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The Honorable Mel Watt
Director, Federal Housing Finance Agency
400 7th St SW, Ninth Floor
Washington, DC 20024

Re: 2015-17 Enterprise Housing Goals

Director Watt,

Thank you for the opportunity to comment on the critical issue of the Enterprises' affordable housing goals. The following response from the UNC Center for Community Capital focuses on the single-family housing goals in particular.

The UNC Center for Community Capital at the University of North Carolina at Chapel Hill conducts research to help policymakers, advocates, and the private sector find sustainable ways to broaden economic opportunity. Our research on homeownership finance has examined how risk factors, products and practices affect sustainability for households and lenders alike, particularly for low- and moderate- income households.[1]

By their charter, the Enterprises are encouraged to ensure access to credit for lower income households and neighborhoods. Research from the UNC Center for Community Capital and others demonstrates that such lending is safe for both borrowers and lenders. Nevertheless, the Enterprises have typically lagged the market in the share of business devoted to underserved borrowers. In part, this is because the affordable housing goals have often been too low. As explained below, we believe the prospective benchmarks, particularly the low-income home purchase goal, should be raised.

Rationale for Affordable Housing Goals

The purpose of the Enterprises explicitly includes "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" (12 USC § 1716). This mandate was reaffirmed by the Housing and Economic Recovery Act of 2008 (12 USC § 4513). The charter also includes promoting "access to

[1] See Quercia, Freeman and Ratcliffe, *Regaining the Dream: How to Renew the Promise of Homeownership for America's Working Families*. Brookings Institution Press, Washington DC. For a summary of our decade of research on a national conventional affordable mortgage program demonstration, see *Community Advantage Panel Study: Sustainable Approaches to Affordable Homeownership*. http://ccc.unc.edu/contentitems/community-advantage-panel-study-sustainable-approaches-to-affordable-homeownership/
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mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas)." These provide the statutory basis for the affordable housing goals.

In our commentary on the Enterprises' guarantee fees[2], we argued that the risk-based components of pricing should be offset by a "purpose-based" return on capital. This would allow lower income families, first-time homebuyers and households in underserved areas to participate in the benefits enabled by government-sponsorship of Fannie Mae and Freddie Mac. However, the Enterprises have not always been willing to serve such populations as directed by their charter. Before 2008, the Enterprises were shareholder-owned and conducted business to maximize profits. Since the Enterprises entered conservatorship, FHFA has operated under the perceived mandate to preserve the Enterprises' capital. In either case, a lower return on capital conflicts with the goals of management or regulators, even if such activities are still profitable in accounting terms.

Affordable housing goals as established by the Safety and Soundness Act of 1992, amended by the Housing and Economic Recovery Act of 2008, and implemented by 12 CFR §1282, are intended to ensure that the Enterprises use the privilege of their government-sponsorship to further the public mission described in their charter.

Safety and Soundness

There is ample evidence that lending to lower-income households and communities can be consistent with safety and soundness. Numerous studies have rebutted the notion that the Enterprises' affordable housing goals contributed to the increase in credit risk that occurred during the housing bubble (e.g., Bhutta 2008; Avery and Brevoort 2011; Hernandez-Murillo et al. 2012; Bolotnyy 2012; and Hernandez-Murillo et al. 2012). According to analyses obtained by the Financial Crisis Inquiry Commission (FCIC), the cost of the housing goals between 2000 and 2003 was effectively zero, as the goals were reached through normal business. Afterwards, only four percent of loans purchased by Freddie Mac were bought specifically because they contributed to the housing goals. These loans were expected to account for 19 percent of total projected credit losses—and Freddie had adjusted their guarantee fees accordingly— but they had actually accounted for just 8 percent by late 2008 according to the materials obtained by the FCIC. Instead, a disproportionate share of the Enterprises' credit losses came from Alt-A mortgages, which did not contribute to meeting the goals. Large Enterprise losses also came from purchases of MBS (Park 2010).

Size of the Market and Qualifying Purchases

According to the request for comment, "FHFA's measurement of the single-family mortgage market, which is used to set the benchmark levels and determine the retrospective market share for the single-family housing goals, is intended to reflect the portion of the overall single-family market that is eligible for purchase by the Enterprises." Consequently, a variety of loans are excluded from market

[2] Kevin A. Park and Janneke H. Ratcliffe. Comments RE: Fannie Mae and Freddie Mac Guarantee Fees; Request for Input Center for Community Capital, University of North Carolina at Chapel Hill. September 8, 2014. http://ccc.unc.edu/contentitems/fannie-mae-and-freddie-mac-guarantee-fees/

estimates, such as jumbo loans with loan amounts above the conforming loan limit and loans insured by FHA or another government agency (see 12 CFR § 1282.12(b)).

