CONSUMER MORTGAGE COALITION

May 22, 2009

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

Re: 2009 Enterprise Transition Affordable Housing Goals
RIN 2590-AA25

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 (FHFA) proposed rulemaking regarding the 2009 transition affordable housing goals for the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac.

At the outset, we note our appreciation for your putting forth such a complex proposed rule, in an area of law that your predecessor, the Office of Federal Housing Enterprise Oversight, had not been involved, in such a short time.

I. Background of the 2009 Rulemaking

This rulemaking implements some of the many substantial amendments Congress made in the GSEs' affordable housing goals when it enacted the Housing and Economic Recovery Act of 2008 (HERA).[1] Among many other changes, HERA moved regulatory authority to implement and enforce the GSE affordable housing goals from the Department of Housing and Urban Development (HUD) to FHFA. In 2008, HUD had a regulation that set specific affordable housing goal requirements. Congress mandated a transition process from HUD to FHFA in which the HUD-set affordable housing goals that were in effect during 2008 would stay in effect during 2009. However, Congress required FHFA to review the goals applicable during 2009.

> The annual housing goals effective for 2008 pursuant to this subpart, as in effect before the enactment of [HERA], shall remain in effect for 2009, except that not later than the expiration of the 270-day period beginning

[1] Pub. L. No. 110-289, 122 Stat. 2654.

> on the date of the enactment of such Act, the Director shall review such goals applicable for 2009 to determine the feasibility of such goals given the market conditions current at such time and, after seeking public comment for a period not to exceed 30 days, may make appropriate adjustments consistent with such market conditions.[2]

FHFA must, by regulation, establish for 2010 and each year thereafter, annual housing goals pursuant to the new requirements in HERA.[3] That 2010 undertaking is not part of the present rulemaking. The current rulemaking, then, does not implement all the changes to the GSE affordable housing goals that HERA envisioned. It adjusts the 2008 goals to reflect 2009 market conditions.

Shortly after Congress enacted HERA, both GSEs were placed into conservatorship. The fact of their conservatorships has very substantially altered the GSEs' operations. Among other changes, the conservatorships provide to FHFA all rights and powers of each GSE, and of the stockholders, officers, and directors of each GSE, and the power to operate each GSE.[4] The Department of the Treasury acquired warrants to purchase 79.9% of the common stock of each GSE. The Department of Treasury has committed to maintain a positive net worth for each GSE, and has been funding that commitment. In essence, the GSEs operate as branches of the federal government.

In addition to amending the affordable housing goals, HERA required the GSEs, beginning in 2008, to set aside each year an amount equal to 4.2 basis points for each dollar of the unpaid principal balance of total new business purchases. These allocations were to go into an affordable housing trust fund and a capital magnet trust fund.[5] HERA requires the FHFA Director to suspend these allocations upon finding that the payment would contribute to a GSE's financial instability or would cause a GSE to be classified as undercapitalized.[6] In November 2008, FHFA suspended the requirement to set aside funds for trust funds until further notice because of the GSEs' current financial condition.

HERA also provided FHFA with authority to enforce the affordable housing goals. As written today, the affordable housing goals require each GSE to purchase specified categories of loans, measured as percentages of their loan purchases. The housing goals are designed as pass/fail goals, with which compliance is either complete or completely absent. Should the Director of FHFA preliminarily determine that a GSE has failed, or that there is a substantial probability that a GSE will fail a housing goal, the GSE is afforded an opportunity to be heard. The Director then must determine whether achieving a goal was feasible. Should the Director finally determine that a GSE has not achieved a goal that was feasible, the Director may require a GSE to submit an acceptable housing plan that describes specific actions the GSE will take to achieve the goal. If the GSE does not submit an acceptable plan, or if the GSE submits an acceptable plan but fails to comply with its plan, the Director may issue a cease and desist order or may

[2] HERA § 1128(a), 122 Stat. 2654, 2696 (to be codified at 12 U.S.C. § 1331(c)).
[3] HERA § 1128(a), 122 Stat. 2654, 2696 (to be codified at 12 U.S.C. § 1331(a)).
[4] HERA § 1145(a), 122 Stat. 2654, 2737 (to be codified at 12 U.S.C. § 1367(b)(2)).
[5] HERA § 1131(b), 122 Stat, 2654, 2711 (to be codified at 12 U.S.C. § 1337(a)).
[6] HERA § 1131(b), 122 Stat. 2654, 2712 (to be codified at 12 U.S.C. §§ 1337 (b)).

assess civil money penalties against the GSE. Any civil money penalties collected are paid into the same housing trust fund to which HERA had required the GSEs to make annual allocations of funds.[7]

In other words, should a GSE fail a feasible affordable housing goal during 2009, FHFA could issue a cease and desist order mandating compliance. Since FHFA operates the GSEs, that would amount to FHFA ordering itself to comply with the housing goals, an exercise without purpose. Alternatively or additionally, FHFA could assess a civil money penalty requiring a GSE to contribute funds to a housing trust fund. Since FHFA has determined the GSEs should not contribute to that fund because of their financial condition, this also is not a practical outcome.

Nevertheless, the rulemaking for the 2009 housing goals is still important because the affordable housing goals do affect the mortgage markets. As FHFA notes, "if the Enterprises purchased a substantial volume of a certain type of loan to meet the housing goals in 2008, lenders might be induced to originate more loans of that type in 2009."[8]

Since the GSEs' goals performance is determined on a calendar year basis and since it is already well into 2009, this rulemaking is limited in how it can change the goals for 2009. At the same time, FHFA can make some changes, and does propose to do so. We comment below on the proposal and suggest some additional changes that could readily be implemented mid-year and that would assist affordable housing in 2009. Primarily, we propose that the Community Reinvestment Act of 1977 (CRA) be given more prominence in the GSEs' affordable housing goals, as Congress mandated in 1992 and reiterated again in 2008 with HERA. This Congressional mandate is included, vaguely and without much effect, in HUD's affordable housing goals regulation, and FHFA proposes to retain that vague provision in 2009. We believe that Congress requires more, as we discuss below.

At this time, we do not know what the future of the GSEs will be after 2009. It is possible that they will return to a condition similar to their past, when they were privately owned corporations with a public mission. If this is the case, it will be important to carry into the future the CRA aspects of the affordable housing goals.

In that endeavor, you may find useful the attached comment letter that the CMC filed with HUD in 2004, during the most recent significant revision to the affordable housing goals. This letter and its attachments illustrate the ways in which the affordable housing goals do not support affordable housing as well as the CRA does. In crafting new housing goals, you may find this helpful in designing housing goals that meet affordable housing needs better than the current goals.

It is also possible that the GSEs will not return to their former state but will be fundamentally altered. The need for affordable housing will still remain, but depending

[7] HERA § 1130, 122 Stat. 2654, 2706 – 2711, sets out the Director's authorities for enforcing the affordable housing goals.
[8] 74 Fed. Reg. 20236, 20242 (May 1, 2009).

on how the entire mortgage finance system is redesigned, including the government's housing programs, the affordable housing responsibilities may be better placed elsewhere in a newly designed structure.

II. Support for Community Reinvestment Act

Banks and thrifts are subject to the Community Reinvestment Act of 1977. This law is somewhat similar to the GSE affordable housing goals in that both are aimed at spurring investment in lower-income or underserved areas. While the affordable housing goals were enacted at a different time than CRA was, Congress nevertheless intended that the affordable housing goals support the CRA. As Congress mandated in 1992 in § 1335 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act):

> [E]ach enterprise shall . . . take affirmative steps to . . . assist insured depository institutions to meet their obligations under the Community Reinvestment Act of 1977, which shall include developing appropriate and prudent underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures[.][9]

In 2008, Congress substantially repealed and rewrote the GSE affordable housing goals with HERA. Just as important as what Congress repealed and rewrote is what Congress *neither* repealed *nor* rewrote, namely the § 1335 language quoted above. The fact that Congress, in a major redesign of the affordable housing goals, elected to retain this provision reinforces the Congressional support for § 1335, in addition to the new structure for housing goals.

FHFA does propose to include § 1282.20 in its regulation:

> To meet the goals under this rule, each Enterprise shall operate in accordance with 12 U.S.C. 4565(b) [§ 1335(b)].

This is the same requirement HUD had in its affordable housing goals regulation.[10] It has never been effective because HUD allowed the GSEs to comply with their affordable housing goals without complying with § 1335. Through several rulemakings, HUD's regulation required the GSEs to "operate in accordance with" § 1335, and § 1335 requires the GSEs to assist banks and thrifts with their CRA obligations, but HUD never actually incorporated § 1335 into the housing goals. The GSEs have made a practice of avoiding CRA-related mortgage loans, and HUD deemed this to be permissible. We would encourage FHFA to implement this statutory mandate, even though HUD failed to do so.

We believe that because Congress mandates that the GSEs assist depositories in meeting their CRA obligations, the GSEs should assist depositories in meeting their CRA obligations.

[9] 12 U.S.C. § 4565(a)(3(B).
[10] 24 C.F.R. § 81.20.

One of the reasons the GSEs have avoided CRA-related loans is that the CRA is targeted at a lower-income sector of the population than are the GSE affordable housing goals.

Percent of Area Median Income
Below Which a Borrower Is a Member of a Targeted Population

Targeted Population	AHG	CRA
Low-income	80%	50%
Moderate-income	100%	80%

The CRA requires banks and thrifts nationwide to target mortgage lending to those with lower income levels than the affordable housing goals require of the GSEs. The GSEs are able to meet their housing goals without taking on the costs of CRA activities. Rather than purchasing all loans originated by CRA lenders, or rather than purchasing some percentage of CRA loan production without reference to borrower income, the GSEs are able to meet their affordable housing goals by purchasing only loans made at higher income levels. For example, a GSE can meet its low- and moderate-income housing goal by purchasing loans that finance housing for persons with 100% of area median income, and while avoiding loans that finance housing for persons with 80% of area median income. Unlike the GSEs, depository institutions subject to the CRA must make loans to applicants at or below 80% of the area median income as well as those at or below 50% of the area median income.

CRA lending is expensive. It often requires affirmative outreach to targeted populations, investment in new bricks-and-mortar facilities, innovative programs such as mobile lending centers and, in some cases, subsidizing the cost of consumer loans. Moreover, it requires a permanent commitment of personnel, capital, and managerial attention. We believe that because the GSEs have a public housing mission, and because they have a Congressional mandate to do so, they should be required to assist depositories in meeting their CRA obligations.

FHFA cannot rewrite the 2009 affordable housing goals in their entirety, but it can make some changes. We urge FHFA to implement § 1335 by giving the GSEs extra goals credit for loans that a GSE purchases for which the GSE has reasonable basis, such as originating lender's statement, to believe was originated for purposes of obtaining CRA credit.

Beyond 2009, if the GSEs return to their status as privately owned government-sponsored corporations with a public mission, they should be required to create and maintain a vibrant secondary market for CRA-eligible loans, newly originated as well as seasoned. In summary, their affordable housing goals should be aligned with the requirements under CRA. In this way, the GSEs would, at last, and for the first time, fully support and help increase CRA activities.

III. Support For Homeowner Affordability and Stability Plan

FHFA proposes to treat as loan purchases, for affordable housing goals purposes, GSE modifications of loans in accordance with the Homeowner Affordability and Stability Plan (HASP) if the GSE holds the loan or guarantees a security that the loan backs.[11] This would promote goals credit for such modifications.

We support this proposal because HASP loan modifications are an important part of affordable housing efforts today. We note that servicers have been aggressive in making modifications where possible. It is entirely appropriate that the GSEs receive goals credit for assisting in the HASP effort.

IV. Conclusion

We appreciate FHFA's efforts in pursuing a difficult but important rulemaking on an expedited basis. Although the calendar does not permit wholesale changes to the 2009 affordable housing goals, we do support the effort to do what is possible during 2009 to make the goals appropriate for current market conditions.

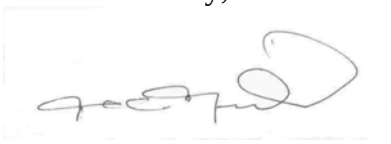
We believe it is important for the affordable housing goals to implement the Congressional mandate that the GSEs assist depositories in meeting their CRA obligations. Congress recently reiterated that mandate, but it has never been effective. Should the GSEs return to their prior status as privately owned corporations with a public mission, they should be required to maintain a secondary market for CRA-related loans, both newly originated and seasoned.

During 2009, it is appropriate for FHFA to count for affordable goals purposes HASP loan modifications of GSE loans as if they were loan purchases.

In the future, should the GSEs be transformed, an entirely new construct may be appropriate, but support for affordable housing should be maintained within a newly redesigned mortgage finance system.

Thank you.

Sincerely,



Anne C. Canfield
Executive Director

Attachment

[11] Proposed 12 C.F.R. § 1282.16(c)(10).

CONSUMER MORTGAGE COALITION

July 13, 2004

Regulations Division
Office of General Counsel
Room 10276
Department of Housing and Urban Development
451 Seventh Street, S.W.
Washington, D.C. 20410

RE: HUD's Proposed Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005-2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac
Docket No. FR-4790-P-01

Dear Sir or Madam:

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 U.S. Department of Housing and Urban Development's ("HUD") Notice of Proposed Rulemaking on May 3, 2004. 69 Fed. Reg. 24228-24493. We applaud HUD's intent to provide the government-sponsored enterprises (each, a "GSE") with effective affordable housing incentives, appropriate to the GSEs' charter mandates.

