S. HRG. 104-703

THE FEDERAL HOUSING ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1992

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
HUD OVERSIGHT AND STRUCTURE

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

TO

CLARIFY AND TO STRENGTHEN HUD'S RESPONSIBILITY TO OVERSEE FANNIE MAE'S AND FREDDIE MAC'S PERFORMANCE AND TO ENSURE THE FINANCIAL SAFETY AND SOUNDNESS OF THE TWO SECONDARY MARKET HOUSING GOVERNMENT-SPONSORED ENTERPRISES [GSE'S]

MARCH 5 AND 21, 1996

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
36-340 CC WASHINGTON : 1996

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-053951-X

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

ALFONSE M. D'AMATO, New York, *Chairman*

PHIL GRAMM, Texas
RICHARD C. SHELBY, Alabama
CHRISTOPHER S. BOND, Missouri
CONNIE MACK, Florida
LAUCH FAIRCLOTH, North Carolina
ROBERT F. BENNETT, Utah
ROD GRAMS, Minnesota
PETE V. DOMENICI, New Mexico

PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
JOHN F. KERRY, Massachusetts
RICHARD H. BRYAN, Nevada
BARBARA BOXER, California
CAROL MOSELEY-BRAUN, Illinois
PATTY MURRAY, Washington

HOWARD A. MENELL, *Staff Director*
ROBERT J. GIUFFRA, JR., *Chief Counsel*
PHILIP E. BECHTEL, *Deputy Staff Director*
STEVEN B. HARRIS, *Democratic Staff Director and Chief Counsel*
EDWARD M. MALAN, *Editor*

SUBCOMMITTEE ON HUD OVERSIGHT AND STRUCTURE

LAUCH FAIRCLOTH, North Carolina, *Chairman*

PHIL GRAMM, Texas
ROD GRAMS, Minnesota

CAROL MOSELEY-BRAUN, Illinois
PATTY MURRAY, Washington

JAMES E. HYLAND, *Staff Director*
MELODY H. FENNEL, *Professional Staff Member*
PAUL WEECH, *Democratic Professional Staff Member*
JOANNA E. SLANEY, *Democratic Legislative Assistant*

CONTENTS

TUESDAY, MARCH 5, 1996

THURSDAY, MARCH 21, 1996

THE FEDERAL HOUSING ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1992

TUESDAY, MARCH 5, 1996

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HUD OVERSIGHT AND STRUCTURE,
Washington, DC.

The Subcommittee met at 10:10 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Lauch Faircloth (Chairman of the Subcommittee on HUD Oversight and Structure) presiding.

OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. The Subcommittee will come to order.

I want to thank our two witnesses for being here this morning. Also, we thank the people in the audience for having an interest in what we are doing and attending.

When I ran for the Senate in 1992, a common concern that people expressed was the size of the U.S. Government and the Federal debt. We all heard it that were running for office.

Not as much concern was expressed, however, about the contingent liability of the Federal Government, which, according to the President's 1997 budget, is $7.3 trillion. But this liability should be of serious concern to our country and certainly to the taxpayers. It's made up of direct loans, guaranteed loans, Federal insurance, and Government-Sponsored Enterprises [GSE's].

This hearing is about making sure that the contingent liabilities under the jurisdiction of this Committee remain just that—contingent—and are not turned into real and current liabilities.

Under HUD's jurisdiction are two of the largest Government-Sponsored Enterprises—Fannie Mae and Freddie Mac. Together, they hold nearly $3 billion in assets, almost more assets than the entire credit union industry. Altogether, they have $1.4 trillion in total obligations. They are privately-held companies, but their securities carry the implied backing of the Federal Government. Additionally, they have over a $2 billion line of credit with the Treasury Department.

In 1992, the Congress passed a bill putting tighter regulations on these two GSE companies. At the time, some said that it was "a solution in search of a crisis." This may be an accurate statement. I hope it is. Despite the savings and loan crisis, we have seen no real financial problems with these two companies in recent years.

So we have to ask ourselves two questions. Will greater regulation from HUD and this new office actually hinder their operations and make them more likely to need taxpayers' assistance? Or are there problems on the horizon that only adequate regulations can spot in order to protect the taxpayers? For example, when Congress passed the 1992 Act, it set the affordable housing goal at 30 percent. HUD has increased it to 42 percent. The question has to be asked if this one-third increase is in the best interest of the taxpayers? These are fundamental questions that this hearing is trying to answer in its review of the impact of the 1992 legislation.

Finally, let me say that the question also has to be posed—would Fannie Mae, Freddie Mac, and the taxpayers be better off if the companies were completely privatized? I think this is a question we need to look at.

I look forward to the testimony of today's witnesses, and with that, let me ask Ranking Member Senator Moseley-Braun for her opening statement.

OPENING STATEMENT OF SENATOR CAROL MOSELEY-BRAUN

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman.

Mr. Chairman, we are here today to talk about the mortgage market, some of the institutions that participate in that market, and about the Government oversight of these institutions. What we are really talking about, however, is the American dream, the ability of every hard-working American to obtain a mortgage to own a home.

The two institutions that are the principal focus of our hearing this morning—The Federal National Mortgage Association, Fannie Mae; and The Federal Home Loan Mortgage Corporation, Freddie Mac—play a critically important role in over 60 percent of all mortgages under $207,000. That fact demonstrates just how important these institutions are to almost every American who wants to buy a home.

Fannie Mae and Freddie Mac are real American success stories. For Americans who want to obtain mortgages, they save literally thousands of dollars each in interest costs over the life of those loans by the lowering of their interest rates. At the same time, these institutions are enormously profitable themselves. Last year, Fannie Mae made over $2 billion and Freddie Mac earned almost a billion dollars.

A major part of the reason they can save American homebuyers money while earning such enormous sums themselves is that they enjoy substantial Government benefits. They have a $2.25 billion line of credit with the Treasury, and that implicit Federal guarantee of their activities allows their securities to trade at rates just slightly above Treasury bond rates. They are exempt from the security registration fees charges by the Securities and Exchange Commission and they are exempt from State and local taxes.

The Federal Government, therefore, has an oversight responsibility with regard to their activities. This oversight is essential to ensure that Fannie Mae and Freddie Mac are not engaging in the kind of high-risk activities that could cost Federal taxpayers enormous sums of money. But just as importantly, oversight is essential to ensure that the enormous public benefits that Fannie Mae and Freddie Mac have been provided with are being passed on, passed through, if you will, to American homebuyers, and particularly low- and moderate-income homebuyers.

To provide the necessary oversight on an ongoing basis, in 1992, Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act. That law created the Office of Federal Housing Enterprise Oversight—OFHEO—a permanent oversight agency.

This kind of oversight mechanism is essential, it seems to me, particularly when one considers that Fannie Mae and Freddie Mac are responsible for well over $1 trillion worth of outstanding mortgages. A trillion dollars. By the way, Mr. Chairman, I found a note that said a trillion dollars was a dollar a second for 23,000 years. I just thought I would pass that on.

[Laughter.]

In any event, in order to protect and enhance the access to affordable mortgages for moderate- and low-income working Americans, the Act also established affordable housing goals for the two mortgage Government-Sponsored Enterprises or GSE's.

Using this authority, the Department of Housing and Urban Development has recently issued three Affordable Housing Goals: One, requiring GSE's to purchase mortgages from low- and moderate-income borrowers in specified percentages; two, covering housing and underserved areas; and three, covering very-low-income units and low-income units in low-income areas.

Three years of efforts went into the creation of this Rule. I want to commend HUD, OFHEA, Fannie Mae, and Freddie Mac for all of the hard work that they have put into it, and for the cooperative way that they came together to turn legislative language to sound, workable rules.

I am pleased with reports that both Fannie Mae and Freddie Mac have either already met these goals or are in a position to meet them this year. In fact, both Fannie Mae and Freddie Mae met or came close to meeting the 1996 goals in 1995.

This raises the question in my mind whether the goals are enough, whether working families, more minority families, more inner-city and rural families could realize the dream of homeownership with more efficient assistance from the GSE's.

I look forward to addressing these issues in today's hearing. I would like to thank Assistant Secretary Retsinas and Director Alvarez for appearing at today's hearing. The safety and soundness of Fannie Mae and Freddie Mac and their ability to provide opportunities for all potential homeowners is of crucial importance to the families of America and I look forward to their testimony, and I thank you for convening this hearing.

Senator FAIRCLOTH. Thank you, Senator Moseley-Braun.

We obviously do not have any other Senators wishing to speak, so we will get on with the panel.

Let me turn to the witnesses now.

Our first witness is Nicolas Retsinas, the Assistant Secretary for Housing and the FHA Commissioner. Our second witness today is Ms. Aida Alvarez, she is Director of the Office of Federal Housing Enterprise Oversight. The first and only so far, she has held the position since 1993.

Mr. Retsinas and Ms. Alvarez, I welcome you and thank you for coming. Before you begin, let me also assure that your written statement will be made a part of the record in its entirety, and we will try to keep the oral statements limited. But if you have an opening statement, you may, Mr. Retsinas, go ahead with it.

OPENING STATEMENT OF NICOLAS P. RETSINAS ASSISTANT SECRETARY FOR HOUSING AND FEDERAL HOUSING COMMISSIONER U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. RETSINAS. Thank you, Mr. Chairman and Senator Moseley-Braun, thank you for those kind words.

I understand how crowded the agenda is these days, and I appreciate, Mr. Chairman, you and Senator Moseley-Braun taking the time because this is, as you point out, an issue of great substance, great gravity, and of great potential. So thank you for doing this and for giving us this opportunity.

I would like to take advantage of your offer, Mr. Chairman, and give you the full written statement along with the appendices for the record, and I will do so.

Senator FAIRCLOTH. So ordered.

Mr. RETSINAS. Let me, if I could, spend a few minutes giving you an overview of our perception of the performance and the activities of the GSE's, the Rule, and perhaps what the future may hold as it relates to those matters, for your consideration.

I am also pleased to be sharing the panel with a colleague and friend, Aida Alvarez. I will be focusing on the mission, on the affordable housing performance of the GSE's, and I am sure Ms. Alvarez will be talking on issues related to safety and soundness. But as you will see, both issues interface and we will talk about that.

I want to speak specifically about the 1992 Act, the Federal Housing Enterprises Financial Safety and Soundness Act. First, I want to talk a little bit about, in retrospect, the questions you posed at the beginning. Does the Act make sense? Was it worth doing? Second, I want to talk about what the GSE's have done pursuant to the Act over the last 2 or 3 years, and I have some graphic information to share with you. I want to talk specifically about our Rule that will oversee their activities in the years ahead. And then I want to speak for a moment on our observations vis-à-vis the Act itself and whether any adjustments are appropriate, given what we have learned over the last couple of years.

Let me start with the Act.

The Act passed in 1992, before I was here, but while you were all here. And I think, generally speaking, that this is a good Act. It received bipartisan support. It would appear to appropriately balance the safety and soundness, the contingent liability concerns, as you posed them, Mr. Chairman, as well as the affordable housing responsibilities.

As Senator Moseley-Braun points out, the GSE's do receive Government benefits. They were chartered and created by the Government. In addition, as the Senator points out, they have access to a line of credit. They are exempt from certain State and local taxes, they are exempt from certain security registration requirements, and they are exempt from other requirements that are posed in other financial services institutions.

I believe the Congress, in its wisdom in 1992, took those into account when it set forward a certain mission for affordable housing responsibility.

The Act now has been in place for several years during this transition period. Let's talk a little bit about the performance of both Fannie Mae and Freddie Mac during that period. What I would like to do is turn your attention, if I could, to the first chart, and I believe you have copies of the charts in front of you. And let me try to just walk through them as simply as I can and as directly as I can.

If you look at this, the years relate to calendar years. In calendar year 1992, that is, before the Act, if you look at the performance of Freddie Mac and Fannie Mae, 24 percent of the units of mortgages purchased were serving low- and moderate-income households. The percentages always relates to units, percentage of units, not percentage of dollars.

For Fannie Mae, it was 28 percent. In 1993, that respectively went up to 30 and 34 percent. In our most recent year, 1995, and we have preliminary information, so we think this is accurate, though we do not have all the final records in, it appeared that for Freddie Mac, 39 percent of the units of mortgages that they purchased went to low- and moderate-income households, and in Fannie Mae's case, it was 46 percent.

Senator FAIRCLOTH. Excuse me. If I may interrupt.

Mr. RETSINAS. Of course.

Senator FAIRCLOTH. A unit, of course, means a housing unit.

Mr. RETSINAS. Yes.

Senator FAIRCLOTH. If it's a multiple housing unit, that would be, say, 10 in it, that would be 10 units.

Mr. RETSINAS. Ten, right. Each unit. In large measure, because of the nature of their business, this is heavily dominated by single-family purchases, the large majority. But you're absolutely right. We are counting the number of units so we can count apples and apples as it relates to it.

So I think it is fair to say, looking over the performance of these Government-Sponsored Enterprises over the last 3 years, there has been significant progress in addressing affordable housing needs. That is, the reasoning which generated and motivated the Act—that we need to address credit needs of low- and moderate-income families—appears to be working. The GSE's would appear to be responsive to the intent of that Act. And the witness is their actual performance—not their will, but their actual performance, which I think is critical.

Let's talk about the second, which is the very-low income. What this goal refers to is helping households of very-low income. The low- and moderate-income referred to households earning up to 100 percent of median income. This is generally families under 50 percent of median income.

And again, as you can see, during the transitional years, 1993 and 1994, Fannie Mae exceeded by a factor of 30 percent their Special Affordable Housing Goal. Freddie Mac exceeded in the single-family arena by 10 percent. In the multifamily arenas, and Senator

Moseley-Braun, you may recall this from the testimony 2 years ago, Fannie Mae has been more successful during the transitional period on the multifamily loans.

