	88%	108%
Low-Income Census Tract (only 1993-2002)	99%	143%
Upper-Income Census Tract (only 1993-2002)	64%	78%
High-Minority Tract (only 1993-2002) (50% or more minority)	113%	167%
Predominantly-White Tract (only 1993-2002) (Less than 10% minority)	53%	64%

GSE purchases showed similar trends, as indicated by the following 1993-to-2003 percentage point increases for metropolitan areas: African-American borrowers (199 percent), Hispanic borrowers (259 percent), and low-income borrowers (212 percent). While their annual purchases of all home loans increased by 60 percent between 1993 and 2003, their purchases of mortgages that qualify for the three housing goals increased as follows: special affordable by 287 percent; low- and moderate-income by 156 percent; and underserved areas by 121 percent.

While low interest rates and economic expansion certainly played an important role in the substantial increase in conventional affordable lending in recent years, most observers believe that the efforts of lenders, private mortgage insurers, and the GSEs were also important contributors. In addition, many observers believe that government initiatives such as the GSE housing goals and the Community Reinvestment Act have also played a role in the growth of affordable lending over the past 10 years.

D.3. Affordable Lending Shares by Major Market Sector

Table 4.1 reports borrower (Table 4.1a) and neighborhood (Table 4.1b) characteristics for home purchase mortgages insured by FHA, purchased by the GSEs, originated by depository institutions (mainly banks and thrift), and originated in the conventional conforming market and in the total market for owner-occupied properties in metropolitan areas.[60] In this case, the "total" market consists of both the conventional conforming market and the government (mainly FHA and VA loans) market; "jumbo" loans above the conventional conforming loan limit are excluded from this analysis.[61]

TABLES 4.1a, 4.1b, AND 4.2

HMDA is the source of the FHA, depository, and market data, while the GSEs provide their own data. Low-income, African-American, Hispanic, and minority borrowers are covered in Table 4.1a. Table 4.1b provides information on four types of neighborhoods—low-income census tracts, tracts where minorities (or African Americans) account for more than 30 percent of the census tract population, and underserved areas as defined by HUD. The average data reported in Tables 4.1a and 4.1b for the years 1999 to 2003 offer a good summary of recent lending to low-income and minority borrowers and their communities.[62] Individual year data are also provided.

The focus of different market sectors on affordable lending is summarized by the percentages reported in Tables 4.1a and 4.1b. These percentages show each sector's "distribution of business," defined as the share of loans originated (or, for the GSEs, purchased) that had a particular borrower or neighborhood characteristic. The interpretation of the "distribution of business" percentages can be illustrated using the FHA percentage for low-income borrowers: between 1999 and 2003, 51.2 percent of all FHA-insured home purchase loans in metropolitan areas were originated for borrowers with an income less than 80 percent of the local area median income. These percentages are to be contrasted with "market share"

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[60] Table 4.2 also provides the same average (1999 to 2002) information as Table 4.1 but for total (both home purchase and refinance) loans. Thus, it provides a complete picture of overall mortgage activity.

[61] The "Total Market" is defined as all loans (including both government and conventional) below the conforming loan limit of $240,000 in 1999, $252,700 in 2000, $275,000 in 2001, $300,700 in 2002, and $322,700 in 2003.

[62] The affordable market shares reported in Table 4.1a for the "Conventional Conforming Market W/O B&C" were derived by excluding the estimated number of B&C loans from the market data reported by HMDA. Because B&C lenders operate mainly in the refinance sector, excluding these loans from the conforming market has little impact on the home purchase percentages reported in Table 4.1a. The method for excluding B&C loans is explained in Section E below and Appendix D.

Table 4.1a

Borrower Characteristics for Major Sectors of the Mortgage Market in Metropolitan Areas
Home Purchase Mortgages, 1996-2003

			Conventional Conforming Market						
						Depositories		Conforming Market	
Borrower Characteristics	Total Market	FHA	Freddie Mac	Fannie Mae	Both GSEs	Total	Portfolio	Total	W/O B&C [2]
Low-Income:									
1999	34.4 %	49.5 % [1]	25.1 %	24.7 %	24.8 %	29.1 %	28.5 %	30.1 %	29.8 %
2000	33.5	48.7	27.8	25.4	26.4	29.4	28.6	29.5	29.1
2001	33.0	50.7	26.8	27.9	27.4	28.2	29.2	28.3	28.1
2002	33.7	54.2	28.6	29.7	29.2	29.4	30.3	29.3	29.2
2003	34.4	54.1	28.6	31.0	30.2	29.5	29.5	29.1	29.1
1996-2003 Average	32.8	49.8	25.3	26.7	26.1	28.2	28.9	28.6	28.5
1999-2003 Average	33.4	51.2	27.4	28.1	27.8	29.1	29.2	29.2	29.1
2001-2003 Average	33.1	52.8	28.0	29.6	29.0	29.1	29.7	28.9	28.8
African American:									
1999	7.9	14.6	3.5	3.4	3.5	4.7	4.7	5.4	5.0
2000	8.3	15.5	4.3	4.2	4.3	5.4	5.0	5.9	5.4
2001	7.6	14.0	3.9	5.2	4.6	4.8	4.9	5.4	5.0
2002	7.5	13.9	3.5	5.4	4.7	4.9	4.8	5.7	5.2
2003	7.6	13.2	3.8	5.8	5.2	5.5	5.2	6.5	6.0
1996-2003 Average	7.7	14.3	3.7	4.7	4.3	4.9	4.8	5.5	5.2
1999-2003 Average	7.8	14.3	3.8	5.0	4.5	5.1	4.9	5.8	5.3
2001-2003 Average	7.6	13.8	3.7	5.5	4.8	5.1	5.0	5.9	5.4
Hispanic:									
1999	9.7	19.3	5.5	6.0	5.8	6.5	6.6	7.1	6.9
2000	10.9	20.7	6.6	8.0	7.4	7.9	7.8	8.3	8.1
2001	11.3	20.3	7.0	8.5	7.9	8.5	9.4	9.0	8.7
2002	12.1	20.6	6.6	10.4	9.0	9.3	9.2	10.3	9.8
2003	12.6	19.4	6.9	10.8	9.6	10.0	9.8	11.7	10.9
1996-2003 Average	10.4	19.2	6.0	8.2	7.3	7.5	7.3	8.3	8.0
1999-2003 Average	11.4	20.1	6.6	9.0	8.1	8.5	8.5	9.4	9.0
2001-2003 Average	12.0	20.1	6.8	10.0	8.8	9.3	9.5	10.4	9.9
Minority:									
1999	23.4	37.7	15.0	17.4	16.4	17.7	17.3	19.0	18.4
2000	25.3	40.2	17.6	20.2	19.0	20.3	19.7	21.1	20.4
2001	25.1	38.0	18.3	21.9	20.3	20.3	21.4	21.5	20.8
2002	26.7	38.5	18.9	24.9	22.7	22.1	21.4	24.1	23.1
2003	27.2	36.0	18.3	25.3	23.1	22.9	21.9	25.8	24.5
1996-2003 Average	24.0	37.2	16.3	20.8	19.0	19.0	18.2	20.6	19.8
1999-2003 Average	25.6	38.2	17.7	22.5	20.6	20.8	20.3	22.5	21.6
2001-2003 Average	26.4	37.6	18.5	24.2	22.1	21.8	21.6	24.0	22.9

Notes: The "1999-2003 Average" is a loan-based weighted average. All the data are for home purchase mortgages. The FHA, depositories, and market percentages are derived from HMDA data (various years). The GSE percentages are derived from the loan-level data that Fannie Mae and Freddie Mac provide to HUD. The GSE data include conventional home loans purchased during 1999, 2000, 2001, 2002 and 2003; thus, these data include their purchases of seasoned loans (i.e., mortgages originated prior to 1999 or 2000 or 2001or 2002 or 2003) as well as their purchases of mortgages originated during 1999, 2000, 2001, 2002 and 2003. The "Total Market" combines the government sector (FHA and VA loans) and the conventional conforming market. Thus, it includes all loans except "jumbo" loans above the conforming loan limit which was $322,700 in 2003. "Total Depositories" data are loans originated by HMDA reporters regulated by FDIC, OTS, OCC, FRB, and The National Credit Union Administration; they consist mainly of banks, thrifts, and their subsidieries. The "Portfolio Depositories" data refer to new originations that are not sold by banks and thrift institutions during 1999-2003 and thus are retained in depository portfolios. The HMDA data for low-income borrowers exclude mortgages with a loan-to-borrower-income ratio greater than six.

[1] Each percentage represents the share of a sector's portfolio accounted for by the borrower or neighborhood characteristic based on a "distribution of business" approach or explained in the text. For example, in 1999, 49.5 percent of FHA-insured home loans were loans for low-income borrowers.

[2] HMDA-based market shares that have been adjusted to exclude the B&C portion of the subprime market. It should be recognized that there exists some uncertainty regarding the number of B&C loans in the HMDA data. The adjustment assumes that the B&C loans represent one-half of the subprime market. The adjustment for home purchase loans is small because subprime (B&C) loans are mainly refinance loans.

Table 4.1b

Neighborhood Characteristics for Major Sectors of the Mortgage Market in Metropolitan Areas
Home Purchase Mortgages, 1996-2003

			Conventional Conforming Market						
						Depositories		Conforming Market	
Neighborhood Characteristics	Total Market	FHA	Freddie Mac	Fannie Mae	Both GSEs	Total	Portfolio	Total	W/O B&C [2]
Low-Income Tract:									
1999	12.7	18.2	8.3	7.9	8.1	10.8	11.6	11.3	10.9
2000	13.3	19.2	9.0	9.5	9.3	11.9	12.4	11.9	11.4
2001	12.5	18.2	9.4	10.1	9.8	11.0	12.3	11.0	10.7
2002	12.6	18.8	11.3	11.0	11.1	11.0	12.1	11.4	11.1
2003	12.7	18.0	10.3	11.0	10.8	11.3	12.1	12.0	11.5
1996-2003 Average	12.7	18.6	9.1	9.8	9.5	10.8	12.0	11.3	11.0
1999-2003 Average	12.8	18.5	9.7	10.1	9.9	11.2	12.1	11.5	11.1
2001-2003 Average	12.6	18.3	10.3	10.7	10.6	11.1	12.2	11.5	11.1
High-Minority Tract:									
1999	17.5	26.0	12.3	12.8	12.6	13.9	13.5	15.1	14.6
2000	18.4	26.5	12.8	15.3	14.2	15.6	14.8	16.3	15.7
2001	17.7	24.3	13.2	15.6	14.6	15.2	16.0	16.0	15.4
2002	18.6	24.0	16.2	17.3	16.9	16.1	15.4	17.5	16.7
2003 (2000 Census)	32.1	39.1	24.8	30.0	28.3	28.1	26.8	31.1	29.7
1996-2002 Average	17.7	25.9	12.8	15.1	14.2	14.2	13.9	15.4	14.9
1999-2002 Average	18.1	25.2	13.7	15.4	14.7	15.3	15.0	16.3	15.7
High African-American Tract:									
1999	5.7	8.9	3.4	3.0	3.2	4.3	4.4	4.8	4.4
2000	6.0	9.4	3.9	3.7	3.8	4.9	4.8	5.1	4.7
2001	5.4	8.5	3.9	4.4	4.2	4.4	4.7	4.6	4.3
2002	5.5	8.4	5.3	4.7	4.9	4.5	4.8	4.8	4.6
2003 (2000 Census)	7.4	11.5	5.9	6.3	6.1	6.2	6.2	6.7	6.4
1996-2002 Average	5.7	9.1	3.8	4.0	3.9	4.4	4.6	4.7	4.5
1999-2002 Average	5.7	8.8	4.2	4.0	4.1	4.6	4.7	4.8	4.5
Underserved Areas:									
1999	29.1	40.5	20.9	20.4	20.6	24.6	25.6	25.8	25.2
2000	30.2	42.1	22.0	23.4	22.8	26.6	27.0	27.0	26.2
2001	28.9	40.3	22.3	24.4	23.5	25.4	27.2	25.8	25.2
2002	29.5	40.9	25.8	26.7	26.3	26.0	27.1	27.1	26.3
2003	30.0	39.4	24.0	26.8	25.9	26.8	27.8	28.5	27.6
1996-2003 Average	29.3	40.8	22.0	24.0	23.2	25.1	26.5	26.3	25.7
1999-2003 Average	29.6	40.7	23.1	24.7	24.1	25.9	26.9	26.9	26.2
2001-2003 Average	29.5	40.2	24.1	26.0	25.3	26.1	27.4	27.2	26.4

See notes to Table 4.1a.
Additional Note: In 2003, High-Minority tracts and High African-Amercian tracts are defiend in terms of 2000 census, which explains their higher percentagees. Only the averages through year 2000 are represented here.

Table 4.2

Borrower and Neighborhood Characteristics for Major Sectors of the Mortgage Market in Metropolitan Areas Home Purchase and Refinance Mortgages, 1999-2003

			Conventional Conforming Market					
							Conforming Market	
Borrower Characteristics	Total Market	FHA	Freddie Mac	Fannie Mae	Both GSEs	Depositories	Total	W/O B&C [2]
Low-Income:	29.9 %	50.2 % [1]	25.0 %	26.5 %	25.9 %	27.3 %	28.0 %	27.3 %
African American:	6.7	14.8	3.3	4.1	3.8	4.8	5.5	4.9
Hispanic:	9.1	19.0	5.6	7.6	6.8	7.2	8.0	7.7
Minority:	22.1	37.5	16.4	19.3	18.1	18.5	20.2	19.3
Neighborhood Characteristics								
Low-Income Tract:	11.7	17.6	8.9	9.3	9.1	10.4	11.1	10.5
Underserved Areas:	27.7	39.9	22.1	23.8	23.1	24.8	26.2	25.2

Notes: The "1999-2003 Average" is a loan-based weighted average. All the data are for home purchase and refinance mortgages. The FHA, depositories, and market percentages are derived from 1999, 2000, 2001, 2002 and 2003 HMDA data (various years). The GSE percentages are derived from the loan-level data that Fannie Mae and Freddie Mac provide to HUD. The GSE data include conventional home loans purchased during 1999, 2000, 2001, 2002 and 2003; thus, these data include their purchases of seasoned loans (i.e., mortgages originated prior to 1999 or 2000 or 2001 or 2002 or 2003) as well as their purchases of mortgages originated during 1999, 2000, 2001, 2002 and 2003. The "Total Market" combines the government sector (FHA and VA loans) and the conventional conforming market. Thus, it includes all loans except "jumbo" loans above the conforming loan limit which was $322,700 in 2003. "Depositories" data are loans originated by HMDA reporters regulated by FDIC, OTS, OCC, FRB, and The National Credit Union Administration; they consist mainly of banks, thrifts, and their subsidieries. The HMDA data for low-income borrowers exclude mortgages with a loan-to-borrower-income ratio greater than six.

[1] Each percentage represents the share of a sector's portfolio accounted for by the borrower or neighborhood characteristic based on "distribution of business" approach or explained in the text. For example, 50.2 percent of FHA-insured home loans between 1999 and 2003 were loans for low-income borrowers. It should be noted that due to FHA's streamline refinance program, borrower income data were not available for almost 70 percent of FHA's refinance loans.

[2] HMDA-based market shares that have been adjusted to exclude the B&C portion of the subprime market. It should be recognized that there exists some uncertainty regarding the number of B&C loans in the HMDA data. The adjustment assumes that the B&C loans represent one-half of the subprime market.

percentages, which are presented below in Section F. A "market share" percentage is the share of loans with a particular borrower or neighborhood characteristic that was funded by a particular market sector (e.g., FHA-insured, GSEs, depositories). As will discussed below, FHA's "market share" for low-income borrowers during the 1999-to-2003 period was estimated to be 24 percent which is interpreted as follows: of all home purchase loans originated for low-income borrowers in metropolitan areas between 1999 and 2003, 24 percent were FHA-insured loans. Thus, in this example, the "distribution of business" percentage measures the importance (or concentration) of low-income borrowers in FHA's overall business while the "market share" percentage measures the importance of FHA to the market's overall funding of loans for low-income borrowers. Both concepts are important for evaluating performance—for an industry sector such as FHA or the GSEs to have a significant impact on lending to a targeted group, that sector's business must be concentrated on the targeted group and that sector must be of some size. The discussion below will focus on the degree to which different mortgage sectors concentrate on targeted groups, while Section F will also provide estimates of market shares.

The main insights from the "distribution of business" percentages in Tables 4.1a and 4.1b pertain to four topics.

(i) FHA-Insured Loans. FHA has traditionally been the mechanism used by borrowers who face difficulty obtaining mortgage financing in the private conventional market. FHA has long been recognized as the major source of funding for first-time, low-income and minority homebuyers who are not often able to raise cash for large downpayments.[63] Tables 4.1a and 4.1b show that FHA places much more emphasis on affordable lending than the other market sectors. Between 1999 and 2003, low-income borrowers accounted for 51.2 percent of FHA-insured loans, compared with 27.8 percent of the home loans purchased by the GSEs, 29.1 percent of home loans originated by depositories, and 29.2 percent of all originations in the conventional conforming market (see Table 4.1a). Likewise, 40.7 percent of FHA-insured loans were originated in underserved census tracts, while only 24.1 percent of the GSE-purchased loans, 25.9 percent of home loans originated by depositories, and 26.9 percent of conventional conforming loans were originated in these tracts (see Table 4.1b).[64] As discussed in Section E, FHA's share of the minority lending market is particularly high. While FHA insured only 16 percent of all home purchase mortgages originated below the conforming loan limit in

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[63] Almost two-thirds of the borrowers with an FHA-insured home purchase loan make a downpayment less than five percent, and over 80 percent are first-time home buyers. For discussions of the role of FHA in the mortgage market, see (a) Harold L. Bunce, Charles A. Capone, Sue G. Neal, William J. Reeder, Randall M. Scheessele, and Edward J. Szymanoski, An Analysis of FHA's Single-Family Insurance Program, Office of Policy Development and Research, U.S. Department of Housing and Urban Development, 1995; and (b) Office of Policy Development and Research, "FHA's Impact on Homeownership Opportunities for Low-Income and Minority Families During the 1990s" Issue Brief IV, U.S. Department of Housing and Urban Development, December 2000. For data on the credit characteristics of FHA borrowers, see Harold L. Bunce, William J. Reeder and Randall Scheessele, "Understanding Consumer Credit and Mortgage Scoring: A Work in Progress at HUD", U.S. Department of Housing and Urban Development, Unpublished Paper, 1999.

[64] FHA, which focuses on low downpayment loans and also accepts borrowers with credit blemishes, experiences higher mortgage defaults than conventional lenders and the GSEs. Still, the FHA system is actuarially sound because it charges an insurance premium that covers the higher default costs. For the results of FHA's actuarial analysis, see Deloitte & Touche, Actuarial Review of MMI Fund as of FY 2000, report for the U.S. Department of Housing and Urban Development, January 2001.

metropolitan areas between 1999 and 2003, it is estimated that FHA insured 29 percent of all home loans originated for African-American and Hispanic borrowers.

(ii) Conventional and GSE Minority Lending. The affordable lending shares for the conventional conforming sector are low for minority borrowers, particularly African-American and Hispanic borrowers. These borrowers accounted for only 15.2 percent of all conventional conforming loans originated between 1999 and 2003, compared with 34.4 percent of FHA-insured loans and 19.2 percent of all loans originated in the total (government and conventional conforming) market. Not surprisingly, the minority lending performance of conventional lenders has been subject to much criticism. Recent studies contend that primary lenders in the conventional market are not doing their fair share of minority lending which forces minorities, particularly African-American and Hispanic borrowers, to rely on more costly FHA and subprime loans.[65] Thus, it appears that conventional lenders could be doing a better job helping minority borrowers obtain access to mortgage credit.

- The GSEs' funding of minority loans can be compared with mortgages originated for minority borrowers in the conventional conforming market, although the latter may be a poor benchmark, as discussed above. Between 1999 and 2003, home purchase loans to African-American and Hispanic borrowers accounted for 10.4 percent of Freddie Mac's purchases, 14.0 percent of Fannie Mae's purchases, and 15.2 percent of loans originated in the conventional conforming market (or 14.3 percent if B&C loans are excluded from the market definition). Thus, since 1999, the African-American and Hispanic share of the GSEs' purchases has been lower than the corresponding share for the conventional conforming market.[66]

- As the above comparisons show, Fannie Mae has had a much better record than Freddie Mac in funding loans for minority families. And Fannie Mae significantly increased its purchases of loans for African-American and Hispanic borrowers during 2001, raising the share of its purchases to market levels—13.7 percent for both Fannie Mae and the conforming market (without B&C loans). In 2002, Fannie Mae surpassed the conventional conforming market in funding African-American and Hispanic borrowers (a 15.8 percent share for Fannie Mae and a 15.0 share for the market), but in 2003 fell slightly behind the market (a 16.6 percent share for Fannie Mae and a 16.9 percent share for the market). When all minority borrowers are considered, Fannie Mae has purchased

[65] See Green and Associates, Fair Lending in Montgomery County: A Home Mortgage Lending Study, a report prepared for the Montgomery County Human Relations Commission, March 1998; and Calvin Bradford, Crisis in Déjà vu: A Profile of the Racial Patterns in Home Purchase Lending in the Baltimore Market. Report for The Public Justice Center, May 2000; and The Patterns of GSE Participation in Minority and Racially Changing Markets Reviewed from the Context of Levels of Distress Associated with High Levels of FHA Lending, GSE Study No. 11, U.S. Department of Housing and Urban Development, September 2000. For analysis suggesting some minorities receiving FHA loans could qualify for conventional loans, see Anthony Pennington-Cross, Anthony Yezer, and Joseph Nichols, Credit Risk and Mortgage Lending: Who Uses Subprime and Why? Working Paper No. 00-03. Research Institute for Housing America, 2000. Also see the series of recent studies concerning the lack of mainstream lenders in minority neighborhoods.

[66] For a comprehensive analysis of the GSEs' purchases of minority loans through 1999, see Harold L. Bunce, An Analysis of GSE Purchases of Mortgages for African-American Borrowers and their Neighborhoods, Housing Finance Working Paper No. 11, Office of Policy Development and Research, HUD, December 2000.

mortgages for minority borrowers at a higher rate (years 2001, 2002 and 2003) than these loans were originated by primary lenders in the conventional conforming market (without B&C loans). Freddie Mac, on the other hand, lagged behind both the market and Fannie Mae in funding loans for minority borrowers during 2001-2003, as well as during the entire 1999-to-2003 period. The share of Freddie Mac's purchases for African-American and Hispanic borrowers declined from 10.9 percent in both 2000 and 2001 to 10.1 percent in 2002 before rising slightly to 10.7 percent in 2003.

- Considering the minority census tract data reported in Table 4.1b, Fannie Mae lagged behind the conforming market (without B&C loans) in high-minority neighborhoods and in high-African-American neighborhoods during the 1999-to-2003 period. However, Fannie Mae improved its mortgage purchases in African-American neighborhoods after 2001 and essentially matched the market in 2001-2003. And during 2001, 2002 and 2003, Fannie Mae also purchased loans in high-minority census tracts at a higher rate than loans were originated by conventional lenders in these tracts. While Freddie Mac has generally lagged the primary market in funding minority neighborhoods, note in Table 4.1b that high African-American tracts increased from 3.9 percent of Freddie Mac's purchases in 2001 to 5.3 percent in 2002, placing Freddie Mac above the conventional conforming market level (4.6 percent) in 2002. However, in 2003, Freddie Mac fell behind the market.

(iii) Low-Income Lending by the GSEs. Information is also provided on the GSEs' purchases of home loans for low-income borrowers (4.1a) and for families living in low-income neighborhoods (4.1b). Historically, the GSEs have lagged behind the conventional conforming market in funding affordable loans for these groups. During the 1999-to-2003 period, low-income borrowers (census tracts) accounted for 27.4 (9.7) percent of Freddie Mac's purchases, 28.1 (10.1) percent of Fannie Mae's purchases, 29.1 (11.2) percent of loans originated by depositories, and 29.1 (11.1) percent of home loans originated by conventional conforming lenders (without B&C loans). By the end of this period, Fannie Mae had significantly improved its performance relative to the market. In 2003, low-income borrowers accounted for 31.0 percent of Fannie Mae's purchases, compared with 29.1 percent for the conforming market. It is also interesting that even though Freddie Mac lagged the market in funding home loans for low-income borrowers during 2002 (28.6 percent versus 29.2 percent), it surpassed the market in financing properties in low-income census tracts (11.3 percent versus 11.1 percent). During 2003, Freddie Mac's performance was again below the market in low-income census tracts (a 10.3 share for Freddie Mac and a 11.5 percent share for the market). A more complete analysis of the GSEs' recent improvements in purchasing home loans that qualify for the housing goals is provided below in Section E.

(iv) Depositories. Within the conventional conforming market, depository institutions (mainly banks and thrifts) are important providers of affordable lending for lower-income families and their neighborhoods.[67] Between 1999 and 2003, underserved areas accounted for

[67] Tables 4.1a, 4.1b, and 4,2 include data for all home loans originated by depositories as well as for the subset of loans originated but not sold, the latter being a proxy for loans held in depository portfolios. (See the notes to Table 4.1a for definitions of the depository data.)

