

The **GSE** REPORT™

Special Supplement

Fannie Mae's and Freddie Mac's
UnAffordable Housing Goals

June 2001

TABLE OF CONTENTS

Comparative Analysis

I. Legislative Purpose And Obligations	2
A. Insured Depository Institutions Have Obligations Under The CRA Because Of The DeMinimus Benefits They Receive From Federal Deposit Insurance	2
B. The Government-Sponsored Enterprises Were Created To Provide Liquidity To The Residential Mortgage Market	3
1. The GSEs Have Obligations Under The Affordable Housing Goals Because Of The Valuable Government Benefits They Receive.....	4
2. The GSEs Have A Statutory Obligation Under The Affordable Housing Goals To Provide Liquidity To The Whole Of The Residential Mortgage Market	6
II. Monitoring Mechanisms	7
A. The CRA	7
1. Depository Institutions Face Three Different Tests Of Community Outreach: The Lending Test, The Investment Test And The Service Test	7
2. Depository Institutions Receive Easily Understandable Grades Of Performance: Outstanding, Satisfactory, Needs To Improve Or Substantial Noncompliance	8
B. The Affordable Housing Goals	9
1. The GSEs Have Three Sets Of Goals: Low And Moderate-Income Housing Goals, Special Affordable Housing Goals And Underserved Areas Goals	9
2. The GSEs' Performance Is Not Graded In Any Meaningful Manner	11
III. Definitions Of Qualifying Activity	12
A. The CRA	12
1. Depository Institutions Cannot Use One Activity To Receive Credit Under Multiple Tests	12
2. Depository Institutions Must Use Narrow Definitions Of Low-Income And Moderate-Income	13
B. The Affordable Housing Goals	13
1. The GSEs Can Use One Activity To Receive Credit For Multiple Goals And Can Manipulate The Amount Of Credit Using Special Counting Requirements	13
2. The GSEs Can Use Broader Definitions Of Income Levels To Meet Their Goals	14
3. The Different Definitions Of Income Levels Allow The GSEs To Meet Their Affordable Housing Goals Without Serving The Whole Of The Market.....	16
4. The Broad Definitions Of Geographic Areas Allow The GSEs To Avoid Activity In Truly Underserved Areas.....	18
IV. Performance Context	20
A. Depository Institutions Are Evaluated In The Context Of The Public's Assessment Of Their Efforts To Serve The Whole of the Community	20

B. The GSEs Face Only Minimal Public Scrutiny Of Their Efforts To Serve The Whole Of The Community	21
V. Enforcement.....	23
A. Depository Institutions Can Incur Substantial Reputational And Business Costs For Failing To Comply With The CRA.....	23
B. The GSEs Do Not Face Any Significant Reputational Or Business Risks For Failing To Meet Their Affordable Housing Goals.....	25

Proposed Reforms

Five Reforms HUD Could Implement Immediately, Within Its Current Regulatory Framework

1. Institute Periodic HUD Reports To Congress On GSE Compliance With The Affordable Housing Goals	28
2. Institute A System Of Descriptive Grades Characterizing GSE Compliance.....	28
3. Create And Publicize Standard Reports Of HUD’s Analysis And Verification Of The GSEs’ Compliance With The Affordable Housing Goals.....	29
4. Provide For Interagency Cooperation On Verification Of GSE Data.....	29
5. Require Jurisdictions Applying For HUD Grants To Include In Their Consolidated Plans A Section On GSE Performance Under The Affordable Housing Goals In The Context Of Local Housing Needs.....	30

Six Reforms HUD Could Implement By Changing Its Regulations

6. Require The GSEs To Publish Their Loan Purchase Decision-Making System Assumptions, Methodologies And Outcomes.....	31
7. Establish A Certification Program For Automated Underwriting Systems And Require The GSEs To Accept The Results Of Any Certified System.....	32
8. Conform GSE Reporting Requirements And Definitions Concerning Qualifying Activity To CRA Definitions.....	33
9. Revise Multi-Family Housing Subgoal To Introduce Caps On The Number Of Units And Caps On The Mix Of High-Income And Low-Income Housing In Qualifying Developments	34
10. Prohibit GSEs From Meeting Housing Goals Except By Purchasing Newly-Originated Mortgages, And Count All Other GSE Activities Against The Affordable Housing Goals	35
11. Revise Regulations Regarding New Programs To Define “New Program” Broadly And Condition Approval Of New Programs On Compliance With Affordable Housing Goals	35

One Reform That Would Require A Change In Federal Reserve Regulations

12. Revise Regulation C To Require The GSEs To Report Their Mortgage Loan Purchases In Conformity With HMDA 36

Two Reforms That Would Require A Change in Treasury Regulations

13. Condition GSE Ability To Borrow From Treasury On Achievement Of Outstanding Compliance With Affordable Housing Goals 37

14. Condition Treasury Approval Of GSE Debt Issuances On Achievement Of Compliance With Affordable Housing Goals 38

Comprehensive Reform

The Community Reinvestment Act of 1977¹ (the “CRA”) requires depository institutions to serve their entire communities and authorizes federal regulators to examine the level of investment, lending and service that insured depository financial institutions provide to the communities in which they do business.

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992² (the “FHEFSSA” or the “Affordable Housing Goals”)³ requires the U.S. Department of Housing and Urban Development (“HUD”) to set affordable housing goals for the government-sponsored enterprises Fannie Mae and Freddie Mac (respectively, “Fannie” and “Freddie”; collectively, the “GSEs”). This paper compares the CRA and the Affordable Housing Goals in five areas:

- Legislative Purpose and Obligations
- Monitoring Mechanisms
- Definitions of Qualifying Activity
- Performance Context
- Enforcement

This analysis indicates that the regulatory framework of the CRA imposes requirements on depository financial institutions that are much more substantive than the requirements the Affordable Housing Goals set for the GSEs. Rather than encouraging the GSEs to fulfill their public purpose of leading the affordable housing market, the structure of the Affordable Housing Goals encourages the GSEs to lag the market, generally decreasing the liquidity of the affordable housing market and making it more difficult for depository institutions to meet their CRA obligations.

Furthermore, HUD missed various opportunities to correct these inequalities when it promulgated the most recent final rule implementing the GSEs’ Affordable Housing Goals (the “Final Rule”)⁴ in October 2000. This paper suggests reforms that HUD and other agencies could enact to increase the effectiveness of the Affordable Housing Goals. It also discusses the advisability of a more comprehensive approach to GSE reform, aimed at ensuring the achievement of the GSEs’ public purpose.

¹ 12 U.S.C. §§ 2901, *et seq.*

² 12 U.S.C. §§ 4501 *et seq.*

³ As discussed in greater detail below, FHEFSSA establishes three goals: 1) the Low and Moderate-Income Housing Goals, 2) the Special Affordable Housing Goals, and 3) the Central Cities, Rural Areas, and Other Underserved Areas Housing Goals. This paper refers to the Act and the goals collectively as the “Affordable Housing Goals.”

⁴ HUD issued proposed and final rules in 1995 establishing and implementing the GSEs’ Affordable Housing Goals for 1996 through 1999. This rule provided that the Affordable Housing Goals for 1999 would continue beyond 1999 if HUD did not change the goals, and further provided that HUD could change the level of the goals for the years 2000 and beyond based upon HUD’s experience and in accordance with HUD’s statutory authority and responsibility. Acting under this authority, HUD published a proposed rule on March 9, 2000 and solicited comments. After considering over 250 comments from the GSEs, lending institutions, non-profit organizations, private individuals, consumer groups, and state and local governments, HUD issued a final rule on October 31, 2000, referred to in this paper as the “Final Rule.”

COMPARATIVE ANALYSIS

I. Legislative Purpose And Obligations

FHEFSSA imposes three statutory housing goals on the GSEs: the Low- and Moderate-Income Housing Goal, the Special Affordable Housing Goal, and the Central Cities, Rural Areas, and Other Underserved Areas Goals collectively (the “Underserved Areas Goals”).⁵ This statutory requirement is implemented by regulations promulgated by HUD, which has ultimate responsibility for implementing FHEFSSA.⁶ This tailor-made regulatory structure has been criticized for failing to adequately encourage the GSEs to create liquidity for lending in underserved areas and to low-income borrowers.⁷ In the Final Rule, for example, although HUD increased the levels of the Affordable Housing Goals, it also enlarged the loopholes to achieve compliance.

The similarities between the purpose of the Affordable Housing Goals and the CRA are not surprising, given the common historical roots of both federal deposit insurance and the government-sponsored mortgage liquidity mechanism in the aftermath of the Great Depression. In addition, the GSEs’ Affordable Housing Goals were specifically designed to assist depository institutions in meeting their CRA goals.⁸ Given these purposes, the GSEs should be expected to lead, not lag, the market for affordable housing finance.

A. Insured Depository Institutions Have Obligations Under The CRA Because Of The DeMinimus Benefits They Receive From Federal Deposit Insurance

Federal deposit insurance was created in the aftermath of the U.S. banking crisis of 1933. Its aim was threefold: to protect the economic stakes of small depositors, to restore faith in the U.S. banking system in general and individual insured depository institutions in particular, and by so restoring public faith, to protect individual institutions and the entire system from the destructive effects of bank runs. At first optional, federal deposit insurance has gradually become virtually mandatory for chartered depository institutions.

The CRA imposes a discrete set of obligations upon insured depository institutions, on the theory that the services that depository institutions provide in the communities they serve should be provided throughout those depository institutions’ areas of financial activity. Depository institutions derive a very limited private benefit from the scheme of federal deposit insurance because they can compete successfully for deposit funds at a slightly lower cost than uninsured institutions. In addition, federal deposit insurance protects an insured depository institution against a potentially destructive run on its funds. These are benefits, although the fact that the primary federal deposit insurance fund has been built up with bank premiums rather than

⁵ See 12 U.S.C. §§ 4561 *et seq.*

⁶ 24 C.F.R. Part 81.

⁷ See General Accounting Office, Federal Housing Enterprises: HUD’s Mission Oversight Needs To Be Strengthened, GAO/GGD-98-173 (July 1998) (the “GAO Study”).

⁸ 12 U.S.C. § 4565(3)(B).

tax dollars somewhat blunts the argument of the more aggressive CRA advocates that insured depository institutions “owe” something to the American people in return for the privilege of deposit insurance.

The CRA states that “regulated financial institutions have continuing and affirmative obligations to help meet the credit needs of the local communities in which they are chartered.”⁹ Because a “regulated financial institution” is “an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act)[,]”¹⁰ and because all national banks and most state banks and thrifts are insured, the CRA applies to most depository institutions in the United States, except for credit unions and bankers’ banks. As implemented by regulations promulgated by each type of depository institution’s federal regulator, the CRA sets criteria for evaluating each institution’s lending, investments, and services to low- and moderate-income communities in the institutions’ assessment areas.¹¹

A depository institution’s federal regulator will conduct periodic examinations of the institution’s activities in low- and moderate-income neighborhoods within its assessment area, in most cases every two years. If the regulator finds that a financial institution is not serving these neighborhoods, it can delay or deny that institution’s regulatory applications, including applications to merge with another lender or open a branch.¹²

B. The Government-Sponsored Enterprises Were Created To Provide Liquidity To The Residential Mortgage Market

Congress created the GSEs to provide liquidity to the residential mortgage market. The older of the two, Fannie Mae, like federal deposit insurance, arose out of New Deal experimentation in government-sponsored intervention to remedy socially destructive market failures in the financial services industry. Congress chartered Fannie Mae in 1938 as a government-owned association to buy, hold and securitize for sale on the secondary market mortgages insured by the Federal Housing Administration.¹³ In 1968, Congress reorganized Fannie Mae as a government-sponsored, privately-owned corporation with the power to buy, hold and securitize mortgages, whether or not insured by the Federal Housing Administration, whose initial balances do not exceed an amount that has come to be known as the “conforming” limit.¹⁴ Freddie Mac, modeled on Fannie Mae, was intended as a secondary market liquidity

⁹ 12 U.S.C. §2901(a)(3).

¹⁰ 12 U.S.C. §2903(2).

¹¹ These regulators are (1) the Office of the Comptroller of the Currency (“OCC”) for national banks, 12 C.F.R. Part 25; (2) the Board of Governors of the Federal Reserve System (“Fed”) for all bank holding companies, as well as state-chartered Federal Reserve System member banks, 12 C.F.R. Part 228; (3) the Federal Deposit Insurance Corporation (“FDIC”) for state-chartered non-member banks, 12 C.F.R. Part 345; and (4) the Office of Thrift Supervision (“OTS”) for federal and state-chartered thrifts, as well as all thrift holding companies, 12 C.F.R. Part 563e. The regulations are practically identical and have been cited in a series throughout this paper.

¹² 12 C.F.R. §§25.29(c), 228.29(c), 345.29(c), 563e.29(c).

¹³ Federal National Mortgage Association Charter Act, 12 U.S.C. §§ 1716 *et seq*; see GAO Study at 2.