Based on safety and soundness concerns, subprime loans have long been excluded from estimating the size of the market.[3] Currently, the rule uses information in HMDA on the rate spread to exclude loans with annual percentage rates 150 basis points above the prime offer rate. Bizarrely, the Enterprises count purchases of such higher-priced loans towards their housing goal performance if they still meet their underwriting criteria. We would like to see the exclusion of higher-priced loans for calculating the size of the market (12 CFR § 1282.12(b)) also listed among the list of exclusions for calculating the Enterprises' goal performance (12 CFR § 1282.16(b)). The current benchmark of 150 basis points above the prime offer rate is reasonable and should encourage the Enterprises to minimize price disparities among borrowers.

Loans with missing borrower income are also excluded from the size of the market. For the purposes of calculating goal performance, however, the current rule imputes affordability by multiplying the number of loan purchases with missing borrower income in each census tract by the goals qualifying share of loan purchases in the respective tract. The proposal would revise 12 CFR § 1282.15(b) such that mortgages where a borrower's income is not available would not be counted in the numerator for any of the housing goals. We support the change and would like to see how the reform would change the historical performance of the Enterprises. Income documentation is an important part of the underwriting process, so there is little reason for borrower income to be missing.

Finally, we oppose eliminating the reference to "mortgages with unacceptable terms or conditions" (12 CFR § 1282.16(d)). The requirement may currently be redundant given FHFA has required the Enterprises to restrict purchases to loans that meet the product characteristics of a Qualified Mortgage, as defined under the Dodd-Frank Wall Street Reform and Consumer Protection Act; however, we believe the explicit mention of "mortgages with unacceptable terms or conditions" provides FHFA the flexibility to address the future development of abusive products not addressed by Dodd-Frank. Rather than eliminate the reference, we suggest altering the language such that "all HOEPA mortgages, mortgages that do not meet the product characteristics of a Qualified Mortgage, and other mortgages with unacceptable terms or conditions" are excluded. The definition of mortgages with unacceptable terms and conditions in 12 CFR 1282.1 can be simplified to reduce redundancy with the definition of a Qualified Mortgage, but should retain references to mortgages with terms contrary to banking regulator guidance on nontraditional and subprime lending, mortgages originated using practices that do not comply with fair lending requirements, and "Other terms or conditions that are determined by the Director to be an unacceptable term or condition of a mortgage."

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[3] For example, "with respect to the subprime market, HUD believes that the risky, B&C portion of that market should be excluded from the market estimates for each of the housing goals. Thus, HUD includes only the A-minus portion of the subprime market in its overall estimates of the goals-qualifying market shares." Federal Register, Vol. 65, No. 211 (Tuesday, October 31, 2000) Page 65061.

Market Forecasts

The benchmarks used in affordable housing goals are based on forecasts of the size of the market developed by FHFA. Although the supplemental materials provided by the FHFA are helpful, more information is needed for the public to offer informed input.

The data used by the FHFA for developing models of the goals-qualifying share of the market should be made public to the greatest extent possible. There is no reason the monthly nationwide time series provided by the Federal Financial Examination Institutions Council that serves as the basis for FHFA's forecasting models should not be publicly available. Such aggregated data would not create problems with privacy or confidentiality, but would allow outside researchers to reproduce—and possibly modify— FHFA's results, with the aim of improving their predictive accuracy.

The models used to forecast the market share for each single-family housing goal appear to shuffle explanatory variables. For example, the only common explanatory variable in the Low-Income Borrower Home Purchase Goal and the Very Low Income Home Purchase Goal is the lagged unemployment rate. The model of the Very Low Income Goal includes FHFA's house price index while the model of the Low Income Goal uses the median sales price for existing homes. There is no *a priori* reason to believe the determinants of the very low-income borrower share of home purchase loans would be substantially different than the determinants of the low-income borrower share. Variables appear to have been dropped based on their individual statistical significance, which could have been affected by multicollinearity likely present in the models. However, multicollinearity is not particularly a concern when simply developing a model for forecasting because the purpose is not hypothesis testing of specific variables. Rather, decisions should be based on theory. At the very least, any variable which improves the fit of the model should be included, even if not statistically significant.

