CONSUMER MORTGAGE COALITION

August 31, 2009

Mr. Edward DeMarco
Acting Director
Federal Housing Finance Agency
1700 G Street, N.W.
Washington, D.C. 20552
RegComments@fhfa.gov

Re: Prior Approval for Enterprise Products
RIN 2590-AA17

Dear Acting Director DeMarco:

The Consumer Mortgage Coalition (CMC), a trade association of national mortgage lenders, servicers, and service providers, appreciates the opportunity to submit its comments in response to the Federal Housing Finance Agency (FHFA) interim final regulation regarding prior approval for products of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac.

Background

In comprehensive GSE reform legislation enacted last year,[1] one of the central parts of the legislation was an enhanced requirement for regulatory approval of GSE products. The requirement for regulatory approval itself, however, was not new. Before Congress enacted HERA, the authority to approve new GSE "programs" rested with the Department of Housing and Urban Development (HUD). Due to a number of shortcomings in the earlier statutory scheme for regulation of the GSEs, HUD could not effectively exercise its authority. This was one of the reasons Congress moved that authority from HUD to FHFA and revised the statutory provisions governing regulatory approval.

As revised, the new approval law sets out certain requirements.[2] They include:

[1] Congress reformed GSE regulation in the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (HERA).
[2] HERA § 1123, 122 Stat. at 2689, amending § 1322 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act) and renumbering it as § 1321 (referred to herein as § 1321).

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> The Director shall require each enterprise to obtain the approval of the Director for any product of the enterprise before initially offering the product.[3]

In considering any request for approval of a product, the Director is required to determine whether:

- A product of Fannie Mae is authorized by certain provisions of Fannie Mae's charter act.
- A product of Freddie Mac is authorized by certain provisions of Freddie Mac's charter act.
- The product is in the public interest.
- The product is consistent with the safety and soundness of the enterprise or the mortgage finance system.[4]

Immediately upon receipt of a request for approval of a product, the Director must publish notice and a description of the proposal, and provide a 30-day period for public comment.[5]

The Director may approve or reject a product, or may approve with "terms, conditions, or limitations" on the product.[6]

Prior approval is not required for the following:

- The GSE's automated underwriting systems in existence on July 30, 2008 and a specified category of upgrades to those systems. Prior approval is also not required for modifications to mortgage terms, conditions, and underwriting criteria relating to the mortgages that are "purchased or guaranteed" by the GSEs if the modifications do not include services or financing other than residential mortgage financing.
- Any other activity that is substantially similar, as determined by rule of the Director, to—
  - The activities described above for which prior approval is not necessary, and
  - "other activities that have been approved by the Director in accordance with this section [1321]."[7]

FHFA published an interim final regulation (the Interim Regulation) to implement the new requirements for regulatory approval of GSE products. We offer the following comments on the Interim Regulation.

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[3] Section 1321(a).
[4] Section 1321(b).
[5] Section 1321(c)(2), (3).
[6] Section 1321(d).
[7] Section 1321(e)(1).

GSE Conservatorships

The Interim Regulation does not directly take into consideration the fact that both GSEs are in conservatorship, are majority-owned by the U.S. government, are operated by the U.S. government, have U.S. support in the form of federal purchases of GSE mortgage-backed securities and direct obligations, and have a positive net worth maintained by U.S. funding. While the conservatorships may not be permanent, it is likely that they will be in place for the foreseeable future, and no one knows what form or function the GSEs will have should the conservatorships terminate.

Because HERA's enactment predated the conservatorships, HERA's product approval requirements likewise do not address the conservatorships. But the conservatorships are rather significant in their effects, and should therefore be relevant to FHFA's product approval process.

In conservatorship, the GSEs operate completely differently than in the past. As Fannie Mae stated in its most recent Form 10-K:

> Prior to the conservatorship, our business was managed with a strategy to maximize shareholder returns. However, our conservator has directed us to focus primarily on fulfilling our mission of providing liquidity, stability and affordability to the mortgage market and to provide assistance to struggling homeowners. In support of this focus on our mission, we may take, or be directed by the conservator to take, a variety of actions that could adversely affect our economic returns, possibly significantly . . . .[8]

In conservatorship, the GSEs act as government mortgage agencies focused primarily on fulfilling their mission, as Fannie Mae put it, rather than acting as privately-held corporations seeking to maximize shareholder returns. That is, while the GSEs are in their current state of being run by the federal government solely for the purpose of supporting the mortgage market, there is much less danger that the GSEs will use their government sponsorship to inappropriately expand beyond their mission in pursuit of shareholder returns.

Should one or both conservatorships terminate and one or both GSEs return to a status similar to its pre-conservatorship form, the need for robust regulatory oversight would be heightened.

Because the need for strong regulatory oversight is reduced while the GSEs are in conservatorship but would increase should one or both conservatorships end, we believe the product approval process should take into consideration the fact of the conservatorships.

Further, while the GSEs are in conservatorship, the Federal government has been relying on the GSEs for explicit government functions, such as assisting the Department of the

[8] Fannie Mae Form 10-K for the year ended December 31, 2008, p. 46.

Treasury in administering its Home Affordable Refinance and Home Affordable Modification Programs. CMC has recommended in a June 1, 2009 comment letter to FHFA, for example, that FHFA and the Administration suspend the GSEs' conforming loan limit for loans below $1 million nationwide during the GSEs' conservatorship to ensure liquidity across a broader spectrum of the mortgage market.[9] In the future, there may be other similar programs that are appropriate for a GSE in conservatorship that would not be appropriate for a private GSE. We recommend that FHFA make clear that it has the flexibility to approve programs while the GSEs are in conservatorship that would not otherwise be permissible or appropriate.

For these reasons, we recommend that FHFA add to § 1253.4(b)(3), the factors the Director may consider in determining whether a product is in the public interest, the following:

> If the Enterprise that submitted the Notice of New Activity is not in conservatorship or receivership, the degree to which that Enterprise has any incentive to engage in any action or practice that is not expressly authorized:
>
> (A) As to Fannie Mae, by paragraphs (2), (3), (4), or (5) of section 302(b) or by section 304 of Fannie Mae's charter act, and
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> (B) As to Freddie Mac, by paragraphs (1), (4), or (5) of section 305(a) of the Freddie Mac charter act.
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> If the Enterprise that submitted the Notice of New Activity is in conservatorship or receivership, the degree to which the new product might reasonably be expected to further the housing mission of the Enterprise by providing liquidity and stability to the housing markets, or by preventing avoidable foreclosures.

Congress Requires Approval for Each Product for Each GSE, not for Each Product

Congress requires the GSEs to obtain FHFA's approval for "any product" before initially offering it.[10] Congress exempts from this approval requirement any other activity that is substantially similar to "other activities that have been approved in accordance with" § 1321.[11]

Under the Interim Regulation, the definition of "new product" excludes:

> Any activity that is substantially similar to an activity or product that has been approved in accordance with this part for either Enterprise[.][12]

Under the Interim Regulation, if one GSE were to seek and obtain approval for a product, the other GSE would not need prior approval before permissibly offering the same

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[9] A copy of CMC's June 1, 2009 comment letter is attached.
[10] Section 1321(a).
[11] Section 1321(e)(1)(C)(ii).
[12] 12 C.F.R. § 1253.2, *New product* ¶ (d).

product. While this exemption would reduce the applications that require FHFA's approval, the language in HERA does not permit it.

Section 1321(e)(1)(C)(ii) exempts from prior approval products that have already been approved "in accordance with this section." This "section" refers to § 1321, which requires "**each** enterprise to obtain the approval of the Director for any product of **the enterprise** before initially offering the product."[13] Each GSE must obtain approval of any product of "the enterprise" in the singular, not in the plural. That means each GSE must obtain approval for its new products. It does not require each GSE to obtain approval for "any product of either enterprise" or for any product of "the enterprises" in the plural. FHFA does not have authority to make plural a word that Congress enacted in the singular.

Further, the requirement that "each enterprise" obtain approval means "each enterprise" not "either enterprise." FHFA does not have authority to permit one GSE to seek approval of any product of "either enterprise."

In accordance with HERA, FHFA approves products only for one GSE at a time. This is clear from the Notice of New Activity (Notice), which requires a GSE to submit to FHFA information about activities and products that is unique to that GSE-applicant and that one GSE will not know about the other GSE, such as the projected cost, volume of activity, and risk metrics of the proposed activity.

Approval for one GSE is not approval for both GSEs. When one GSE seeks approval for a product, FHFA will determine all of the following:

- Whether that product is authorized under specific provisions of the charter act of *that* GSE applicant.

- Whether the product, offered by the GSE-applicant, is consistent with the safety and soundness of "the enterprise[,]"[14] in the singular not in the plural.

- What "terms, conditions, or limitations with respect to such product with which the enterprise must comply[,]"[15] with the word "enterprise" again in the singular not the plural.

Charter Act Provisions

FHFA may only approve products that are authorized by specific provisions of the charter acts of the GSEs, as described in § 1321(a)(1) and (2). The two GSEs' charter acts differ. For example, Fannie Mae's charter act authorizes Fannie Mae to:

[13] Section 1321(a) (emphasis added).
[14] Section 1321(b)(4).
[15] Section 1321(d).

> deal in loans or advances of credit for the purchase and installation of home improvements, including energy conserving improvements or solar energy systems . . . and residential energy conservation measures . . . financed by a public utility . . . .[16]

Freddie Mac's charter act does not authorize such investments for Freddie Mac. If Fannie Mae were to obtain FHFA's approval to offer loans for home improvements as authorized by Fannie Mae's charter act language, under the Interim Regulation as written, Freddie Mac would not require FHFA's prior approval to offer the same product. We believe this is inappropriate. FHFA does not have authority to expand the charter acts.

Safety and Soundness of Each Enterprise

In approving GSE products, FHFA must consider whether the product is consistent with the safety and soundness of the GSE that seeks FHFA's approval. What is safe and sound for one GSE is not necessarily safe and sound for the other GSE. They operate differently, have differing risk scenarios, and different safety and soundness controls. If one GSE were well capitalized and soundly managed, a particular product may be safe and sound for it. At the same time, the other GSE may be capital-constrained, poorly hedged, or under other forms of stress that may make the same product unsafe and unsound for that GSE.

Terms, Conditions, or Limitations

FHFA may impose terms, conditions, or limitations on products that it approves. These may, and likely will, take into consideration the unique circumstances of the individual GSE applicant. These circumstances will likely differ from the circumstances of the other GSE. Terms, conditions, or limitations appropriate for one GSE may be quite inappropriate for the other, even for the same product.

Congress has explicitly set out a requirement that each GSE obtain approval for each of its new products. Approval of a product for one GSE does not necessarily authorize the other GSE to offer the same product.

Public Notice and Public Comment Are Required

Each GSE is required to obtain prior approval for "any" new product under § 1321(a), even if the other GSE has already been approved to offer the same product. When approval is required, the GSE is required to submit a request for approval under § 1321(c)(1). This submission entitles the public to notice and the ability to comment on the proposed product:

> Immediately upon receipt of a request for approval of a product, as required under paragraph (1), the Director shall publish notice of such request and of the period for public comment pursuant to paragraph (3) regarding the product, and a

[16] Section 302(b)(3) of the Fannie Mae Charter Act, 12 U.S.C. § 1717(b)(3).

> description of the product proposed by the request. The Director **shall** give interested parties the opportunity to respond in writing to the proposed product.[17]

FHFA does not have authority to exempt a second GSE from prior approval of a new product merely because one GSE has been approved to offer the product. FHFA does not have authority to remove the public's right to notice of and to comment on products.

For these reasons, we believe the Interim Regulation should be amended to require a GSE to obtain approval for a product even if the other GSE has obtained FHFA approval to offer the same product. The fact that FHFA has already considered the product once may make the second review shorter, but it is no less important for FHFA to accept public input and to consider all the myriad issues that a new product may entail.

We recommend that the Interim Regulation be clarified as follows:

- The Interim Regulation requires a GSE to file a Notice before "commencing a new activity[.]"[18] We recommend clarifying that the GSEs must file a Notice before commencing any "new activity or product."

- We recommend amending the § 1253.2 definition of "new product," in ¶ (d), to clarify that a "new product" does not include "Any activity of an Enterprise that is substantially similar, as determined by rule of the Director, to an activity that has been approved by the Director in accordance with this part, for that Enterprise. Approval for one Enterprise does not authorize the other Enterprise to offer any product or to engage in any activity."