As you recall, we were mutually concerned last year about the performance of Freddie Mac. As you can see here, during 1993 and 1994, Freddie Mac did not achieve its multifamily goals under the Special Affordable category. You can also see, in 1995, however, the news picks up for both. Fannie Mae continues to exceed their multifamily Special Affordable Housing Goals, and now Freddie Mac, in 1995, is also significantly exceeding its multifamily goal.

So the concerns that you and others raised 2 years ago has apparently resonated in terms of their participation in the marketplace. Both are now achieving their multifamily goals.

Let me now look at the next chart which relates to—we will see it together when it comes up—Central City Goals.

As you know, the Act speaks of three goals. It speaks of Low- and Moderate-Income households, which is the first chart we talked about. It speaks about Special Affordable, which is very-low-income households. But there is also a geographical——

Senator FAIRCLOTH. What was it?

Mr. RETSINAS. The Special Affordable was for very-low-income households.

The third goal was geographic. I might add, parenthetically, if one of the GSE's makes a loan for a very-low-income household in a geographically-targeted area, they get credit for all three goals. It's not mutually exclusive.

In this particular case, in 1992—using the transitional Central City definition—22 percent of the units Freddie Mac purchased were in central cities. For Fannie Mae, the respective number was 26 percent. In 1993, the Freddie Mac activity went up slightly to 24 percent. The Fannie Mae activity stayed at about 26 percent. In 1994, Freddie Mac went up a little bit to 25 percent. And Fannie Mae went up significantly to 31 percent. And our preliminary information from 1995 shows a slight fall-off for both Freddie Mac and Fannie Mae.

The assessment of these numbers is for 1993, 1994, and 1995, Fannie Mae met or exceeded its Central City Goals. I regret to inform you that for 1993, 1994, and 1995, Freddie Mac has not achieved its Central City Goals that were set for the transitional period.

Let's talk about one other chart that really is not a goal, but I know it certainly is one we are aware of and was an interest of the Committee in 1994, when we last had the opportunity to testify. And that really has to do with the mortgage purchases made to minority borrowers. What we have done here is track——

Senator FAIRCLOTH. If you don't mind, put it on the other stand. It's easier to see.

Mr. RETSINAS. Sure.

Senator FAIRCLOTH. Thank you.

Mr. RETSINAS. Is that OK, Senator?

Senator FAIRCLOTH. Yes.

Mr. RETSINAS. As you can see, we have tracked the different subcategories of the minority borrowers—African-American, Hispanic, other, and Asian-Pacific.

In 1993, Freddie Mac's percentage that went to minority borrowers was 12.9 percent. In 1995, last year, it went up to 15 percent. For Fannie Mae, in 1993, it was 13 percent. In 1995, it was 18.5 percent. Clearly, that varies within the subcategories.

For example, and, again, you have the detailed information before you, let's look at African-American homebuyers. For Fannie Mae, in 1993, that number is 2.3 percent. In 1995, that increased to 4.5 percent. For Freddie Mac, in 1993, it was 3 percent. In 1995, it—I'm sorry. For Freddie Mac, in 1993, it was 1.7 percent; and in 1995, it increased to 3.3 percent. So there has been some increase in the percentage of mortgages to minority borrowers.

Generally speaking, the performance of the GSE's is at a market level, both when looking at comparable institutions and when looking at the universe of the marketplace. In the written testimony, we give you some additional comparisons with other kinds of institutions. Again, in general, there has been progress. But, we believe this is something that we need to continue to be vigilant on.

Senator MOSELEY-BRAUN. Mr. Retsinas.

Mr. RETSINAS. Yes, Senator.

Senator MOSELEY-BRAUN. On this chart, the Hispanic community is seeing a greater increase and looks like greater volume overall.

Mr. RETSINAS. Right.

Senator MOSELEY-BRAUN. Is that correct?

Mr. RETSINAS. Yes, it is. Let me give you the specific numbers as an example. In——

Senator MOSELEY-BRAUN. How does that happen?

Mr. RETSINAS. Let me give you the numbers and I will speculate with you.

Senator MOSELEY-BRAUN. OK.

Mr. RETSINAS. For Fannie Mae, in 1993, it was 3.4 percent. In 1995, it was 5.94 percent, not quite doubling. For Freddie Mac, it was 3.3 in 1993, and 4.5 in 1995. In many ways, that number reflects the growing numbers. The percentage increases in that population are larger percentage increases.

Senator FAIRCLOTH. The Asian-Pacific seems to be growing, but maybe not as rapidly as the Hispanic.

Mr. RETSINAS. In absolute numbers, the percentage, for example, of Fannie Mae of the Asian-American, it was 4.4 percent of their total mortgages in 1993. In 1995, it was 4.26 percent. So it did go down a little bit. And similarly, for the Freddie Mac numbers.

Senator FAIRCLOTH. But it would be interesting seeing the figures as to how they compare and break out.

Mr. RETSINAS. We will have that for you.

Let me spend a moment or two talking about the Rule, that I referred to previously, which was published for effect earlier this year. Let me make a couple of comments about it.

First, I'm pleased to say on behalf of Secretary Cisneros, that the Rulemaking process exceeded the openness requirements of the statute, which is to say we reached out more, we consulted more, we talked more, we listened more. So I believe that there was a full airing of issues and concerns during the Rulemaking process. Witness the extensive comments that were received and the dialogue that took place.

Second, I believe that the Rule is consistent with the intent of the Act. We looked very carefully at the balancing act the Congress undertook when it passed the Act in 1992. The balance that talked about setting goals, that talked about having these GSE's lead the marketplace. But at the same time, we did not want to be intrusive in what we both have labeled our success stories in terms of these institutions. So we tried to achieve that balance.

In terms of the goals, we believe the goals are reasonable and balanced. And again, I'm going to go back, if I could, to that first chart. We have set and we have applied the goals equally to both institutions as it relates to the Low- and Moderate-Income Goal.

In 1996, the year we are in now, we have set as a goal 40 percent. And for the years 1997, 1998, and 1999, we have set as a goal 42 percent. In setting those goals, the statute instructs us to take six different factors into consideration. Let me walk through those factors, if I could.

First, "What are the housing needs of this Nation?" Clearly, the greater the housing needs, the higher the goal, generally speaking.

Second, "What are the economic conditions that exist in the marketplace and are likely to exist during the period ensuing?"

Third, you asked us to look at the actual performance of the GSE's. Assess what have they been able to do, and factor that into the goal setting process.

Fourth, you asked us to look at the size of the conventional marketplace as it relates to these different categories.

Fifth, you asked us to assess the ability of these Enterprises, to, quote, using words from the statute, "to lead the industry." How can they be leaders and not followers?

And sixth, very, very important, you asked us to be mindful of the financial condition of those institutions.

So it, indeed, is a balancing act, as was the original statute. And we have heard the constructive criticism that you both offered this morning. On the one hand, are they set too high? Are they intrusive? Do they cross that line? Or, on the other hand, given the fact that they have exceeded many of these goals, are they set too low? I might add, Senator, when I hear those kinds of criticisms, I think, well, maybe we hit it pretty close to where it ought to be.

If you look at the Low- and Moderate-Income Goal, as you can see, Freddie Mac is on the verge of achieving that goal. With some attention and some focus, I am confident that they can reach this goal in 1996. Fannie Mae already exceeds this goal. We did not want to game this in any way, so we have tried to set the goals at reasonable, achievable levels.

As it relates to Special Affordable, we have tried to make this goal even more focused. It's a little bit like comparing apples and oranges when you look year to year. But, again, we want to make sure that in meeting the Affordable Housing Goals, we pay special attention to people of very-low income.

And again, if you look at the numbers, Freddie Mac, with some attention, will be able to meet the goal for 1996. We do not have the 1995 numbers. They are not in yet.

Fannie Mae met the goal and exceeded the goal in 1994, and from all preliminary indications, met the goal in 1995. They appear to have the capacity to meet these goals.

And last, on central cities, as per the instructions of the Act, we have looked carefully at the definition of central cities. I shared with you some maps that I do not have large blow-ups on. Your handouts contain maps with colors that show how we have redefined the Central City Goals. The original Central City Goals we thought was broad, too broad, and left some anomalies.

For example, under the original Central City Goals, communities like Patterson, New Jersey and Compton, California didn't qualify. And yet, parts of Washington, DC, like Georgetown, did qualify to meet the Central City Goal. So we have now redefined that goal to make it more targeted and focused on areas that are underserved.

If you look at these maps you can generally pick out those parts of your communities that are underserved, which will be the focus of the newly-deferred, geographically-targeted goal.

So while the numbers would appear to be somewhat less in terms of performance, in part, it is because it is a more focused goal on underserved areas.

Let me conclude, and I apologize for going on so long, with some comments on the Act itself, if I could, to take you up on your offer.

I do believe, as I said before, that the 1992 Act was an appropriate balance of the safety and soundness concerns that you articulate on behalf of the American taxpayer and an appropriate mission for these institutions that were created by the Government and continue to receive Government benefits.

There is no piece of legislation that is perfect and I am not going to argue or say that this is perfect legislation. But in an industry of the scale of this industry, I would suggest that we consider very carefully before we make major changes to the law.

I think we need more time. I think the Act is working. I think the GSE's are addressing affordable housing needs. There are some areas where we need to focus—some of the Central City Goals and multifamily purchases. But overall, it is working. So I believe it is premature to consider any changes in the Act because I believe it is working. It is achieving the desired balance.

Mr. Chairman, Senator Moseley-Braun, I would be happy to answer any questions you might have.

Senator FAIRCLOTH. Thank you. But first we will hear from Ms. Alvarez.

OPENING STATEMENT OF AIDA ALVAREZ, DIRECTOR OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Ms. ALVAREZ. Thank you, sir.

I am delighted to have this opportunity to report to you, Mr. Chairman, and Senator Moseley-Braun, on the activities of the Office of Federal Housing Enterprise Oversight, OFHEO, as we meet our responsibilities under the Act.

This is really my first opportunity to provide a report on my office. It's a relatively new office, as you noted. I hope you will bear with me as I tell you a little bit about the office and the nature of the responsibilities.

I appreciate your accepting my testimony and I do have a prepared statement. And no charts.

[Laughter.]

To begin with, the legislative history makes clear that the Congress was concerned that the Federal sponsorship of Fannie Mae and Freddie Mac not result in a cost to the taxpayer. Although the debt securities that are issued or guaranteed by these companies carry a disclaimer stating explicitly that they are not guaranteed by the U.S. Government, it's clear that for years, financial market participants have perceived that Congress would not permit these obligations to default. And that perception, of course, is not only based on the important role that these two companies play in the housing finance arena, but on the special privileges—that you, sir, and Nic, my colleague, outlined—privileges that are not generally provided to private firms.

We view it at OFHEO as our job to make sure that Congress is never forced into a difficult position of having to decide whether to bail-out these companies.

The possibility of such a situation occurring is not purely hypothetical. Back in 1987, another GSE', the Farm Credit System, needed and received Federal assistance. That has never been the case with Fannie Mae or Freddie Mac. But Fannie Mae did come perilously close to needing some assistance in the 1980's when, by some estimates, the values of its liabilities exceeded the market value of its assets by one-fourth.

Senator FAIRCLOTH. What year in the 1980's? Was that the early 1980's?

Ms. ALVAREZ. That was in the early 1980's, when they were losing $1 million a day.

Senator FAIRCLOTH. When interest rates were up at 20 percent?

Ms. ALVAREZ. Excuse me.

Senator FAIRCLOTH. When interest rates were at 20 percent, or whatever?

Ms. ALVAREZ. That's right. There was a mismatch between their assets and their liabilities. As you've noted, both companies have $1.4 trillion of obligations outstanding, which is actually more than half the total volume of insured deposits of all banks and thrifts. So it's major business. And a failure that could cost even a small fraction of that amount could still be catastrophic.

In doing our job, we take into consideration three principal sources of risk to Fannie and Freddie. To begin with, unanticipated changes in interest rates is one important source of risk. And while the interest rate risk on loans that are securitized is small, both Fannie Mae and Freddie Mac retain on their balance sheets a very large and growing portion of the loans that they purchase. On these assets, they do accept a degree of vulnerability to large swings in interest rests. Together, these two companies now own more than $360 billion of mortgages, which is more than twice as much as they held when the law creating OFHEO was passed.

They are also exposed to credit risks on the mortgages that they own or guarantee, and that's the second source of risk. Credit risk has continued to grow rapidly in recent years. Their overall volume of assets at risk, including both the mortgages they own and those they have securitized, has doubled in the past 5½ years.

The third source of risk is management and operations risk. The financial well-being of these two institutions depends critically on the strength and the effectiveness of their financial controls, the reliability of their information and data processing systems, and their management's adaptability to fundamental changes in the marketplace.

The question now is what is OFHEO doing about this? How do we assess those risks?

Well, our business is to ensure that these two companies maintain sufficient capital and operate in a safe and sound manner. Accordingly, OFHEO must develop a sophisticated, risk-based capital standard. We conduct risk-focus examinations, and we conduct sufficient research into Enterprise and industry developments to anticipate future potential risks and to properly design our capital standards and examinations.

I am happy to report that OFHEO has made, I think, significant progress in each of these areas. When I was appointed Director of OFHEO in June 1993, I was also the first employee. In a relatively short amount of time, I have assembled what I believe is a top-flight staff, with experience in financial markets and financial institutions regulation, which of course was my top priority. And I believe we now have nearly a full complement of the folks that we need to do this job.

Senator FAIRCLOTH. How many people do you have on your staff?

Ms. ALVAREZ. We now have 65 people on our staff.

Senator FAIRCLOTH. Fifty-five?

Ms. ALVAREZ. Sixty-five.

Senator FAIRCLOTH. Sixty-five.

Ms. ALVAREZ. Yes, we are almost fully staffed for the year.

In the area of capital supervision, we are responsible for administering two types of capital standards.