Like the General Accounting Office, the Federal Reserve Board, the Urban Institute and others, HUD has, once again, concluded that the GSEs continue to lag rather than lead the affordable housing market and that they have failed to utilize their taxpayer-provided subsidies in leading the market in serving targeted, underserved, and lower-income markets: "The GSEs generally have been less active in historically underserved markets where there is a need for additional sources of financing to address persistent housing and credit needs, and fully private companies, operating without the benefits of

GSE status, perform better in those markets."[1] As HUD states in the introduction to the proposed rule, "the GSEs need to increase their efforts further and demonstrate their capacity to be industry leaders."[2]

We note that HUD reiterates the four main principles that it defined for its monitoring role in previous rulemakings on this issue. These are –

1. To make the GSEs the leaders in the market (related to national housing goals);
2. To eliminate discrimination in lending;
3. To set parameters without dictating specific loan products or delivery mechanisms; and
4. To support an active secondary mortgage market in multifamily lending.

Even though HUD has been guided in three prior goal setting cycles by the principle that the GSEs should *lead* the market in service to key areas and populations, the proposed Affordable Housing Goals will still place the GSEs *behind* the market in key respects. We believe that our comprehensive proposal will achieve HUD's intended goals, and we urge HUD to adopt our proposal in lieu of the 2004 proposed rule. The CMC's comprehensive proposal will be more effective at ensuring that the GSEs at least *match* the market in meeting the nation's affordable housing needs, if not eventually move the GSEs to a position that would lead the market.

A number of studies, including those previously cited, have indicated that goals set under the Federal Housing Enterprises Financial Safety and Soundness Act ("the 1992 Act"), Pub. L. 102-550 (October 28, 1992), *codified* at 12 U.S.C. §§ 4501 *et. seq*., have not been met by the GSEs. Other studies have shown significant advancement by the private sector in increasing home financing in these markets and, specifically, to African-American and Hispanic homebuyers.

A principal reason for the private sector's superior track record in serving the nation's affordable housing needs is that banks and thrift institutions are required to meet their obligations under the Community Reinvestment Act of 1977 (CRA)[3]. CRA is an effective approach in ensuring that the housing finance needs of low- and moderate-income ("LMI") borrowers and underserved areas are met.

Among other benefits, as discussed below, CRA uses definitions that target more truly needy segments of the population than do the GSE goals and subgoals as they are now written:

[1] Federal Register, Vol. 69, No. 85, May 3, 2004, at p. 24231.
[2] *Ibid*.
[3] 12 U.S.C. §§ 2901, *et seq*.

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

Targeted Population Label	GSE Definition	CRA Definition
"Low-income"	80	50
"Moderate-income"	100	80

For clarity, this comment letter uses the term "low-and moderate-income ("LMI")" to refer to the CRA definitions. In other words, LMI borrowers and communities are those with less than 80 percent of area median income.

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 recognizes the importance of CRA in its mandate that the GSEs should, "take affirmative steps to…assist insured depository institutions to meet their obligations under the Community Reinvestment Act of 1977, which shall include developing appropriate and prudent underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures."[4]

Repeated studies have shown that the GSEs will serve the parts of the affordable housing market that are easiest and most profitable to serve rather than those parts that most need support from the GSEs and the subsidies that the government provides to them. Therefore, the CMC urges HUD to adjust its proposed rule in two fundamental ways. First, HUD should maintain the current Low- and Moderate-Income and Special Affordable Housing Goals at their 2004 levels and to redefine the Underserved Areas Goal to apply only to communities with incomes below 80 percent of the area median. This will remove the incentives for the GSEs to concentrate their affordable housing activities on borrowers up to 100 percent of the area median income (or 80 percent of the area median in the case of the Special Affordable Housing Goal) and communities up to 120 percent of the area median income.

Second, HUD should require the GSEs to provide improved secondary market support for CRA-eligible home-purchase mortgage loans in a manner comparable to the rest of the market, as we describe in the remainder of this comment letter.[5] The result will be that the GSEs will serve the underserved part of the affordable housing sector rather than the median- and above-median income borrowers and communities that the GSEs would serve under the proposed rule.

The CMC wishes to make the following points with respect to the proposed rule:

1. The final rule should include a new goal to implement Section 1335 of the 1992 Act that requires each GSE to purchase CRA-eligible loans. This would

[4] Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Title 13, Section 1335, "Other Requirements," codified at 42 U.S.C. Sec. 4565.
[5] "CRA-eligible" mortgage loans mean mortgage loans serving low- and moderate-income borrowers and communities that CRA lenders make under the definitions of the CRA in addition to those that non-CRA lenders make that also meet those same definitions.

be an express goal for the GSEs to purchase stated amounts, as described below, of CRA-eligible home-purchase mortgage loans with low-and moderate-income subgoals as follows: (1) loans to borrowers with incomes below 80 percent of the area median income, (2) loans to borrowers with incomes below 50 percent of the area median income, and (3) loans to borrowers who live in communities with incomes below 80 percent of the metropolitan area income. The goal and subgoals would be applied to each MSA and non-metropolitan area in proportion to the market for such loans.

The 1992 Act requires HUD to set goals by regulation, which include (1) low and moderate-income housing (hereafter called the Affordable Housing Goal, to avoid confusion with the LMI definitions), (2) special affordable housing, and (3) underserved areas. As an alternative to setting a separate CRA goal, the final rule could instead set home-purchase mortgage subgoals within each of these goals that require the GSEs to purchase stated percentages of LMI loans and loans in LMI census tracts (again, as LMI is defined by the CRA), as set forth below, of CRA-eligible mortgage loans to meet these goal requirements. As with the other subgoals in the proposed HUD rule, the GSEs would be allowed to count purchased CRA-compliant loans towards both the CRA goal and the CRA subgoals.

2. In setting the CRA Affordable Housing Goal and the CRA subgoals, HUD should use its general regulatory authority[6] to require the GSEs to develop appropriate underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures to assure that the benefits of GSE status, including the federal subsidies granted to the GSEs, flow through to the low- and moderate-income borrowers and underserved areas that are served by CRA mortgage lending.

   To discourage onerous business practices such as unreasonable recourse requirements, it is important that the GSEs not be given credit for purchasing CRA-eligible loans that they later require the lender to repurchase (for reasons other than fraud or other serious misconduct). HUD can make retrospective adjustments similar to the procedure set forth in subections 81.102(c) and 81.102(d) of the proposed rule.

3. Each of the GSE goals and subgoals for affordable housing should be discrete for the single family and multifamily sector. Setting a specific single-family subgoal is consistent with the President's and the nation's goals of expanding homeownership, particularly for low-and moderate-income families.[7]

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[6] Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Title 13, Section 1321, "Regulatory Authority," codified at 42 U.S.C. Sec. 4541.

[7] The discretion of the Secretary to separate single-family from multifamily counting of housing units is authorized by Section 1331(b) of the 1992 Act, codified at 12 U.S.C. 4561(b): "In establishing any goal under this subpart, the Secretary *may* take into consideration the number of housing units financed by any mortgage on multifamily housing purchased by an enterprise." (emphasis added). This discretionary

4. HUD should work with the federal bank and thrift regulators that have responsibility for overseeing compliance with CRA to establish the size of the market for CRA-eligible home-purchase mortgage loans and the appropriate percentage goals and subgoals that the GSEs should meet in each MSA and non-metropolitan area.

5. HUD's verification of GSE performance under the Affordable Housing Goals should include crosschecking GSE reports against available HMDA and CRA data, in addition to other sources, to determine the GSEs' performance vis-à-vis the non-GSE market in each MSA. In addition, HUD should work closely with the bank and thrift regulators to maximize the coordination between the GSEs' affordable housing requirements and the regulated entities' CRA requirements.

6. Consistent with HMDA, CRA, and the requirement that the GSEs lead the market, HUD should not count mortgages for the GSE Affordable Housing Goals if the mortgages lack borrower income information.

7. HUD should also include in the final rule a set of reforms further to enhance service of the GSEs to affordable housing:

    - Institute periodic HUD reports to Congress on GSE compliance with the Affordable Housing Goals
    - Institute a system of descriptive grades characterizing GSE compliance
    - Create and publicize standard reports, including HMDA-based reports, of HUD's analysis and verification of the GSEs' compliance with the affordable housing goals
    - Provide for interagency cooperation on verification of GSE data
    - Require jurisdictions applying for HUD grants to include in their consolidated plans a section on GSE performance under the Affordable Housing Goals in the context of local housing needs
    - Use automated underwriting guidelines to expand LMI homeownership opportunities, either by having the GSEs accept mortgages originated through automated underwriting systems developed by private enterprise or by opening GSE technology to public evaluation.
    - Require the GSEs to publish their loan purchase decision-making system assumptions, methodologies and outcomes
    - Establish a certification program for automated underwriting systems and require the GSEs to accept the results of any certified system
    - Conform GSE reporting requirements and definitions concerning qualifying activity to CRA definitions

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language would allow the Secretary, for example, to set within each housing goal a single-family subgoal that does not include multifamily units.

- Prohibit GSEs from meeting housing goals with activities that do not support community affordable housing needs
- Revise regulations regarding new programs to define "New Program" broadly and condition approval of new programs on compliance with the Affordable Housing Goals

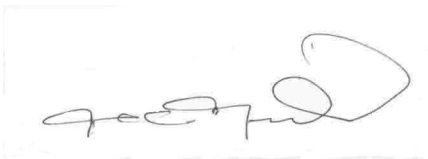
These recommendations are critically important to ensuring that the final rule achieves its intended goals. HUD should implement Section 1335 of the 1992 Act and focus on integrating the requirements of the CRA with those of the 1992 Act as a way to ensure that the GSEs are serving those most in need.

There are four attachments to this comment letter that describe in greater detail our comprehensive proposal and the analysis supporting our proposal:

1. CMC recommendations for creation of a new CRA Affordable Housing Goal, with subgoals, to help implement Section 1335 of the 1992 Act (Attachment A, page 7);
2. CMC recommendations for creation of new CRA Affordable Housing Subgoals for each of the three statutory Affordable Housing Goals to help implement Section 1335 of the 1992 Act (Attachment B, page 12);
3. CMC recommendations to improve the GSEs' service to affordable housing (Attachment C, page 15); and
4. A description of the structure of the Community Reinvestment Act and the comparison with the GSE Affordable Housing Goals. This information provides the basis for the recommendations concerning implementation of Section 1335 of the 1992 Act and the need for establishment of a CRA Affordable Housing goal and CRA Affordable Housing subgoals for the GSEs (Attachment D, page 24).

The CMC appreciates this opportunity to comment on HUD's proposed Affordable Housing Rule. We believe the time has come for HUD to finalize a rule that will assure that the efforts of the GSEs are directed to the underserved part of the affordable housing market and that the GSEs be required to at least match, if not eventually lead that market.

Sincerely,



Anne C. Canfield
Executive Director

Attachments

ATTACHMENT A

CREATING A NEW CRA AFFORDABLE HOUSING GOAL FOR THE GSEs TO ENSURE IMPLEMENTATION OF SECTION 1335 OF THE 1992 ACT[8]

The Community Reinvestment Act of 1977 requires depository institutions to serve their entire communities and authorizes federal regulators to examine the level of investment, lending and service that insured depository financial institutions provide to the communities in which they do business. Similarly, the 1992 Act requires the HUD to set affordable housing goals for Fannie Mae and Freddie Mac.

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

The GSEs trail their own customers in making credit available to borrowers who qualify under the current Special Affordable Housing Goal. Depository institutions that originate loans above 80% of the area median income do not receive lending credit under the CRA. In 2002, approximately 21.5% of the GSEs' conforming purchases were loans to CRA-eligible low- and moderate-income households, versus 23.4% for the market as a whole. The GSEs, however, led the market for lending to middle- and upper-income families.

Loans to CRA-Eligible Low- and Moderate-Income (LMI) Households in 2002

	Total Loans	Low %	Mod %	**LMI %**	Middle %	Upper %
Total Market	19,152,700	6.2%	17.2%	**23.4%**	23.6%	36.0%
Total FNMA & FHLMC	7,303,370	5.3%	16.2%	**21.5%**	24.7%	40.3%

The Congress took steps to correct this problem by requiring the GSEs to support the secondary market for CRA loans as a part of their responsibilities under the 1992 Act. Neither the current regulations nor the proposed rule, however, require the GSEs to meet their statutory responsibilities to "take affirmative steps to…assist insured depository institutions to meet their obligations under the Community Reinvestment Act of 1977, which shall include developing appropriate and prudent underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures."[9]

[8] Section 1335 is codified at 42 U.S.C. Sec. 4565.
[9] 42 U.S.C. Sec. 4565.

Indeed, HUD's regulatory analysis, which is quite thorough in other respects, essentially relegates discussion of the GSEs and CRA loans to the observation that:

> "One strategy for the GSEs to meet their housing goal and subgoal requirements is to increase their purchases of CRA-loans from the portfolios of banks and thrifts. As explained in Appendix A to this chapter, Fannie Mae, in particular, has purchased seasoned loans to increase its goal percentages…. The billions of dollars worth of CRA loans that will be originated, as well as the CRA loans being held in bank and thrift portfolios, offer both GSEs an opportunity to improve their performance in the single-family area."[10]

HUD made similar hopeful statements when it issued the 2000 Final Rule:

> "Given its enormous size, the CRA market segment provides an opportunity for Fannie Mae and Freddie Mac to expand their affordable lending programs. . . Fannie Mae is beginning to purchase these seasoned loans. . . . With billions of dollars worth of CRA loans in bank portfolios, the early experience of Fannie Mae suggests that this could not only be an important strategy for reaching the housing goals but could also provide needed liquidity for a market that is serving the needs of low-income and minority homeowners."[11]

Given the failure of the GSEs to respond to HUD's past hopeful statements, it is obvious that formal regulatory implementation is needed. The CMC requests that HUD implement Section 1335 of the 1992 Act by setting an express goal for the GSEs to purchase CRA-eligible home-purchase mortgage loans with subgoals as follows:

1. loans to borrowers with incomes below 80 percent of the area median income,
2. loans to borrowers with incomes below 50 percent of the area median income, and
3. loans to borrowers who live in communities with incomes below 80 percent of the metropolitan or non-metropolitan area median income.