- We recommend striking § 1253.8 from the Interim Regulation. It would authorize a GSE to engage in a new product without a full approval process, and specifically without public notice and comment. FHFA does not have the authority to deprive the public of its statutory right to be notified of, and to provide input regarding, new GSE products merely because a product was approved for a different GSE than the GSE currently seeking approval.

<u>Congress Grandfathered Only Specific Products</u>

Congress exempted from prior approval certain aspects of the automated underwriting systems of a GSE, certain mortgage terms and conditions, and activities substantially similar to those.[19] The Interim Regulation follows this in its definition of new product.[20] Lastly, Congress also exempted from prior approval "other activities that have been approved by the Director in accordance with this section."[21] The Interim Regulation incorporates this final exception in its definition of "new product," in ¶ (d). The Interim

[17] Section 1321(c)(2) (emphasis added).
[18] 12 C.F.R. § 1253.3(a).
[19] Section 1321(e)(1)(A), (B), and (C)(i).
[20] 12 C.F.R. § 1253.2, *New product* ¶ (a), (b), and (c).
[21] Section 1321(e)(1)(C)(ii).

Regulation, in paragraphs (a) through (d) of the "new product" definition, incorporates all the exemptions from prior approval that Congress authorized.

The Interim Regulation, in addition, goes beyond the statute and creates a new exclusion from the approval requirement for:

> Any activity that is substantially similar to an activity or product continuously undertaken by the other Enterprise since prior to July 30, 2008.[22]

This authority to engage in any activity either GSE engaged in prior to enactment of HERA is beyond what Congress has authorized. Congress excluded from the prior approval requirement only a narrow set of products. Congress did not exempt from approval *any* activity *either* GSE has been engaged in continuously since before HERA's enactment.

It is possible that one GSE has been using a product continuously since July 30, 2008 that is not appropriate, for itself, for the other GSE, or for both. As written, the Interim Regulation would exempt this inappropriate product from the prior approval requirement for the second GSE. Congress enacted no such exemption from regulatory authority or from public notice and comment for past GSE products. Rather, Congress intended for FHFA to have full regulatory authority over all GSE activities, as discussed next.

Beyond the narrow exemptions, prior approval, including public notice of and comment on new products, is required, regardless of whether the product predates HERA. FHFA does not have authority to deprive the public of its right to notice and comment.

We recommend deleting the § 1253.2 definition of "new product," in ¶ (e) because it is beyond FHFA's authority. The other exclusions from the definition of "new product" in the Interim Regulation incorporate all the exemptions from prior approval that Congress enacted. FHFA has no authority to create new exemptions from a statutory requirement.

Congress Expects Mission Compliance as to "All New and Existing Products or Activities"

That Congress grandfathered only specific products from *prior approval* means only that. Congress did not grandfather any product, or any activity, from anything other than prior approval. Quite the contrary, Congress authorized FHFA to "review all new **and existing** products or activities to determine that such products or activities are consistent with the statutory mission of an enterprise."[23] That is, Congress recognized that a product that a GSE today offers that FHFA has never reviewed may or may not be a permissible or appropriate GSE product. Congress expressly decided to subject to regulatory scrutiny all past GSE products and activities.

[22] 12 C.F.R. § 1253.2, *New product* ¶ (e).
[23] Section 1321(f)(2) (emphasis added).

It is possible that existing products may not *require* FHFA's approval, but FHFA review of any product or activity may still be appropriate. We believe FHFA should clarify in the Interim Regulation that "The Director may, at any time, require an Enterprise to submit for the Director's review a Notice of New Activity regarding any activity or product of the Enterprise. The Director may so require regardless of when the product or activity began."

In the past, the GSE regulators' resources and authority limited their ability to be fully effective in keeping the GSEs strictly within their public mission. This had led the GSEs to exceed their public mission. For example, on August 8, 2006, Fannie Mae obtained a patent expressly targeted to serve borrowers in the primary mortgage market, even though Fannie Mae's charter act prohibits it from originating loans. Further, the patent is so broad that, were Fannie Mae to begin using it, it would not meet the requirement that new GSE products be "in the public interest[.]"[24] Moreover, held by any single party, this patent would create such a threat of patent infringement litigation that it would stifle innovation of technologies that make mortgage markets more efficient and make mortgage credit less expensive.[25]

The Interim Regulation states, "In general, a new activity would not include an increase in an existing product or activity of less than a 25% investment increase."[26] The dollar investment in an activity is not necessarily the best or only determinant of its mission adherence.

We believe the Interim Regulation, including its Appendix, should not constrain FHFA's authority to review any GSE matter as appropriate. We recommend clarifying in the Appendix that "A Notice of New Activity may be required regardless of the amount of investment in, or the time of commencement of, any product or activity. All activities and products must be authorized by applicable law regardless of their volume and regardless of their commencement date."

We recommend that § 1253.1 of the Interim Regulation be amended to provide that the purpose of Part 1253 includes approval of products that are not new, by adding the words in bold: "The purpose of this part is to "establish policies and procedures implementing the **approval and** prior approval authority for enterprise products . . . ."

FHFA Should Routinely Review GSE Activities For Charter Compliance

The Interim Regulation requires the GSEs to file a Notice for each new activity or product. Upon receipt of a Notice, FHFA will determine whether the Notice concerns an

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[24] Section 1321(b)(3).

[25] At this time, we recommend that FHFA require Fannie Mae to place this patent into the public domain so that Fannie Mae, through this patent, will not be in violation of its charter. In addition, we would also recommend that FHFA review any additional patents held by either Fannie Mae or Freddie Mac to ensure that they do not violate their charters or exceed their mission, and very importantly, that all GSE patents are in the public interest.

[26] Appendix to Part 1253, at ¶ A.1

activity or product. If it is not a product, the Notice states that FHFA will review the safety and soundness of the activity as part of its routine supervisory program.[27]

A safety and soundness review is certainly sensible, but FHFA is not merely a safety and soundness regulator. In enacting HERA, Congress gave FHFA the important role of mission regulator as well as safety and soundness regulator. Mission compliance is important in products, but is just as important in "activities" that are not products. We urge FHFA to ensure that the GSEs are adhering to their mission and their charter acts in all aspects of their operations, not just in some aspects of their operations. We urge FHFA to routinely review the mission and charter act compliance of every aspect of the GSEs' operations, including all products and activities as to which FHFA receives a Notice.

Safety and soundness and mission compliance often overlap, especially in the important area of affordable housing support. Without trying the impossible task of distinguishing mission from safety and soundness, we note that the GSEs do retain large investment portfolios that pose rather significant safety and soundness as well as systemic risks.

As CMC detailed in a June 1, 2009 comment letter to FHFA, the portfolios are not necessary for the GSEs' support of affordable housing. The GSEs' support for affordable housing predates the existence of large portfolios. The portfolios grew almost exclusively for the purpose of enriching GSE shareholders. We believe that the GSEs should focus on their guarantee role, on which housing, and affordable housing in particular, depends.

As FHFA exercises its oversight of the large portfolios, it is important that GSE support for affordable housing not be a reason for the GSEs to hold loans in portfolio. Their guarantee adds liquidity on which the market depends, while GSE portfolios do not assist affordable housing.

<u>Congress Did Not Exempt Pilot Programs From Prior Approval</u>

The Appendix to the Interim regulation states that a new activity "will include a pilot program."[28] The Appendix further states:

> a significant expansion of an activity or product constitutes an expanded existing activity or product, subject to a submission requirement for a safety and soundness review, if it . . . [is a] movement from a pilot program or product test to a fully deployed activity or product[.]"[29]

This implies that a GSE may begin a pilot program before submitting a Notice. It implies that prior approval is not required for pilot products that are not yet "fully deployed." If this is the intent, we believe it is well beyond the Congressional mandate that the GSEs

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[27] Appendix to Part 1253, Notice of New Activity Form, p. 1.
[28] Appendix to Part 1253, at ¶ A.1.
[29] Appendix to Part 1253, at ¶ A.3.

get prior approval for "any product of the enterprise before initially offering the product."[30] There is no statutory exemption for pilot products, for products that are only partially "deployed," or for products that a GSE would like to "test." FHFA does not have authority to provide any such exemptions.

We recommend that FHFA amend the Appendix to make clear that "all new products require prior approval unless they fit into one of the narrow exceptions provided in § 1321(e)(1). This is true for 'pilot' and 'test' products or programs. No product requiring prior approval may be initiated before approval is given."

Congress Has Not Authorized a "Necessary and Incidental" Exception to the Product Approval Requirement

The Notice instructs a GSE to provide a legal opinion on whether a proposed activity is leally permissible. Further, the Notice instructs:

> If the Enterprise is relying on the 'necessary and incidental' authority, describe in detail how the proposed new activity is necessary and incidental to one or more charter authorities.[31]

At the time a GSE files a Notice, there has not yet been any determination whether the subject of the Notice is a product or activity. In either event, the product or activity must be authorized by the applicable charter act. The language quoted above seems to imply that either GSE may rely on "necessary and incidental authority" to offer in a new product. The GSEs have no such authority.

In requiring FHFA approval for GSE products, Congress was specific about which authority the GSEs must rely on for the product. They may not rely on any provision of their charter acts that may support an argument that the product is permissible. Rather, Congress was explicit that Fannie Mae must have authority for its products under § 302(b)(2), (3), (4), or (5), or under § 304 of its charter act.[32] Congress was explicit that Freddie Mac must have authority under § 305(a)(1), (4), or (5) of its charter act.[33] None of these specified provisions provide either GSE with any "necessary and incidental" authority for products.

Fannie Mae's charter act does provide Fannie Mae with power to "do all things as are necessary or incidental to the proper management of its affairs and the proper conduct of its business."[34] However, that is in § 309 of Fannie Mae's charter act, and § 309 clearly is not included in the authorities that permit GSE products.

Freddie Mac's charter act does not authorize Freddie Mac to engage in acts "necessary and incidental" to those authorities its charter act enumerates. FHFA does not have

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[30] Section 1321(a).
[31] Appendix to Part 1253, Notice of New Activity Form, p. 3 at ¶ 7.
[32] Section 1321(b)(1).
[33] Section 1321(b)(2).
[34] Fannie Mae Charter Act § 309(a), 12 U.S.C. § 1723a(a).

authority to approve or to permit Freddie Mac products or actions that are "necessary and incidental" to any product or action Freddie Mac may have authority to offer or to undertake.

The requirement that new products be authorized by only specific provisions of the charter acts was not enacted in HERA. Before HERA, HUD reviewed authority for new programs under the same specific charter act provisions. In 2003, HUD reviewed a Fannie Mae application for approval of a program of acquisition, development, and construction loan financing. Fannie Mae had cited its incidental powers under § 309(a) of its charter act for authority to engage in the new program. HUD rejected Fannie Mae's incidental powers as authority for a new program:

> The Department has determined, however, that [the 1992 Act] explicitly requires that any new program submitted for review must be authorized under Sections 302(b)(2)-(5) or 304 of the Charter. [The 1992 Act] contains no provision for authorizing a new program under Fannie Mae's Section 309 authority for necessary and incidental activities. Furthermore, the Department does not regard the 'necessary or incidental' clause and other corporate provisions of Section 309(a) as an independent source of authority for Fannie Mae to engage in new programs and programs that are outside the scope of the purposes enumerated in Section 301 of its Charter. Fannie Mae was chartered as a limited purpose corporation. The character of a corporation is determined by the terms of its charter and the general law under which it was organized. As a government sponsored enterprise, Fannie Mae was created by the government to serve public purposes connected with the administration of government and to implement public policy; and is therefore a public corporation. Much like the national banks, Fannie Mae cannot rely upon the 'necessary and incidental' provisions of its charter to engage in practices not otherwise authorized under the law. Like Fannie Mae's authorities under Sections 302 and 304, the scope of Fannie Mae's authorities under Section 309 is bounded by its Charter purposes under Section 301.[35]

Further support for HUD's ruling that Fannie Mae's incidental powers do not provide independent authority to engage in activities is in the language of Fannie Mae's incidental powers. This language provides that Fannie Mae may:

> do all things as are necessary or incidental to the **proper** management of its affairs and the **proper** conduct of its business.[36]

The incidental activities must be "proper," a term that the incidental powers clause does not define. The propriety of each activity must therefore be defined by another charter act authority, not by the incidental powers clause.