Dropping variables that are not statistically significant can have unintended consequences. For example, while the model of the Very Low Income Home Purchase Goal includes a measure of the general price level, no such variable is included in the model of the Low Income Goal. Consequently, the median sales price of existing homes is modeled in nominal terms. Nominal prices typically rise over time due to general inflation but this does not necessarily indicate a decline in affordability because household incomes also typically rise in nominal terms. Between 2004 and the forecasted level in 2017, the median price on existing homes is expected to increase 11 percent in nominal terms; however, inflation-adjusted prices are expected to *fall* 16 percent over that time, which is not unexpected given dramatic declines experienced between 2006 and 2010.[4] The general upward trend in nominal prices combined with the negative coefficient on median house prices in FHFA's model may create a perpetual decline in the projected low income share of the home purchase market.

Modelling is also complicated by the endogeneity created by the Enterprises' dominate share of the current mortgage market: the low income share of loans purchased by the Enterprises has a strong

[4] The forecast of median sales prices are found on Table 3 of Federal Housing Finance Agency. "The Size of the Affordable Mortgage Market: 2015-2017 Enterprise Single-Family Housing Goals." August 2014. The forecasted change in the Consumer Price Index is found on Table 4. Specifically, the CPI is projected to increase 1.4%, 2.1% and 1.6% in 2015, 2016 and 2017, respectively, for a 5.2% cumulative increase in the price level.

effect on the low income share of the overall market, which is subsequently used to set the future low income share of loan purchases required of the Enterprises. Consequently, a trend in the behavior of the Enterprises, such as a tightening of underwriting standards, is perpetuated through the model into the forecast.

Similarly, the increased market presence of the Federal Housing Administration since the start of the Great Recession may explain a downward trend in the lower income share of the conventional (i.e, not insured by FHA or other government agency) market not accounted for by other factors. But FHA's market share is directly affected by the Enterprises guarantee fees and loan-level price adjustments as well as private mortgage insurance premiums, which are all influenced by FHFA decisions and regulations. Rather than develop models based only on the conventional market, FHFA should estimate the goals-qualifying share of the entire mortgage market and then make assumptions of the cumulative share of the market that will be accounted for by FHA, the Veteran's Administration and other government agencies. Still, a large FHA market share does not excuse lower performance towards affordable housing goals. Instead, it raises questions about why the Enterprises cannot compete with FHA, particularly when FHA's recent endorsements have large "negative subsidies" (i.e., recent books of business are profitable).

The current forecast is for the low income share of the home purchase market to fall to 19.8 percent in 2017, from a historical peak of 29.6 percent in 2009. That means the low income share of the home purchase market is expected to fall by roughly a third (9.8 percentage points) in less than a decade. This is despite the fact that most of the drivers of the low income share highlighted by FHFA are not substantially different in 2017 from their 2004 levels, when the share was 27.2 percent. Further, despite independent variables being selected to minimize standard errors, there is a +/- 9 percentage point range in the forecast, meaning the low income share could be as high as 28.8 percent (still below its historical peak) or as absurdly low as 10.8 percent.

The problems and uncertainty in the forecasting methodology used to set benchmarks suggests that they should not be given the determinative role in evaluating the performance of the Enterprises towards their affordable housing goals.

Retrospective and Prospective Measures

An Enterprise is currently considered in compliance with its single-family housing goals if its performance meets or exceeds *either* the benchmark level for the goal *or* the share of the market that qualifies for the goal (12 CFR § 1282.12(a)). The two-part test is meant to provide relief in the event that the prospective benchmarks have been set too high than feasible under safe and sound practices. In addition, the Enterprises may also submit a housing plan detailing evidence of actual market conditions and negotiate a revised benchmark (12 CFR § 1282.21).

If the benchmarks were largely accurate and unbiased, this might be an acceptable situation. Unfortunately, the benchmarks appear routinely set below the market going back to the housing goals before the reforms under HERA, allowing the Enterprises to persistently lag the market. Between 2003 and 2005 both Fannie Mae and Freddie Mac's performance on the Low- and Moderate-Income Borrower Goal (then set at 100 percent of area median income) was consistently above the 50 percent benchmark but below the actual market share, which ranged between 52.9 percent and 57.2 percent. The same story is true for the Special Affordable and Underserved Areas Goals between 2002 and 2006.[5]

Calculating performance back to 2004 using the goal criteria revised under HERA, the Enterprises have underperformed the market 75 percent of the time in the Low-Income Home Purchase and Very Low-Income Home Purchase goals, and 60 percent of the time on the Low-Income Refinance Goal (see charts below). Admittedly, the Enterprises were not subject to the current housing goals regime for most of that time, but that only demonstrates the importance of setting strong benchmarks. Nevertheless, the Enterprises have only fallen below the current Low-Income Home Purchase Goal (23 percent) twice since 2001.

