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The “Mission Regulator” for Fannie Mae and Freddie Mac

A brief introduction

The Housing and Urban Development Department (HUD) was established as the “mission regulator” for Fannie Mae and Freddie Mac under the Federal Housing Enterprises Financial Safety and Soundness Act (FHEFSSA), 1992. The Act made HUD responsible for setting the GSEs’ affordable housing goals, including monitoring and enforcing them, and with overall oversight authority to ensure that they complied with the public purposes of their charters. This included approving new programs; collecting loan-level data from the GSEs on their mortgage purchase activities; making available to the public a data base of non-proprietary GSE loan-purchase information; reviewing and commenting on the GSEs’ underwriting guidelines; and ensuring GSE compliance with fair lending requirements. HUD also had “general regulatory powers” over the GSEs and was required to “make such rules and regulations as shall be necessary and proper to ensure” that the Act’s provisions and the GSEs’ charters were fulfilled; this included meeting the requirements of the Fair Lending Act (it was HUD’s responsibility to review their appraisal and underwriting guidelines to that effect). In addition, the Office of Federal Housing Enterprise Oversight (OFHEO), an independent office of HUD, regulated the GSEs for safety and soundness. OFHEO was responsible for ensuring that the GSEs were adequately capitalized and operated their businesses in a “safe and sound manner.” HUD was not confined to oversight of the GSEs, but was responsible for a wide and ever-changing range of public housing programs, and voucher schemes for privately rented housing.

Setting the housing goals

This was HUD’s most important activity as far as the GSEs were concerned. The refinements to the Community Reinvestment Act (CRA) were the first step in increasing home purchase for minorities and low- to moderate-income families, as discussed in previous chapters. The second step was to use the GSEs, originally set up after the Great Depression to bring liquidity to the

market, which they did by purchasing loans directly from private mortgage originators, such as mortgage bankers and depository institutions, and then either holding these loans in portfolio or selling them in mortgage-backed securities (MBSs), which are then sold into the capital markets to a wide range of investors. When the GSEs bought loans, they assumed the credit risk, and charged guaranty fees by way of compensation for the credit risk they assumed, as they guaranteed timely payment of both the interest and the principal. They guaranteed that the loan would be paid on time, at a time when prepayment risk was thought to be a more serious risk than credit risk; these risks were then taken on by Fannie and Freddie when they purchased the loans. Having passed on the risks by paying the guaranty fee, the lender then had the resources to provide more mortgages. In this way, the liquidity of the mortgage market was assured.

The Act and the Administration then decided what proportion of loans should be made by lenders to minorities and low- to median-income families, by laying down the percentage of loans made to such categories that Fannie and Freddie had to purchase. Since the GSEs had to buy the loans, lenders could afford to lend, supplying millions of loans to minorities and to low- to medium-income borrowers, secure in the knowledge that they had passed on the risks. The politicians, on the other hand, thought that their main concerns were being met: banks were no longer taking monies from low-income and underserved borrowers and transferring them to more affluent neighborhoods; they were lending to the underserved areas and helping many more achieve the American dream.

By 1998, HUD estimated that 11.7m homes were financed by “conventional conforming” mortgages, and that the GSEs provided financing for each of these homes. “Conventional” mortgages exclude loans which are insured by the Federal Housing Administration, the Rural Housing Administration or the Veterans Administration. “Conforming” loans refers not to the structure or characteristics of such loans, but to the level of the unpaid principal balance, which must be no greater than the maximum allowable under the GSEs’ charter acts. In 2000, that limit was \$252,700 for single-family homes in most parts of the USA, and the limit was raised from time to time as house prices rose. The proportion of mortgages financed by the GSEs continued to grow: they came to dominate the market, but it was a gradual process.

A cautious approach at first

“The housing goals play an important role in encouraging mortgage originators to undertake more affordable lending.” So stated HUD in its Issue Brief of January 2001.¹ The department set the transitional goals for 1993–95 before the goals were revised, and the “final rule” GSE housing

goals were established for 1996–99. This transition period was important since, according to Senator Alfonse M. D’Amato, “It’s critical that these goals are not unrealistic or unfeasible, because defaults are counterproductive for everyone.” There were both penalties and incentives. The penalties for failing to reach the stated goals involved explaining to the Secretary of State why they failed, or having to file an “affordable housing plan” setting out how it was planned to meet these goals in the future.

The incentives were bonus points for the purchase of two types of mortgages: small multi-family properties, or single-family rental properties. HUD also established a “temporary adjustment factor” for Freddie Mac, whereby each goal-qualifying unit in a large multi-family property counted as 1.35 units in the numerator and 1 unit in the denominator, in calculating goal performance. This was introduced by Congress because it was thought that Freddie Mac was disadvantaged in the multi-family market in the early 1990s. It appears that this did have an effect on the small multi-family mortgage purchases between 2001 and 2003. It was withdrawn in 2003.

Defining the affordable housing goals

The focus of HUD’s activity was the affordable housing goals, which had to be defined according to the categories established by Congress. As with the CRA requirements, it is difficult to explain the nature of the affordable housing goals without providing a brief summary of rules of mind-boggling complexity. The commitment to the goals has to be seen in the context of the National Homeownership Strategy, announced by President Clinton in 1995 and for which Henry Cisneros worked so assiduously during his time as Secretary for Housing from 1993 to 1997.

The legislation itself called for three broad categories, which were defined in HUD’s regulations as follows:

- A low- and moderate-income goal, for families with incomes below area median income;
- A special affordable goal, for very low-income families and low-income families in low-income areas;
- An underserved areas goal, originally established by Congress as a central cities goal, with authority for HUD to broaden the definition of underserved areas.

The “special affordable goal” was designed to meet the “unaddressed needs of low-income families in low-income areas, and very low-income

families, for suitable housing.” This category was defined in the 1992 Act as: “(i) 45% shall be mortgages of low-income families who live in census tracts in which the median income does not exceed 80% of the area median income; and (ii) 55% shall be mortgages of the very low income families.” The Act initially required the GSEs to spend “not less than 1% of the dollar amount of the mortgage purchases by the GSEs for the previous year;” this requirement was increased substantially by HUD in later years, and, unsurprisingly, it was a difficult target for them to meet.

It is useful to have some indication of the meaning of the income requirements. Although the definitions themselves are not stated in dollars, but in relative terms, they do give some indication of just how low the incomes on which Congress, government and others expected families to sustain a mortgage. A low income is defined as not more than 80% of the median income in a metropolitan statistical area or county; a very low income is 50% or less of the median income; and an extremely low income is less than 30% of the median income. Given the wide variation in wages and salary levels in the USA, a national average wage is not a helpful concept. Instead, it might be useful to set these percentages against the national “poverty line” for a family of four, which has generally been taken to be about 40–45% of the national median household income since 1993.