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[35] *Summary of Findings and Determination by the Department of Housing and Urban Development respecting the Fannie Mae Single-Family Acquisition, Development and Construction (ADC) Mortgage Program*, pp. 8 – 9, August 15, 2003 (footnotes omitted) (copy attached).
[36] Fannie Mae Charter Act § 309(a) (emphasis added).

Because Fannie Mae has no authority to engage in products that are beyond the provisions specified in § 1321(b)(1), and because Freddie Mac has no authority to engage in products that are beyond the provisions specified in § 1321(b)(2), we urge FHFA to make clear what Congress has directed – that neither GSE has "necessary and incidental" authority for any product at any time. Further, because the phrase "necessary and incidental" is not contained anywhere in Freddie Mac's charter act, it is entirely irrelevant to any activity, or any matter, of Freddie Mac. Freddie Mac does not have incidental powers.

It is important that FHFA ensure the GSEs' adherence to their statutory mission, and that FHFA not permit the GSEs to avoid the specific limitations of their charter acts. We recommend that FHFA implement this Congressional mandate by clarifying in § 1253.4(b)(2) of the Interim Regulation that:

> "The Director will approve a product—
>
> (i) For Fannie Mae, only if the product is authorized under paragraph (2), (3), (4), or (5) of section 302(b) or section 304 of the Federal National Mortgage Association Charter Act; and
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> (ii) For Freddie Mac, only if the product is authorized under paragraph (1), (4), or (5) of section 305(a) of the Federal Home Loan Mortgage Corporation Act."

Moreover, the GSEs may have in the past relied on "incidental powers" to justify actions that are beyond their proper and appropriate missions. Congress ensured that FHFA has authority under § 1321(f)(2) "to review all new and existing products or activities to determine that such products or activities are consistent with the statutory mission of an enterprise." FHFA incorporated this authority in § 1253.9 of the Interim Regulation. We urge FHFA to exercise this authority to ensure that Fannie Mae is not relying on its incidental powers inappropriately, and that Freddie Mac is not relying on incidental powers it does not have.

Affordable Housing Is Important in GSE Activities and Products

Support for affordable housing is so critical to the GSEs' mission that it merits a prominent role in regulatory oversight of GSE activities and products. FHFA has appropriately incorporated this need into the enumeration of factors the Director will consider in reviewing whether products are in the public interest. For example, the first factor on the enumerated list is "[t]he degree to which the new product might reasonably be expected to advance any of the purposes of the Enterprise under the applicable authorizing statute[.]"[37]

A longstanding Congressional direction to the GSEs is that they "take affirmative steps to . . . assist insured depository institutions to meet their obligations under the Community Reinvestment Act of 1977[.]"[38] Although this requirement is not new, the GSEs have

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[37] 12 C.F.R. § 1253.4(b)(3)(i).
[38] 12 U.S.C. § 4565(b)(3)(B).

never given it the serious attention it merits. The GSEs are in a unique position to develop a vibrant secondary market for loans eligible for credit under the Community Reinvestment Act of 1977 (CRA), yet they have never done so. The result is that CRA lending is more difficult than it needs to be.

We believe it is important that FHFA begin to remedy this chronic lack of attention to a Congressional mandate. We recommend that FHFA incorporate into the list of factors it considers in reviewing GSE products:

> The degree to which the new product would divert resources, including but not limited to management resources, from the Enterprise's creation of and support for a fully developed and liquid secondary market for loans that are eligible for credit under the Community Reinvestment Act of 1977.

<u>Public Notice of GSE Programs is Central to Congressional Requirements, and Should be Fully Implemented</u>

Complete Product Descriptions Are Critical To Public Input

The Interim Regulation states that FHFA will publish public notice of proposed GSE products, and "will describe the new product[.]"[39] The Appendix to Part 1253 details a number of materials a GSE must file with each application. The Interim Regulation does not make clear what FHFA will publish.

Public comment on new GSE products is a central part of the new mission adherence mechanism that Congress enacted in HERA. For the public comment process to be meaningful and effective, and for Congressional direction to be implemented, it is important that FHFA publish a full description of each proposed product.

FHFA is limited in what it can publish by the Trade Secrets Act.[40] At the same time, HERA requires informed public input on new GSE programs. We urge FHFA to publish, as to each new product, every part of the Notice and its supporting materials as to which the Trade Secrets Act does not prohibit publication.

The Notice states that FHFA will "automatically" consider confidential any presentations and decision documents a GSE provides to its board of directors.[41] Such an "automatic" decision may be too broad in some cases. It is likely that a GSE will present to its board materials that have no need to be confidential. A board may review, for example, marketing materials the GSE plans to use. Automatically exempting from publication any document a GSE presents to its board gives the GSEs an incentive to provide to their boards every document they would prefer to keep out of the public eye, even if board review is not necessary. This can defeat the purpose of Congressionally-mandated informed public input on all GSE programs. We believe FHFA should have the ability to

[39] 12 C.F.R. § 1253.4(a)(1).
[40] 18 U.S.C. § 1905.
[41] Appendix to Part 1253, Notice of New Activity Form, p. 4, ¶ 17.

publish even documents the GSEs may wish to remain private when publication would inform the public input, consistent with the Trade Secrets Act.

We recommend that FHFA add to § 1253.4(a) of the Interim Regulation, "The Director will publish all materials it receives in connection with a Notice of New Activity, consistent with the Trade Secrets Act."

Website Publication Will Enhance Public Input

FHFA will publish notices of new product applications in the *Federal Register*. The Office of the Federal Register typically requires three business days to publish a notice. We recommend that FHFA publish the notices on its website as soon as possible, before official *Federal Register* publication. FHFA can speed the publication process by requiring the GSEs to file their product applications electronically, which presumably they will do in any event.

Three days may not appear significant, but when a comment period is only 30 days, three days can improve the quality and helpfulness of the comment letters FHFA receives, thereby enhancing the entire program approval process and further implementing Congressional intent.

FHFA's Construction of Fifteen Business Days After Receipt Will Enhance Public Input

The Interim Regulation appropriately clarifies two procedural matters about which Congress was not exact.

First, Congress requires that FHFA determine within "15 days" of receipt of a notice whether the notice concerns a product for which FHFA's approval is required.[42] The Interim Regulation clarifies that the term "15 days" means 15 business days.[43] We believe this is an important, fair, and reasonable clarification of an ambiguous statutory term. As a practical matter, there is not much difference between fifteen calendar days and fifteen business days. But because the determinations FHFA is required to make may, in some cases, be complex, defining the term to mean fifteen business days is entirely appropriate.

Second, Congress directed that the fifteen days begin to run "after the date of receipt of a notice" from a GSE.[44] The Interim Regulation makes clear that the "receipt" occurs when FHFA has received a Notice that is "complete[.]"[45] This clarification remedies a problem that plagued HUD. Under HUD's prior authority, HUD had a period of time to complete its review of new program applications, but had extremely limited authority to lengthen its review period. Therefore, partial applications could begin the clock on HUD's review, and prevent HUD from having the time it needed to review full

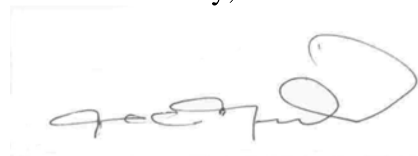
[42] Section 1321(e)(2)(B).
[43] 12 C.F.R. § 1235.3(c).
[44] Section 1325(e)(2)(B).
[45] 12 C.F.R. § 1253.3(b).

information about new programs. FHFA, by clarifying the term "receipt" of a notice, has established a procedure by which GSE products can receive the appropriate review, based on the complete information that effective review requires. We support this important clarification because it will help fully implement the review process that Congress has mandated.

Conclusion

We urge FHFA to be an effective mission regulator for Fannie Mae and Freddie Mac, consistent with the provisions of HERA. While the GSEs are in conservatorship, the need for a strong mission regulator may be somewhat reduced. However, we do not know the future of the GSEs. We therefore recommend that the Interim Regulation be amended to account for the fact of the conservatorships. We also urge amendments to the Interim Regulation to strengthen GSE mission regulation because it is possible that the conservatorships may terminate and the need for strong and effective mission regulation may be as important as it was before the conservators were put in place.

Sincerely,



Anne C. Canfield
Executive Director

Attachments

CONSUMER MORTGAGE COALITION

June 1, 2009

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
1700 G Street, N.W.
Washington, D.C. 20552
RegComments@fhfa.gov

Re: Portfolio Holdings IFR/RFC
RIN 2590-AA22

Dear Mr. Pollard:

The Consumer Mortgage Coalition (CMC), a trade association of national mortgage lenders, servicers, and service providers, appreciates the opportunity to submit its comments in response to the Federal Housing Finance Agency's (FHFA) proposed rulemaking regarding the portfolio holdings of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac.

I. Background

Congress enacted major reform of the regulation of the GSEs with the Housing and Economic Recovery Act of 2008 (HERA).[1] Among many other significant reforms, the law requires the Director of FHFA to regulate the GSEs' investment portfolios.

> The Director shall, by regulation, establish criteria governing the portfolio holdings of the enterprises, to ensure that the holdings are backed by sufficient capital and consistent with the mission and the safe and sound operations of the enterprises. In establishing such criteria, the Director shall consider the ability of the enterprises to provide a liquid secondary market through securitization activities, the portfolio holdings in relation to the overall mortgage market, and adherence to the standards specified in section 1313B.[2]

HERA also provides the Director more flexible authority to temporarily adjust the GSEs' portfolios without the need for a rulemaking process.

[1] Pub. L. No. 110-289, 122 Stat. 2654.
[2] HERA § 1109(a), 122 Stat 2654, 2675 (to be codified at 12 U.S.C. § 4624(a)).

101 Constitution Ave., NW, 9th Floor West; Washington, DC 20001
TEL: (202) 742-4366 FAX: (202) 403-3926

> The Director may, by order, make temporary adjustments to the established standards for an enterprise or both enterprises, such as during times of economic distress or market disruption. . . . The Director shall monitor the portfolio of each enterprise. Pursuant to subsection (a) and notwithstanding the capital classifications of the enterprises, the Director may, by order, require an enterprise, under such terms and conditions as the Director determines to be appropriate, to dispose of or acquire any asset, if the Director determines that such action is consistent with the purposes of this Act or any of the authorizing statutes [charter acts].[3]

Congress has directed that the portfolio holdings meet three requirements: they must be –

- backed by sufficient capital;
- consistent with the mission of the GSEs; and
- consistent with safe and sound operations of the enterprises.

In establishing these requirements, the FHFA Director must consider a number of factors, including the ability of the GSEs to provide a liquid secondary market through securitization activities; the portfolio holdings in relation to the overall mortgage market; and the adherence to the prudential management and operation standards of § 1313B.[4]

II. Government Operation of the GSEs Changes The Portfolio Question

Congress enacted HERA before the GSEs were placed into conservatorship. Today, the GSEs effectively are federal government entities with FHFA directing the enterprises' operations as conservator. The United States holds warrants to purchase 79.9% of the common stock of each GSE. The GSEs are both wholly dependent on federal funding to keep the enterprises solvent. The federal government is using the GSEs as its fiscal agent and its compliance agents to implement the Homeowner Affordability and Stability Plan.

The relevant question is no longer whether there is sufficient capital to support the portfolios, or whether the GSEs are safe and sound, questions that, pre-conservatorship, Congress directed FHFA to address. Today, the relevant question is what the government should do with the two GSEs that it now is responsible for operating and whose capital it now fully supplies.

At the risk of stating the obvious, the GSEs' portfolios and their low capital requirements—combined with the fact that the GSEs funded 36% of the subprime market—put the GSEs into their current distressed condition. As FHFA noted:

> Recent events that eventually caused FHFA to place the Enterprises in conservatorship highlight the risks posed by their large mortgage portfolio

[3] HERA § 1109(a), 122 Stat 2654, 2675 (to be codified at 12 U.S.C. § 4624(b) and (c)).
[4] Section 1313B is HERA § 1108, 122 Stat. 2654, 2673 (to be codified at 12 U.S.C. § 4513b).