¹⁴ 12 U.S.C. § 1717(b)(1), (2).

mechanism for the Federal Home Loan Bank System when it was chartered in 1970.¹⁵ In 1989, Congress reorganized Freddie Mac as a government-sponsored, privately-owned corporation like Fannie Mae, having similar powers.¹⁶

1. The GSEs Have Obligations Under The Affordable Housing Goals Because Of The Valuable Government Benefits They Receive

One of the reasons to impose housing goals upon the GSEs parallels the underlying rationale of the CRA: the GSEs have derived tangible private benefits from various rights extended to them by the public, and “the benefits of the federal charters enjoyed by the enterprises place certain obligations on the enterprises.”¹⁷ Some of the most important benefits Fannie Mae and Freddie Mac receive are:

- Each GSE can borrow up to \$2.25 billion directly from the Treasury, subject to Treasury approval.¹⁸ There are no statutory conditions on Treasury approval of direct borrowing by the GSEs, unlike the statutory limits on the ability of Treasury to declare an FDIC-insured depository institution “too big to fail.”¹⁹
- Securities issued or backed by each GSE are exempt from SEC registration or other regulation.²⁰ As a result, the GSEs save significant regulatory compliance costs and registration fees.
- Each GSE is exempt from state and local taxation, except for real estate taxes.²¹ As a result, the GSEs save considerable amounts that would otherwise be distributed to states and localities throughout the United States. The benefits of this exemption are growing as the GSEs seek to consolidate fully private and taxable lines of business into their two organizations.
- The GSEs may conduct business in any state or territory without the need to comply with any filing, licensing, or other business laws.²²

¹⁵ Federal Home Loan Mortgage Corporation Act, 12 U.S.C. §§ 1451 *et seq.*; *see* GAO Study at 2.

¹⁶ 12 U.S.C. §§ 1452(a)(1), 1454(a)(1).

¹⁷ H. Rep. 102-206 at 28 (1992).

¹⁸ 12 U.S.C. §§ 1719(c) (Fannie), 1455(c) (Freddie).

¹⁹ *See* 12 U.S.C. §§ 1823(c)(4)(A), 347b. At least in part as a result of this authority, financial markets regard GSE-issued or GSE-backed securities as implicitly guaranteed by the federal government. It is widely believed that this perceived implicit guarantee permits the GSEs to borrow at advantageous rates. *See* Richard Carnell, “Seeking Safety in Numbers: Characterizing Federally Insured Depository Institutions as Government-Sponsored Enterprises” (American Enterprise Institute Conference Paper, Sept. 8, 1999).

²⁰ 12 U.S.C. §§ 1719(d) (Fannie), 1456(g) (Freddie).

²¹ 12 U.S.C. §§ 1723a(c)(2) (Fannie), 1452(e) (Freddie).

²² 12 U.S.C. §§ 1723a(a) (Fannie), 1456(a) (Freddie).

- Debt securities and mortgage-backed securities issued by the GSEs receive almost the same preferential investment status as Treasury debt. Those securities can be used in many ways in lieu of U.S. Government Securities, for example as eligible collateral for advances from the Federal Reserve Banks and Federal Home Loan Banks²³; for open-market purchase by the Federal Reserve Banks²⁴; and for collateralizing public deposits.²⁵
- GSE debt securities and mortgage-backed securities receive more favorable risk weights than other mortgage loan assets for the purpose of calculating risk-based capital requirements for insured depository institutions.²⁶
- The GSEs are permitted to issue and transfer securities through the Federal Reserve's electronic book-entry system.²⁷
- The GSEs can issue callable long-term debt, subject to approval by the Treasury. This ability, combined with the implicit federal guarantee of the GSE debt, provides the GSEs with unique financial flexibility.²⁸
- The GSEs have lower capital requirements than other financial institutions. As a result, the GSEs can maximize the use of leverage.²⁹
- The GSEs have unique charters. As a result, Fannie and Freddie have no effective competition other than each other, and their duopoly is virtually guaranteed.

The Congressional Budget Office has estimated that the various benefits received by the GSEs cost the government and taxpayers approximately \$10.6 billion annually.³⁰ Of this amount, approximately one-third is retained by the GSEs for their own use.³¹ By any measure, this is a very substantial benefit and Congress has determined that this benefit must be directed to serve larger policy priorities. The Affordable Housing Goals provide a mechanism to ensure that the valuable benefits provided to the GSEs are shared throughout the community. Congress has stated that “[g]iven the dominating role of these entities in mortgage finance markets and the large indirect federal subsidies they receive, it is essential that their activities promote the achievement of other national housing goals.”³² In light of these substantial benefits, it is

²³ 12 U.S.C. §§ 347 (Fannie), 1430(a)(2) (Freddie).

²⁴ 12 U.S.C. §§ 355(2).

²⁵ 12 U.S.C. §§ 1723c, (Fannie), 1452(g) (Freddie).

²⁶ *See, e.g.*, 12 C.F.R. Part 3, Appendix A(a)(2)(vii) (OCC regulations).

²⁷ 12 U.S.C. §§ 1723a(g) (Fannie), 1452(d) (Freddie).

²⁸ 12 U.S.C. §§ 1719(e) (Fannie), 1455(j) (Freddie).

²⁹ *See* Capitol Financial Insights, “Competitive Threat of Government Sponsored Enterprises,” Table E-1 (Jan. 16, 1998).

³⁰ Congressional Budget Office, *Federal Subsidies and the Housing GSEs* (2001).

³¹ *See id.*

³² S. Rep. 102-282 at 9 (1992).

imperative that the Affordable Housing Goals accurately measure the GSEs' efforts to increase liquidity for the underserved areas of the residential mortgage market.

2. The GSEs Have A Statutory Obligation Under The Affordable Housing Goals To Provide Liquidity To The Whole Of The Residential Mortgage Market

In addition to the CRA-type argument that government benefits should be redistributed broadly rather than narrowly, Congress had an additional reason to impose housing goals upon the GSEs, based upon their statutory purpose of promoting liquidity in the national housing market.³³ Depository institutions must make mortgage loans in historically underserved areas to fulfill their CRA obligations. Therefore, FHEFSSA explicitly states that "each enterprise shall...take affirmative steps to...assist insured depository institutions to meet their obligations under the Community Reinvestment Act of 1977, which shall include developing appropriate and prudent underwriting standards, business practices, repurchase requirements, pricing, fees and procedures[.]"³⁴ The Senate Report on FHEFFSA emphasized that the GSEs should "lead the mortgage finance industry in making mortgage credit available for low- and moderate-income families."³⁵ Clearly, the most important affirmative step the GSEs could take to help depository institutions meet their CRA obligations would be to purchase CRA-compliant mortgage loans.

The GSEs have been criticized for their failure to lead the affordable housing market. In the preamble to the Final Rule, HUD stated that the GSEs' mortgage purchases continue to lag the overall market, and, more problematic, the GSEs' purchase of lower-income loans tends to focus on those loans that have relatively high down payments.³⁶ This situation raises questions about the GSEs commitment to fulfilling its statutory purpose of providing liquidity for the whole of the market. Given the substantial subsidies the GSEs receive, they should be able to serve the lower-income tier of the mortgage market, including those mortgages that may bear a higher risk. In addition, according to HUD, the GSEs are well-equipped to lead the affordable housing market because of their state-of-the art technology, staff resources, share of the total conventional, conforming market, and financial strength.³⁷

With its issuance of the Final Rule, HUD restructured the regulations relating to the GSEs' Affordable Housing Goals. Unfortunately, the Final Rule does not adequately address the disparity between the obligations faced by depository institutions under the CRA and those faced by the GSEs. For example, HUD did not create a mechanism in the Final Rule for determining whether the GSEs are shifting the credit risk of lending to low- and moderate-income individuals to depository institutions by focusing their loan purchases on those loans that have credit enhancements (such as mortgage insurance). At this time, HUD awards full goals credit for the purchase of most mortgages regardless of the level of credit risk. HUD has noted that the issues

³³ 12 U.S.C. §§ 1716(4) (Fannie), 1451(b)(4) (Freddie).

³⁴ 12 U.S.C. § 4565(3)(B).

³⁵ See S.Rep. No. 282, 102d Cong., 2d Sess. 34 (1992).

³⁶ See 65 Fed. Reg. 65044, 65051 (2000).

³⁷ See *id.*

are complex because the GSEs' charter acts require them to obtain mortgage insurance or the equivalent credit enhancement on many single-family mortgages and because of general safety-and-soundness considerations, and has stated that it will be undertaking further review of this situation in the future.³⁸ In the meantime, the rule leaves open the possibility that the GSEs will receive full goals credit in situations in which they take on little or no real credit risk.

II. Monitoring Mechanisms

Both the CRA and the GSE Affordable Housing Goals are implemented through a monitoring process conducted by the relevant federal regulator. Both systems have multiple categories of examinations or goals. The categories of a CRA examination, however, have to do with various sorts of investment, while the categories of the GSE housing goals have to do with somewhat different, though overlapping, sets of recipients of financial services.

A. The CRA

1. Depository Institutions Face Three Different Tests Of Community Outreach: The Lending Test, The Investment Test And The Service Test

The CRA establishes three different types of examinations depending on whether the financial institution is classified as “large,” “small” or “wholesale or limited purpose.” The examinations, or “tests,” for large financial institutions are most relevant to this analysis.

A “large” financial institution is defined as having assets greater than \$250 million.³⁹ Large financial institutions are subject to an examination that consists of three “Performance Tests”: (1) lending, (2) investment, and (3) service.⁴⁰

The lending test examines the number and amount of home mortgage, small business, small farm, and community development loans made to low- and moderate-income people in the institution's assessment area.⁴¹ Examples of community development loans include:

- Loans for construction, rehabilitation, or permanent financing of multifamily rental property serving low- and moderate-income persons;
- Loans to not-for-profit organizations serving primarily low- and moderate-income housing needs;
- Loans to construct or rehabilitate community facilities located in low- and moderate-income areas;
- Loans to community development financial institutions (CDFIs) or community development corporation (CDCs); and
- Loans to local, state and tribal governments for community development activities.⁴²

³⁸ See HUD's Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65081 (2000)

³⁹ 12 C.F.R. §§ 25.12(t), 228.12(t), 345.12(t), 563e.12(s).

⁴⁰ 12 C.F.R. §§ 25.21(a), 228.21(a), 345.21(a), 563e.21(a).

⁴¹ 12 C.F.R. §§ 25.22(a)(1), 228.22(a)(1), 342.22(a)(1), 563e.22(a)(1).

The investment test examines the number and amount of “qualified investments” made in the institution’s assessment area.⁴³ Qualified investments are investments, deposits, membership shares, or grants that have as their primary purpose community development. Examples of community development qualified investments include investments, grants, deposits, or shares in or to:

- Financial intermediaries such as CDFIs or CDCs;
- Organizations that engage in the rehabilitation and/or construction of affordable housing;
- Projects eligible for low-income housing tax credits; and
- Organizations that promote economic development.⁴⁴

The service test examines the availability of retail banking services to low- and moderate-income people in the institution’s assessment area.⁴⁵ Community development services include providing any of the following:

- Financial services with the primary purposes of community development, such as low-cost bank accounts;
- Technical assistance to community development organizations or small businesses;
- Counseling for credit use, home buying, or financial planning;
- Assistance to community development organizations in developing loan application and underwriting standards.⁴⁶

2. Depository Institutions Receive Easily Understandable Grades Of Performance: Outstanding, Satisfactory, Needs To Improve Or Substantial Noncompliance

After a CRA examination, the federal regulator provides one of the following five grades to the financial institution depending on its performance under each of the three tests: “outstanding,” “high satisfactory,” “low satisfactory,” “needs to improve,” or “substantial noncompliance.”⁴⁷ These grades have quantitative as well as qualitative components. For example, under the lending test, a financial institution will receive a grade based on the dollar amount of the loans made as well as the innovative or flexible-lending practices used to address the credit needs of low- or moderate-income individuals.⁴⁸ Depending on the grade received for

⁴² See Interagency Questions and Answers Regarding the Community Reinvestment Act, 65 Fed. Reg. 25088, 25094 (2000).

⁴³ 12 C.F.R. §§ 25.23(a), 228.23(a), 345.23(a), 563e.23(a).

⁴⁴ See Interagency Questions and Answers Regarding the Community Reinvestment Act, 65 Fed. Reg. 25088, 25097 (2000).

⁴⁵ 12 C.F.R. §§ 25.24(a), 228.24(a), 345.24(a), 563e.24(a).

⁴⁶ See Interagency Questions and Answers Regarding the Community Reinvestment Act, 65 Fed. Reg. 25088, 25096 (2000).

⁴⁷ 12 C.F.R. Appendix A to Parts 25, 226, 345, 563e.

⁴⁸ 12 C.F.R. §§ 25.22, 228.22, 342.22, 563e.22.

each of the three tests, the regulator will then give the financial institution an overall grade from one of four categories: “outstanding,” “satisfactory,” “needs to improve,” or “substantial noncompliance.”⁴⁹

The grades help the financial institution and the public to understand the level of performance achieved under the CRA tests. The grades are publicly available on the Internet and easily understood by community groups that are seeking to evaluate a lender’s performance for purposes of deciding whether or not to protest the institution’s proposed applications before a federal regulator. The grades also increase public pressure on the institution to serve the community in which it does business, and motivate the institution to try to distinguish itself from other lenders in the area of CRA performance. Because most large financial institutions either have or plan to have applications pending before the federal regulators, they have an incentive to achieve a CRA grade of “outstanding” in order to bolster community support and ease the application process.⁵⁰

B. The Affordable Housing Goals

1. The GSEs Have Three Sets Of Goals: Low And Moderate-Income Housing Goals, Special Affordable Housing Goals And Underserved Areas Goals

FHEFSSA requires HUD to establish three “goals” for the GSEs: (1) Low- and Moderate-Income Housing Goals, (2) Special Affordable Housing Goals, and (3) Underserved Areas Goals.⁵¹ Unlike the CRA tests, which require CRA lenders to undertake different kinds of activities, the Affordable Housing Goals all require the GSEs to undertake the same type of activity — purchasing mortgage loans.⁵² This suggests that the Affordable Housing Goals should be an effective means of enforcing GSE compliance with the goals of FHEFSSA. Purchasing mortgage loans, after all, is the core activity of the GSEs, and the Affordable Housing Goals are unambiguous numerical or percentage targets for annual mortgage purchases. Loose definitions of the activities that count towards meeting the housing goals, however, have substantially weakened their effectiveness. The Final Rule, for example, did nothing to tighten the definitions of “low-income,” “moderate-income” and “underserved areas.” As a result, even though HUD has increased the goals over the years, the GSEs can be expected to continue to lag, rather than lead, the affordable housing market.

a. Low And Moderate Income Housing Goals

Through regulations, the Secretary of HUD sets yearly Low- and Moderate-Income Housing Goals for the GSEs’ purchase of mortgages on housing for low- and moderate-income

⁴⁹ 12 C.F.R. Appendix A to Parts 25, 226, 345, 563e.