26.9 percent of loans held in depository portfolios, which compares favorably with the underserved areas percentage (26.2 percent) for the overall conventional conforming market.[68] Depository lenders have extensive knowledge of their communities and direct interactions with their borrowers, which may enable them to introduce flexibility into their underwriting standards without unduly increasing their credit risk. The Community Reinvestment Act provides an incentive for banks and thrifts to initiate affordable lending programs with underwriting flexibility and to reach out to lower income families and their communities.[69] Many of the CRA loans are held in portfolio by lenders, rather than sold to Fannie Mae or Freddie Mac.[70]

(v) First-time Homebuyers. Market information on first-time homebuyers is not as readily available as the HMDA data reported in Tables 4.1a and 4.1b on the income and racial characteristics of borrowers and census tracts served by the mortgage market. However, the limited market data that are available from the American Housing Survey, combined with the first-time homebuyer data reported by FHA and the GSEs, indicate a rather large variation in the funding of first-time homebuyers across the different sectors of the mortgage market. Based on the American Housing Survey (AHS), it is estimated that first-time homebuyers accounted for 42.3 percent of all home purchase loans originated throughout the market between 1999 and 2001,[71] and for 37.6 percent of home loans originated in the conventional conforming market. The AHS defines a first-time homebuyer as someone who has never owned a home. Using a more liberal definition of a first-time homebuyer (someone who has not owned a home in the past three years), FHA reports that first-time homebuyers accounted for 80.5 percent of all home loans that it insured between 1999 and 2001 and the GSEs report that first-time homebuyers accounted for 26.5 percent of the home loans purchased by each GSE during that same period. Given FHA's low downpayment requirements, it is not surprising that FHA focuses on first-time homebuyers. The GSEs, on the other hand, fall at the other end of the continuum, with their first-time homebuyer share (26.5 percent) falling far short of the first-time homebuyer share (37.6 percent) of the conventional conforming market. Section E will include a more detailed comparison of the GSEs and the conventional conforming market in serving first-time homebuyers. In addition, Section E will conduct a market share analysis that examines the funding of minority first-time homebuyers. Consistent with the earlier discussion, that analysis suggests that conventional lenders and the GSEs have played a relatively small role in the market

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[68] However, as shown in Table 4.1a , depository institutions resemble other conventional lenders in their relatively low level of originating loans for African-American, Hispanic and minority borrowers. Within the conventional conforming market, Fannie Mae has done a better job than depositories in funding minority borrowers, particularly Hispanic borrowers and minority borrowers as a group. During the last three years, Fannie Mae has also funded African-American borrowers at a higher rate than have depository institutions.

[69] CRA loans are typically made to low-income borrowers earning less than 80 percent of area median income, and in moderate-income neighborhoods. For a comprehensive analysis of CRA and its impact on affordable lending, see Robert E. Litan, Nicolas P. Retsinas, Eric S. Belsky and Susan White Haag, The Community Reinvestment Act After Financial Modernization: A Baseline Report, U.S. Department of Treasury, 2000.

[70] Evidence is growing that CRA-type lending to low-income families can be profitable, particularly when combined with intensive loss mitigation efforts to control credit risk. In a survey conducted by the Federal Reserve, lenders reported that most CRA loans are profitable although not as profitable as the lenders' standard products. See Board of Governors of the Federal Reserve System. The Performance and Profitability of CRA-Related Lending. Washington, DC, 2000.

[71] In this case, the market includes all government and conventional loans, including jumbo loans.

for minority first-time homebuyers. One analysis reported in Section E estimates that mortgage purchases by the GSEs between 1999 and 2001 totaled 41.5 percent of all home loans originated, but they accounted for only 14.3 percent of home loans originated for first-time African-American and Hispanic homebuyers.

E. GSEs Compared with the Primary Conventional Conforming Mortgage Market

Section C above has provided an overview of the affordable lending market, highlighting the funding role of major sectors of the government and conventional mortgage markets. This section focuses on the GSEs' performance within the conventional conforming portion of the market, which is the portion of the market where the GSEs purchase loans. The purpose of this analysis is to examine how Fannie Mae and Freddie Mac have performed in funding single-family loans under the housing goals. The analysis will show that the GSEs have improved their performance and closed their gaps with the primary market, but there is room for further improvement if they are going to market leaders in funding single-family loans.

The section examines the extent to which the GSEs' loan purchases mirror or depart from the patterns found in the conventional conforming mortgage market. Dimensions of lending considered include the three "goals-qualifying" categories—special affordable borrowers, less-than-median income borrowers, and underserved areas. The special affordable category consists mainly of very-low-income borrowers, or borrowers who have an annual income less than 60 percent of area median income. Because this category is more targeted than the broadly-defined less-than-median-income (or low-mod) category, the discussion below will often focus on the special affordable category as well as the underserved areas category which adds a neighborhood dimension (low-income and high-minority census tracts) to the analysis. The analysis also compares the performance of Fannie Mae and Freddie Mac in funding first-time homebuyers with that of primary lenders in the conventional conforming market. The GSEs' performance is measured from loan-level data that they report to HUD, while information about the mortgage market is drawn mainly from Home Mortgage Disclosure Act (HMDA) data. Following earlier HUD research, this analysis focuses on home purchase loans, which are important for homeownership opportunities. However, to provide a complete picture of the GSEs' mortgage activity, much of the home purchase analysis is reproduced for total loans, which include refinance as well as home purchase loans. Most of the analysis is conducted at a very aggregate level, as the GSEs' purchases are reported for all metropolitan areas combined or for the entire U.S.[72]

There have been several studies by HUD staff and other researchers concerning the GSEs' performance in providing affordable lending under the housing goals.[73] These studies focus on

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[72] Other studies are beginning to examine the GSEs' mortgage purchases in individual metropolitan areas. For examples, see the 2001 issue of *Cityscape* referenced above and Bradford (2000b).

[73] See Bunce and Scheessele (1996, 1998), Bunce (2000, 2002), Canner and Gabriel (1992), Lind (1996a,b; 2000), Manchester (1998, 2002), Manchester *et al*. (1998), and U.S. Department of HUD (1996; 2000a,b). The GSE grant studies that HUD's Office of Policy Development and Research (PD&R) recently funded used a variety of data bases and analytical techniques to examine the GSEs' affordable lending performance. Five of the eleven grant studies are presented in a special 2001 issue—entitled *Fannie Mae and Freddie Mac in the Housing Finance*

whether or not the GSEs are "leading the market" in funding affordable loans. "Leading the market" is typically determined by comparing (a) the percentage of the GSEs' purchases accounted for by a particular affordable lending category (say loans for low-income families) with (b) the corresponding percentage for loans originated in the overall conventional conforming market. Most of these studies conclude that while the GSEs have significantly improved their affordable loan purchases under the housing goals, their performance has lagged that of primary lenders (such as banks and thrifts) in the overall conventional market.[74]

This section focuses on "distribution of business" percentages that measure how much each GSE has focused on first-time homebuyers and the groups covered by the housing goals, as compared with the primary conventional conforming market. For purposes of this Regulatory Analysis, the findings reported below will provide a measure of the impact of the housing goals on the affordable lending performance of the GSEs—for example, have the housing goals led to an improvement in the GSEs' purchases of home loans for targeted groups, and have the GSEs' performance improved relative to the primary market. Section E below will also provide a "market share" analysis that focuses on the GSEs' overall role in the low-income and first-time homebuyer mortgage markets. For purposes of this Regulatory Analysis, the "market share" analysis provides a measure of the room for further GSE growth in specific market segments. Those markets where the GSEs have a particularly low share may provide opportunities for further growth under the housing goals.

Because of the length of the analysis, this section includes only a summary of the main findings. Readers are referred to Appendix A of the Final Rule for the complete analysis.

Main Findings. There are three main findings from this analysis concerning the GSEs' purchases of single-family-owner mortgages:

1. While Freddie Mac has improved its affordable lending performance in recent years, it has consistently lagged the conventional conforming market in funding affordable home purchase loans for special affordable and low-moderate-income borrowers and underserved neighborhoods targeted by the housing goals.[75] In 2003, its performance on the underserved areas goal was particularly low relative to both the performances of Fannie Mae and the market; in that year, underserved area loans accounted for only 24.0

System: I—of PD&R's *Cityscape: A Journal of Policy Development and Research*. In that publication, see the overview of the studies by Gardner, *et al.* (2001) as well as the specific studies by Williams, McConnell and Nesiba (2001), McClure (2001), Boxall and Silver (2001), MacDonald (2001), and Pearce (2001). Also see Bradford (2000b) and Case and Gillen (2000)

[74] Fannie Mae and Freddie Mac each conduct similar analyses but reach different conclusions—they conclude that they match or exceed the primary market in funding affordable loans for lower-income families. Their analyses are reported in their comments on HUD's final GSE rule; see Fannie Mae (2000) and Freddie Mac (2000). See U.S. Department of Housing and Urban Development (2000b) for HUD's response to the GSEs' comments.

[75] The "affordable lending performance" of Fannie Mae and Freddie Mac refers to the performance of the GSEs in funding loans for low-income and underserved borrowers through their purchase (or guarantee) of loans originated by primary lenders. It does not, of course, imply that the GSEs themselves are lenders originating loans in the primary market.

percent of Freddie Mac's purchases compared with 26.8 percent of Fannie Mae's purchases and 27.6 percent of market originations.

2. In general, Fannie Mae's affordable lending performance has been better than Freddie Mac's. But like Freddie Mac, Fannie Mae's average performance during past periods (e.g., 1993-2003, 1996-2003, 1999-2003) has been below market levels. However, it is encouraging that Fannie Mae markedly improved its affordable lending performance relative to the market during 2001, 2002, and 2003, the first three years under the higher housing goal targets that HUD established in the GSE Final Rule dated October 2000. Over this three-year period, Fannie Mae led the primary market in funding special affordable and low-mod loans but lagged the market in funding underserved areas loans. In 2003, Fannie Mae's increased performance placed it significantly above the special affordable market (a 17.1 percent share for Fannie Mae compared with a 15.9 percent share for the market) and the low-mod market (a 47.0 percent share for Fannie Mae compared with a 44.6 percent share for the market). However, Fannie Mae continued to lag the underserved areas market in 2003 (a 26.8 percent share for Fannie Mae compared with a 27.6 percent share for the market). In this case, which is referred to in the text as the "purchase year" approach, Fannie Mae's performance is based on comparing its purchases of all loans (both seasoned loans and newly-originated mortgages) during a particular year with loans originated in the market in that year. When Fannie Mae's performance is measured on an "origination year" basis (that is, allocating Fannie Mae's purchases in a particular year to the year that the purchased loan was originated), Fannie Mae also led the 2003 market in funding special affordable and low- and moderate-income loans, and lagged the market in funding underserved area loans.

3. Both Fannie Mae and Freddie lag the conventional conforming market in funding first-time homebuyers, and by a rather wide margin. Between 1999 and 2001, first-time homebuyers accounted for 27 percent of each GSE's purchases of home loans, compared with 38 percent for home loans originated in the conventional conforming market.[76]

Specific Findings. This section presents 12 specific findings from the analyses reported in Sections E.7 through 12 of Appendix A of the Final Rule; they are grouped under the following five topic-headings:

(b.1) Longer-term Performance of the GSEs;
(b.2) Performance of the GSEs During Recent Years;
(b.3) The GSEs' Funding First-time Homebuyer Loans;
(b.4) Performance of the GSEs Based on Total (Home Purchase and Refinance) Loans;

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[76] As discussed in Appendix A of the Final GSE Rule, these first-time homebuyer numbers are taken from a study by Harold Bunce and John Gardner, entitled "First-time Homebuyers in the Conventional Conforming Mortgage Market – The Role of the GSEs" (January 2004). An updated paper by these authors shows that the results do not change much when data through 2003 are incorporated into the analysis. For example, between 2001 and 2003, first-time homebuyers accounted for approximately 26 percent of each GSE's purchases of home loans, compared with 39 percent for home loans originated in the conventional conforming market. See Harold Bunce and John Gardner, "First-time Homebuyers in the Conventional Conforming Mortgage Market – The Role of the GSEs: An Update" (October 2004).

E. 1. Longer-term Performance of the GSEs

The longer-run performance of the GSEs is examined between 1993 and 2003 (which covers the period since the housing goals were put into effect) and between 1996 and 2003 (which covers the period under the current definitions of the housing goals). Of the two borrower-income goals, the analysis below will typically focus on the special affordable category, which is a more targeted category than the rather broadly defined low- and moderate-income category.

(1) Since the early nineties, the mortgage industry has introduced new affordable lending programs and has allowed greater flexibility in underwriting lower-income loans. There is evidence that these programs are paying off in terms of more mortgages for low-income and minority borrowers. As noted earlier, Fannie Mae and Freddie Mac have played an active role in this upsurge of affordable lending, as indicated by the high growth rates of their goals-qualifying business.

- Between 1993 and 2003, the GSEs' purchases of home loans in metropolitan areas increased by 60 percent.[77] Their purchases of home loans for the three housing goals increased at much higher rates—287 percent for special affordable loans, 156 percent for low- and moderate-income loans, and 121 percent for loans in underserved census tracts.

(2) Both Fannie Mae and Freddie Mac have improved their purchases of affordable loans since the housing goals were put in place, as indicated by the increasing share of their business going to the three goals-qualifying categories.

- Between 1992 and 2003, the special affordable share of Fannie Mae's business almost tripled, rising from 6.3 percent to 17.1 percent, while the underserved areas share increased more modestly, from 18.3 percent to 26.8 percent. The figures for Freddie Mac are similar. The special affordable share of Freddie Mac's business rose from 6.5 percent to 15.6 percent, while the underserved areas share also increased but more modestly, from 18.6 percent to 24.0 percent.

(3) While both GSEs improved their performance, they have lagged the primary market in providing affordable loans to low-income borrowers and underserved neighborhoods. Freddie Mac's average performance, in particular, fell far short of market performance during the 1990s. Fannie Mae's average performance was better than Freddie Mac's during the 1993-2003 period as well as during the 1996-2003 period, which covers the period under HUD's currently-defined housing goals.

- Between 1993 and 2003, 12.2 percent of Freddie Mac's mortgage purchases were for special affordable borrowers, compared with 13.3 percent of Fannie Mae's purchases,

[77] Throughout this analysis, the terms "home loan" and "home mortgage" will refer to a "home purchase loan," as opposed to a "refinance loan." As noted earlier, the mortgage data reported in this paper are for metropolitan areas, unless stated otherwise. Restricting the GSE data to metropolitan areas is necessary to make it comparable with the HMDA-reported conventional primary market data, which is more reliable for metropolitan areas. The analysis of first-time homebuyers in Sections E.9 and E.12 cover both metropolitan and non-metropolitan areas.

15.4 percent of loans originated by depositories, and 15.5 percent of loans originated in the conventional conforming market (without estimated B&C loans).[78]

- Considering the underserved areas category for the 1996-2003 period, 22.0 percent of Freddie Mac's purchases financed properties in underserved neighborhoods, compared with 24.0 percent of Fannie Mae's purchases, 25.1 percent of loans originated by depositories, and 25.7 percent of loans originated in the conventional conforming market.

E.2. Performance of the GSEs During Recent Years

The recent performance of the GSEs is examined for the four-year period between 1999 and 2003 and then for 2001, 2002, and 2003, which were the first three years that the GSEs operated under the higher goal targets established by HUD in the 2000 Rule. As explained below, the most interesting recent trend concerned Fannie Mae, which improved its performance during 2001-2003, at a time when the conventional conforming market was showing little change in affordable lending.

(4) During the recent 1999-to-2003 period, both Fannie Mae and Freddie Mac fell significantly below the market in funding affordable loans.

- Between 1999 and 2003, special affordable loans accounted for 15.1 percent of Fannie Mae's purchases, 14.7 percent of Freddie Mac's purchases, and 16.2 percent of loans originated in the market; thus, the "Fannie-Mae-to-market" ratio was 0.93 and the "Freddie-Mac-to-market" ratio was also 0.91.

- During the same period, underserved area loans accounted for 24.7 percent of Fannie Mae's purchases, 23.1 percent of Freddie Mac's purchases, and 26.2 percent of loans originated in the market; the "Fannie-Mae-to-market" ratio was 0.94 and the "Freddie-Mac-to-market" ratio was only 0.88.[79]

(5) After experiencing declines from 1997 to 1999, Fannie Mae's affordable lending performance improved between 2000 and 2003.

- After declining from 23.0 percent in 1997 to 20.4 percent in 1999, the share of Fannie Mae's purchases financing properties in underserved areas jumped by three percentage points to 23.4 percent in 2000, and then increased further to 26.7 percent in 2002 and 26.8 percent in 2003.

[78] Unless otherwise noted, the conventional conforming market data reported in this section exclude an estimate of B&C loans; the less-risky A-minus portion of the subprime market is included in the market definition. See Section E.7 and Appendix D for a discussion of primary market definitions and the uncertainty surrounding estimates of the number of B&C loans in HMDA data. As noted there, B&C loans are much more likely to be refinance loans rather than home purchase loans.

[79] Fannie Mae had a particularly poor year during 1999. Therefore, the text also reports averages for 2000-2003, dropping the year 1999 (see Table A.13 in Section E.9).

- After declining from 13.2 percent in 1998 to 12.5 percent in 1999, the share of Fannie Mae's purchases going to special affordable loans rebounded to 13.3 percent in 2000, 14.9 percent in 2001, 16.3 percent in 2002 and 17.1 percent in 2003.

(6) Freddie Mac's performance on the two borrower-income categories improved between 2000 and 2002, but not as much as Fannie Mae's performance. Freddie Mac's performance on the underserved areas category increased substantially between 2001 and 2002, but then declined between 2002 and 2003.

- The share of Freddie Mac's single-family-owner business going to special affordable home loans increased from 9.2 in 1997 to 14.7 percent in 2000 before falling to 14.4 percent in 2001 and rising to 15.8 percent in 2001 and 15.6 percent in 2003.

- Freddie Mac's purchases of underserved area loans increased at a modest rate from 19.7 percent in 1997 to 22.3 percent in 2001, before jumping to 25.8 percent in 2002 and then dropping to 24.0 percent in 2003.

(7) The long-standing pattern of Fannie Mae outperforming Freddie Mac was reversed during 1999 and 2000. But that pattern returned in 2001-2003 when Fannie Mae outperformed Freddie Mac on all three goals-qualifying categories.

- Fannie Mae and Freddie Mac had practically the same performance in 1992 on the three housing goal categories—special affordable loans accounted for 6.3 percent of Fannie Mae's purchases and 6.5 percent of Freddie Mac's purchases, for a "Fannie-Mae-to-Freddie-Mac" ratio of 0.97. The 1992 ratio for underserved areas was also 0.98 and that for low-mod, 1.02. Reflecting Fannie Mae's much better performance, the special affordable "Fannie-Mae-to-Freddie-Mac" ratio had risen to 1.27 by 1997, the underserved area ratio to 1.17, and the low-mod ratio to 1.10.

- However, in 1999, the "Fannie-Mae-to-Freddie-Mac" ratio for each of the three goals-qualifying categories fell to slightly below one. 1999 was the first year since 1992 that Freddie Mac had outperformed Fannie Mae in purchasing affordable home loans (although only by a very slight margin).

- In 2000, Freddie Mac's sharper increases in special affordable and low-mod purchases further reduced the "Fannie-Mae-to-Freddie-Mac" ratios for these two categories to 0.90 and 0.96, respectively. Fannie Mae's sharper increase in underserved areas funding resulted in the "Fannie-Mae-to-Freddie-Mac" ratio rising from slightly below one (0.98) in 1999 to 1.06 in 2000.

- Fannie Mae's stronger performance during 2001-2003 returned the "Fannie-Mae-to-Freddie-Mac" ratios for special affordable and low-mod loans to above one (1.10 and 1.07 respectively), indicating better performance for Fannie Mae in 2003. The "Fannie-Mae-to-Freddie-Mac" ratio for the underserved area category increased to 1.12 by 2003.

(8) While Freddie Mac has consistently improved its performance relative to the market, it continued to lag the market in funding affordable home loans during 2001-2003.

- Unlike Fannie Mae, Freddie Mac had not made any progress through 1997 in closing its gap with the market. The "Freddie Mac-to-market" ratio for the special affordable category actually declined from 0.63 in 1992 to 0.59 in 1996. But Freddie Mac's sharp improvement in special affordable purchases resulted in the "Freddie-Mac-to-market" ratio rising to 0.89 by 2000. After declining from 0.84 in 1992 to 0.79 in 1997, the "Freddie-Mac-to-market" ratio for underserved areas had risen only modestly to 0.84 by the year 2000. Thus, Freddie Mac's improvements prior to 2001 allowed it to close its gap with the market, mainly for the special affordable category where its gap had been the widest.

- During 2001, 2002 and 2003, Freddie Mac continued to close its gap with the market on the special affordable and low-mod categories. By 2003, these "Freddie-Mac-to-market" ratios were higher than in 2000, although they both continued to fall below one: at 0.98 for both categories. Between 2002 and 2003, Freddie Mac's market ratio for underserved areas fell from 0.98 to 0.87 (24.0 percent for Freddie Mac and 27.6 percent for Fannie Mae). Thus, during 2003, Freddie Mac lagged the market on all three goals-qualifying categories.

(9) Through 1998, Fannie Mae had significantly improved its performance relative to the market. But as a result of shifts in its purchases of affordable loans, Fannie Mae lagged the market even further in 2000 than it had in some earlier years. During 2001-2003, Fannie Mae again improved its performance relative to the market and, in 2003, Fannie Mae led the special affordable and low-mod markets but lagged the underserved areas market.

- The above analysis and the data reported under this specific finding (9) are based on the "purchase year" approach for measuring GSE activity. The purchase year approach assigns GSE purchases of both prior-year (seasoned) and newly-originated mortgages to the calendar year in which they were purchased by the GSE; this results in an inconsistency with the HMDA-reported market data, which covers only newly-originated mortgages. Sections E.9 and E.10 also report the results of an alternative "origination year" approach that assigns GSE purchases to their year of origination, placing them on a more consistent basis with the HMDA-reported market data. The findings from the origination-year approach are discussed under specific finding (10).

- Fannie Mae's decline in performance during 1999 resulted in the "Fannie-Mae-to-market" ratio falling sharply to 0.74 for special affordable, to 0.81 for underserved areas and to 0.89 for low-mod. In 2000, Fannie Mae improved and reversed its declining trend, as the "Fannie-Mae-to-market" ratios increased to 0.80 for special affordable purchases, to 0.89 for underserved area purchases, and to 0.93 for low-mod purchases.

- During 2001, Fannie Mae increased its special affordable percentage by 1.6 percentage points to 14.9 percent, which was only 0.7 percentage point below the market's performance of 15.6 percent. Fannie Mae increased its low-mod percentage from 40.8 percent to 42.9 percent at the same time that the low-mod share of the primary market was falling from 43.9 percent to 42.9 percent, placing Fannie Mae at the market's performance. Similarly, Fannie Mae increased its underserved area percentage from 23.4 percent in 2000 to 24.4 in 2001 percent while the underserved area share of the primary market was falling from 26.2 percent to 25.2 percent, placing Fannie Mae at 0.8 percentage point from the market's performance.

- During 2002, Fannie Mae continued to improve its performance on all three goals categories. Using the purchase-year approach to measure GSE performance, Fannie Mae slightly led the market on the special affordable category (16.3 percent for Fannie Mae and 16.1 percent for the market), led the market on the low-mod category (45.3 percent for Fannie Mae compared with 44.6 percent for the market), and led the market on the underserved area category (26.7 percent for Fannie Mae versus 26.3 percent for the market).

- During 2003, Fannie Mae's further improvement resulted in Fannie Mae leading the special affordable market (17.1 percent for Fannie Mae compared with 15.9 percent for the market) and continuing to lead the low-mod market (47.0 percent for Fannie Mae compared with 44.6 percent for the market). During 2003, Fannie Mae lagged behind the underserved areas market (26.8 percent for Fannie Mae compared with 27.6 percent for the market).

(10) This analysis addresses several technical issues involved in measuring GSE performance. The above analysis was based on the "purchase year" approach, as defined in (9) above. An alternative "origination year" approach has also been utilized, which assigns GSE purchases to their year of origination, placing them on a more consistent basis with the HMDA-reported market data. While the average results (e.g., 1999-2003 GSE performance) are similar under the two reporting approaches, GSE performance in any particular year can be affected, depending on the extent to which the GSE has purchased goals-qualifying seasoned loans in that particular year.

- The choice of which approach to follow particularly affected conclusions about Fannie Mae's performance relative to the market in 2002. Under the origination-year approach, Fannie Mae lagged the market on all three housing goal categories during 2001 and on the underserved area category during 2002. In 2002, Fannie Mae matched the market on the special affordable category and led the market on the low-mod category (45.5 percent for Fannie Mae compared with 44.6 percent of the market).

- During 2003, the origination year approach gives the similar results as the purchase year approach – Fannie Mae led the special affordable and low-mod markets and lagged the underserved areas market.

E.3. The GSEs' Funding of First-time Homebuyer Loans

(11) The GSEs' funding of first-time homebuyers has been compared to that of primary lenders in the conventional conforming market. Both Fannie Mae and Freddie lag the market in funding first-time homebuyers, and by a rather wide margin.

- First-time homebuyers account for 27 percent of each GSE's purchases of home loans, compared with 38 percent for home loans originated in the conventional conforming market.