The generally accepted definition of “affordable housing” is that it should be less than 30% of a family’s annual gross income (including taxes and insurance for home owners, and often utility costs as well); above that level, the family is considered to be “cost-burdened.” Given that, it is hard to see how “affordable” for families with very low incomes could be achieved without the mortgages exceeding 30% of a family’s annual income in the years between 1996 and 2008, especially when the sharp rise in housing costs relative to income is taken into account.

The housing goals HUD set out for the GSEs in that period required them to purchase a certain percentage of loans in each category. The percentages increased over the period, every three to four years. All three of the housing goals are expressed as minimum goal-qualifying percentages of all units purchased by each GSE in a calendar year, with the GSEs calculating their performance, and then submitting their loan-level data to HUD, which then analyses these to determine the “official goal performance.” The latter is calculated annually. In 1996, HUD also established dollar-based multi-family subgoals, and then in 2004, home purchase subgoals for GSE acquisitions of home purchase mortgages on owner-occupied single-family homes for each of the categories covered by the overall housing goals. In each case the goals described below refers to the purchases of the mortgages, as Fannie Mae and Freddie Mac operated only in the secondary market, not the primary market.

Setting the affordable housing goals

Goals for 1996–2000

- (A) The low- and moderate-income (LM) goal: at least 40% of the dwelling units purchased by each GSE had to be for LM families in 1996, and this rose to 42% for 1997–2000.
- (B) The special affordable (SA) goal: at least 12% of the units purchased by each GSE had to be for SA families in 1996, rising to 14% for 1997–2000.
- (C) The underserved areas (UA) goal: at least 21% of the units purchased by each GSE had to be for families in UAs in 1996, and the goal rose to 24% for 1997–2000.
- (D) The special affordable multi-family (SAMF) subgoal: for each year 1996–2000, Freddie Mac had to purchase at least \$0.99 billion in special affordable multi-family housing, and Fannie Mae had to finance at least \$1.29bn.²

In selecting these goals, Secretary Henry Cisneros, anxious as he was to increase home ownership for blacks and Hispanics, and having identified national housing needs, found that the housing goal regulations were necessary to meet these needs. He decided that many Americans were unable to afford adequate housing due to insufficient incomes, high debt levels and rising home prices. The way forward was to ensure that they had a much larger role in promoting affordable housing. Establishing these specific goals was a departure from the way in which the GSEs had operated up until then. The proposals were published on February 16, 1995 and received 163 responses from the industry, Fannie Mae and Freddie Mac (about 200 pages each, mostly strongly opposed), community organizations, Members of Congress, local and state governments, non-profit organizations, governors and mayors. The final rules took the comments into account, but still established housing goals that were much greater than the transitional rules and “will ensure that the GSEs continue and strengthen their efforts to carry out Congress’s intent that the GSEs provide the benefits of a secondary market to families throughout the Nation.”³

HUD’s research, as reported in the Federal Register, concluded that “almost three-fifths of American households qualify as low- and moderate-income under FHEFSSA’s definitions. Data from the Census and from the American Housing Surveys demonstrate that housing problems and needs for affordable housing are indeed substantial among low- and moderate-income families. These households, particularly those with very low incomes, are burdened with high rent payments and are likely to continue to face serious

housing problems, given the dim prospects for earnings growth in entry-level occupations.”⁴

Cisneros apparently interpreted the Act to mean that the GSEs should “lead the industry” by using their dominant position to help ensure additional affordable mortgage originations. They should also provide technical assistance for mortgage originators so that they would also extend mortgages to targeted groups and provide financial standards for the industry. The goals he set were with the safety and soundness of the GSEs in mind, and were in fact conservatively set below HUD’s estimates of the targeted mortgage originations already occurring in the primary market.⁵ He might have been cautious in terms of numbers, but the context meant that underwriting standards were lowered, especially with regard to down payments and the borrower’s credit history, or lack of one. HUD acknowledged that mortgages to be purchased by Fannie and Freddie in “underserved” areas had a higher risk of default, but this did not mean that there was a “safety and soundness impediment” to the policy.⁶ Other concerns were the heightened credit risk associated with increased multi-family mortgage purchase volumes, and the feasibility of the goals overall. Taking the likely default implications of the goals into account, HUD concluded that they implied no meaningful increase in risk to the sound financial condition of the GSEs’ operations.⁷ Fannie Mae and Freddie Mac did respond to the goals, and in the case of Fannie Mae, quite quickly. In a press briefing in 1996, Cisneros responded to a journalist’s question, “We’re working with Fannie Mae and Freddie Mac-to do things they can do to indicate to the banks that have a lower down payment. Fannie Mae has this 97 and 3 – 3% down payment program that they’ve innovated over the last year.”⁸ The significance here is that the Secretary for Housing apparently approved of down payments as low as 3%.

Henry Cisneros was not there to see it through. He resigned after admitting that he had lied to the FBI about money he had paid to a former mistress, following a four-year investigation which cost over \$9m. He agreed to a \$10,000 fine and a \$25 court assessment, following which he was free to pursue other careers, including elected office.

In 2000, Cisneros formed a housing development partnership with KB Homes, and became a director along with James Johnson, former CEO of Fannie Mae, which bought many of the mortgages used for developing these homes. It was “a cozy network ... Fannie’s biggest mortgage client was Countrywide;”⁹ in 2001, Cisneros joined the board of Countrywide, supporting its \$1 trillion dollar commitment, the We House America Challenge, announced in February 2005. He resigned from the board on October 18, 2007, saying he needed to spend more time as Chairman of CityView to “put the company in the best position to adjust to the demands of the period ahead.” He also stated that Countrywide was a “well-managed company” and that he had “enormous confidence” in its leadership, including its Chief Executive, Angelo Mozilo.¹⁰

On October 26, 2007, Countywide reported a \$1bn loss for the third quarter, much larger than Wall Street expected, but predicted that it would soon return to profitability.¹¹ It did not.

Andrew Cuomo becomes Secretary for Housing

Following Henry Cisneros's resignation, Andrew Cuomo, who had been Assistant Secretary for Housing since 1993, was appointed as Secretary for Housing in 1997 and remained in that position until 2001.¹² Cuomo was an energetic Secretary, who realised the value of the position in advancing his political career. His administration issued 302 press releases in 2000, almost one a day, and spent almost \$1m on brochures dealing with HUD's work, which inevitably highlighted his position, strategies and achievements. When he entered the gubernatorial race for New York, not surprisingly he made 25 official visits to the state, 21 more than to any other.