In each of these categories the GSEs should be required to match the percent of newly originated loans made by the non-GSE market, plus an amount equal to five percent of the currently available seasoned CRA residential mortgage loans in each category. Purchases of newly originated loans should be of unseasoned loans that were originated within one year of their purchase by a GSE. The new CRA Affordable Housing Goal would be the aggregate volume of each of the subgoals, set as a percentage of the market for newly originated CRA-eligible loans plus five percent of all currently

[10] Regulatory Analysis, pp. IV-55, IV-57. See also 69 Fed. Reg., p. 24231 (GSEs have ample opportunities to expand their service to affordable housing, including expanding their penetration of the market for CRA-related loans).
[11] 65 Fed. Reg. 12632, 12640 (March 9, 2000).

available seasoned CRA residential mortgage loans. HUD should accompany the new CRA goal with an adjustment to the proposed rule to maintain the 2004 goal levels for the three statutory affordable housing goals, as described above, so that the GSEs focus their activities on the most important part of the affordable housing market.

HUD should work with the bank and thrift regulators to establish the size of the market for CRA-eligible home-purchase mortgage loans and the appropriate percentage goals and subgoals that the GSEs should meet in each MSA and non-metropolitan area. The HMDA data shows that banks and thrifts originated $179 billion of CRA home-purchase mortgage loans in 2002. As HUD notes in its regulatory analysis, GSE purchase of such loans will allow banks and thrifts to free up capital to make new CRA loans.[12] In addition, if the GSEs create a robust secondary market for these loans, non-bank and non-thrift mortgage lenders and originators will be encouraged to expand service to these markets.

The new Affordable Housing Goal for purchases of CRA-eligible loans should be structured to reflect the language of the 1992 Act with respect to, "developing appropriate and prudent underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures." In other words, to assure that the GSEs actually pass on their subsidy advantages to CRA-eligible borrowers, the Congress intended that the GSEs should adjust their pricing, fees, repurchase requirements, and business practices when they purchase CRA-eligible loans.

In carrying out its statutory responsibilities under Section 1335, HUD needs to monitor GSE compliance with the new CRA Affordable Housing Goal and focus on whether the GSEs are relaxing the terms and conditions on these loans in accordance with the charter act requirement that the GSEs serve the affordable housing by making less profit on such loans than they do in their other business activities. Typically, the GSEs impose very stringent terms and conditions on the lenders selling them affordable housing loans that protect the GSEs from incurring losses on these loans. The loan loss levels reported in the GSEs' financial statements reflect this reality. HUD also recognized this point in their regulatory analysis. These terms and conditions effectively require lenders to repurchase loans that go into default or foreclosure. This is unacceptable both under the GSE charters and the 1992 Act.

HUD should monitor the GSEs to ensure that they do not impose stringent business practices, repurchase requirements, or procedures on their purchases of CRA-eligible loans. For example, to discourage onerous business practices such as unreasonable recourse requirements, it is important that the GSEs not be given credit for purchasing CRA-eligible loans that the GSEs require a lender to repurchase. HUD can make retrospective adjustments similar to the procedure set forth in Section 81.102(c) of the proposed rule. This is completely consistent with the requirements of Section 1335 of the 1992 Act.

[12] Regulatory Analysis, p. IV-7.

Also, the new CRA loan purchase goal may involve a relaxation of the underwriting standards of the GSEs to the extent that this is needed to achieve the regulatory goal. This is also consistent with the requirements of the 1992 Act. HUD should include information about, "underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures,"[13] in its report on GSE compliance with the Affordable Housing Goals, which the CMC recommends below.

As HUD's regulatory analysis states, "…CRA-type lending to low-income families can be profitable, particularly when combined with intensive loss mitigation efforts to control credit risk."[14] The Federal Reserve has completed a survey that indicates that lenders report most CRA loans to be profitable, although not as profitable as the lenders' standard products.[15] This conforms closely to the GSE charter provisions that require the GSEs to "provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities)…"[16] There is little risk to GSE safety and soundness from increased purchases of CRA-eligible mortgage loans. To the extent that the GSEs' very low level of credit losses were to increase, OFHEO could compensate through application of the risk-based capital requirement to require the GSEs to reserve more capital as a cushion.

The CMC would urge HUD to apply the new CRA Affordable Housing Goal on the basis of individual MSAs and non-metropolitan areas. This would assure that the GSEs serve all parts of the CRA-eligible residential mortgage market, including the most underserved areas, and do not focus their activities on providing most of their credit in areas that are already relatively well served. For this reason, the CMC also supports HUD's proposed use of census tracts rather than counties for determining whether an area is underserved in counting towards the Underserved Area Affordable Housing Goal.

The new CRA Affordable Housing Goal should include two subgoals, one for single-family and the other for multifamily mortgages. Again the GSEs should be required to meet these subgoals by matching the percentage of such loans served by the non-GSE market.

HUD should administer the new CRA Affordable Housing Goal in a manner consistent with the other goals. That means that the GSEs would receive credit for their purchases of CRA-eligible loans and also could count these purchases, to the extent that the loans qualify, against the three other goals. As HUD's Regulatory Analysis states,

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[13] This is the language of Section 1335 of the 1992 Act.
[14] At p. IV-30.
[15] Board of Governors of the Federal Reserve System, *The Performance and Profitability of CRA-Related Lending*, Washington, DC, 2000.
[16] "Regulatory Analysis for the Secretary of HUD's Proposed Rule on HUD's Regulation of The Federal National Mortgage Association (Fannie Mae) and The Federal Home Loan Mortgage Corporation (Freddie Mac)," U.S. Department of Housing and Urban Development, Office of Policy Development and Research, April 2004, pp. I-1 – I-2.

the purchase of CRA-eligible loans provides a good opportunity for the GSEs to meet these other goals as well.

ATTACHMENT B

CREATING NEW CRA AFFORDABLE HOUSING SUBGOALS FOR THE GSEs TO ENSURE IMPLEMENTATION OF SECTION 1335 OF THE 1992 ACT

As an alternative to setting a new CRA Affordable Housing Goal, HUD should set subgoals for purchases of CRA-eligible home purchase mortgage loans within the three current goals: Affordable Housing, Special Affordable Housing, and Underserved Areas. The three CRA subgoals should be consistent numerically with the larger new CRA Affordable Housing Goal. They also should be consistent in that they require the GSEs to develop appropriate and prudent underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures in the manner explained above for the CRA Affordable Housing Goal.

HUD should maintain the current Affordable Housing and Special Affordable Housing Goals at their 2004 levels and redefine the Underserved Areas Goal to apply only to communities with incomes below 80 percent of the area median. This will remove the incentives for the GSEs to concentrate their affordable housing activities on borrowers up to 100 percent of the area median income (or 80 percent of the area median in the case of the Special Affordable Housing Goal) and communities up to 120 percent of the area median income. When coupled with the CRA subgoals recommended by the CMC, this adjustment will direct the GSEs to serve those parts of the affordable housing market that truly need support rather than the median and above-median borrowers and communities that the GSEs tend to serve under the current affordable housing framework.

Three Recommended CRA Subgoals

Statutory GSE Goals (1992 Act)	Applicable CRA Subgoal (Home-Purchase Mortgages)
Affordable Housing Goal	Borrowers below 80 percent of area median income
Special Affordable Housing Goal	Borrowers below 50 percent of area median income
Underserved Areas Goal	Communities below 80 percent of metropolitan or non-metropolitan area median income

The new subgoals would be applied on the basis of individual MSAs and non-metropolitan areas. Only home-purchase loans would count for the subgoals and the subgoals would each be separated into distinct single-family and multifamily categories. Again, in each of these categories the GSEs would be required to match the percent of

newly originated loans made by the non-GSE market, plus an amount equal to five percent of the currently available seasoned CRA residential mortgage loans in each category.

The addition of CRA subgoals will have a salutary effect on GSE support for affordable housing. To the extent that the GSEs purchase CRA-eligible loans, they will become more focused on the borrowers and communities that most need their support. Moreover, by purchasing CRA-eligible home-purchase loans, including both newly originated and seasoned loans, the GSEs will be directing their affordable housing efforts to the more underserved parts of the market. These subgoals are not draconian; they merely require the GSEs to match the rest of the market, perhaps eventually lead the affordable housing market.

While the statutory Affordable Housing Goal includes service to families up to the median income, the proposed new CRA subgoal we are proposing will assure that the GSEs serve families with incomes below 80 percent of the area median, and at least match, if not eventually lead the market in this regard. Similarly, the statutory Special Affordable Housing Goal includes service to families with incomes below 80 percent of the area median income and the proposed new CRA subgoal will assure that the GSEs will at least match the market in serving families with incomes below 50 percent of the area median.

The addition of a CRA subgoal to the Underserved Areas Goal will be especially salutary in directing the GSEs to serve families in genuinely underserved areas, i.e., those with incomes below 80 percent of the area median. The current definition of underserved areas as including a median income up to 120 percent of the median income of the metropolitan area, and a minority population of at least 30 percent, opens the door to counting GSE activities that in fact do not serve borrowers who need special support through the Affordable Housing Goals.

This becomes clear when the GSE's performance is reviewed. Using the CRA regulations' definition for Low- and Moderate-Income (LMI) communities, the 2002 HMDA data shows that only 9% of Fannie Mae and Freddie Mac total HMDA-reportable purchases of loans with principal amounts of $300,000 or less, combined, consisted of loans for properties in LMI census tracts versus nearly 12% for the market as a whole.

Loans in CRA-Eligible Low- and Moderate-Income (LMI) Census Tracts in 2002

	Total Loans	Low %	Mod %	**LMI %**	Middle %	Upper %
Total Market	19,152,700	1.3%	10.4%	**11.7%**	53.1%	33.7%
Total FNMA & FHLMC	7,303,370	0.9%	8.1%	**9.0%**	51.8%	38.1%

Therefore, HUD should either (1) modify the Underserved Area Goal to be defined as census tracts where the median income is less than 80% of the area median income, or (2) create the proposed Underserved Areas CRA subgoal for census tracts where the median income is less than 80% of the area median income.

Again, the CMC urges HUD to monitor GSE compliance with the new CRA subgoals and to focus in particular on whether the GSEs are discounting their pricing and fees in accordance with the charter act requirement that the GSEs serve affordable housing by making less profit on such loans than they do in their other business. To assure that the GSEs do not simply recoup their pricing discounts by changing their terms and conditions, HUD also should monitor the GSEs to ensure that they do not impose more stringent business practices, repurchase requirements, or procedures on their purchases of CRA-eligible loans than they impose with respect to their purchases of prime mortgages. Also, the new CRA loan purchase goal may involve a relaxation of the underwriting standards of the GSEs to the extent that this is needed to achieve the regulatory goal. All of this is consistent with the requirements of the 1992 Act. Again, HUD should include information about, "underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures," in its report on GSE compliance with the Affordable Housing Goals.

ATTACHMENT C

MAKING ADDITIONAL IMPROVEMENTS TO THE REGULATORY FRAMEWORK

The CRA is effective because it targets populations that are defined more narrowly than those of the Affordable Housing Goals, focuses the attention of the public as well as regulators on the activities of depository institutions, and imposes direct negative consequences upon those depository institutions for failing to meet their CRA responsibilities. The 1992 Act would be made more effective if the Affordable Housing Goals' target populations were defined more narrowly, public attention were focused on the activities of the GSEs, and it were made clear to the GSEs and to third parties that not meeting the goals would have a direct negative effect upon the GSEs' business. Specific changes along these lines could reduce the gap between the 1992 Act and the CRA in terms of effectiveness, and thereby help the GSEs to at least to match, if not lead the market.

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

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

1. Institute Periodic HUD Reports to Congress on GSE Compliance with Its Affordable Housing Goals

The 1992 Act contemplates that HUD will receive and evaluate interim information in order to determine whether "there is a substantial probability that an enterprise will fail...to meet [a] housing goal[.]"[17] HUD has already determined that the 1992 Act empowers it to receive specified information regularly from the GSEs concerning their compliance with the Affordable Housing Goals.[18] The 1992 Act requires HUD to notify Congress of "each determination that an enterprise has failed, or that there is a substantial probability that the enterprise will fail, to meet a housing goal [together with] the reasons for each such determination."[19] Taken together, these provisions strongly suggest that HUD is empowered to notify Congress of interim progress by the GSEs in attaining their Affordable Housing Goals, perhaps at regular intervals such as quarterly or semi-annually. While HUD already includes information concerning GSE performance with reference to the housing goals in communications to Congress, it would appear that HUD has the authority to communicate such information

[17] 12 U.S.C. § 4566(b)(1).
[18] *See* 24 C.F.R. § 81.61 *et seq*.
[19] 12 U.S.C. § 4566(b)(3)(C).

in a more focused fashion through GSE-specific reports. It does not appear that HUD would need to make any changes in its regulations in order to initiate such a policy.