E.4. Performance of the GSEs Based on Total (Home Purchase and Refinance) Loans

(12) The GSEs' acquisitions of total loans (including refinance loans as well as home purchase loans) were also examined. The main results indicate (a) Freddie Mac has improved its performance but has consistently lagged the market in funding loans (home purchase and refinance) that qualify for the housing goals; and (b) Fannie Mae has not only improved its performance but matched the low-mod market in 2001 and 2002 and led both the special affordable and low-mod markets in 2003. Fannie Mae, however, lagged the primary market in funding underserved areas during 2003.

- <u>1999–2003</u>. During the recent 1999-to-2003 period, both Fannie Mae and Freddie Mac fell significantly below the market in funding affordable total (home purchase and refinance) loans. Between 1999 and 2003, special affordable loans accounted for 14.0 percent of Fannie Mae's purchases, 13.2 percent of Freddie Mac's purchases, and 15.6 percent of loans originated in the market; thus, the "Fannie-Mae-to-market" ratio was 0.93 and the "Freddie-Mac-to-market" ratio was 0.88 during this period.

- During the same period, underserved area loans accounted for 23.8 percent of Fannie Mae's purchases, 22.1 percent of Freddie Mac's purchases, and 25.2 percent of loans originated in the market; thus, the "Fannie-Mae-to-market" ratio was 0.94 and the "Freddie-Mac-to-market" ratio was 0.88. [80]

- <u>2002 and 2003.</u> During 2002, the first of these two years of heavy refinancing, Fannie Mae's performance was slightly above the market on the low-mod category and slightly below market performance on the special affordable and underserved areas categories; essentially, Fannie Mae matched the market on all three categories in 2002. In 2003, Fannie Mae led the market on the special affordable and low-mod categories and lagged the market on the underserved areas category. The 2003 "Fannie-Mae-to-market" ratios were 1.02 for special affordable loans, 1.03 for low-mod loans, and 0.97 for underserved area loans. In 2003, the "Freddie-Mac-to-

[80] As explained in Section E.9, deducting B&C loans from the market totals has more impact on the market percentages for total (both home purchase and refinance) loans than for only home purchase loans. The effects of excluding B&C loans from the total market can be seen by comparing the third and sixth columns of data in Table A.19 in Section E.10.

market" ratios were much lower lower: 0.86 for special affordable loans, 0.90 for low-mod loans, and 0.82 for underserved area loans.

F. GSE Market Shares: Home Purchase and First-Time Homebuyer Loans

F.1. Introduction

This section examines the role that the GSEs have played in the overall affordable lending market for home loans. The analysis focuses on "market share" percentages rather than "distribution of business" percentages. A "market share" percentage measures the share of loans with a particular borrower or neighborhood characteristic that is funded by a particular market sector (such as FHA or the GSEs). In other words, a "market share" percentage measures a sector's share of all home loans originated for a particular targeted group. The "market share" of a sector depends not only on the degree to which that sector concentrates its business on a targeted group (i.e., its "distribution of business" percentage) but also on the size, or overall mortgage volume, of the sector. If an industry sector has a large "market share" for a targeted group, then that sector is making an important contribution to meeting the credit needs of the group. Both "distribution of business" and "market share" data are important for evaluating the GSEs' performance. In fact, given the large size of the GSEs, one would expect that a "market share" analysis would highlight their importance to the affordable lending market. For purposes of this Regulatory Analysis, the "market share" analysis also provides a measure of the room for further GSE growth in specific market segments. Those markets where the GSEs have a particularly low share may provide opportunities for further growth under the housing goals.

Because of the length of the analysis, this section includes only a summary of the main findings. Appendix A of the Final Rule presents the detailed analysis.

Main Findings: GSE Market Shares. While the GSEs have accounted for a large share of the overall market for home purchase loans, they have accounted for a very small share of the market for important groups such as minority first-time homebuyers. But as this section documents, the GSEs have been increasing their share of the low-income and minority market. There are three sets of main findings in this section:

1. The GSEs have accounted for a significant share of the total (government as well as conventional) market for home purchase loans, but their market share for each of the affordable lending categories (e.g., low-income borrowers and census tracts) has been less than their share of the overall market.

2. The GSEs also account for a very small share of the market for important groups such as minority first-time homebuyers. Considering the total mortgage market (both government and conventional loans), it is estimated that the GSEs purchased only 14 percent of loans originated between 1999 and 2001 for African-American and Hispanic first-time homebuyers, or one-third of their share (42 percent) of all home purchase loans originated during that period. Considering the conventional conforming market and the same time period, it is estimated that the GSEs purchased

only 31 percent of loans originated for African-American and Hispanic first-time homebuyers, or about one-half of their share (57 percent) of all home purchase loans in that market.

3. The GSEs' small share of the first-time homebuyer market could be due to the preponderance of high (over 20 percent) downpayment loans in their mortgage purchases.

F.2. Specific Findings: GSE Market Shares

(1) The GSEs account for a significant share of the total (government as well as conventional conforming) market for home purchase loans. However, the GSEs' market share for each of the affordable lending categories is much less than their share of the overall market.

- The GSEs' purchases were estimated to be 46 percent of all home loans originated in metropolitan areas between 1999 and 2003 but only 30 percent of loans originated for African-American and Hispanic borrowers, 38 percent of loans originated for low-income borrowers, and 37 percent for properties in underserved areas. The GSEs' market share for the various affordable lending categories increased during 2001-2003, but the above-mentioned pattern remained.

- A study by staff from the Federal Reserve Board suggests that the GSEs have a much more limited role in the affordable lending market than is suggested by the data presented above.[81] The Fed study, which combined market share, downpayment, and default data, concluded that the GSEs play a very minimal role in providing credit support and assuming credit risk for low-income and minority borrowers; for example, the study concluded that in 1995 the GSEs provided only four percent of the credit support going to African-Americans and Hispanic borrowers.

- Section V of this study begins to reconcile these different results by examining the role of the GSEs in the first-time homebuyer market and the downpayment characteristics of mortgages purchased by the GSEs.

(2) The market role of the GSEs appears to be particularly low in important market segments such as minority first-time homebuyers.

- Recent analysis has estimated that the GSEs' share of the market for first-time African-American and Hispanic homebuyers was only 14.3 percent between 1999 and 2001, or about one-third of their share (41.5 percent) of all home purchases

[81] See Glenn B. Canner, Wayne Passmore, and Brian J. Surette, "Distribution of Credit Risk Among Providers of Mortgages to Lower-Income and Minority Homebuyers" in *Federal Reserve Bulletin*, 82(12): 1077-1102, December, 1996.

during that period. This analysis includes the total market, including government and conventional loans.

- A similar market share analysis was conducted for the conventional conforming market. Between 1999 and 2001, the GSEs' purchases accounted for 56.6 percent of all home loans originated in the conventional conforming market of both metropolitan areas and non-metropolitan areas. Their purchases of first-time homebuyer loans, on the other hand, accounted for only 39.8 percent of all first-time homebuyer loans originated in that market.

- The GSEs have funded an even lower share of the minority first-time homebuyer market in the conventional conforming market. Between 1999 and 2001, the GSEs purchases of African-American and Hispanic first-time homebuyer loans represented 30.9 percent of the conventional conforming market for these loans. Thus, while the GSEs have accounted for 56.6 percent of all home loans in the conventional conforming market, they have accounted for only 30.9 percent of loans originated in that market for African-American and Hispanic first-time homebuyers.

(3) A noticeable pattern among the lower-income-borrower loans purchased by the GSEs is the predominance of loans with high downpayments. This pattern of purchasing mainly high downpayment loans is one factor explaining why the Fed study found such a small market role for the GSEs. It may be the explanation for the small role of Fannie Mae and Freddie Mac in the first-time homebuyer market. Further study of this issue is needed.

- During 2001 and 2002, approximately 50 percent of Fannie Mae's special affordable, low-mod, and underserved areas loans had downpayments of at least 20 percent, a percentage only slightly smaller that the corresponding percentage (53 percent) for all Fannie Mae's home loan purchases. Similar patterns of above-20-percent downpayments on goals-qualifying loans were evident in Freddie Mac's 2001, 2002, and 2003 purchases, as well as in prior years for both GSEs. During 2003, Fannie Mae's high downpayment share of their special affordable purchases dropped to 45 percent while the patterns for Fannie Mae's low-mod and underserved area purchases did not change, remaining about 50 percent.

G. Impacts of the Housing Goals

Earlier sections have discussed the fact that some low-income families and underserved neighborhoods are not receiving the full benefits of low-cost home financing that can be obtained through the GSEs' activities in the secondary mortgage market. The housing goals are designed to encourage the GSEs to reach out to low-income families and underserved neighborhoods. This section examines the success of the housing goals in raising the shares of the GSEs' loans to families targeted by the income-based goals. It identifies areas where the housing goals appear to be having positive impacts, but others where the impacts are not as apparent. HUD intends that the final new housing goals will further encourage the GSEs to do more to benefit families targeted by the goals.

This section is organized as follows. The first subsection compares the GSEs' combined performance on the three broad goals for 1996-2002 and calculates the corresponding increase in the number of families targeted by the income-based goals over this period, recognizing that other factors besides the goals have played a role in this development. The second subsection adjusts the GSEs' performance for changes in the mix between home purchase loans and refinance loans and highlights recent developments in their acquisitions of home purchase loans. The next three subsections focus on changes in the GSEs' underwriting guidelines, their new products, and their partnership activities. The last two subsections summarize the GSE role in the CRA and subprime markets.

G.1. Trends in Goal Performance

The combined performances of the GSEs on the three broad goals for 1996-2003 are shown in Figures 4.1 through 4.3. These results are based on HUD's analysis of the GSEs' loan-level data for those years.

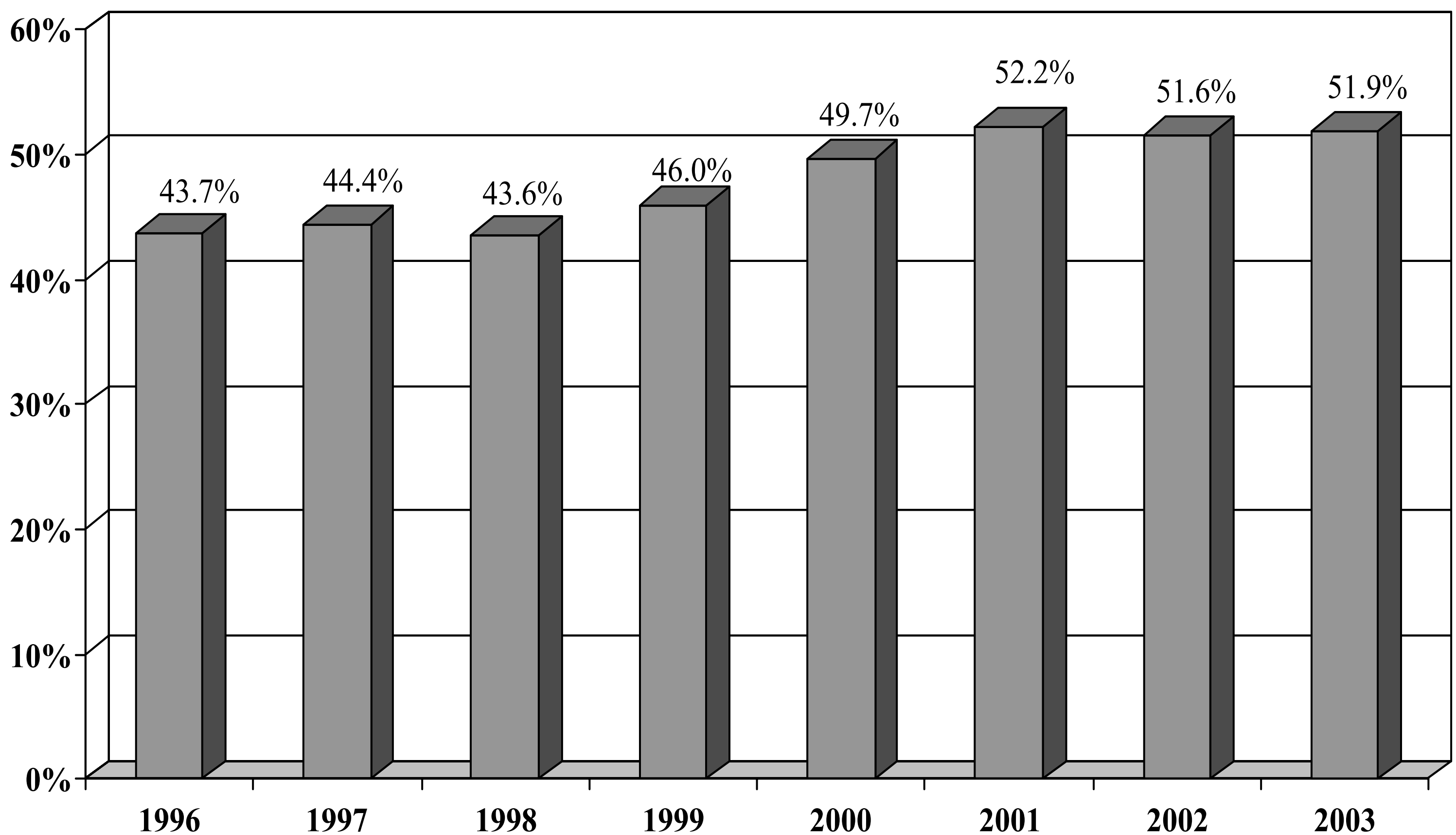
FIGURES 4.1, 4.2, AND 4.3

Low- and Moderate-Income Goal. The GSEs' combined performance on the low- and moderate-income goal rose from 43.7 percent in 1996, before the current goals took effect, to 46.0 percent in 1999, 49.7 percent in 2000, 52.2 percent in 2001, 51.6 percent in 2002, and 51.9 percent in 2003, as shown in Figure 4.1. However, as discussed in Appendix A of the final GSE Rule, performance in 2001-03 is not strictly comparable with performance in 1996-2000, due to counting rule changes adopted in 2000, including the application of bonus points for purchases of goal-qualifying mortgages on small multifamily properties and owner-occupied 2-4 unit properties for both GSEs and, for Freddie Mac only, application of the temporary adjustment factor (TAF) for purchases of goal-qualifying mortgages on large multifamily properties.

As shown in Table A.9 of the final GSE Rule, measured on a consistent basis, both GSEs' performance on the low-mod goal peaked in 2000. Without the application of bonus points and the TAF, the GSEs' combined performance on the low-mod goal in 2003 would have been 47.3 percent, lower than peak combined performance in 2000 (49.7 percent), but still much higher than combined performance in 1996 (43.7 percent).[82] Thus, in 2003 an additional 538,000 low-mod units were financed above the number that would have been financed on 2003 volume if combined performance had remained at the 1996 percentage level—this amounted to 8 percent of the 7.0 million low-mod units financed by the GSEs in 2003.

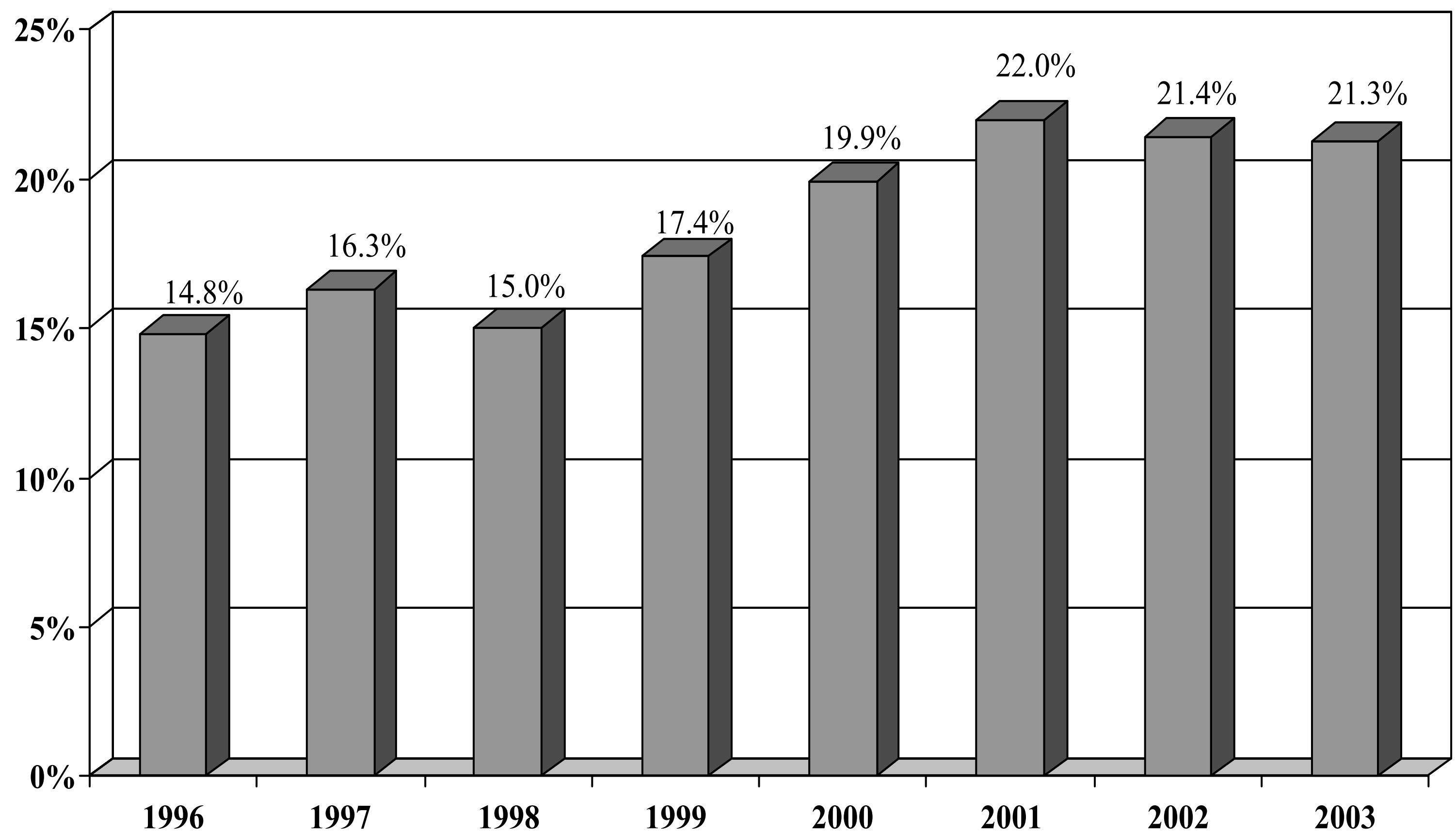
[82] These calculations do not adjust for technical changes in counting rules that took effect in 2000.

Figure 4.1
Growth in Fannie Mae and Freddie Mac Purchases of Mortgages for Low- and Moderate-Income Families



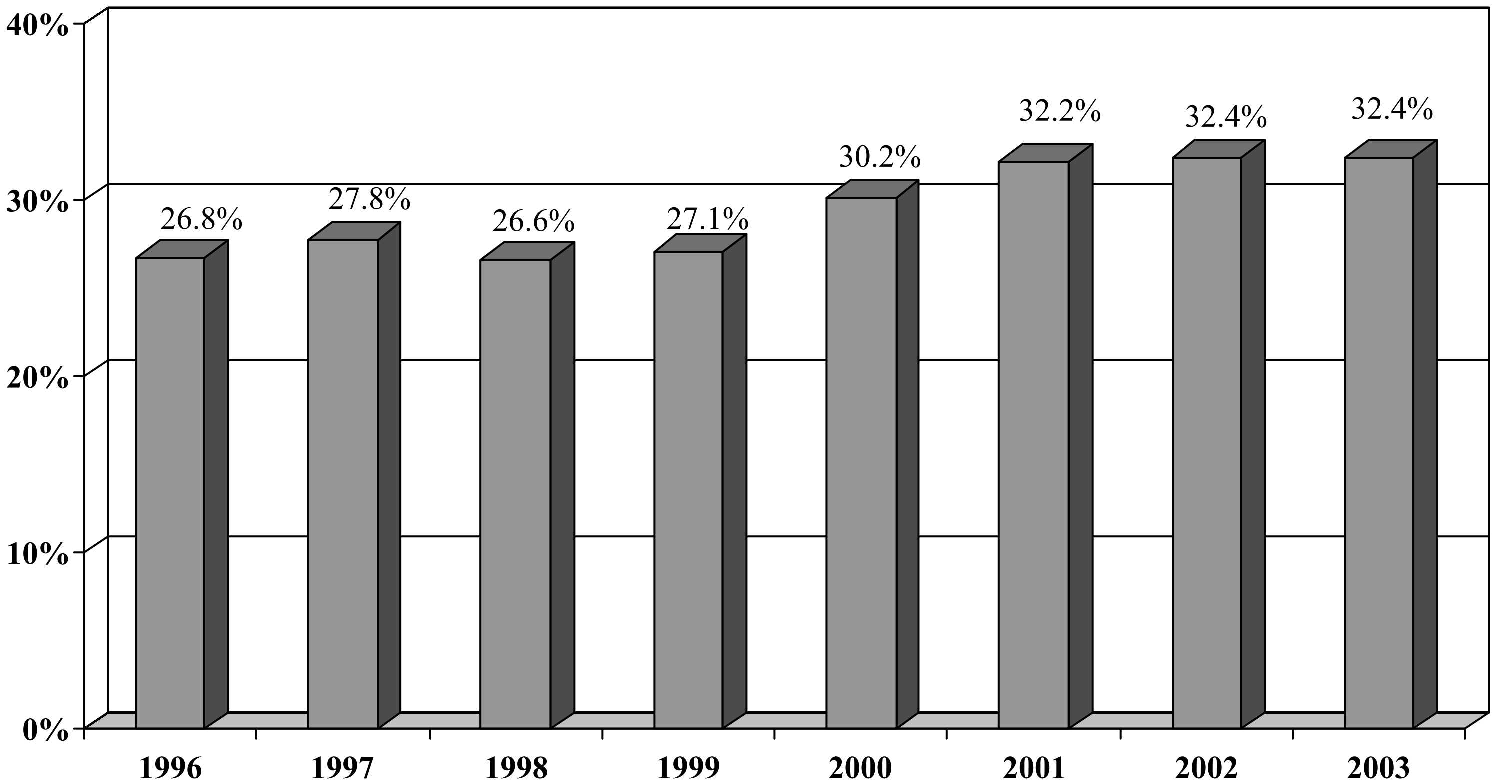
Note: Low- and moderate-income refers to families with less-than-area-median income. In 2003, 51.9 percent of Fannie Mae and Freddie Mac combined purchases of mortgages for owner and rental properties were for low- and-Moderate-income families. Performance in 2001-03 is not strictly comparable with performance in 1996-2000 due to changes in goal counting rules that took effect in 2001.

Figure 4.2
Growth in Fannie Mae and Freddie Mac Purchases of Special Affordable Mortgages



Note: Special affordable refers to very low-income families and low-income families living in low-income areas. In 2003, 21.3 percent of Fannie Mae's and Freddie Mac's combined purchases of mortgages for owner and rental properties were for special affordable families. Performance in 2001-03 is not strictly comparable with performance in 1996-2000 due to changes in goal counting rules that took effect in 2001.

Figure 4.3
Growth in Fannie Mae and Freddie Mac Purchases of Underserved Areas Mortgages



Note: Underserved Areas are metropolitan census tracts and nonmetro counties that have low incomes or large minority populations, and which have experienced high mortgage denial rates and low mortgage origination rates. In 2003, 32.4 percent of Fannie Mae's and Freddie Mac's combined purchases of mortgages for owner and rental properties were on properties in underserved areas. Performance in 2001-03 is not strictly comparable with performance in 1996-2000 due to changes in goal counting rules that took effect in 2001.

Special Affordable Goal. The GSEs' combined performance on the special affordable goal rose from 14.8 percent in 1996, before the current goals took effect, to 17.4 percent in 1999, 19.9 percent in 2000, 22.0 percent in 2001, 21.4 percent in 2002, and 21.3 percent in 2003, as shown in Figure 4.2. However, as discussed above, performance in 2001-03 is not strictly comparable with performance in 1996-2000, due to counting rule changes adopted in 2000.

As shown in Table C.2 of the final GSE Rule, measured on a consistent basis, both GSEs' performance on the special affordable goal peaked in 2000. Without the application of bonus points and Freddie Mac's temporary adjustment factor, the GSEs' combined performance on the special affordable goal in 2003 would have been 18.8 percent, lower than peak combined performance in 2000 (19.9 percent), but still much higher than combined performance in 1996 (14.8 percent). Thus, in 2003 an additional 586,000 special affordable units were financed above the number that would have been financed on 2003 volume if combined performance had remained at the 1996 percentage level—this amounted to 21 percent of the 2.8 million special affordable units financed by the GSEs in 2003.

Underserved Areas Goal. The GSEs' combined performance on the underserved areas goal was 26.8 percent in 1996 and remained at approximately the same level for 1997 through 1999, as shown in Figure 4.3. Combined performance jumped significantly in 2000 to 30.0 percent, and was 32.2 percent in 2001 and 32.4 percent in both 2002 and 2003. However, as discussed above, performance in 2001-03 is not strictly comparable with performance in 1996-2000, due to counting rule changes adopted in 2000.