⁵⁰ In addition, financial institutions now have an incentive to achieve a CRA grade of “satisfactory” in order for their loans to count toward the GSE Special Affordable Housing Goals. See 24 C.F.R. § 81.14(e)(vi)(C); HUD’s Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65074 (2000).

⁵¹ 12 U.S.C. § 4561.

⁵² 24 C.F.R. § 81.16(a).

families.⁵³ The goal for the years 2001 to 2003 requires that 50% of the total number of dwelling units financed by the GSEs' mortgage purchases should be for housing for low- and moderate-income families.⁵⁴ The Secretary may also establish specific subgoals within the stated yearly goal, but these subgoals are not enforceable.⁵⁵

b. Special Affordable Housing Goals

The Secretary also sets yearly Special Affordable Housing Goals for GSE purchase of mortgages on rental and owner-occupied housing which are affordable to, and which meet the then existing unaddressed needs of low-income families in low-income areas and very low-income families.⁵⁶ The Special Affordable Housing Goals for the years 2001 to 2003 are set at 20% of the total number of dwelling units financed by the GSEs during the year.⁵⁷

FHEFSSA seems to allow HUD to establish specific enforceable subgoals within the stated yearly Special Affordable Housing Goals. Parallel sections of FHEFSSA that establish the other housing goals specifically state that "the Secretary may establish separate subgoals within the goal under this section and such subgoals shall not be enforceable."⁵⁸ On the theory that Congress could have included such a provision in the Special Affordable Housing Goals and must have intended not to, it would at least arguably appear that HUD is within its power to establish subgoals and enforce them in connection with the affordable housing goal.

HUD seems to agree with this interpretation, because it has established subgoals in connection with the Special Affordable Housing Goal. The Special Affordable Housing Goals for the years 2001 to 2003 include a subgoal related to the type of property financed. The subgoal states that the GSEs must purchase mortgages financing dwelling units in multifamily housing up to an amount not less than 1.0% of the dollar volume of mortgages purchased by the respective GSE in the years 1997, 1998 and 1999.⁵⁹

Despite the increased requirement, this subgoal is not likely to have the intended socially beneficial effect. It is not as specific as the transition subgoals, originally set out in the statute, which related to both the income levels of occupants (very low-income and low-income) and the

⁵³ 12 U.S.C. § 4562(a).

⁵⁴ 24 C.F.R. §81.12(c)(1)(2000). For the years 1993 to 1995, the Low- and Moderate-Income Housing Goal was set at 30%. 12 U.S.C. §4562(d)(1). For 1996, it was set at 40%. 24 C.F.R. §81.12(c)(1)(1999). For 1997 to 1999, the goal was at 42%. 24 C.F.R. §81.12(c)(2)(1999).

⁵⁵ 12 U.S.C. § 4562(a).

⁵⁶ 12 U.S.C. 4563(a).

⁵⁷ 24 C.F.R. §81.14(c)(1)(2000). For the years 1993 to 1995, the Special Affordable Housing Goal was not described as a percentage but was set for Fannie Mae at not less than \$2 billion in affordable housing mortgage purchases annually; for Freddie Mac at not less than \$1.5 billion in affordable housing mortgage purchases annually. 12 U.S.C. § 4563(d). For 1996, it was set at 12%. 24 C.F.R. §81.14(c)(1)(1999). For 1997 to 1999, the goal was at 14%. 24 C.F.R. §81.14(c)(2)(1999).

⁵⁸ *Id.* §§ 4562(a), 4564(a).

⁵⁹ 24 C.F.R. § 81.14(c)(1)(2000).

type of property financed (multifamily or single family). As a result of its lack of specificity, the multifamily housing subgoal can be satisfied by the purchase of loans that finance housing bearing little relationship to traditional “affordable” housing. For example, funding for a hypothetical multifamily housing project with 1000 units, 800 of which are luxury apartments and 200 of which are low-cost housing for graduate students, would appear to count towards the multifamily housing subgoal up to 20% of the value of the mortgage.⁶⁰ This would appear to be the case despite the fact that such housing does little or nothing to increase the stock of affordable housing accessible to the long-term disadvantaged (as opposed to graduate students, who are at best short-term disadvantaged). This would also appear to be in spite of the fact that there is no apparent need for government-sponsored intervention in the financing of such projects, there already being ample private incentive to construct luxury rental housing. Indeed, it can be argued that, to the extent that the Affordable Housing Goals allow the GSEs to divert their resources to the funding of such so-called “80/20” projects, they do not force them to make adequate efforts to stimulate the sorts of multifamily housing finance for which there are not adequate private incentives. Finally, the GSEs participation in these types of transactions do not necessarily result in the monthly rental payments being reduced. The GSEs participation generally accrues to the financial benefit of the developer and the GSEs’ shareholders.

c. Underserved Areas Goals

The Secretary also sets yearly Underserved Areas Goals for the GSEs’ purchase of mortgages on housing located in these areas.⁶¹ The Secretary may also establish specific subgoals within the stated yearly goal, but these subgoals are not enforceable.⁶² For the years 1993 to 1995, this goal stated that 30% of the total dwelling units financed should be purchases of mortgages located in central cities.⁶³ For the years after 1995, the goal was expanded to include rural areas and other underserved areas as well as central cities. However, the goal was actually decreased from the previous level. For 1996, the goal was only 21% of the total units financed, and for the years 1997 to 1999, the goal was only 24% of the total units financed.⁶⁴ In the Final Rule, HUD set the Underserved Areas Goals for the years 2001 to 2003 at 31% of the total number of dwelling units financed by the GSEs during that year.⁶⁵ For the first time, this goal is now increased from the level set by FHEFSSA in 1992 – but by only 1%.

2. The GSEs’ Performance Is Not Graded In Any Meaningful Manner

Currently, HUD does not distinguish the GSEs’ performance under the goals. HUD simply evaluates the GSEs on a pass/fail basis. That is, on the basis of the data provided to HUD by the GSEs, HUD determines whether or not the GSEs have met the goals. The failure by HUD to require easily intelligible grades decreases the transparency of this monitoring mechanism and

⁶⁰ See 24 C.F.R. § 81.14(d)(2000).

⁶¹ 12 U.S.C. 4564(a).

⁶² 12 U.S.C. §4564(a).

⁶³ 12 U.S.C. §4564(d).

⁶⁴ 24 C.F.R. §81.13(c)(1999).

⁶⁵ 24 C.F.R. §81.13(c)(1)(2000).

has two other negative effects. First, as soon as the GSEs have reached their yearly goal, they can merely announce that fact and their obligations terminate. Because there is no nuanced or qualitative component to the Affordable Housing Goals, the GSEs are only motivated to hit their numerical target. In addition, any community group wishing to understand the GSEs' activities must wade through various charts and statistics of years past, rather than rely on a simple grading system.

III. Definitions Of Qualifying Activity

Both the CRA and FHEFSSA define the activities that will qualify as meeting the tests or goals. However, the definitions used by the CRA display a general firmness and discipline that is lacking in the Affordable Housing Goals.

A. The CRA

1. Depository Institutions Cannot Use One Activity To Receive Credit Under Multiple Tests

The CRA specifically prohibits financial institutions from receiving credit under multiple tests for a single activity. The regulations state that “[a]ctivities considered under the lending or service tests may not be considered under the investment test.”⁶⁶ This prohibition contains a minor exception for some types of qualified investments. For example, if a financial institution makes an investment in a community organization that makes community development loans, the financial institution may count this toward the investment test, or the lending test, or some proportional share of both the lending and investment tests. However, the institution cannot get full credit under both tests.⁶⁷

Regulators are committed to extending this prohibition on double counting to secondary market activities conducted by depository institutions. The agencies responsible for interpreting the CRA have proposed that a financial institution be prohibited from receiving credit under the investment test for the purchase of mortgage-backed securities backed by home mortgages it originated or purchased and for which it already received credit under the lending test.⁶⁸ The agencies reason that not creating such a prohibition would allow the financial institution to receive credit under both tests for the same set of activities.⁶⁹

⁶⁶ 12 C.F.R. §§25.23(b), 226.23(b), 345.23(b), 563e.23(b).

⁶⁷ Interagency Questions and Answers Regarding Community Investment, 65 Fed. Reg. 25088, 25108 (2000).

⁶⁸ *Id.*

⁶⁹ *Id.*

2. Depository Institutions Must Use Narrow Definitions Of Low-Income And Moderate-Income

The CRA requires federal regulators to evaluate a financial institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, under three tests: lending, investment, and service. The definition of income levels determines what activities will qualify under the three tests. Under the CRA:

- “Low-income” means income that is less than 50 percent of the area median income.⁷⁰
- “Moderate-income” means income that is at least 50 percent and less than 80 percent of the area median income.⁷¹

B. The Affordable Housing Goals

FHEFSSA requires HUD to monitor the GSEs' record of purchasing mortgages that meet three housing goals: the Low- and Moderate-Income Housing Goal, the Special Affordable Housing Goal, and the Underserved Areas Housing Goal. As with the CRA, statutory definitions determine what activities count towards compliance with these goals.

1. The GSEs Can Use One Activity To Receive Credit For Multiple Goals And Can Manipulate The Amount Of Credit Using Special Counting Requirements

Unlike the CRA, FHEFSSA allows the GSEs to receive credit toward multiple goals. The regulations state that “[a] mortgage purchase (or dwelling unit financed by such purchase) by a GSE in a particular year shall count toward the achievement of each housing goal for which such purchase (or dwelling unit) qualified in that year.”⁷² Since there is no qualitative component to the Affordable Housing Goals, the GSEs only have an incentive to reach a certain numerical target. By counting one activity under multiple goals, the GSEs can more easily reach that target without searching for innovative ways to serve various aspects of the market.

In addition, in the Final Rule, HUD created special counting requirements that allow the GSEs to receive extra credit for a single activity. The GSEs receive “bonus points” for purchasing mortgages on small multifamily properties and units in 2-4 unit owner-occupied properties.⁷³ Purchases of such mortgages will receive double credit toward any of the Affordable Housing Goals, except the Special Affordable Housing subgoal.⁷⁴ The fact that HUD chose to award bonus points for activities related to multifamily properties, rather than enact

⁷⁰ 12 C.F.R. §§ 25.12(n)(1), 228.12(n)(1), 345.12(n)(1), 563e.12(m)(1).

⁷¹ 12 C.F.R. §§ 25.12(n)(2), 228.12(n)(2), 345.12(n)(2), 563e.12(m)(2).

⁷² 24 C.F.R. §81.15(c). However, the GSEs cannot count the purchase of seasoned mortgages that were already counted in a previous year. 24 C.F.R. §81.16(c)(6). Nor can they count toward the Special Affordable Housing Goals any purchase or securitization of mortgages associated with the refinancing of the GSEs' existing mortgage or mortgage-backed securities portfolios. 24 C.F.R. § 81.14(f).

⁷³ 24 C.F.R. §81.16(c)(10).

⁷⁴ *Id.*

subgoals, reflects the underlying carrot-but-no-stick philosophy of the Affordable Housing Goals. In this manner, the GSEs can inflate the amount of their activity related to much-needed multi-unit multifamily properties while avoiding potential embarrassment over missing a yearly target for activity in this area. Not surprisingly, both GSEs have supported the use of bonus points, but opposed subgoals.⁷⁵

Moreover, under the Final Rule, HUD now allows Freddie Mac to receive special consideration for its activities in the multifamily housing market. In the early 1990s, Freddie Mac dismantled its multifamily mortgage purchase program and thus its multifamily mortgage portfolio is less developed than that of Fannie Mae. Recognizing this disadvantage, HUD granted Freddie Mac a “temporary adjustment factor.”⁷⁶ In determining Freddie Mac’s performance on the Low- and Moderate-Income Housing Goal and the Special Affordable Housing Goal, HUD agreed to count each qualifying unit in a property with more than 50 units as 1.2 units for the years 2001 to 2003.⁷⁷ Unsatisfied with this measure, Freddie Mac sought even more enhanced special treatment in an omnibus appropriations bill. Currently, Freddie Mac will receive a credit of 1.35 units for each qualifying multifamily mortgage unit purchased in the years 2001 to 2003.⁷⁸

2. The GSEs Can Use Broader Definitions Of Income Levels To Meet Their Goals

Compliance with the goals for mortgages for low- and moderate-income families, and for affordable housing, is determined with reference to the income of the owner or tenant occupying a particular property.