Looking forward, although the benchmarks for the Low-Income Purchase and Very Low-Income Purchase Goals are set above the (flawed) market estimates, the Low-Income Areas Purchase Goal and particularly the Low-Income Refinance Goal are set below FHFA's own forecast of the market.

The Enterprises have outlets if the benchmarks have been set above the market, but little incentive to increase purchases if the benchmarks have been set too low. Consequently, we believe the benchmarks should be set in the upper-range of the market estimates and that performance should be primarily judged on the retrospective measure of the actual market share. Consistently setting the benchmarks too low is a failure of FHFA's oversight as much as the Enterprises' execution of their public mission as described in their charter.

Conclusion

The mission of the Enterprises—the reason for their government sponsorship—explicitly includes ensuring access to mortgage credit for lower income households and underserved areas. The charter even mentions that such activities may involve below market returns. Yet too often the Enterprises have underperformed the market. In part, this is because FHFA has routinely set affordable housing goals benchmarks below the relevant market share.

The common assumption is that the Enterprises meet their housing goals by increasing their purchases of loans from lower income borrowers and lower income neighborhoods. That is only half-true. Housing goals can also be met by reducing the number of non-goal qualifying loan purchases. Given calls for the Enterprises to reduce their market share, the most appropriate segment of the market to "crowd in private capital" is that which can be adequately served with a market return on capital, including lower-risk, higher-income borrowers that would not qualify for credit toward housing goals.

[5] The only exception being Fannie Mae's performance in the Special Affordable goal in 2006 which barely outperformed the market, 27.8 percent to 27.5 percent.

Moreover, because lower income households typically cannot afford substantial downpayments, goals-qualifying loans will often involve private mortgage insurance. Consequently, a layer of private capital protects the Enterprises and, indirectly, taxpayers. This is largely preferable to the direct exposure to taxpayers if these borrowers are pushed into obtaining mortgage insurance through the Federal Housing Administration. The economic value of FHA's recent books of business suggests that the Enterprises are not adequately serving the lower income segment of the market.