As shown in Table B.7a of the final GSE Rule, measured on a consistent basis excluding the effects of bonus points and Freddie Mac's TAF, under one measure both GSEs' performance on the underserved areas goal peaked in 2000. On that basis, as shown by Baseline B in Table B.7a, Fannie Mae's underserved areas goal performance fell slightly, from 31.0 percent in 2000 to 30.4 percent in 2001, 30.1 percent in 2002 and 29.2 percent in 2003, while Freddie Mac's performance also fell slightly, from 29.2 percent in 2000 to 28.2 percent in 2001, 28.4 percent in 2002, and 27.7 percent in 2003. However, performance for both GSEs continued to increase in 2001-03 on an alternative consistent basis, as shown by Baseline C in Table B.7a. Under this measure, Fannie Mae's performance rose modestly, from 32.3 percent in 2000 to 32.6 percent in 2001, 32.8 percent in 2002, and 32.1 percent in 2003, while Freddie Mac's performance also rose modestly, from 31.4 percent in 2000 to 31.7 percent in 2001, 31.9 percent in 2002, and 32.7 percent in 2003. The different conclusions on the trend in underserved area goal performance between 2000 and 2003 arise from the fact that both enterprises stepped up their purchases of mortgages on small multifamily and owner-occupied 2-4 unit family properties in underserved areas over this period. Thus the bonus points for purchases of qualifying mortgages in these two categories added much more to performance in 2003 than they would have added if they had been in effect in 2000.

In any case it is clear that both GSEs played a larger role in financing properties in underserved areas in 2003 than they did in 1996. That is, combined performance on the underserved areas goal was 26.8 percent in 1996, and it would have been 28.7 percent in 2003 without the application of bonus points and the TAF. Thus, in 2003 an additional 281,000 underserved area units were financed above the number that would have been financed on 2003 volume if combined performance had remained at the 1996 percentage level—this amounted to 6 percent of the 4.3 million underserved area units financed by the GSEs in 2003.

G.2. Characteristics of Home Purchase Mortgages Acquired

One factor, which may affect goal performance, is the breakdown of the single-family mortgage market between mortgages for the purchase of a home and loans to refinance an existing mortgage. In some years the goal-qualifying percentage of home purchase loans on owner-occupied 1-unit mortgages has been significantly higher than the corresponding percentage of refinance mortgages. In this situation, goal performance can vary over time simply due to changes in the shares of mortgages for home purchase and for refinancing.

Table 4.3 presents data for home purchase mortgages only.[83] This table presents the shares of such mortgages for various income and racial/ethnic groups and neighborhoods over the 1996-2003 period. As indicated, the trends are mixed. For very low-income borrowers, major gains were made in the 1996-98 period, but these were partially reversed over the next several years, thus their share of purchase mortgages for the GSEs combined rose from 7 percent in 1996 to 13 percent in 1998, before falling back to 11 percent in 1999.[84] There was a divergence between the GSEs in the changes in very low-income shares of their home purchase mortgages between 1999 and 2000, with a further gain by Freddie Mac, but a decline for Fannie Mae. As a result, the share of Freddie Mac's home purchase loans to this group (12.1 percent) exceeded the corresponding share for Fannie Mae (11.1 percent) for the first time. The very low-income shares rose to record levels for both GSEs in 2002, with a further increase for Fannie Mae in 2003, thus for the 1996-2003 period there were major increases in the shares of both GSEs' loans for this group. A similar pattern prevailed for low-income census tracts, with major gains in their shares over the 1996-98 period, followed by significant declines in 1999. Gains were made again in 2000-01, and especially in 2002. Thus the low-income tract shares reached record levels for both GSEs in 2002, and Freddie Mac surpassed Fannie Mae in the share of its loans in this category for only the second time. This pattern was reversed in 2003, with the low-income tract shares falling for both GSEs, and Fannie Mae again surpassing Freddie Mac in this area.

TABLE 4.3

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[83] This table is adapted and updated from Table 4.13 of Paul B. Manchester, *Goal Performance and Characteristics of Mortgages Purchased by Fannie Mae and Freddie Mac, 1998-2000,* Working Paper No. HF-015, Working Papers in Housing Finance, Department of Housing and Urban Development, May 2002. The table excludes the GSEs' purchases of government-backed loans. The analysis in this section includes all GSE acquisitions of conventional home purchase loans, on properties in both metropolitan and non-metropolitan areas.

[84] Comparisons of the shares of the GSEs' mortgage purchases for various types of borrowers and various locations are contained in the Appendix to this chapter. These comparisons are made for 1993-98—market data for 1999 was not available when this analysis was prepared.

Table 4.3

Trends in the Characteristics of Home Purchase Loans Acquired by the GSEs, 1996-2003[1]

Characteristic	1996	1997	1998	1999	2000	2001	2002	2003
Very-Low-Income Borrowers[2]								
Fannie Mae	8.3 %	9.5 %	13.3 %	11.4 %	11.1 %	12.4 %	13.7 %	14.4 %
Freddie Mac	7.3	7.4	12.8	11.0	12.1	12.0	13.5	13.4
Freddie Mac/Fannie Mae	0.88	0.78	0.96	0.96	1.09	0.97	0.99	0.93
African American Borrowers[3]								
Fannie Mae	3.5	4.0	3.4	2.9	3.4	4.5	5.0	5.0
Freddie Mac	2.8	2.7	3.5	2.9	3.6	3.2	2.9	2.9
Freddie Mac/Fannie Mae	0.80	0.68	1.03	1.00	1.06	0.71	0.58	0.58
Hispanic Borrowers[4]								
Fannie Mae	5.6	5.0	4.9	4.9	6.2	7.0	8.6	9.0
Freddie Mac	3.9	3.9	3.8	4.3	5.4	5.7	5.5	5.4
Freddie Mac/Fannie Mae	0.70	0.78	0.78	0.88	0.87	0.81	0.64	0.60
Low-Income Tracts								
Fannie Mae	8.4	9.2	10.0	8.2	9.0	9.5	10.4	10.3
Freddie Mac	7.5	7.6	9.5	8.5	8.7	9.0	10.8	9.9
Freddie Mac/Fannie Mae	0.89	0.83	0.95	1.04	0.97	0.95	1.04	0.96
High-Minority Tracts[5]								
Fannie Mae	13.8	14.7	14.3	12.6	14.4	14.8	16.7	27.3
Freddie Mac	10.8	10.7	12.3	11.9	11.9	12.2	15.1	22.6
Freddie Mac/Fannie Mae	0.78	0.73	0.86	0.94	0.83	0.82	0.90	0.83
Underserved Areas								
Fannie Mae	23.3	24.9	27.6	23.4	24.5	25.4	28.5	28.1
Freddie Mac	21.3	21.1	26.7	23.6	23.5	23.8	28.0	26.1
Freddie Mac/Fannie Mae	0.91	0.85	0.97	1.01	0.96	0.94	0.98	0.93

Source: HUD analysis of GSEs' loan-level data on home purchase mortgages on owner-occupied one-unit properties. From National File B, HUD's GSE Public Use Data Base. Excludes purchases of government-backed mortgages.

[1] As a percentage of loans for which information was reported by the GSEs - - i.e., excludes loans with missing information.

[2] I.e., 8.3% of the home purchase mortgages on owner-occupied one-unit properties purchased by Fannie Mae in 1996 were for very-low-income borrowers (those with income less than or equal to 60 percent of area median income).

[3] Does not include households where one borrower is African American and one is not.

[4] Does not include households where one borrower is Hispanic and one is not.

[5] Geography shifts from 1990 census to 2000 census with the 2003 PUDB.

The patterns of GSE purchases were somewhat mixed for African-American and Hispanic borrowers over the 1996-2003 period.[85] There was essentially no change in African-Americans' share of Fannie Mae's acquisitions of home purchase loans between 1996 and 2000, but significant gains were made in both 2001 and 2002. Thus their share of Fannie Mae's loans reached a record level in 2002, and remained at this level in 2003. On the other hand, African Americans' share of Freddie Mac's loans rose between 1996 and 2000, but fell in 2001 and 2002 and was unchanged in 2003. Thus there was essentially no overall change in their share of Freddie Mac's loans between 1996 and 2003, and the ratio of the share of Freddie Mac's loans to their share of Fannie Mae's loans was at the lowest level on record. On the other hand, Hispanics' shares of both GSEs' home purchase loans increased fairly steadily for both GSEs over the 1996-2003 period—from 5.6 percent in 1996 to a record level of 9.0 percent for Fannie Mae in 2003, and from 3.9 percent in 1996 to 5.4 percent in 2003 for Freddie Mac. Hispanics' share of Freddie Mac's loans was at the third highest level on record last year, but as a result of even larger increases in their share of Fannie Mae's loans last year, the Freddie Mac-Fannie Mae ratio was only 0.60, the lowest during this period.

With regard to high-minority census tracts, there were gains in their shares over the 1996-98 period, followed by significant declines in 1999. Gains were made again in 2000-01, and especially in 2002. Thus the high-minority tract shares reached record levels for both GSEs in 2002, and Freddie Mac closed a portion of the gap between it and Fannie Mae in the share of its loans in this category. High-minority tract shares were much higher for both GSEs in 2003, reflecting the inclusion of data from the 2000 census.

Since underserved areas consist of low-income tracts and high-minority tracts, the trends in the shares of the GSEs' loans in underserved areas, not surprisingly, lie between the results reported above for these two types of tracts. That is, there were gains in the shares of home purchase mortgages for properties in underserved areas over the 1996-98 period, followed by significant declines in 1999. For Fannie Mae, gains were made again in 2000-01, and especially in 2002. The undeserved area share of Freddie Mac's mortgages was essentially unchanged from the 1999 level in 2000 and 2001, but then jumped very sharply in 2002. Thus by 2002 Freddie Mac had nearly equaled Fannie Mae in this regard, and the underserved area shares were at record levels for both GSEs.

G.3. Underwriting and Purchasing Guidelines

An important purpose of the housing goals is to encourage the GSEs to make prudent adjustments to their underwriting and purchase guidelines that make it easier for creditworthy low-income families to obtain low-cost, conventional financing.

Congress realized in the early 1990s that many aspects of the GSEs' activities play a crucial role in increasing access to the mortgage market for lower-income and minority

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[85] No specific goals were established by HUD for the GSEs by borrower race or ethnicity. But to the degree that certain groups have lower incomes or live in lower-income/high-minority areas, gains in the shares of lending by income or location would be expected to yield gains in the shares of loans for such groups.

borrowers and borrowers seeking to buy homes in areas which have traditionally been underserved by the market. In particular, Congress focused on the importance of the GSEs' underwriting guidelines, finding that:

> Inadequate access to mortgage credit is a particular problem which results, in large part, from the vestiges of redlining and the unintended consequences of the enterprises' orientation toward suburban and "plain vanilla" mortgages.[86]

Similar concerns were expressed in the 1991 Report of the Advisory Commission on Regulatory Barriers to Affordable Housing, which stated that:

> Fannie Mae's and Freddie Mac's underwriting standards are oriented towards "plain vanilla" mortgages. The standards encourage lending in suburban, growing, homogeneous, and higher income areas, where housing and zoning requirements result in the production of "cookie cutter" new homes in uniformly single-family neighborhoods. These standards work against more diverse building types and mixed-use neighborhoods, which are more difficult to assess and underwrite.[87]

In response to these concerns, Congress required under FHEFSSA that the Secretary should "periodically review and comment on the underwriting and appraisal guidelines of each enterprise to ensure that such guidelines are consistent with the Fair Housing Act and this section."[88]

During the mid-to-late 1990s, lenders, mortgage insurers, and the GSEs modified their mortgage underwriting standards to address the needs of families who had historically found it difficult to qualify under traditional guidelines. In addition to the changes in underwriting standards, the use of automated underwriting dramatically transformed the mortgage application process. This section focuses on changes to traditional underwriting standards and recent GSE initiatives for credit-impaired borrowers. Subsequent sections will provide more details on the impact of automated underwriting.

The GSEs modified their underwriting standards to address the needs of families who find qualifying under traditional guidelines difficult. The goal of these underwriting changes was not to loosen underwriting standards, but rather to identify creditworthiness by alternative means that more appropriately measures the unique circumstances of low-income, immigrant, and minority households. Examples of changes that the GSEs and others in the industry have made to their underwriting standards include the following:

- Using a stable income standard rather than a stable job standard (or a minimum period of employment). This particularly benefits low-skilled applicants who have successfully remained employed, even with frequent job changes.

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[86] Senate Report 102-282, May 1992, p. 38.

[87] *"Not in My Back Yard:" Removing Barriers to Affordable Housing*, Report to President Bush and Secretary Kemp by the Advisory Commission on Regulatory Barriers to Affordable Housing, 1991, p. 3-13.

[88] FHEFSSA, Section 1325 (6).

- Using an applicant's history of rent and utility payments as a measure of creditworthiness. This measure benefits lower-income applicants who have not established a credit history.

- Allowing pooling of funds for qualification purposes. This change benefits applicants with extended family members. Freddie Mac, for example, allows income from relatives who live together to pool their funds to cover downpayment and closing costs and to combine their incomes for use in calculating the borrower's stable monthly income.

These underwriting changes have been accompanied by homeownership counseling to ensure homeowners are ready for the responsibilities of homeownership. In addition, the industry has engaged in intensive loss mitigation to control risks.

In November 1998 the Center for Urban Policy Research (CUPR) at Rutgers University prepared a study for HUD, *Successful Mortgage Lending Strategies for the Underserved*. The first volume, titled *Industry Strategies*, reached several conclusions with regard to the GSEs:

- The GSEs' underwriting guidelines have been made more flexible since 1990 in both their standard programs and their affordable programs. Both types of loans have benefited previously underserved borrowers, who found it difficult to qualify for traditional or "historical" mortgages. The GSEs' affordable mortgages, involving lower down payments and higher front-end and back-end ratios, have contributed to the "revolution in financing terms" which has been integral to successful lending industry strategies.

- Despite progress toward providing more credit to lower-income and minority borrowers through their standard and affordable mortgages, the "Portfolio Affordable Mortgages" retained by some lenders are more flexible than the GSEs' affordable mortgages as well as their standard mortgages. For example, these portfolio loans place less emphasis on credit scoring, they are more receptive to extenuating circumstances, and they may count the income of all adult household members (not only the income of co-mortgagors).[89]

- The tension between the GSEs and local lenders can be a "creative force." For example, Fannie Mae developed the Community Homebuyer's Program with GE Capital and the National Training and Information Center, Fannie Mae then took it national, and some local lenders took it one step further. This is termed a "reiterative, creative process" in developing successful strategies for reaching lower-income and minority borrowers.[90]

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[89] See Exhibit 4.4, pp. 90-91.

[90] The Rutgers report and other studies emphasize the importance of detailed knowledge of local communities in promoting affordable lending. Local lenders' partnerships with nonprofits and community-based organizations (CBOs) enable these lenders to tap into the specialized knowledge about local markets that these organizations have developed over the years. The GSEs can benefit in turn from this knowledge, or they can obtain it directly from their own efforts, such as the Partnership Offices established by Fannie Mae.

In 1999, HUD commissioned a study by the Urban Institute to examine the underwriting criteria that the GSEs use when purchasing mortgages from primary lenders.[91] According to the study, while the GSEs had improved their ability to serve low- and moderate-income borrows, it did not appear at that time that they had gone as far as some primary lenders to serve these borrowers. From the Urban Institute's discussion with lenders, it was found that primary lenders were originating mortgages to lower-income borrowers using underwriting guidelines that allow lower down payments, higher debt-to-income ratios and poorer credit histories than allowed by the GSEs' guidelines.

From this and other evidence, the Urban Institute concluded that the GSEs were lagging the market in servicing low- and moderate-income and minority borrowers. Furthermore, the Urban Institute found "that the GSEs' efforts to increase underwriting flexibility and outreach has been noticed and is applauded by lenders and community advocates. Despite the GSEs' efforts in recent years to review and revise their underwriting criteria, however, they could do more to serve low- and moderate-income borrowers and to minimize disproportionate effects on minorities."[92]

In general, the conclusions of the Urban Institute largely mirrored those of the Rutgers study. Both state that the GSEs played a major role in the gains in lending to lower-income and minority families during the mid-to-late 1990s, but both find that in some cases local portfolio lenders had developed more flexible approaches than the GSEs, and both conclude that additional innovations may result from the various interactions between the GSEs and portfolio lenders. Since the Urban Institute and Rutgers studies, Freddie Mac and Fannie Mae have been playing a larger role in financing low-income borrowers. (See Section D)

In addition to offering low-down-payment programs, the GSEs' recent efforts have also centered around their automated underwriting systems and their treatment of borrowers with blemished credit, the latter being perhaps the most controversial underwriting issue over the past few years. Freddie Mac recently launched a variety of new products aimed at providing borrowers with impaired credit more mortgage product choices. Examples of the new products include: "CreditWorks," which helps borrowers with excessive debt and impaired credit to qualify for a prime market rate mortgage more quickly than before, and "LeasePurchase Plus Initiative," which provides closing cost and down payment assistance in addition to extensive counseling for borrowers who have had bad credit or who have never established a credit history.[93] During 2002, Freddie Mac entered into several new markets under the "LeasePurchase Plus Initiative" and purchased more than $16 million in loans.[94] Other examples of the GSEs new products are provided in Section F.4.

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[91] Kenneth Temkin, Roberto Quercia, George Galster, and Sheila O'Leary, *A Study of the GSEs' Single Family Underwriting Guidelines: Final Report*. Washington DC: U.S. Department of Housing and Urban Development, April 1999.

[92] Temkin, et al. 1999, p. 28.

[93] Freddie Mac, *2001 Annual Housing Activities Report*, 2002, p.28

[94] Freddie Mac, *2002 Annual Housing Activities Report*, 2003, p. 35.

According to Freddie Mac, its automated underwriting system, "Loan Prospector" has reduced costs, made approving mortgages easier and faster, and increased the consistency of the application of objective underwriting criteria. In addition, Freddie Mac states that "Loan Prospector" extends the benefits of the mortgage finance system to borrowers with less traditional credit profiles and limited savings by more accurately measuring risk. Freddie Mac reports that its automated underwriting system, Loan Prospector, has resulted in higher approval rates for minority borrowers than under traditional manual underwriting because of improved predictive powers. As discussed in Section G.1, the 2000 version of LP approved 87.1 percent of loans generated through affordable housing programs, compared to 51.6 percent approved by manual underwriting. The Freddie Mac study found automated mortgage scoring less discriminatory and more accurate in predicting risk. However, as noted below in the automated mortgage scoring section, there are concerns that the codification of certain underwriting guidelines could result in unintentional discrimination or disparate treatment across groups. In response to the potential disparate impact of automated underwriting, Freddie Mac have launched initiatives to make the mortgage process more transparent by disclosing both credit and non-credit factors that Loan Prospector consider when evaluating a loan application. In 2000, Freddie Mac launched an initiative that published a list of all of the factors that Loan Prospector uses to analyze loans, and put the list on the Freddie Mac website.[95]

In 2002, Fannie Mae released two versions of its automated underwriting service, "Desktop Underwriter" (DU), to expand its mortgage product offerings and to update underwriting guidelines. These enhancements—labeled DU 5.2 and DU 5.2.1—were intended to increase homeownership opportunities for low- and moderate-income borrowers and borrowers with small downpayments by enhancing DU's risk assessment capabilities for certain high loan-to-value loans. For example, DU 5.2.1 enhanced its *Expanded Approval*™ policies to allow 100 percent loan-to-value limited cash-out refinances and the origination of 5/1 ARMs.[96] The *Expanded Approval* feature and *Timely Payment Rewards* option in DU were created by Fannie Mae in 1999 to enable lenders to more comprehensively review a borrower's creditworthiness. The *Timely Payment Rewards* option reduces the interest rate of qualified borrowers of up to one percent after making timely mortgage payments for a given time period.[97] With these options, lenders can offer mortgage loans to many borrowers previously unable to receive financing from a mainstream lender. A borrower who is recommended for approval for either of these features would be eligible for an initial mortgage rate that is lower than that available through the subprime market.[98] Automated mortgage scoring and the potential for disparate impacts on borrowers will be further discussed in Section G.1.

Desktop Underwriter® 5.3, which was released in 2003, outlined new eligibility requirements for mortgages secured by manufactured homes. It also expanded the *InterestFirst*™ mortgage product line to offer borrowers greater purchasing power by allowing lower initial monthly payments than those available with traditional loan products. With the release of *Desktop Underwriter® 5.3.1* enhancements to the *Flexible 100* mortgage allowed

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[95] *Ibid*. p. 57.

[96] Fannie Mae, *2002 Annual Housing Activities Report*, 2003, p. 10.

[97] *Ibid*. p. 6.

[98] Fannie Mae, *2002 Annual Housing Activities Report*, 2003, p. 32.

borrowers to contribute as little as $500 of their own funds to the transaction. The remainder of the funds can come from flexible sources of funds and interested party contributions subject to Fannie Mae's standard contribution limit.[99] In addition, Fannie Mae added *MyCommunityMortgage* to *Desktop Underwriter®* in 2003, providing lenders easier access to customized CRA-targeted loan products.[100] Automated mortgage scoring and the potential for disparate impacts on borrowers will be further discussed in a later section.

G.4. New Products and Programs Developed by the GSEs

In addition to concerted efforts to step up their acquisitions of loans targeted by HUD's housing goals and to change their underwriting guidelines to facilitate purchases of these mortgages, the GSEs have developed a number of new products since HUD's goals were established.

Many of the GSEs' new products have focused on reducing the required down payment. Numerous studies have concluded that saving enough cash for a down payment and for up-front closing costs is the greatest barrier that low-income and minority families face when considering homeownership.[101] To assist in overcoming this barrier, the industry (including lenders, private mortgage insurers and the GSEs) began offering in 1994 mortgage products that required down payments of only 3 percent, plus points and closing costs. Other industry efforts to reduce borrowers' up-front costs included zero-point-interest-rate mortgages and monthly insurance premiums with no up front component. These new plans eliminated large up-front points and premiums normally required at closing.

In 2000, Fannie Mae launched the "*MyCommunityMortgage*" suite of products, which provides high loan-to-value product options for low- and moderate-income borrowers. In 2003, Fannie Mae purchased or securitized more than $2.27 billion of *MyCommunityMortgage* products, which helped provide affordable housing solutions for 20,400 households. In addition, Fannie Mae enhanced the *MyCommunityMortgage* to help lenders further expand affordable financing to underserved families. Examples of these enhancements included adding *MyCommunityMortgage* to *Desktop Underwriter* in order to provide lenders easier access to customized CRA-targeted loan products, adding new credit and income flexibilities for borrowers purchasing single family homes, *Community HomeChoice* which offers more flexible requirements for persons with disabilities, *Community 2-4 Family*™ to help make the purchase of 2-4 unit homes more affordable for first time homebuyers, and *Community Renovation*™ *1-4*

[99] Fannie Mae, *2003 Annual Housing Activities Report*, 2004, pp. 11-12.
[100] Fannie Mae, "Fannie Mae's Comments on HUD's Proposed Housing Goals for Fannie Mae and Freddie Mac for the years 2005-2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac," July 16, 2004, p. I-57.

[101] See Charles, K. K. and E. Hurst (2002). "The Transition to Home Ownership and the Black-White Wealth Gap." *The Review of Economics and Statistics*, 84(2): 281-297; Mayer, C. and G. Engelhardt (1996). "Gift Down Payments and Housing Affordability." *Journal of Housing Research*, 7(1): 59-77; and Quercia, R. G., G. W. McCarthy, et al. (2003). "The Impacts of Affordable Lending Efforts on Homeownership Rates." *Journal of Housing Economics*, 12(1): 29-59.