The first is primarily based on leverage ratios for balance sheet assets and off balance sheet obligations. And it establishes what in the legislation is described as a minimum capital level for each Enterprise. OFHEO published a proposed rule for determining the minimum capital levels last year, and we expect to have the final rule by this spring.

The second capital adequacy standard is more important because it is tailored more carefully to the specific risks of the Enterprise activities. And this standard will be much more sophisticated than the existing capital standards for other financial institutions.

Last spring, we published an advance notice of proposed rulemaking concerning that risk-based capital regulation. The ANPR asked for comments on a wide range of issues that must be decided in designing this regulation. Since then, OFHEO has made excellent progress. Just last week, I am happy to report, we submitted a proposed rule concerning two important pieces of the stress test to OMB for interagency clearance. And we expect to be able to send to Congress and publish the proposal in 2 to 4 months.

We have also made considerable progress in the other principal areas of stress test development and we plan to have a complete stress test by the end of this year.

The other major focus of OFHEO's activities is the examination area. The approach that we've followed over the past 2 years concentrates on evaluating the management and operations systems and, in particular, the processes used by each of the Enterprises to identify and control exposure to risk.

What we do, first of all, is start with a big picture appraisal of management structure, planning strategy, audits, and control systems, and then we move to a more detailed investigation where our appraisal indicates that it's warranted. We believe that this is a relatively unobtrusive approach that concentrates our efforts in the most critical areas and minimizes the burden on the regulated institutions. And I believe that the other regulators of financial institutions are moving increasingly in this direction.

Most of our findings and the work of our office are contained in the annual report which we send to Congress each year. Last year, in that annual report, we described the results of our first on-site exams of the two Enterprises. Unlike other regulators, we are required to send our reports directly to Congress, which gives you an opportunity to know of any major problems shortly after we do and before they show up in poor operating results.

I would like to talk briefly about the first set of our exams which targeted the use of derivatives contracts, which I know has been of great concern to the Congress. This exam started at about the time of a number of disturbances back in 1994.

What we concluded was that the use of these contracts by the Enterprises posed no significant safety and soundness concerns. We did make a number of recommendations for change with regard to risk management, but we concluded that the Enterprises use these instruments safely. They use them basically to access funds at a lower cost. They are not speculators. They are not dealers. Our recommendations related to improving their risk management and internal controls.

Senator FAIRCLOTH. They use them for what?

Ms. ALVAREZ. To lower the cost of funds. This way they can structure——

Senator FAIRCLOTH. You mean to hedge.

Ms. ALVAREZ. Yes. That's right.

Senator FAIRCLOTH. OK.

Ms. ALVAREZ. That, too. And both Enterprises complied with our recommendations in a satisfactory manner.

We are now finishing a very important set of examinations on the Enterprises' risk-management structures, their controls, and their practices. We haven't completed that report yet, so I can't share the results with you today. But they will be included in the annual report, which, as required by statute, we will get to you by June 15th.

In the area of affordable housing, which Nic so ably testified on, OFHEO participated in the interagency comment process for HUD's Affordable Housing Rule, which has been adopted in a final form. Both Enterprises have increased their activities in this area markedly during the legislative and rulemaking process that produced the requirements. But it is important to note that for the past 2 years, as Nic did note, Fannie Mae has already been achieving all of these goals at the 1997 to 1999 levels. Freddie Mac is not yet at those levels, but they're within 10 to 20 percent.

I do not believe that these goals should force either of the Enterprises to sacrifice overall safety and soundness. Each has already shown an ability to meet or approach meeting the goals, with no indication that doing so will substantially reduce, for example, the rate of return on equity, which in both cases has been consistently more than 20 percent in recent years. And I expect that they will continue to make progress in learning how to do this business successfully, and that they will keep the risks involved well within the acceptable bounds.

We will, of course, continue to review the area by following closely their new initiatives in our examinations and our off-site monitoring. We will also require the companies to hold adequate capital as part of our risk-based capital standard to protect against risks associated with affordable housing activities.

Looking forward, OFHEO needs to maintain the flexibility to respond to rapid changes in the mortgage finance industry. Fannie Mae and Freddie Mac are changing with the industry and, in many respects, they are leading the industry. In just the last year and a half, we have seen strong movements toward automated underwriting, credit-scoring, and consolidation in mortgage banking. We have seen a variety of new trends in mortgage transactions at the Enterprises, including 97 percent LTV's, use of lender-provided spread accounts as credit enhancement, reverse amortization mortgages, and securities involving home equity loans and B&C class mortgages. The Enterprises are also becoming more involved in the process by which credit reports, appraisals, and title insurance are provided.

Mr. Chairman, I know that you and others on the Banking Committee have questions about OFHEO's location at HUD. Our relationship with the rest of HUD has worked well and, I believe, to our mutual benefit. Our respective roles in regulating Fannie Mae and Freddie Mac are, of necessity, interrelated. Being in the same Department with the programmatic regulator of the Enterprises has facilitated communications and the sharing of expertise. As an example, we were able to express our views on the safety and soundness aspects of HUD's affordable housing regulations more effectively and earlier by virtue of our association.

At the same time, though, we are well aware of the potential for a difference of views reflecting the different natures of our responsibilities. Congress was also cognizant of this potential in designing our structure. While we are within HUD, we are substantially independent of HUD in all of our regulatory activities bearing on safety and soundness. The Secretary of HUD has no authority over our safety and soundness regulations, enforcement, or examination activities. Nor does he have any authority over our budget or the management of our office.

I think that is well understood at both OFHEO and at other sections of HUD. To help ensure that no misunderstandings developed, I decided as one of my first acts to move OFHEO out of the HUD building, so that we are not physically located at HUD. We are at 17th and G.

Given our mutual interests, I think the decision to place OFHEO in HUD was a wise one. I see no reason to change it. But I think that the most important decision the Congress made in designing our structure was to provide OFHEO with the same type of independent authorities that are granted to other financial institution regulators. Those measures of independence which create accountability and credibility are necessary for OFHEO to do an effective job. Mr. Chairman, the structure that you proposed for OFHEO in your bill, S. 1145, clearly recognizes the importance of this independence.

One aspect of OFHEO's independence is particularly relevant today. Like the other financial regulators, I am able to give you, and I am giving you my views. You can be confident that any information I give you about Fannie Mae or Freddie Mac has not been screened or altered by HUD or anyone else.

Thank you, and I will be happy to answer any questions that you may have.

Senator FAIRCLOTH. Thank you, Ms. Alvarez.

I have a number of questions and I guess the first question I have is for both witnesses. Currently, are Fannie Mae and Freddie Mac in sound financial condition? Is there anything on the horizon that poses a threat to their condition that Congress should be aware of?

Ms. ALVAREZ. I think that—and in our report to Congress, we indicated that—we don't see any problems in the near-term for either Enterprise.

They continue to be very profitable institutions. They posted record profits of $3 billion between the two of them last year. Their return on equity for several years has been over 20 percent.

I think with low mortgage rates and stable housing prices, the outlook for the housing market is good. And even where there has been a bit of an increase over the past several quarters with respect to delinquencies, they actually still have historically low rates of delinquencies, and so, they remain at a manageable level.

I think that with respect to the long term, we do have to keep paying close attention to the Enterprises because, as I outlined in my testimony, they are leading many changes in the industry and those changes have consequences that need to be watched.

Senator FAIRCLOTH. Mr. Retsinas.

Mr. RETSINAS. I would concur in that assessment. I am certainly not aware of any activities on the horizon which might in any way undermine or jeopardize their financial condition.

I would note that the mortgage marketplace and the capital markets are rapidly evolving. I do believe that these institutions are well positioned during that evolvement. But I would not underestimate the evolving changes in the marketplace.

Senator FAIRCLOTH. Mr. Retsinas, HUD increased the Affordable Housing Goal from 30 to 40 percent this year and 42 percent in years after that.

Mr. RETSINAS. Right.

Senator FAIRCLOTH. This is a one-third increase in the goal, and Freddie Mac did not even meet this goal in 1995. Do you think the goal impairs the safety and soundness of Fannie Mae, Freddie Mac? Do you see any way it could?

Mr. RETSINAS. I do not believe it does. As I indicated during my remarks, it is a balancing act. The goal is increased, but, really, it is increased less than the increase in their own activities. Again, as you can recall from the charts, for example, Fannie Mae already far exceeds the goal from the preliminary information we have in 1995, and it appears that Freddie is essentially at the goal also in 1995. So I am confident that those organizations will not only meet those goals, but also I am relatively confident that they will continue to exceed the goals.

Senator FAIRCLOTH. My question, though, we know that they can meet the goals but will it affect the financial integrity of the companies? And, is it potentially damaging or in any slight way to the—well, I will ask for the profitability and to the stability of the company?

Mr. RETSINAS. I do not believe so because if we had thought so, we would not have set the goals at the level we did. But let me elaborate beyond that. Again, I have great respect and confidence in the ability of these organizations. But in addition, there are other reviewers. As my colleague, Ms. Alvarez, says, we have communication with her office to make sure that she is aware, and she is one watchdog over that issue and gives us consultation.

I also, Mr. Chairman, look at the marketplace. As I look at the market and its assessment when the final goals were recently published, when the Act was passed, and when the transitional goals were initially published, there has really been no diminution in the market's expectation in terms of performance of these organizations.

Senator FAIRCLOTH. You mean the stock price.

Mr. RETSINAS. Right. The Department believes that the goals are reasonable. As Ms. Alvarez reported in her own testimony, her office does not believe that the goals would impinge on safety and soundness and it appears the market has that same perspective.

Senator FAIRCLOTH. Well, of course, the market has been extremely strong since you have instituted the goals, too, on everything pretty much.

Mr. RETSINAS. We won't take full credit for that, but thank you. [Laughter.]

But you can, if you like.

[Laughter.]

Ms. ALVAREZ. Mr. Chairman.

Senator FAIRCLOTH. Yes.

Ms. ALVAREZ. Just to add to what my colleague Nic has said, I think what matters here is the speed with which goals are increased. And I think there's an understanding by HUD that any increase has to be gradual. If there were to be a very abrupt, sudden increase in a goal to a level well beyond their current achievement, we would certainly be concerned. But I don't think that that's likely to happen.

Senator FAIRCLOTH. Ms. Alvarez, you said they were holding more of their own paper.

Ms. ALVAREZ. Right.

Senator FAIRCLOTH. Is this more of the affordable housing loan paper or is it more of their paper across the board?

Ms. ALVAREZ. Across the board.

Senator FAIRCLOTH. Are you having any trouble selling the affordable housing on paper? Does it move as well as the other?

Ms. ALVAREZ. I would suggest that a return on equity of over 20 percent is an indication that these companies are in a good line of business. That includes the affordable housing paper.

I have never heard anything to indicate otherwise—that Fannie Mae and Freddie Mac believe they are in the right line of business and that they are doing very well, frankly, as they also achieve these goals. It serves the public and it serves the companies.

Senator FAIRCLOTH. We'll come back to that later.

Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman.

Ms. Alvarez, I sit on the Finance Committee as well and there has been a lot of debate on that Committee about the tax policy changes, specifically changes, or repeal, actually of the home mortgage interest deduction.

There have been some studies to suggest that the repeal of the home interest deduction would cause a decline in home prices of as much as 15 to 25 percent. The question is would a repeal of the mortgage interest deduction raise safety and soundness issues for the GSE's?

Ms. ALVAREZ. I would say certainly the issue of the flat tax and eliminating the mortgage interest deduction——

Senator MOSELEY-BRAUN. We could get rid of the mortgage interest deduction without having a flat tax.

Ms. ALVAREZ. That's true.

Senator MOSELEY-BRAUN. But just that specific issue.

Ms. ALVAREZ. This is the sort of issue that we study as it evolves. It's obvious that one point of view is that it would lower the value of housing and that that could increase the possibility of losses from defaults.

So from a safety and soundness perspective, we would be concerned about whether in fact it would result in an increase of losses from defaults. But I couldn't say right now that this would necessarily raise a safety and soundness alarm.

Senator MOSELEY-BRAUN. Would you look into that and get me a letter of response in writing on that issue?

Ms. ALVAREZ. Absolutely.

Senator MOSELEY-BRAUN. Thank you very much.

The second issue is having to do with the historical, the financial performance between—and this gets to Senator Faircloth's question or the issue about privatization—specifically on the issue of the performance and return on equity of these institutions.

You mentioned in your statement that the return on equity is in the 20 percentile, or 20 percent, or thereabouts. Actually, in 1994, for Fannie Mae, the return on equity was 24.3 percent. For Freddie Mac, it was 23.2 percent. For the private sector, at the same time, for banks, commercial banks, FDIC-insured commercial banks, the return on equity was, in 1994, 14.6 percent.

Now, given the fact that the GSE's enjoy basically almost a 50-basis point advantage vis-à-vis the commercial banks, the question is, therefore, is it not the case, or does it not suggest that in light of these enormous profits by the GSE's, that perhaps they may be creaming the market or taking risk-averse behavior steps with regard to the secondary markets, generally, as opposed to the private sector that suggest a too-conservative approach to the lending activity or purchasing activity or, alternatively, creaming of what's out there?

Ms. ALVAREZ. Well, it is certainly our mission to ensure that these companies manage risk carefully and that they continue to be healthy.

And we have observed that in areas where they are venturing out to take more risks, that they tend to take a pilot project approach, which we think is a very good approach to take. With, for example, the 97 percent LTV loans or reverse amortization loans we expect them to do things on a smaller scale first, to ensure that they can then grow in those lines of businesses safely.

I think the two companies are in the business of fulfilling their charter and also of making money. And I think they try to balance both of those activities. That isn't necessarily creaming.

Senator MOSELEY-BRAUN. Maybe that was too strong a word. Let me try another one. In looking at delinquency rates, the private sector's delinquency rates, 0.64; Fannie Mae, 0.57; and Freddie Mac, 0.57. So it appears, therefore, that the private sector has a higher delinquency rate.