In January 2001, Cuomo issued a press release entitled, "Success of HUD Management Reforms Confirmed by GAO. Department Removed from High Risk List." It included carefully selected excerpts from the GAO report and cited both the increase in its Budget year on year and the fact that "over the past four years, the staff at HUD have worked tirelessly to ensure that our programs serve the nation's most vulnerable people more efficiently and effectively ... We've transformed a monolithic government agency into a model of government reinvention." This was a rosy picture of HUD's achievements, as the GAO report makes clear; in fact, only one program, the Community Planning and Development program, had been removed from the "high risk" category. Whilst recognizing that progress has been made in other areas, such as the re-organization of the department, and some improvements have resulted from the implementation of the 2020 Management Reform Plan, significant weaknesses remain, especially with internal controls, information and financial management systems, organizational deficiencies and staffing problems, particularly in the FHA single-family programs.¹³ Even with these efforts, HUD remained a badly managed department, subject to waste, fraud, abuse and mismanagement.

During Cuomo's time, further steps were taken that increased the risks of delinquencies and foreclosures, both in the FHA program, with the introduction of seller down-payment assistance programs as a result of pressures from Nehemiah, and despite the increased risks identified in the OIG audit report.¹⁴ Cuomo did not take any action regarding these risks. The limits for FHA-insured loans were also raised, with the purpose of "creating more homeowners, more home construction, more jobs and more economic growth."¹⁵

The goals for Fannie and Freddie were raised substantially. Franklin Raines warned that Secretary Cuomo was moving into risky territory, but added,

“We have not been a major presence in the subprime market, but you can bet that under these goals, we will be.” He saw that this gave him the cover for moving further into a market in which he was already a player. Secretary Cuomo apparently recognized that the GSE presence in the subprime market could be of significant benefit to lower-income families, minorities and families living in underserved areas. Some see raising the housing goals for low- to moderate-income families as a prime mover in the subprime lending crisis; it may not be quite that, but it undoubtedly played a part as did the failure to impose any new reporting requirements on the GSEs. The goals were agreed but the requirement to provide loan level data was not.

Goals for 2001–2004

The LM (low- to moderate-income) goal was raised to 50%.

The SA (special assistance) goal was increased to 20%, and the dollar-based special affordable multi-family subgoals were also increased for both GSEs.

The US (underserved areas) goal was increased to 31%.

The bonus point and the temporary adjustment system were also introduced for the years 2001–2003.

HUD’s failure to require data for its oversight responsibilities

It was HUD’s responsibility to monitor the loans the GSEs purchased, not only to ensure that they met their goals, but also to understand the quality of the loans they purchased with a view, for example, ensuring that the GSEs did not receive credit for predatory loans. Under the Federal Housing Enterprises Financial Safety and Soundness Act (FHEFSSA), Congress had indicated that the GSEs’ mortgage purchases should be recorded in the GSE public use data base, designed to supplement HMDA data. Such a data base is available, but the data recorded there are carefully structured to exclude information which was considered to be proprietary from other loan level data but without geographical indicators. HUD published this data from 1996 onwards. The purpose of the data base was to enable the public, including mortgage lenders, planners, researchers, housing industry groups, HUD and other government agencies, to examine the GSEs’ mortgage activities and the flow of mortgage credit and capital into the nation’s communities. The changes HUD proposed would have made publicly available the same data at loan level as primary lenders report under HMDA requirements.

The responses HUD received were almost equally divided between those who approved and those who opposed on privacy grounds. It is, however, the GSEs' responses that are the most noteworthy. Both were strongly opposed to increased disclosure, citing "competitive issues" resulting from the release of what each GSE considered to be proprietary, confidential business information. Fannie Mae and Freddie Mac expressed general concern that recording certain loan level data as non-proprietary at either the Census tract level or national file level would reveal information about lender relationships, pricing arrangements, and management of credit and interest rate risks. Fannie Mae also took issue with HUD's efforts to conform data available in the GSE public-use data base to HMDA data for research purposes, contending that "both data bases are fundamentally different and cannot be reconciled."¹⁶ Some of the GSEs' reasons ought to have given cause for concern, but instead HUD announced that based on the comments received, it was not making a determination based on this matter as part of this rule-making. A decision on which matters were proprietary and which were not would be given in a separate order.

However, HUD also noted that the changes included in the final rule involved changes in data-reporting requirements. Some of these changes were significant, such as the identification of units with estimated affordability data mortgage loans receiving bonus points, the temporary adjustment factor and high cost mortgage loans. HUD noted that the Treasury recommended the Federal Reserve should require the collection of such data, including borrower debt-to-income ratio for HOEPA (Home Ownership and Protection Act) loans under HMDA. That happened eventually, but not until 2005. At this point, however, HUD merely noted that if such recommendations were implemented, they might affect the data reporting required under this rule. In March, HUD admitted that the new purchasing pressures on the GSEs might "warrant increased monitoring and additional reporting." But after all the responses had been received, especially those from the GSEs, the introduction of new reporting requirements was postponed. They did not form part of the Final Rule.

HUD also proposed that high-cost mortgages should be disallowed for credit as far as the GSEs were concerned. The definition of "high cost" was also considered, as to whether it should be defined using the HOEPA or an alternative definition. The former defined high cost as having an APR of 10% above the yield on Treasury securities of comparable maturity as well as prepayment penalties, balloon payments, negative amortization and failure to consider the borrower's ability to repay.¹⁷

The two GSEs announced corporate policies during the consultation period for the Final Rule on their goals for 2001–2003. Fannie Mae announced that it would not purchase high-cost loans as defined under HOEPA, loans with points and fees charged to the borrower at above 5%, except where this would result

in an unprofitable origination. In addition, it would not purchase or securitize any mortgage for which a prepaid single premium credit life insurance policy was sold to the borrower, and would not generally allow prepayment penalties if there was some benefit to the borrower (such as a rate or fee reduction) or if the borrower was offered an alternative, amongst other conditions. Fannie Mae also announced that it would not purchase loans from lenders who steered borrowers towards higher-cost loans if they would have qualified for lower-cost products. Freddie Mac made similar but fewer commitments: it decided that it would not purchase HOEPA loans or mortgages with single premium credit life insurance. Despite the GSEs' apparent commitment to distance themselves from predatory lending, HUD noted that their policies lacked important details and were subject to changes in corporate direction. HUD considered that regulations may be required.

The first issue that HUD considered was whether to allow credit to the GSEs for purchases of high-cost mortgages. They and a number of respondents expressing similar views argued that they should be able to purchase legitimate subprime loans; that is, ones without the predatory features, such as prepayment penalties. It is interesting to note Fannie Mae's arguments, especially in view of all that happened in subsequent years. The GSEs argued that they were using their respective automated underwriting systems “to allow them to offer products targeted toward borrowers with impaired credit, and that they were able to move into the legitimate subprime market in a responsible and prudent manner, bringing liquidity, standardization, and efficiency to that market.” Not allowing credit for high-cost mortgages would provide a disincentive for them to reach out to those borrowers, and would do nothing to combat predatory lending practices. It would simply drive predatory lending into “secondary market sources who are less responsible than Fannie Mae on this issue.” At any rate, tracking high-cost mortgages would be very difficult, if not impossible, “owing to the lack of reliable mortgage data on loan costs.”