Family Pilot to help borrowers with home improvement and housing preservation costs.[102] Additionally, in 2003, Fannie Mae enhanced Community 2-4 Family and Community Renovation 1-4 Family pilots. This product provides lower down payments and flexible parameters for owner-occupants of 1-4 unit properties.[103]

Fannie Mae also expanded its "Flexible" product line with the "Flexible 100" product, which eliminates the requirement for a down payment by providing 100 percent loan-to-value financing. The borrower is required to make either a minimum of 3% (of the lesser of the sales price or appraised value) from approved flexible sources or making a minimum contribution of $500 from their own funds. The 3% may come from a variety on sources such as gifts, grants, or unsecured loans from relatives, employers, public agencies, or nonprofits. In 2003, Fannie Mae purchased $13.7 billion in *Flexible* loans that benefited 100,866 households.[104]

Fannie Mae has also developed products specifically geared toward populations with unique needs such as seniors, Native Americans and families living near public transit routes. Examples of these targeted products include the *Home Equity Conversion Mortgage (HECM)* which allows seniors to convert the equity in their homes to receive cash. In 2003, Fannie Mae purchased 27,644 HECM's for a total value of $1.87 billion. *PaymentPower™* allows borrowers with strong credit to skip their regularly scheduled monthly payment up to two times during a twelve-month period and up to ten times during the life of the loan. This pilot was launched in July 2002 and by year-end 2003, Fannie Mae purchased 963 *PaymentPower™* mortgages totaling $126 million. *Navajo Community Guaranty Initiative* allows Navajo families to contribute a minimum of $500 or 1% of the purchase price, whichever is lower. This initiative, announced in 2003, will provide $3 million in home financing to help 60 families currently living on a reservation. The *Smart Commute™ Initiative*, which targets borrowers purchasing homes near a public transit route, recognizes that homebuyers will save commuting expenses and therefore have more disposable income to pay housing expenses. In 2003 Fannie Mae purchased approximately $5 million in *Smart Commute™ Initiative* loans.[105]

In 2000, Freddie Mac introduced its "Freddie Mac 100" product, which is designed to assist borrowers who have good credit but lack the ability to provide a large down payment. "Freddie Mac 100" allows a 100 percent loan-to-value ratio with the condition that the borrower has the funds for closing costs. In 2003, a refinance option was added to Freddie Mac 100 and the cost of the loan was reduced through lower mortgage insurance coverage and a lower fee for the product. These changes have made the Freddie Mac 100 available to borrowers who may not have been able to take advantage of the refinance boom as a result of low or no equity in their homes.[106]

Another Freddie Mac product, Affordable Gold® 97 permits borrowers to make 3% down

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[102] Fannie Mae, *2003 Annual Housing Activities Report*, 2004, pp. 8-9.
[103] Fannie Mae, "Fannie Mae's Comments on HUD's Proposed Housing Goals for Fannie Mae and Freddie Mac for the years 2005-2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac," July 16, 2004, p. I-58.
[104] Fannie Mae, *2003 Annual Housing Activities Report*, 2004, p. 6.
[105] Fannie Mae, *2003 Annual Housing Activities Report*, 2004, pp. 9-10.
[106] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003*, March 15, 2004, p. 62.

payments from personal cash and to use other sources to cover their closing costs, and offers flexible ratio and reserves guidelines. In 2003 this product was enhanced with a refinance option allowing more borrowers to take advantage of the low rates in the market. The Affordable Gold® 100 provides 100 percent financing to low- and moderate-income borrowers for the purchase price of a home in California. Affordable Gold® 100 combines mortgage insurance benefits provided by a state insurance fund, the secondary mortgage market, and a team of the nation's leading mortgage lenders.[107]

Additional Freddie Mac products include the Alt 97℠ for borrowers who have good credit but limited cash for a down payment. In 2003, this product was enhanced with a refinance option and reduced fees. The Two-Family 95 Percent LTV Program offers low down payment loans to purchasers of two-family properties when the borrowers occupy one of the units as their primary residence.[108] Other initiatives include policies aimed at improving the homeownership rate among immigrant families and the Section 8 Rental to Homeownership program, which allows people currently receiving Section 8 rental subsidies to use them toward mortgage payments.[109] Freddie Mac purchases loans in which the borrower's down payment consists of funds that have been matched through an Individual Development Account homebuyer savings program. And in 2003, Freddie Mac provided increased liquidity for affordable housing through a series of targeted investments in Mortgage Revenue Bonds containing state and local housing finance agency mortgages.[110]

G.5. Partnerships

Both GSEs, but especially Fannie Mae, have formed partnerships with a wide variety of organizations to increase mortgage availability for historically underserved borrowers and their neighborhoods. The partnerships involve national organizations or community groups or lenders in certain parts of the country.

Fannie Mae operates 55 partnership offices throughout the country, including the West Virginia Partnership Office, which opened in 2003. These offices coordinate Fannie Mae's programs with local governments, lenders, public officials, housing organizations, community nonprofits, real estate professionals, and other local stakeholders.[111]

Fannie Mae continues to reach out to national groups and work with local affiliates to expand homeownership. Fannie Mae has established multi-year partnerships to increase affordable housing opportunities with organizations such as: The Enterprise Foundation, The Neighborhood Reinvestment Corporation, ACORN Housing Corporation, The National Council

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[107] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003*, March 15, 2004, p. 62.

[108] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003*, March 15, 2004, p. 62-64.

[109] Freddie Mac Public Comment Letter on HUD's Proposed Goals, July 2004, p. 2.

[110] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003*, March 15, 2004, pp. 62-64

[111] Fannie Mae, *2003 Annual Housing Activities Report*, 2004, pp. 22-24.

of La Raza, and many others engaged in promoting affordable housing. In 2003, Fannie Mae financed $1.3 billion of mortgages with these national partners and participating lenders, which resulted in 9,597 loans. For example, Fannie Mae maintains a partnership with the National Urban League (NUL) and the JP Morgan Chase Bank to increase NUL's homeownership counseling capacity by providing the necessary technology and tools to support the effort, and to purchase $50 million in mortgage products over five years that are specifically targeted to increase homeownership among minorities. In 2003, approximately $6 million in loans were originated through this initiative. Another example is Fannie Mae's partnership with the AFL-CIO Housing Investment Trust (HIT) and Countrywide Home Loans, which launched "HIT HOME" in 2001. HIT HOME is an affordable home mortgage initiative that targets 13 million union members in 35 cities throughout the nation to provide union members with a variety of affordable mortgage choices that enable them to qualify for competitively priced loans with new re-payment terms. In 2003, over $132 million worth of mortgages were originated through this partnership.[112]

In order to meet the needs of underserved and low- and moderate-income populations, Fannie Mae has targeted specific populations for initiatives. These include the *Section 8 Homeownership Initiative*, which purchased 81 Section 8 loans and funded an additional 55 loans through a Community Development Financial Institution investment; the *Native American Homeownership Initiative*, which has committed to invest at least $350 million to support homeownership strategies for 4,600 Native American families and to work with 100 tribes; the *Minority- and Women-Owned Lenders Initiative,* to reach underserved communities and to develop innovative solutions for increasing business opportunities for these lenders; The *Employer-Assisted Housing Initiative,* designed to assist employers in developing a company benefit that helps employees meet their housing needs; and the *Initiative to Reduce Barriers to Affordable Housing,* which has established local partnerships in seven new states and localities in 2003. Additionally, Fannie Mae conducts various underwriting experiments aimed at eliminating obstacles faced by prospective homebuyers across the country. In 2003, Fannie Mae approved $222 million worth of Housing and Community Development place-based commitments for a total of 55 experiments.[113]

Fannie Mae's *American Dream Commitment* is part of its National Minority Homeownership Initiative that pledged to contribute at least $700 billion in private capital to serve 4.6 million families towards President George W. Bush's goal of expanding homeownership to 5.5 million new minority Americans by the end of the decade. Towards this goal, in 2003, Fannie Mae executed 17 new Housing and Community Development lender partnerships that sought to provide $394 billion in affordable housing lending to minority families.[114]

Under the *American Dream Commitment,* Fannie Mae has committed to establishing 250 faith-based homeownership partnerships in communities across the country by the end of the current decade. The objective of this initiative is to build strong partnerships with national faith-based organizations in order to reach potential new homeowners, work with faith-based and

[112] Fannie Mae, *2003 Annual Housing Activities Report*, 2004, pp. 13-16.
[113] Fannie Mae, *2003 Annual Housing Activities Report*, 2004, pp. 17-22.
[114] Fannie Mae, *2003 Annual Housing Activities Report*, 2004, pp. 16.

nonprofit partners to help increase access to homeownership information and education, partner with lenders to increase access to mortgage financing, and provide faith-based organizations with the tools, training, and resources needed to advance their community development efforts. Fannie Mae's work under the *Faith-Based Initiative* in 2003 resulted in $125 million in mortgage financing to underserved families across the country.[115] Additionally, Fannie Mae attended more than 12 faith-based symposiums providing training and technical assistance to over 2,000 symposium attendees.[116]

Freddie Mac does not have a partnership office structure similar to Fannie Mae's, but it has undertaken a number of initiatives in specific metropolitan areas.[117] Freddie Mac works with affordable housing lenders to design creative solutions to meet homeownership needs of specific populations in targeted areas; explore efficient use of public subsidies to make homeownership more affordable and develop homebuyer education/counseling and debt management assistance programs.[118] In 2001, Freddie Mac joined the Congressional Black Caucus to launch a new initiative, "With Ownership Wealth," designed to increase African-American homeownership with one million new families by 2005.[119] Freddie Mac has partnered with the National Council of La Raza (NCLR), 20 community based NCLR affiliated housing counseling organizations, the National Association of Hispanic Real Estate Professionals (NAHREP), EMT Applications and participating Freddie Mac Seller/Servicers including Bank of America, U.S. Bank and Wells Fargo Home Mortgage on the "En Su Casa" initiative. This $200 million homeownership initiative combines technology tools with flexible mortgage products to meet the needs of Hispanic borrowers. Mortgage products include low down payments, flexible credit underwriting and debt-to-income ratios, and streamlined processing for resident alien borrowers.[120]

In 2002, Freddie Mac joined with the City of Boston and the U.S. Conference of Mayors to make available the "Don't Borrow Trouble" predatory lending educational campaign to approximately 1,100 cities. As of the end of 2003, the campaign has been launched in more than 30 localities. Additionally, in late 2003, Freddie Mac sponsored a national Don't Borrow Trouble summit. Attorney's, community activists and local leaders from 23 cities convened to share campaign experiences and to learn about emerging predatory lending trends from some of the nation's leading community lending experts.[121]

In addition, Freddie Mac joined with Rainbow/PUSH and the National Urban League to promote the CreditSmart® financial educational curriculum that helps consumers understand,

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[115] Fannie Mae, *2003 Annual Housing Activities Report*, 2004, pp. 17-18.
[116] Fannie Mae, "Fannie Mae's Comments on HUD's Proposed Housing Goals for Fannie Mae and Freddie Mac for the years 2005-2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac," July 16, 2004, p. I-60.

[117] Freddie Mac, *News Release,* January 15, 1999.

[118] Freddie Mac Public Comment Letter on HUD's Proposed Goals, July 2004, p. 3.
[119] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, pp. 67.
[120] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, pp. 66-67.
[121] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, pp. 37-38.

obtain and maintain good credit, thereby preparing them for homeownership and other personal financial goals. Rainbow/PUSH has organized CreditSmart® classes with more than 80 churches across the nation, reaching more than 2,500 congregants. Bilingual curriculum was launched for this program in December 2002, and during 2003 CreditSmart® Español conducted a total of 23 Train-the-Trainer workshops for their partners and their local partners resulting in 326 trainers who are authorized to teach the CreditSmart® Español curriculum. Thus far 503 adults have been trained in the CreditSmart® Español financial literacy program.[122] The CreditSmart®/Homeownership Development Initiative with the National Urban League has nine affiliates located in Birmingham, AL; Charlotte, NC; Louisville, KY; Greenville, SC; Oklahoma City, OK; Springfield, IL; and Washington, DC; with Orlando, FL and Knoxville, TN added in 2003. Since the initiative's launch in early 2002, 41 CreditSmart® financial literacy workshops have been presented to more than 600 minority participants. Those participants are proceeding to the next steps to achieving homeownership, and in 2003 313 loans have closed as a direct result.[123]

In 2002 and 2003, Freddie Mac joined with the American Community Bankers, the Credit Union National Association, and the Independent Community Bankers of America in strategic alliances to better enable member banks and credit unions access to the secondary market.[124]

In June 2002, President George W. Bush challenged the nation's housing industry to invest more than $1 trillion to make homeownership a reality for 5.5 million more minority households for the decade. Freddie Mac responded to the challenge with *Catch the Dream* which is a comprehensive set of 25 high impact initiatives aimed at accelerating the growth in minority homeownership. The initiatives range from homebuyer education and outreach, to new technologies with innovative mortgage products. Freddie Mac has committed to purchase $400 billion in mortgages made to minority families by the end of the decade.[125] Catch the Dream represents a collaborative effort with lenders, nonprofit housing and community-based organizations, and other industry participants to expand homeownership opportunities for America's minorities.[126] 2003 initiatives were implemented in Birmingham, Charlotte, Atlanta, DeKalb County (GA), Lansing, and San Antonio. In 2003, single-family owner occupied mortgage purchases financed homes for almost 700,000 minority families, including mortgages for 133,000 African-American and 250,000 Hispanic families (this comprised 16% of Freddie Mac's single-family, owner-occupied mortgage purchases and 22.6% of their first-time homebuyer mortgage purchases).[127]

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[122] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, pp. 38-39.
[123] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, pp. 39-40.
[124] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, pp. 42-43.
[125] Freddie Mac Public Comment Letter on HUD's Proposed Goals, July 2004, p. 4.
[126] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, pp. 29-30.
[127] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, pp. 30-34.

The programs mentioned above are examples of the partnership efforts undertaken by the GSEs. There are more partnership programs than can be adequately described here. Fuller descriptions of these programs are provided in their Annual Housing Activity Reports.

G.6. Purchases of Seasoned CRA Mortgages

One strategy for the GSEs to meet their new housing goal and subgoal requirements is to increase their purchases of CRA-loans from the portfolios of banks and thrifts. The Community Reinvestment Act (CRA) requires depository institutions to help meet the credit needs of their communities.[128] CRA loans are typically made to low-income borrowers earning less than 80 percent of area median income, and in moderate-income neighborhoods. CRA provides an incentive for lenders to initiate affordable lending programs with underwriting flexibility. CRA loans are usually smaller than typical conventional mortgages and also are more likely to have a higher LTV, higher debt-to-income ratios and no payment reserves, and may not be carrying private mortgage insurance (PMI). Generally, at the time CRA loans are originated, many do not meet the underwriting guidelines required in order for them to be purchased by one of the GSEs. Therefore, many of the CRA loans are held in portfolio by lenders, rather than sold to Fannie Mae or Freddie Mac. Evidence is growing that CRA-type lending to low-income families can be profitable, particularly when combined with intensive loss mitigation efforts to control credit risk. In a recent survey conducted by the Federal Reserve, lenders reported that most CRA loans are profitable although not as profitable as the lenders' standard products.[129]

Some anticipate that the big growth market over the next decade for CRA-type lending will be urban areas. There has been some movement of population back to cities, consisting of aging Baby Boomers (so-called "empty nesters"), the children of Baby Boomers (the Echo Boomers aged 18-25), and immigrants, particularly Hispanics but also Asians.[130] The current low homeownership in inner cities (compared with the suburbs) also suggests that urban areas may be a potential growth market for lenders. Lenders are beginning to recognize that urban borrowers are different from suburban borrowers. A new or recent immigrant may have no credit history or, more likely, a loan-worthy credit history that can't be substantiated by the usual methods.[131] Products for duplexes and four-plexes are not the same as a mortgage for a subdivision house in the suburbs. Programs are being implemented to meet the unique needs of urban borrowers. One program emphasizing urban areas was initiated by the American Community Bankers (ACB). Under the ACB program, which made $16.2 billion in loans in

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128. For a comprehensive analysis of CRA and its impact on affordable lending, see Robert E. Litan, Nicolas P. Retsinas, Eric S. Belsky and Susan White Haag, *The Community Reinvestment Act After Financial Modernization: A Baseline Report*, U.S. Department of Treasury, 2000.

129 Board of Governors of the Federal Reserve System. *The Performance and Profitability of CRA-Related Lending*. Washington, DC, 2000.

130 This discussion of urban lending draws from Jeff Siegel, "Urban Lending Helps Increase Volume and Meet CRA Requirements," *Secondary Marketing Executive*, February 2003, pp. 21-23.

131 Ibid.

2002, lenders originated a variety of affordable products for first-time homebuyers and non-traditional borrowers that are then sold to Fannie Mae, Freddie Mac, Countrywide, or other investors that are partnering with the ACB. It is reported that some lenders are making these non-traditional loans for the first time.

For banks and thrifts, selling their CRA loans to the GSEs will free up capital to make new CRA loans. As a result, the CRA market segment provides an opportunity for Fannie Mae and Freddie Mac to expand their affordable lending programs. Fannie Mae has been offering CRA programs since mid-1997, when it launched a pilot program, "Community Reinvestment Act Portfolio Initiative," for purchasing seasoned CRA loans in bulk transactions, taking into account track record as opposed to relying just on underwriting guidelines. Fannie Mae also started another pilot program in 1998, involving purchases of CRA loans on a flow basis, as they are originated. As part of the *American Dream Commitment*, Fannie Mae has committed to investing $20 billion in CRA-targeted business, and funding $530 billion in CRA-eligible investments. One CRA-eligible product in 2003 included the *MyCommunityMortgage*™ suite, which provides flexible product options for low- to moderate-income families, including minorities, immigrants, first-time homebuyers, and underserved borrowers living in rural areas. MyCommunityMortgage is offered by over 300 lender partners nationwide, and marries targeted pricing with affordability features, such as 100 percent loan-to-value ratios with only $500 from the borrower's own funds.[132] In 2003, Fannie Mae purchased or securitized more than $2.27 billion of *MyCommunityMortgage* products, which helped provide affordable housing solutions for 20,400 households.[133]

In addition, Freddie Mac is also purchasing seasoned affordable mortgage portfolios originated by depositories to help meet their CRA objectives. In 2003, Freddie Mac developed credit enhancements that enable depositories to profitably sell their loans to Freddie Mac – these transactions facilitate targeted affordable lending activity by providing immediate liquidity. Freddie Mac also increased its ability to purchase smaller portfolios opening this option to many community banks that otherwise would not have an outlet for their portfolios.[134]
The billions of dollars worth of CRA loans that will be originated, as well as the CRA loans being held in bank and thrift portfolios, offer both GSEs an opportunity to improve their performance in the single-family area.

G.7. Purchases of Subprime Loans

One potential area where the housing goals may have an impact is GSEs' purchases of subprime loans, as these loans qualify for the housing goals at high rate. Both GSEs indicated that they would need to increase their purchase of subprime loans to meet the higher goals. In the past, Fannie Mae and Freddie Mac have voluntarily decided not to purchases subprime loans with features such as single-premium life, Home Ownership and Equity Protection Act

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[132] [132] Fannie Mae, "Fannie Mae's Comments on HUD's Proposed Housing Goals for Fannie Mae and Freddie Mac for the years 2005-2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac," July 16, 2004, p. I-59.
[133] Fannie Mae, *2003 Annual Housing Activities Report*, 2004, pp. 8-9.
[134] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003*, March 15, 2004, p. 64.

(HOEPA) loans, and prepayment penalty terms that exceed three years. Freddie Mac indicated that the increased goals would limit its ability to influence subprime lending practices. More specifically, Freddie Mac claimed that to meet the higher housing goals it might not have the option in the future of turning away subprime loans that have less desirable loan terms than the subprime business it currently purchases.

Several commenters suggested that if the GSEs are pushed to serve more of the subprime market, they will skim a significant portion of the lower-risk borrowers from that market. This would have at least two adverse effects. First, the resulting smaller subprime market would be comprised of the neediest borrowers. These higher risk borrowers would pay more because lower risk borrowers would not be present to subsidize them plus the market's high fixed costs would be distributed across fewer borrowers. Second, the subprime market left over for private lenders would be significantly smaller. As a result, lenders would be driven out of business translating into less competition.

Some industry commenters welcome the entrance of the GSEs into the subprime market because their presence brings stability and standardizes business practices, but cautioned that unrealistically high goals could force the GSEs to jump into the market in a manner that negatively distorts underwriting and pricing. These commenters contend that the GSEs could bring capital and standards up but that they must gradually and carefully enter the subprime market to have a positive effect.

The GSEs have been prudent in their pursue of subprime lending, focusing on the top part of the market, the "A-minus" and "Alt A" segments.[135] The GSEs subprime products are integrated into their automated underwriting systems and are approved based on mortgage scoring models. These models have proven over the years to be an effective tool in limiting risk layering. The GSEs charge lenders higher fees for making these loans. As a result these higher risk loans are priced above those offered to prime borrowers but below what subprime lenders would otherwise charge for these loans.

The GSEs' presence in the subprime mortgage market benefits many low-income and minority borrowers whose risk profiles differ markedly from borrowers who qualify for prime mortgage products. Millions of Americans with less than perfect credit or that cannot meet some of the tougher underwriting requirements of the prime market for reasons such as inadequate income documentation, limited down payment or cash reserves, or the desire to take more cash out in a refinancing than conventional loans allows, rely on the allow rely on subprime lenders for access to the mortgage financing. As the GSEs reach deeper into the subprime market, more borrowers will benefit from the advantages that they create through greater stability and standardization.

Between 1999 and 2002, 27.6 percent of subprime loans qualified as special affordable, 58.2 percent as low-mod, and 44.2 percent as an underserved area loan. These

[135]A-minus mortgages are typically those where borrowers have less than perfect credit. Alt A mortgages are originated to borrowers who cannot document all of the underwriting information in the application but generally have FICO scores similar to those in the prime market.

subprime percentages are much higher than those for non-subprime loans in the conventional conforming market (14.9 percent, 42.4 percent, and 24.5 percent, respectively). Currently, the majority of subprime loans are not purchased by GSEs, and the numbers of lenders originating subprime loans typically do not issue a large amount of prime loans. However, over the past few years, the GSEs have been cautiously entering this market. In the 2000 GSE Rule, HUD identified subprime borrowers as a market that can assist Fannie Mae and Freddie Mac in reaching their higher affordable housing goals while also helping establish more standardization in the subprime market. A greater GSE role in this market would possibly encourage more mainstream lenders to enter those inner city neighborhoods that today rely heavily on subprime lenders for mortgage financing.

The subprime mortgage market provides mortgage financing to credit-impaired borrowers—those who may have blemishes in their credit record, insufficient credit history, or non-traditional credit sources. This section examines several topics related to subprime lending including (a) the growth and characteristics of subprime loans, (b) the neighborhood concentration of subprime lending, and (c) purchases of subprime mortgages by the GSEs.

a. The Growth and Characteristics of Subprime Loans

The subprime market has grown rapidly over the past several years, increasing from an estimated $35 billion in 1994 to $160 billion in 1999 and $173.3 billion in 2001, before rising to $213 billion in 2002. The subprime share of total market originations rose from 4.6 percent in 1994 to a high of 15 percent in 1999, and then fell to 8.5 percent in both 2001 and 2002.[136] Various factors have led to the rapid growth in the subprime market: federal legislation preempting state restrictions on allowable rates and loan features, the tax reform act of 1986 which encouraged tax-exempt home equity financing of consumer debt, increased demand for and availability of consumer debt, a substantial increase in homeowner equity due to house price appreciation, and a ready supply of available funds through Wall Street securitization.[137] It is important to note that subprime lending grew in the 1990s mostly without the assistance of Fannie Mae and Freddie Mac.

Generally, there are three different types of products available for subprime borrowers. These include: home purchase and refinance mortgages designed for borrowers with poor credit histories; "Alt A" mortgages that are usually originated for borrowers who are unable to document all of the underwriting information but who may have solid credit records; and high loan-to-value mortgages originated to borrowers with fairly good credit. Fannie Mae and Freddie Mac are more likely to serve the first two types of subprime borrowers.[138]

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[136] Subprime origination data are from Inside Mortgage Finance. For the 2002 estimates, see "Subprime Origination Market Shows Strong Growth in 2002," *Inside B&C Lending*, published by Inside Mortgage Finance, February 3, 2003, page 1.

[137] Temkin et. al, 2002, p. 1

[138] Kenneth Temkin, Jennifer E.H. Johnson, Diane Levy, *Subprime Markets, The Role of GSEs, and Risk Based Pricing*, Washington: The Urban Institute. Report Prepared for the Department of Housing and Urban Development, 2002, p. 4.

Borrowers use subprime loans for various purposes, which include debt consolidation, home improvements, and an alternative source of consumer credit. Between 1999 and 2001, about two-thirds of subprime loans were refinance loans. It has been estimated that 59 percent of refinance loans were 'cash out' loans.[139] According to a joint HUD-Treasury report, first liens accounted for more than three out of four loans in the subprime market.

The subprime market is divided into different risk categories, ranging from least risky to most risky: A-minus, B, C, and D. While there are no clear industry standards for defining the subprime risk categories, Inside Mortgage Finance defines them in terms of FICO scores—580-620 for A-minus, 560-580 for B, 540-560 for C, and less than 540 for D. The A-minus share of the subprime market rose from 61.6 percent in 2000 to 70.7 percent in 2001.[140] For the first nine months of 2002, the A-minus share accounted for 74 percent of the market, while the B share accounted for 11 percent, the C share accounted for 7.2 percent, and the D share accounted for 7.9 percent of the market.[141]

Delinquency rates by type of subprime loan are as follows: 3.36 percent for A-minus loans, 6.67 percent for B, 9.22 percent for C, and 21.03 percent for D, according to the Mortgage Information Corporation.[142] Because of their higher risk of default, subprime loans typically carry much higher mortgage rates than prime mortgages. Recent quotes for a 30-year Fixed Rate Mortgage were 8.85 percent for A-minus (with an 85 percent LTV), 9.10 percent for B credit (with an 80 percent LTV), and 10.35 percent for C credit (with a 75 percent LTV).[143] [144] As the low loan-to-value (LTV) ratios indicate, one loss mitigation technique used by subprime lenders is a high down payment requirement. Some housing advocates have expressed concern that the perceptions about the risk of subprime loans may not always

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139 U.S. Department of Housing and Urban Development/U.S. Department of the Treasury, *Curbing Predatory Lending Report*, 2000, p.31.

140 "Wholesale Dominates Subprime Market Through 3rd Quarter '02," *Inside B&C Lending*, published by Inside Mortgage Finance, December 16, 2002, pp. 1-2.

141 *Inside B&C Lending*, November 16, 2002, p.2.

142 Mortgage Information Corporation, *The Market Pulse*, Winter 2001, pp. 4-6.

143 *Inside B&C Lending*, published by Inside Mortgage Finance, February 17, 2003, page 13.