The Low- and Moderate-Income Housing Goal obviously applies to low- and moderate-income families. The statute and the regulations do not divide this housing goal into a subgoal for low-income families and another subgoal for moderate-income families; nor do they divide the goals into subgoals for multifamily and single family mortgages. In preamble to the Final Rule, HUD stated that it does not believe it is “necessary or appropriate” to establish separate goals for multifamily and single family markets,⁷⁹ despite the fact that HUD recognizes that multifamily housing serves the housing needs of lower-income families to a greater extent than single family housing.⁸⁰

The Special Affordable Housing Goal applies to low-income and very low-income families.⁸¹ FHEFSSA set out subgoals for low-income and very low-income families as well as

⁷⁵ See HUD’s Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65066 (2000).

⁷⁶ 24 C.F.R. § 81.16(c)(11).

⁷⁷ *Id.*

⁷⁸ See Pub.L. 105-554 (Dec. 21, 2000).

⁷⁹ HUD’s Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65062 (2000).

⁸⁰ HUD’s Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65066 (2000).

⁸¹ 42 U.S.C. § 4563. In addition, dwelling units only count under this goal if 20% of the units in the particular multifamily property are affordable to “especially low-income families” or if 40% of the units are affordable to very

subgoals for multifamily and single family mortgages for the years 1993 and 1994. Subsequently, HUD regulations have not established such subgoals, but only a volume subgoal for multi-family housing. In the preamble to the Final Rule, HUD justified its avoidance of such subgoals by citing concerns about micro-managing the GSEs' efforts to achieve the housing goals.⁸²

Although the regulations do not provide subgoals for owner-occupied single family mortgages and multifamily rental housing mortgages, they do provide a means of evaluating whether these types of mortgages count toward the Low- and Moderate-Income and Special Affordable Housing Goals. Specifically, the purchase of these mortgages is evaluated under three categories:

- (1) in the case of owner-occupied dwellings, the mortgagor's income at the time of origination of a mortgage on an owner-occupied dwelling;
- (2) in the case of rental housing, the income of the prospective or actual tenants for a mortgage on a rental dwelling; or
- (3) if the income of the tenants is not available, the rent levels affordable to low- and moderate-income families for a mortgage on a rental dwelling.⁸³

"Affordable" is defined as a rent level that does not exceed 30 percent of the maximum income level of the income categories referred to in the section.⁸⁴

Thus, the definition of income levels is important to the evaluation of whether a purchased mortgage qualifies for the type of housing goals and for the type of property. The following are the definitions of income levels used in the Affordable Housing Goals:

- "Very low-income" is defined as income not in excess of 60 percent of the area median income.⁸⁵
- "Low-income" is defined as income not in excess of 80 percent of the area median income.⁸⁶
- "Moderate-income" is defined as income not in excess of the area median income.⁸⁷

low-income families. 24 C.F.R. § 81.14(d)(1). "Especially low-income" is defined as income not in excess of 50% of the area median income. 24 C.F.R. § 81.17(d).

⁸² HUD's Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65066 (2000).

⁸³ See 12 U.S.C. § 4562(c).

⁸⁴ 12 U.S.C. §§ 4562(c), 4563(c).

⁸⁵ 12 U.S.C. § 4502(19).

⁸⁶ 12 U.S.C. § 4502(8).

⁸⁷ 12 U.S.C. § 4502(10).

3. The Different Definitions Of Income Levels Allow The GSEs To Meet Their Affordable Housing Goals Without Serving The Whole Of The Market

The definitions for the various income levels can be compared to the definitions set by HUD for its assisted housing programs (including the Section 8 program) and to those established by federal regulators for CRA compliance. The CRA definitions are noted above. The HUD definitions can be found in Section 3(b)(2) of the U.S. Housing Act of 1937, as amended.⁸⁸ Following is the description of income levels found in the U.S. Housing Act:

- “Very low-income families” are defined as those families whose incomes do not exceed 50 percent of the area median income.
- “Low-income families” are defined as those families who incomes do not exceed 80 percent of the median income for the area.
- Moderate-income families are not defined in the statute.

A table makes the disparities between the various definitions clear.

**Percent of Area Median Income
Below Which A Borrower Qualifies as a Member of a Targeted Population**

Targeted Population Label	GSE Definition	CRA Definition	HUD Definition for Section 8 Purposes
“Very low-income”	60	N/A	50
“Low-income”	80	50	80
“Moderate-income”	100	80	N/A

These disparities permit the GSEs to avoid the economic costs the CRA lenders must bear, while reaping at least the same if not more economic benefits from the CRA lenders’ targeted lending. CRA lending is expensive: it often requires affirmative outreach to targeted populations, investment in new bricks-and-mortar facilities, innovative programs such as mobile lending centers and, in some cases, subsidizing the actual cost of the loans made to consumers. Moreover, it requires a long-term commitment of personnel, capital, and managerial attention. Because CRA activities are more expensive, institutions expect them to be, and they generally are, less profitable than non-CRA activities. Depository institutions therefore expect that their non-CRA activities will effectively cover their CRA activities in determining return on equity and profit margin. This is understood to be a cost of doing business.

⁸⁸ 42 U.S.C. §1437a(b)(2).

What may be objectionable, however, is that the GSEs are able to use the disparities noted above to avoid taking on analogous costs. Rather than purchasing all loans originated by CRA lenders, or purchasing some percentage of CRA loan production without reference to borrower income, the GSEs are able, without violating the Affordable Housing Goals, to purchase only loans made at higher income levels. For example, a GSE could decide to meet its Low- and Moderate-Income Housing Goals by purchasing loans financing housing for persons with 100% of area median income in preference to loans financing housing for persons with 80% of area median income, on the theory that such loans would be more credit worthy. Depository institutions subject to the CRA, by contrast, must make loans to applicants at or below 80% of the area median income as well as those at or below 50% of the area median income. Because of the different definitions of the same terms, the GSEs are able to say that they are taking actions that benefit “low-income” or “moderate-income” persons without taking the business risks that CRA lenders must take in order to make the same claims. HUD’s Final Rule does nothing to remedy the disparity in definitions.

Statistical as well as anecdotal evidence shows that GSEs do in fact take advantage of the disparities in the definitions. In a press release published earlier this year, Fannie Mae proudly announced that it had achieved its Affordable Housing Goals, but also revealed that of the “low-income” and “moderate-income” units financed, 72% went to those with incomes at or below 80% of their area’s median income, 36 percent went to those with incomes between 60% to 80% of the median, and 36% went to those with incomes at or below 60% of the median.⁸⁹ This implies that 28% of the units financed went to families with incomes between 80% and 100% of the area median, an activity that would not even receive consideration under the CRA. At the same time, Fannie Mae announced record earnings of \$4.448 billion for 2000, up 15.3% from 1999.⁹⁰ Meanwhile, depository institutions are forced to portfolio loans made to meet their CRA obligations, or dispose of them via alternative channels because the GSEs will not purchase these loans.⁹¹ As a result, it is more economically difficult for CRA lenders to undertake the CRA lending that Congress intended to foster, because they have little or no secondary market support for their expensive CRA initiatives.

Other aspects of the GSEs’ loan purchase strategies do nothing to ameliorate this problem and may exacerbate it. A HUD study has pointed out that the GSEs appear to be disproportionately likely to purchase “affordable housing” loans associated with substantial down payments.⁹² This is economically rational for the GSEs, of course, because loans at lower

⁸⁹ Fannie Mae, News Release: Over 49 Percent of Fannie Mae’s 2000 Financing Went to Low- and Moderate-Income Households; Company Exceeded All Goals (Feb. 2, 2001).

⁹⁰ Fannie Mae, News Release: Fannie Mae Reports Record 2000 Earnings of \$4.448 billion, or \$4.29 Per Diluted Common Share; 2000 Earnings Per Diluted Common Share Up 15 Percent Over 1999 (Jan. 11, 2001).

⁹¹ The same is true at other levels of occupant target income: the GSEs do not have incentives to purchase loans at any level of occupant target income below 80% that are as strong as the incentives the CRA lenders have to make such loans.

⁹² HUD, Office of Policy Development and Research, *The GSEs’ Funding of Affordable Loans: A 1996 Update*, (“HUD Study Update”) (July 1998). *See also* HUD’s *Regulation of Fannie Mae and Freddie Mac*, 65 Fed. Reg. 65044, 65051 (2000) (noting that a large percentage of the lower-income loans purchased by the GSEs have relatively high down payments).

loan-to-value ratios are generally more creditworthy loans. But it has the effect of stripping the lenders' CRA loan portfolios of the "best" loans, leaving lenders the loans with the highest associated costs and consequently the lowest associated profits. Moreover, this pattern of GSE loan purchases does little to stimulate home ownership among the truly needy. As the HUD study points out, "[m]ost consider lack of funds for down payments to be one of the main impediments to home ownership, particularly for lower-income families who find it difficult to accumulate enough cash for a down payment."⁹³ By disproportionately purchasing those loans with large down payments, the GSEs do nothing to overcome one of the main impediments to low-income home ownership, and they also burden the CRA programs that actually do seek to overcome this impediment. In the Final Rule, HUD declined to address this problem and postponed the matter for further evaluation.⁹⁴

The persistence of this bias in GSE loan purchasing may result from the routinization of the GSEs' loan purchase decision-making systems.⁹⁵ The GSEs rely heavily on the evaluations made by their proprietary automated underwriting programs in selecting which loans to purchase and which not to. This lends a veneer of objectivity to GSE loan purchase decisions, an impression which cannot be assessed or challenged because the GSEs refuse to disclose the assumptions upon which their automated underwriting systems are based, and because they refuse to establish any basis for empirical comparison by accepting the decisions of other automated underwriting programs. These routinized loan purchase decision-making systems would therefore appear to be a significant contributing factor to the GSEs' lack of support for lender CRA initiatives.

4. The Broad Definitions Of Geographic Areas Allow The GSEs To Avoid Activity In Truly Underserved Areas

HUD evaluates the GSEs' compliance with the goal of purchasing mortgages in underserved areas on the basis of the geographic location of the properties subject to purchased mortgages.⁹⁶ Currently, this goal applies to central cities, rural areas and underserved areas. These definitions are complex and HUD defines them as follows:

- "Central city" includes the underserved areas located in any political subdivision designated as a central city by the Office of Management and Budget ("OMB").⁹⁷

- "Underserved area" includes:

(1) For purposes of the definitions of "central city" and "other underserved area," a census tract having:

⁹³ HUD Study Update (July 1998).

⁹⁴ HUD's Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65081 (2000).

⁹⁵ *See id.*

⁹⁶ 12 U.S.C. § 4564(c).

⁹⁷ 24 C.F.R. § 81.2(b).

A median income at or below 120% of the median income of the metropolitan area and a minority population of 30% or greater; or

A median income at or below 90% of median income of the metropolitan area.

(2) For purposes of the definition of “rural area,” a county having:

A median income at or below 120% of the greater of the state or nationwide median income of the non-metropolitan area and a minority population of 30% or greater; or

A median income at or below 95% of the greater of the state or nationwide non-metropolitan median income.⁹⁸

As with the definitions of income levels, the definition of underserved area is broad enough to allow the GSEs a flexibility that financial institutions with CRA obligations do not enjoy. CRA lenders can meet their obligations only by lending to families at or below 80 percent of the area median income, and may not concentrate their lending or other CRA activities geographically. The GSEs, by comparison, can meet their Underserved Area Housing Goals for the entire United States by purchasing mortgages in as many or as few 30 percent minority census tracts with income levels up to 120 percent of the area median income as they choose. While insured depository institutions must lend in inner cities, the GSEs are under no effective obligation to purchase such loans. They may well find it in their interest to satisfy their obligations by purchasing loans made in above-average-income suburbs with relatively large minority populations, such as prosperous areas of Prince George’s County, Maryland, rather than those made in more economically disadvantaged areas of the same metropolitan area, such as southeast Washington, D.C.

Although HUD recognized the inconsistency between CRA requirements and the existing definition of an “underserved area” applicable to the GSEs, it declined in the Final Rule to conform the two definitions until results of the 2000 Census are available.⁹⁹ HUD accepted the GSEs’ argument that there have been many demographic changes since the 1990 Census affecting which census tracts would qualify as underserved, although it reserved the right to revisit the issue once the updated census figures are released. Thus, for the time being, the GSEs can still take advantage of a much more liberal definition of an “underserved area” than is available to the depository institutions.

⁹⁸ 24 C.F.R. § 81.2(b). A separate definition applicable only to New England permits the division of counties into rural and non-rural areas.

⁹⁹ See HUD’s Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65145 (2000).

IV. Performance Context

The CRA establishes a performance context within which to identify the needs of the assessment area. Under the CRA, regulators analyze the information an institution maintains on the credit needs of its community, along with relevant information received from other sources such as local governments, community groups and civic groups. HUD has no such process in place to assess the adequacy of the GSEs' performance under the Affordable Housing Goals. Moreover, because the GSEs are not subject to the reporting requirements of the Home Mortgage Disclosure Act ("HMDA"),¹⁰⁰ it is more difficult to ascertain whether the GSEs are leading, matching or lagging the affordable housing market as compared with the depository institutions.