HUD's response was to determine that the GSEs should not receive any credit for purchasing high-cost loans with unacceptable features, resulting from unacceptable practices. Their statutory responsibility was to lead the industry in making mortgage credit available to low- and moderate-income families, and therefore they should seek to make the lowest-cost credit available, while ensuring that they do not purchase loans that actually harm borrowers and support unfair lending practices. But HUD also quotes their own report, “While the secondary market could be viewed as part of the problem of abusive practices in the subprime mortgage market, it may also represent a large part of the solution to the problem. If the secondary market refuses to purchase loans that carry abusive terms, or loans originated by lenders engaging in abusive practices, the primary market might react to the resulting loss of liquidity by ceasing to make these loans.”¹⁸ The restrictions applied both to mortgages

purchased through the GSEs' "flow" business as well as to mortgages purchased or guaranteed through structured transactions.

Then the rest of HUD's determinations with regard to these mortgages are illuminating:

Since these restrictions and provisions are consistent with the GSEs' own measures, the Department does not believe that any of these restrictions will provide a disincentive for the GSEs to provide financing for borrowers with slightly impaired credit through innovative products that can bring competition and efficiencies to the legitimate subprime market.

While the GSEs themselves will presumably be obtaining certain additional data and information to carry out their previously announced purchase restrictions and to monitor lending practices, HUD is not establishing any requirements for additional data to carry out these provisions under this rule. Subsequently HUD plans to request only such original data as is necessary. In this regard, HUD will consult with the GSEs, as practicable, to develop reasonable data reporting requirements that will not present an undue additional burden.¹⁹

In this regard, Secretary Cuomo was particularly concerned to ensure that the GSEs were indeed playing their part in ensuring that mortgages were offered to very low-income families, for whom he increased the goal, and to minorities. William Apgar was quoted in the *Washington Post* at the time: "We believe that there are a lot of loans to black Americans that could be safely purchased by Fannie Mae and Freddie Mac if these companies were more flexible."

HUD's lack of oversight and lack of resources

The GSEs had already made it clear that the data available to identify even high-cost loans was not available. In this and previous responses to the GSEs and other respondents, HUD in turn made it entirely clear that, even if at any time it intended to monitor the GSEs' activities in the secondary market, it did not have the resources to do so. In fact, it was quite clear that HUD did not intend to monitor the GSEs as required; and, indeed, that neither HUD nor the GSEs, on their own admission, had the resources or tools to do so.

The GAO published a report in 1998 on HUD's ability to regulate the GSEs.²⁰ The report first of all referred to the budgetary constraints and the lack of properly qualified staff (often far too few in number) to carry out that task. Apart from the fact that HUD's research resources were insufficient to enable HUD to set the appropriate goals, or to understand the effect of the goals on promoting home ownership and housing opportunities, the most important issues concerned the shortcomings of the data and HUD's failure to address them.

These included the lack of inspections to assess the accuracy of Enterprise-Supplied Goal Compliance Data. This is especially important, since the data

the GSEs collect and report to HUD regarding their mortgage purchases come from many sources, are often complex, and can be subject to errors. The data are supplied by the original lenders to borrowers: the lenders in turn give the data to the GSEs when they sell the loans to them, and the GSEs collect the data and report them to HUD. The GSEs were only able to conduct limited tests to check the data, but at that stage, HUD had not established a program to carry out independent checks, nor was OFHEO's verification of the GSEs' data systems and controls linked to that of HUD.

The GAO notes that HUD took the view that the much-vaunted automated underwriting systems introduced by Fannie Mae and Freddie Mac merited further oversight. In 1996, HUD conducted a review and concluded that, although the systems may require a further assessment in terms of fair lending concerns, they were not new mortgage programs; the department concluded that they were alternative business programs and, as such, did not have to be submitted to HUD for approval.

The report was issued in 1998, but, given the nature of HUD's responses with reference to its proposed new rules in 2000, it is highly unlikely that any further work was carried out to ensure the accuracy of the data or the GSEs' use of the automated underwriting system, apart from the Fair Lending issues. The automated underwriting systems, developed in the 1990s, and in which the GSEs were market leaders in their development and implementation, were also adaptable systems. In 2000, Fannie Mae and Freddie Mac decided to increase their efficiency in the purchase of Alt-As (with little or no borrower income and asset documentation) and A-minus (loans made to borrowers who cannot qualify for prime mortgages because of blemished credit, but whose credit is higher than is typically found for a subprime loan) by altering their automated underwriting systems. Fannie Mae implemented the Expanded Credit Approval System, and Freddie Mac the Loan Prospectus System, to accommodate risk-based pricing.

That nothing had changed was confirmed by Allen Fishbein, a general counsel of the Neighborhood Revitalization Project, in an article entitled "Going Subprime."²¹ Fishbein was a senior adviser for Government Sponsored Enterprises Oversight at HUD from 1999 to 2000, where he helped supervise the establishment of new affordable housing goals for Fannie Mae and Freddie Mac. "HUD needs to enhance its ability to monitor the increases in GSE subprime loan purchases. While HUD currently collects loan level data about GSE loan level purchases, this reporting at present does not provide the detail about pricing and loan terms needed to permit effective monitoring activity. Are the GSEs in compliance with their own standards and HUD rules regarding the purchase of loans with predatory features? Are subprime borrowers benefiting from a larger GSE role? These are questions the agency should have the necessary information to answer ... It is ironic that with all the talk in Washington about investor need for transparency about the capital

market activities of the GSEs, the discussion does not extend to finding ways to improve the monitoring of their loan purchase activity.”²²

Fishbein also describes the reasons for the GSEs to expand into the subprime market. Their traditional market of conventional prime mortgages had matured and they were looking for new ways to sustain the previous decade’s economic success and investor expectations. It was a relatively untapped (for them) but a growing market. It is small wonder, then, that the CEO of Fannie Mae at that time, Franklin Raines, welcomed the goals and the possibility of being recognised as a major player in the subprime market.