> holdings and the failure of the Enterprises to hold capital commensurate with the risks posed by those holdings.[5]

The GSEs' portfolios were not designed to resolve some preexisting problem in the mortgage industry. In fact, the GSEs successfully fulfilled their mission of ensuring a liquid and stable secondary mortgage market prior to their decision to grow their portfolios. Even the GSEs recognized that they did not need large portfolios to fulfill their Congressionally-mandated mission. In testimony before Congress in 1989, then Freddie Mac Chairman Leland Brendsel explained that his company refused to increase its portfolio to avoid interest rate risk and to maintain Freddie's safety and soundness, saying:

> "Since inception since 1970 Freddie Mac has had the same strategy, business strategy of avoiding interest rate risk. ...This strategy was started by its founders in 1970, continued on by my predecessors, and I carry on that tradition today."
>
> "We avoid interest rate risks by financing about 95 percent of all the mortgages we purchase with mortgage backed securities. ...As a result we are insulated largely from the squeeze on earnings experiences by most depository institutions when interest rates rise . . . [6]
>
> * * * *
>
> Chairman Pickle [Rep. J.J. Pickle, D-TX]: "[H]ow much extra interest risk would it pose if you began a large portfolio in your lending program? ...What would prevent Freddie Mac, then, from becoming a large portfolio lender, anything? Yes, what?"
>
> Mr. Brendsel: "Me, the board of directors. Let me mention again—"
>
> Chairman Pickle: "'Me' is not 'the law.'"
>
> Mr. Brendsel: "No, I understand Mr. Chairman. The mission of the corporation is to increase the availability and the affordability of mortgage money. ...In order to do that, we must operate in a safe and sound manner..." [7]

According to nearly every government study conducted, the only purpose of the GSEs' portfolios was to enhance returns for private shareholders. It is completely inappropriate for these portfolios to create systemic risk and to put taxpayers at risk of loss for the sole benefit of private shareholders.

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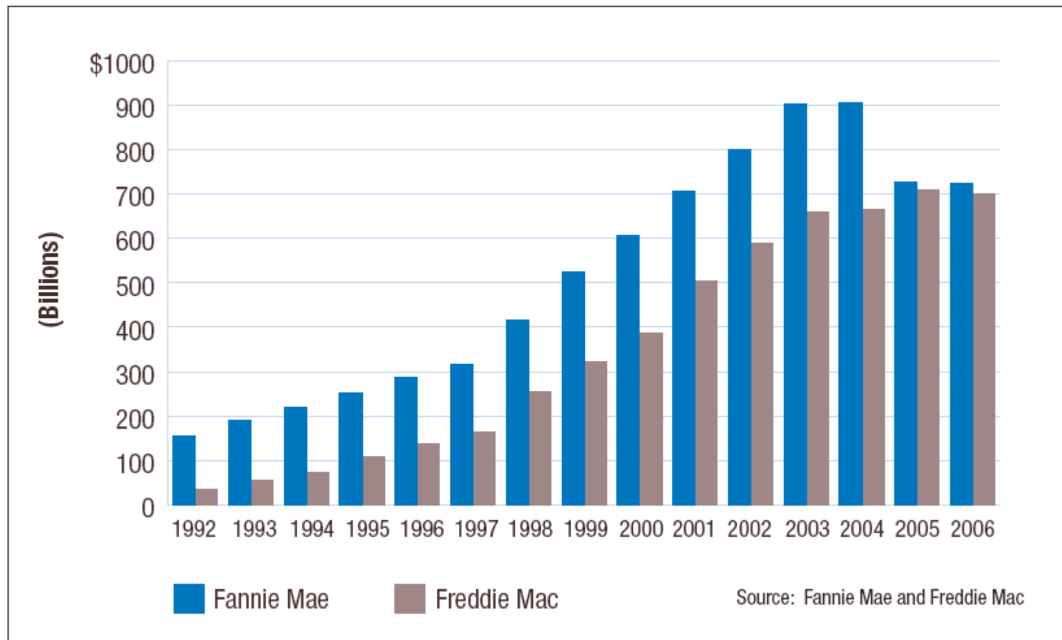
[5] 74 Fed. Reg. 5609, 5612 (January 30, 2009).
[6] "Government-Sponsored Enterprises," Hearing before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Serial 101-65, September 28, 1989 (Testimony of Leland Brendsel), at p. 55.
[7] *Id*. at p. 99 – 100.

As FHFA notes, and the following chart illustrates, the GSEs' portfolios did not begin their substantial growth until the 1990s.[8]

Mortgage Markets and the GSEs Long Predate the Portfolios



In response to FHFA's second specific question posed in its proposed rulemaking, whether it is possible for the GSEs to fulfill their mission without portfolios of mortgage assets, certainly the answer is yes. Historically, the GSEs have fulfilled their mission from their inception until the 1990s without portfolios.

There is not and never has been any need from a market need for the GSEs to retain large mortgage portfolios. FHFA should, as it announced when the GSEs were placed into conservatorship, mandate the GSEs to direct the run-off of the portfolios over time so as not to disrupt markets, and thereafter only to allow the GSEs to maintain a small portfolio for cash flow purposes in the future. Furthermore, the holdings in that portfolio should be regulated so that the portfolio holdings are invested only in very safe and sound securities, similar to the investment restrictions imposed on the private financial guaranty insurance companies.

The portfolios are not, and never have been, a deliberate federal housing policy or strategy. Rather than design federal housing policy around the GSEs' portfolios, it makes sense to first identify the federal housing policy priorities and then develop an implementation strategy which implements those policies.

[8] 74 Fed. Reg. 5609, 5613 (January 30, 2009). The chart is from a 2007 Office of Federal Housing Enterprise Oversight Report To Congress.

In the third specific question posed in its rulemaking, FHFA asks: Could the federal government better ensure the liquidity and stability of the secondary market other than through GSE portfolios? Again, the answer is clearly yes, and that question is the primary focus of this letter. We begin our analysis by identifying what caused today's problems, then we propose a solution that would address these problems in Section V of this comment letter.

III. Conforming Loan Limit Should be Temporarily Suspended for Loans Below $1 Million Nationwide

While we do not believe that the allowing the GSEs to hold large portfolios would be of any benefit to the mortgage market, it would be most helpful if FHFA and the Administration were to immediately suspend the GSEs' conforming loan limit for loans below $1 million nationwide. This would allow the enterprises to ensure the liquidity and stability of the secondary mortgage market for the spectrum of mortgage loans across the country under $1 million.

Currently, the GSEs are not permitted to guarantee loans that exceed a stated dollar amount, called the conforming loan limit. This limit adjusts for inflation and home size, and is higher in certain geographic areas. Currently, it ranges from $417,000 to $729,750 for one-unit properties. In the past, Congress used the conforming loan limit to require the GSEs to focus their government backing on loans to lower- and middle-income families. In today's distressed mortgage markets, however, this policy is causing market disruptions. Loans above the limit are often quite difficult to finance, and are expensive. Without government support, the non-conforming segment of the mortgage market is dysfunctional.

We recommend that the conforming loan limit be suspended for loans below $1 million while FHFA serves as the GSE conservator so that the GSEs can add liquidity throughout the mortgage market and across the country. The suspension could be lifted to reinstate the conforming loan limit after the mortgage market has stabilized and the GSEs emerge from conservatorship.

If policymakers embrace our recommendations for reforming the structure of the GSEs over the longer term, the GSEs would have a more limited role in the mortgage market and the conforming loan limit would be permanently eliminated, as discussed in Section V of this comment letter.

IV. Problems That Caused the Present Mortgage Industry Crisis

The secondary mortgage market is one of the most significant developments in the history of modern finance. The flow of capital from the secondary market has been a key factor in the record rates of homeownership that our country has seen in recent years. However, the very characteristic of the secondary market that results in a flow of capital to lenders—the transfer of risk—enabled some marginally-capitalized entities to engage in mortgage lending (and related transactions) with an insufficient level of due diligence

and very little, if any, capital at risk. In Wall Street parlance, these entities "had no skin in the game." The ultimate investors, to a large extent, relied on the rating agencies—that also had no skin in the game.

In the simplest terms, much of the problem in the mortgage market was that many of those responsible for making loans had too little financial interest in the performance of those loans and many of those with financial interest in the loans had too little involvement in the how the loans were made.

Over much of the last century, savings and loan associations, or "thrifts," originated the bulk of the mortgage loans in the U.S. In the traditional lending model, the thrift solicited deposits from its customers and then loaned that money to other customers to finance home purchases. If the borrower was unable to make his mortgage payment, the thrift would suffer the consequences directly. With the advent of deposit insurance, the depositors were protected and the only risk was to the institution's capital. With limited risk management capability and limited ability to raise deposits outside of their branch network, thrifts were subject to boom and bust cycles, creating erratic and uneven capital flows for mortgage lending.

The secondary market for mortgages was created to separate the process of originating mortgages from the capital required to fund the loans. In the secondary market, the risk of borrower default was transferred to an investor. Investors for the most part, however, were unwilling to take on the risk of borrowers whose credit characteristics were unknown to them. To facilitate the availability of capital, Ginnie Mae, Fannie Mae and Freddie Mac were established. Without getting into the full history or details, the main impact of these agencies was to assume the credit risk of borrowers and enable financial market participants to provide the funding for mortgages.

These agencies, along with private mortgage insurance companies, bore the primary risk of default. To protect themselves, they established underwriting criteria for the types of loans they would own or guarantee. While they did not originate loans (and are prohibited from doing so), these agencies have actively monitored the process of loan origination.

To further insure the performance of purchased loans, the mortgage market developed the practice of requiring representations ("reps") and warranties on purchased loans. These reps and warranties are designed to insure that the loans sold meet the purchaser's underwriting guidelines. This is necessary because mortgage market participants have long recognized that there is substantial risk in acquiring loans originated by someone else. Reps and warranties are only valuable, however, when the providers of those promises have sufficient capital to back up their obligations to repurchase any loans subsequently determined to be inconsistent with the reps and warranties.

Credit rating agencies played a central role by setting criteria to establish credit enhancement levels, which ultimately lead to ratings on bonds. In essence, <u>the rating agencies acted as a gateway to the secondary market</u>.

Rating agencies generally rely upon historical statistical analysis to set ratings. In rating mortgage-backed securities, the agencies typically used measures such as loan-to-value and debt-to-income ratios to make their determinations. While the agencies review the origination practices of the major mortgage banks, they generally do not review loans files or "re-underwrite" the mortgages.

Rating agencies also do not share in the economic cost of loan defaults. The agencies' methodology allowed for the inclusion of loans of dubious quality into subprime mortgage pools, including no- or low-documentation loans that allowed for an enormous amount of fraud to occur. With regard to ratings given to GSE credit-enhanced securities, the rating agencies based their ratings on the fact that the securities were enhanced by a government-sponsored entity, which enjoys an implicit guarantee by the federal government.

Despite warning signs regarding the problems and inherent danger of investing in riskier mortgages, investors continued to invest in this sector as the risks grew and reward decreased because they relied upon the ratings given by the ratings agencies on the securities. If the investment risk were presented in a transparent manner, in almost all cases, the investor could have attained the same level of income at a lower risk level. Once investors are blind to the level of risk inherent in an investment that obfuscates risk, market forces will work to increase the risk of those investments beyond the investors' expectations.

Thus, the primary problem facing the subprime market is a failure of industrial organization. The key risk takers in the market were too far from the origination process. At the origination end, without the discipline of a skeptical buyer, abuses grew. The buyer was not sufficiently concerned with the process of loan origination and the broker was not subject to sufficient constraints or supervision. Stories abound on the amount of fraud that has occurred. The mortgage investor was like an absentee landlord. Without supervision and oversight, there is no constraint on a volume-driven originator, whose compensation is based upon production. These fundamental structural problems of the secondary market have resulted in a dysfunctional mortgage market and staggering losses to end investors and the U.S. taxpayers.

An unintended consequence of the readily available credit provided largely by the marginally-capitalized mortgage market participants was that many borrowers were able to buy homes that they otherwise could not afford. As demand for housing rose, the price of houses soared. When home prices stopped rising, the inadequacy of loan underwriting standards become clear to all market participants.

V. Recommendations for Mortgage Industry Improvements

While we continue to develop our recommendations for the future of the GSEs, the following are our suggestions for reengineering the mortgage finance system at this time.

Mortgage Clearinghouse – Public / Private Joint Venture

The Mortgage Clearinghouse, an at-cost cooperative entity, would be established to standardize, centralize, and enhance the residential mortgage securitization process. (This cooperative would be analogous to the Depository Trust & Clearing Corporation, which provides an efficient and safe way for buyers and sellers of securities to make their exchange, and thus “clear and settle” transactions.)