144 The high rate of foreclosures in the subprime market has been documented by HUD and others in recent research studies. For an overview of these studies, see Harold L. Bunce, Debbie Gruenstein, Christopher E. Herbert, Randall M. Scheessele, *Subprime Foreclosures: The Smoking Gun of Predatory Lending*, 2000. Also see Abt Associates Inc., *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Atlanta Metro Area*, February 2000 and *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Boston Metro Area*, September 2000; National Training and Information Center, *Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosures*, 2000; and the HUD study, *Unequal Burden in Baltimore: Income and Racial Disparities in Subprime Lending*, May 2000. These studies have found that foreclosures by subprime lenders grew rapidly during the 1990s and now exceed the subprime lenders' share of originations. In addition, the studies indicate that foreclosures of subprime loans occur much more quickly than foreclosures on prime loans, and that they are concentrated in low-income and African-American neighborhoods. Of course, given the riskier nature of these loans, a higher foreclosure rate would be expected. With the information available it is not possible to evaluate whether the disparity in foreclosure rates are within the range of what would be expected for loans prudently originated within this risk class. But findings from these studies about the high rate of mortgage foreclosure associated with subprime lending reinforce the concern that predatory lending can potentially have devastating effects for individual families and their neighborhoods.

be accurate, for example, creditworthy borrowers in inner city neighborhoods may be forced to use subprime lenders because mainstream lenders are not doing business in their neighborhoods (see below).

Subprime borrowers are much more likely to be low income and be a minority than other borrowers. Between 1999 and 2002, 41.3 percent of subprime loans in the conventional conforming market went to low-income borrowers, compared with 27.2 percent of non-subprime conventional conforming loans. During that same period, 18.4 percent of subprime loans were for African-American borrowers, compared with 4.3 percent of non-subprime conventional conforming loans. However, what distinguishes subprime loans from other loans is their concentration in African-American neighborhoods.

b. The Neighborhood Concentration of Subprime Lending

The growth in subprime lending over the last several years has benefited credit-impaired borrowers as well as those borrowers who choose to provide little documentation for underwriting. However, studies showing that subprime lending is disproportionately concentrated in low-income and minority neighborhoods have raised concerns about whether mainstream lenders are adequately serving these neighborhoods. A study of subprime lending in Chicago by The Woodstock Institute concluded that a dual, hypersegmented mortgage market existed in Chicago, as mainstream lenders active in white and upper-income neighborhoods were much less active in low-income and minority neighborhoods—effectively leaving these neighborhoods to unregulated subprime lenders.[145] As part of the HUD-Treasury Task Force on Predatory Lending, HUD's Office of Policy Development and Research released a national level study— entitled *Unequal Burden: Income and Racial Disparities in Subprime Lending in America*— that showed families living in low-income and African-American neighborhoods in 1998 relied disproportionately on subprime refinance lending, even after controlling for neighborhood income. An update of that analysis for the year 2000 yields the following trends:[146]

- In 2000, 36 percent of refinance mortgages in low-income neighborhoods were subprime, compared with only 16 percent in upper-income neighborhoods.

- Subprime lending accounted for 50 percent of refinance loans in majority African American neighborhoods—compared with only 21 percent in predominantly white areas (less than 30 percent of population is African American).

[145] Daniel Immergluck, *The Predatory Lending Crisis in Chicago: The Dual Mortgage Market and Local Policy*, testimony before the Chicago City Council, April 5, 2000. Immergluck found that subprime lenders received 74 percent of refinance applications in predominantly black tracts compared to 21 percent in predominantly white tracts in 1998. According to Immergluck,, these racial disparities provide evidence that the residential finance market in Chicago is hypersegmented, resulting in the increased likelihood that minorities receive mortgage credit from a subprime, rather than a prime, lender in Chicago. Also see Daniel Immergluck, *Stark Differences: The Explosion of the Subprime Industry and Racial Hypersegmentation in Home Equity Lending*, Woodstock Institute, October 2000

[146] See Randall M. Scheessele, *Black and White Disparities in Subprime Mortgage Refinance Lending*, Housing Finance Working Paper HF-014, Office of Policy Development and Research, U.S. Department of Housing and Urban Development, April 2002.

- The most dramatic view of the disparity in subprime lending comes from comparing homeowners in upper-income African-American and white neighborhoods. Among homeowners living in the upper-income white neighborhoods, only 16 percent turn to subprime lenders in 2000. But 42 percent of homeowners living in upper-income African-American neighborhoods relied upon subprime refinancing which is substantially more than the rate (30 percent) for homeowners living in low-income white neighborhoods.

- Similar results are obtained when the analysis is conducted for borrowers instead of neighborhoods. Upper-income African-American borrowers are twice as likely as low-income white borrowers to have subprime loans. Over one-half (54 percent) of low-income African-American borrowers turn to subprime lenders, as does over one-third (35 percent) of upper-income African-American borrowers. By comparison, only 24 percent of low-income white borrowers and 12 percent of upper-income white borrowers, rely upon subprime lenders for their refinance loans.[147]

It does not seem likely that these high market shares by subprime lenders in low-income and African-American neighborhoods can be justified by a heavier concentration of households with poor credit in these neighborhoods. Rather it appears that subprime lenders may have attained such high market shares by serving areas where prime lenders do not have a significant presence. The above finding that upper-income black borrowers rely more heavily on the subprime market than low-income white borrowers suggests that a portion of subprime lending is occurring with borrowers whose credit would qualify them for lower cost conventional prime loans. A lack of competition from prime lenders in low-income and minority neighborhoods has increased the chances that borrowers in these communities are paying a high cost for credit. As explained next, there is also evidence that the higher interest rates charged by subprime lenders cannot be fully explained solely as a function of the additional risks they bear. Thus, a greater presence by mainstream lenders could possibly reduce the high up-front fees and interest rates being paid by residents of low-income and minority neighborhoods.

The Freddie Mac study presented evidence that subprime loans bear interest rates that are higher than necessary to offset the higher credit risks of these loans.[148] The study compared (a) the interest rate on subprime loans rated A-minus by the lenders originating these loans with (b) the interest rates on prime loans purchased by Freddie Mac and rated A-minus by a Freddie Mac underwriting model. Despite the fact that both loan groups were rated A-minus, on average the subprime loans bore interest rates that were 215 basis points higher. Even assuming that the credit risk of the subprime loans was in fact higher than the prime loans, the study could not account for such a large discrepancy in interest rates. Assuming that default rates might be three to four times higher for the subprime loans would account for a 90 basis point interest rate

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[147] For an update to 2001, see The Association of Community Organizers for Reform Now (ACORN), *Separate and Unequal Predatory Lending in America,* 2002. In 2001, subprime lenders originated 27.8 percent of all conventional refinance loans for African-Americans, 13.6 percent for Hispanic homeowners, and just 6.3 percent for white homeowners. Overall, African-Americans were 4.4 times more likely to use a subprime lender than whites, and Hispanics were 2.2 times more likely to do so.

[148] Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, "Subprime Lending: An Investigation of Economic Efficiency," February 25, 2000.

differential. Assuming that servicing the subprime loans would be more costly would justify an additional 25 basis point differential. But even after allowing for these possible differences, the Freddie Mac researchers concluded that the subprime loans had an unexplained interest rate premium of 100 basis points on average.[149]

Banking regulators have recognized the link between the growth in subprime lending and the absence of mainstream lenders and have urged banks and thrifts that lending in these neighborhoods not only demonstrates responsible corporate citizenship but also profitable lending. Ellen Seidman, former Director of the Office of Thrift Supervision, stated that, “Many of those served by the subprime market are creditworthy borrowers who are simply stuck with subprime loans or subprime lenders because they live in neighborhoods that have too few credit or banking opportunities.”

With respect to the question of whether borrowers in the subprime market are sufficiently creditworthy to qualify for more traditional loans, Freddie Mac has said that one of the promises of automated underwriting is that it might be better able to identify borrowers who are unnecessarily assigned to the high-cost subprime market. Freddie Mac has estimated that 10-30 percent of borrowers who obtain mortgages in the subprime market could qualify for a conventional prime loan through Loan Prospector, Freddie Mac’s automated underwriting system.[150] Fannie Mae has stated that half of all mortgage borrowers steered to the high-cost subprime market are in the A-minus category, and therefore are prime candidates for Fannie Mae.[151]

c. Purchases of Subprime Mortgages by the GSEs

Fannie Mae and Freddie Mac have shown increasing interest in the subprime market since the latter half of the 1990s. The GSEs entered this market by purchasing securities backed by non-conforming loans. Freddie Mac, in particular, increased its subprime business through structured transactions, with Freddie Mac guaranteeing the senior classes of senior/subordinated securities. The two GSEs also purchase subprime loans on a flow basis. Fannie Mae began purchasing subprime loans through its Timely Payment Reward Mortgage program in June 1999, and Freddie Mac rolled out a similar product, Affordable Merit Rate, in May 2000 (described below). In addition to purchasing subprime loans for borrowers with blemished credit, the GSEs also purchase another non-conforming loan called an Alternative-A or “Alt-A” mortgage. These mortgages are made to prime borrowers who do not want to provide full documentation for loans. The GSEs’ interest in the subprime market has coincided with a maturation of their traditional market (the conforming conventional mortgage market), and their development of mortgage scoring systems, which they believe allows them to accurately model credit risk.

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[149] It should also be noted that higher interest rates are only one component of the higher cost of subprime loans since borrowers also often face higher origination points. The Freddie Mac study did not find a large differential between prime and subprime loans in points paid, but the study notes that subprime loans often have points rolled into the loan principal, which cannot be identified with their data.

[150] Freddie Mac, *We Open Doors for America’s Families*, Freddie Mac’s Annual Housing Activities Report for 1997, March 16, 1998, p. 23.

[151] Tommy Fernandez, "Fannie Mae Eyes Half of the Subprime Market," in *The American Banker*, March 1, 2002. Also see “Fannie Mae Vows More Minority Lending,” *Washington Post*, March 16, 2000, p. EO1.

Although the GSEs account for only a modest share of the subprime market today, some market analysts estimate that they could purchase as much as half of the overall subprime market in the next few years.[152]

Precise information on the GSEs' purchases of subprime loans is not readily available. Data can be pieced together from various sources, but this can be a confusing exercise because of the different types of non-conforming loans (Alt-A and subprime) and the different channels through which the GSEs purchase these loans (through securitizations and through their "flow-based" product offerings). Freddie Mac, which has been the more aggressive GSE in the subprime market, purchased approximately $12 billion in subprime loans during 1999—$7 billion of A-minus and alternative-A loans through its standard flow programs and $5 billion through structured transactions.[153] In 2000, Freddie Mac purchased $18.6 billion of subprime loans on a flow basis in addition to another $7.7 billion of subprime loans through structured transactions.[154] Freddie Mac securitized $9 billion in subprime and Alt-A product in 2001 and $11.1 billion in 2002.[155]

Fannie Mae initiated its Timely Payments product in September 1999, under which borrowers with slightly damaged credit can qualify for a mortgage with a higher interest rate than prime borrowers. Under this product, a borrower's interest rate will be reduced by 100 basis points if the borrower makes 24 consecutive monthly payments without a delinquency. Fannie Mae has revamped its automated underwriting system (Desktop Underwriter) so loans that were traditionally referred for manual underwriting are now given four risk classifications, three of which identify potential subprime (A-minus) loans.[156] Fannie purchased about $600 million of subprime loans on a flow basis in 2000.[157] Fannie Mae securitized around $0.6 billion in subprime mortgages in 2000, before increasing to $5.0 billion in 2001 and 7.3 billion in 2002.[158] In terms of total subprime activity (both flow and securitization activities), Fannie Mae purchased $9.2 billion in 2001 and over $15 billion in 2002, the latter figure representing about 10 percent of the market, according to Fannie Mae staff.[159]

A greater GSE role in the subprime lending market will most likely have a significant impact on the subprime market. Currently, the majority of subprime loans are not purchased by

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[152] Temkin et al., 2002, p. 1.

[153] David A. Andrukonis, "Entering the Subprime Arena," *Mortgage Banking*, May 2000, pp. 57-60.

[154] Subprime Lenders Mixed on Issue of GSE Mission Creep," Inside B and C Lending, March 19, 2001.

[155] Inside Mortgage Finance (IMF) recently reported that issuers of subprime securities sold a record number of securities to Fannie Mae and Freddie Mac in 2003. According to IMF, 20 firms sent $80 billion (representing 49 percent of total subprime MBS production) to the GSEs in 2003, compared with $38 billion (representing 34 percent of total subprime MBS production) to the GSEs in 2002. See Inside Mortgage Finance, *Inside B&C Lending*, January 26, p.1.

[156] See Lederman, et al., Op cit.

[157] Kenneth Temkin, Jennifer E. H. Johnson, and Diane K. Levy, "Subprime Markets, the Role of GSEs, and Risk-Based Pricing," *Urban Institute*, August 2001, p. 1.

[158] *Inside Mortgage Finance's*, "Inside MBS & ABS," December 15, 2000 and March 8, 2002.

[159] Statement by Mercy Jimenez of Fannie Mae in "Fannie Mae: Forges Ahead in Subprime," *Secondary Marketing Executive*, February 2003, p.15.

GSEs, and the numbers of lenders originating subprime loans typically do not issue a large amount of prime loans. Partly in response to higher affordable housing goals set by HUD in its new rule set in 2000, the GSEs are increasing their business in the subprime market. In the 2000 GSE Rule, HUD identified subprime borrowers as a market that can assist Fannie Mae and Freddie Mac in reaching their higher affordable housing goals while also helping establish more standardization in the subprime market. According to an Urban Institute study in 2002, many subprime lenders believe that successful companies serving high-risk borrowers need to have specialized expertise in outreach, servicing, and underwriting, which is lacking among most prime lenders.[160] These lenders do not believe the more standardized approaches of prime lenders and the GSEs will work with subprime borrowers, who require the more customized and intensive origination and loan servicing processes currently offered by experienced subprime lenders.

As noted above, both Fannie Mae and Freddie Mac make the claim that the subprime market is inefficient, pointing to evidence indicating that subprime borrowers pay interest rates, points, and fees in excess of the increased costs associated with serving riskier borrowers in the subprime market. [161] A recent Freddie Mac study found automated mortgage scoring less discriminatory and more accurate in predicting risk than manual systems such as those currently used by subprime lenders.[162] According to Fannie Mae, although a high proportion of borrowers in the subprime market could qualify for less costly prime mortgages, it remains unclear why these borrowers end up in the subprime market.[163] Fannie Mae and Freddie Mac believe they can bring more efficiency to the subprime market by creating standardized underwriting and pricing guidelines in the subprime market. An expanded GSE presence in the subprime market could be of significant benefit to lower-income and minority families if it attracted more mainstream lenders and competition to those inner-city neighborhoods that are currently served mainly by subprime lenders.

Many subprime lenders do not think it is appropriate for Fannie Mae and Freddie Mac to increase their role in the subprime market because they do not view the subprime market as inefficient. Some officials in subprime mortgage markets claim the higher prices paid by borrowers in the subprime market appropriately reflect the risks that come from extending credit to riskier borrowers. These officials believe it is unfair for GSE's to enter an efficient, private market that provides a necessary service to credit-impaired borrowers. Opponents of a larger GSE role in the subprime market argue GSEs have an unfair competitive advantage because they can secure capital at cheaper rates.[164] Because the GSEs have a funding advantage over other market participants, they have the ability to underprice their competitors and increase their market share.[165] This advantage, as has been the case in the prime market, could allow the GSEs

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[160] Temkin et al., 2002, p. 1

[161] See Lax et al., 2000.

[162] Zorn, et al., 2001, p. 5.

[163] Fannie Mae, Remarks Prepared for Delivery by Franklin Raines, Chairman and CEO of Fannie Mae to the National Community Reinvestment Coalition. Washington, D.C. March 20, 2000.

[164] Temkin et al., 2002, p. 1.

[165]. For an explanation of the GSEs funding advantage see *Government Sponsorship of FNMA and FHLMC*, United

to eventually play a significant role in the subprime market. Many subprime lenders fear they will be unfairly driven out of business as the GSEs increase their role in the subprime market.

G.8. Conclusions

The above sections summarize a few of the major developments in the GSEs' activities in recent years. It is not possible to identify specifically which recent actions taken by the GSEs were a direct result of the goals, but it is likely that the goals have played a significant role in these various aspects of the operations of Fannie Mae and Freddie Mac.

In most of the areas discussed, Fannie Mae has undertaken more initiatives than Freddie Mac.[166] Although it is not possible to isolate the effects of any particular GSE program, it seems likely its greater emphasis on such programs as partnership offices and purchases of seasoned CRA loans may be one reason why Fannie Mae had generally higher performance on all of the housing goals through 1998. One effect of the higher goals in this final rule would be to provide incentives for both GSEs to step up their emphasis on special affordable mortgage programs and financing home purchase mortgages, especially for lower-income and first-time homebuyers. And the final new housing goals may also encourage the GSEs to play enhanced roles in markets which involve large numbers of lower-income families. Some of these families are currently unable to obtain mortgage credit or they may be paying interest rates on their mortgages that exceed the rates for which they could qualify if the GSEs step up their presence in these markets.

H. Automated Underwriting and Risk-Based Pricing

According to Fannie Mae and Freddie Mac, the improved ability to predict defaults using their new automated mortgage scoring systems has allowed them to enter lower-income markets that they would not have reached using their traditional underwriting systems. Thus, with the new housing goal targets and the new home purchase subgoals, the GSEs will likely continue to enhance their automated underwriting systems to discern risks of low-income and underserved borrowers. A related issue concerns the use of risk-based pricing, or charging more to guarantee higher risk loans. This section discusses these two issues.

H.1. Automated Underwriting and Mortgage Scorecards

This, and the following two sections, discuss special topics that have impacted the primary and secondary mortgage markets in recent years. They are automated mortgage scoring, subprime loans, and risk-based pricing. The GSEs' use of automated underwriting and mortgage scoring systems was briefly discussed in the earlier section on underwriting standards. This section expands on issues related to automated underwriting, a process that has spread

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States Department of the Treasury, July 11, 1996.

[166] An exception to this general pattern is involvement in subprime lending, where Freddie Mac has played a larger role to date than Fannie Mae.

throughout the mortgage landscape over the past five years, due mainly to the efforts of Fannie Mae and Freddie Mac.

According to Freddie Mac economists, automated mortgage scoring has enabled lenders to expand homeownership opportunities, particularly for underserved populations.[167] There is growing evidence that automated mortgage scoring is more accurate than manual underwriting in predicting borrower risks. Mortgage scorecards express the probability that an applicant will default as a function of several underwriting variables such as the level of down payment, monthly-payment-to-income ratios, cash reserves, and various indicators of an applicant's creditworthiness or credit history. Mortgage scorecards are statistically estimated regression-type equations, based on historical relationships between mortgage foreclosures (or defaults) and the underwriting variables. The level of down payment and credit history indicators, such as a FICO score, are typically the most important predictors of default in mortgage scoring systems.

This increased accuracy in risk assessment of mortgage scorecards has allowed risk managers to set more lenient risk standards, and thus originate more loans to marginal applicants. Applicants, who would otherwise be rejected by manual underwriting, are being qualified for mortgages with automated mortgage scoring in part because the scorecard allows an applicant's weaker areas to be offset by stronger characteristics. Typically, applicants whose projected monthly debt payment (mortgage payment plus credit card payment plus automobile loan payment and so on) comprise a high percentage of their monthly income would be turned down by a traditional underwriting system that relied on fixed debt-to-income ratios (such as 36 percent). In a mortgage scoring system, these same applicants might be automatically accepted for a loan due to their stellar credit record or to their ability to raise more cash for a down payment. The entity funding or insuring the mortgage (i.e., a lender, private mortgage insurer, or a GSE) allows these positive characteristics to offset the negative characteristics because its confidence in the ability of the empirically-based mortgage scorecard to accurately identify those applicants who are more likely or less likely to eventually default on their loan.

Automated mortgage scoring was developed as a high-tech tool with the purpose of identifying credit risks in a more efficient manner. Automated mortgage scoring has grown as competition and decreased profit margins have created demands to reduce loan origination costs. As a result, automated mortgage scoring has become the predominant (around 60 to 70 percent) mortgage underwriting method. [168] As time and cost are reduced by the automated system, the hope was that more time would be devoted by underwriters to qualifying marginal loan applicants that are referred by the automated system for more a intensive, manual underwriting review. Fannie Mae and Freddie Mac are in the forefront of new developments in automated mortgage scoring technology. Both enterprises released automated underwriting systems in 1995—Freddie Mac's Loan Prospector and Fannie Mae's Desktop Underwriter. Each system

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[167] Peter M. Zorn, Gates, Susan, and Vanessa Perry, "Automated Underwriting and Lending Outcomes: The Effect of Improved Mortgage Risk Assessment on Under-Served Populations. Program on Housing and Urban Policy," *Conference Paper Series*, Fisher Center for Real Estate and Urban Economics. University of California Berkeley, 2001, p. 5.

[168] John W. Straka, "A Shift in the Mortgage Landscape: The 1990s Move to Automated Credit Evaluations," *Journal of Housing Research*, 2000, (11)2: p. 207.

uses numerical credit scores, such as those developed by Fair, Isaac, and Company, and additional data submitted by the borrower, such as loan-to-value ratios and available assets, to calculate a mortgage score that evaluates the likelihood of a borrower defaulting on the loan. The mortgage score is in essence a recommendation to the lender to accept the application, or to refer it for further review through manual underwriting. Accepted loans benefit from reduced document requirements and expedited processing.

As explained above, automated mortgage scoring allows tradeoffs between risk factors to be quantified more precisely, providing the industry more confidence in "pushing the envelope" of acceptable expected default rates. The GSEs' willingness to offer low-down-payment programs was based on their belief that their scoring models could identify the more creditworthy of the cash-constrained applicants. The GSEs' new "timely reward" products for subprime borrowers (discussed later) are integrated with their mortgage scoring systems. Automated mortgage scoring presents the opportunity to remove discrimination from mortgage underwriting, to accept all applicants, and to bring fair, objective, statistically based competitive pricing, greatly reducing costs for all risk groups. Some institutions have sought to better model and automate marginal and higher-risk loans, which have tended to be more costly to underwrite and more difficult to automate.[169]

Along with the promise of benefits, however, automated mortgage scoring has raised concerns. These concerns are related to the possibility of disparate impact and the proprietary nature of the mortgage score inputs. The first concern is that low-income and minority homebuyers will not score well enough to be accepted by the automated underwriting system, resulting in their getting fewer loans. African-American and Hispanic borrowers, for example, tend to have a poorer credit history record than other borrowers, which means they are more likely to be referred (rather than automatically accepted) by automated mortgage scoring systems that rely heavily on credit history measures such as a FICO score. There is also a significant statistical relationship between credit history scores and the minority composition of an area, after controlling for other locational characteristics.[170]

The second concern relates to the "black box" nature of the scoring algorithm. The scoring algorithm is proprietary and therefore it is difficult for applicants to know the reasons for their scores. However, it should be noted that the GSEs have taken steps to make their automated underwriting systems more transparent. Both Fannie Mae and Freddie Mac have published the factors used to make loan purchase decisions in Desktop Underwriter and Loan Prospector, respectively. In response to criticisms aimed at using FICO scores in mortgage underwriting, Fannie Mae's new version of Desktop Underwriter (DU) 5.0 replaces credit scores with specific credit characteristics and provides expanded approval product offerings for borrowers who have blemished credit. The specific credit characteristics include variables such as past delinquencies; credit records, foreclosures, and accounts in collection; credit card line and use; age of accounts; and number of credit inquiries.[171]

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[169] *Ibid.* pp. 208-217.

[170] Robert B. Avery, Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner, *Credit Scoring: Issues and Evidence form Credit Bureau Files*, mimeo, 1998, p. 24.

[171] Fannie Mae, September 4, 2002, p. 33.

With automated mortgage scoring replacing traditional manual underwriting comes the fear that the loss of individual attention poses a problem for people who have inaccuracies on their credit report or for members of cultural groups or recent immigrants who do not use traditional credit and do not have a credit score. Some subprime lenders and underwriters have claimed that their manual underwriting of high-risk borrowers cannot be automated with mortgage scoring. Although automated mortgage scoring has greatly reduced the cost of many lower-risk loans that are easier to rate, the cost of manually underwriting gray-area and higher-risk applicants still remains high.[172] There is also the fear that applicants who are referred by the automated system will not be given the full manual underwriting for the product that they initially applied for—rather they might be pushed off to higher priced products such as a subprime or FHA loan. In this case, the applicant may have had special circumstances that would have been clarified by the traditional manual underwriting, thus enabling the applicant to receive a prime loan consistent with his or her creditworthiness.

Banking regulators and legal analysts acknowledge the value of automated mortgage scoring, although some skeptics have noted concerns regarding fair lending, potential fraud, privacy issues, and the ability of models to withstand changing economic conditions.[173] With the rise of automated mortgage scoring, the great difference in Internet usage known as the "digital divide" could result in informational disadvantages for less educated and lower-income consumers. In addition to the digital divide, the lack of financial literacy in the United States may also result in a disparate impact on low-income and minority borrowers.[174]

<u>2002 Urban Institute Study:</u> The Urban Institute submitted a report to HUD in 2002 on subprime markets, the role of GSEs, and risk-based pricing.[175] The study took a preliminary look at the use of automated underwriting systems for a small sample of lenders. After conducting interviews with both subprime and prime lenders, the report noted that all of the lenders in the study had implemented some type of automated underwriting system. These lenders stated that automated underwriting raised their business volume and streamlined their approval process. In addition, the lenders reported they were able to direct more underwriting resources to borderline applications despite an increase in business volume.