A. Depository Institutions Are Evaluated In The Context Of The Public's Assessment Of Their Efforts To Serve The Whole of the Community

The CRA performance context informs the regulator of the credit and other banking needs of the area. The regulator can analyze the information an institution maintains on the credit needs of its community along with relevant information available from other sources, such as local government, community groups, and civic groups.¹⁰¹ Specifically, the regulator will evaluate the performance of the financial institution in the context of at least six factors:

- (1) Demographic data on median income levels, distribution of household income, nature of housing stock, housing costs, and other relevant data;
- (2) Any information about lending, investment and service opportunities in the assessment area maintained by the financial institution or obtained from community organizations, state, local, and tribal governments, economic development agencies, or other sources;
- (3) The financial institution's product offerings and business strategy;
- (4) Institutional capacity and constraints, including the size and financial condition of the financial institution, the economic climate of the area, the safety and soundness limitation, and any other significantly limiting factors;
- (5) The financial institution's past performance and the performance of similarly situated financial institutions; and
- (6) The financial institution's public files and any written comments about the financial institution's performance.¹⁰²

¹⁰⁰ 12 U.S.C. § 2801 *et seq.*

¹⁰¹ Interagency Questions and Answers Regarding Community Reinvestment, 65 Fed. Reg. 25088, 25099 (2000).

¹⁰² 12 C.F.R. §§ 25.21(b), 228.21(b), 345.21(b), 563e.21(b).

Through the performance context, the regulators can gather information from local community, civic and government leaders regarding the economic and demographic details specific to that community.¹⁰³ This process provides a context against which the statistics and initiatives of the depository institution can be measured.

In addition to this regulatory performance context, CRA lenders must be prepared for evaluation of their lending and mortgage purchase decisions by interested parties using data generated under HMDA. All depository institutions must report to their federal regulator and publicly disclose a great deal of data concerning each mortgage loan that they make or purchase.¹⁰⁴ While this information is unwieldy, it can still be used to construct a profile of an institution's lending and mortgage purchase patterns that can in effect serve as a check on the accuracy of the CRA performance context. Indeed, HMDA data has anchored almost every study of home mortgage lending patterns, and community groups have used HMDA data extensively to review the lending and mortgage purchase decisions of depository institutions and nondepository lenders.

B. The GSEs Face Only Minimal Public Scrutiny Of Their Efforts To Serve The Whole Of The Community

Currently, HUD has no systematic process in place to assess the adequacy of the GSEs' performance under the Affordable Housing Goals in the context of the credit needs of different areas of the country. Although FHEFSSA encourages HUD to consider need when it sets the housing goals for the GSEs, the current structure precludes any effective evaluation of or response to local needs. Without a performance context, a publicly available HMDA-like database, or specific subgoals, the GSEs only face minimal scrutiny of their efforts to serve the whole of the community.

HUD has no process for seeking input from community, civic and government leaders to determine whether the GSEs have adequately performed in their community and to assess whether HUD has set appropriate levels for the Affordable Housing Goals. Unlike the federal banking regulators, HUD does not interview or solicit official public comment from community groups in order to place the GSEs' performance in the context of local needs. Moreover, in the preamble to the Final Rule, HUD has indicated that community groups, not HUD, bear the responsibility for informing their communities about the GSEs' activities. HUD states that it "encourages the residents of local communities and regions of the country to increase their knowledge of the roles the GSEs play in their areas," but offers little toward achieving that end, except to make a database of raw data available to the public.¹⁰⁵ Without a specific process for submitting comments regarding local GSE activity, it is burdensome for community groups to provide information to HUD and, likewise, it would seem difficult for HUD to evaluate the GSEs' performance in the context of community need.

¹⁰³ Interagency Questions and Answers Regarding Community Reinvestment, 65 Fed. Reg. 25088, 25099 (2000).

¹⁰⁴ 12 U.S.C. § 2803(a)(1).

¹⁰⁵ HUD's Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65082 (2000).

Although community groups have become very familiar with HMDA data, the GSEs are not currently subject to HMDA reporting requirements. Without such data, it is problematic for community groups to independently evaluate GSE activity and to compare it with the performance of depository institutions. Although the statute specifically applies to all institutions “engaged for profit in the business of mortgage lending,”¹⁰⁶ and requires the disclosure of information related to the mortgage loans that were purchased by that institution,¹⁰⁷ the Federal Reserve has promulgated regulations that apply HMDA requirements only to for-profit mortgage-lending institutions (excluding depository institutions) whose home-purchase loan originations equaled or exceeded 10 percent of its loan-origination volume in the preceding calendar year.¹⁰⁸ Depository institutions are covered if they originated at least one home purchase loan in the previous year.¹⁰⁹ This test excludes any institution whose involvement in the mortgage financing business is immense, but which does not technically “originate” any home-purchase loans. Because the GSEs are permitted to purchase, but not originate, home purchase mortgage loans, they have not had to make HMDA reports of their mortgage loan purchases, nor have they been scrutinized by community groups seeking to independently investigate the level of GSE activity in their area. HUD has considered making the GSEs’ reporting requirements more analogous to HMDA, but declined to take any action on this matter in the Final Rule.¹¹⁰

HUD has worked to increase the amount of information about the GSEs that is available to the public, but the format of the information is difficult to comprehend. HUD makes available the raw data related to the GSE Affordable Housing Goals as well as its working papers documenting various analyses of the data.¹¹¹ In addition, the Annual Housing Activity Reports that the GSEs submit to HUD are available upon request.¹¹² While this information is useful, it still places the burden on community groups to review voluminous databases or rely on the GSEs’ own assessment of their performance in order to evaluate the activity of the GSEs. By contrast, any interested party can access the standard, consolidated CRA report of any depository institution over the Internet. In this way, community groups can easily compare the CRA record of a depository institution over time or compare it with the records of other depository institutions. Without an easily accessible and comprehensible standard report from HUD, community groups find it difficult to review the GSEs’ performance under the Affordable Housing Goals.

¹⁰⁶ 12 U.S.C. § 2802(4).

¹⁰⁷ *Id.* § 2803(a)(1).

¹⁰⁸ Regulation C, 12 C.F.R. § 203.2(e)(2). At this time, the Federal Reserve has proposed extending coverage to for-profit mortgage lending institutions whose prior-year home purchase loan originations, including refinancings, equaled or exceeded \$50 million. However, this test would still limit coverage to institutions that originate a large volume of home purchase loans.

¹⁰⁹ Regulation C, 12 C.F.R. § 203.2(3)(1).

¹¹⁰ HUD’s Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65082 (2000).

¹¹¹ See <<http://www.huduser.org/datasets/gse.html>>.

¹¹² The GSEs are required to submit an Annual Housing Activity Report to HUD that details, among other things, whether the GSEs’ underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures promote affordable housing and fair lending. 24 C.F.R. § 81.63.

In the Final Rule, HUD did not use its ability to establish Affordable Housing subgoals to increase the transparency of GSE activity. HUD is empowered to establish subgoals in connection with the Low and Moderate-Income Housing Goals and the Underserved Areas Housing Goals, even though it may not use the failure to achieve those subgoals as a basis for enforcement action. For these two goals, HUD did not choose to establish subgoals even for purposes of its own analysis of GSE performance. Instead, HUD has decided to reward the GSEs with bonus points for any activity related to small multifamily properties. As a result, it becomes very difficult for interested parties to determine whether the GSEs have accomplished an appropriate level of activity in a subcategory that is related to the overall housing goal.

In connection with the Special Affordable Housing Goal, FHEFSSA empowers HUD to set enforceable subgoals. HUD has taken advantage of this authority only in connection with requiring a small absolute volume of multifamily mortgage purchases. As noted above, FHEFSSA provided subgoals based on the income and type of property related to the mortgages purchased. However, these subgoals have not been incorporated in subsequent regulations, including the Final Rule. HUD's failure to set subgoals based on income and type of property means that the GSEs are free to purchase mortgages based on lack of business risk to the GSEs, rather than on local need for multifamily, low-income or very low-income housing. In addition, without quantifiable subgoals, it is difficult for community groups to assess the level of the GSEs' performance in these areas.

V. Enforcement

Both the CRA and the Affordable Housing Goals have enforcement mechanisms, but the effectiveness of the two mechanisms at actually achieving the statutory purposes for which they have been crafted differs widely. The effectiveness of the CRA at enforcing compliance by insured depository institutions, compared with the general ineffectiveness of the Affordable Housing Goals at enforcing compliance by the GSEs, would appear to be the largest single difference between the two systems.

A. Depository Institutions Can Incur Substantial Reputational And Business Costs For Failing To Comply With The CRA

CRA is not self-enforcing, but it is nevertheless an effective statute because the approval of so many important applications hinges upon an institution's success in meeting its CRA obligations. CRA itself requires that "[i]n connection with its examination of a financial institution, the appropriate Federal financial supervisory agency shall ... (1) assess the institution's record of meeting the credit needs of its entire community [and] (2) take such record into account in its evaluation of an application for a deposit facility by such institution."¹¹³ This puts two forms of pressure on institutions to comply with the CRA: the ordinary pressure that derives from the examination process, and the extraordinary pressure that an institution interested in obtaining approval for expanded activities, such as opening a new deposit-taking branch, will feel to meet its CRA obligations in order to obtain unconditional approval of such an application.

¹¹³ 12 U.S.C. § 2903(a).

Applying pressure on institutions by conditioning the approval of various applications upon compliance with CRA obligations has developed into the primary method of enforcing CRA. In addition to applications to open a deposit-taking branch, applications for approval of an interstate merger are subject to a statutory requirement that the appropriate federal regulator “take into account the most recent written evaluation under Section 804 of the Community Reinvestment Act of 1977 of any bank which would be an affiliate of the resulting bank[.]”¹¹⁴ Beyond these statutory requirements, federal regulators have established CRA compliance as a factor in the consideration of many regulatory applications. The FDIC, for example, “takes into account the record of performance under the CRA of each applicant bank in considering an application for approval of ... [t]he relocation of the bank’s main office or a branch; [t]he merger, consolidation, acquisition of assets, or assumption of liabilities; and [d]eposit insurance for a newly chartered financial institution.”¹¹⁵ Thus, in addition to the normal pressure that is applied through the bank examination process, making CRA performance a part of the application process that is crucial to banks that do not have an entirely static business strategy creates substantial pressure on banks to fulfill the letter and the spirit of their CRA obligations.

¹¹⁴ 12 U.S.C. § 1831u(b)(3)(B).

¹¹⁵ 12 C.F.R. § 345.29(a) The other federal regulatory agencies have established slightly different lists of applications that require consideration of CRA compliance:

- OCC regulations require consideration of CRA performance in applications for: (1) the establishment of a domestic branch; (2) the relocation of the main office or a branch; (3) under the Banker Merger Act (12 U.S.C. § 1828(c)), the merger or consolidation with or acquisition of assets or assumption of liabilities of an insured depository institution; and (4) the conversion of an insured depository institution to a national bank charter. 12 C.F.R. § 25.29(a).
- Federal Reserve Board regulations require consideration of CRA performance of: (1) each applicant bank for: (i) establishment of a domestic branch by a State member bank; and (ii) merger, consolidation, acquisition of assets, or assumption of liabilities requiring approval under the Bank Merger Act (12 U.S.C. § 1828(c)) if the acquiring, assuming, or resulting bank is to be a State member bank; and (2) each insured depository institution (as defined in 12 U.S.C. § 1813) controlled by an applicant and [each] subsidiary bank or savings association proposed to be controlled by an applicant: (i) to become a bank holding company in a transaction that requires approval under section 3 of the Bank Holding Company Act (12 U.S.C. § 1842); (ii) to acquire ownership or control of shares or all or substantially all of the assets of a bank, to cause a bank to become a subsidiary of a bank holding company, or to merge or consolidate a bank holding company with any other bank holding company in a transaction that requires approval under section 3 of the Bank Holding Company Act (12 U.S.C. § 1842); and (iii) to own, control or operate a savings association in a transaction that requires approval under section 4 of the Bank Holding Company Act (12 U.S.C. § 1843). 12 C.F.R. § 228.29(a).
- OTS regulations require consideration of CRA performance in applications for: (1) the establishment of a domestic branch or other facility that would be authorized to take deposits; (2) the relocation of the main office or a branch; (3) the merger or consolidation with or the acquisition of the assets or assumption of the liabilities of an insured depository institution requiring OTS approval under the Bank Merger Act (12 U.S.C. § 1828(c)); (4) a Federal thrift charter; and (5) acquisitions subject to section 10(e) of the Home Owners' Loan Act (12 U.S.C. § 1467a(e)). 12 C.F.R. § 563e.29(a).

Moreover, the publicity associated with CRA examinations interacts with public application procedures to empower community groups to put pressure on depository institutions to increase the flow of credit and capital to their communities. CRA reports are publicly available on the Internet and community groups can easily research the record of a financial institution in meeting the credit needs of the community. When a regulator is considering a financial institution's application for merging or service expansion, neighborhood organizations and citizens can offer comments for the official public record stating their opinions as to whether the regulator should approve the institution's application. Although the Act does not authorize a private right of action, the community groups can protest the application, trying to persuade a regulator to delay, deny, or condition approval of the application by documenting the institution's lack of lending, investments, or services in low- and moderate-income areas. To avoid the possibility of delay or denial, the financial institution will often enter into agreements with community groups to demonstrate to the regulator that it is willing to work with its community and that it is committed to the letter and spirit of CRA. Thus, the explicit statutory and regulatory incentives to comply with CRA are strengthened by the pressure of public scrutiny exerted by the community groups. Although the financial institutions do not have to meet specific goals for lending, investment, or service to the community, their desire to protect their reputation often motivates them to improve their performance under these tests.