In 2000, when introducing the goals for 2001–2004, HUD concluded that the GSEs were in a strong position to handle the increased “affordable lending” goals. “A wide variety of quantitative and qualitative indicators indicate that the GSEs have the financial strength to improve their affordable lending performance. For example, their combined net income has risen steadily over the last decade, from \$677m in 1987 to \$6.1bn in 1999, an average growth rate of 20% per year. This financial strength provides the GSEs with the resources to lead the industry in supporting mortgage lending for properties located in geographically targeted areas.”²³

There were no further assessments of HUD’s oversight of the GSEs or of its inability to carry out this task throughout the whole of the following decade. Fannie Mae and Freddie Mac continued to purchase loans and keep a large and growing proportion in their portfolios, but there was no way of knowing what they had purchased.

No changes for the GSEs with a new Secretary for Housing

With the change in the Administration in 2001, President George Bush appointed as Housing Secretary Mel Martinez, who had spent two years as head of Orlando’s housing authority in the 1980s and two further years as Orange County’s Chief Executive before taking up the HUD position. The American Dream Down Payment Initiative was introduced in December 2003, which provided up to \$200m annually to help low-income, first-time buyers with down-payment and closing costs. HUD finalized a rule to protect home buyers from predatory lending practices; in this case from fraudulent appraisers, by making lenders accountable for the appraisals performed by the appraisers they hire. This applied particularly to appraisals of properties to be used as security for the FHA-insured mortgages. He is also thought to have quietly opposed the proposal for a National Affordable Housing Trust Fund financed by the federal mortgage insurance surpluses. Martinez announced his

candidacy for the Senate for his home state of Florida in December 2003, and resigned from his Cabinet post.

Alphonso Jackson becomes Secretary for Housing

Jackson had already been appointed Deputy Secretary for HUD in 1991 and was acting Secretary for Housing when nominated by President Bush in January 2004, following Mel Martinez's resignation. He had been Chief Executive of the housing authority of Dallas and later President of the Texas General Services Commission. In response to OFHEO's Special Examination, Jackson announced a review of Fannie and Freddie's investments in June 2006, when speaking to a Congressional caucus, but the outcome of the review was never published. In so far as any action was taken to reduce the portfolios, that was in the hands of OFHEO.²⁴ He can however take credit for some advances with the management of HUD, since in January 2007 the GAO took HUD off the “high risk” list; this was the first time since 1994 that none of the HUD programs was on that list. Jackson stated, “HUD serves the nation best when all its programs are working effectively and efficiently.”²⁵

However, as with previous Secretaries for Housing, Jackson failed to understand the risks involved in extending affordable housing loans, and the risks accumulating in the programs for which HUD had the oversight. The GAO warned about the risks involved in zero down payments: its report of July 2007 pointed out that if the risk-based pricing proposal had been in force in 2005, then 20% of borrowers would not have qualified for FHA insurance. Without any program changes, the FHA estimated then that the fund would require an appropriation of approximately \$143m in 2008. The GAO added that “the proposal to lower down payments is of particular concern given the greater default risk of these loans ... One of the ways in which FHA plans to mitigate new or increased risks is through stricter underwriting standards, but it does not plan to pilot any zero-down payment product. Other mortgage institutions use pilots to manage the risks associated with changing or expanding product lines.”²⁶ The increase in the housing goals for the GSEs, which was resisted at first, turned out to be another huge error in the context of the changing mortgage market and the GSEs' purchases of subprime loans. By mid-2007, HUD's attention was inevitably focused on preventing foreclosures.

Secretary Jackson faced calls for his resignation in 2008, arising from allegations that he improperly directed his staff to steer federal housing contracts to political allies. Senate Banking Committee Chairman Christopher Dodd stated in a letter to President Bush on March 21, 2008 that Jackson was “unfit” to run the agency during a national housing crisis, and added in a

further statement that he hoped for a “change in policy that brings real solutions to the housing crisis that has triggered this economic recession.” Jackson had favored an industry-led program that would encourage lenders to voluntarily refinance troubled loans rather than using federal funds to deal with the crisis.²⁷ He resigned on March 31, 2008. Two years later, it was announced that the Justice Department had ended its investigations without charges. HUD’s Inspector General had previously concluded that Jackson had not exercised any improper influence over contracts.²⁸

Goals for 2005–2008

The new rule was finally published in November, 2004 to take effect on January 1, 2005. It differed from previous rules in that it proposed increasing the goals for each year between 2005 and 2008:

Low to Moderate Incomes (LMs) 52% in 2005; 53% in 2006; 55% in 2007; and 57% in 2008.

Special Affordable Goals (SAs) 22% in 2005; 23% in 2006; 25% in 2007; and 27% in 2008.

Underserved areas (US) 37% in 2005; 38% in 2006; 38% in 2007; and 39% in 2008.

In addition, the GSEs minimum special affordable multi-family subgoals were increased to \$5.49bn per year for 2005–2008 for Fannie Mae, and to \$3.92bn per year for 2005–2008 for Freddie Mac. The Final Rule (which takes up about 50 pages in the Federal Register) contained some interesting additional requirements. These included further regulations preventing the GSEs from double counting mortgage purchases; that is, counting ones in the current year that it had already counted in the previous year. It also prevents the GSEs from counting mortgage purchases where the seller has an option to dissolve the transaction so that credit can only be received when the seller’s option is limited by a one-year lockout period.

The other two requirements provide an insight into the way in which the GSEs may have conducted the business of buying mortgages, based on the fact that the new rules are designed to prevent certain transactions. These include measures for dealing with missing borrower income data, and also to ensure the “integrity of data, information and reports provided to HUD by the GSEs, including a requirement that the GSEs submit a certification with certain reports provided to HUD and providing mechanisms for addressing material errors, omissions and discrepancies in current and prior year data submissions.”²⁹ The fact that such rules had to be put in place does tend to undermine the credibility of GSE reporting.

HUD pushed for these more ambitious goals, despite the fact that many doubted such goals could be achieved in a high-refinance period in which higher-income home owners would represent a larger share of the market. HUD's original proposals for 2006 through to 2008 were (apart from one case) reduced by 1% for the years 2006–2008. However, the Housing Secretary, Alphonso Jackson, stated: “These new affordable housing goals will help the GSEs achieve the standard that Congress intended, leading the mortgage finance industry in helping low- and moderate-income families afford decent housing. These new goals will push the GSEs to genuinely lead the market.”³⁰

HUD's aims and the GSEs

What was the nature of the progress which Secretary Jackson and other Secretaries of State before him wished to achieve? That was set out in an early Issues Brief, provided by HUD, which points out that “given the dominant role of the GSEs in the mortgage market, the housing goals play an important role in encouraging mortgage originators to undertake more affordable lending.” The brief reaches the conclusion that “lower-income and minority families have made major gains in access to the mortgage markets in the 1990s. A variety of reasons have accounted for these gains, including improved housing affordability, enhanced enforcement of the Community Reinvestment Act, *more flexible mortgage underwriting*, and stepped-up enforcement of the Fair Housing Act. But most industry observers believe that one factor behind these gains has been the improved performance of Fannie Mae and Freddie Mac under HUD's affordable lending goals. HUD's recent increases in the goals for 2001–2003 will encourage the GSEs to further step up their support for affordable lending.”³¹

When HUD again increased the affordable housing goals for Fannie Mae and Freddie Mac in 2004, it responded extensively to the results of the consultation preceding the introduction of the rules. These had to be approved by Congress before their introduction in November of that year. In its response to comments on the consequences of the goals for the subprime market, HUD replied that: “The GSEs' presence in the subprime market benefits many low- to moderate-income families, whose risk profiles differ markedly from borrowers who qualify for prime mortgage products. Millions of Americans with less than perfect credit or who 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 out more cash in a refinancing than conventional loans allow, rely on subprime lenders for access to mortgage financing. If the GSEs reach deeper into the subprime market, more borrowers will benefit from the advantages that greater stability and standardization create.”