Here you have private sector higher delinquency rates on the mortgages, a lower return on equity, and the Federal Government is giving, again, a 50-basis point advantage to these GSE's. Does that not suggest that perhaps they're being a little too conservative in their outreach?

Ms. ALVAREZ. These companies are taking on some business that may be riskier than they have in the past. They may experience higher losses on some of those loans. We actually have some concerns about that, except that they appear able to manage their risks.

Overall, the companies are healthy, which means that they have been able to assume these risks and make money. I think it's really up to HUD to decide to what degree HUD would want to be more aggressive going forward. But as I cautioned before, it's very important that changes occur gradually. Any sort of abrupt change could lead to problems.

Senator MOSELEY-BRAUN. Well, but that kind of gets to the point, and Mr. Retsinas, you can pitch in whenever you get ready, with regard to low- and moderate-income mortgage purchases.

Fannie Mae is outperforming Freddie Mac. You've gone through the whole issue. Specifically on the issue of the central cities, it appears that there's been a real problem with Freddie Mac in terms of multifamily housing.

So, again, in light of the profits, the loss ratios, the advantage over the private sector, would that not suggest that it makes more sense for these institutions to do more in terms of low- and moderate-income housing, in terms of central cities, and, again, in terms of the part of the portfolio in which the private sector would be at a disadvantage vis-à-vis these entities?

Mr. RETSINAS. Clearly, we concur with the spirit of your remarks, which I would interpret—and tell me if it is a correct interpretation—that in return for substantial public benefits—the Government assistance that you outlined in your opening remarks—it is appropriate to ask that these institutions help fulfill the credit needs of communities and households all through this country.

We need to ensure in doing so that they pay special attention to those who are traditionally underserved, which is why we have suggested some increases in the goals, mindful of the balancing act that Senator Faircloth talked about.

But we think increases are appropriate and we've suggested so.

Senator FAIRCLOTH. Thank you.

Senator MOSELEY-BRAUN. I have other questions, Mr. Chairman, but I'll wait because the light went off.

Senator FAIRCLOTH. All right. We'll go several rounds, as many as you would like.

Senator MOSELEY-BRAUN. OK. Fine.

Senator FAIRCLOTH. As for your question on the impact on the flat tax and removing the mortgage interest deduction, I do not think that President Dole will support that.

[Laughter.]

Senator MOSELEY-BRAUN. Good. Then we don't have anything to worry about do we?

[Laughter.]

Senator FAIRCLOTH. Ms. Alvarez.

Ms. ALVAREZ. Yes.

Senator FAIRCLOTH. What is the minimum capital for the two companies?

Ms. ALVAREZ. The OFHEO has two capital standards. The second is the risk-based capital stress test which we are in the process of developing. But the first, which is the one that I immediately implemented once I was installed as Director, is the minimum capital requirement. And right now, both companies are classified as adequately capitalized. What that means is that Freddie Mac, for example, has a minimum capital requirement of $5.6 billion, and is holding core capital of $5.8 billion. Fannie Mae has a minimum capital requirement, using the ratios in the legislation, of $10.5 billion. They currently hold core capital of $11 billion. So each of these companies is classified as adequately capitalized.

Senator FAIRCLOTH. Just to be on the double- to triple-safe side as to what you were talking about a while ago, we were talking about enormous amounts of money, of course. It doesn't take much of a recession to chew up the kind of capital that you are talking about, as you well know, when you have this vast amount of money out there.

Should the capital requirements be raised? The reason I am saying that is a lot of small banks in this country are, i.e., overcapitalized. They have two to three times and far beyond the ratio that you're talking about here.

Just to make the American taxpayers assured that they don't have to pick up a bail-out of either one of these two companies, as you said, the debenture clearly says that it is not an obligation of the Federal Government. But can you imagine the chaos that would develop if these debentures started to default and the Federal Government says, you read the fine print, we hope. So what do you say to that the capitalization should be increased?

Ms. ALVAREZ. Well, first of all, I think you're right, that Fannie and Freddie potentially could pose a systemic risk given the nature of their financial activity.

A lot of thought went into the legislation that proposed the stress test that we are currently developing. The idea was that this stress test would be very finely attuned to the financial profile of those two companies and the risks that they are taking. It's a very complex test and it's unique in the world of financial regulation.

What the final number would be is something that I can't speak to right now because we are developing this test, and the results will be available with the final rule later on.

I think, though, you make a very good observation, which is that, relative to other financial institutions, some might say that these companies are thinly capitalized.

On the other hand, the risk profile of these companies is different from some of these other financial institutions. These are national companies. A regional collapse would not necessarily have a debilitating impact on the entire company because they're so vast.

But I do think that if you consider, for example, that other companies hold substantially more capital and they are insured, it is very important that we at OFHEO do our job right and that we consider every aspect of risk as we develop the stress test.

The minimum capital that they are holding right now does not reflect the risk involved in their businesses, necessarily.

Senator FAIRCLOTH. It does not?

Ms. ALVAREZ. No. It's an interim standard that was created so that they would at least be capitalized to a certain degree as we developed our stress test. So I think your observations are very reasonable ones.

Senator FAIRCLOTH. Mr. Retsinas, what is the rate of failure on your low- and moderate-income loans as compared to the other 70 or 60 percent?

Mr. RETSINAS. Generally speaking, we have been looking at that subject very closely, not just as it relates to the GSE's, but there are other institutions doing affordable loans in this country besides the Government-Sponsored Enterprises. We are looking at it very carefully. If you look at the rate of failure, to use that term, it's very low.

Senator FAIRCLOTH. Well, what other term would you use for failure, if they don't pay the bill and you repossess the house?

Mr. RETSINAS. Right, but I am looking at delinquency rates and default rates. The rate of failure is relatively low.

Senator FAIRCLOTH. On the affordable loans?

Mr. RETSINAS. On the affordable loans, right.

Senator FAIRCLOTH. The failure rate is about 1 percent.

Mr. RETSINAS. Right.

Senator FAIRCLOTH. Are there additional costs involved? Collecting the delinquent loans?

Mr. RETSINAS. Yes, there are. The holding costs and all that in addition to the cost of collections.

Senator FAIRCLOTH. If there is an ultimate collapse and failure.

Mr. RETSINAS. I think, clearly, by definition, the loans that have higher loan-to-value ratios, i.e., lower downpayments, are susceptible to more risk. The issue is how do we ensure that risk is managed and minimized?

So that the point is not to avoid risk. You can avoid risk by not making any loans. That is the best way to avoid risk. But you can't do that and stay in business.

Senator FAIRCLOTH. I was arguing that with a bank board one time. Where would you put your money?

Mr. RETSINAS. That doesn't have any risk?

Senator FAIRCLOTH. Yes.

Mr. RETSINAS. There are a lot of places that you can put your money that are sort of less risky, but you're not going to get any return from it.

Senator FAIRCLOTH. But what is risk-free?

Mr. RETSINAS. There is nothing that is risk-free.

Senator FAIRCLOTH. I thought you were going to tell me Federal debentures, you're sure of that.

Mr. RETSINAS. It's pretty close.

[Laughter.]

There is nothing that is risk-free. But, again, I think the issue is how do we manage risk, how do we minimize risk, and yet, still be attentive to what are very legitimate credit needs of communities and households all through this country?

Senator FAIRCLOTH. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you.

Before I came to the Senate, I was a recorder of deeds at Cooke County in Illinois. That meant that I had occasion to deal with housing issues from the inside, the minutia. It is as true in housing as in anything else that the devil lurks in the details. And so I raise with you the question today, and this is for both Mr. Retsinas as well as Ms. Alvarez, regarding the automated underwriting and credit scoring.

Both Fannie Mae and Freddie Mac are moving aggressively toward automation for underwriting of mortgages. Quite frankly, I have a real concern, and the concern has been raised that these details may have a disparate impact on nontraditional borrowers, minority borrowers, women, and others who do not have cookie cutter credit histories, and that then will mean that those people will more likely than not be locked out of the opportunities for the American dream and for homeownership. So, my question is, have these issues been considered, and what, if any, is the response?

Ms. ALVAREZ. I think that it's a legitimate concern and it's probably too early to tell what the effect is. But I think the intent of credit scoring and automated underwriting is to produce better quality loan transactions and potentially lower the cost for the homeowner.

There is a possibility that on the one hand, you might end up with sort of a colorblind approach if you're talking about automated underwriting, which could result in a fairer treatment of people who might ordinarily be turned away for reasons that are not relevant to the business transaction.

And yet, you're right. If it appears that using automated underwriting and credit scoring results in a rejection of a larger percentage of people of color, then you may end up with a disparate impact on that group.

Senator MOSELEY-BRAUN. How far along are the agencies in terms of employing these techniques?

Ms. ALVAREZ. It is still not a widespread practice. There are specific relationships with certain lenders and it is still not totally widespread in the industry.

Nic, do you want to comment?

Mr. RETSINAS. Sure. Senator, I would agree with Aida.

Senator the issue you raise, automated underwriting, is one of the most significant issues before us in the days ahead. We are looking at it closely, and let me give you a couple of the observations from that close look so far.

One, there is a certain inevitability to the increasing use of technology that whether we want it to happen or not happen. Technology more and more determines the way work is conducted in a variety of different arenas, and the mortgage marketplace is no different.

However, during this early period, this period of figuring out how to assess what it all means, I have concerns. We have this notion of a black box, where the information sort of goes in. No one is exactly sure how it's looked at, except those who are designing the box. And, this process might have the unintended consequence of keeping people out.

I think our challenge is how do we use technology to create more opportunities? How do we use technology to focus on those people who are creditworthy, but don't fall within the confines of a box and adapt it to do so?

So we need to look at this issue very, very closely. In some ways, it really parallels the emergence and evolvement of the secondary market as a whole, which has set certain guidelines. This is the next generation, when you look at it very closely.

Senator MOSELEY-BRAUN. Well, certainly, if having the computers make these decisions as opposed to real people make these decisions results in a hardening of disparate impacts, then that would not be the direction that I would think that would make sense for these Governmentally-supported institutions.

Put aside the private sector for a second.

These institutions I think have a special duty in this regard. And I would like your response to this question—that you would consider giving us some experience, doing this on a trial basis, as opposed to letting this be system-wide, before we look up and discover that we have done some harm here that could have been avoided.

Mr. RETSINAS. You're absolutely right. Now, we are engaging in a number of different things. We are looking at pilots, putting on my FHA hat for a second. We are looking at some pilots very, very carefully. We are talking with the GSE's about their use because the goal, of course, is to use the technology as a way to allow more creditworthy borrowers in.

Senator MOSELEY-BRAUN. Not less.

Mr. RETSINAS. Not to keep people out.

Senator MOSELEY-BRAUN. Right.

Mr. RETSINAS. That's the real challenge. But it's not going to be done if we just sit on the sidelines. We need to think this through and clearly understand what's at stake.

Senator MOSELEY-BRAUN. Well, that's right. We know what the best intentions yield, don't we?

Mr. RETSINAS. Yes, we do.

Senator MOSELEY-BRAUN. So we just want to make sure that this is done right.

Mr. RETSINAS. We surely do.

Senator MOSELEY-BRAUN. My last question, and I just said to the Chairman, this will be my last question for the day, and if I have any others, I'll put them in writing to you.

Ms. Alvarez, you particularly mentioned in your testimony that you issued a request for proposals to obtain assistance in helping determine—we issued a request for proposals to obtain assistance in helping us determine how to meet our statutory responsibility to prohibit excessive compensation. And you indicated there had been some preliminary work done in this regard.

I don't know to what extent comparisons can be made with the private sector or even if comparisons with the private sector are appropriate. But the salary levels, the top guy at Fannie Mae made over $1.5 million, which doesn't even include the long-term compensation last year—1994, I'm sorry. The second guy at Fannie Mae made $1 million, not including long-term compensation. At Freddie Mac, the top guy made $1.5 million, and the second guy made $950,000, again, not including long-term compensation. That, in these days and times when people are concerned about these issues of CEO compensation, is really kind of extraordinary.

You mentioned in your statement that you have done some preliminary work in this regard. But to what extent—one would think that the agency itself would be sensitive to this issue. To what extent have you gotten any conversation from the agency heads about this particular concern? These are awfully high. The salaries——

Ms. ALVAREZ. We have had extensive conversations over time with them about the issue of executive compensation. Part of the reason it's taken a while, in addition to the time needed for creating an office, was that my first objective was to look at the safety and soundness aspects of those two businesses.

How you frame the questions and the issues is very important. We have spent a great amount of time not only looking at their compensation structure, but also thinking about comparisons because we need to think about their compensation in comparison to other businesses.

The GSE's are really quite unique and that's part of the difficulty of this challenge. There are some who would say, putting on a public sector hat, that such compensation is out of hand. There are others who would say, putting on their private sector hat, that that is reasonable compensation for a job well done. And somewhere in between, we have to balance those perspectives and use expertise that's available to come up with—to fulfill our responsibility.

Senator MOSELEY-BRAUN. Well, again, I would like——

Ms. ALVAREZ. Your point is well taken. I understand your point.

Senator MOSELEY-BRAUN. It seems to me that it's a confusion in terms of the vision. Either these institutions are quasi-public, in which case they act like public bodies and they do things like low- and moderate-income housing, multifamily housing, and central cities and help to lift up the housing stock of this country, or, alternatively, they're private institutions, in which case they ought to go out and compete in the private sector and not get a 50-basis point advantage from the taxpayers. You cannot be a duck and a chicken at the same time, it seems to me.

Ms. ALVAREZ. They may be.

Senator MOSELEY-BRAUN. I understand, but if they are a duck and a chicken, then we need to have a definition of what duck-chickens do.

[Laughter.]

Ms. ALVAREZ. A very good observation. Thank you, Senator.

Senator FAIRCLOTH. Ms. Alvarez, as you well know, the Banking Committee as a whole, and particularly since the Orange County fiasco, and Ms. Lumas' articles in Fortune magazine on derivatives, that we're pretty highly attuned to derivatives. And I think that maybe one of the problems is that most of us don't understand them. Do you see any risk with the derivative holdings in either one of the companies? And I use the word, any risk. Any significant risk whatsoever.