Even with the use of automated mortgage scoring, the lenders in the study continued to conduct at least a cursory review to validate the application material. The majority of the lenders still used manual underwriting to originate loans not recommended for approval with automated mortgage scoring. The lenders reported they formulated their policies and procedures to make

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[172] Kenneth Temkin , Jennifer E.H. Johnson, and Diane Levy, *Subprime Markets, The Role of GSEs, and Risk-Based Pricing*, Washington: The Urban Institute. Report Prepared for the U.S. Department of Housing and Urban Development, 2002.

[173] Allen J. Fishbein, "Is Credit Scoring a Winner for Everyone?" *Stone Soup*, 2000, 14(3): pp. 14-15. See also Fitch IBCA, Inc., *Residential Mortgage Credit Scoring,* New York, 1995 and Jim Kunkel, "The Risk of Mortgage Automation," in *Mortgage Banking*, 1995, 57(8): pp. 69-76.

[174] Zorn et al., 2001, pp. 19-20.

[175] Kenneth Temkin, Jennifer E.H .Johnson, and Diane Levy, *Subprime Markets, The Role of GSEs, and Risk-Based Pricing,* Washington: The Urban Institute. Report Prepared for the U.S. Department of Housing and Urban Development, 2002.

certain that borrowers receive the best mortgage, according to product eligibility. This study will be further referenced in a following section regarding subprime markets.

2001 Freddie Mac Study. According to a Freddie Mac study published by the Fisher Center for Real Estate and Urban Economics at University of California at Berkeley, underserved populations have benefited from automated mortgage scoring because of the increased ability to distinguish between a range of credit risks. In this paper, Freddie Mac economists compared the manual and automated mortgage scoring approval rates of a sample of minority loans originated in 1993-94 and purchased by Freddie Mac. While manual underwriters rated 51 percent of the minority loans in the sample as accept, automated mortgage scoring would have rated 79 percent of the loans as accept.[176]

In comparison to manual underwriting, this study found automated mortgage scoring not only less discriminatory and but also a more accurate in predicting risk. Two versions of Freddie Mac's automated underwriting system, Loan Prospector (LP), were used to review three groups of mortgage loans purchased by Freddie Mac.[177] The study found that LP was a highly accurate predictor of mortgage default. The resulting improved accuracy translates into benefits for borrowers, who would otherwise be rejected by manual underwriting to qualify for mortgages.

Analysis of the first group of loans showed that loans rated as "caution" were four times more likely to default than the average for all loans. Minority borrowers whose loans were rated as "caution" were five times more likely to default, and low-income borrowers whose loans were rated as "caution" were four times more likely to default than the average for all loans. The 2000 version of LP approved 87.1 percent of loans generated through affordable housing programs, compared to a 51.6 percent approval rate when the same loans were assessed using manual underwriting procedures. Further, the study found LP more accurate than manual underwriting at predicting default risk even with a higher approval rate. The study also demonstrated that Freddie Mac's year 2000 version of LP was more accurate in predicting risk than its 1995 version.

Concluding Observations. Automated underwriting has enabled lenders to reach new markets and expand homeownership opportunities, as illustrated by the 2001 Freddie Mac study. Increased accuracy with automated mortgage scoring has led to the development of new mortgage products that would have been previously considered too risky. For example, Freddie Mac uses Loan Prospector to approve Alt A loans, which tend to have nontraditional documentation; A-minus loans, which pose a higher risk of default; and other higher-risk mortgages, like 100 percent LTV loans. Both GSEs have and continue to add new products to develop their automated underwriting systems to reach more marginal borrowers.

Despite the gains in automated mortgage scoring and other innovations, minorities are still less likely to be approved for a loan. The difference in minority and non-minority accept rates may reflect greater social inequities in financial capacity and credit, which are integral variables in both manual and automated underwriting. In the future, the accuracy of automated

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[176] Zorn, et al., 2001, pp. 14-15.

[177] *Ibid*. p. 5.

mortgage scoring will hinge on updating the models and making them more predictive while reducing the disparate impact on low-income and minority borrowers.[178] The fairness of automated scoring systems will also depend importantly on whether referred applicants receive a traditional manual underwriting for the loan that they initially applied for, rather than being immediately offered a higher priced loan that does not recognize their true creditworthiness.

In addition to using automated underwriting systems as a tool to help determine whether a mortgage application should be approved, the GSEs' automated underwriting systems are being further adapted to facilitate risk-basked pricing. With risk-based pricing, mortgage lenders can offer each borrower an individual rate based on his or her risk. The division between the subprime and the prime mortgage market will begin to fade with the rise of risk-based pricing, which is discussed in the next section on the subprime market.

H. 2. Risk-Based Pricing

The expanded use of automated underwriting and the initial uses of risk-based pricing are changing the mortgage lending environment, often blurring the distinctions between the prime and subprime market. Prime lenders are now using automated underwriting systems that are being adapted to facilitate risk-based pricing. For some time, the majority of prime mortgage borrowers have received loan rates based on average cost pricing. Generally, borrowers receive roughly the same Annual Percentage Rate[179] (APR), regardless of the risk of loss to the lender. The risk of all borrowers is averaged together, and the price is determined by the average risk.

In contrast, risk-based pricing enables mortgage lenders to offer each borrower an individualized interest rate based on his or her risk. Or, more broadly, to offer interest rates based on whether or not the borrower falls into a certain category of risk, such as specific loan-to-value and FICO score combination or specified mortgage score range. Lenders could also set the interest rate based on various factors including the probability of prepayment and characteristics of the underlying collateral, as well as the default risk of the borrower. Borrowers that pose a lower risk of loss to the lender would then be charged a comparatively lower rate than those borrowers with greater risk. Rather than lower risk borrowers cross-subsidizing higher risk borrowers like in average cost pricing, lower risk borrowers pay a relatively lower rate.

In response to the expanded use of automated underwriting and pressures from the GSEs, other purchasers of loans, mortgage insurers, and rating firms, lenders are increasing their use of risk-based pricing.[180] In today's markets, some form of differential pricing exists for the various subprime categories, for new products targeted at credit-impaired borrowers (such as Fannie Mae's Timely Payments product), and for private mortgage insurance across all credit ranges. For example, private mortgage insurers use FICO scores and "Accept" determinations from the

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[178] *Ibid*. pp. 18-19.

[179] Annual Percentage Rate takes into account points, fees, and the periodic interest rate.

[180] Temkin et al., 2002, p.29.

GSEs' automated underwriting systems to make adjustments to insurance premiums.[181] Rating agencies vary subordination requirements based on the credit qualify of the underlying collateral.

Many believe there is cross-subsidization within the crude risk categories used in today's market. For example, some of the better quality subprime borrowers in the A-minus category may be inappropriately assigned to the subprime market. The GSEs and others are attempting to learn more about the subprime market, and their initial efforts suggest that there will be an increase in the use of risk-based pricing within this market, although it is recognized that the expansion of risk-based pricing depends importantly on these parties gaining a better understanding of the subprime borrower and the ability of their mortgage scoring systems to predict risk within this market. It must be noted that the power of the underlying algorithm in automated underwriting systems determines the ability of these systems to accurately predict risk and set prices.

If prime lenders adopted risk-based pricing, many would be willing to lend to riskier subprime borrowers because their risk would now be offset with an increase in price. In theory, the mortgage market should expand because all mortgages will be approved at a price commensurate with risk, rather than setting a risk floor and approving no one beneath the floor. Risk-based pricing could also expand the prime lenders' market by enabling them to reach a new group of underserved customers.[182] Taking advantage of GSEs' lower cost of capital, GSEs may be able to offer borrowers who could not afford a rate in the subprime market a rate they can afford resulting from risk-based pricing.

Risk-based pricing also poses challenges on the mortgage market because some of the more risky borrowers (who are currently cross-subsidized by less risky borrowers) may not be able to afford their higher, risk-based interest rate. Also, the adoption of an automated risk-based pricing system may have an uncertain effect on minority groups, who tend to have lower credit scores, as discussed earlier. On the other hand, if minorities are eligible for prime financing, the cost of financing minorities may fall as will the potential for subprime lenders to draw minorities to their higher-priced products.

As the GSEs become more comfortable with subprime lending, the line between what today is considered a subprime loan versus a prime loan will likely deteriorate, making expansion by the GSEs look more like an increase in the prime market. This melding of markets could occur even if many of the underlying characteristics of subprime borrowers and the market's evaluation of the risks posed by these borrowers remain unchanged. Increased involvement by the GSEs in the subprime market will result in more standardized underwriting guidelines and the increased participation of traditional lenders. In fact, there are indications that mainstream players are already increasing their activity in this market. According to staff from Moody's Investors Service, the growing role of large mortgage aggregators in the subprime market has been a key factor in the improving credit qualify on deals issued in 2002.[183] According to a representative from Washington Mutual, subprime

[181] For example, see Radian's product offerings at www.radiangroupinc.com.

[182] Vanessa Bush, "Risk-Based Pricing Trend Could Make Mortgage Lending More Efficient," *America's Community Banker*, October 1, 1998.

[183] "Improving Credit Quality, Maturing Business Stoke Confidence in Subprime MBS Market," *Inside MBS &*

credit qualify has also improved as lenders carve out new loan categories that fall somewhere between the large Alt A market and traditional subprime business.[184] As the subprime market becomes more standardized, market efficiencies will reduce borrowing costs. Lending to credit-impaired borrowers will, in turn, increasingly make good business sense for the mortgage market.

I. Single-Family Market Effects—Competitive Considerations

The effects of increased GSE purchases on market shares of both conventional portfolio lenders and FHA lenders are considered in this section. The principal conclusion is that the non-GSE portions of the goal-qualifying markets are quite large, which suggests that there is room for the GSEs to increase their purchases without significantly affecting the relative shares of industry participants. Chapter 3 provided estimates of the additional single-family-owner loans that the GSEs will purchase under the new housing goal targets. That analysis highlights the extent to which the GSEs will have to move deeper into the lower-income-end of the market in order to meet the new housing goals. Section I.2 below summarizes the main findings from that analysis, as background for examining the market effects of the housing goals.
As discussed in Chapter 3, increased GSE efforts under the higher 2005-2008 goals could cause some realignment in market shares away from portfolio and possibly FHA lenders. The increased volume of affordable housing loans and the analysis by the Urban Institute and others indicate the existence of potential homebuyers, which would allow for increased lending by all lender types. Realignment of industry market shares will be limited to the extent that the industry volume of affordable housing loans rises.

Section I.1 examines the GSEs' share of the conventional conforming market; Section I.2 summarizes findings about market effects from Chapter III; Section I.3 discusses effects on portfolio lenders; Section I.4 discusses the impact on the subprime market; and Section I.5 examines issues raised by commenters about potential impacts of the new housing goal targets on FHA.

I.1. The GSE Portions of the Market

Overall Mortgage Market. The GSEs' role in the mortgage market varies somewhat from year to year in response to changes in interest rates, mortgage product types, and a variety of other factors. The Office of Federal Housing Enterprise Oversight (OFHEO) estimates that the GSEs' share of total originations in the conventional single-family mortgage market, measured in dollars, declined from 37 percent in 1996 to 32 percent in 1997—well below the peak of 51 percent attained in 1993. However, OFHEO estimates that the GSEs' share of the conventional market rebounded sharply in 1998-99, to 43-42 percent. The GSEs' share then decreased to approximately 30 percent of the single-family conventional mortgages originated in

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ABS, published by Inside Mortgage Finance, February 21, 2003.

[184] *Ibid*.

2000, and then increased sharply to 40 percent in 2001. Total GSE purchases, including loans originated in prior years, amounted to 46 percent of conventional originations in 2001.[185] OFHEO has not updated these estimtes, but HUD projects that the corresponding figures would be slightly over 50 percent for 2002 and almost 60 percent for 2003. The GSEs have indicated that they expect their role in the mortgage market to continue to increase in the future, as they develop new products, refine existing products, and enter markets where they have not played a major role in the past. The Department's goals for the GSEs also anticipate that their involvement in the mortgage market will continue to rise, as they reach out to lead the market in funding home purchase loans.

Appendix A of the Final Rule presents an analysis of the GSEs' role in the overall mortgage market between 1999 and 2002, as well their role in each of the three goals-qualifying markets. The results are summarized in Tables 4.4 and 4.5a, which compare GSE mortgage purchases with HUD's estimates of the numbers of units financed in the conventional conforming market. Table 4.4 presents aggregate data for 1999-2002 while Table 4.5a presents more summary market share data for individual years 2000, 2001 and 2002.[186] HUD estimates that there were 47,551,039 single-family-owner, single-family rental, and multifamily rental units financed by new conventional conforming mortgages between 1999 and 2002. Fannie Mae's and Freddie Mac's mortgage purchases financed 26,118,927 of these dwelling units, or 55 percent of all dwelling units financed.

TABLES 4.4 AND 4.5a

Goals-Qualifying Markets. As shown in Table 4.4, the GSEs have played a smaller role in the goals-qualifying markets than they have played in the overall market. Between 1999 and 2002, new mortgages were originated for 26,051,771 dwelling units that qualified for the Low- and Moderate-Income Goal; the GSEs low-mod purchases financed 12,608,215 dwelling units, or 48 percent of the low-mod market. Similarly, the GSEs' purchases accounted for 48 percent of the underserved areas market, but only 41 percent of the special affordable market. Obviously, the GSEs have not been leading the industry in financing units that qualify for the three housing goals. They need to improve their performance and it appears that there is ample room in the non-GSE portions of the goals-qualifying markets for them to do so. For instance, the GSEs were not involved in over one-half of the special affordable market during the 1999-to-2002

[185] Office of Federal Housing Enterprise Oversight. "Mortgage Markets and The Enterprises in 2001," August 2002, p. 13. OFHEO attributes the 1997 downturn in the GSEs' role to increased holdings of mortgages in portfolio by depository institutions and to increased competition with Fannie Mae and Freddie Mac by private label issuers.

[186] Tables 4.4 and 4.5a examine GSE purchases on a "going forward basis by origination year". Specifically, it considers GSE purchases of: (a) 2000 mortgage originations during 2000, 2001, 2002 and 2003; (b) 2001 originations during 2001, 2002 and 2003; and (c) 2002 originations during 2002 and 2003. In other words, this analysis looks at the GSEs' purchases of a particular origination year cohort through 2003. This approach contrasts with the approach that examines GSE purchases on a "backward looking basis by purchase year", for example, GSE purchases during 2000 of both new 2000 originations and originations during previous years (the latter called "prior-year" or seasoned loans). Either approach is a valid method for examining GSE purchases; in fact, when analyzing aggregated data such as the combined 1999-2002 data in Table 4.4, the two approaches yield somewhat similar results. HUD's methodology for deriving the market estimates is explained in Appendix D of the Final GSE Rule. B&C loans have been excluded from the market estimates in Tables 4.4 and 4.5a.

Table 4.4

Number of Newly-Mortgaged Units by Type in the 1999-2002 Conventional Conforming Market Compared To Fannie Mae and Freddie Mac Purchases

	Single-Family Owner		Single-Family Rental		Multifamily		Total Rental		Total Market	
Total Units										
Market	35,501,562	74.7%	5,031,433	10.6%	7,018,044	14.8%	12,049,477	25.3%	47,551,039	100.0%
Fannie Mae	12,529,937	81.8%	1,301,070	8.5%	1,482,109	9.7%	2,783,179	18.2%	15,313,116	100.0%
Freddie Mac	9,122,244	84.4%	686,131	6.3%	997,436	9.2%	1,683,567	15.6%	10,805,811	100.0%
GSE Total	21,652,181	82.9%	1,987,201	7.6%	2,479,545	9.5%	4,466,746	17.1%	26,118,927	100.0%
GSE % of Market	61.0%		39.5%		35.3%		37.1%		54.9%	
Low-Mod Units										
Market	15,207,242	58.4%	4,528,290	17.4%	6,316,239	24.2%	10,844,529	41.6%	26,051,771	100.0%
Fannie Mae	5,030,333	66.9%	1,129,485	15.0%	1,361,022	18.1%	2,490,507	33.1%	7,520,841	100.0%
Freddie Mac	3,561,496	70.0%	600,065	11.8%	925,814	18.2%	1,525,878	30.0%	5,087,375	100.0%
GSE Total	8,591,830	68.1%	1,729,550	13.7%	2,286,836	18.1%	4,016,385	31.9%	12,608,215	100.0%
GSE % of Market	56.5%		38.2%		36.2%		37.0%		48.4%	
Underserved Area Units										
Market	9,627,980	62.1%	2,212,607	14.3%	3,672,576	23.7%	5,885,183	37.9%	15,513,163	100.0%
Fannie Mae	3,102,848	70.6%	678,042	15.4%	616,263	14.0%	1,294,305	29.4%	4,397,153	100.0%
Freddie Mac	2,202,637	73.7%	334,675	11.2%	451,077	15.1%	785,752	26.3%	2,988,389	100.0%
GSE Total	5,305,485	71.8%	1,012,717	13.7%	1,067,340	14.5%	2,080,057	28.2%	7,385,542	100.0%
GSE % of Market	55.1%		45.8%		29.1%		35.3%		47.6%	
Special Affordable Units										
Market	5,425,061	43.7%	2,918,232	23.5%	4,070,466	32.8%	6,988,698	56.3%	12,413,759	100.0%
Fannie Mae	1,653,476	53.8%	633,572	20.6%	786,892	25.6%	1,420,464	46.2%	3,073,940	100.0%
Freddie Mac	1,188,829	58.6%	339,990	16.8%	500,427	24.7%	840,417	41.4%	2,029,246	100.0%
GSE Total	2,842,304	55.7%	973,562	19.1%	1,287,319	25.2%	2,260,882	44.3%	5,103,186	100.0%
GSE % of Market	52.4%		33.4%		31.6%		32.4%		41.1%	

Source: The market data are the estimated number of newly mortgaged units between 1999-2002. The single-family owner market data exclude B&C loans. See Appendix D for an explanation of the market methodology. The GSE data include units from mortgages originated between 1999 and 2002 and purchased by one of the GSEs during 1999 and 2003. GSE data with missing affordability or geocode are reallocated based the distribution of existing data.

Table 4.5a

GSE Share of Newly-Mortgaged Units
Conventional Conforming Market
2000, 2001, and 2002

	Single-Family Owner	Single-Family Rental	Multifamily	Total Rental	Total Market
2000 Financed Units					
Total	48	30	35	33	44
Low-Mod	45	29	37	34	40
Underserved Area	44	36	28	31	38
Special Affordable	41	26	32	30	34
2001 Financed Units					
Total	55	38	34	36	51
Low-Mod	53	38	35	37	46
Underserved Area	50	43	29	34	44
Special Affordable	49	34	30	32	39
2002 Financed Units					
Total	74	51	41	46	68
Low-Mod	69	49	42	45	60
Underserved Area	68	59	33	44	59
Special Affordable	67	43	37	40	53

Source: See notes to Table 4.4. The first figure ("48") is interpreted as follows: Fannie Mae's and Freddie Mac's acquisitions (during 2000, 2001, 2002, and 2003) of single-family-owner home purchase mortgages originated in 2000 accounted for 48 percent of all such mortgages originated that year in the conventional conforming market.

period. To summarize, the data in Table 4.4 show that the non-GSE portions of the goals-qualifying markets are large relative to existing GSE purchases, which suggests that there is room for the GSEs to increase their purchases.

As seen in the fifth row of Table 4.4, the GSEs' market share varies across the different market sectors; the GSE share is 61 percent for the single-family-owner market, 40 percent for the single-family rental market, and 35 percent for the multifamily rental market.[187] Thus, it is interesting to examine the GSE role in each market.

Single-Family Owner Market. The GSEs' purchases of single-family-owner loans represented 61 percent of all single-family-owner loans originated between 1999 and 2002, compared with 57 percent of the low-mod loans that were originated, 55 percent of underserved area loans, and 52 percent of the special affordable loans. There are ample opportunities for the GSEs to continue the improvement that they have recently made under the housing goals. Almost one-half of the goals-qualifying loans originated during 1999-2002 remained available to the GSEs to purchase; there are clearly affordable loans being originated that the GSEs can purchase.

Section E above presented similar data with respect to first-time homebuyers. Considering the total mortgage market (both government and conventional loans), it is estimated that the GSEs purchased only 24 percent of all first-time homebuyer loans between 1999 and 2001, and only 14 percent of loans originated during that same period for African-American and Hispanic first-time homebuyers. Considering the conventional conforming market and the same time period, it is estimated that the GSEs purchased only 40 percent of the first-time homebuyer loans originated in that market, and only 31 percent of loans originated for African-American and Hispanic first-time homebuyers. These data suggest there is a sizable market left for the GSEs to enter.

Furthermore, the GSEs' purchases under the housing goals are not limited to new mortgages that are originated in the current calendar year. The GSEs can purchase loans from the substantial, existing stock of affordable loans held in lenders' portfolios, after these loans have seasoned and the GSEs have had the opportunity to observe their payment performance. In fact, based on Fannie Mae's recent experience, the purchase of seasoned loans appears to be one effective strategy for purchasing goals-qualifying loans.

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[187] As discussed in Appendix D, the GSEs questioned HUD's historical estimates of the multifamily market as too high. Section C of Appendix D discusses these comments and responds. As indicated in Table 4.4, multifamily loans accounted for 14.8 percent of all financed units in the market, excluding B&C loans. As reported in Appendix D, HUD also conducted sensitivity analyses that reduced its 1999-2002 multifamily shares for the market by approximately two percentage points. The results for these lower multifamily market shares are reported in Table 4.5b (1999-2002 aggregate results) and Table 4.5c (2000-2002 individual year results). In this case, 1999-2002 multifamily units decreased from 7,018,044 units to 5,991,036 units (reducing the multifamily share from 14.8 percent to 12.9 percent). With these reduced multifamily market numbers, the GSEs' share of the multifamily market increased from 35 percent to 41 percent. The GSEs' shares of the overall goals-qualifying markets increased as follows: low-mod -- from 48 percent (see right column of Table 4.4) to 50 percent (see right column of Table 4.5b); underserved areas – from 48 percent to 49 percent; and special affordable – from 41 percent to 43 percent.

The data in Table 4.5a show a strong upward trend from 2000 and 2001 to 2002 in the GSE share of the single-family-owner market. Their share of 2000 financed units in the conventional conforming market totaled 48 percent. This increased to 55 percent in 2001 then to 74 percent in 2002. The large increase in 2002 can be attributed to the relatively low interest rates in that year. During such a period, the share of fixed rate mortgage originations increases relative to adjustable rate mortgages. Due to the higher risk associated with fixed rate mortgages, less thrift institutions are willing to hold them, and, thus, more are sold to the GSEs. As a result, during low interest rate periods, the GSE share of mortgages increases.

Single-Family Rental Market. As explained in Appendix A of the final rule, the GSEs are much less active in this market than in the single-family owner market. HUD estimates that GSE purchases between 1999 and 2002 totaled only 40 percent of all single-family rental units that were financed in the conventional conforming market. Many of these properties are "mom-and-pop" operations, which may not follow financing procedures consistent with the GSEs' guidelines. Much of the financing needed in this area is for rehabilitation loans on 2-4 unit properties in older areas, a market in which the GSEs' have not played a major role. However, this sector could certainly benefit from an enhanced role by the GSEs, and the data in Table A.30 indicate that there is room for such an enhanced role, as approximately two-thirds of this market remains for the GSEs to enter.

While HUD recognizes that some segments of the market may be more challenging for the GSEs than others, the data reported in Table 4.4 shows that the GSEs have ample opportunities to purchase targeted single-family mortgages. Furthermore, if a GSE makes a business decision to not pursue certain types of goals-qualifying loans in one segment of the market, they are free to pursue goals-qualifying owner and rental property mortgages in other segments of the market. As market leaders, the GSEs should be looking for innovative ways to pursue this business. Chapter 6 of this Regulatory Analysis provides evidence that the GSEs can earn financial returns on their purchases of goals-qualifying loans that are only slightly below their return on equity from their normal business.

Once again, Table 4.5a shows a large increase in the GSE share of newly-mortgaged single-family units financed in 2002 compared to those financed in 2000 and 2001. As described above for the single-family owner market, this large increase is due to the large share of fixed-rate mortgages, compared to adjustable rate mortgages, originated during the refinancing wave of 2002.

The above discussion illustrate that there is ample room for the GSEs to purchase additional targeted loans. The impacts on other market actors would depend on how aggressively the GSEs pursue these market opportunities.

[Note: The data in Tables 4.5b and 4.5c are based on a market analysis with a lower multifamily share. These data are discussed in Chapter V.]