Later in the same document, HUD stated that, “While the GSEs can choose any strategy for leading the market, the leadership role can likely be accomplished by building on the many initiatives and programs that the enterprises have already started, including:

- (i) Their outreach to underserved markets and their partnership efforts that encourage mainstream lenders to move into these markets.
- (ii) Their incorporation of greater flexibility into their purchase and underwriting guidelines.
- (iii) Their development of new products for borrowers with little cash for the down payment and for borrowers with credit blemishes or non-traditional credit histories.
- (iv) Their use of automated underwriting technology to qualify creditworthy borrowers that would not have been deemed creditworthy under traditional underwriting rules.

In the past, HUD added that the GSEs have always lagged behind the primary market in financing mortgages for low- to moderate-income borrowers, but “over the past three years, Fannie Mae has closed its historical gap in the market and now leads the primary market in funding mortgages for low- to moderate-income borrowers.”³²

But HUD ignored the risks

Ignored the results of its own analyses

HUD commissioned research in 2005 on “Recent House Price Trends and Home Ownership Affordability,” which examined amongst other issues, the impact of various factors on the demand for housing, and concluded that one of the significant factors was indeed the role of HUD. It stated that “more liberal financing has contributed to the increase in demand for housing. During the 1990s, lenders have been encouraged by HUD and banking regulators to increase lending to low-income and minority households. The Community Reinvestment Act, Home Mortgage Disclosure Act, the GSEs and fair lending laws have strongly encouraged mortgage brokers and lenders to market to low-income borrowers and minority borrowers. Sometimes these borrowers are higher risk, with blemished credit histories and high debt or simply not enough savings for a down payment. Lenders have responded with low down-payment loan products and automated underwriting, which has allowed them to more carefully determine the risk of the loan. Other factors that have facilitated liberal financing include low and falling interest rates, low default rates, rising

house prices, competition from subprime lenders and strong investor demand for mortgage-backed securities. The net effect has been a booming mortgage market that has generated strong demand for housing, which in turn, has boosted house prices.”³³

It is therefore quite clear that HUD did foster the growth of subprime and other forms of high-risk lending from the early 1990s onwards. HUD could only extend lending to low- and moderate-income groups by lowering underwriting standards. That has been seen in the preceding chapters through the FHA, the GSEs and every other aspect of the mortgage market over which HUD had influence. Successive Secretaries for Housing pursued the same policies, which is hardly surprising since these were set out by President Clinton and then by President Bush throughout most of his term. Republicans in the Senate began to be concerned about the GSEs in 2004, and before the end of his Presidency, the Bush Administration had to put the GSEs into conservatorship, when the housing market collapsed in 2008.

HUD was committed to the “affordable housing” ideology

HUD believed it had achieved the change in mortgage lending it had been seeking by 2004, when in the Federal Register, it stated that “over the past ten years, there has been a ‘revolution in affordable lending’ that has extended home ownership opportunities to historically underserved households. Fannie Mae and Freddie Mac have been a substantial part in this ‘revolution in affordable lending’. During the mid-to-late 1990s, they added flexibility to their underwriting guidelines, introduced new low down-payment products, and worked to expand the use of automated underwriting in evaluating the credit worthiness of loan applicants. HMDA data suggest that the industry and the GSE initiatives are increasing the flow of credit to underserved borrowers. Between 1993 and 2003, conventional loans (not insured by the FHA or guaranteed by the VA) increased at a much faster rate than loans to upper income and nonminority families.”³⁴ That, however, did not stop HUD from pushing for yet more loans to these groups.

HUD’s determination to push for the GSEs to attain the higher goals set for them is shown in the discussion regarding subgoals and other matters in the Federal Register. For example, with reference to the Special Affordable Housing Goal Multi-Family Subgoals expressed in terms of minimum dollar volumes, HUD wished to retain these goals, but the GSEs were not anxious to do so, this despite the fact that the GSEs had exceeded these targets every year, reaching \$12.2bn in 2003 for Fannie Mae (twice its minimum subgoal in every year since 1997); Freddie Mac’s performance outstripped Fannie Mae’s, reaching \$21.5bn in the same year. Only one multi-family lender demurred, expressing his concern that increasing this goal would “push the GSEs to extend credit to unqualified borrowers with poor quality properties that should not be eligible

for long-term, low-cost financing.”³⁵ His was a lone voice amongst advocacy groups, all of whom wanted to see increases in multi-family lending.

HUD did not insist on accurate data for Low-Doc or No-Doc loans

The issue of data raised its head again. By this time, HUD was aware of the increase in mortgages termed “Low-Doc” or “No Doc”. First of all, an accurate measurement of GSE performance depends on the completeness of data on property location and borrower income. HUD notes that missing or incomplete geographical information constituted 1%, but missing borrower-income data has been “of the order of several percent each year.” Low-Doc and No-Doc loans do not require the borrower to provide income information, but the borrower may sometimes provide information on assets because the “assets are easier to document,” or the mortgages may be originated entirely on the basis of a credit report, property appraisal, and cash for the down payment, although these may be larger than usual and subject to higher interest rates. HUD had consulted market participants and advocacy groups about the missing data problem and whether or not such mortgages should be accepted for the GSEs’ goals.

As a result of the consultation exercise (in which the GSEs participated extensively), HUD came to the following conclusion: that some level of estimation for affordability data is reasonable and consistent with the statutory intent that the GSEs serve the affordable housing needs of families *even if the actual data are not available*.

