GSE Affordable Housing Goals: Politicized Credit Allocation

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The views expressed are those of the author alone and do not necessarily represent those of the American Enterprise Institute.
By way of background

- Real estate lending is double leveraged:
  - Borrower
  - Investor
- Borrowers may be leveraged in many ways:
  - Balance sheet – assets and liabilities - LTV and amortization (loan term)
  - Income and expenses - debt to income and amortization
  - Credit: expanding lending to individuals with impaired credit
- Moving out risk curve (by increasing leverage) creates additional demand
- Concept of moral hazard – deductible/co-pay on insurance vs. none
- Politicization of lending increases in direct proportion to value of government perks
  - Dangers from politicization of lending...my experience
  - Lending money is easy; collecting it is the hard part
The private financial sector can and will do dumb things on its own

- The private sector is perfectly capable of doing incredibly dumb things on its own. In a boom period, risks appear low, memories are short, and the temptation to increase leverage and profit are great.
  - Think of it as moving further and further out onto the thin ice. Everyone is surprised when the ice gives way.

- The private sector does not need government encouragement to take on more risk. However, with government encouragement, one moves further and further out on the ice.
  - Hold onto your wallet because the duration, quantity and poor quality of risk taking will be exponentially expanded.
Government policies and loosened standards

- Government policies promoted a systematic loosening of underwriting standards in an effort to promote affordable housing, which then contributed mightily to the housing bubble, mortgage meltdown and resulting financial crisis.

- The government's role in the crisis:
  - In the late-1980s and early-1990s ACORN and other community groups claimed that Fannie and Freddie were standing in the way of their efforts to replace traditional underwriting with flexible underwriting.
  - 1991 testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs:

    "'Lenders will respond to the most conservative standards unless [Fannie Mae and Freddie Mac] are aggressive and convincing in their efforts to expand historically narrow underwriting.'"
Enlisting Fannie and Freddie

• These community groups lobbied Congress to force the Fannie and Freddie (the GSEs) to abandon their traditional underwriting standards.
  – In 1992 these community groups were successful in convincing Congress to impose affordable housing (AH) mandates on Fannie and Freddie. This set in motion 14 years of ever looser loan standards.

• Fannie embraced AH mandates for one reason—to buy the political protection it would need to defeat any unwelcome changes to its lucrative charter benefits.
  – To this end, it vowed to “transform” the housing finance system (1994) and outlines plans to spend $1 trillion.
  – One article described it as a “Trillion Dollar Giveaway.”
  – The strategy worked—Fannie alone ultimately spent $5 trillion—keeping the GSEs politically unassailable until 2008.
HUD wore many hats

• GSE Mission regulator
• FHA
• Best Practices Initiative
  – Flexible underwriting
  – “Administer(ing) a review process for loan applications to ensure that all applicants have every opportunity to qualify for a mortgage”
• National Homeownership Strategy
  – Social policy of a dramatically increased percentage of homeownership accomplished with loosened lending standards.
    • The highly leveraged government entities of Fannie, Freddie, and FHA were the leaders in driving these changes throughout mortgage finance industry.
      – Fannie and Freddie are willing and able participants – buying them congressional protection. Most of rest of the industry doesn’t need to be asked twice – it will sell more homes and expand lending.
  – The National Homeownership Strategy resulted in the substantial elimination of downpayments.
    • The proportion of home purchase loans with down payments of 3 percent or less steadily increased from 0.5 percent in 1990 to 40 percent by 2007
Role of affordable housing goals

Sources: HUD, FHFA, Case-Shiller Index, and compiled by Edward Pinto
### Role of affordable housing goals

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Compiled by Edward Pinto

- While the Mod Housing Goal (net of Special Affordable) increased from 23% (1993 actual) to 31% (2007 goal), the Special Affordable increased from 7% (1993 actual) to 25% (2007 goal)
FHA: the Indy pace car leading the way to looser lending
Percentage of Annual Home Purchase Volume with LTV/CLTV $\geq 97\%$

Dissenting voices predict disaster:

1998: Theodore Day and Stanley Liebowitz (University of Texas (Dallas)

“After the warm and fuzzy glow of ‘flexible underwriting standards’ has worn off, we may discover that they are nothing more than standards that led to bad loans. If the ‘traditional’ bank lending processes were rational, we are likely to find, with the adoption of flexible underwriting standards, that we are merely encouraging banks to make unsound loans. If this is the case, current policy will not have helped its intended beneficiaries if in future years they are dispossessed from their homes due to an inability to make their mortgage payments.”

1999: New York Times - “Fannie Mae Eases Credit to Aid Mortgage Lending”

"In a move that could help increase home ownership rates among minorities and low-income consumers, the Fannie Mae Corporation is easing the credit requirements on loans that it will purchase from banks and other lenders. . . .

“In moving, even tentatively, into this new area of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan industry in the 1980's.

‘From the perspective of many people, including me, this is another thrift industry growing up around us,’ said Peter Wallison a resident fellow at the American Enterprise Institute. ‘If they fail, the government will have to step up and bail them out the way it stepped up and bailed out the thrift industry.’
Simultaneously promoting and masking what was happening

• As flexible lending expands the volume and risk characteristics increases markedly, yet these loans were still called prime. HUD acknowledged as much in a 2000 rule making.

  • "As the GSEs become more comfortable with subprime lending, the line between what today is considered a subprime loan versus a prime loan will likely deteriorate, making expansion by the GSEs look more like an increase in the prime market. Since . . . one could define a prime loan as one that the GSEs will purchase, the difference between the prime and subprime markets will become less clear. This melding of markets could occur even if many of the underlying characteristics of subprime borrowers and the market's (i.e., non-GSE participants) evaluation of the risks posed by these borrowers remain unchanged."

• The SEC agreements with Fannie and Freddie confirm this.
HUD revolution in affordable lending

• The United States, alone among developed countries, turned its prudential regulation of underwriting standards over to a social welfare agency.
  – In 2004, HUD extols its “revolution in affordable lending.”
    • “Over the past ten years, there has been a ‘revolution in affordable lending’ that has extended homeownership opportunities to historically underserved households. Fannie Mae and Freddie Mac have been a substantial part of this ‘revolution in affordable lending’. During the mid-to-late 1990s, they added flexibility to their underwriting guidelines, introduced new low-downpayment products, and worked to expand the use of automated underwriting in evaluating the creditworthiness of loan applicants. HMDA data suggest that the industry and GSE initiatives are increasing the flow of credit to underserved borrowers. Between 1993 and 2003, conventional loans to low income and minority families increased at much faster rates than loans to upper-income and non-minority families.”
Major cause of the financial crisis

- The major cause of the financial crisis in the United States was the collapse of housing and mortgage markets resulting from an accumulation of an unprecedented number of weak and risky non-traditional mortgages (NTMs).
  - These NTMs began to default en masse beginning in 2006, triggering the collapse of the worldwide market for mortgage-backed securities and in turn triggering the instability and insolvency of financial institutions that we call the financial crisis.
  - Government policies forced a systematic industry-wide loosening of underwriting standards in an effort to promote affordable housing, compounded by moral hazard spread by Fannie and Freddie.
The way forward for affordable housing

• Four principles for reform:
  1. Step back from markets that can be served by the private sector.
  2. Stop knowingly lending to people who cannot afford to repay their loans.
  3. Help homeowners establish meaningful equity in their homes.
  4. Concentrate on homebuyers who truly need help purchasing their first home.
Interested in more?

• **Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study**

• **Taking the government out of housing finance: principles for reforming the housing finance market**