TABLES 4.5b AND 4.5c

The above discussion illustrates that there is room for the GSEs to purchase additional

Table 4.5b

Number of Newly-Mortgaged Units by Type in the 1999-2002 Conventional Conforming Market Compared To Fannie Mae and Freddie Mac Purchases: Lower Multifamily Market Shares

	Single-Family Owner		Single-Family Rental		Multifamily		Total Rental		Total Market	
Total Units										
Market	35,501,562	76.3%	5,031,433	10.8%	5,991,036	12.9%	11,022,469	23.7%	46,524,031	100.0%
Fannie Mae	12,529,937	81.8%	1,301,070	8.5%	1,482,109	9.7%	2,783,179	18.2%	15,313,116	100.0%
Freddie Mac	9,122,244	84.4%	686,131	6.3%	997,436	9.2%	1,683,567	15.6%	10,805,811	100.0%
GSE Total	21,652,181	82.9%	1,987,201	7.6%	2,479,545	9.5%	4,466,746	17.1%	26,118,927	100.0%
GSE % of Market	61.0%		39.5%		41.4%		40.5%		56.1%	
Low-Mod Units										
Market	15,207,242	60.5%	4,528,290	18.0%	5,391,932	21.5%	9,920,222	39.5%	25,127,464	100.0%
Fannie Mae	5,030,333	66.9%	1,129,485	15.0%	1,361,022	18.1%	2,490,507	33.1%	7,520,841	100.0%
Freddie Mac	3,561,496	70.0%	600,065	11.8%	925,814	18.2%	1,525,878	30.0%	5,087,375	100.0%
GSE Total	8,591,830	68.1%	1,729,550	13.7%	2,286,836	18.1%	4,016,385	31.9%	12,608,215	100.0%
GSE % of Market	56.5%		38.2%		42.4%		40.5%		50.2%	
Underserved Area Units										
Market	9,627,980	64.3%	2,212,607	14.8%	3,135,059	20.9%	5,347,666	35.7%	14,975,646	100.0%
Fannie Mae	3,102,848	70.6%	678,042	15.4%	616,263	14.0%	1,294,305	29.4%	4,397,153	100.0%
Freddie Mac	2,202,637	73.7%	334,675	11.2%	451,077	15.1%	785,752	26.3%	2,988,389	100.0%
GSE Total	5,305,485	71.8%	1,012,717	13.7%	1,067,340	14.5%	2,080,057	28.2%	7,385,542	100.0%
GSE % of Market	55.1%		45.8%		34.0%		38.9%		49.3%	
Special Affordable Units										
Market	5,425,061	45.9%	2,918,232	24.7%	3,474,800	29.4%	6,393,032	54.1%	11,818,093	100.0%
Fannie Mae	1,653,476	53.8%	633,572	20.6%	786,892	25.6%	1,420,464	46.2%	3,073,940	100.0%
Freddie Mac	1,188,829	58.6%	339,990	16.8%	500,427	24.7%	840,417	41.4%	2,029,246	100.0%
GSE Total	2,842,304	55.7%	973,562	19.1%	1,287,319	25.2%	2,260,882	44.3%	5,103,186	100.0%
GSE % of Market	52.4%		33.4%		37.0%		35.4%		43.2%	

Source: Compared with Table 4.4, this table assumes lower multifamily shares in the mortgage market, as explanined in Sections F-H of Appendix D. The market data are the estimated number of newly mortgaged units between 1999-2002. The single-family owner market data exclude B&C loans. See Appendix D for an explanation of the market methodology. The GSE data include units from mortgages originated between 1999 and 2002 and purchased by one of the GSEs during 1999 and 2003. GSE data with missing affordability or geocode are reallocated based the distribution of existing data.

Table 4.5c

GSE Share of Newly-Mortgaged Units
Conventional Conforming Market
2000, 2001, and 2002
Lower Multifamily Market Shares

	Single-Family Owner	Single-Family Rental	Multifamily	Total Rental	Total Market
2000 Financed Units					
Total	48	30	41	37	45
Low-Mod	45	29	43	37	42
Underserved Area	44	36	33	34	40
Special Affordable	41	26	38	33	36
2001 Financed Units					
Total	55	38	39	39	52
Low-Mod	53	38	41	39	48
Underserved Area	50	43	33	37	46
Special Affordable	49	34	35	34	41
2002 Financed Units					
Total	74	51	49	50	69
Low-Mod	69	49	49	49	62
Underserved Area	68	59	39	48	61
Special Affordable	67	43	44	43	55

Source: See notes to Table 4.5b. The first figure ("48") is interpreted as follows: Fannie Mae's and Freddie Mac's acquisitions (during 2000, 2001, 2002, and 2003) of single-family-owner home purchase mortgages originated in 2000 accounted for 48 percent of all such mortgages originated that year in the conventional conforming market.

targeted loans. The impacts on other market actors would depend on how aggressively the GSEs have to pursue these market opportunities in order to reach the new housing goal targets, an issue examined in Chapter III. Therefore, as background for the discussion of the specific market sectors, the main findings from Chapter III are summarized in the next section.

I.2. Findings from Chapter 3's Market Analysis of Additional GSE Goals Purchases

In their comments, both GSEs made several statements about the infeasibility of their accomplishing the housing goals, the likelihood they would have to "manage their denominator" (i.e., restrict their purchases of non-goals-qualifying loans in order to reduce their denominator in the goals calculation, so that their goals percentage would be high enough to meet the new targets), the negative impacts of the higher goals on middle-class borrowers, and the potential higher costs to lower-income borrowers as there would be less opportunity to cross-subsidize these borrowers with revenues from non-goals-qualifying borrowers. Many of the GSEs' comments dealt with the combination of a heavy refinance environment (such as 2002 and 2003) and the higher, out-year goals. As explained in Chapter III, HUD is publishing in the Federal Register an Advance Notice of Proposed Rulemaking that advises the public of HUD's intention to consider by separate rulemaking a provision that recognizes and takes into consideration the impact of high volumes of refinance transactions on the GSEs' ability to achieve the housing goals in certain years, and solicits proposals on how any such provision should be structured and implemented. Still, the GSEs seemed to generalize their concerns to other economic environments as well (such as a home purchase environment).

Sections C.4e and C.4f of Chapter III dealt with these market issues by estimating the additional goals-qualifying purchases that Fannie Mae and Freddie Mac will have to make in order to meet the 2005-2008 goal and subgoal targets. Essentially, this involved projecting the goals percentages for each GSE based on their past behavior, estimating the extent to which each GSE's projected baseline performance fell short of the new goal and subgoal targets, estimating the additional purchases needed to satisfy the shortfalls, and expressing the additional GSE purchases as a share of the non-GSE portion of the conventional conforming market. More specifically, the modeling effort had the following three parts:

(1) Baseline Performance: The goals-qualifying purchases of each GSE were projected assuming that a home purchase environment will characterize the 2005-2008 market and assuming that the GSEs' will purchase single-family-owner (SFO) goals-qualifying loans at their 2001-2002 average rates for home loans (called Scenario A) and at their previous peak rates for home loans (called Scenario B).[188] The projection model also assumed an initial multifamily share of 10 percent for Freddie Mac and 12 percent for Fannie Mae. For each GSE, the projection model yielded baseline percentages for each of the three housing goals and three home purchase subgoals. **Shortfalls**, and the need for **additional purchases**, were then determined by comparing the baseline goals percentages with the new goal and subgoal target levels.

(2) Additional Goals-Qualifying Purchases. In cases where a GSE's baseline

[188] Less affordable market environments were simulated by discounting the goals qualifying rates in scenarios A and B (e.g., 0.975 times scenario B, 0.95 times scenario B)

performance fell short of the goals, HUD's projection model estimated the additional single-family and multifamily purchases needed to satisfy that shortfall and meet the new goal and subgoal targets. As emphasized in Chapter III, these additional-purchase scenarios were purely illustrative, as the GSEs could engage in a variety of purchase strategies to address their shortfalls. Still, the additional-purchase scenarios provide a sense of the effort needed by each GSE to meet the new goals and subgoals.

(3) Additional Purchases as a Share of the Non-GSE Market. The final step was to express the additional goals-qualifying purchases as a percentage of the non-GSE portion of the conventional conforming market which, for special affordable loans, was defined as the total special affordable market minus the GSEs' baseline purchases of special affordable loans. This percentage is an indicator of how far into the remaining market the GSEs would have to go in order to meet the new housing goals.

Main Findings from Market Analysis. The main findings concerning single-family market effects from the analyses conducted in Chapter III are as follows:

- Fannie Mae's projected baseline performance would surpass the 2005 and 2006 goals and almost meet the 2007 goals. While Fannie Mae would have to improve its past performance in order to meet the 2007 and 2008 goals, the new housing goals and subgoals appear quite feasible for Fannie Mae. Even in those scenarios that assumed less affordable market conditions, and thus projected a lower baseline performance for Fannie Mae, the firm would have time to develop strategies to meet the out-year (2007 and 2008) goal targets. The concerns raised about "denominator management" do not seem to be an issue for Fannie Mae. Given its focus (as compared with Freddie Mac) on purchasing mortgages for single-family rental and multifamily rental properties, and given its recent improvement in purchasing single-family-owner mortgages that qualify as special affordable and low-mod, Fannie Mae is projected to have a relatively high baseline performance during a home purchase environment, which places it in a good position to meet the new housing goal targets.

- The situation is different for Freddie Mac. Freddie Mac does not focus as much as Fannie Mae on rental mortgages, and Freddie Mac has not purchased goals-qualifying SFO loans to the same degree as Fannie Mae. Thus, HUD's model projects a lower baseline performance for Freddie Mac and a large shortfall from the goal targets, particularly during 2007 and 2008.

- While the 2007 goals will be challenging for Freddie Mac, they will be feasible with more effort by Freddie Mac. Considering two scenarios (A and B) for meeting the 2007 goals, Freddie Mac would have to increase (over baseline) its SFO special affordable purchases by 20-25 percent, its SFO low-mod and underserved area purchases by about 10-15 percent, and its MF purchases by 20-26 percent (thereby raising its MF mix from 10.0 percent to almost 11.5 percent). Obviously, the most challenging goal for Freddie Mac (as well as for Fannie Mae) is the special affordable goal.

- The 2008 goals would require even further increases in goals-qualifying purchases for

Freddie Mac. Under the same two scenarios, Freddie Mac would have to increase its SFO special affordable purchases by 30-38 percent to meet the 2008 goals, its SFO low-mod purchases by 13-18 percent, its SFO underserved area purchases by 20-24 percent, and its MF purchases by 28-34 percent (thereby raising its MF mix from 10.0 percent to almost 12 percent).

- Chapter III notes that if Freddie Mac's business was more like Fannie Mae's (i.e., more targeted SFO purchases and more purchases of mortgages for rental properties), it would not fall so far short of the new 2007-2008 housing goals. Given the staged increases of the goals, and the fact that the 2005 and 2006 goals appear quite feasible for Freddie Mac, the firm will have time to develop its own strategy for satisfying the more challenging goals during 2007 and 2008.

- To gauge how far into the market the GSEs will have to go to meet the new goals, the additional goals-qualifying purchases were expressed as a percentage share of the remaining, non-GSE portion of the conventional conforming market. Under the same two scenarios, the additional purchases needed to meet the 2007 goals represented the following shares of the non-GSE market: (1) 9-14 percent for special affordable; (2) 5-9 percent for low-mod; and (3) 5-8 percent for underserved areas. To meet the 2008 goals, the remainder-of-the market shares are higher, particularly for the special affordable category: (1) 21-26 percent for special affordable; (2) 10-13 percent for low-mod; and (3) 9-12 percent for underserved areas. Most of these additional purchases (about two-thirds) would be made by Freddie Mac.

- Whether the GSEs could meet the 2007 and 2008 targets without loosening their underwriting standards in any significant way cannot be shown conclusively by an analysis such as this. Freddie Mac, in particular, has to increase its goals purchases (including single-family and multifamily loans) much more than Fannie Mae, which suggests new products might have to be developed, outreach to lower-income markets might have to be increased, and underwriting and purchase guidelines might have to be made more flexible.

- Chapter III presents data showing that the GSEs' goals-qualifying purchases are often characterized by low LTV ratios (i.e., high down payments) and high FICO scores – suggesting that the GSEs have not had to extend themselves a great deal to meet the past goal levels. However, given the above findings concerning the additional required purchases, it is anticipated that the GSEs will have to move deeper into the lower-end of the affordable market in order to reach the new housing goal and subgoal targets. In other words, the GSEs' goals-qualifying loans will include more low-downpayment and more low-credit-score loans than they have in the past.

- Chapter III and Chapter VI present analyses showing that the GSEs' financial returns on equity (ROEs) may go down somewhat as a result of their having to increase their goals-qualifying purchases in order to meet the new housing goal and subgoal targets. Still, the GSEs' ROEs on their goals-qualifying purchases will continue at more than reasonable levels, given the GSEs' expertise in controlling credit risk and their reliance on credit enhancements (e.g., private mortgage insurance) to limit their losses from mortgage defaults. In addition, the GSEs' overall ROEs (on both their goals-qualifying and non-goals-qualifying business) will only be modestly reduced from past levels, unless there is a significant deterioration in market conditions.

- With respect to single-family market effects, the analysis in Chapter III makes clear that the GSEs are going to have to step up their efforts and go beyond the recent improvements that they have made. Several market strategies are available -- introducing new targeted products, adjusting their underwriting standards to be more flexible, purchasing more seasoned CRA-type loans, moving further into the subprime markets, and attempting to attract FHA borrowers that meet their underwriting standards.

With this background, some further comments are provided on specific market sectors in the remainder of this section.

I.3. Effects on Portfolio Lenders

Section C explained the role that portfolio (depository) institutions have played in the affordable lending market. While there is a possibility that the new housing goals and home purchase subgoals could lead to some crowding out of traditional portfolio lenders as the GSEs further increase their activity in the affordable housing arena, there are several reasons why the housing goals should not by themselves cause a significant crowding out of conventional portfolio lenders. First, the market for affordable loans has continued to expand in recent years (see Appendix D of the Final GSE Rule), which suggests their will be ample loans for portfolio lenders who often rely on their local knowledge of the market to make loans that would not meet the GSEs' qualification standards. Second, because there are many different products and strategies, which could be chosen by the GSEs to meet the housing goals, it is unlikely that any one segment of the lender community will be adversely affected in a significant manner. Third, portfolio lenders generally originate a significant volume of conforming loans either for immediate delivery to the secondary market, or to maintain the potential for future liquidity via sales to the GSEs. The GSEs are then not entirely competitors for market shares, but rather business facilitators. In addition, the GSEs' purchases of seasoned loans allow portfolio lenders to recycle funds into low-income neighborhoods. Section F.6 reviews various CRA programs offered by the GSEs. Finally, portfolio lenders prefer to hold adjustable-rate loans, while the GSEs mainly purchase fixed-rate mortgages for their affordable loan programs. Having secondary market outlets allows portfolio lenders to offer a wider variety of loan products to their customers, helping them to compete with mortgage bankers.

As summarized in Section I.2, HUD's estimates of the additional goals-qualifying purchases as a share of the non-GSE market suggests that the GSEs will have to extend their reach in order to meet the higher goals, particularly in 2007 and 2008. Indeed, expanded GSE purchases of both newly-originated and seasoned mortgages in goals-oriented areas create more viable markets for lenders to operate in. Increased lender liquidity increases credit availability, which not only helps borrowers but also generates increased originations and servicing volumes for the lenders.

I.4. Effects on Subprime Lenders

Appendix A of the final GSE rule and Section F.7 of this chapter included a discussion of the subprime market, GSE purchases of subprime loans, and the potential benefits of a greater GSE role in that market. More involvement by the GSEs in the subprime market could result in more standardized underwriting guidelines and more traditional products being offered—both of which would attract more mainstream lenders to the subprime market. If the subprime market became more standardized, market competition and efficiencies could reduce borrowing costs. Thus, there is the potential that increased GSE activity in the subprime market could demonstrate to mainstream lenders that lending to credit-impaired borrowers (particularly, the least risky, A-minus subprime borrowers) makes good business sense. While the GSEs have been entering this market over the past few years, they done so cautiously.

As discussed in Section F.7 many subprime lenders believe that successful companies serving high-risk borrowers need to have specialized expertise in outreach, servicing, and underwriting, which is lacking among most prime lenders.[189] These lenders do not believe the more standardized approaches of prime lenders and the GSEs will work with subprime borrowers, who require the more customized and intensive origination and loan servicing processes currently offered by experienced subprime lenders. These subprime lenders do not think it is appropriate for Fannie Mae and Freddie Mac to increase their role in the subprime market because they do not view the subprime market as inefficient. Some officials in subprime mortgage markets claim the higher prices paid by borrowers in the subprime market appropriately reflect the risks that come from extending credit to riskier borrowers. These officials believe it is unfair for GSEs to enter an efficient, private market that provides a necessary service to credit-impaired borrowers. Opponents of a larger GSE role in the subprime market argue GSEs have an unfair competitive advantage because they can secure capital at cheaper rates.[190] Because the GSEs have a funding advantage over other market participants, they have the ability to underprice their competitors and increase their market share.[191] This advantage, as has been the case in the prime market, could allow the GSEs to eventually play a significant role in the subprime market. Many subprime lenders fear they will be unfairly driven out of business as the GSEs increase their role in the subprime market.

Given the dynamic nature of this market and the fact that the GSEs have only recently started new purchase programs, more time is needed to gauge the impacts of the GSEs in this market. While a greater GSE presence could encourage mainstream lenders to further increase their originations of subprime loans, it would be difficult to disentangle this GSE effect from all the other changes currently taking place in this market.

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[189] Temkin et al., 2002, p. 1

[190] Temkin et al., 2002, p. 1.

[191]. For an explanation of the GSEs funding advantage see *Government Sponsorship of FNMA and FHLMC*, United States Department of the Treasury, July 11, 1996.

I.5 Effects on FHA Lenders

FHA's single-family home mortgage programs may be affected by these new housing goals to the extent that enhanced GSE-affordable lending efforts increase the competition for government-insured loan products. Specifically, some of the relatively lower-risk loans that FHA has historically insured could increasingly be made by conventional lenders.

Fannie Mae, Freddie Mac, several trade associations, two advocacy groups and two financial institutions expressed concern over the impact HUD's proposed goals would have on the future solvency of the FHA program. One trade association asserted that "excessive goals will push GSEs to expand into the least-risky part of the FHA market and put into question FHA's long-term viability."

The aforementioned commenters reiterated this point by stating that unrealistically high goals would compel the GSEs to increase competition with FHA for higher credit quality borrowers and would therefore further undermine the FHA program in the long-run.

Freddie Mac and Fannie Mae agreed that they would be compelled to more aggressively compete with FHA in procuring top-quality borrowers. Freddie Mac stated that the GSEs would take as many as "1/3 of all FHA borrowers." Freddie Mac and two trade associations further contended that such a loss to the FHA program would be seen in the increasing expenses to the remaining FHA borrowers. As the FHA program loses better quality loans to the GSEs, the result would be "higher fees to FHA borrowers or government subsidies to pay claims, effectively making FHA the lender of last resort," said one trade association.

One financial institution stated that the so-called competition for goals-qualifying loans would not be between traditional conventional lenders vying for loans with a separate group of traditional FHA lenders, but rather an acceleration of product competition within a single group of existing lenders who originate for both markets. This commenter stated that 12 of the top 15 (by volume) FHA/VA lenders are also among the top 15 conventional lenders and indicated that the increased product competition would not result in a net increase in goals-qualifying loans, but in a shift from FHA to the GSEs of FHA's relatively lower risks.

The Department agrees with many of these commenters that improvements in technology, such as the widespread use of commercial credit scores, mortgage scores, and automated underwriting systems, have fundamentally changed the way lenders process loan applications in recent years. Where once rules-based underwriting distinctions between prime conventional and FHA loans were fairly clear, in recent years, with the new technology, these distinctions have become blurred. For example, loan applications with payment-to-income ratios above conventional market guidelines were once clearly candidates for FHA financing because FHA would accept applicants with higher payment-to-income ratios. However, today, the same application would be processed using an automated underwriting system (AUS) that scores the application based on the totality of the application's risk factors. What once may have been an unacceptable payment-to-income ratio for a prime conventional loan may now be acceptable if the application contains offsetting low risks in other key areas such as borrower cash reserves, loan-to-value ratio, or commercial credit scores.

In addition to these technological changes, FHA made several changes to its underwriting guidelines in FY 1995 in order to promote increased homeownership opportunities among low-income and minority homebuyers. By doing so, FHA modestly increased the risk characteristics of its post- 1995 books of business, but it succeeded in raising FHA's proportion of first-time homebuyers from 60.9 percent in fiscal year 1994 to 73.0 percent in fiscal year 2003. During the same period (fiscal years 1994 to 2003), FHA's proportion of minority borrowers increased from 24.8 percent to 33.0 percent, and has since remained at this level, or higher.

The new technology may allow the conventional market to identify lower risk loan applications that historically have come to FHA. However, the ability to identify risks does not, in and of itself, equate to shifts in market share from FHA to conventional lenders. Better pricing for borrowers by the conventional market is required to lure lower risk borrowers from FHA. If conventional lenders use the new technology to not only evaluate risks but also to price according to risk, then there may be some shift from FHA to the conventional market. Such a shift can produce tangible benefits for borrowers in the form of lower cost mortgage financing.

The Department does not believe it is FHA's mission to compete with the private sector. Rather, FHA's mission is to complement the conventional market, using FHA's cost of capital advantage where it can have the most benefit in creating homeownership opportunities for those households who might not otherwise be served by the prime conventional market.

HUD gauges the soundness of FHA's insurance funds in several ways. The statutorily mandated annual independent actuarial review of FHA's principal single-family insurance fund, the Mutual Mortgage Insurance Fund (MMIF), provides the Department, and the public, with an outside expert's estimate of the capital ratio of the overall fund, and the economic value of new business coming into the fund. The capital ratio indicates whether the existing books of business (current portfolio) are financially sound, while the economic value estimates of new business show whether if the marginal impact of new loans insured is adding or detracting from the financial health of the fund.[192] Specifically, the Fiscal Year 2003 actuarial review estimated the economic value of the MMIF at the end of Fiscal Year 2003 to be $22.7 billion and the fund's capital ratio to be 5.21 percent -- the eighth full year this ratio has exceeded the Congressionally-mandated minimum of 2.0 percent. The economic value of new loans endorsed for insurance during 2003 was estimated by FHA's independent actuary to be $2.8 billion, indicating new business coming into FHA is further contributing to FHA's reserves.

In comparison, the Fiscal Year 2002 actuarial review estimated the economic value and capital ratio of the MMIF at $22.6 billion and 4.52 percent, respectively. The increases in both measures for Fiscal Year 2003 were driven by the large positive economic value the actuary placed on a record dollar volume of new loans FHA insured in FY 2003 along with the rapid prepayment of older loans, keeping the end-of-year insurance-in-force (denominator of the capital ratio) down.

Overlap Between GSE and FHA Loans. Finally, the extent to which the GSEs will begin purchasing FHA loans depends importantly on the overlap between GSE and FHA loans.

[192] "Economic value" is the net present value of the fund's reserves plus expected future cash flows, and the "capital ratio" is economic value divided by insurance-in-force.

The premise implied by the stated concerns about the housing goals threatening the viability of FHA is that there is either 1) substantial overlap in the mortgage risk profile currently served by both FHA and the GSEs so that the GSEs could easily attract a substantial portion of FHA business without increasing its risk exposure or 2) given little overlap, the GSEs would be willing and able to take on higher levels of risk to satisfy the goal levels. Previous studies by HUD as well as GAO have concluded that the potential for overlap appears to be small since many factors, even before controlling for borrower credit, distinguish the FHA loans from the GSE loans in the relatively modest grouping having similar payment-to-income and LTV ratios. HUD's analysis of FHA and GSE loans originated in 1993 revealed that only one-third of the FHA loans had LTVs within the range available from GSEs where PMI was required. When this third was compared with GSE loans having similar LTVs, the FHA loan was typified by lower borrower age, lower relative loan size, lower relative income, lower median cost of housing, higher payment-to-income, higher likelihood of being a first-time homebuyer, higher likelihood of being a black or Hispanic borrower, and more likely to be for a home located in the center city or minority neighborhood.[193]

Preliminary analysis by Abt Associates of more recent FHA and GSE loans originated in 1998 through 2000 that controls for borrower (FICO) credit finds a modest overlap between FHA and GSE mortgage lending. Under HUD Contract C-OPC-21895, Task Order CHI-T0003,[194] the study is examining the extent of overlap between the mortgage market sectors, particularly FHA and the GSEs (Fannie Mae and Freddie Mac). The analysis focused on home purchase loans. The HMDA data was supplemented with Experian data to provide FICO credit scores and house values (used to calculate loan-to-value (LTV) ratios). There were 11 MSAs for which the match rate was at least 56 percent. The matched, loan-level data was divided by mortgage market sector and tabulated to compare borrower, loan, property and neighborhood characteristics. For example, GSE loans have the highest average FICO score (726) followed by private mortgage insurance (PMI) loans (712), depositories (699), FHA (643) and subprime (637). The share of loans in low-income areas (tract income below 90 percent of median income) is nearly the reverse order: subprime (35 percent), FHA (33 percent), depositories (25 percent), PMI (21 percent) and GSE (16 percent).

In order to determine which loans were selected for each mortgage sector, a series of origination models were estimated. For the choice between FHA and GSE, the most important factors were LTV, FICO, payment-to-income ratio and borrower race/ethnicity. The predicted probability of FHA conveniently compresses all the credit and non-credit factors into a single dimension. The distribution of predictions for FHA loans was overlaid on the distribution of predictions for GSE loans and the FHA overlap was measured to be 10-14 percent, depending on the statistical methods used. It appears that 10-14 percent of FHA loans were as qualified as many GSE-purchased loans. While there were some minor differences in income, FICO and LTV, overall the FHA loans in the overlap region looked remarkably similar to the GSE loans.

[193] U.S. Department of Housing and Urban Development, *An Analysis of FHA's Single-Family Insurance Program* (Office of Policy Development and Research, Washington, DC, 1995) pp. 6-21 - 6-26.

[194] This study is ongoing; therefore, the results reported here should be interpreted as preliminary, rather than final.