The purpose of the Mortgage Clearinghouse would be to act as a “gateway” for securitized mortgage loans which would restore liquidity to the securitization market now and maintain the integrity of the market in the future. To accomplish these purposes, the Mortgage Clearinghouse would establish sound and fair loan origination underwriting rules, require sensible data transparency for secondary market investors, and provide financial guaranty reinsurance coverage, backed by effective levels of capital, on the securitizations. The GSEs, in a reconstituted form, along with their private sector partner/investors, would participate by providing some government sponsorship of securitizations, sufficient to support the long-term (e.g., 30-yeear, fixed rate) prepayable consumer mortgage loan. Under this structure, the GSEs would not put taxpayers and financial markets at risk for the benefit of private shareholders.

Fair and Sound Origination Standards

Some of the problems we see today were caused by loan originators who had an incentive to make loans, even inappropriate loans. It is necessary to restrict the types of mortgage loans that can be made to consumers. The Mortgage Clearinghouse would ensure all loans placed in a securitization meet basic underwriting and eligibility standards, established by its board of directors (the Board). These conventions should include fair and sound standards, such as full documentation of income and financial resources, no negative amortization, acceptable loan-to-value ratios, and clear consumer disclosures. All investors would be assured that all loans in the secondary market meet these standards.

Transparent Loan Data for Investors

Secondary market investors need data on the particular characteristics of their investments so they will not need to rely on credit ratings. While rating agencies need enhanced regulation, investors and securitizers should themselves ensure the soundness of loans underlying a securitization. The Mortgage Clearinghouse would make available to all investors standardized data on each loan in a mortgage-backed security. The data must cover both the creditworthiness of the borrowers and the characteristics of the property. The Mortgage Clearinghouse can enhance transparency for investors and improve information efficiency by setting standardized disclosure requirements for loan originators.

Ownership Structure

We suggest that the Mortgage Clearinghouse would be half owned by well-capitalized private investors and half by a government entity, with Board members appointed by the respective parties. We recommend that the government entity be a single GSE resulting from the merger of Fannie Mae and Freddie Mac. We also recommend that the merged

GSE have this role and no other. Because the Mortgage Clearinghouse safeguards are important regardless of loan size, there would be no continuing need for the GSE conforming loan limit. The GSE's presence would facilitate continued federal support of homeownership and the mortgage industry. Investors would put their private capital at risk of loss to prevent today's problems from recurring.

Reinsurance Backed by Capital

The Mortgage Clearinghouse would process securitizations and provide a public/private financial guaranty reinsurance "wrap" on its securitizations, placing the private industry lender owners at risk of loss for the securitizations they sponsor. That responsibility could be shared mutually or could be born individually. Either way, this risk of loss would mean only loans that have a reasonable ability to perform would be able to enter the secondary market. This vehicle does not exist in the market place today.

The GSE participation would ensure that the securities would be liquid and marketable. Even in today's very distressed markets, agency securities remain liquid. Under the Mortgage Clearinghouse, the market would retain that aspect of government support, which would ensure the continued availability of a long-term, prepayable consumer mortgage.

Affordable Housing Support

Under this re-engineered structure, the current GSE affordable housing goals also would need to be redesigned. There are a large number of federal policies and programs that support affordable housing. These programs should be reviewed to ensure that they are both effective and safe and sound, and then integrated into a reengineered housing finance system.

Portfolios

The Mortgage Clearinghouse would not be allowed to hold a large portfolio. Again, a small portfolio might be held for cash flow purposes only, and the holdings in that portfolio would need to subject to regulation to ensure that the investments were limited to very secure, safe and sound, low-yielding investments.

VI. Portfolio Restrictions Should Be In Regulation As Well As In Senior Preferred Stock Purchase Agreements

The GSEs' portfolios today are limited by Senior Preferred Stock Purchase Agreements (Agreements) that each GSE has entered into with the Department of Treasury. Those Agreements were originally executed in September 2008, and were amended in May 2009.[9] One of the May amendments increased from $850 billion to $900 billion the amount that each GSE may hold in its portfolio during 2009.

[9] The amendments are in GSE securities filings. *See* Fannie Mae's March 31 Form 10-Q, Exh 4.21; Freddie Mac's March 31 Form 10-Q, Exh 10.6.

The proposed regulation would not itself set criteria governing the GSEs' portfolios. It would merely incorporate the Agreements by reference:

> The Enterprises are required to comply with the portfolio holdings criteria set forth in their respective Senior Preferred Stock Purchase Agreements with the Department of the Treasury, as they may be amended from time to time.[10]

The proposed regulation would remain in effect as long as –

> This part has not been superseded through amendment, and [the GSEs] remain[ ] subject to the terms and obligations of the respective Senior Preferred Stock Purchase Agreement.[11]

It is unclear whether or how the Agreements will be amended in the future. The May amendments to the Agreements were not preceded by public notice and opportunity to comment. It also is unclear how long the Agreements will remain in effect and what, if any, portfolio regulations would be in place when the Agreements terminate. We believe it would be advisable to have a regulation in place for that event. Congress requires FHFA to establish portfolio criteria by regulation, not by GSE agreements.

> The Director shall, by regulation, establish criteria governing the portfolio holdings of the enterprises, to ensure that the holdings are backed by sufficient capital and consistent with the mission and the safe and sound operations of the enterprises.[12]

We therefore recommend that the portfolio limitations that are in the Agreements be restated in FHFA's final regulation directly rather than by reference to GSE Agreements. Doing so would in no way constrain FHFA's ability to take emergency action if needed, as Congress gave FHFA express authority to do so:

> The Director may, by order, make temporary adjustments to the established standards for an enterprise or both enterprises, such as during times of economic distress or market disruption.[13]

By putting the specific limitations in regulation, regardless of when the Agreements are terminated, there would be a regulation in place that would prohibit unregulated portfolio growth. Also, by putting the limitations in a regulation, FHFA would continue to provide notice to the public and opportunity to comment on portfolio regulations, as Congress requires.

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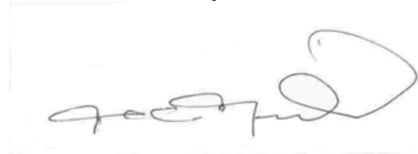
[10] Proposed 12 C.F.R. § 1252.1.
[11] Proposed 12 C.F.R. § 1252.2
[12] HERA § 1109(a)(2) (to be codified at 12 U.S.C. § 4624(a).)
[13] HERA § 1109(a)(2) (to be codified at 12 U.S.C. § 4624(b).)

VII. Conclusion

The GSEs' mortgage portfolios are not—and never have been—necessary. The risks the GSEs bore and the enormous losses they have placed on American taxpayers and on the financial markets were an unfortunate and avoidable outcome. The portfolios were not designed to implement or support any housing policy; they were designed to increase the GSEs' earnings per share for their private stockholders. The portfolios remain an inappropriate and counterproductive way for the GSEs to participate in housing markets.

The GSEs' losses are so enormous that a serious redesign of the GSEs' business model is imperative. We suggest a redesign that could provide federal support for the long-term, prepayable consumer mortgage loan, a basic ingredient of American housing policy. Importantly, this proposal would provide that support without the risks of the portfolios, risks that inevitably have been realized to the country's detriment.

Sincerely,



Anne C. Canfield
Executive Director

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

August 15, 2003

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

VIA COURIER

Mr. Franklin D. Raines
Chairman and
Chief Executive Officer
Fannie Mae
3900 Wisconsin Avenue, NW
Washington, DC 20016-2892

Dear Mr. Raines:

On June 18, 2003, Fannie Mae submitted a new program request under Section 1322 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA) and its implementing regulations, to purchase mortgages, or interests in mortgages, related to single-family acquisition, development and/or construction loans ("ADC mortgages"). The request sought permanent approval for a pilot program originally approved by the Department of Housing and Urban Development on January 24, 1991. Fannie Mae's request triggered a 45-day period for review by the Department, which was extended to 60 days due to the Department's request for additional information.

The Department has completed its review of the new program request. For the reasons detailed in the enclosed Findings and Determination, the Secretary has determined that the program is a new program subject to new program review and that the program meets the standards for approval set by FHEFSSA. Accordingly, the ADC Program for purchasing mortgages or participations in mortgages related to single-family residential acquisition, development, and/or construction loans, as described in the attached Findings and Determination, is approved.

This approval extends to the program described in HUD's approval for the pilot program for Single Family Construction Loans as subsequently revised on January 17, 1992, January 12, 2001, and October 30, 2001. The pilot program authorized Fannie Mae to purchase mortgages, or participations in mortgages, for the acquisition, development and construction of single-family residences. The Department has also considered all information that Fannie Mae has provided regarding this new program approval request up to the present date. This approval is not in any way in derogation of the requirements of the Charter Act or FHEFSSA.

Any changes to the program that may make it significantly different from the program covered by this approval or any purchases or participations by Fannie Mae outside the scope of this approval may be subject to the Secretary's review as new programs.

Sincerely,

John C. Weicher
Assistant Secretary for Housing

Enclosure

cc: The Honorable Richard C. Shelby
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate
Washington, DC 20510-6075

The Honorable Michael G. Oxley
Chairman, Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515-6050

SUMMARY OF FINDINGS AND DETERMINATION BY THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT RESPECTING THE FANNIE MAE SINGLE-FAMILY ACQUISTION, DEVELOPMENT AND CONSTRUCTION (ADC) MORTGAGE PROGRAM

FINDINGS

On August 15, 2003, the Department of Housing and Urban Development (the Department) completed a review of Fannie Mae's proposed program for the purchase of mortgages, or participation interests in mortgages, related to single-family acquisition, development and/or construction loans (the "ADC Program") under Section 1322 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA). The review included consideration of a program request submitted to the Department by Fannie Mae on June 18, 2003 and supplemental materials received on July 18 and July 21, 2003. In conducting this review, the Department relied on its analysis and information submitted by Fannie Mae. Pursuant to Section 1322, the Department considered whether the ADC Program was a new program, whether it was authorized under the applicable provisions of Fannie Mae's Charter ("the Charter"), and whether the ADC Program was not in the public interest. For the reasons explained below, the Department has determined in accordance with FHEFSSA that the ADC Program, as submitted to the Department, is a new program and that it is approved to the extent that it operates in accordance with Fannie Mae's Charter requirements, as detailed below. Moreover, as required by FHEFSSA, the Department has reviewed the public interest implications of the program and has determined that there is not a sufficient basis to conclude that the ADC program is "not in the public interest."

A. Description of the ADC Program and the ADC Pilot Program

On June 18, 2003, Fannie Mae submitted a request to the Department for permanent approval of a program for the purchase of mortgages, or participation interests in mortgages, related to single-family acquisition, development and/or construction loans ("ADC mortgages") that Fannie Mae has operated as a pilot program (the "ADC Pilot") since it was approved by the Department on January 24, 1991.

In its request, Fannie Mae stated that from time-to-time, HUD has approved substantive changes to the ADC Pilot (discussed below) to clarify and update the pilot's requirements. Fannie Mae indicated that the only limitations currently imposed on the ADC Pilot are that: (1) ADC Pilot transactions must involve participations in mortgages for the acquisition, development and construction of single family units; (2) Fannie Mae's purchases of mortgages or participations in mortgages must be secondary market transactions; and (3) ADC Pilot purchases are limited to a $500 million cap on aggregate commitments under the pilot.

Fannie Mae proposes to operate the program consistent with the ADC Pilot limitations except that the $500 million cap would be removed. Fannie Mae also says that a substantial majority (i.e., two-thirds) of the units financed by the loans in which Fannie Mae participates under the ADC Program would be offered at initial sales prices that would support mortgages

that are anticipated to be within Fannie Mae's conforming loan limit (applying a reasonable loan-to-value ratio for the product type and location). Fannie Mae estimates that the total volume of ADC Program commitments over the next two years would be approximately $400-500 million and the total over the next five years will be approximately $1.2-1.6 billion

The ADC Pilot Program

By letter dated November 28, 1990, Fannie Mae requested HUD's approval under Section 302(b)(2) of the Fannie Mae Charter for the ADC Pilot to purchase participation interests in single-family construction loans. Fannie Mae's stated purpose for the pilot was to encourage lenders to provide construction loan financing to homebuilders. Individual loans could have a land development component incidental to the home construction itself; eligible projects would be small housing developments that would consist of single family homes; and upon completion, each home would be expected to have a sale price of no greater than an amount that could sustain a 95 percent loan-to-value conventional mortgage within Fannie Mae's mortgage limits. Each construction loan could not exceed $6 million. In requesting approval for the ADC Pilot, Fannie Mae stated that the pilot would address a problem that HUD had identified, i.e., that because of the impact of loans-to-one-borrower restrictions on lending institutions that had recently been tightened pursuant to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA),[1] single-family home builders were experiencing difficulty in obtaining construction loans.