Sincerely

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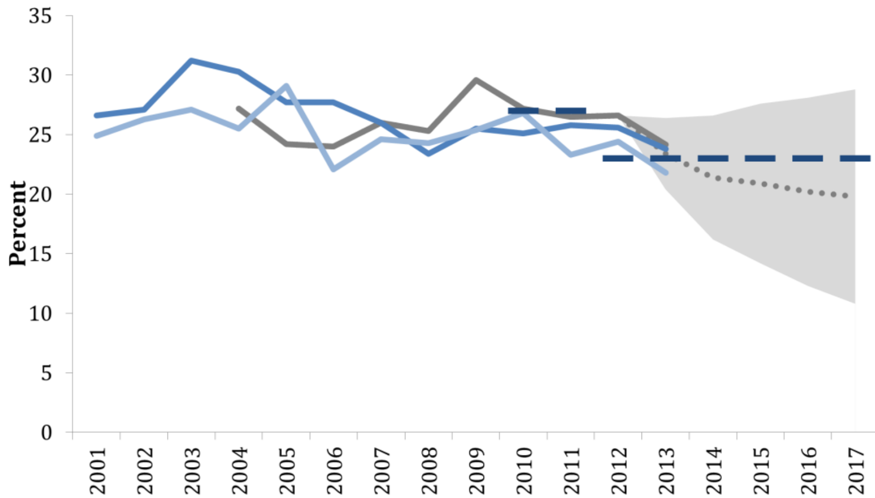
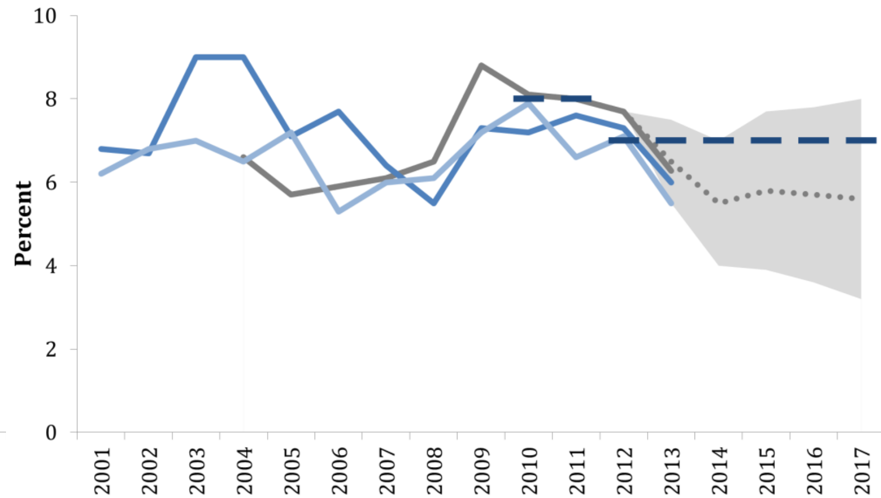
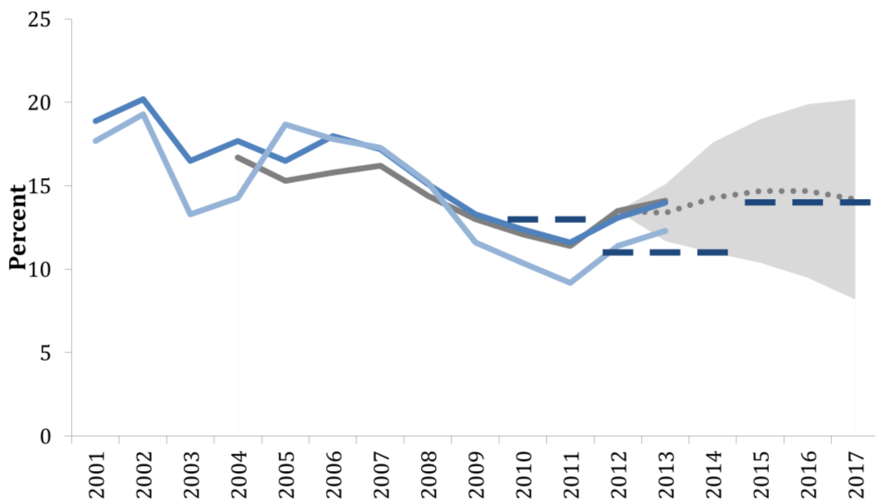
Low-Income Purchase Goal



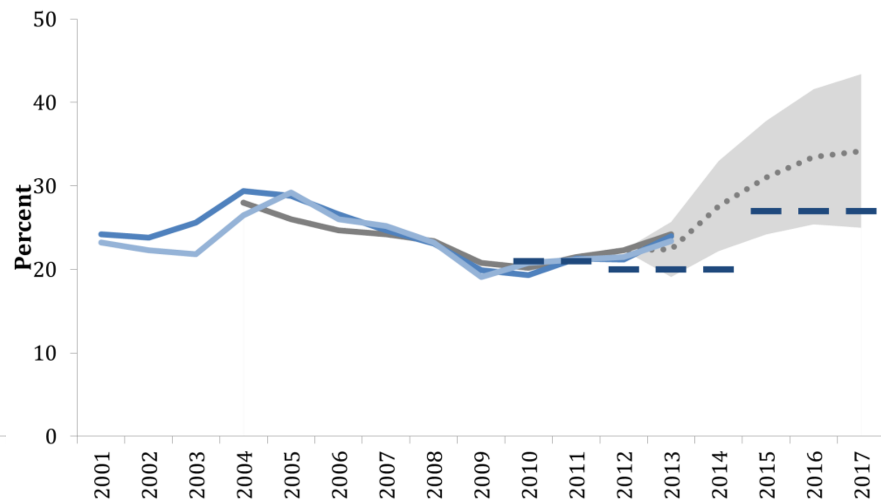
Very Low-Income Purchase Goal



Low-Income Areas Purchase Goal



Low-Income Refinance Goal



Actual Market Estimate Goal Fannie Mae Freddie Mac

Sources: Federal Register Vol. 75, No. 38 (Feb. 26, 2010), Pg. 9041; Federal Register Vol. 77, No. 219 (Nov. 13, 2012), Pg. 67545; Federal Register Vol. 79, No. 176 (Sept. 11, 2014), Pg. 54512; Federal Housing Finance Agency. "The Size of the Affordable Housing Market: 2015-2017 Enterprise Single-Family Housing Goals. 2014; UNC Center for Community Capital tabulations of 2013 HMDA data.