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

2. Institute a System of Descriptive Grades Characterizing GSE Compliance

HUD currently evaluates the GSEs' performance with respect to housing goals on a pass/fail basis. By contrast, the CRA requires regulators to grade the performance of the depository institutions on a scale with four categories of descending compliance: "outstanding," "satisfactory," "needs to improve," or "substantial noncompliance."[20] As the 1992 Act contains no statutory prohibition on HUD providing characterizations of GSE compliance with the Affordable Housing Goals, there would be no need for HUD to promulgate new regulations in order to begin using categories modeled on these CRA categories to evaluate GSE performance. HUD has considered implementing a system for evaluating GSE performance under which compliance with the Affordable Housing Goals without additional efforts would not earn a GSE the highest possible commendation from HUD. Our proposed evaluation system described would not be significantly different from HUD's contemplated system, except that it would use the immediately recognizable CRA categories. A "satisfactory" rating would mean that the GSE has at least matched the rest of the mortgage market in affordable lending.

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

3. Create And Publicize Standard Reports, Including HMDA-Based Reports, of HUD's Analysis and Verification of the GSEs' Compliance With the Affordable Housing Goals

HUD is already required by law to "make available to the public, in forms useful to the public (including forms accessible by computers)" the raw data submitted by the GSEs, concerning which mortgage loans they purchase fall into which housing goals

[20] 12 U.S.C. § 2906(b)(2); 12 C.F.R. Appendix A to Parts 25, 228, 345, 563e.

categories.[21] Publication of information obtained under the 1992 Act is subject only to the rule that "certain information shall be treated as proprietary information and not subject to disclosure," pursuant to HUD regulations defining what information is proprietary to the GSEs.[22] Currently, HUD makes raw data, HUD working papers and the GSE Annual Housing Activity Reports available to the public. HUD does not, however, issue a standard, consolidated report that is comparable to the CRA reports regarding the performance of depository institutions. Such reports provide a standard overview of an institution's CRA performance that makes it possible for interested parties to compare an institution's historical performance and compare its performance with that of other institutions. If HUD were to use a similar standardized format, then interested parties could easily compare the performance of Fannie Mae versus Freddie Mac (and vice versa) as well as evaluate the performance of both GSEs over time. This policy change would improve public understanding of the GSEs' compliance with the housing goals.

HUD should rely on the already available HMDA data to assist in the evaluation of GSE performance under the Affordable Housing Goals. Virtually every lender that sells loans to Fannie Mae or Freddie Mac reports HMDA data annually. That data already includes the purchaser information. Although there are excellent reasons why the GSE's would purchase seasoned loans, and while purchasing of such loans does provide liquidity to lenders who have taken risks, comparing GSE self-reported performance to publicly available HMDA data would help to improve transparency. Today there is no way to distinguish between a GSE that has made significant product enhancements to help reach previously underserved communities, and one that simply buys loans, at par, off the shelf of lenders in order to meet their goals. Comparison of HMDA data with self-reported GSE performance would illuminate these issues.

4. Provide For Interagency Cooperation on Verification of GSE Data

HUD currently has primary responsibility for establishing and enforcing the GSE housing goals, despite the fact that the 1992 Act, which created those goals, also created a new agency, the Office of Federal Housing Enterprise Oversight ("OFHEO"), specifically to ensure that the GSEs operate safely.[23] HUD's regulations provide that it may "independently verify the accuracy and completeness of the data, information, and reports provided by each GSE, including conducting on-site verification."[24] HUD should use this authority to conduct on-site verifications, potentially in conjunction with OFHEO's regular examination of the GSEs. HUD housing goals examiners could, for

[21] 12 U.S.C. 4543(a); *see also* 24 C.F.R. Part 81 Subpart F. In the preamble to the 1995 regulations, HUD notes the importance of this data by saying that "Congress indicated its intent that the GSE public-use database supplement HMDA." 60 Fed. Reg. 61845, 61875 (1995).

[22] 12 U.S.C. § 4546(a).
[23] 12 U.S.C. § 4513.
[24] 24 C.F.R. §81.102.

example, make arrangements with OFHEO examiners to conduct a parallel examination, pursuant to HUD's authority to obtain information concerning the GSEs generally.[25]

Alternatively, HUD could delegate to OFHEO the task of training and conducting verifications of compliance with housing goals, or make arrangements with the Fed, FDIC, OCC or OTS to detail some of those agencies' CRA examiners to HUD to conduct verifications, looking into GSE activities under HUD's authority. The federal bank examiners have extensive experience scrutinizing financial institution affordable housing programs, and their input and views on the GSEs' progress in meeting their goals could provide useful additional information.

5. Require Jurisdictions Applying For HUD Grants to Include in Their Consolidated Plans a Section on GSE Performance under the Affordable Housing Goals in the Context of Local Housing Needs

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

For example, the Community Development Block Grants ("CDBG") program, which HUD administers, could be adapted to give local community, civic and government leaders the opportunity to comment on GSE activity in their area. To receive annual CDBG funds and other grants, eligible communities and states must have an approved Consolidated Plan detailing, among other things, community housing needs and the non-governmental resources already available to meet those needs.[26] HUD regulations require that jurisdictions preparing Consolidated Plans provide for and encourage citizens to participate in the development of the consolidated plan, any substantial amendments to the Consolidated Plan, and the Performance Report. These requirements are designed especially to encourage participation by low- and moderate-income persons and residents of low- and moderate-income neighborhoods. Before a jurisdiction adopts a Consolidated Plan, the jurisdiction must make available information concerning the plan to citizens, public agencies, and other interested parties.

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

Consistent with this regulatory authority, in accumulating housing data, a jurisdiction could be required to seek input from financial institutions lending within the

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[25] *See* 42 U.S.C. §§ 1723a (Fannie Mae), 1456 (Freddie Mac), or specifically under the 1992 Act, 12 U.S.C. § 4567.

[26] *See* 24 C.F.R. Part 91.

jurisdiction's low- and moderate-income neighborhoods and to low- and moderate-income persons living in the jurisdiction. Specifically, it could be required to seek from such institutions information on projected GSE activity in the jurisdiction and the impact of such projected activity on lending to low- and moderate- income persons and in low- and moderate-income areas.

Support for this proposition can be found in two areas of the preamble to the 1995 regulations. First, Freddie Mac expressed concern that HUD had failed to establish a link between identified housing needs and the housing goals.[27] This proposal addresses that concern, and as under CRA, provides the HUD regulator with a means of evaluating GSE performance based on the context of local need. Second, HUD specifically mentioned CDBG programs as a model for conducting a neighborhood-based approach to reinvestment efforts.[28] While the preamble to the 1995 regulations indicated that the GSEs were free to coordinate with localities, HUD may want to go further by actually facilitating this coordination through use of the Consolidated Plan structure that is already in place.

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

Six Reforms That HUD Could Implement Through Improvements to the Proposed Rule

6. Require the GSEs to Publish Their Loan Purchase Decision-Making System Assumptions, Methodologies and Outcomes

The GSEs have come to rely heavily on their automated underwriting programs in making decisions about which mortgage loans to purchase. Even with the additional information that the GSEs have begun to disclose, these systems remain black boxes, which make it difficult to discern whether an applicant's loan will be purchased by the GSE, and if not, why not. Furthermore, the black boxes were designed using existing GSE customer bases for validation. Since the GSEs have trailed the market in funding loans to previously underserved communities, the artificial intelligence systems perpetuate the trend. As with the mismatch of GSE standards to CRA standards, this gives the GSEs a way to select the least risky loans. This adverse selection leaves the more risky loans in the portfolios of other affordable housing lenders, primarily depository institutions that are left without a robust secondary market for many loans.

Also, lenders, community groups and government agencies have no comprehensive way to understand the decision-making process. The secrecy of the automated underwriting process reduces the ability of lenders or non-profit groups to

[27] 60 Fed. Reg. 61845, 61850 (1995).
[28] *Id.* at 61856.

counsel applicants as to what actions they can take to become eligible for the lower mortgage rates associated with loans purchased by the GSEs. Buying a home is a mysterious process for most consumers. These black boxes add yet another level of unnecessary secrecy to an already complex process. Consumers considering a loan should know why they are not eligible for the lower rates available from GSE-purchased financing and what they can do to become eligible. That is, just because an applicant is rejected by the automated underwriting system does not mean that the applicant is not creditworthy.

Requiring the GSEs to open up their automated underwriting systems could help to de-mystify this process. Doing so could help to implement the requirements of Section 1335 of the 1992 Act by supporting CRA lending through changes in the GSEs' business practices, and would reduce the perception that the GSEs are burdening depository institutions by buying the least risky affordable housing loan products. It could thereby create a broader based secondary market for CRA and other affordable housing loans and assist in counseling applicants into better loan products.

7. Establish a Certification Program for Automated Underwriting Systems and Require the GSEs to Accept the Results of Any Certified System

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

According to HUD, the GSEs' monopoly on automated underwriting systems may be a significant factor in the comparatively high mortgage loan denial rates for racial minorities. In the 2000 Final Rule, HUD concluded that the GSEs' automated underwriting systems have a disparate impact on minorities based on two studies.[29] First, a study conducted by the Board of Governors of the Federal Reserve System found a significant statistical relationship between credit history scores and the minority composition of an area. Second, a study by the Urban Institute found that minorities were more likely than whites to fail the GSEs' single-family underwriting guidelines. From these observations, HUD concluded that "the question whether mortgage credit scoring models raise any problems of legal discrimination based on disparate effects would hinge on a business necessity analysis and analysis of whether any alternate underwriting procedures with less adverse disproportionate effect exist."[30] Given this

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

[30] Id.

analysis, it seems imperative that the use of alternative automated underwriting systems be explored.

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

8. Conform GSE Reporting Requirements and Definitions Concerning Qualifying Activity to CRA Definitions

The 1992 Act requires HUD to set Affordable Housing Goals with relation to "low-income" or "low- and moderate-income" families.[31] The federal agencies administering the CRA have defined "low-income" to mean "less than 50 percent of area median income."[32] They have imposed CRA lending requirements upon insured depository institutions on that basis. Pursuant to statutory requirements, however, HUD defines "low-income" for purposes of the GSE housing goals to mean "income not in excess of 80 percent of area median income,"[33] and has set those goals accordingly. As a result, there is a distinct mismatch between the loans that must be made by depository institutions and those that should be purchased by the GSEs.

The GSEs have a statutory duty to "take affirmative steps to...assist insured depository institutions to meet their obligations under the Community Reinvestment Act of 1977[.]"[34] In order to resolve the apparent tension between these two statutory requirements, HUD should change its GSE housing goals regulations by requiring the GSEs to *report* "low-income" loans in two categories, "low-income" and "very low-income," with the definitions conforming to the CRA definitions. The GSEs should be required to report their purchases of low- and moderate-income mortgages (as defined by CRA) for each low- and moderate-income census tract. Although merely reporting such purchases would not be the same as actually having an obligation to make such purchases in specified quantities, these reporting requirements would allow HUD to monitor the GSEs' efforts to assist depository institutions in meeting their CRA obligations.

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[31] *See* 12 U.S.C. §§ 4562(a), 4563(a).
[32] *See* 12 C.F.R. §§ 25.12(n)(1), 228.12(n)(1), 345.12(n)(1), 563e.12(m)(1).
[33] 24 C.F.R. § 81.17(b)(1)
[34] 12 U.S.C. § 4566(3)(B).

9. Prohibit GSEs From Meeting Housing Goals with Activities That Do Not Support Community Affordable Housing Needs

The GSEs currently can meet their housing goals by a variety of activities that do not support affordable housing in any practical way. These include such activities as purchasing "AAA"-rated REMIC tranches and mortgage revenue bonds issued by states and municipalities.[35] These activities are extraneous to the GSEs' core purpose of providing liquidity in the purchase-money mortgage market. Moreover, GSE purchase of AAA-rated REMIC tranches, mortgage revenue bonds, and other such activities does nothing to help create affordable housing that would not be done if the GSEs did not purchase those mortgages or bonds. Allowing these activities to qualify as meeting the housing goals thus simultaneously diverts the GSEs from their core purpose and diverts them from using their special powers to help achieve the policy intent underlying the housing goals. HUD could easily remedy this problem and should do so by prohibiting the counting of such activities towards meeting the housing goals.

10. Revise Regulations Regarding New Programs to Define "New Program" Broadly and Condition Approval of New Programs on Compliance with Affordable Housing Goals

Unlike the federal banking regulators, HUD is rarely in the position of being approached by the GSEs to approve an application. The only time that the GSEs must request HUD approval is when they implement new programs.[36] The statutory definition of "new program" encompasses "any program...significantly different" from any program existing as of October 28, 1992.[37] In the absence of clear regulations delineating what constitutes a "significant" difference, the GSEs could conclude that no program was really a new program and thus that no application was necessary. HUD has not yet produced clear regulations, stating only that "[s]ubmission of a program request is not required where the program that the GSE proposes to implement is not significantly different from (1) a program that has already been approved in writing by the Secretary; or (2) a program that was engaged in by the GSE prior to October 28, 1992[38] In response, the GSEs have made few applications, contending that they are not instituting new programs because nothing is "significantly" different from what went before. This failure of the GSEs to make applications, and HUD's neglect of this important part of the 1992 Act, prevents HUD from being able to do with the new program applications what the federal banking regulators have done with applications for regulatory permission by depository institutions: use these applications as opportunities to press their regulated institutions on complying with housing goals.