Other responses indicated that Low-Doc or No-Doc loans might indicate predatory lending, but HUD replied it did not find that “these loans are essentially predatory in nature.” Given that the GSEs had publicly announced that they would not finance any loans with predatory features, HUD would rely on its expectation that the GSEs would “continue to vigorously enforce these policies.” The department’s existing rules contained strong safeguards against abusive lending by excluding loans with excessive fees and prepayment penalties from counting towards affordable housing goals, and would continue to monitor the GSEs’ performance where different types of loans with other features such as prepayment penalties after three years were purchased, noting that such features were not taken into account when the regulations were adopted in 2000.³⁶

With regard to the Low-Doc and No-Doc loans, HUD decided to allow the GSEs to use an HUD-approved affordability estimation methodology for all single-family owner-occupied units with missing borrower income data up to a specified maximum. This allowed for the distribution of borrower incomes within Census tracts in determining how to treat loans with missing income data, according to a complex formula set out in the Federal Register. The purpose of these complex changes is to enable HUD to determine the number of goal-qualifying loan purchases.³⁷

HUD backed down, when it should have insisted on being able to *count* the number of loans the GSEs purchased

The other issues raised in the process of consultation in 2004, as opposed to 2000, show both the changing nature of the business and the increasing difficulties HUD faced even in the most basic aspect of its oversight work; that is, identifying and counting the number of eligible purchases the GSEs were making in order to determine whether or not they had reached the goals set for them. In that regard, it is interesting to note that the GSEs made extensive contributions, designed, it seems, to ensure that they had as much leeway as possible.

The nature of the mortgage purchases by the GSEs had begun to change to such an extent that HUD had decided to consult widely on whether seasoned mortgages (those which had been in force for more than a year) should count towards the targets, and whether their counting rules were sufficiently specific to determine which seasoned mortgages or large-scale transactions were equivalent to mortgage purposes.

In late 2003, both GSEs had undertaken large-scale transactions of seasoned loans. One such transaction with Washington Mutual contained an option for dissolution in the following year. HUD again received a variety of responses, with one policy group suggesting that definitions were changed in order to exclude loans with recourse clauses because they did not alleviate risk from the market.

One trade association supported counting bulk purchases that occurred towards the end of the year, stressing the efficiencies of such purchases; for example, the market for multi-family units is large and fragmented, and seasoned portfolio transactions are an efficient way for the GSEs to acquire smaller loans in the under-50 unit segment of the market. For Fannie Mae, every mortgage purchase contributes to its housing mission, so the qualification of mortgages purchased should not change. Large-scale purchases lower transaction costs for the buyers and sellers; bulk purchases serve the purposes of lenders without a direct relationship with Fannie Mae. The GSE added that two-thirds of its bulk purchases between 2001 and 2003 were for new loans, not seasoned loans (that is, those which had been in existence for over a year). The latter loans were an important component of the liquidity of current mortgages. “Knowing that there is a ready market allows financial institutions to hold some of their assets in the form of mortgages, and affords them the opportunity to sell these mortgages later to manage liquidity, improve profitability, strengthen their capital position and manage certain risks.”

The GSEs and Fannie Mae in particular also referred to dissolution options, stating that lenders sometimes request the option to dissolve securities swapped with the GSEs. The reason for such options is that they give lenders greater control over their balance sheets, capital position, and other financial

concerns. Such options are also requested because they obtain more favorable rates and can make more loans.³⁸ HUD regarded the fact that the seller can exercise his option to reverse or wind down a transaction and take back mortgages within a specified time means the transaction appears temporary in nature, although the liquidity that results from the buy-back appears the same. Even if the short-term liquidity is valuable to mortgage sellers, especially for balance sheet management, it does not contribute to longer-term liquidity; the sellers do not need it, especially if alternative solutions are backed by seasoned loans. HUD therefore imposed a one-year lock-out on dissolution securities, taking the view that this would prevent potential misuse and still allow sellers of mortgages to manage their portfolios in the short and long term. HUD decided to monitor the one-year lock-out to observe whether it was still accomplishing its intended purpose. No other restrictions were placed on mortgage purchases.

HUD did not insist on proper verification procedures for GSE loan purchases ...

HUD then turned to the issues of verification and enforcement to ensure GSE data integrity. To this end, the department proposed an independent verification authority to attest to the “accuracy, completeness of data, information and reports submitted by the GSEs in addition to the Department’s existing authority to conduct on-site verifications and performance reviews.” As a result, the GSEs would be required to provide a certification, confirming Annual Housing Activity Reports (AHAR), data submissions and information are “current, complete, and do not contain any untrue statement of a material fact,” signed and attested by the GSE Certifying Official. HUD noted that in requiring this information it was “fully aware that the GSEs collect millions of data elements from hundreds of sources and that the GSEs must depend on these sources to provide accurate data. In requiring a certification, HUD intends that the GSEs will use and rely on their internal controls and other due diligence processes and procedures for collecting, verifying the accuracy of, and reporting the data received from sellers.”³⁹

HUD already conducted computerized consistency checks on the loan-level data provided by the GSEs in their annual returns, tested the data by applying their counting rules to the GSEs’ data to ensure that they are consistent with their own, and also reconciled the GSEs’ total business volume as in the shareholder reports with the adjusted mortgage purchases provided for HUD. In the light of all of these comments, HUD withdrew the requirement for independent verification and instead simply required the senior officer responsible for submitting the Annual Mortgage Report and other reports to certify that: “To the best of my knowledge and belief, the information provided herein is true, correct and complete.” Even then, its evaluation was deferred until

the fourth quarter in 2005, but leaving it open as to when further verification regulations might be required if introduced. HUD intended this to apply to the entire AHAR submission, including the narrative text, data tables, and computerized loan level data; and all of this was to be subject to appropriate internal review procedures by the GSEs. Any errors, omissions or discrepancies must be material and must be ones that indicate to HUD, as a result of HUD's review of the reports, a serious problem in the GSEs' internal procedures.

HUD therefore decided to refer to this rule as Procedures for Prior Year Reporting Errors, under which there is a possibility that HUD may discover, during a performance review, that a serious overstatement of credit towards one or more housing goals occurred in the prior year under review. The GSEs firmly resisted the notion that HUD could deduct the previous year's overstatement of housing goal credit (due to errors, omissions or discrepancies in that year) from the current year's housing goal credit. HUD accepted their objections and altered the rule so that discrepancies such as overstatements (that is, the overstated units enabling the GSE to meet a housing goal that it otherwise could not have met) could be rectified up to 24 months after the close of a calendar year's performance. For example, if overstatements were discovered for 2005 and 2006 and the GSE was notified in 2007, then the GSE could be required to make up the overstatements in 2008.

HUD also responded to further issues raised: goal levels and the effects on the FHA, the subprime market and mortgage default rates. In the light of subsequent events and the policies adopted by Fannie Mae in particular at the time, HUD's responses were complacent, to say the least.