By letter dated January 24, 1991, the Department approved Fannie Mae's ADC Pilot, with a funding cap limitation of $50 million and certain requirements, including that: (1) Fannie Mae staff have sufficient experience to judge the riskiness of the pilot before permanent approval of the pilot as a program would be considered; (2) Fannie Mae take necessary steps to structure the pilot as a secondary mortgage purchase program rather than as a program of direct loans or joint ventures; and (3) Fannie Mae provide HUD with data for monitoring the pilot, particularly to evaluate the extent to which it supplemented existing lenders.

In April 2000, Fannie Mae requested an increase in the funding cap for the ADC Pilot to $500 million in order to continue to evaluate the viability of the pilot. Fannie Mae stated that "loans under the ADC pilot help to satisfy the mandates of Section 1335 of the 1992 Act [FHESSA] which require Fannie Mae to foster relationships with non-profit and for-profit organizations that develop and finance housing and with state and local governments, including housing finance agencies and to assist insured depositories in meeting CRA obligations."[2] After the Department's receipt of data on ADC performance to-date, the Department, by letter dated January 12, 2001, approved an increase in the funding cap for the pilot to $350 million. HUD's letter stated "even though the program has been in the pilot phase for nine years, additional

[1] FIRREA (P.L. 101-73) extended to savings associations a rule already in effect for national banks, which limited total loans and extensions of credit to any one borrower to 25 percent of the institution's capital, including a maximum of 15 percent for non-fully secured loans. FIRREA also provided that a savings association could make loans to any one borrower for residential housing development up to the lesser of $30 million or 30 percent of the savings association's capital, under stipulated conditions. See 12 U.S.C. 84 for national banks and 12 U.S.C. 1464(u) for savings associations.

[2] Letter from Jamie S. Gorelick, Vice Chair, Fannie Mae, to William C. Apgar, Assistant Secretary for Housing, U.S. Department of Housing and Urban Development, April 26, 2000.

testing and evaluation in today's marketplace with its greater emphasis on affordable housing may be appropriate." HUD also imposed a requirement for quarterly performance reporting. The Department's revised quarterly reporting requirements were designed to provide the Department with more information regarding the extent to which the ADC Pilot was serving affordable housing markets. [3]

At Fannie Mae's request, by letter dated October 30, 2001, the Department approved a second increase in the funding cap for the ADC Pilot to $500 million and, following publication of a risk-based capital rule by the Office of Federal Housing Enterprise Oversight, removed certain restrictions for the pilot program, including the original 50 percent limitation on the participation percentage in ADC mortgages.

In taking these actions, HUD stated that it authorized the modifications in an effort to assist Fannie Mae in completing its feasibility assessments of the ADC Pilot, including how the program could help Fannie Mae achieve affordable housing objectives. During the ADC Pilot phase, the Department did not modify or waive the requirements, or conditions, set forth in the original ADC Pilot approval with the exception of the explicit expansion of the funding cap, increase in the participation percentage, and removal of the total dollar limits applicable to each loan.[4]

Request for Permanent Approval

Because Fannie Mae's request for permanent approval is limited to a program for Fannie Mae's purchase of mortgages, or participations in mortgages, for acquisition, development and/or construction of single-family housing as secondary market transactions, the Department confined its review (and approval as discussed below) to such a program.[5]

B. The ADC Program is Reviewable as a New Program

The ADC Program satisfies the definition of a "New Program" set forth in Section 1303(13) of FHEFSSA and accordingly is subject to the Department's review under Section 1322 of the Act.

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[3] In its letter of October 30, 2001 to Fannie Mae, HUD observed that reports it had received to that date from Fannie Mae on the ADC Pilot had not adequately described the extent to which the pilot was serving underserved markets. HUD implemented new reporting requirements to inform HUD's review of the ADC Pilot as new program under the public interest standard, especially with respect to affordability factors and overall volume. While Fannie Mae reported some specific ADC transactions during the ADC Pilot period, HUD made no determinations during that period to approve or disapprove these transactions, pending permanent approval of the ADC Program. Transactions engaged in under this permanent approval must conform to the scope of the permanent approval, Fannie Mae's Charter, and FHEFSSA.

[4] Fannie Mae says in correspondence that HUD also approved a waiver to one of the original terms of the ADC Pilot; that is, that Fannie Mae would focus on projects where each single-family home, upon completion, would be expected to have a sale price no greater than an amount that could sustain a 95 percent LTV conventional mortgage within Fannie Mae's loan limits. However, the Department has made no waiver of this limitation throughout the pilot phase of ADC.

[5] Fannie Mae's letter of June 18, 2003 sought approval for a program to purchase acquisition, development, and/or construction mortgages. Where the Department has characterized this request herein, the "and/or" is assumed.

Under Section 1303 (13), a "program" engaged in by Fannie Mae is a "new program" subject to the Department's new program review authority under Section 1322 if:

(i) It is "any program for the purchasing, servicing, selling, lending on the security of, or otherwise dealing in, conventional mortgages;" and *either*

(ii) It is "significantly different" from programs that have been approved under FHEFSSA or that were approved or engaged in by Fannie Mae before October 28, 1992; *or*

(iii) It represents an expansion, in terms of the dollar volume or number of mortgages or securities involved, of programs above limits expressly contained in any prior approval.

Under HUD's rules, "conventional mortgages" are mortgages that are not guaranteed or insured by the Federal government. 24 C.F.R. 81.2. In addition, under HUD's rules a "mortgage" is:

> [A] member of such classes of liens, including subordinate liens, as are commonly given or are legally effective to secure advances on, or the unpaid purchase price of, real estate under the laws of the State in which the real estate is located. 24 C.F.R. 81.2.

Under these definitions, to the extent a lien, including a subordinate lien, in conjunction with a loan for acquisition, development and construction secures advances on the unpaid purchase price of real estate, it is a "mortgage." Moreover, since the program involves a program for the purchase of mortgages or participations in mortgages for the acquisition, development and construction of single-family housing, the ADC Program may be regarded as a program for "purchasing, servicing, selling, lending on the security of, or otherwise dealing in conventional mortgages." Accordingly, based upon Fannie Mae's submission and HUD's analysis of the program, the Department finds that the ADC Program meets the new program definition of purchasing, servicing, selling, lending on the security of, or otherwise dealing in, conventional mortgages for purposes of a new program review.

Further, the Department finds that notwithstanding that the Department approved the ADC Pilot on January 24, 1991, prior to enactment of FHEFSSA, Fannie Mae's ADC Program is significantly different from a program approved or engaged in as a permanent program by Fannie Mae prior to the enactment of FHEFSSA (October 28, 1992). The Department's approval of the ADC Pilot clearly stipulated that Fannie Mae "would share conclusions [about the pilot] with HUD before deciding whether to seek permanent authority to operate the program." Fannie Mae's letter dated November 28, 1990 seeking approval for the pilot also stated its intent to evaluate the ADC Pilot before deciding "whether to seek permanent authority to operate the program."

Also, since Fannie Mae is seeking permanent authority for the ADC Pilot, the ADC Program may be regarded as representing an expansion, in terms of dollar volume, beyond the

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funding cap limitation on the ADC Pilot, as modified by the Department in October 2001, of $500 million. Accordingly, the program is a "new program" subject to HUD's new program review authority.

C. Standard of Review

FHEFSSA requires that Fannie Mae "obtain the approval of the Secretary for any new program of the enterprise before implementing the program." 12 U.S.C. 4542(a). This Section further states that the Secretary must approve any new program of Fannie Mae unless it is not authorized under Sections 302(b)(2)-(5) or Section 304 of Fannie Mae's Charter, or the Secretary determines that the program is not in the public interest. 12 U.S.C. 4542(b)(1).

The provisions of the Charter that are relevant to whether the ADC program is legally authorized are Sections 302(b)(2) and 304 of the Fannie Mae Charter. Section 302(b)(2), says "For the purposes set forth in Section 301(a), [Fannie Mae] is authorized, pursuant to commitments or otherwise, to purchase, service, sell, lend on the security of, or otherwise deal in," conventional mortgages. This Section also limits loan-to-value ratios without credit enhancements and sets maximum loan amounts. Section 304 states that, "To carry out the purposes set forth in paragraph (a) of Section 301," Fannie Mae is, among other things, confined so far as practicable to mortgages which are deemed by the corporation to be of such quality, type and class meeting the purchase standards imposed by institutional mortgage investors, authorized to purchase FHA mortgages under Section 243 of the National Housing Act and prohibited from originating mortgages.[6] Sections 302(b)(3), (4) and (5) are not relevant to this review.[7]

Under Sections 302(b)(2) and 304, a program must effectuate Fannie Mae's public purposes as set forth in Section 301 of the Fannie Mae Charter. Section 301 describes the public purposes of Fannie Mae as providing stability in the secondary market for residential mortgages; responding appropriately to the private capital market; providing on-going assistance to the

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[6] Section 304 goes on to state that the volume of purchases and sales, lending activities, establishment of loan ratios, interest rates, maturities, prices and fees in the secondary market should prevent excessive use and operations should be self supporting; that Fannie Mae shall not be permitted to use its lending authority to originate mortgage loans; and that Fannie Mae may provide by contract, before or after default for the settlement or extinguishment, upon default, of any redemption or other right in the mortgage and the mortgage shall become the property of Fannie Mae. Section 304 states that Fannie Mae can issue obligations with Treasury approval; that Treasury can purchase Fannie Mae obligations; that Fannie Mae can issue and sell securities based on the mortgages and subordinated obligations; and that the U. S. will not impose fees on Fannie Mae's securities.

[7] These Sections authorize Fannie Mae to purchase, service, sell, lend on the security of, and otherwise deal in loans or advances of credit for the purchase and installation of home improvements, including energy conserving improvements or solar energy systems and residential energy conservation measures [Section 302(b)(3)]; to purchase, service, sell, lend on the security of, and otherwise deal in loans or advances of credit secured by mortgages or liens against manufactured homes[Section 302(b)(4)]; and to purchase, service, sell, lend on the security of, and otherwise deal in conventional mortgages secured by subordinate liens on 1- to 4-family principal residences or properties of 5 or more units. The aggregate principal amount of loans on one property owned by Fannie Mae cannot exceed the maximum [Section 302(b)(5)].

secondary market, including for mortgages related to low-and moderate-income housing; and promoting access to mortgage credit throughout the Nation.[8]

1. Charter Authority Determination

The Department also has concluded that to the extent the ADC Program is a program for "purchasing, servicing, selling, lending on the security of, or otherwise dealing in, mortgages" under Section 302(b)(2) of the Charter that fulfills the public purposes requirements set forth in Section 301 of the Charter, the program is authorized under the Charter. As indicated below, a program for purchasing acquisition, development and construction mortgages for single-family housing is authorized as long as the program (1) involves only purchases of mortgages or participations in mortgages in the secondary market and Fannie Mae does not engage in direct lending or origination under the program; (2) satisfies Fannie Mae's public purposes of providing a secondary market for residential mortgages; and (3) meets other restrictions generally applicable to Fannie Mae's mortgage purchase authority, including that Fannie Mae confine its single-family mortgage purchases to mortgages under the conforming loan limits established by Congress.

a) The Program May Involve Only Secondary Market Purchases of Mortgages or Participations in Mortgages

Section 301 of Fannie Mae's Charter makes clear that Fannie Mae's purposes must be directed to facilitating a *secondary market* for residential mortgages.[9] Also, under Section 304(a)(2) of the Charter, Fannie Mae is expressly prohibited from direct lending and loan origination. Accordingly, under the ADC program Fannie Mae's purchase of these mortgages or participations in these mortgages must be secondary market transactions. Further, because a determination of charter authority, as set forth herein, is for Fannie Mae's purchase of mortgages or participations in mortgages, Fannie Mae must ensure that the mortgages or participations in mortgages it purchases under the program meet the definition of mortgages and are secured by the real estate which is the subject of the project.