HUD could reassert its authority to approve new GSE programs and thereby give teeth to the Affordable Housing Goals. It would need to revise its new program regulations in two ways. First, it would need to specify what constitutes a "significant"

[35] 24 C.F.R. § 81.16(c)(7), (8).
[36] 12 U.S.C. §§ 1717(b)(6) (Fannie), 1454(c) (Freddie).
[37] 12 U.S.C. § 4502(13).
[38] 24 C.F.R. § 81.52(a).

difference from existing programs, either in terms of budget, personnel, revenues, profits, losses, all of the above, or some other criteria. Second, it would need to specify that progress in achieving Affordable Housing Goals would be taken into account in approving applications to engage in new programs.

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

11. Verify and Enforce GSE Data Integrity

The CMC supports HUD's current efforts, in Section 81.102 of the proposed rule, to strengthen its regulatory oversight to ensure that the GSEs submit data, information, and reports in a manner that is accurate and fully complies with HUD's Housing Goal regulations. HUD needs to make these changes to improve the department's regulatory oversight of Fannie Mae and Freddie Mac with regard to submission by Fannie Mae and Freddie Mac of data needed to calculate Housing Goals performance. The CMC supports HUD's reassertion of its authority to verify independently the accuracy and completeness of data, information and reports submitted by the GSEs. The department is also asking that the GSEs certify that their Annual Housing Activities Report (AHAR) is "current, complete and does not contain any untrue statement of material fact." HUD is also proposing to change its regulations regarding adjustments to correct current year-end errors, omissions or discrepancies as well as to correct prior year reporting errors. Finally, HUD will make clear that if a GSE's reports are "incomplete, not current, or contain an untrue statement of material fact," HUD will consider that "as equivalent to failing to submit such data, information or reports," in response to which HUD may bring an enforcement action, including issuing a cease and desist order or levying civil money penalties. The CMC supports HUD's efforts in this regard and the proposed new section of the rule.

ATTACHMENT D

COMPARATIVE ANALYSIS OF THE COMMUNITY REINVESTMENT ACT AND THE GSE AFFORDABLE HOUSING GOALS

This analysis compares the CRA and the Affordable Housing Goals in five years:

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

I. Legislative Purpose and Obligations

The 1992 Act imposes three express statutory housing goals on the GSEs: The Low- and Moderate-Income Housing Goal, the Special Affordable Housing Goal, and the Central Cities, Rural Areas, and Other Underserved Areas Goals collectively ("Underserved Areas Goals').[39] The statutory requirement is implemented by regulations promulgated by HUD, which has ultimate responsibility for implementing the 1992 Act.

The similarities between the purpose of the Affordable Housing Goals and the CRA are not surprising, given the common historical roots of both federal deposit insurance and the government-sponsored mortgage liquidity mechanism in the aftermath of the Great Depression. In addition, the GSEs' Affordable Housing Goals were specifically designed to assist depository institutions in meeting their CRA goals.[40] Given these purposes, the GSEs should be expected to at least match, if not lead, the market for affordable housing finance.

A. Insured Depository Institutions Have Obligations Under the CRA Because of the De Minimus Benefits They Receive From Federal Deposit Insurance

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

[39] *See* 12 U.S.C. §§ 4561 *et seq.*
[40] 12 U.S.C. § 4565(3) (B).

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

The CRA states that "regulated financial institutions have continuing and affirmative obligations to help meet the credit needs of local communities in which they are chartered.[41] Since a "regulated financial institution" is "an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act)[,]"[42] and because all national banks most state banks and thrifts are insured, the CRA applies to most depository institutions in the United States, except for credit unions and bankers' banks. As implemented by regulations promulgated by each type of depository institution's federal regulator, the CRA sets criteria for evaluating each institution's lending, investments, and services to low- and moderate-income communities in the institutions' assessment areas.[43]

A depository institution's federal regulator will conduct periodic examinations of the institution's activities in low- and moderate-income neighborhoods within its assessment area, in most cases every two years. If the regulator finds that a financial institution is not serving these neighborhoods, it can delay or deny that institution's regulatory applications, including applications to merge with another lender or open a branch. [44]

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

Congress created the GSEs to provide liquidity to the residential mortgage market. The older of the two, Fannie Mae, like federal deposit insurance, arose out of New Deal experimentation in government-sponsored intervention to remedy socially

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[41] 12 U.S.C. § 2901(a)(3).
[42] 12 U.S.C. § 2903(2).
[43] These regulations are (1) the Office of the Comptroller of the Currency ("OCC") for national banks, 12 C.F.R. Part 25; (2) the Board of Governors of the Federal Reserve System ("Fed") for all bank holding companies, as well as state-chartered Federal Reserve System member banks, 12 C.F.R. Part 228; (3) the Federal Deposit Insurance Corporation ("FDIC") for state-chartered non-member banks, 12 C.F.R. Part 345; and (4) the Office of Thrift Supervision ("OTS") for federal and state-chartered thrifts, as well as all thrift holding companies, 12 C.F.R. Part 563e. The regulations are practically identical and have been cited in a series throughout this analysis.
[44] 12 C.F.R. § 25.29©, 228.29©, 345.29©, 563e.29©.

destructive market failures in the financial services industry. Congress chartered Fannie Mae in 1938 as a government-owned association to buy, hold and securitize for sale on the secondary market mortgages insured by the Federal Housing Administration.[45] In 1968, Congress reorganized Fannie Mae as a government-sponsored, privately owned corporation with the power to buy, hold and securitize mortgages. In 1970, the Congress expanded Fannie Mae's powers to allow the corporation to deal in mortgages, whether or not insured by the Federal Housing Administration, whose initial balances do not exceed an amount that has come to be known as the "conforming" limit.[46] Freddie Mac, modeled after Fannie Mae, was intended as the secondary market liquidity mechanism for the Federal Home Loan Bank System when it was chartered in 1970.[47] In 1989, Congress reorganized Freddie Mac as a government-sponsored, privately owned corporation like Fannie Mae, with a similar governance structure.[48]

1. The GSEs Have Obligations under the Affordable Housing Goals Because of the Valuable Government Benefits They Receive

One of the reasons to impose housing goals upon the GSEs parallels the underlying rationale of the CRA: the GSEs have derived tangible private benefits from various rights extended to them by the public, and the "benefits of the federal charters enjoyed by the enterprises place certain obligations on the enterprises.[49] Some of the most important benefits Fannie Mae and Freddie Mac receive are:

- Each GSE can borrow up to $2.25 billion directly from the Treasury, subject to Treasury approval.[50] There are no statutory conditions on Treasury approval of direct borrowing by the GSEs, unlike the statutory limits on the ability of Treasury to declare an FDIC-insured depository institution "too big to fail."[51]

- Securities issued or backed by each GSE are exempt from SEC registration or other regulation.[52] As a result, the GSEs save significant regulatory compliance costs and registration fees.

- Each GSE is exempt from state and local taxation, except for real estate taxes.[53] As a result, the GSEs save considerable amounts that would otherwise be

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[45] Federal National Mortgage Association Charter Act, 12 U.S.C. § 1716 *et seq.*
[46] 12 U.S.C. § 1717(b) (1) (2).
[47] Federal Home Loan Mortgage Corporation Act, 12 U.S.C. § 1451 *et seq.*; *see* GAO Study at 2.
[48] 12 U.S.C. §§ 1452(a) (1), 1454(a) (1).
[49] H. Rep. 102-206 at 28 (1992)
[50] 12 U.S.C. §§ 1719(c) (Fannie), 1455(c) (Freddie).
[51] *See* 12 U.S.C. §§ 1823(c)(4)(A), 347b. At least in part as a result of this authority, financial markets regard GSE-issued or GSE-backed securities as implicitly guaranteed by the federal government. It is widely believed that this perceived implicit guarantee permits the GSEs to borrow at advantageous rates. *See* Richard Carnell, "Seeking Safety in Numbers: Characterizing Federally Insured Depository Institutions as Government-Sponsored Enterprises" (American Enterprise Institute Conference Paper, Sept. 8, 1999).

[52] 12 U.S.C. §§ 1719(d) (Fannie), 1456(g) (Freddie).

distributed to states and localities throughout the United States. The benefits of this exemption are growing as the GSEs seek to consolidate fully private and taxable lines of business into their two organizations.

- The GSEs may conduct business in any state or territory without the need to comply with any filing, licensing, or other business laws.[54]

- Debt securities and mortgage-backed securities issued by the GSEs receive almost the same preferential investment status as Treasury debt. Those securities can be used in many ways in lieu of U.S. Government Securities, for example as eligible collateral for advances from the Federal Reserve Banks and Federal Home Loan Banks[55]; for open-market purchase by the Federal Reserve Banks[56]; and for collateralizing public deposits.[57]

- GSE debt securities and mortgage-backed securities receive more favorable risk weights than other mortgage loan assets for the purpose of calculating risk-based capital requirements for insured depository institutions.[58]

- The GSEs are permitted to issue and transfer securities through the Federal Reserve's electronic book-entry system.[59]

- The GSEs can issue callable long-term debt, subject to approval by the Treasury. This ability, combined with the implicit federal guarantee of the GSE debt, provides the GSEs with unique financial flexibility.[60]

- The GSEs have lower capital requirements than other financial institutions. As a result, the GSEs can maximize the use of leverage.[61]

- The GSEs have unique charters. As a result, Fannie and Freddie have no effective competition other than each other, and their duopoly is virtually guaranteed.

The Congressional Budget Office has estimated that the various benefits received by the GSEs cost the government and taxpayers approximately $23 billion in 2003 alone.[62] Of this amount, approximately one-third is retained by the GSEs for their own use.[63] By any measure, this is a very substantial benefit and Congress has determined

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[53] 12 U.S.C. §§ 1723a(c)(2) (Fannie), 1452(e) (Freddie).
[54] 12 U.S.C. §§ 1723a(a) (Fannie), 1456(a) (Freddie).
[55] 12 U.S.C. §§ 347 (Fannie), 1430(a)(2) (Freddie).
[56] 12 U.S.C. §§ 355(2).
[57] 12 U.S.C. §§ 1723c, (Fannie), 1452(g) (Freddie).
[58] *See, e.g.*, 12 C.F.R. Part 3, Appendix A(a)(2)(vii) (OCC regulations).
[59] 12 U.S.C. §§ 1723a(g) (Fannie), 1452(d) (Freddie).
[60] 12 U.S.C. §§ 1719(e) (Fannie), 1455(j) (Freddie).
[61] *See* Capitol Financial Insights, "Competitive Threat of Government Sponsored Enterprises," Table E-1 (Jan. 16, 1998),.
[62] Congressional Budget Office, *Updated Estimates of the Subsidies to the Housing GSEs,* April 8, 2004..
[63] *See id.*

that this benefit must be directed to serve larger policy priorities. The Affordable Housing Goals provide a mechanism to ensure that the valuable benefits provided to the GSEs are shared throughout the community. Congress has stated that "[g]iven the dominating role of these entities in mortgage finance markets and the large indirect federal subsidies they receive, it is essential that their activities promote the achievement of other national housing goals."[64] In light of these substantial benefits, it is imperative that the Affordable Housing Goals accurately measure the GSEs' efforts to increase liquidity for the underserved areas of the residential mortgage market.

2. The GSEs Have a Statutory Obligation Under the Affordable Housing Goals to Provide Liquidity to the Whole of the Conforming Residential Loan Market

In addition to the CRA-type argument that government benefits should be redistributed broadly rather than narrowly, Congress had an additional reason to impose housing goals upon the GSEs, based upon their statutory purpose of promoting liquidity in the national housing market.[65] Depository institutions must make mortgage loans in historically underserved areas to fulfill their CRA obligations. Therefore, the 1992 Act explicitly states that "each enterprise shall...take affirmative steps to...assist insured depository institutions to meet their obligations under the Community Reinvestment Act of 1977, which shall include developing appropriate and prudent underwriting standards, business practices, repurchase requirements, pricing, fees and procedures[.]"[66] The Senate Report on the 1992 Act emphasized that the GSEs should "lead the mortgage finance industry in making mortgage credit available for low- and moderate-income families."[67] Clearly, the most important affirmative step the GSEs could take to help depository institutions meet their CRA obligations would be to purchase CRA-compliant mortgage loans.

The GSEs have been criticized for their failure to lead the affordable housing market. In the preamble to the 2000 Final Rule, HUD stated that the GSEs' mortgage purchases continue to lag the overall market, and, more problematic, the GSEs' purchase of lower-income loans tends to focus on those loans that have relatively high down payments.[68] This situation raises questions about the GSEs commitment to fulfilling its statutory purpose of providing liquidity for the whole of the market. Given the substantial subsidies the GSEs receive, they should be able to serve the lower-income tier of the mortgage market, including those mortgages that may bear a higher risk. In addition, according to HUD, the GSEs are well equipped to lead the affordable housing market because of their state-of-the art technology, staff resources, share of the total conventional, conforming market, and financial strength.[69]

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[64] S. Rep. 102-282 at 9 (1992).
[65] 12 U.S.C. §§ 1716(4) (Fannie), 1451(b)(4) (Freddie).
[66] 12 U.S.C. § 4565(3)(B).
[67] *See* S.Rep. No. 282, 102d Cong., 2d Sess. 34 (1992).
[68] *See* 65 Fed. Reg. 65044, 65051 (2000).
[69] *See id.*

With its issuance of the new proposed rule in 2004, HUD proposes to restructure the regulations relating to the GSEs' Affordable Housing Goals. Unfortunately, the proposed rule does not adequately address the disparity between the obligations faced by depository institutions under the CRA and those faced by the GSEs.