Ms. ALVAREZ. We really devoted a great deal of time to this issue and reported on the results of our examination in this area. It was one of the first examinations that we did.

And what we concluded was that, as I said before, these institutions are not using derivatives for speculative purposes. They're really using them to hedge, to reduce funding costs. Derivatives help them achieve an overall liability structure that they desire at lower cost than they could otherwise achieve.

This is one of those areas that we really do keep an eye on and we conducted an examination and made specific recommendations. At Fannie Mae, we urged greater involvement by the board of directors. We asked them for a clearer delineation of their derivatives policies. We asked them to expand their internal reporting. We made similar recommendations to Freddie Mac. We asked them to develop a more in-house capacity to measure current credit exposures.

In both cases, the Enterprises have complied with our recommendations in a fully satisfactory manner. So, sir, we are very mindful that this is a very sensitive area and we will continue to monitor this through our exam process. And those risks will also be reflected in the stress test.

Senator FAIRCLOTH. Not only is it sensitive. It is explosive.

Ms. ALVAREZ. It is.

Senator FAIRCLOTH. As we all know. Mr. Retsinas, the goal of affordable housing is certainly admirable and we're all sensitive to it and what it does. But assets, money are not infinite.

You are raising your percentage of loans to affordable housing. What effect is it going to have on low- and moderate-income mortgages? And is it going to have a detrimental effect on the low to moderate group, and are they going to be, in effect, pushed out or is it going to be more difficult for them to get a mortgage? If you are pushing your percentage up, how do you do that without the moderate-income mortgage suffering or being restricted?

Mr. RETSINAS. Well, again, we are talking about increasing percentages, we believe, reasonably and prudently for low and moderate income. And as we look at the mortgage marketplace, almost by definition, close to half of all the mortgages are for families of low and moderate income. That's the definition of moderate or median income.

Senator FAIRCLOTH. What's the definition of moderate?

Mr. RETSINAS. One hundred percent of median income.

Senator FAIRCLOTH. One hundred percent of median.

Mr. RETSINAS. Right.

Senator FAIRCLOTH. And that varies from——

Mr. RETSINAS. Place to place, metropolitan area to metropolitan area.

Senator FAIRCLOTH. —place to place.

Mr. RETSINAS. Generally speaking. It could be anywhere from $25,000 per family to $40,000 to $45,000, depending on the markets and the like.

We believe that these institutions have and can continue to add value by making credit available to low- and moderate-income families. In many ways, moderate-income households have been the primary beneficiaries of these important institutions. As I'm sure you know, Mr. Chairman, last year, President Clinton set forth a new national homeownership goal, believing, as I know you do, that if we are going to revitalize our communities, promoting homeownership is a good way to do that.

We believe and know these institutions are strong partners in that effort and we believe their performance and their willingness not only to meet these goals, but exceed them is evidence of that commitment. I have confidence that they will exceed these goals on a voluntary basis and make homeownership more possible for literally hundreds of thousands of American families.

Senator FAIRCLOTH. All right. If I understood you, roughly, low and moderate income, you say roughly 50 percent.

Mr. RETSINAS. Our estimate of the market, yes, roughly.

Senator FAIRCLOTH. Well, roughly, OK.

Mr. RETSINAS. Right.

Senator FAIRCLOTH. What would be the average-income level of the other 50 percent?

Mr. RETSINAS. It will vary significantly. The low- and moderate-income levels are statistical defined groups encompassing people of median income.

People's income, as we have heard from Senator Moseley-Braun, can be very, very high. Generally speaking, however, as you know, these institutions are bound by the conforming loan limits. So people at very, very-high income will not use the Government-Sponsored Enterprises because the amount of the mortgages they require usually exceed those conforming loan limits.

Senator FAIRCLOTH. What is the limit now?

Mr. RETSINAS. $207,000.

Senator FAIRCLOTH. $207,000?

Mr. RETSINAS. $207,000, sir.

Senator FAIRCLOTH. $207,000. I know we have been talking about changing it.

Mr. RETSINAS. It went up recently from $203,00 to $207,000.

Senator FAIRCLOTH. They've been talking about change.

Mr. RETSINAS. Right. It's indexed to housing prices, sir.

Senator FAIRCLOTH. A somewhat controversial issue has been the recent—news reports have indicated that Fannie Mae and Freddie Mac ran political ads in Iowa attacking the flat tax. Does the Department have a position as to whether this is a proper function of a guaranteed and Government-Sponsored Enterprise?

Ms. ALVAREZ. Nic?

[Laughter.]

Mr. RETSINAS. We believe that we need to be careful that the Department does not micro-manage these Enterprises. We believe it is appropriate for these institutions to inform the public about the impact of pending issues.

Senator FAIRCLOTH. Inform the public about, what, now?

Mr. RETSINAS. Pending issues. Basically, they have an obligation as large institutions to make sure people are aware of public policy implications. We do not have a specific position as it relates to this specific activity, a specific ad. Again, we have been trying to focus, pursuant to the 1992 Act, on the performance on affordable housing loans. That has been our focus.

Senator FAIRCLOTH. I disagree to the extent that I think they should stay totally out of politics because you're dealing with such a thin line between issues and individuals.

How do you support—of course Mr. Forbes came with this flat tax, but the flat tax was out there other than by him, of course.

But any Government-guaranteed, sponsored, as closely tied to the Federal Government and to taxpayers as is these two companies, I think ought to avoid political involvement to the nth degree.

Ms. Alvarez, what was your thought?

Ms. ALVAREZ. It doesn't appear to constitute a safety and soundness concern. I think that these two companies are involved in the public arena. They're involved in a line of business that is of public interest and of public concern.

I do think that it's certainly appropriate for you, sir, to comment on their activities since these are Federally-chartered companies. But I think that, from our perspective, we do stay away from telling them what to do, and we do accept the fact that they do have a right to inform the public. Now where that seems to cross the line is something for you to decide.

Senator FAIRCLOTH. I think it's an extremely dangerous area and I don't see how—you get into this informing the public. Everybody wants to inform the public.

Mr. Retsinas, last summer, Jim Leach suggested that Fannie Mae and Freddie Mac should pay part of the financing corporation FICO debt. Under the Administration's plan, commercial banks will pay about two-thirds of the $800 million a year debt. Can you think of any reason why these two companies should not pay part of this debt?

Mr. RETSINAS. I am familiar generally with the preliminary proposal of Chairman Leach, which was later withdrawn.

Our focus continues to be how we promote affordable housing. We believe that that's an appropriate focus for us under the legislation. It is not part of the Administration's plan that in dealing with the resolution of other outstanding financial issues, that this is a way to address those issues.

As we said at the outset, as we both said at the outset, this is a balancing act. It is a balancing act between the profitability of institutions and a balancing act between their obligation to address credit needs. We believe that the current act and the current distribution of that balance is the appropriate one.

Senator FAIRCLOTH. But you don't think that they should pay part of this debt? I'm sorry?

Mr. RETSINAS. In terms of the part of that, that's part——

Senator FAIRCLOTH. In other words, Jim Leach says they ought to pay part of the debt.

Mr. RETSINAS. That's right. That was the initial proposal, so many basis points.

Senator FAIRCLOTH. Do you think they should?

Mr. RETSINAS. No, we do not believe they should pay part of that debt in that isolation. We can look at the larger picture of the budget. But, we need to understand the trade-offs. So, no, we did not support that proposal.

Senator FAIRCLOTH. Ms. Alvarez, what would the impact of the two companies be if they were required to pay, say, approximately $600 million in FICO debt?

Ms. ALVAREZ. Six hundred million is a significant amount of money, although there are those who would say that for two companies that have made $3 billion in profits, that it would not be out of the realm of possibility.

Again, I think that I share my colleague's view that the proposal involves changes that deviate from the charter and from the mission that we have been set up to do. So I would rather not comment on it.

Senator FAIRCLOTH. All right. Mr. Retsinas, what is the status of your report on the privatization of Fannie Mae and Freddie Mac? And would you like to offer an opinion on it now?

Mr. RETSINAS. We expect to complete the report by the end of the month and I think prudence would dictate that we complete the report before we offer you our opinion. But we would be happy to do so at that time, sir.

Senator FAIRCLOTH. All right. Ms. Alvarez, has your office been part of the report on privatization?

Ms. ALVAREZ. We are not charged with producing a report on privatization, but we have held discussions and have been part of the discussions with all the agencies that are involved. We have been told that we may be asked to appear at a hearing in April on the topic of privatization and hopefully, by then, we will have formulated our own conclusions.

Senator FAIRCLOTH. Would you like to give us an opinion now?

Ms. ALVAREZ. No, sir.

[Laughter.]

Senator FAIRCLOTH. Well, since Senator Moseley-Braun has left, and I don't believe I have any more questions, I would like very much to thank you both for coming.

Let me say that it will be in order to submit questions in writing. So you may expect that some Members that could not be with us today will possibly be contacting you and following up with questions for the record.

With that, we stand adjourned, and thank you for coming.

Mr. RETSINAS. Thank you, Mr. Chairman.

Ms. ALVAREZ. Thank you.

[Whereupon, at 11:45 a.m., the Subcommittee was recessed.]

[Prepared statements and response to written questions supplied for the record follow:]

**STATEMENT BEFORE THE SENATE
SUBCOMMITTEE ON
HUD OVERSIGHT AND STRUCTURE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS**

**WASHINGTON, DC
MARCH 5, 1996**

**BY
NICOLAS RETSINAS
ASSISTANT SECRETARY FOR HOUSING
FEDERAL HOUSING COMMISSIONER**

Mr. Chairman, thank you for the opportunity to speak about the recently published Rule implementing the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the Act). As you know, that Act clarified and strengthened HUD's responsibility to oversee Fannie Mae's and Freddie Mac's performance in meeting the public purposes set forth by Congress in their Charters. It also set forth a framework to ensure the financial safety and soundness of these two secondary market housing Government-Sponsored Enterprises (GSEs). Aida Alvarez, Director of HUD's Office of Federal Housing Enterprise Oversight, is here to address regulation of the GSEs' safety and soundness issues. I will discuss the Secretary's role in monitoring the GSEs' performance in carrying out their public purposes.

The Act Makes Sense

The Act reaffirmed the Secretary's oversight role and reinforced the GSEs' obligation to fulfill public purposes in exchange for the substantial public privileges they derive from their Government-sponsored status. The law makes sense. Fannie Mae and Freddie Mac are two of the largest companies in the Nation, measured in terms of their assets and profits. They are sophisticated and well-run and play an important role in this country's mortgage finance system. Given the explicit and implicit benefits the GSEs receive from their relationship with the Federal Government, the intent of the law—ensuring that these huge corporations provide the benefits of a secondary mortgage market to all citizens including low-income Americans and others who traditionally have been underserved by the mortgage market—is appropriate.

The Secretary's new Rule, which became effective January 2nd, establishes a framework for carrying out the reasonable legislative decisions made by Congress in 1992. The public purposes of the GSEs, reinforced by the 1992 Act, include: Increasing the liquidity of mortgage investments; providing ongoing assistance to the secondary market for residential mortgages, including activities relating to mortgages on housing for low- and moderate-income families; and promoting access to mortgage credit throughout the Nation, including central cities, rural areas, and other underserved areas. The Act established three housing goals to target a reasonable amount of the GSEs' mortgage purchases to housing for very-low-, low-, and moderate-income families and housing located in central cities, rural areas, and other underserved areas. In addition, the Act required that the Secretary: Advance fair lending by prohibiting the GSEs from discriminating in their mortgage purchases; review and approve of new GSE programs; and collect data and information on the GSEs' housing activities for public dissemination. *The Rule, published this past December, achieves the Congressional intent of elevating the importance of the GSEs' public mission, without undue interference or heavy-handed regulation and without threatening the GSEs' financial condition.*

The Rulemaking Process was Open

The Rulemaking process was informed, open, and participatory; it far exceeded the requirements and expectations of the Administrative Procedures Act and Rulemaking Guidelines. The Rule was developed under a collaborative process, after extensive analysis of mortgage market data, and with significant consideration of statutorily-mandated factors and comments received from numerous housing industry representatives. Throughout the Rule-development process, HUD staff sought out information and data from experts in the housing field. We convened a series of interagency working group meetings and public forums, contracted with housing researchers and the Urban Institute to collect and analyze data, and discussed our work with the GSEs' themselves to ensure that the goals established in the final rule were appropriate. *As a result of all of HUD's outreach efforts, the Rule itself reflects the concerns and suggestions of the housing industry.*

The Rule Carries Out the Intent of the 1992 Act

FACTORS CONSIDERED IN ESTABLISHING THE GOALS

The statutorily-mandated Affordable Housing Goals—the Low- and Moderate-Income Housing Goal; the Special Affordable Housing Goal; and the Geographically-Targeted Goal—are designed to focus a portion of the GSEs' mortgage purchases on housing for lower-income families and families in areas underserved by the mortgage market.

The levels at which these goals were set are achievable, yet rigorous. The levels of the goals were established following consideration of the factors set forth in the Act. Throughout the Rule-development process, HUD considered these factors to ensure that the levels at which the goals were ultimately set would be consistent with mortgage trends and would not impose an undue financial burden on or materially impact the financial condition of the GSEs. I'll briefly outline our findings regarding each of these statutorily-mandated factors.

NATIONAL HOUSING NEEDS. *Homeownership and the provision of affordable housing are basic objectives of U.S. housing policy.* In determining the level of each goal, HUD examined the history of homeownership rates and concluded that homeownership has become more elusive for lower-income families, as many were closed out of the housing market during the 1980's. Low-income families with children, who could most benefit from the advantages of ownership, bore the brunt of the decline in ownership rates. This decline in homeownership rates has been compounded by the difficulty of poor households in finding affordable housing as low-cost rental units are lost to disrepair or are upgraded to serve higher-income renters.