B. The GSEs Do Not Face Any Significant Reputational Or Business Risks For Failing To Meet Their Affordable Housing Goals

HUD has limited power directly to enforce compliance with the Affordable Housing Goals it sets in accordance with FHEFSSA. It can provide formal notice to a GSE that the GSE has failed or is substantially likely to fail to meet a housing goal, in which case the GSE has a set period of time in which to respond before HUD makes a final determination concerning the GSEs' failure and communicates that determination to Congress.¹¹⁶ If HUD finds that the GSE has in fact failed, it must require the GSE to submit a housing plan for approval, specifying feasible steps that the GSE will take to achieve the housing goal in the subsequent year.¹¹⁷ If HUD disapproves the plan, the GSE must submit a new one.¹¹⁸ If the GSE fails to submit a housing plan substantially in compliance with HUD's requirements, HUD is authorized to impose civil money penalties of up to \$25,000 per day on the GSE until it does comply.¹¹⁹ If a GSE fails to make a good faith effort to comply with a housing plan prepared according to this procedure, HUD is authorized to impose civil money penalties of up to \$10,000 per day upon the GSE until HUD deems it to be in compliance.¹²⁰ This ability to impose civil money penalties is the only enforcement mechanism explicitly mandated by FHEFSSA.

¹¹⁶ 12 U.S.C. § 4566(b).

¹¹⁷ *Id.* § 4566(c)(1)-(5).

¹¹⁸ *Id.* § 4566(c)(6).

¹¹⁹ *Id.* § 4585(b)(1).

¹²⁰ *Id.* § 4585(b)(2).

FHEFSSA does not provide directly for the sort of regulatory pressure and public scrutiny that have functioned as effective enforcement mechanisms for CRA. The GSEs have little need to go to HUD for regulatory approvals or other actions analogous to approving an application. Virtually the only power HUD has to approve or deny in connection with the GSEs has to do with new programs. Even there, HUD has not chosen to make compliance with the GSE housing goals a factor in making decisions on GSE applications for approval of new programs.¹²¹

In addition, because of the lack of consolidated, comprehensible information regarding the GSE Affordable Housing Goals, interested private persons and organizations cannot generally scrutinize the activities of the GSEs. HUD has no system for discussing GSE performance with community groups, nor is there any process for soliciting public comments. The raw data and working papers that are available from HUD, while helpful, are dense and do not provide a comparative analysis of GSE performance. As a result of this lack of information, the GSEs are largely safe from challenges to their public reputations. In sum, enforcement of the GSE Affordable Housing Goals effectively lacks the regulatory scrutiny and public pressure that are the hallmarks of CRA enforcement.

¹²¹ See 24 C.F.R. § 81.51 *et seq.*

PROPOSED REFORMS

The foregoing comparison has identified differences in the two systems and explains the reasons for the relative ineffectiveness of the GSEs' Affordable Housing Goals. Certain specific differences make the CRA more effective at motivating insured depository institutions to comply with federal regulators' guidelines than are the Affordable Housing Goals at motivating the GSEs. The CRA is effective because it targets populations that are defined more narrowly than those of the Affordable Housing Goals, focuses the attention of the public as well as regulators on the activities of depository institutions, and imposes direct negative consequences upon those depository institutions for failing to meet their CRA responsibilities. FHEFSSA would be made more effective if the Affordable Housing Goals' target populations were defined more narrowly, public attention were focused on the activities of the GSEs, and it were made clear to the GSEs and to third parties that not meeting the goals would have a direct negative effect upon the GSEs' business. Specific changes along these lines, could make FHEFSSA comparable to the CRA in its effectiveness. The following list identifies the proposed reforms, grouped into five categories:

- Reforms that HUD could implement immediately, within the current regulatory framework
- Reforms that HUD could implement by changing its regulations
- Reforms that the Federal Reserve could implement by changing its regulations
- Reforms that could be implemented by a change in Treasury regulations
- Systemic reform related to the GSEs' charters or to the market

The goal of the listed reforms is to narrow the gap between the CRA obligations of insured depository institutions and the Affordable Housing Goals of the GSEs. CRA obligations are generally acknowledged to be effective at motivating those institutions to undertake socially meaningful economic action in underserved areas, while the effectiveness of the Affordable Housing Goals is doubtful at best.

Five Reforms HUD Could Implement Immediately, Within the Current Regulatory Framework

These reform options would require the shortest period of time to implement, not needing to be submitted for Congressional, OMB or public notice and comment. Although it would be possible to challenge these reforms as being beyond the power of HUD to implement without notice and comment pursuant to the Administrative Procedures Act, all of them appear to be consistent with current regulations, and, therefore, such challenges seem unlikely to be successful. As a result, these reforms would appear to involve relatively little short-term uncertainty. In the longer term, they will always be subject to political pressure or contingencies such as budget problems or staffing shortfalls; HUD could change its mind at some point in the future and shelve the reforms just as easily. Making these reforms immune to such changes could require new regulations or legislative action, which might generate more support as after-the-fact consolidations of changes first introduced by the agency than they would have generated as brand-new regulatory initiatives without proven track records. Consolidating regulatory or

legislative changes should therefore be considered as possible follow-ups to these administrative reforms.

1. Institute Periodic HUD Reports To Congress On GSE Compliance With Its Affordable Housing Goals

FHEFSSA contemplates that HUD will receive and evaluate interim information in order to determine whether “there is a substantial probability that an enterprise will fail...to meet [a] housing goal[.]”¹²² HUD has already determined that FHEFSSA empowers it to receive specified information regularly from the GSEs concerning their compliance with the Affordable Housing Goals.¹²³ FHEFSSA requires HUD to notify Congress of “each determination that an enterprise has failed, or that there is a substantial probability that the enterprise will fail, to meet a housing goal [together with] the reasons for each such determination.”¹²⁴ Taken together, these provisions strongly suggest that HUD is empowered to notify Congress of interim progress by the GSEs in attaining their Affordable Housing Goals, perhaps at regular intervals such as quarterly or semi-annually. While HUD already includes information concerning GSE performance with reference to the housing goals in communications to Congress, it would appear that HUD has the authority to communicate such information in a more focused fashion through GSE-specific reports. It does not appear that HUD would need to make any changes in its regulations in order to initiate such a policy.

This policy change could have the effect of creating regular press scrutiny and Congressional notice of the compliance issue and of HUD’s conclusions. While this policy change alone would probably be insufficient to accomplish significant reform, it could be valuable in conjunction with the other reforms identified below.

2. Institute A System Of Descriptive Grades Characterizing GSE Compliance

HUD currently evaluates the GSEs’ performance with respect to housing goals on a pass/fail basis. By contrast, the CRA requires regulators to grade the performance of the depository institutions on a scale with four categories of descending compliance: “outstanding,” “satisfactory,” “needs to improve,” or “substantial noncompliance.”¹²⁵ As FHEFSSA contains no statutory prohibition on HUD providing characterizations of GSE compliance with the Affordable Housing Goals, there would be no need for HUD to promulgate new regulations in order to begin using categories modeled on these CRA categories to evaluate GSE performance. HUD has considered implementing a system for evaluating GSE performance under which compliance with the Affordable Housing Goals without additional efforts would not earn a GSE the highest possible commendation from HUD. The proposed evaluation system described here would not be significantly different from HUD’s contemplated system, except that it would use the immediately recognizable CRA categories.

¹²² 12 U.S.C. § 4566(b)(1).

¹²³ See 24 C.F.R. § 81.61 *et seq.*

¹²⁴ 12 U.S.C. § 4566(b)(3)(C).

¹²⁵ 12 U.S.C. § 2906(b)(2); 12 C.F.R. Appendix A to Parts 25, 228, 345, 563e.

Implementing such an evaluation system could have several effects. First, because it would permit a more nuanced comparison between the activities of Fannie and Freddie, the use of such a grading scale could increase competition between the two GSEs. Each would strive to obtain and hold a higher grade than the other, or at least avoid receiving a lower grade. Second, use of a scale well known to community groups familiar with CRA grading could make GSE performance more immediately understandable to such groups. This, in turn, by increasing public scrutiny, could increase public pressure on the GSEs to comply with the Affordable Housing Goals. Finally, if the grades had a qualitative component, then the GSEs would be motivated to seek more innovative methods of providing liquidity to the whole of the market, rather than being satisfied with reaching mere numerical targets.

3. Create And Publicize Standard Reports Of HUD's Analysis And Verification Of The GSEs' Compliance With The Affordable Housing Goals

HUD is already required by law to “make available to the public, in forms useful to the public (including forms accessible by computers)” the raw data submitted by the GSEs, concerning which mortgage loans they purchase fall into which housing goals categories.¹²⁶ Publication of information obtained under FHEFSSA is subject only to the rule that “certain information shall be treated as proprietary information and not subject to disclosure,” pursuant to HUD regulations defining what information is proprietary to the GSEs.¹²⁷ Currently, HUD makes the raw data, HUD working papers and the GSE Annual Housing Activity Reports available to the public. However, HUD does not issue a standard, consolidated report that is comparable to the CRA reports regarding the performance of depository institutions. Such reports provide a standard overview of an institution’s CRA performance that makes it possible for interested parties to compare an institution’s historical performance and compare its performance with that of other institutions. If HUD were to use a similar standardized format, then interested parties could easily compare the performance of Fannie Mae versus Freddie Mac (and vice versa) as well as evaluate the performance of both GSEs over time. This policy change would improve public understanding of the GSEs’ compliance with the housing goals. There does not appear to be any need for HUD to make changes in its regulations in order to accomplish this policy change.

4. Provide For Interagency Cooperation On Verification Of GSE Data

HUD currently has primary responsibility for establishing and enforcing the GSE housing goals, despite the fact that FHEFSSA, which created those goals, also created a new agency, the Office of Federal Housing Enterprise Oversight (“OFHEO”), specifically to ensure that the GSEs operate in a safe and sound manner.¹²⁸ HUD’s regulations provide that it may “independently verify the accuracy and completeness of the data, information, and reports provided by each

¹²⁶ 12 U.S.C. 4543(a); *see also* 24 C.F.R. Part 81 Subpart F. In the preamble to the 1995 regulations, HUD notes the importance of this data by saying that “Congress indicated its intent that the GSE public-use database supplement HMDA.” 60 Fed. Reg. 61845, 61875 (1995).

¹²⁷ 12 U.S.C. § 4546(a).

¹²⁸ 12 U.S.C. § 4541.

GSE, including conducting on-site verification.”¹²⁹ HUD should use this authority to conduct on-site verifications, potentially in conjunction with OFHEO’s regular examination of the GSEs. HUD housing goals examiners could, for example, make arrangements with OFHEO examiners to conduct a parallel examination, pursuant to HUD’s authority to obtain information concerning the GSEs generally.¹³⁰ Alternatively, HUD could delegate to OFHEO the task of training and conducting verifications of compliance with housing goals, or make arrangements with the Fed, FDIC, OCC or OTS to detail some of those agencies’ CRA examiners to HUD to conduct verifications, looking into GSE activities under HUD’s authority. The federal bank examiners have extensive experience scrutinizing financial institution affordable housing programs, and their input and views on the GSEs’ progress in meeting their goals could provide useful additional information.

5. Require Jurisdictions Applying For HUD Grants To Include In Their Consolidated Plans A Section On GSE Performance Under The Affordable Housing Goals In The Context Of Local Housing Needs

As discussed above, the CRA performance context provides regulators with a mechanism for evaluating the performance of a financial institution in light of the needs of the local community, as determined by the financial institution, local government and community groups. HUD has mechanisms that could be adapted to permit the evaluation of GSE performance in the context of community need.

For example, the Community Development Block Grants (“CDBG”) program, which HUD administers, could be adapted to give local community, civic and government leaders the opportunity to comment on GSE activity in their area. To receive annual CDBG funds and other grants, eligible communities and states must have an approved Consolidated Plan detailing, among other things, community housing needs and the non-governmental resources already available to meet those needs.¹³¹ HUD regulations require that jurisdictions preparing Consolidated Plans provide for and encourage citizens to participate in the development of the consolidated plan, any substantial amendments to the Consolidated Plan, and the Performance Report. These requirements are designed especially to encourage participation by low- and moderate-income persons and residents of low- and moderate-income neighborhoods. Before a jurisdiction adopts a Consolidated Plan, the jurisdiction must make available information concerning the plan to citizens, public agencies, and other interested parties.

The Consolidated Plan must describe the estimated housing needs projected for the ensuing five-year period. Housing data included in this portion of the plan are based on U.S. Census data, as provided by HUD, as updated by any properly conducted local studies or any other reliable sources that the jurisdiction identifies and should include information obtained through the citizen participation process.

¹²⁹ 24 C.F.R. §81.102.

¹³⁰ See 42 U.S.C. §§ 1723a (Fannie), 1456 (Freddie), or specifically under FHEFSSA, 12 U.S.C. § 4567.

¹³¹ See 24 C.F.R. Part 91.

Consistent with this regulatory authority, in accumulating housing data, a jurisdiction could be required to seek input from financial institutions lending within the jurisdiction's low- and moderate-income neighborhoods and to low- and moderate-income persons living in the jurisdiction. Specifically, it could be required to seek from such institutions information on projected GSE activity in the jurisdiction and the impact of such projected activity on lending to low- and moderate- income persons and in low- and moderate-income areas.