II. Monitoring Mechanisms

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

A. The CRA

1. Depository Institutions Face Three Different Tests of Community Outreach: The Lending Test, the Investment Test, and the Service Test

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

A "large" financial institution is defined as having assets greater than $250 million.[70] Large financial institutions are subject to an examination that consists of three "Performance Tests": (1) lending, (2) investment, and (3) service.[71]

The lending test examines the number and amount of home mortgage, small business, small farm, and community development loans made to low- and moderate-income people in the institution's assessment area.[72] Examples of community development loans include:

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

[70] 12 C.F.R. §§ 25.12(t), 228.12(t), 345.12(t), 563e.12(s).
[71] 12 C.F.R. §§ 25.21(a), 228.21(a), 345.21(a), 563e.21(a).
[72] 12 C.F.R. §§ 25.22(a)(1), 228.22(a)(1), 342.22(a)(1), 563e.22(a)(1).

- Loans to local, state and tribal governments for community development activities.[73]

The investment test examines the number and amount of "qualified investments" made in the institution's assessment area.[74] Qualified investments are investments, deposits, membership shares, or grants that have as their primary purpose community development. Examples of community development qualified investments include investments, grants, deposits, or shares in or to:

- Financial intermediaries such as CDFIs or CDCs;
- Organizations that engage in the rehabilitation and/or construction of affordable housing;
- Projects eligible for low-income housing tax credits; and
- Organizations that promote economic development.[75]

The service test examines the availability of retail banking services to low- and moderate-income people in the institution's assessment area.[76] Community development services include providing any of the following:

- Financial services with the primary purposes of community development, such as low-cost bank accounts;
- Technical assistance to community development organizations or small businesses;
- Counseling for credit use, home buying, or financial planning;
- Assistance to community development organizations in developing loan application and underwriting standards.[77]

2. Depository Institutions Receive Easily Understandable Grades of Performance: Outstanding, Satisfactory, Needs to Improve or Substantial Noncompliance

After a CRA examination, the federal regulator provides one of the following five grades to the financial institution depending on its performance under each of the three tests: "outstanding," "high satisfactory," "low satisfactory," "needs to improve," or "substantial noncompliance."[78] These grades have quantitative as well as qualitative components. For example, under the lending test, a financial institution will receive a

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

[74] 12 C.F.R. §§ 25.23(a), 228.23(a), 345.23(a), 563e.23(a).
[75] *See* Interagency Questions and Answers Regarding the Community Reinvestment Act, 65 Fed. Reg. 25088, 25097 (2000).
[76] 12 C.F.R. §§ 25.24(a), 228.24(a), 345.24(a), 563e.24(a).
[77] *See* Interagency Questions and Answers Regarding the Community Reinvestment Act, 65 Fed. Reg. 25088, 25096 (2000).

[78] 12 C.F.R. Appendix A to Parts 25, 226, 345, 563e.

grade based on the dollar amount of the loans made as well as the innovative or flexible-lending practices used to address the credit needs of low- or moderate-income individuals.[79] Depending on the grade received for each of the three tests, the regulator will then give the financial institution an overall grade from one of four categories: "outstanding," "satisfactory," "needs to improve," or "substantial noncompliance."[80]

The grades help the financial institution and the public to understand the level of performance achieved under the CRA tests. The grades are publicly available on the Internet and easily understood by community groups that are seeking to evaluate a lender's performance for purposes of deciding whether or not to protest the institution's proposed applications before a federal regulator. The grades also increase public pressure on the institution to serve the community in which it does business, and motivate the institution to try to distinguish itself from other lenders in the area of CRA performance. Because most large financial institutions either have or plan to have applications pending before the federal regulators, they have an incentive to achieve a CRA grade of "outstanding" in order to bolster community support and ease the application process.[81]

B. The Affordable Housing Goals

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

The 1992 Act expressly requires HUD to establish three "goals" for the GSEs: (1) Low- and Moderate-Income Housing Goals, (2) Special Affordable Housing Goals, and (3) Underserved Areas Goals.[82] Unlike the CRA tests, which require CRA lenders to undertake different kinds of activities, the Affordable Housing Goals all require the GSEs to undertake the same type of activity — purchasing mortgage loans.[83] This suggests that the Affordable Housing Goals should be an effective means of enforcing GSE compliance with the goals of the 1992 Act. Purchasing mortgage loans, after all, is the core activity of the GSEs, and the Affordable Housing Goals are unambiguous numerical or percentage targets for annual mortgage purchases. Loose definitions of the activities that count towards meeting the housing goals, however, have substantially weakened their effectiveness. The 2004 proposed rule, for example, did not tighten the definitions of "low-income," "moderate-income" and "underserved areas." As a result, even though HUD has increased the goals over the years, the GSEs can be expected to continue to lag, rather than lead, the affordable housing market.

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[79] 12 C.F.R. §§ 25.22, 228.22, 342.22, 563e.22.
[80] 12 C.F.R. Appendix A to Parts 25, 226, 345, 563e.

[81] In addition, financial institutions now have an incentive to achieve a CRA grade of "satisfactory" in order for their loans to count toward the GSE Special Affordable Housing Goals. *See* 24 C.F.R. § 81.14(e)(vi)(C); HUD's Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65074 (2000).
[82] 12 U.S.C. § 4561.
[83] 24 C.F.R. § 81.16(a).

a. Low- and Moderate-Income Housing Goals

Through regulations, the Secretary of HUD sets yearly Low- and Moderate-Income Housing Goals for the GSEs' purchase of mortgages on housing for low- and moderate-income families.[84] The goal for the years 2001 to 2003 requires that 50% of the total number of dwelling units financed by the GSEs' mortgage purchases should be for housing for low- and moderate-income families.[85] The 2004 proposed rule would increases these percentages. The Secretary may also establish specific subgoals within the stated yearly goal.[86]

b. Special Affordable Housing Goals

The Secretary also sets yearly Special Affordable Housing Goals for GSE purchase of mortgages on rental and owner-occupied housing which are affordable to, and which meet the then existing unaddressed needs of low-income families in low-income areas and very low-income families.[87] The Special Affordable Housing Goals for the years 2001 to 2003 are set at 20% of the total number of dwelling units financed by the GSEs during the year.[88] The 2004 proposed rule would increase these percentages.

The 1992 Act seems to allow HUD to establish specific enforceable subgoals within the stated yearly Special Affordable Housing Goals. Parallel sections of the 1992 Act that establish the other housing goals specifically state that "the Secretary may establish separate subgoals within the goal under this section and such subgoals shall not be enforceable."[89] On the theory that Congress could have included such a non-enforcement provision in the Special Affordable Housing Goals and must have intended not to, it would at least arguably appear that HUD is within its power to establish subgoals and enforce them in connection with the affordable housing goal.

There do not seem to have been objections to this interpretation when HUD, in the 2000 Final Rule, established subgoals in connection with the Special Affordable Housing Goal. The Special Affordable Housing Goals for the years 2001 to 2003 include a subgoal related to the type of property financed. The subgoal states that the GSEs must purchase mortgages financing dwelling units in multifamily housing up to an amount not

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[84] 12 U.S.C. § 4562(a).

[85] 24 C.F.R. §81.12(c)(1)(2000). For the years 1993 to 1995, the Low- and Moderate-Income Housing Goal was set at 30%. 12 U.S.C. §4562(d)(1). For 1996, it was set at 40%. 24 C.F.R. §81.12(c)(1)(1999). For 1997 to 1999, the goal was at 42%. 24 C.F.R. §81.12(c)(2)(1999).

[86] 12 U.S.C. § 4562(a).

[87] 12 U.S.C. 4563(a).

[88] 24 C.F.R. §81.14(c)(1)(2000). For the years 1993 to 1995, the Special Affordable Housing Goal was not described as a percentage but was set for Fannie Mae at not less than $2 billion in affordable housing mortgage purchases annually; for Freddie Mac at not less than $1.5 billion in affordable housing mortgage purchases annually. 12 U.S.C. § 4563(d). For 1996, it was set at 12%. 24 C.F.R. §81.14(c)(1)(1999). For 1997 to 1999, the goal was at 14%. 24 C.F.R. §81.14(c)(2)(1999).

[89] *Id.* §§ 4562(a), 4564(a).

less than 1.0% of the dollar volume of mortgages purchased by the respective GSE in the years 2000, 2001 and 2002.[90]

Despite the increased requirement, this subgoal was not likely to have the intended socially beneficial effect. It was not as specific as the transition subgoals, originally set out in the statute, which related to both the income levels of occupants (very low-income and low-income) and the type of property financed (multifamily or single family). As a result of its lack of specificity, the multifamily housing subgoal can be satisfied by the purchase of loans that finance housing bearing little relationship to traditional "affordable" housing.

[90] 24 C.F.R. § 81.14(c)(1)(2000).

c. Underserved Areas Goals

The Secretary also sets yearly Underserved Areas Goals for the GSEs' purchase of mortgages on housing located in these areas.[91] The Secretary may also establish specific subgoals within the stated yearly goal.[92] For the years 1993 to 1995, this goal stated that 30% of the total dwelling units financed should be purchases of mortgages located in central cities.[93] For the years after 1995, the goal was expanded to include rural areas and other underserved areas as well as central cities. However, the goal was actually decreased from the previous level. For 1996, the goal was only 21% of the total units financed, and for the years 1997 to 1999, the goal was only 24% of the total units financed.[94] In the 2000 Final Rule, HUD set the Underserved Areas Goals for the years 2001 to 2003 at 31% of the total number of dwelling units financed by the GSEs during that year.[95] For the first time, this goal was increased from the level set by the 1992 Act – but by only 1%.

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

Currently, HUD does not distinguish the GSEs' performance under the goals. HUD simply evaluates the GSEs on a pass/fail basis. That is, on the basis of the data provided to HUD by the GSEs, HUD determines whether or not the GSEs have met the goals. The failure to require easily intelligible grades decreases the transparency of this monitoring mechanism and has two other negative effects. As soon as the GSEs have reached their yearly goal, they can merely announce that fact and their obligations terminate. Since there is no nuanced or qualitative component to the Affordable Housing Goals, the GSEs are only motivated to hit their numerical target. In addition, any community group wishing to understand the GSEs' activities must wade through various charts and statistics of years past, rather than rely on a simple grading system.

III. Definitions of Qualifying Activity

Both the CRA and the 1992 Act define the activities that will qualify as meeting the tests or goals. The definitions used by the CRA, however, display a general firmness and discipline that is lacking in the Affordable Housing Goals.

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[91] 12 U.S.C. 4564(a).
[92] 12 U.S.C. §4564(a).
[93] 12 U.S.C. §4564(d).
[94] 24 C.F.R. §81.13(c)(1999).
[95] 24 C.F.R. §81.13(c)(1)(2000).

A. The CRA

1. Depository Institutions Cannot Use One Activity to Receive Credit under Multiple Tests

The CRA specifically prohibits financial institutions from receiving credit under multiple tests for a single activity. The regulations state that "[a]ctivities considered under the lending or service tests may not be considered under the investment test."[96] This prohibition contains a minor exception for some types of qualified investments. For example, if a financial institution makes an investment in a community organization that makes community development loans, the financial institution may count this toward the investment test, or the lending test, or some proportional share of both the lending and investment tests. However, the institution cannot get full credit under both tests.[97]

Regulators are committed to extending this prohibition on double counting to secondary market activities conducted by depository institutions. The agencies responsible for interpreting the CRA have proposed that a financial institution be prohibited from receiving credit under the investment test for the purchase of mortgage-backed securities backed by home mortgages it originated or purchased and for which it already received credit under the lending test.[98] The agencies reason that not creating such a prohibition would allow the financial institution to receive credit under both tests for the same set of activities.[99]

2. Depository Institutions Must Use Narrow Definitions of Low-Income and Moderate-Income

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

- "Low-income" means income that is less than 50 percent of the area median income.[100]

- "Moderate-income" means income that is at least 50 percent and less than 80 percent of the area median income.[101]

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[96] 12 C.F.R. §§25.23(b), 226.23(b), 345.23(b), 563e.23(b).
[97] Interagency Questions and Answers Regarding Community Investment, 65 Fed. Reg. 25088, 25108 (2000).
[98] *Id*.
[99] *Id.*
[100] 12 C.F.R. §§ 25.12(n)(1), 228.12(n)(1), 345.12(n)(1), 563e.12(m)(1).
[101] 12 C.F.R. §§ 25.12(n)(2), 228.12(n)(2), 345.12(n)(2), 563e.12(m)(2).

B. The Affordable Housing Goals

The 1992 Act requires HUD to monitor the GSEs' record of purchasing mortgages that meet three housing goals: the Low- and Moderate-Income Housing Goal, the Special Affordable Housing Goal, and the Underserved Areas Housing Goal. As with the CRA, statutory definitions determine what activities count towards compliance with these goals.

1. The GSEs Can Use One Activity to Receive Credit For Multiple Goals and Can Manipulate the Amount of Credit Using Special Counting Requirements

Unlike the CRA, the 1992 Act allows the GSEs to receive credit toward multiple goals. The regulations state that "[a] mortgage purchase (or dwelling unit financed by such purchase) by a GSE in a particular year shall count toward the achievement of each housing goal for which such purchase (or dwelling unit) qualified in that year."[102] Since there is no qualitative component to the Affordable Housing Goals, the GSEs only have an incentive to reach a certain numerical target. By counting one activity under multiple goals, the GSEs can more easily reach that target without searching for innovative ways to serve various aspects of the market.