ECONOMIC, HOUSING, & DEMOGRAPHIC CONDITIONS. *HUD considered the condition of the housing market overall and relative to each of the goals.* Several demographic changes will affect the demand for housing over the next few years, including: Continued increases in immigration, changes in age and family composition of households, and growth of nontraditional households such as singles and single-parent households. Demand from first-time homebuyers, many of whom were closed out of the market during the 1980's, should remain strong, given the increased flexibility of underwriting standards applied by the GSEs, private mortgage insurance companies, and lenders. A recent study by the Urban Institute concluded that there was a significant lower-income population of potential creditworthy business.

HUD also considered the effect of changes in interest rates. Interest rates continue to remain lower and housing more affordable than was true for any previous extended period since 1977. HUD also considered that certain property types have a greater impact on meeting the goals. For example, about 90 percent of the units in multifamily properties, qualify as low- and moderate-income housing. Both of the GSEs have indicated that they will be purchasing a larger share of mortgages on multifamily properties relative to their single-family mortgage purchases. Thus, a shift in the shares of property types purchased by the GSEs will increase the ability of the GSEs to meet the goals. The housing goals have been set so that they will remain appropriate should the interest rate environment become less affordable than existed during 1993–95.

PREVIOUS PERFORMANCE OF THE GSES. HUD analyzed the GSEs' mortgage purchase activities in 1993 and 1994 in detail. In particular, HUD focused on the GSEs' performances with respect to their transition goals and the GSEs' efforts to achieve the goals through the introduction of new marketing efforts, programs, products, and relationships. The GSEs' specific performance relative to the goals and the other market players is discussed in more detail subsequently. However, *in establishing the goals, consideration was given to the facts that: (1) the GSEs have, generally, improved their performances relative to the transitional goals over the past 3 years; and (2) that the GSEs' purchases of low-income loans continues to lag those of other mortgage market participants including portfolio lenders.*

SIZE OF THE CONVENTIONAL MARKET. *An important consideration in determining the level of the goals was the size of the relevant loan market relative to the overall conventional, conforming market.* Calculations of market size, based on extensive analysis of mortgage market data, convinced us that it was feasible to readjust the levels of the goals from the transition targets set out in the 1992 Act. I'll go into more detail on this factor below.

ABILITY OF THE ENTERPRISES TO LEAD THE INDUSTRY. *The GSEs have the ability to lead the mortgage finance industry in making mortgage credit available for the groups and regions targeted by the goals.* The GSEs' leadership role in the mortgage markets due to their high-market share, standardization of underwriting standards, development of new programs and products, and development and use of cutting-edge technology, in addition to their substantial staff expertise and financial resources, was considered in setting each of the goals.

NEED TO MAINTAIN THE SOUND FINANCIAL CONDITION OF THE ENTERPRISES. The GSEs are substantial corporations as measured by asset size and profits. HUD considered the effect of each of the goals on the respective financial strength of each GSE by evaluating the credit risks the GSE would assume through the purchase of additional mortgages that are affordable to lower-income households and that are for properties located in underserved areas. *The increase in risk to the GSEs is limited and the goals do not raise any significant concerns regarding the stability and soundness of their financial condition.* The law requires the GSEs to continually review their underwriting standards to detect unfair treatment of lower-income borrowers and to make changes as appropriate. HUD believes that this can be done without jeopardizing the financial soundness of the GSEs.

36-340 96 - 2

MARKET METHODOLOGY

As mentioned above, the factor that required the most extensive analysis was estimating the size of the market for each housing goal. For example, what percentage of newly mortgaged owner and rental dwelling units are occupied by low- and moderate-income families. HUD's basic model for calculating the size of the markets relevant to each of the housing goals involved estimating: (1) the share of the market (in dwelling units) by type of property (single-family owner, single-family rental, and multifamily); (2) the proportion of dwelling units financed by mortgages for each type of property meeting each goal; and (3) the size of the market by weighing each such goal share by the corresponding market share.

The main difficulty HUD encountered for estimating market share was gathering complete and consistent mortgage data. No single data set was available for calculating either the property shares or the housing goal percentages. HUD relied on several major data bases, which provided a wealth of useful information particularly for the single-family mortgage market. HUD combined information from the Home Mortgage Disclosure Act (HMDA) reports, the American Housing Survey (AHS), HUD's Survey of Mortgage Lending Activity (SMLA), and the Census Bureau's Residential Finance Survey (RFS).

To reduce the range of uncertainty in the market estimates, HUD carefully reviewed all of the known major data sources and conducted numerous sensitivity analyses to show the effects of alternative assumptions about market conditions. In addition, HUD contracted with the Urban Institute to comment on the reasonableness of its market share approach and to conduct analyses related to specific comments received from the public about the market share methodology. The Urban Institute affirmed the validity of HUD's methodology.

LEVEL AND DEFINITION OF EACH GOAL

As mentioned above, I believe that HUD fairly and reasonably established the levels of the goals in the final rule. The levels of the goals were based on sensible market-size calculations, consideration of the additional statutorily-mandated factors, and refined, more-targeted definitions of the goals. Let me expand upon each goal in turn to provide a more detailed explanation of the final definitions and characteristics of the goals.

LOW- AND MODERATE-INCOME HOUSING GOAL. The Low- and Moderate-Income Goal directs the GSEs to purchase mortgages financing housing for low- and moderate-income families—i.e., families with incomes below area median income. After consideration of the relevant factors, HUD set the goal at 40 percent of the GSEs' purchases (measured in dwelling units) for 1996 and 42 percent for 1997–1999.

Based on the market share calculations discussed above, HUD determined that the estimated range of the size of the low- to moderate-income market was 48–52 percent. This range indicates that of the total number of dwelling units financed in the conforming conventional primary mortgage market, 48–52 percent are occupied by or affordable to families with incomes less than the area median income.

HUD raised the level of the goal from the 30 percent target set out in the Act so that the goals would be more on a level with market performance, as well as the GSEs' recent performance. In 1994, 45 percent of Fannie Mae's and 38 percent of Freddie Mac's mortgage purchases supported housing for low- and moderate-income families. HUD considered Fannie Mae's suggestion that the Low- and Moderate-Income Housing Goal be set at 38 percent, but felt that this level would be inconsistent with the legislative history of the Act, which calls for goals that "the Enterprises would need to stretch their efforts to achieve." HUD also considered raising the level of the goal to 50 percent, but dismissed this alternative as too drastic. A 50 percent goal would represent a precipitous increase from the 1993–1995 goal of 30 percent. *HUD adopted an approach that moves the GSEs significantly, but judiciously, toward the market size considered most appropriate at this time.*

GEOGRAPHICALLY-TARGETED GOAL. During the transition period from 1993–1995, the GSEs were operating under a goal that included only OMB-defined central cities and that set a mortgage purchase target of 30 percent by the end of 1994. After the transition period, the Secretary was directed to refine and expand this goal to cover rural areas and other underserved areas. The Secretary was to examine available data to establish appropriate definitions for underserved areas for central cities, rural areas, and other underserved areas and to determine the size of the mortgage market available for GSE purchase in those areas to set the level of the goal. HUD analyzed data on mortgage origination and denial rates and determined that low-origination and high-denial rates correlated with areas where median incomes were low and where the concentration of minorities was high. Based on this analysis, HUD used low-median income and high-minority concentration as proxies for underservedness. This approach is supported by numerous academic and government studies that examine the types of neighborhoods that have difficulty accessing mortgage credit.

Based on research on mortgage flows, HUD determined that for *metropolitan* areas, this goal for the GSEs' mortgage purchases should be targeted to areas where the median income of families was less than or equal to 90 percent of the area median income OR where 30 percent or more of the residents in the census tract were minority and the median income of families was at or below 120 percent of area median income. For *non-metropolitan* areas, the goal would target counties where the median income did not exceed 95 percent of the greater of the State non-metropolitan median income or the nationwide non-metropolitan median income OR where minorities comprised 30 percent or more of the residents and the median income of families was at or below 120 percent of the State non-metropolitan median income.

The goal established in the final rule was set at 21 percent for 1996 and at 24 percent for 1997–99. The level of the goal decreased from the 30 percent transition target to accommodate the more targeted definition of the final rule. HUD estimated that mortgages in underserved areas account for 25–28 percent of the conventional conforming market.

The clear advantage of HUD's geographically-targeted goal is that it has been defined to better target areas of the country that are underserved by the mortgage market. HUD considered maintaining the OMB-definition of central cities set out in the Act for the transition period, but concluded from research conducted by HUD staff, the GSEs, and other mortgage-market analysts that the broad central city definition did not address the Congressional intent of increasing GSEs' activity in areas underserved by the mortgage market. Using the OMB-definition to target the goal, the GSEs would receive credit for mortgage purchases on housing located in well-served areas of central cities, such as Chicago's "Gold Coast" and Washington's Georgetown. The mortgage denial rate in these better-off portions of central cities is only one-half of the denial rate in underserved areas (11 percent versus 22 percent).

The broader definition also excluded some severely distressed areas located just outside of the OMB-defined central city jurisdictions, such as Paterson, NJ and Compton, CA. In addition, the substantial regional variation in urban boundaries was overlooked by the OMB-definition. In Southern and Western States, cities have grown in size by annexing adjacent territory, whereas in the Northeast, cities have retained their historical boundaries. Therefore, a greater portion of the population in the South and West lived in central cities than in the Northeast. HUD's new, targeted definition addresses each of these problems and encourages the GSEs to increase their presence in areas truly underserved by the mortgage market.

SPECIAL AFFORDABLE GOAL. The Special Affordable Housing Goal is designed to target GSEs' mortgage purchases to rental and owner-occupied housing that meets the needs of very-low-income families and low-income families living in low-income areas. These are the families experiencing the most difficult affordability problems. The final rule sets the level of the Special Affordable Housing Goal for 1996 at 12 percent of the total number of dwelling units financed by each GSE's mortgage purchases and for 1997–1999 at 14 percent. HUD estimated this market to range in size from 20–23 percent of the total market.

The final rule also requires that each GSE annually purchase multifamily mortgages in an amount at least equal to 0.8 percent of the total dollar volume of mortgages purchased by the GSE in 1994. Based on total mortgages acquired by the GSEs in 1994, Fannie Mae's multifamily requirement is $1.3 billion, and Freddie Mac's multifamily requirement is $980 million. This component of the goal further encourages the development of a secondary market for Special Affordable multifamily loans.

The final rule overhauls the Special Affordable transition targets established in the Act. The transition goal was fairly complicated, with two subgoals and two subcategories for each subgoal. In addition, the transition goal set out a dollar volume of business for the GSEs to meet. The simplified goal of the final rule sets a dollar volume multifamily subcategory and the total goal is based on a percentage of total number of dwelling units, similar to the other two goals.

To restate, the final goals are feasible and reasonable. The goals comply with the statutory requirements set forth in the Act, require the GSEs to fulfill their public responsibilities; yet, the goals allow the GSEs' flexibility to choose business strategies that best meet their needs as large, shareholder-owned corporations. Features of all of the goals that enable the GSEs to balance their public responsibility with the corporate framework include: (1) the goals are measured as a percentage of the total number of units financed, which means that the proportion of goal-related business is consistent with the overall activity of the GSEs for any given year—the goals adjust to current-year volume; (2) the goals were established for a 4-year period so that the GSEs could better plan their business activities in advance—the goals do not "ratchet upward" each year; (3) the GSEs can receive credit under each of the goals for their purchase of one mortgage—in other words, one mortgage can satisfy all three goals; and (4) the goals are designed to be achievable under varying economic conditions to accommodate inevitable market fluctuations.

EFFECTS OF HOUSING GOALS ON THE MARKET: SINGLE FAMILY

The benefits of a well-developed secondary market for mortgage loans have long been recognized. Fannie Mae and Freddie Mac have helped to channel lower-cost capital to the housing markets, expanding the benefits of homeownership and improving the condition of renter households. But often, lower-income families have not shared fully in the benefits of the overall secondary market. The housing goals are one mechanism for remedying this situation.

Specifically, they are intended to encourage the GSEs to continue their pursuit of more customized mortgage products, underwriting, and outreach. It is thereby hoped that the secondary market's benefit of lower cost financing and the benefits of homeownership can be extended to creditworthy, low- and moderate-income households, or specific geographic areas that have not been as well-served with traditional products, underwriting, and marketing.

Some observers have raised concerns about the potential market effects of the housing goals. Worries have been expressed about whether additional good quality loans satisfying the goals remain to be made or whether the goals might only be satisfied at the cost of reducing the volume of loans that would otherwise be made by non-GSE portfolio and FHA lenders. The goals appear to be in line with what is happening in the broader market for housing finance. The recent affordable housing initiatives supported by lenders, Private Mortgage Insurers (PMIs), and the GSEs suggest that there is room for expansion in the affordable lending market without compromising the business base of non-GSE portfolio or FHA lenders.

HUD also concluded from examination of market trends that while increased efforts and activity by the GSEs in the affordable housing arena could cause some realignment in market shares away from conventional portfolio and FHA lenders, the magnitudes are likely to be small. Both the increased volume of affordable housing loans and results from analysis conducted by the Urban Institute and others indicate the existence of potential homebuyers which would allow for increased lending by all lender types.

There are many reasons why the housing goals should not by themselves have any significant impact on either portfolio or FHA lenders. First, the market for affordable loans continued to expand in 1994 and 1995, such that GSEs may need only to keep pace with market developments and not have to measurably increase their market penetration. Second, because there are many different products and strategies the GSEs could use to meet the goals, and because any one loan purchase may qualify toward as many as two or three goals, it is unlikely that any one segment of the lender community will be adversely affected in a significant manner. Third, portfolio lenders generally originate a significant volume of conforming loans either for immediate delivery to the secondary market, or to maintain the potential for future liquidity via sales to the GSEs. The GSEs are then not entirely competitors for market shares, but rather business facilitators. Fourth and last, portfolio lenders prefer to hold adjustable-rate loans, while the mortgage insurers and GSEs have mainly accepted loans with fixed-interest rates and payment schedules into their affordable loan programs. Having secondary market outlets allows portfolio lenders to offer a wider variety of loan products to their customers, helping them to compete with mortgage bankers.