Support for this proposition can be found in two areas of the preamble to the 1995 regulations. First, Freddie Mac has expressed concern that HUD had failed to establish a link between identified housing needs and the housing goals.¹³² This idea addresses that concern, and like the CRA Performance Context, provides the HUD regulator with a means of evaluating GSE performance based on the context of local need. Second, HUD had specifically mentioned CDBG programs as a model for conducting a neighborhood-based approach to reinvestment efforts.¹³³ While the preamble to the 1995 regulations indicated that the GSEs were free to coordinate with localities, HUD may want to go further by actually facilitating this coordination through use of the Consolidated Plan structure that is already in place.

The collection of this information on an ongoing basis would have the effect of providing HUD with additional information to assist in establishing appropriate goals and to more fairly assess performance of the GSEs nationwide. This process has the added advantage of increasing public information concerning the relationship between lending in low- and moderate-income areas and the activities of the GSEs.

Six Reforms HUD Could Implement by Changing Its Regulations

These reforms would require some time to implement because they would need to be submitted to Congress and OMB for approval, followed by a period of public notice and comment. Such a process, with its inherent time lag, would permit changes to creep into the proposed reforms unless the process was closely monitored and the prime movers sufficiently motivated. On the positive side, however, once these reforms were written into regulation it would be more difficult to sweep them aside.

6. Require The GSEs To Publish Their Loan Purchase Decision-Making System Assumptions, Methodologies And Outcomes

The GSEs have come to rely heavily on their automated underwriting programs in making decisions about which mortgage loans to purchase. These systems are black boxes, which make it difficult to discern whether an applicant's loan will be purchased by the GSE, and if not, why not. This leads to at least two problems in affordable housing lending. First, as with the mismatch of GSE standards to CRA standards, it gives the GSEs a way to "cherry pick" the least risky loans. This adverse selection leaves the more risky loans in the portfolios of other affordable housing lenders, primarily depository institutions that are left without a robust secondary market for many loans. Second, lenders, community groups and government agencies

¹³² 60 Fed. Reg. 61845, 61850 (1995).

¹³³ *Id.* at 61856.

have no way to understand the decision-making process. The secrecy of the automated underwriting process reduces the ability of lenders or non-profit groups to counsel applicants as to what actions they can take to become eligible for the lower mortgage rates associated with loans purchased by the GSEs. Buying a home is a mysterious process for most consumers. These black boxes add yet another level of unnecessary secrecy to an already complex process. Consumers considering a loan should know why they are not eligible for the lower rates available from GSE-purchased financing and what they can do to become eligible. That is, just because an applicant is rejected by the automated underwriting system does not mean that the applicant is not creditworthy.

Requiring the GSEs to open up their automated underwriting systems could help to demystify this process. Doing so could reduce the perception that the GSEs are burdening depository institutions by buying the least risky affordable housing loan products. It could thereby create a broader based secondary market for affordable housing loans and assist in counseling applicants into better loan products.

7. Establish A Certification Program For Automated Underwriting Systems And Require The GSEs To Accept The Results Of Any Certified System

The duopoly of the GSEs, combined with their funding advantages, makes their automated underwriting systems the final word on mortgage loan underwriting. Applicants will either fit into the one of the GSEs models or will get a higher priced loan, and advances in loan underwriting will depend on the advances being implemented by one of the two GSEs. Many of the most innovative affordable housing loan programs have been initiated by other financial institutions and only later accepted by the GSEs for purchase. Depending on the GSEs for advances in affordable housing loan underwriting significantly slows progress. Another financial institution's automated underwriting system, even if it was equally predictive of credit risk as the GSEs' systems and could broaden the base of successful applicants by including different or non-traditional data or by better interpreting traditional data, may not be accepted by the GSEs.

According to HUD, the GSEs' monopoly on automated underwriting systems may be a significant factor in the comparatively high mortgage loan denial rates for racial minorities. In the Final Rule, HUD concluded that the GSEs' automated underwriting systems have a disparate impact on minorities based on two studies.¹³⁴ First, a study conducted by the Board of Governors of the Federal Reserve System found a significant statistical relationship between credit history scores and the minority composition of an area. Second, a study by the Urban Institute found that minorities were more likely than whites to fail the GSEs' single-family underwriting guidelines. From these observations, HUD concluded that "the question whether mortgage credit scoring models raise any problems of legal discrimination based on disparate effects would hinge on a business necessity analysis and analysis of whether any alternate underwriting procedures with less adverse disproportionate effect exist."¹³⁵ Given this analysis, it seems imperative that the use of alternative automated underwriting systems be explored.

¹³⁴ HUD's Regulation of Fannie Mae and Freddie Mac, 12 C.F.R. Part 81, Appendix A (2000).

¹³⁵ Id.

The base of approved applicants could be broader if there were a process for certifying competing automated underwriting systems as being of substantially equal predictive power and establishing requirements for the GSEs to accept the results of such certified alternative automated underwriting systems. Automated mortgage underwriting is still in its infancy, and a certification process would allow the area to continue developing rather than being quickly winnowed to a two-party market. Even in the riskiest pools of loans, the vast majority of borrowers are expected to pay in full, and the remaining question is whether and how lenders can identify the apparently risky borrowers that are in fact excellent credits. This change would have the effect of creating robust competition for developing better predictors, and broadening the group of borrowers that can obtain favorable loan rates.

8. Conform GSE Reporting Requirements And Definitions Concerning Qualifying Activity To CRA Definitions

FHEFSSA requires HUD to set Affordable Housing Goals with relation to “low-income” or “low- and moderate-income” families.¹³⁶ The federal agencies administering the CRA have defined “low-income” to mean “less than 50 percent of area median income.”¹³⁷ They have imposed CRA lending requirements upon insured depository institutions on that basis. Pursuant to statutory requirements, however, HUD defines “low-income” for purposes of the GSE housing goals to mean “income not in excess of 80 percent of area median income,”¹³⁸ and has set those goals accordingly. As a result, there is a distinct mismatch between the loans that must be made by depository institutions and those that should be purchased by the GSEs. The GSEs have a statutory duty to “take affirmative steps to...assist insured depository institutions to meet their obligations under the Community Reinvestment Act of 1977[.]”¹³⁹ In order to resolve the apparent tension between these two statutory requirements, HUD could change its GSE housing goals regulations by requiring the GSEs to *report* “low-income” loans in two categories, “low-income” and “very low-income,” with the latter conforming to the CRA definition of a “low-income” loan. Although merely reporting such purchases would not be the same as actually having an obligation to make such purchases in specified quantities, it would allow HUD to monitor the GSEs’ efforts to assist depository institutions in meeting their CRA obligations.

FHEFSSA also requires HUD to set Affordable Housing Goals with reference to central cities, rural areas and other underserved areas, without defining those areas.¹⁴⁰ As noted above, the regulatory definitions HUD created for these areas has permitted the GSEs to purchase loans made in suburban areas with specific demographic characteristics (less than 120% of area median income, greater than 30% minority populations) and count those loans towards their underserved areas housing goals. While some such suburban areas may be underserved, HUD’s definitions have inadvertently permitted the GSEs to avoid the manifest intent of FHEFSSA that

¹³⁶ See 12 U.S.C. §§ 4562(a), 4563(a).

¹³⁷ See 12 C.F.R. §§ 25.12(n)(1), 228.12(n)(1), 345.12(n)(1), 563e.12(m)(1).

¹³⁸ 24 C.F.R. § 81.17(b)(1)

¹³⁹ 12 U.S.C. § 4566(3)(B).

¹⁴⁰ 12 U.S.C. § 4564(a).

the GSEs purchase loans made, not in the suburbs of metropolitan statistical areas having central cities, but in the central cities themselves. HUD could change the definition of “central city” under its GSE regulations by narrowing the provision permitting lending in suburban areas. This would require the GSEs to purchase loans made in the cities themselves, thereby assisting depository institutions who, under the CRA’s generally more geographically targeted requirements, are already making such loans and would otherwise experience difficulty in selling such loan product into the secondary market.

9. Revise Multi-Family Housing Subgoal To Introduce Caps On The Number Of Units And Caps On The Mix Of High-Income And Low-Income Housing In Qualifying Developments

Loopholes similar to those that permit the GSEs to avoid purchasing CRA low-income mortgage product, while still claiming that they meet HUD’s test for mortgage purchases that qualify towards the Affordable Housing Goals, also apply to the special multi-family housing subgoal. Multifamily housing in which “20 percent of the dwelling units in the particular multifamily property are affordable to especially low-income families” counts towards meeting the subgoal.¹⁴¹ This is regardless of the average affordability of the entire multifamily housing project, which could be significantly above the area median income if it were primarily luxury housing. The subgoal also does not take into account the size of the multifamily property, which could be so large that it included a low-income building physically segregated from the buildings intended for luxury housing. The subgoal simply defines “family” as “one or more individuals who occupy the same dwelling unit,” permitting student housing to qualify as multifamily housing.¹⁴² And the subgoal establishes no geographical targets for the multifamily housing being created, permitting 80/20 luxury/student housing on the Upper West Side of Manhattan, for example, to receive the same credit as low-income housing in the South Bronx or Brooklyn. As a result, the GSEs can meet their multifamily housing subgoal by purchasing mortgages that have done nothing to alleviate local or national shortages of affordable rental housing.

Closing these loopholes could involve as little as changing the definitions identified above. Raising the percentage of affordable units for a project to qualify, establishing average affordability criteria for the entire project, prohibiting physical segregation of low-income housing within the project or establishing caps on project size, redefining “family” at least to require a head of household to be the primary tenant, and establishing a list of zip codes within which multifamily housing construction or rehabilitation qualifies towards the goals, would all be helpful in making the multifamily housing subgoal effective. If instituted as a package, they would act as a stimulus for the development of low-income housing nationwide. Moreover, such a public change would put developers on notice that they would need to undertake a new sort of multifamily housing development in order to obtain favorable GSE financing.

¹⁴¹ 24 C.F.R. § 81.14(d)(1)(i).

¹⁴² *Id.* § 81.2(b).

10. Prohibit GSEs From Meeting Housing Goals Except By Purchasing Newly-Originated Mortgages, And Count All Other GSE Activities Against The Affordable Housing Goals

The GSEs can meet their housing goals by a variety of activities other than purchasing newly originated mortgages. These include such activities as purchasing refinanced mortgages and purchasing mortgage revenue bonds issued by states and municipalities.¹⁴³ These activities are extraneous to the GSEs' core purpose of providing liquidity in the purchase-money mortgage market. Moreover, GSE purchase of refinanced mortgages and mortgage revenue bonds does nothing to help create affordable housing that would not be done if the GSEs did not purchase those mortgages or bonds. Allowing these activities to qualify as meeting the housing goals thus simultaneously diverts the GSEs from their core purpose and diverts them from using their special powers to help achieve the policy intent underlying the housing goals. Indeed, to the degree that the GSEs absorb opportunities that depository institutions with CRA obligations could have taken advantage of to meet their CRA investment requirements, the GSEs are actually thwarting the Congressional intent that underlies the CRA. HUD could easily remedy this problem by prohibiting the counting of such activities towards meeting the housing goals.

In a larger sense, the regulations governing the housing goals need to focus GSE attention on the core competencies of the GSEs, rather than on the ancillary activities in which the GSEs have over time become involved. HUD regulations currently take this need into account to some degree in considering what activities should count towards meeting the GSEs' housing goals. They list a number of activities that "shall not count toward any achievement of any of the housing goals," including equity investments in housing developments, purchase of nonconventional mortgages, and mortgage purchases that finance second homes.¹⁴⁴ At the same time, however, HUD regulations also state that such activities "shall not be included in the denominator in calculating either GSE's performance under the housing goals."¹⁴⁵ As a result, the GSEs are not rewarded but also are not penalized for undertaking ancillary activities that do nothing to achieve the goals of FHEFSSA. By changing the regulation to add such activities into the denominator as effectively counting *against* achieving the housing goals, HUD could have the effect of refocusing the GSEs on their core activities.

11. Revise Regulations Regarding New Programs To Define "New Program" Broadly And Condition Approval Of New Programs On Compliance With Affordable Housing Goals

Unlike the federal banking regulators, HUD is rarely in the position of being approached by the GSEs to approve an application. The only time that the GSEs must request HUD approval is when they implement new programs.¹⁴⁶ The statutory definition of "new program" encompasses "any program...significantly different" from any program existing as of October 28,

¹⁴³ 24 C.F.R. § 81.16(c)(7), (8).

¹⁴⁴ 24 C.F.R. § 81.16(b).

¹⁴⁵ *Id.*

¹⁴⁶ 12 U.S.C. §§ 1717(b)(6) (Fannie), 1454(c) (Freddie).

1992.¹⁴⁷ In the absence of clear regulations delineating what constitutes a “significant” difference, the GSEs could conclude that no program was really a new program and thus that no application was necessary. HUD has not so far produced clear regulations, stating only that “[s]ubmission of a program request is not required where the program that the GSE proposes to implement is not significantly different from (1) a program that has already been approved in writing by the Secretary; or (2) a program that was engaged in by the GSE prior to October 28, 1992¹⁴⁸ In response, the GSEs have made few applications, contending that they are not instituting new programs because nothing is “significantly” different from what went before. This failure to make applications prevents HUD from being able to do with the new program applications what the federal banking regulators have done with applications for regulatory permission by depository institutions: use these applications as opportunities to press their regulated institutions on complying with housing goals.

HUD could reassert its authority to approve new GSE programs and thereby give teeth to the Affordable Housing Goals. It would need to revise its new program regulations in two ways. First, it would need to specify what constitutes a “significant” difference from existing programs, either in terms of budget, personnel, revenues, profits, losses, all of the above, or some other criteria. Second, it would need to specify that progress in achieving Affordable Housing Goals would be taken into account in approving applications to engage in new programs.