In addition, in the 2000 Final Rule, HUD created special counting requirements that allowed the GSEs to receive extra credit for a single activity. The GSEs receive "bonus points" for purchasing mortgages on small multifamily properties and units in 2-4 unit owner-occupied properties.[103] Purchases of such mortgages received double credit toward any of the Affordable Housing Goals, except the Special Affordable Housing subgoal.[104] The fact that HUD chose to award bonus points for activities related to multifamily properties, rather than enact subgoals, reflects the underlying carrot-but-no-stick philosophy of the Affordable Housing Goals. In this manner, the GSEs could inflate the amount of their activity related to much-needed multi-unit multifamily properties while avoiding potential embarrassment over missing a yearly target for activity in this area. Not surprisingly, both GSEs have supported the use of bonus points, but opposed subgoals.[105] At the end of 2003, HUD finally eliminated the bonus points.

Moreover, under the 2000 Final Rule, HUD allowed Freddie Mac to receive special consideration for its activities in the multifamily housing market. In the early 1990s, Freddie Mac dismantled its multifamily mortgage purchase program and thus its multifamily mortgage portfolio is less developed than that of Fannie Mae. Recognizing this disadvantage, HUD granted Freddie Mac a "temporary adjustment factor."[106] In

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[102] 24 C.F.R. §81.15(c). However, the GSEs cannot count the purchase of seasoned mortgages that were already counted in a previous year. 24 C.F.R. §81.16(c)(6). Nor can they count toward the Special Affordable Housing Goals any purchase or securitization of mortgages associated with the refinancing of the GSEs' existing mortgage or mortgage-backed securities portfolios. 24 C.F.R. § 81.14(f).
[103] 24 C.F.R. §81.16(c)(10).
[104] *Id.*
[105] *See* HUD's Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65066 (2000).
[106] 24 C.F.R. § 81.16(c)(11).

determining Freddie Mac's performance on the Low- and Moderate-Income Housing Goal and the Special Affordable Housing Goal, HUD agreed to count each qualifying unit in a property with more than 50 units as 1.2 units for the years 2001 to 2003.[107] Unsatisfied with this measure, Freddie Mac sought even more enhanced special treatment in an omnibus appropriations bill. Freddie Mac received a credit of 1.35 units for each qualifying multifamily mortgage unit purchased in the years 2001 to 2003.[108] At the end of 2003, HUD finally eliminated this special treatment for Freddie Mac.

2. The GSEs can Use Broader Definitions of Income Levels to Meet Their Goals

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

The Low- and Moderate-Income Housing Goal applies to low- and moderate-income families, as those terms are defined by the 1992 Act. The statute and the regulations do not divide this housing goal into a subgoal for low-income families and another subgoal for moderate-income families; nor do they divide the goals into subgoals for multifamily and single family mortgages. In preamble to the 2000 Final Rule, HUD stated that it does not believe it is "necessary or appropriate" to establish separate goals for multifamily and single family markets,[109] despite the fact that HUD recognizes that multifamily housing serves the housing needs of lower-income families to a greater extent than single family housing.[110]

The Special Affordable Housing Goal applies to low-income and very low-income families.[111] The 1992 Act set out subgoals for low-income and very low-income families as well as subgoals for multifamily and single family mortgages for the years 1993 and 1994. Subsequently, HUD regulations have not established such subgoals, but only a volume subgoal for multi-family housing. In the preamble to the 2000 Final Rule, HUD justified its avoidance of such subgoals by citing concerns about micro-managing the GSEs' efforts to achieve the housing goals.[112]

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

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[107] *Id.*
[108] *See* Pub.L. 105-554 (Dec. 21, 2000).
[109] HUD's Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65062 (2000).
[110] HUD's Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65066 (2000).
[111] 42 U.S.C. § 4563. In addition, dwelling units only count under this goal if 20% of the units in the particular multifamily property are affordable to "especially low-income families" or if 40% of the units are affordable to very low-income families. 24 C.F.R. § 81.14(d)(1). "Especially low-income" is defined as income not in excess of 50% of the area median income. 24 C.F.R. § 81.17(d).
[112] HUD's Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65066 (2000).

(1) in the case of owner-occupied dwellings, the mortgagor's income at the time of origination of a mortgage on an owner-occupied dwelling;

(2) in the case of rental housing, the income of the prospective or actual tenants for a mortgage on a rental dwelling; or

(3) if the income of the tenants is not available, the rent levels affordable to low- and moderate-income families for a mortgage on a rental dwelling.[113]

"Affordable" is defined as a rent level that does not exceed 30 percent of the maximum income level of the income categories referred to in the section.[114]

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

- "Very low-income" is defined as income not in excess of 60 percent of the area median income.[115]

- "Low-income" is defined as income not in excess of 80 percent of the area median income.[116]

- "Moderate-income" is defined as income not in excess of the area median income.[117]

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

The definitions for the various income levels can be compared to the definitions set by HUD for its assisted housing programs (including the Section 8 program) and to those established by federal regulators for CRA compliance. The CRA definitions are noted above. The HUD definitions can be found in Section 3(b)(2) of the U.S. Housing Act of 1937, as amended.[118] Following is the description of income levels found in the U.S. Housing Act:

- "Very low-income families" are defined as those families whose incomes do not exceed 50 percent of the area median income.

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[113] *See* 12 U.S.C. § 4562(c).
[114] 12 U.S.C. §§ 4562(c), 4563(c).
[115] 12 U.S.C. § 4502(19).
[116] 12 U.S.C. § 4502(8).
[117] 12 U.S.C. § 4502(10).
[118] 42 U.S.C. §1437a(b)(2).

- "Low-income families" are defined as those families who incomes do not exceed 80 percent of the median income for the area.

- Moderate-income families are not defined in the statute.

A table makes the disparities between the various definitions clear.

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

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

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

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

Statistical as well as anecdotal evidence shows that GSEs do in fact take advantage of the disparities in the definitions. In a press release published earlier this year, Fannie Mae proudly announced that it had achieved its Affordable Housing Goals, but also revealed that of the "low-income" and "moderate-income" units financed, 72% went to those with incomes at or below 80% of their area's median income, 36 percent went to those with incomes between 60% to 80% of the median, and 36% went to those with incomes at or below 60% of the median.[119] This implies that 28% of the units financed went to families with incomes between 80% and 100% of the area median, an activity that would not even receive consideration under the CRA. At the same time, Fannie Mae announced record earnings of $4.448 billion for 2000, up 15.3% from 1999.[120] Meanwhile, depository institutions are forced to portfolio loans made to meet their CRA obligations, or dispose of them via alternative channels because the GSEs will not purchase these loans.[121] As a result, it is more economically difficult for CRA lenders to undertake the CRA lending that Congress intended to foster, because they have little or no secondary market support for their expensive CRA initiatives.

Other aspects of the GSEs' loan purchase strategies do nothing to ameliorate this problem and may exacerbate it. A HUD study made clear that the GSEs appear to be disproportionately likely to purchase "affordable housing" loans associated with substantial down payments.[122] This is economically rational for the GSEs, of course, because loans at lower loan-to-value ratios are generally more creditworthy loans. But it has the effect of stripping the lenders' CRA loan portfolios of the "best" loans, leaving lenders the loans with the highest associated costs and consequently the lowest associated profits. Moreover, this pattern of GSE loan purchases does little to stimulate home ownership among the truly needy. As the HUD study points out, "[m]ost consider lack of funds for down payments to be one of the main impediments to home ownership, particularly for lower-income families who find it difficult to accumulate enough cash for a down payment." [123] By disproportionately purchasing those loans with large down payments, the GSEs do nothing to overcome one of the main impediments to low-income home ownership, and they also burden the CRA programs that actually do seek to overcome this impediment. In the 2000 Final Rule, HUD declined to address this problem and postponed the matter for further evaluation.[124]

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

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

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

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

[123] HUD Study Update (July 1998).

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

The persistence of this bias in GSE loan purchasing may result from the routinization of the GSEs' loan purchase decision-making systems.[125] The GSEs rely heavily on the evaluations made by their proprietary automated underwriting programs in selecting which loans to purchase and which not to. This lends a veneer of objectivity to GSE loan purchase decisions, an impression which cannot be assessed or challenged because the GSEs refuse to disclose the assumptions upon which their automated underwriting systems are based, and because they refuse to establish any basis for empirical comparison by accepting the decisions of other automated underwriting programs. These routinized loan purchase decision-making systems may be a significant contributing factor to the GSEs' lack of support for lender CRA initiatives.

4. The Broad Definitions of Geographic Areas Allow The GSEs to Avoid Truly Underserved Areas

HUD evaluates the GSEs' compliance with the goal of purchasing mortgages in underserved areas on the basis of the geographic location of the properties subject to purchased mortgages.[126] Currently, this goal applies to central cities, rural areas and underserved areas. These definitions are complex and HUD defines them as follows:

- "Central city" includes the underserved areas located in any political subdivision designated as a central city by the Office of Management and Budget ("OMB").[127]

- "Underserved area" includes:

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

  > A median income at or below 120% of the median income of the metropolitan area and a minority population of 30% or greater; or
  >
  > A median income at or below 90% of median income of the metropolitan area.

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

  > A median income at or below 120% of the greater of the state or nationwide median income of the non-metropolitan area and a minority population of 30% or greater; or
  >
  > A median income at or below 95% of the greater of the state or nationwide non-metropolitan median income.[128]

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[125] *See id.*
[126] 12 U.S.C. § 4564(c).
[127] 24 C.F.R. § 81.2(b).

As with the definitions of income levels, the definition of underserved area is broad enough to allow the GSEs a flexibility that financial institutions with CRA obligations do not enjoy. CRA lenders can meet their obligations only by lending to families at or below 80 percent of the area median income, and may not concentrate their lending or other CRA activities geographically. The GSEs, by comparison, can meet their Underserved Area Housing Goals for the entire United States by purchasing mortgages in as many or as few 30 percent minority census tracts with income levels up to 120 percent of the area median income as they choose. While insured depository institutions must lend in inner cities, the GSEs are under no effective obligation to purchase such loans. Indeed, HUD observes that, "GSE purchases of loans from underserved areas are mainly from moderate- or high-income borrowers."[129] HUD concedes that –

> "I[I]t should be noted that while borrowers in underserved metropolitan areas tend to have much lower incomes than borrowers in other areas, this does not mean that GSE mortgage purchases in underserved areas must necessarily be mortgage on housing for lower-income families. Between 1999 and 2001, housing for above median-income households accounted for nearly 60 percent of the single-family owner-occupied mortgages the GSEs purchased in underserved areas."[130]

Although HUD recognized the inconsistency between CRA requirements and the existing definition of an "underserved area" applicable to the GSEs, it declined in the 2000 Final Rule to conform the two definitions until results of the 2000 Census would become available.[131] HUD accepted the GSEs' argument that there have been many demographic changes since the 1990 Census affecting which census tracts would qualify as underserved, although it reserved the right to revisit the issue once the updated census figures are released.

Now HUD states that it has conducted an analysis of the existing definition "using 2000 Census data and has determined" that the existing "definition continues to be a good proxy for underserved areas in metropolitan areas."[132] At a minimum, before declining to conform the definition of underserved areas to the definitions in CRA, HUD should perform a detailed analysis to determine whether a change in the definition of underserved metropolitan and non-metropolitan area census tracts would more sharply focus the GSEs on low-income and minority borrowers. The CMC recommends that HUD should conform the definition of an "underserved area" in the final rule to the definition that applies under CRA to depository institutions.

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[128] 24 C.F.R. § 81.2(b). A separate definition applicable only to New England permits the division of counties into rural and non-rural areas.

[129] Regulatory Analysis, p. VI-21.
[130] 69 Fed. Reg. At 24257.
[131] *See* HUD's Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65145 (2000).
[132] 69 Fed. Reg. At 24417.

IV. Performance Context

The CRA establishes a performance context within which to identify the needs of the assessment area. Under the CRA, regulators analyze the information an institution maintains on the credit needs of its community, along with relevant information received from other sources such as local governments, community groups and civic groups. HUD has no such process in place to assess the adequacy of the GSEs' performance under the Affordable Housing Goals. Moreover, because the GSEs are not subject to the reporting requirements of the Home Mortgage Disclosure Act ("HMDA"),[133] it is more difficult to ascertain whether the GSEs are leading, matching or lagging the affordable housing market as compared with the depository institutions.

A. Depository Institutions Are Evaluated in the Context of the Public's Assessment of Their Efforts to Serve the Whole of the Community

The CRA performance context informs the regulator of the credit and other banking needs of the area. The regulator can analyze the information an institution maintains on the credit needs of its community along with relevant information available from other sources, such as local government, community groups, and civic groups.[134] Specifically, the regulator will evaluate the performance of the financial institution in the context of at least six factors:

> (1) Demographic data on median income levels, distribution of household income, nature of housing stock, housing costs, and other relevant data;
>
> (2) Any information about lending, investment and service opportunities in the assessment area maintained by the financial institution or obtained from community organizations, state, local, and tribal governments, economic development agencies, or other sources;
>
> (3) The financial institution's product offerings and business strategy;
>
> (4) Institutional capacity and constraints, including the size and financial condition of the financial institution, the economic climate of the area, the safety and soundness limitation, and any other significantly limiting factors;
>
> (5) The financial institution's past performance and the performance of similarly situated financial institutions; and
>
> (6) The financial institution's public files and any written comments about the financial institution's performance.[135]

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[133] 12 U.S.C. § 2801 *et seq*.
[134] Interagency Questions and Answers Regarding Community Reinvestment, 65 Fed. Reg. 25088, 25099 (2000).
[135] 12 C.F.R. §§ 25.21(b), 228.21(b), 345.21(b), 563e.21(b).