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[8] Section 301 of the Charter identifies Fannie Mae's public purposes as:

(1) provide stability in the secondary market for residential mortgages; (2) respond appropriately to the private capital market; (3) provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and (4) promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing. 12 U.S.C. 1716.

[9] The provisions of Section 301 directly relevant to Fannie Mae's ADC Program, Section 301(1), (3),(4), specifically state that Fannie Mae's activities must be for the purposes of providing stability for and ongoing assistance to the secondary market for residential mortgages, as well as improving the distribution of investment capital available for residential mortgage financing. 12 U.S.C. 1716.

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b) The Program Must be Confined Generally to Residential Mortgages

In light of Section 301's objective that Fannie Mae provide a secondary market for *residential mortgages*, in order for the program to be authorized and approved, the program also must be confined to purchasing mortgages or participations in mortgages for acquisition, development and construction of single-family residential housing.

Fannie Mae has indicated in its submissions that under the ADC Pilot, it has exclusively purchased ADC mortgages for single-family for-sale developments, but that "in some cases" such developments may include "some non-residential space that is integral to the ADC project," critical to the success of the development, and beneficially impacts the development. For example, in certain projects this may include space set aside for parks, playgrounds, or other amenities such as community pools. Fannie Mae also stated that in high rise condominium or cooperative developments, particularly those in urban areas, ground floor retail or parking garages are common features and provide residents with much needed services. In addition, local zoning may require open or common space as well as retail space on the ground floor.

Fannie Mae stated that one of the guiding principles of its activities under the ADC Pilot and under a permanent program would be that, in order for Fannie Mae to participate in a housing acquisition, development, and construction mortgage, the "overall project must be residential in nature." Fannie Mae also indicated that it will review non-residential uses to determine if they are supportive of residential space and that it will prohibit specific uses of non-residential space during the time Fannie Mae is participating in a project's financing. Fannie Mae further stated that where a project's residential and non-residential space will be financed separately, Fannie Mae will participate only in the residential portion. Fannie Mae also noted that over 70 percent of all ADC Pilot transactions purchased by Fannie Mae were for residential-only purposes.

Sections 301 and 302(b)(2) of Fannie Mae's Charter limit Fannie Mae to purchasing, servicing, selling, lending on the security of, or otherwise dealing in, conventional mortgages in furtherance of Fannie Mae's purposes, which include facilitating the secondary market for residential mortgages. The Department is aware that in constructing some single-family residential housing projects, in addition to the construction of residential dwelling units, zoning requirements may mandate that certain non-dwelling residential uses, such as adequate parking, green space, and other facilities, be included in projects to meet local requirements. The Department, therefore, approves Fannie Mae's purchases of mortgages or participations in mortgages under this program for residential dwelling units and those non-dwelling residential uses that are integral, necessary or required for the development of the residential project, such as parking, walkways, community space and outdoor areas, and further are minimal in the context of that portion of the project in which Fannie Mae will participate.

The Department is also aware that in constructing some single-family projects, zoning requirements may mandate that commercial space be provided in primarily residential projects. Therefore, only to the extent that such commercial uses are *required* to fulfill local zoning mandates, are necessary to a single-family residential housing construction project, or are minimal in the context of that portion of the project in which Fannie Mae will participate, could

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financing of such commercial space by Fannie Mae's mortgage purchases be authorized under Section 302(b)(2) of Fannie Mae's Charter. Accordingly, as a general matter, Fannie Mae's purchases of mortgages or participations in mortgages must finance residential housing. Where a project is mixed-use (e.g., two-thirds commercial and one-third residential), Fannie Mae must limit its involvement to purchasing mortgages or participations in mortgages that finance only the residential portion of the project.

The Department has concerns regarding Fannie Mae's statement that it has "not published specific internal policies, including limitations and legal opinions, with respect to the non-residential components of the single-family, for-sale projects that have been financed under the ADC Pilot," but that "several principles apply to the pilot and each transaction is evaluated on a case-by-case basis." As indicated above, the Department views three types of uses to be potentially relevant to each ADC project: Residential dwelling units, non-dwelling residential spaces, and commercial spaces. Before the ADC Program proceeds, HUD requires that Fannie Mae must develop specific guidelines that are consistent with the terms of this approval, Fannie Mae's Charter and FHEFSSA, including limitations and restrictions on Fannie Mae's funding of non-dwelling residential and commercial portions of ADC projects, and submit these guidelines to the Department. These guidelines must ensure that the ADC program is a residential mortgage purchase program consistent with Fannie Mae's Charter. As a general matter, these guidelines should ensure that non-residential spaces and structures funded through Fannie Mae's ADC Program activities are for the benefit of the project and its residents, and that these and commercial uses are necessary to a single-family construction project, required by zoning laws, or limited to a minimal, specified percentage of Fannie Mae's participation in each ADC project.[10] The guidelines must also demonstrate how Fannie Mae will ensure that it is purchasing mortgages or participation interests in mortgages secured by the real estate that is the subject of the project and that all residential units to be financed will be reasonably anticipated to be eligible for permanent financing within Fannie Mae's conforming loan limit.

Fannie Mae also has indicated in its submission that its activities for purchasing mortgages financing non-residential components of a construction project are authorized under Section 309 of its charter which authorizes Fannie Mae to undertake activities "necessary and incidental" to the proper management of its affairs and proper conduct of its business. The Department has determined, however, that FHEFSSA explicitly requires that any new program submitted for review must be authorized under Sections 302(b)(2)-(5) or 304 of the Charter. FHEFSSA contains no provision for authorizing a new program under Fannie Mae's Section 309 authority for necessary and incidental activities. Furthermore, the Department does not regard the "necessary or incidental" clause and other corporate provisions of Section 309(a) as an independent source of authority for Fannie Mae to engage in new programs and programs that

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[10] See, for example, the Federal Housing Administration's (FHA) Multifamily Accelerated Processing (MAP), and the MAP Guide (Chapter 6 – Cost Processing), and Notice H2001-10, which provide national standards for approved Lenders to prepare, process and submit loan applications for FHA multifamily mortgage insurance, and which puts percentage cost limits on certain multifamily project amenities and uses other than dwelling uses, including commercial space. Specifically, the standards permit a maximum of 15 percent of the cost of a project to be allocated to non-dwelling residential space and a maximum of 15 percent of the cost to be allocated to commercial space. While these guidelines are not directly applicable to Fannie Mae, to the extent that they involve mixed-use multifamily projects, the descriptions of non-dwelling residential and commercial uses as well as the allocation of costs among these uses should be helpful in Fannie Mae's development of guidelines.

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are outside the scope of the purposes enumerated in Section 301 of its Charter. Fannie Mae was chartered as a limited purpose corporation. The character of a corporation is determined by the terms of its charter and the general law under which it was organized. As a government sponsored enterprise, Fannie Mae was created by the government to serve public purposes connected with the administration of government and to implement public policy; and is therefore a public corporation.[11] Much like the national banks, Fannie Mae cannot rely upon the "necessary and incidental" provisions of its charter to engage in practices not otherwise authorized under the law.[12] Like Fannie Mae's authorities under Sections 302 and 304, the scope of Fannie Mae's authorities under Section 309 is bounded by its Charter purposes under Section 301.

c) The Program Must Comply With Fannie Mae's Conforming Loan Limitation

Fannie Mae's authority to purchase mortgages or participations in mortgages for the acquisition, development and construction of residential housing under the ADC Program is found in Section 302(b)(2) of the Charter. This Section contains a requirement that Fannie Mae "shall establish limitations governing the maximum original principal obligation of conventional mortgages that are purchased by it," and that such limitations shall not exceed established conforming loan limits based on property size as indicated. Fannie Mae's June 18, 2003 letter requesting permanent approval of the ADC program states that "a substantial majority of the units financed by the loans in which [Fannie Mae] participates under the ADC Program would be offered at initial sales prices that would support a mortgage that is within Fannie Mae's loan limit (applying a reasonable loan-to-value ratio for the product type and location)." Supplemental material provided by Fannie Mae states, "we propose that a 'substantial majority' means a minimal standard of no less than two-thirds (2/3) of the units financed by the loans in which we participate are within Fannie Mae's loan limit..."

The requirement that Fannie Mae purchase mortgages that are within the conforming loan limit applies to the ADC Program under Section 302(b)(2). Moreover, the Department notes that a recurring purpose cited in Fannie Mae's request for permanent approval of the ADC Program is to facilitate the flow of capital for construction of affordable housing. Financing single-family units that Fannie Mae anticipates would be offered at sales prices in excess of the conforming loan limit at the time the ADC mortgage is purchased would be inconsistent with this purpose and with Section 302(b)(2). The Department is aware, however, that between the time a project is planned for construction and the time a constructed unit is offered for sale, there can be a degree of uncertainty regarding the level of final sales prices for all units. Nevertheless, in

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[11] 18 Am.Jur.2d *Corporations* §30 (1985).

[12] While there is no direct precedent interpreting Fannie Mae's Charter, the courts have consistently held that national banks, limited in their authority by the National Bank Act, may not use necessary and incidental provision of the Act to engage in practices not otherwise authorized by the Act. *See, e.g.*, Independent. Ins. Agents of Am., Inc. v. Hawke, 211 F.3d 638 (2000); Arnold Tours, Inc. v. Camp, 472 F.2d 427 (1st Cir. 1972) (stating that "a national bank's activity is authorized as an incidental power, "necessary to carry out the business of banking," within the meaning of [the National Bank Act], if it is convenient or useful in connection with the performance of one of the bank's established activities pursuant to its express powers under the National Bank Act. 472 F.2d 432). Also, a statute under which a corporation is established not only confers authority but also imposes the duty to exercise corporate functions in conformity with such statute. 18B Am.Jur.2d Corporations Sec. 1990 (1985).

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granting its approval of the ADC program, the Department requires that Fannie Mae's participation be limited to projects where Fannie Mae can reasonably anticipate that all units will be offered at sales prices that would result in permanent mortgages within Fannie Mae's conforming loan limit. The minimal standard proposed by Fannie Mae that no less than two-thirds of units financed under the ADC program would be eligible for permanent conforming mortgages does not meet this requirement.

2. Public Interest Determination

Under Section 1322, even if a program is authorized, the program must be disapproved if the Department determines that the program is not in the public interest. The Department has broad discretion in determining what factors are to be considered under a public interest standard.

In evaluating the impact of the ADC Program on the public interest, the Department considered the following factors: a) The program's effects on liquidity and market competition; b) Effects of the program on market stability; c) Effects on housing affordability and homeownership; and d) Risks associated with ADC lending.

(a) Effects on Liquidity and Market Competition

The scale of ADC activity annually in the U.S. (based on U.S. Bureau of the Census figures) is substantial. For example, in 2002, 974,000 new single-family home sales (in housing units) were constructed nationwide. The National Association of Home Builders (NAHB) characterizes ADC lending as a $216 billion annual industry.

In comparison, Fannie Mae's activity under the ADC Pilot has averaged about $50 million in any one year. Between December 1991 and March 2003, the ADC Pilot funded 57 projects, of which 46 have been funded since January 2000. Fannie Mae's commitments during the ADC Pilot totaled $147.9 million for all years, or an average of $2.6 million per project. According to data provided by Fannie Mae, the ADC Pilot funded the acquisition, development, and construction of approximately 10,000 single-family units since its inception in 1991. Projects for which structure type was reported (i.e., those funded in 2002 and the first quarter of 2003) included 4,935 single-family units. Of these, 3,920 were single-family detached, 703 were condominiums, and 312 were townhouses. The ADC Pilot included both new construction and rehabilitation. Projects were geographically dispersed among all regions of the country.

Fannie Mae projects that its ADC program activity will reach the $200 million level for 2003 and up to $300 million annually by 2005. While Fannie Mae's performance under the ADC Pilot indicates that it has provided some market liquidity for ADC loans, both its past and projected activity suggests that, relative to the national marketplace as a whole, the amount of liquidity resulting from this program is likely to be relatively small.