Our research has led us to conclude that far from restructuring the markets of portfolio or FHA lenders, *expanded GSEs' purchases of mortgages in goals-oriented areas creates more viable markets in which lenders can operate. Increased lender liquidity increases credit availability, which not only helps borrowers but also generates increased originations and servicing volumes for the lenders.*

EFFECTS OF HOUSING GOALS ON THE MARKET: MULTIFAMILY

The secondary market activity for multifamily housing is not nearly as developed as that for single-family housing. About one-third of multifamily mortgages are sold on the secondary market, compared to about three-fourths for single-family mortgages. The Government-Sponsored Enterprises do not dominate the multifamily mortgage market as they do the single-family market—according to annual reports submitted to HUD, Fannie Mae's and Freddie Mac's combined purchases of multifamily mortgages in 1994 were approximately $5.7 billion out of a total market estimated to be in excess of $30 billion.

As a result, debt financing for multifamily mortgages remains dependent on portfolio lenders, many of whom are depository institutions (banks and thrifts). Despite the difficulties posed by institutional changes in the past two decades originations of multifamily mortgages banks and thrifts have increased. And in addition, multifamily securitization increased significantly in 1994. However, these trends have not increased access to credit for certain classes of multifamily properties, including smaller, inner-city properties; larger redevelopment projects; seniors' housing; and affordable new construction in higher growth markets.

The availability of credit for higher-income classes of multifamily properties demonstrates the benefits the goal will bring to the affordable rental housing market. Specifically, the current competition for multifamily mortgages on amenity-rich apartments has resulted in increased liquidity of the mortgages and a tightening of mortgage yield spreads to comparable maturity Treasury yields for privately-issued multifamily Mortgage-Backed Securities (MBS). Lower mortgage yields on multifamily mortgages lower the capital costs for owners, which, in turn, reduce rents paid by tenants, improve the quality of the existing housing stock, or both. *Therefore, the Government-Sponsored Enterprises can ultimately improve housing quality and/or lower rents paid by low-income families by similarly reducing the cost of capital for affordable housing.*

By further developing a secondary market for multifamily mortgages, the GSEs can extend the benefits that come from increased mortgage liquidity to many more lower-income families over time while helping private owners to maintain the quality of the existing affordable housing stock. That is, greater liquidity and stability in the secondary market will benefit lower-income renters. This is the main role for the GSEs in the multifamily market.

The Act is Working: The GSEs' Performance is Improving

On February 29, 1996, Fannie Mae and Freddie Mac submitted annual reports on their 1995 performance to HUD. The 1995 performance is measured in terms of the transition goals that were set forth in the 1992 Act, rather than in terms of the final goals, discussed above. However, Graphs 1, 8, and 9 show how the GSEs' performance in 1993–1995 would appear using the final goals' definitions and levels. As you can see from the graphs, both Fannie Mae's and Freddie Mac's performance has improved over the past 3 years. However, it is apparent that Fannie Mae's efforts to purchase mortgages that count toward the goals have improved their performance at a significantly faster rate than Freddie Mac's efforts.

Before I discuss the GSEs' performance on the goals, I should mention that the numbers I will cover are taken from tables of aggregated loan data submitted by the Enterprises with computer tapes that provide more detailed data on all of the loans purchased in 1995. Unfortunately, because of the sizable volume of mortgages covered in the computer tapes, we did not have time to analyze all of the loan-level data to verify the GSEs' stated performance or to do more detailed analysis. However, from the aggregated loan data provided in the tables, we can extract a good deal of information on the GSEs' performance.

LOW- AND MODERATE-INCOME GOAL

Graph 1 clearly demonstrates the progress the GSEs have made in serving the low- and moderate-income sector of the market. Fannie Mae and Freddie Mac exceeded both the transitional Low- and Moderate-Income Housing Goal for 1993 through 1995 and the goal established in the final rule. Fannie Mae's performance improved measurably, moving from 34 percent of their mortgage purchases in 1993 to 46 percent in 1995. Prior to passage of the Act, Fannie Mae's low- and moderate-income purchases were at 28 percent. Freddie Mac also made progress under this goal, increasing their low- and moderate-income activity from 30 percent of their mortgage purchases in 1993 to 39 percent in 1995. Freddie Mac's 1992 low- and moderate-income purchases were only 24 percent.

SPECIAL AFFORDABLE GOAL

Graphs 2 and 3 show the GSEs' performance under the Special Affordable Goal has also improved. The Special Affordable Goal targets housing for very-low-income families and for low-income families living in low-income areas. Under the transition goal, GSEs' activity for 1993–1994 period was combined and dollar targets were set for both single-family and multifamily mortgage purchases. Graph 2 shows that during the 1993–1994 period, both Fannie Mae and Freddie Mac achieved the single-family portion of the goal, with Fannie Mae achieving 131 percent of the goal and Freddie Mac achieving 110 percent. Under the multifamily portion of the goal, however, Freddie Mac was less successful. While Fannie Mae achieved 125 percent of the goal, Freddie Mac achieved only 63 percent.

The transitional goals were extended through 1995, while the final rule was being completed. Graph 3 shows that the GSEs' performance continued to improve in 1995. Fannie Mae achieved 182 percent of the single-family portion of the goal and 188 percent of the multifamily portion. Freddie Mac showed a dramatic increase in its Special Affordable activities in 1995. Freddie Mac achieved 148 percent of the single-family portion of the goal and an impressive 283 percent of the multifamily portion. I am very encouraged by the continuing expansion of the GSEs' multifamily business because multifamily housing serves more lower-income families than single-family housing.

CENTRAL CITY GOALS

Graph 4 demonstrates the GSEs' performance under the Central City Goals. During the transition period, this goal targeted mortgage purchases in OMB-defined central cities. This goal has been more problematic than the other goals. Fannie Mae has made progress in achieving this goal during the transition period, but Freddie Mac has consistently failed to meet the goal targets in all of the 3 years covered by the transition goals.

Fannie Mae's 1993 performance, 26.3 percent, did not meet the 1993 goal of 28 percent. In 1994 and 1995, however, Fannie Mae achieved the targeted level, even as the level of the goal increased to 30 percent. 31.5 percent and 30.4 percent of Fannie Mae's mortgage purchases counted toward the goal in 1994 and 1995 respectively. As mentioned above, Freddie Mac failed to achieve the Central City Goals for 3 consecutive years. In 1993, 24.1 percent of Freddie Mac's mortgage purchases qualified toward the 26 percent goal. In 1994 and 1995, the level of the goal was raised to 30 percent, but Freddie Mac's performance was only 25 percent and 23.4 percent respectively.

The Department continues to be troubled by Freddie Mac's performance under this goal. A housing plan was requested from Freddie Mac for their failure to meet this goal in 1993 and 1994 and is currently being requested based on their 1995 performance.

INCOME DISTRIBUTION AND MINORITY LENDING DISTRIBUTION

Other areas the Department has been assessing relative to the GSEs' performance under the goals are the distribution of mortgage purchases across income levels and among minority groups.

As you can see from Graph 5, both GSEs' single-family mortgage purchases are concentrated at the higher end of the income scale—those above 120 percent of median income. I am encouraged, however, by the substantial proportion of their mortgage purchases in the 60–100 percent of median-income category. I believe this trend is directly related to the emphasis the goals have placed on this market segment.

Another area the Department is analyzing is that portion of the GSEs' mortgage purchases that are devoted to minority borrowers. Graph 6 demonstrates the percentage of GSEs' mortgage purchases that finance housing for minority borrowers and shows that the percentage of business devoted to African Americans and Hispanics has increased over the transition period.

Using HMDA data, Graph 7 compares the GSEs' minority activities in 1994 to other market participants. Fannie Mae and Freddie Mac do trail most of the other market participants, although not by an overwhelming amount. You should also note that there is a certain overlap among the various groups identified on this chart.

In general, I am encouraged by the progress made by both Fannie Mae and Freddie Mac in achieving the affordable housing goals during the transition period. I think the final rule will encourage the GSEs to continue to improve their performance through more targeted and focused goals. Both GSEs have demonstrated their commitment to increasing the availability and accessibility of mortgage credit across the Nation by creating innovative products to reach new customers. In addition, both are partners in the National Homeownership Strategy, the national effort to raise the homeownership rate to an all-time high of 67.5 percent by the year 2000.

The Act is Appropriate: Changing the Law Now Would be Premature

As mentioned earlier in my testimony, I believe that the 1992 Act is a sensible piece of legislation; the law balances the GSEs' public benefits with their public responsibilities in a rational way. In turn, the Rule developed by HUD is reasonable and consistent with the intent of the law. The goals promulgated by HUD's Rule are simple, flexible, and achievable. The additional regulatory responsibilities required by the 1992 Act are also practical. The Act charges the Secretary with: Advancing fair housing and fair lending by encouraging the GSEs to monitor their business practices for disparate impact; reviewing and approving of new programs proposed by the GSEs; and collecting and disseminating information and data on the GSEs' business activities. HUD's Rule codifies these legislative decisions, often with few or no changes from the statutory language. The Fair Lending provisions require the GSEs to monitor their own business practices to prevent unintentional discrimination. The Rule also provides important protection for lenders. The Rule does not interfere with the GSEs' corporate business strategies or charge the GSEs with policing lenders' activities. Similarly, the New Program Approval provisions in the Rule avoid HUD micro-management of the GSEs, requiring only that the GSEs approach HUD with proposals for new programs, rather than HUD intervening in the corporations' innovative initiatives. Each of the additional provisions is intended to meet a need identified by the industry, is consistent with current industry activities, and allows the GSEs to choose what products and delivery mechanisms best suit their needs as private corporations.

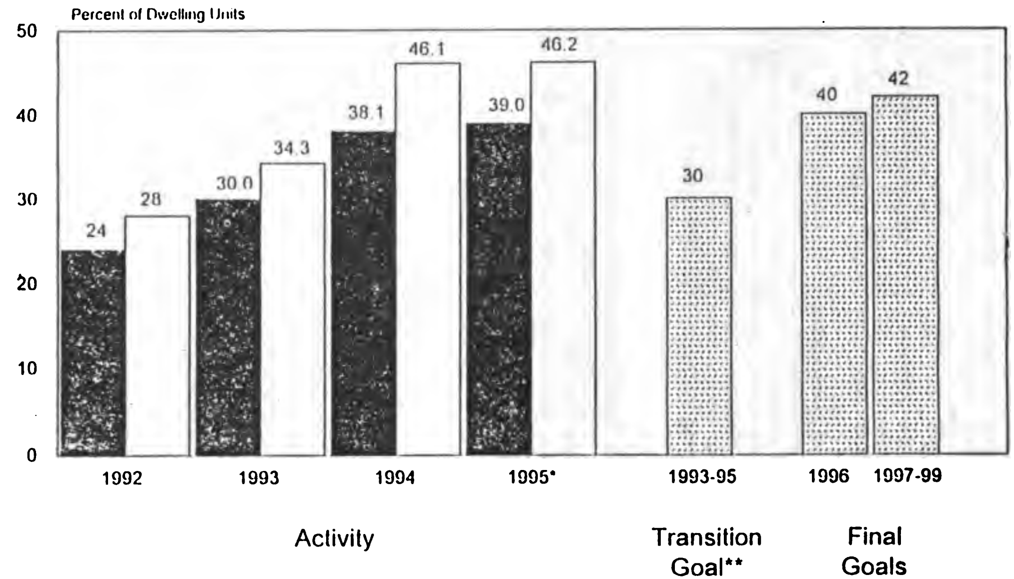
The Act, then, requires no modification at this point in time. As I see it, this law will improve not only the performance of the GSEs, but also will boost the performance of the industry as a whole. At this point in the implementation process, only 3 months after the Rule executing the Act was published in the *Federal Register*, it would be premature to change or discontinue these regulations. The Act and the Rule challenge the GSEs to ensure that their secondary market operations provide capital access to all mortgage lenders serving low-income families and other special-needs borrowers.

Conclusion

Mr. Chairman, I want to thank you again for the opportunity to testify on behalf of HUD as the regulator of Fannie Mae and Freddie Mac. I assure you and the Members of this Committee that HUD is committed to being an effective and diligent regulator of the GSEs, and I look forward to working with this Committee as we carry out that important responsibility.

I would be happy to answer any questions you may have.