Conditioning approval of new programs on achieving Affordable Housing Goals would put the GSEs in the same position as depository institutions currently are in with relation to the CRA: they would have to take their compliance with the Affordable Housing Goals into account in making any plans to expand their business lines. Moreover, to the degree that an application to engage in a new program was made public, the GSEs would find their success at meeting their Affordable Housing Goals subject to public scrutiny, just as community activists now scrutinize the CRA records of depository institutions applying to merge or expand their services.

One Reform That Would Require a Change in Federal Reserve Regulations

Like the reform of HUD regulations, this reform would take time to implement, given both the ordinary processes of proposing changes to regulations and the potential reluctance of the Federal Reserve to change established regulations. This reform, however, would be worth the effort because it would make it easier to get at the essential issue of what the GSEs’ loan purchase decisions actually do in terms of their business.

12. Revise Regulation C To Require The GSEs To Report Their Mortgage Loan Purchases In Conformity With HMDA

CRA lenders are subject to HMDA reporting requirements, while the GSEs are not. As a result, in addition to being assessed for their CRA compliance within unique performance contexts, each depository institution must make public enough information about its mortgage loan origination and purchase decisions to permit regulators or community groups to construct

¹⁴⁷ 12 U.S.C. § 4502(13).

¹⁴⁸ 24 C.F.R. § 81.52(a).

very detailed models about each lender's decision-making process. The pressure of knowing that this information is a matter of public record serves as an additional impetus for depository institutions to take their CRA responsibilities seriously – although flawed, the HMDA data will demonstrate any obvious discrepancy between expectation and performance in connection with loan originations to underserved populations. Meanwhile, the GSEs, which are already subject to the less rigorous Affordable Housing Goals, escape such reporting requirements because the Federal Reserve has defined them out of HMDA pursuant to its regulatory authority. Thus, the GSEs avoid the uncomfortable but salutary pressure that full disclosure along HMDA lines might create.

Rectifying this situation would be a matter of changing the Regulation C definitions that control to whom HMDA applies. Regulation C currently applies HMDA reporting requirements to mortgage lending institutions, despite the fact that the statute applies to all institutions “engaged for profit in the mortgage lending business” without further qualification.¹⁴⁹ It would appear to be within the Board's powers under the statute to apply HMDA to mortgage *purchasing* institutions as well -- such institutions, after all, are generally engaged in the mortgage financing business. Such a change would subject the GSEs to the same disclosure-related pressures that the CRA lenders currently face, and it would thereby provide an additional spur to take greater action in connection with underserved communities.

Two Reforms That Would Require a Change in Treasury Regulations

Like the reform of HUD regulations, this would take time to implement, given the ordinary process of drafting, providing public notice and permitting public comment on a significant regulation. Nevertheless, these reforms might repay such an effort, because they would be direct methods of imposing CRA-type pressures on the GSEs.

13. Condition GSE Ability To Borrow From Treasury On Achievement Of Outstanding Compliance With Affordable Housing Goals

The GSEs have the unique ability to borrow \$2.25 billion each directly from the Treasury, subject to the discretion of the Secretary of the Treasury.¹⁵⁰ That ability exercises a powerful hold on the imagination of the financial markets, which perceive it as one aspect of the implicit federal guarantee of every security issued or guaranteed by Fannie and Freddie. It is on the basis of this belief in an implicit guarantee that the GSEs can borrow at lower rates and sell securities at higher premiums than private issuers.

Treasury's discretion to permit the GSEs to borrow is currently unfettered by regulation: the GSEs have never tried to use their borrowing privileges, and Treasury has apparently never seen it as necessary to explain whether and under what circumstances it would permit them to do so. This has not worried the financial markets, which have not seriously considered the possibility that Treasury would not exercise its discretion to permit the GSEs to borrow up to (or even beyond) their statutory limits.

¹⁴⁹ 12 U.S.C. § 2802(4).

¹⁵⁰ 12 U.S.C. §§ 1719(c) (Fannie), 1455(c) (Freddie).

There is no statutory bar to providing regulatory guidance in the use of this discretionary power. Treasury could condition the GSEs' ability to borrow upon a showing of success at meeting the Affordable Housing Goals set by HUD. Perhaps even more effectively, Treasury could raise the evidentiary requirement for the GSEs to show their need to borrow directly from the Treasury, according to how successfully they complied with the Affordable Housing Goals: "outstanding" compliance would permit the GSEs to borrow from the Treasury upon a showing of mere need; "satisfactory" compliance would obligate the GSEs to make a showing of extreme need; "substantial noncompliance" would mean that the GSEs could not borrow at all, or would have to obtain a waiver of the housing goals by Act of Congress. Treasury could make its announcement of GSE compliance annually or more frequently, effectively establishing for the ensuing period whether or not, or to what degree, the GSEs' activities were in fact guaranteed by the federal government, regardless of whether the GSEs even seek to use their borrowing authority.

Creating such regulatory guidelines for the exercise of Treasury discretion could change the financial markets' heretofore uncritical willingness to price the implicit guarantee as though it were an express guarantee. It would be unlikely that the GSEs would leave to chance any possibility of improving the results of Treasury's evaluation, or of HUD's evaluation if Treasury were prepared to accept HUD's conclusions as the basis for its regulatory system. The effect would be to make the GSEs take the Affordable Housing Goals as seriously as the most reputation-conscious and merger-interested depository institution currently takes its CRA obligations.

14. Condition Treasury Approval Of GSE Debt Issuances On Achievement Of Compliance With Affordable Housing Goals

While the GSEs have the power to issue debt obligations, they can only exercise that power with the approval of Treasury.¹⁵¹ In earlier years Treasury did disapprove at least one Fannie Mae borrowing in its entirety and probably disapproved terms and conditions on other offerings. Treasury, however, never issued regulations routinizing the approval process. In the mid-1990s, Treasury decided that it would no longer review individual GSE offerings. The GSEs and the financial markets have come to think that the GSEs have all the debt issuance powers of autonomous corporate entities. Coupled with the implicit federal guarantee of GSE obligations, this has meant that the GSEs have had largely unrestricted access to credit at very low rates, which has become crucial to the GSEs' future profitability.

Precisely because this access to credit is so important to the GSEs, conditioning this access on compliance with the Affordable Housing Goals could have an immediate and dramatic effect on GSE activities. As with the GSEs' ability to borrow directly from the Treasury, there is no statutory bar to the Treasury instituting regulations to govern the exercise of its approval power. It could provide the same *carte blanche* approval as currently, but only if and for the period that the GSEs met their housing goals. It could, as with the regulation of its line of credit to the GSEs, provide approval subject to evidentiary requirements that would decrease with a

¹⁵¹ 12 U.S.C. §§ 1719(b) (Fannie), 1455(k)(1) (Freddie).

GSE's success in meeting the Affordable Housing Goals. Perhaps most effectively, Treasury could require that each request for approval of a specific debt issuance contain an explanation of the uses to which the debt issuance would be put, including a commitment to the proceeds from the debt issuance to achieve compliance with the Affordable Housing Goals. Treasury could then deny approval of subsequent debt issuance requests as a sanction for a GSE failing to abide by such a commitment.

This would have direct effects on the GSEs and the capital markets. The GSEs would be forced to consider compliance with the Affordable Housing Goals in connection with all of their activities, rather than treating their affordable housing compliance as a separate area. The capital markets, meanwhile, would be made to see that the GSEs are not simply independent corporations with a government guarantee, but have social obligations that government is serious about having them fulfill. This realization would require both the GSEs and the capital markets to remember that the GSEs cannot pursue profits without consideration of the social mission imposed on them through the Affordable Housing Goals.

Comprehensive Reform

From time to time, proposals have surfaced to undertake more comprehensive reforms of the GSEs and their executive-branch supervision, on the theory that the GSEs' failure to meet a wide range of policy objectives for which they were chartered was serious enough that piecemeal reforms would be inadequate to cause the GSEs to succeed. Proposals for significant reform have taken a number of forms, but most have fallen into one of two categories: charter reform or market reform.

Advocates of charter reform have suggested that, as currently constituted legally, the GSEs cannot help but pursue their goal of shareholder return on equity at the expense of their social goals, including affordable housing. They have suggested that the solution to this problem of incompatible goals is to mandate what the GSEs are to do when such incompatibilities arise. Relying upon charter reform alone to recall the GSEs to their duty of supporting affordable housing, however, might not be a complete solution.

Market reform is another approach that could have a positive effect on the GSEs' affordable housing activities. Increasing the competitive pressures on the GSEs would undoubtedly reduce the cost of housing credit that would, in turn, make some mortgages more affordable. But HUD, among many others, has pointed out the lack of funds for a downpayment is at least as significant barrier to homeownership as are mortgage rates.¹⁵²

This suggests that comprehensive reform of the GSEs to make them more effective at meeting America's affordable housing needs should include both charter reform and market reform. Comprehensive reform of this type would require a detailed proposal and would involve a number of complex issues that are beyond the scope of this paper. Comprehensive reform, however, may be the only alternative because the GSEs' consistent response to suggestions that they have not met their statutory goals has been blanket denial, coupled with intense media and

¹⁵² See HUD Study Update at 7.

lobbying campaigns to protect the status quo, rather than a good-faith effort to explore solutions to their shortcomings. The persistence of these difficulties suggests that comprehensive reform would be a contentious course of action, but one that may be necessary.

The following are a list of recommendations that is not inclusive:

Charter Reform:

1. Adopt goals modeled after the CRA. Alternatively, if policymakers determine that the GSEs' affordable housing requirements are sufficient, then federal policymakers should act to conform the CRA goals imposed on depository institutions to the GSEs' affordable housing goals.
2. If underwriting decisions are being outsourced to the GSEs' automated underwriting systems and the GSEs are effectively establishing the standard in the marketplace, the GSEs should be held responsible for the decisions their proprietary systems are making. The GSEs should be responsible under the federal fair lending laws, including the Fair Housing Act, the Equal Credit Opportunity Act, and the Home Mortgage Disclosure Act.
3. Adopt a system similar to that of the Federal Housing Finance Board, which channels 10% of Federal Home Loan Banks' annual profits into an affordable housing fund that allows each member bank to undertake its own affordable housing activities. Proceeds from the GSE affordable housing fund could then be used to subsidize the downpayments of those most in need, as an example. (HUD's record of not setting or enforcing meaningful affordable housing requirements evidences the need to relocate this responsibility to an agency where effective regulatory oversight could occur and to change the system by which the GSEs are regulated.)
4. Means-test the focus of the GSEs' business activities so that the GSEs are only permitted to purchase loans made to individuals with incomes 115% or below of area-median income – the limitation that is imposed on state housing finance agencies bond issuances. This proposal would focus the GSEs on serving the segment of the population that is most in need of assistance.
5. Require that the GSEs operate as an “essential facility” and regulate them like a utility, thereby ensuring that consumers and industry are better served. For example, this approach might require the GSEs to charge the same guarantee fee for all mortgage originators, thereby eliminating the GSEs' current practice of discriminating among originators. This approach might also require the GSEs to lower substantially their guarantee fees and thereby lower costs to consumers. Because the GSEs are a shared-monopoly, their guarantee fees are substantially higher than they would be in a more competitive environment. Finally, this approach might also require the GSEs to “open up” their automated underwriting systems as suggested earlier in this paper.

6. Consolidate and relocate the GSEs' regulator into a single regulator, located at either the Federal Reserve Board or as a Bureau within the Treasury Department. HUD has not been able to impose affordable housing requirements on Fannie Mae and Freddie Mac that would cause the GSEs to lead, rather than lag depository institutions in meeting the nation's affordable housing needs. By contrast, the bank and thrift regulatory bureaus located within Treasury and the Federal Reserve Board all have a far superior record in enforcing CRA compliance. Treasury also has an exemplary record in supporting the CDFI Fund and its commitment to meeting community needs.

Market Reform:

1. Ensure that the Federal Home Loan Banks' MPF and MPP programs are able to operate as a competitive outlet for mortgage loans, thereby providing some competition for Fannie Mae and Freddie Mac and, as a result, lowering costs for consumers. Consumers would also benefit because a variety of competitive underwriting systems would be used in qualifying consumers for loans.
2. Allow Ginnie Mae to guarantee pools of conventional mortgages. Since Ginnie Mae does not have shareholders, it is not driven to increase returns for shareholders but, instead, acts as an "essential facility" for both consumers and the industry alike. Among other things, Ginnie Mae charges the same guarantee fee to all mortgage originators/consumers, a guarantee fee that is substantially lower than the fee charged by Fannie Mae and Freddie Mae; and it accepts loans underwritten by a variety of different underwriting systems, both automated and manual.
3. Make the GSEs' charters widely available to qualified applicants, like bank and thrift charters, thereby ending their shared-monopoly status.

Increased competition in the GSEs' sector has a number of benefits. It will reduce costs and increase the choices that are available to consumers. And, although counterintuitive, increased competition will also reduce systemic risk. Competition will not necessarily increase the overall size of the market, but it will diversify the risk across a greater number of market participants.

In summary, the GSEs need to be treated less like *sui generis* institutions, and more like the possessors of a charter that, like a bank or thrift charter, carries with it well-established rights, effective regulatory oversight, an accepted role in the industry, and unquestioned affordable housing responsibilities. The challenge to reforming the GSEs is to create an effective combination of competition and professional regulatory oversight.

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