Further assertions relating to potential liquidity in the market are made in material submitted by Fannie Mae. For example, in correspondence to the Department supporting Fannie Mae's program approval request, the NAHB states that program approval will help to establish a

more efficient market for housing production credit in the capital markets. Financial institutions—such as Bank of America, US Bank, Bank One, JP Morgan Chase, Whitney National Bank—affirm that the program has demonstrated it can promote provision of liquidity to the market.

With regard to market competition, the National Association of Realtors reports that the sources and structure of ADC funding have been stable since 1992 and include mainly commercial banks and, to a lesser extent, thrifts and community banks. For example, one survey reports that commercial banks and thrifts account for more than 90 percent of residential ADC lending, and that commercial banks alone account for more than 80 percent of such activity. There is no secondary market for most of these loans, which have traditionally been held in portfolio by lenders. Despite these facts, since the credit crunch of the early 1990s, there has been no evidence of any deficiency in the amount of capital available for ADC lending. This suggests that some competition to fund viable projects will continue to be evident but probably not to a greater extent than is already the case. Additional competition, however, could have the effect of reducing costs to builders and ultimately to homebuyers. Indeed, Fannie Mae states that a key objective for its ADC Program will be to produce secondary market efficiencies that ultimately reduce costs to potential home buyers. Conversely, competition could also encourage less restrictive underwriting and more risk-taking by lenders competing for ADC loans.

Some believe that Fannie Mae's ADC Pilot has enabled both large and small builders and developers to obtain funding from a broader range of funding sources, such as through leveraging with community banks or participation with pension or equity partnerships. In evaluating the degree to which Fannie Mae's continued involvement in ADC lending would impact competition, the Department reviewed comments from a number of large commercial banks, smaller community banks, state and local housing finance corporations, and nonprofit lenders engaged in affordable community development. Nearly all the commenters provided descriptions of recent transactions to support the view that permanent approval of the ADC program could improve the efficiency of the ADC market by providing new sources for liquidity, especially in the production of additional affordable housing units, and that permanent approval would likely be especially beneficial in expanding the ability of non-traditional lenders serving affordable markets to better leverage public dollars.

Accordingly, the Department finds that there is not a sufficient basis to determine that, with respect to the effects on market liquidity and competition, the program is "not in the public interest."

(b) <u>Effects on Market Stability</u>

Fannie Mae, along with the NAHB, among other organizations that commented on the program proposal, asserts that in the ADC Pilot, lenders prevented from lending to creditworthy home builders by the loans-to-one-borrower restrictions were able to provide ADC funding that they would otherwise not have been able to provide. Approval of the ADC Pilot was said to be a turning point in remedying the "credit crunch" of the early 1990s. One commenter stated that "capital market access for housing production credit would...avoid future severe disruptions to the home building industry and the economy..." Fannie Mae asserts that the statutory loans-to-

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one-borrower restrictions have imposed, and will continue to impose, a constraint on developers' access to credit which Fannie Mae can ameliorate.

However, the Department's research suggests that the loans-to-one-borrower restriction may not have impeded ADC lending to any appreciable extent. For example, in a 1994 study, Kevin Villani and Amy Bogdon found that the industry's response to the loans-to-one -borrower restriction was a shift toward syndication of credit risks through various channels and, potentially, a shift by middle-sized builders toward larger equity positions in their projects as intended by the legislation. They comment further that in the early 1990s, numerous sources of liquidity were available to home construction lenders, and they expressed an opinion that providing more would not have increased construction lending at that time.[13]

Another study on the post-FIRREA course of real estate and construction lending finds that although terms and availability of ADC financing tightened in 1989-1992, the decline in construction activity at that time can also be traced to overbuilding in the 1980s.[14] This period is distinguished from earlier periods (1973-74 and 1980-82) in which disintermediation by financial institutions, in the context of regulatory interest rate restrictions, was a factor affecting the supply of credit for ADC. Yet another study refers to the experience of the early 1990s as a "capital crunch" created by increased capital requirements on financial institutions.[15]

Despite this controversy regarding the events of the late 1980s and early 1990s, there is, nevertheless, support for the contention that cyclical periods of tight credit can bear upon small construction businesses in a way that affects aggregate construction. This conclusion is supported through analysis of housing starts relative to national trends in wage levels and interest rates from 1970 to 1994, which includes a variable to capture the effect of the enactment of FIRREA in 1989.[16] Given the regional and national variables that can influence the availability of financing for ADC loans, this suggests that there is some likelihood that approval of the ADC program on a permanent basis could enhance stability during times of tight credit.

Accordingly, the Department finds that there is not a sufficient basis to determine that, with respect to its effects on market stability, the program is "not in the public interest."

c) <u>Effects on Housing Affordability and Homeownership</u>

Fannie Mae has provided the Department with quarterly reports that describe performance under the ADC Pilot relative to housing affordability. Specifically, projects *for which affordability was reported* [i.e., reports received since 2000] included 5,924 units, of which all but 420 units were projected for occupancy at or below median income as follows:

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[13] "Construction Lending" in Report to Congress on the Federal Home Loan Bank System, U.S. Department of Housing and Urban Development, Office of Policy Development and Research, page 4-5 (1994).
[14] James T. Fergus and John L. Goodman, Jr., "The 1989-92 *Credit Crunch for Real Estate:* A Retrospective." Journal of the American Real Estate and Urban Economics Association, vol. 22, no. 1, pp. 5-32 (1994).
[15] Joe Peek and Eric S. Rosengren, "Bank Real Estate Lending and the New England Capital Crunch," Journal of the American Real Estate and Urban Economics Association, vol. 22, no. 1, pp. 33-58 (1994).
[16] Thomas Sai-Fan Chan, "Residential Construction and Credit Market Imperfection." Journal of Real Estate Finance and Economics, vol. 18, no. 1, pp. 125-139 (1999).

4,423 units in the 80.01-100 percent of median income range; 790 units at 60.01-80 percent of median income; and 291 units at 60 percent or less of median income.

The Department reviewed letters from 21 lenders attesting to the impact that Fannie Mae's ADC Pilot had had in their lending areas with respect to the construction of affordable housing units in urban revitalization areas, rural areas, and underserved markets that generally meet Community Reinvestment Act objectives. These accounts of the ADC Pilot's impact on financing construction and rehabilitation in distressed areas along with data provided to the Department by Fannie Mae suggest that Fannie Mae's continued focus on ADC lending that addresses housing affordability and first-time homeownership has had, and can be expected to continue to have, a beneficial effect on housing affordability. In its letter of June 18, 2003 requesting approval of the ADC program, Fannie Mae stated that the ADC Program's goals will be "to increase the supply of affordable housing, increase homeownership among minorities and bring innovative housing solutions to underserved areas." The Department expects that Fannie Mae will adhere to these goals going forward.

Accordingly, the Department finds that there is not a sufficient basis to determine that, with respect to its effects on housing affordability and homeownership, the program is "not in the public interest."

(d) <u>Risks Associated with ADC Lending</u>

Underwriting construction loans involves specialized risks associated with assessing and controlling risks that result from the construction process itself and from local conditions. These risks include:[17]

a. Collateral for the loan that includes unfinished or partially completed projects;

b. Unknown construction risks, such as unexpected increases in material costs, strikes, poor weather, and financial difficulties of subcontractors;

c. Intervening rights of third parties, such as mechanic's liens or claims for personal injury by construction workers;

d. Possible loss of permanent financing should the permanent lender fail to honor a commitment; and

e. Failure to comply with building codes which may result in a denial of the certificate of occupancy.

The major risk factor in ADC lending is that the value of the property (collateral) may not increase proportionally to the expenditures for construction during the construction period. Other risks include changes in the interest rate during the construction period and possible delays in construction. For ADC loans that carry a floating interest rate, a rise in the rate of interest

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[17] From Terrence M. Clauretie and G. Stacy Sirmans, Real Estate Finance: Theory and Practice, Upper Saddle River, NJ, Prentice Hall, Third Edition, p. 379, 384-386 (1999).

during construction will increase the developer's interest costs. Delays in construction can result in a larger balance due on the ADC loan at completion. In the event interest rates rise and delays occur, the amount due on the ADC loan may begin to approach or exceed the value of the property.

Office of Thrift Supervision (OTS) data, summarized in a release from the NAHB, demonstrates that default propensities are greater for ADC loans than for mortgage loans on occupied housing.[18] Specifically, the data show average net charge-off rates for OTS-supervised thrift institutions (outstanding loan balances) of 0.155% for 1-4 unit residential mortgage loans, but 0.283% for 1-4 unit residential construction loans, and 0.580% for land loans, in 1990-2002. Charge-off rates for 1-4 unit residential loans peaked at 0.42% in 1993 and have declined steadily since then, to 0.055% in 2002. In comparison, charge-off rates for 1-4 unit residential construction loans have risen and fallen, with a peak at 1.1% in 1991 and a 2002 rate of 0.138% or over double the rate for residential mortgage loans. These figures imply that volatility of construction loan default rates is a significant risk factor. Default rates were very high during the period of credit "crunch" in and around 1991.

The FDIC has reported that "ADC lending is a highly specialized field with inherent risks that must be managed and controlled to ensure that this activity remains profitable. Management's ability to identify, measure, monitor, and control portfolio risk through effective underwriting policies, systems, and internal controls is crucial to a sound ADC lending program."[19]

Villani and Bogdon, commenting early in the life of the Fannie Mae ADC Pilot, emphasized that potential risks to Fannie Mae are substantially greater than in their traditional secondary market activities. Therefore, Fannie Mae must exercise commensurately greater caution in underwriting these loans.

Fannie Mae has stated that the program presents no safety and soundness concerns. To supplement its analysis under this public interest standard, the Department requested that the Office of Federal Housing Enterprise Oversight (OFHEO) conduct a safety and soundness review of the ADC Pilot. In a memorandum provided to the Department by OFHEO dated August 8, 2003, OFHEO concluded that the ADC program is administered in a safe and sound manner as of the date of OFHEO's review and further observed that "the [Fannie Mae] personnel responsible for the program possess the requisite expertise to manage the Enterprise's associated credit risk exposures; and the internal control framework and risk management practices applied to the program are sound."

The Department notes, however, that this program presents greater risks than those associated with Fannie Mae's permanent financing purchase program and, therefore, requires substantial and diligent oversight to control for these risks. The recitation of risks presented above supports the importance of sound underwriting, including close scrutiny of the reputation of the developer, and ongoing monitoring so that corrective actions can be taken as soon as

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[18] "Acquisition, Development and Construction (AD&C) Loan Performance Data," Housing & Finance Policy Area, National Association of Home Builders, undated.
[19] "Acquisition, Development, and Construction Lending," October 8, 1998 (Financial Institution Letter 110-98).

possible when problems arise. For a national-level financial institution such as Fannie Mae, this further implies a need for sound quality control on the primary lender, who will have responsibility for on-site monitoring. While Fannie Mae's experience under the ADC Pilot has enabled Fannie Mae to gain relevant experience, and data available to the Department suggest that all loans have performed satisfactorily during the ADC Pilot, the Department expects that Fannie Mae will continue to exercise due diligence in its management of this program.

Accordingly, the Department finds that there is not a sufficient basis to determine that, with respect to risk associated with ADC lending and loan performance under the ADC Pilot, the program is "not in the public interest."

DETERMINATION

Having considered Fannie Mae's program request and relevant submissions in support thereof, the applicable authorizing law, and the public interest, the Department approves Fannie Mae's program to purchase mortgages or participation interests in mortgages for single-family residential acquisition, development, and construction loans (the ADC Program) without program cap limitations. This approval is in accordance with Fannie Mae's Charter requirements and, therefore, applies to a program of (1) secondary market transactions where the mortgage or mortgage participation purchase is secured by the real estate which is the subject of the project; (2) purchases of ADC mortgages or participations in mortgages for the acquisition, development and construction of residential dwelling units, and only such non-dwelling residential and commercial spaces that are necessary, required by zoning, or are minimal in the context of that portion of the project in which Fannie Mae will participate; and (3) the purchase of mortgages or participations in mortgages where Fannie Mae reasonably anticipates that all units will be offered at sales prices that would result in permanent mortgages within Fannie Mae's conforming loan limit. Before the ADC Program proceeds, Fannie Mae must develop guidelines that are consistent with the terms of this approval, Fannie Mae's Charter, and FHEFSSA, and submit these guidelines to the Department.

This approval covers only the ADC Program described herein. Any other investments or dealings in acquisition, development, and construction financing not expressly described would be outside the scope of this approval.