HUD overrode risk warnings in favor of affordable housing goals

With regard to the FHA, a number of respondents to the consultation (including the GSEs) took the view that the unrealistically high goals would affect the future solvency of the FHA. One trade association asserted that “excessive goals will push the GSEs to expand into the least risky part of the FHA market and put into question the FHA's long-term viability.”⁴⁰ HUD then reports that Fannie Mae and Freddie Mac agreed that they would be compelled to “more aggressively compete with the FHA in procuring top quality borrowers.” This actually became Fannie Mae's chosen strategy, as opposed to a strategy that was forced upon it, but all of these concerns were dismissed by HUD.

HUD responded by stating that it was not the FHA's mission to compete with the private sector and then to agree that automated underwriting had blurred the underwriting distinctions between prime conventional and FHA loans. For example, an application with high payment-to-income ratios would be processed using an automated underwriting system which scores the application based on a totality of risk factors. The result was that 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 credit score.

With regard to subprime loans, both GSEs stated that they would need to increase their purchase of subprime loans in order to meet the higher goals. Freddie Mac, in particular, argued that in order to meet these goals, it might not have the option in the future of turning away subprime loans with less desirable terms than the subprime business it currently purchases. Once again, HUD stressed the GSEs' approach to predatory lending; their prudence in focusing on the higher levels of the subprime market (A-minus and Alt-A segments, the latter group being those who cannot document all the underwriting information). "The GSEs' subprime products are integrated into their automotive underwriting system and are approved based on mortgage scoring models, which has proved to be an effective tool in limiting risk layering. The GSEs charge lenders higher fees for guaranteeing 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."

HUD again praised the GSEs' presence in the subprime market. The content of these remarks is worth noting: "Millions of Americans with less than perfect credit or who cannot meet some of the tougher underwriting requirements of the prime market such as inadequate income documentation, limited down-payment or cash reserves, or the desire to take out more cash than conventional loans allow, rely on subprime lenders for access to mortgage financing. If the GSEs reach deeper into the subprime market, more borrowers will benefit from the advantages that greater stability and standardization create."⁴¹

Respondents recognized that the higher goals would lead to more expanded affordable housing products as well as higher foreclosures, and were extremely concerned about the impact of a higher level of foreclosure on underserved areas, especially inner-city areas. HUD was warned that affordable loans introduced into the market in favorable economic circumstances can experience higher increasing defaults and foreclosures during periods of higher interest rates, higher unemployment and/or lower house price appreciation rates. One respondent estimated that 15% or more of borrowers in some affordable housing products could experience default in an economic downturn.

Once again, all the warnings were dismissed by HUD, which insisted that an active GSE effort in these neighborhoods would encourage traditional, mainstream lenders to increase their lending activities in these underserved areas. This would result in additional funding opportunities for lower-income and minority borrowers, who would otherwise take out high-cost loans. "As a result the Department believes that GSE participation is a net benefit to lower-income households."⁴² Despite such reassurances, the serious anxieties of many within the industry remained, and HUD received more than one explicit warning.

The dangers inherent in the 2004 decision to raise the targets to such an extent did not go unnoticed at the time. The National Association of Realtors

in their letter to the Federal Housing Finance Agency (the successor body to the OHEO) in April 2010 referred to their previous comments on HUD’s 2004 proposals. Their letter of July 2004 had warned HUD that “the Proposed Rule assumes a GSE market share and future economic conditions that are too optimistic. In particular, we were worried that the goals would ‘distort mortgage markets’ and pointed out that ‘goals set too high can be just as damaging as goals that are set too low’.” HUD did not heed NAR’s warnings.

HUD’s litany of oversight failures contributed to the subprime mortgage crisis

In their 2010 letter, NAR pointed out that the post-2005 HUD goals forcing the GSEs to take undue risks to meet their targets appear to have been a factor behind the market dislocations that have led, and are still leading, to millions of foreclosures. Of course, there were many other factors, including the GSEs’ overreaching for market share, accepting weak “Alt-A” underwriting, and purchasing tranches of poor-quality private label securities, as well as weak underwriting by too many subprime lenders, inappropriate commercial lending by FDIC-insured institutions that made possible the operations of abusive subprime lenders, and a flood of excess capital worldwide. NAR reviewed abuses in the subprime lending market starting at the end of 2004, and in May 2005 issued its policy calling for underwriting that is consistent with sustainable home ownership. Regulators have “subsequently taken action consistent with many of these regulations.”⁴³

The lengthy discussions, which lay behind the introduction of the housing goals especially in 2000 and 2004, have been included here, because at every turn they show the weaknesses and indecisiveness of HUD as a mission regulator. HUD’s oversight of Fannie Mae and Freddie Mac consisted in ensuring that they were enhancing the availability of mortgage credit by creating and maintaining a secondary market for residential mortgages. HUD is, as set out above, charged with establishing the goals and monitoring the compliance of Fannie Mae and Freddie Mac’s financing of housing for low- and moderate-income families, housing in central cities and other “underserved areas”. The department failed in every aspect of its mission, including the failure to see the increased risks for borrowers in the categories which the GSEs were supposed to serve of taking on subprime loans, which in fact turned out to be new forms of predatory lending. Even when such issues were raised by respondents to the proposed goal changes, they were either assured that the existing rules on predatory lending were sufficient, or that the GSEs own voluntary restrictions on predatory lending would provide sufficient safeguards, or that the matter required further investigation. For example, in 2000, HUD emphasized that the GSEs “have a public responsibility to help eliminate predatory mortgage

practices which are inimical to the home financing and homeownership objectives that the GSEs were established to serve.”⁴⁴ The rule confirmed the corporate policies adopted by Fannie Mae and Freddie Mac, that they would not purchase predatory mortgages, by disallowing them from receiving goals credit for predatory loan purchases. HUD should have continued to challenge the GSEs by encouraging them to act more aggressively in ending predatory practices in the subprime market; but it did not, and instead took a complacent view of the subprime market and of the risks involved.

A careful reading of all the submissions from Fannie Mae and Freddie Mac shows that they successfully fought off any attempt to monitor their activities more closely. That was especially true of the seller dissolution options on units acquired in transactions with the lenders; that is, where the seller of the mortgages to the GSEs has an option to dissolve or otherwise cancel a mortgage purchase arrangement or a loan sale. The mortgages are then returned to the mortgage lender or seller. The lock-out proposal was a useful solution, but the problem remained as to whether or not HUD would be able to identify such sales, especially where bulk purchases were concerned shortly before the end of the financial year.

This brief history of the role of HUD between 1995 and 2008 shows that the department did not have the resources, even if it had the will, to oversee the GSEs and the FHA. It did not have the will, because the four Secretaries of Housing were committed to the affordable housing ideology, as were the Administrations of which they were part. They pushed ahead with the affordable housing goals and entirely failed to understand, or, if they understood, chose to ignore, the risks involved, until it was too late.