Through the performance context, the regulators can gather information from local community, civic and government leaders regarding the economic and demographic details specific to that community.[136] This process provides a context against which the statistics and initiatives of the depository institution can be measured.

In addition to this regulatory performance context, CRA lenders must be prepared for evaluation of their lending and mortgage purchase decisions by interested parties using data generated under HMDA. All depository institutions must report to their federal regulator and publicly disclose a great deal of data concerning each mortgage loan that they make or purchase.[137] While this information is unwieldy, it can still be used to construct a profile of an institution's lending and mortgage purchase patterns that can in effect serve as a check on the accuracy of the CRA performance context. Indeed, HMDA data has anchored almost every study of home mortgage lending patterns, and community groups have used HMDA data extensively to review the lending and mortgage purchase decisions of depository institutions and nondepository lenders.

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

Currently, HUD has no systematic process in place to assess the adequacy of the GSEs' performance under the Affordable Housing Goals in the context of the credit needs of different areas of the country. Although the 1992 Act encourages HUD to consider need when it sets the housing goals for the GSEs, the current structure precludes any effective evaluation of or response to local needs. Without a performance context, a publicly available HMDA-like database, or specific subgoals, the GSEs only face minimal scrutiny of their efforts to serve the whole of the community.

HUD has no process for seeking input from community, civic and government leaders to determine whether the GSEs have adequately performed in their community and to assess whether HUD has set appropriate levels for the Affordable Housing Goals. Unlike the federal banking regulators, HUD does not interview or solicit official public comment from community groups in order to place the GSEs' performance in the context of local needs. Moreover, in the preamble to the 2000 Final Rule, HUD has indicated that community groups, not HUD, bear the responsibility for informing their communities about the GSEs' activities. HUD states that it "encourages the residents of local communities and regions of the country to increase their knowledge of the roles the GSEs play in their areas," but offers little toward achieving that end, except to make a database of raw data available to the public.[138] Without a specific process for submitting comments regarding local GSE activity, it is burdensome for community groups to provide information to HUD and, likewise, it would seem difficult for HUD to evaluate the GSEs' performance in the context of community need.

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[136] Interagency Questions and Answers Regarding Community Reinvestment, 65 Fed. Reg. 25088, 25099 (2000).
[137] 12 U.S.C. § 2803(a)(1).
[138] HUD's Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65082 (2000).

Although community groups have become very familiar with HMDA data, the GSEs are not currently subject to HMDA reporting requirements. Without such data, it is problematic for community groups to independently evaluate GSE activity and to compare it with the performance of depository institutions. Although the statute specifically applies to all institutions "engaged for profit in the business of mortgage lending,"[139] and requires the disclosure of information related to the mortgage loans that were purchased by that institution,[140] the Federal Reserve has promulgated regulations that apply HMDA requirements only to for-profit mortgage-lending institutions (excluding depository institutions) whose home-purchase loan originations equaled or exceeded 10 percent of its loan-origination volume in the preceding calendar year.[141] Depository institutions are covered if they originated at least one home purchase loan in the previous year.[142] This test excludes any institution whose involvement in the mortgage financing business is immense, but which does not technically "originate" any home-purchase loans. Since the GSEs are permitted to purchase, but not originate, home purchase mortgage loans, they have not had to make HMDA reports of their mortgage loan purchases, nor have they been scrutinized by community groups seeking to independently investigate the level of GSE activity in their area. HUD has considered making the GSEs' reporting requirements more analogous to HMDA, but declined to take any action on this matter in the 2000 Final Rule.[143]

HUD has worked to increase the amount of information about the GSEs that is available to the public, but the format of the information is difficult to comprehend. HUD makes available the raw data related to the GSE Affordable Housing Goals as well as its working papers documenting various analyses of the data.[144] In addition, the Annual Housing Activity Reports that the GSEs submit to HUD are available upon request.[145] While this information is useful, it still places the burden on community groups to review voluminous databases or rely on the GSEs' own assessment of their performance in order to evaluate the activity of the GSEs. By contrast, any interested party can access the standard, consolidated CRA report of any depository institution over the Internet. In this way, community groups can easily compare the CRA record of a depository institution over time or compare it with the records of other depository institutions. In addition, a HMDA report is available for every HMDA reporting institution. Tables can be compared to peers, the market, or the national aggregate. Without an easily accessible and comprehensible standard report from HUD, community groups find it difficult to review the GSEs' performance under the Affordable Housing Goals.

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[139] 12 U.S.C. § 2802(4).
[140] *Id.* § 2803(a)(1).
[141] Regulation C, 12 C.F.R. § 203.2(e)(2). At this time, the Federal Reserve has proposed extending coverage to for-profit mortgage lending institutions whose prior-year home purchase loan originations, including refinancings, equaled or exceeded $50 million. However, this test would still limit coverage to institutions that originate a large volume of home purchase loans.
[142] Regulation C, 12 C.F.R. § 203.2(3)(1).
[143] HUD's Regulation of Fannie Mae and Freddie Mac, 65 Fed. Reg. 65044, 65082 (2000).
[144] *See* <http://www.huduser.org/datasets/gse.html>.
[145] The GSEs are required to submit an Annual Housing Activity Report to HUD that details, among other things, whether the GSEs' underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures promote affordable housing and fair lending. 24 C.F.R. § 81.63.

In the 2000 Final Rule, HUD did not use its ability to establish Affordable Housing subgoals to increase the transparency of GSE activity. HUD is empowered to establish subgoals in connection with the Low and Moderate-Income Housing Goals and the Underserved Areas Housing Goals, even though it may not use the failure to achieve those subgoals as a basis for enforcement action. For these two goals, HUD did not choose to establish subgoals even for purposes of its own analysis of GSE performance. Instead, HUD decided to reward the GSEs with bonus points for any activity related to small multifamily properties. As a result, it has become very difficult for interested parties to determine whether the GSEs have accomplished an appropriate level of activity in a subcategory that is related to the overall housing goal.

In connection with the Special Affordable Housing Goal, 1992 Act empowers HUD to set enforceable subgoals. HUD has taken advantage of this authority only in connection with requiring a small absolute volume of multifamily mortgage purchases. In addition, the 2004 proposed rule would set home purchase subgoals for each of the three Affordable Housing Goals. As noted above, the 1992 Act provided subgoals based on the income and type of property related to the mortgages purchased. However, these subgoals have not been incorporated in subsequent regulations, including the 2000 Final Rule. HUD's failure to set subgoals based on borrower and community income and type of property means that the GSEs are free to purchase mortgages based on lack of business risk to the GSEs, rather than on local need for multifamily, low-income or very low-income housing. In addition, without quantifiable subgoals, it is difficult for community groups to assess the level of the GSEs' performance in these areas.

Finally, while the 2004 proposed rule does not address the matter of GSE compliance with the disclosure requirements, there are reports that HUD plans soon to release new loan-level information about mortgages purchased by the GSEs.[146] The CMC commends HUD for this very important step in increase the ability of community groups and others to understand the actual performance of the GSEs with respect to lending to affordable housing families and communities.

V. Enforcement

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

[146] *Inside Mortgage Finance,* "HUD Reportedly Ready to Re-Classify Key GSE Loan-Level Data as 'Nonproprietary,'" June 11, 2004, pp. 6-7.

A. Depository Institutions Can Incur Substantial Reputational and Business Costs for Failing to Comply With the CRA

CRA is not self-enforcing, but it is nevertheless an effective statute because the approval of so many important applications hinges upon an institution's success in meeting its CRA obligations. CRA itself requires that "[i]n connection with its examination of a financial institution, the appropriate Federal financial supervisory agency shall ... (1) assess the institution's record of meeting the credit needs of its entire community [and] (2) take such record into account in its evaluation of an application for a deposit facility by such institution."[147] This puts two forms of pressure on institutions to comply with the CRA: the ordinary pressure that derives from the examination process, and the extraordinary pressure that an institution interested in obtaining approval for expanded activities, such as opening a new deposit-taking branch, will feel to meet its CRA obligations in order to obtain unconditional approval of such an application.

Applying pressure on institutions by conditioning the approval of various applications upon compliance with CRA obligations has developed into the primary method of enforcing CRA. In addition to applications to open a deposit-taking branch, applications for approval of an interstate merger are subject to a statutory requirement that the appropriate federal regulator "take into account the most recent written evaluation under Section 804 of the Community Reinvestment Act of 1977 of any bank which would be an affiliate of the resulting bank[.]"[148] Beyond these statutory requirements, federal regulators have established CRA compliance as a factor in the consideration of many regulatory applications. The FDIC, for example, "takes into account the record of performance under the CRA of each applicant bank in considering an application for approval of ... [t]he relocation of the bank's main office or a branch; [t]he merger, consolidation, acquisition of assets, or assumption of liabilities; and [d]eposit insurance for a newly chartered financial institution."[149] Thus, in addition to the

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[147] 12 U.S.C. § 2903(a).

[148] 12 U.S.C. § 1831u(b)(3)(B).

[149] 12 C.F.R. § 345.29(a) The other federal regulatory agencies have established slightly different lists of applications that require consideration of CRA compliance:

- OCC regulations require consideration of CRA performance in applications for: (1) the establishment of a domestic branch; (2) the relocation of the main office or a branch; (3) under the Banker Merger Act (12 U.S.C. § 1828(c)), the merger or consolidation with or acquisition of assets or assumption of liabilities of an insured depository institution; and (4) the conversion of an insured depository institution to a national bank charter. 12 C.F.R. § 25.29(a).

- Federal Reserve Board regulations require consideration of CRA performance of: (1) each applicant bank for: (i) establishment of a domestic branch by a State member bank; and (ii) merger, consolidation, acquisition of assets, or assumption of liabilities requiring approval under the Bank Merger Act (12 U.S.C. § 1828(c)) if the acquiring, assuming, or resulting bank is to be a State member bank; and (2) each insured depository institution (as defined in 12 U.S.C. § 1813) controlled by an applicant and [each] subsidiary bank or savings association proposed to be controlled by an applicant:(i) to become a bank holding company in a transaction that requires approval under section 3 of the Bank Holding Company Act (12 U.S.C. § 1842); (ii) to acquire ownership or control of shares or all or substantially all of the assets of a bank, to cause a bank to become a subsidiary of a bank holding company, or to merge or consolidate a bank holding

normal pressure that is applied through the bank examination process, making CRA performance a part of the application process that is crucial to banks that do not have an entirely static business strategy creates substantial pressure on banks to fulfill the letter and the spirit of their CRA obligations.

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

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company with any other bank holding company in a transaction that requires approval under section 3 of the Bank Holding Company Act (12 U.S.C. § 1842); and (iii) to own, control or operate a savings association in a transaction that requires approval under section 4 of the Bank Holding Company Act (12 U.S.C. § 1843).12 C.F.R. § 228.29(a).

- OTS regulations require consideration of CRA performance in applications for: (1) the establishment of a domestic branch or other facility that would be authorized to take deposits; (2) the relocation of the main office or a branch; (3) the merger or consolidation with or the acquisition of the assets or assumption of the liabilities of an insured depository institution requiring OTS approval under the Bank Merger Act (12 U.S.C. § 1828(c));(4) a Federal thrift charter; and (5) acquisitions subject to section 10(e) of the Home Owners' Loan Act (12 U.S.C. § 1467a(e)). 12 C.F.R. § 563e.29(a).

B. The GSEs Do Not Face Any Significant Reputational Risk or Business Risks For Failing to Meet Their Affordable Housing Goals

HUD has limited power directly to enforce compliance with the Affordable Housing Goals it sets in accordance with the 1992 Act. It can provide formal notice to a GSE that the GSE has failed or is substantially likely to fail to meet a housing goal, in which case the GSE has a set period of time in which to respond before HUD makes a final determination concerning the GSEs' failure and communicates that determination to Congress.[150] If HUD finds that the GSE has in fact failed, it must require the GSE to submit a housing plan for approval, specifying feasible steps that the GSE will take to achieve the housing goal in the subsequent year.[151] If HUD disapproves the plan, the GSE must submit a new one.[152] If the GSE fails to submit a housing plan substantially in compliance with HUD's requirements, HUD is authorized to impose civil money penalties of up to $25,000 per day on the GSE until it does comply.[153] If a GSE fails to make a good faith effort to comply with a housing plan prepared according to this procedure, HUD is authorized to impose civil money penalties of up to $10,000 per day upon the GSE until HUD deems it to be in compliance.[154] This ability to impose civil money penalties, and HUD's cease-and desist authority to require a corrective affordable housing plan, are the only enforcement mechanisms explicitly mandated by the 1992 Act.

The 1992 Act does not provide directly for the sort of regulatory pressure and public scrutiny that have functioned as effective enforcement mechanisms for CRA. The GSEs have little need to go to HUD for regulatory approvals or other actions analogous to approving an application. Virtually the only power HUD has to approve or deny the GSEs has to do with new programs. Even there, HUD has not chosen to make compliance with the GSE housing goals a factor in making decisions on GSE applications for approval of new programs.[155]

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

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[150] 12 U.S.C. § 4566(b).
[151] *Id.* § 4566(c)(1)-(5).
[152] *Id.* § 4566(c)(6).
[153] *Id.* § 4585(b)(1).
[154] *Id.* § 4585(b)(2).
[155] *See* 24 C.F.R. § 81.51 *et seq.*