Low- and Moderate-Income Activity and Goals for Fannie Mae and Freddie Mac

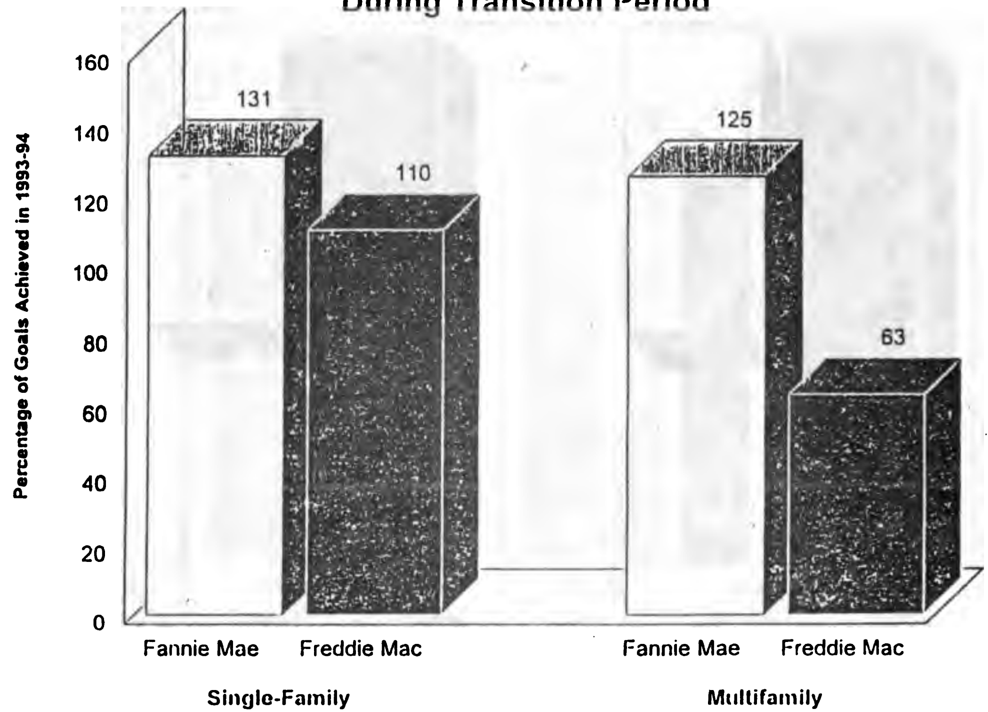


* Based on annual report submissions under Interim Notice Counting Rules

** Freddie Mac's 1993 goal was 28%

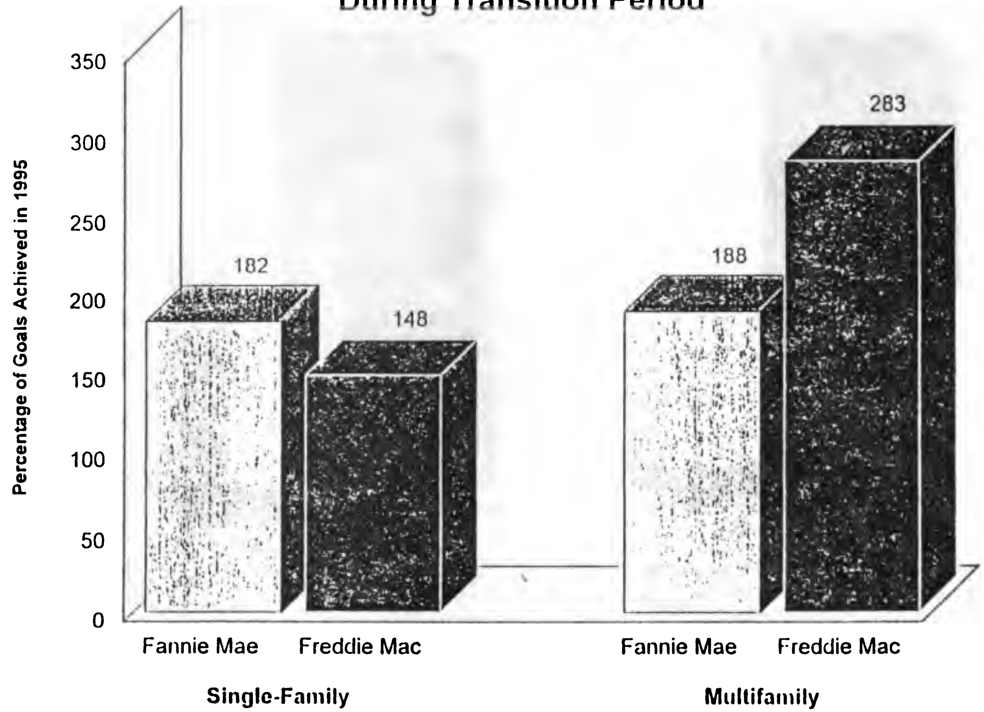
1

1993-94 Special Affordable Goal
Summary of GSEs' Activity and Goals
During Transition Period



1993-94 Goals. Single Family --Fannie Mae $12.7 Billion, Freddie Mac $11.1 Billion; Multifamily-- Fannie Mae $3.6 Billion, Freddie Mac $0.8 Billion.

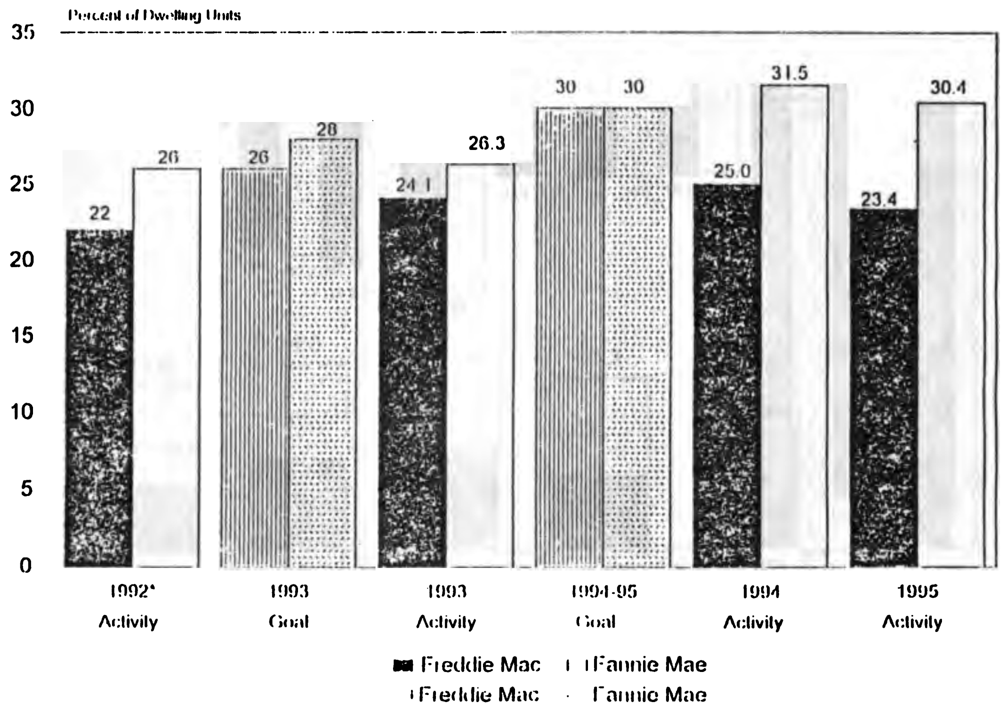
1995 Special Affordable Goal
Summary of GSEs' Activity and Goals
During Transition Period



1995 Goals Single Family - Fannie Mae $1.4 Billion, Freddie Mac $3.0 Billion, Multifamily - Fannie Mae $1.2 Billion, Freddie Mac $0.4 Billion

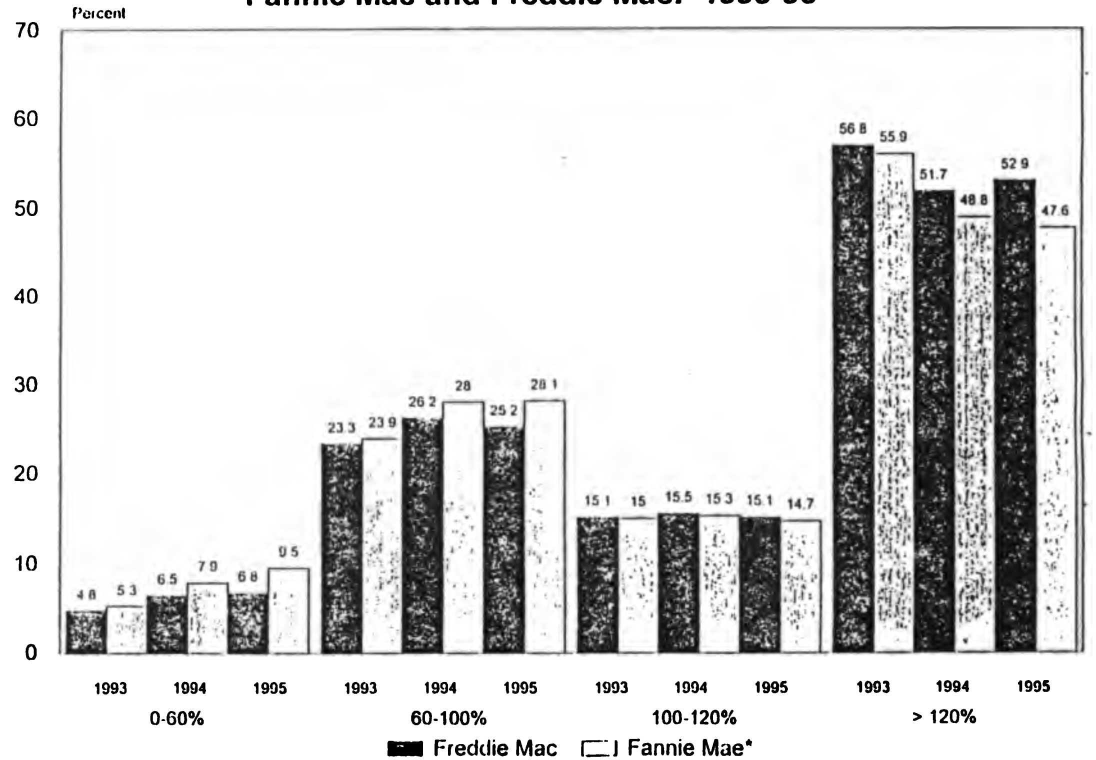
3

Central City Activity and Goals for Fannie Mae and Freddie Mac



4

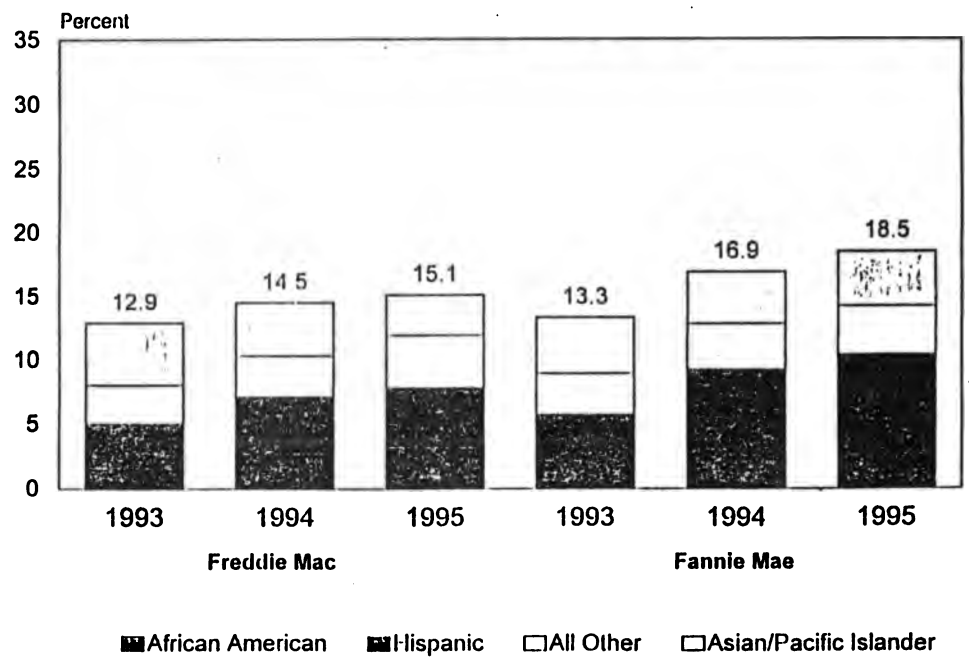
Income Distribution of Single-Family Owner-Occupied Units for Fannie Mae and Freddie Mac: 1993-95



* Fannie Mae's 1995 percentages include rental units from owner-occupied 2-4 unit properties

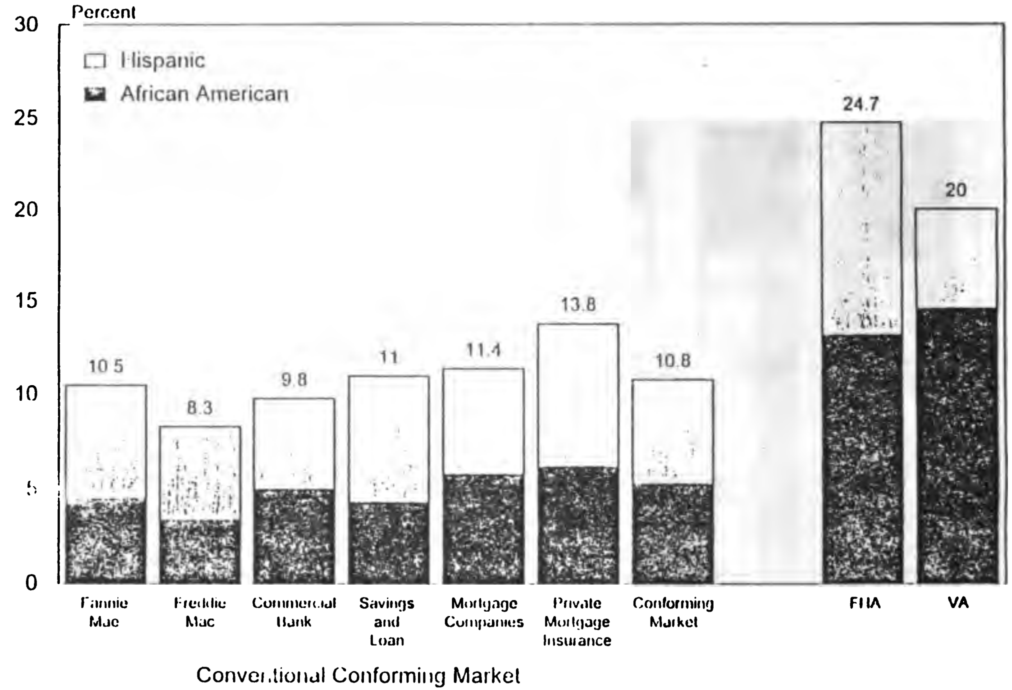
5

Distribution Of GSEs' Mortgage Purchases Made To Minority Borrowers



6

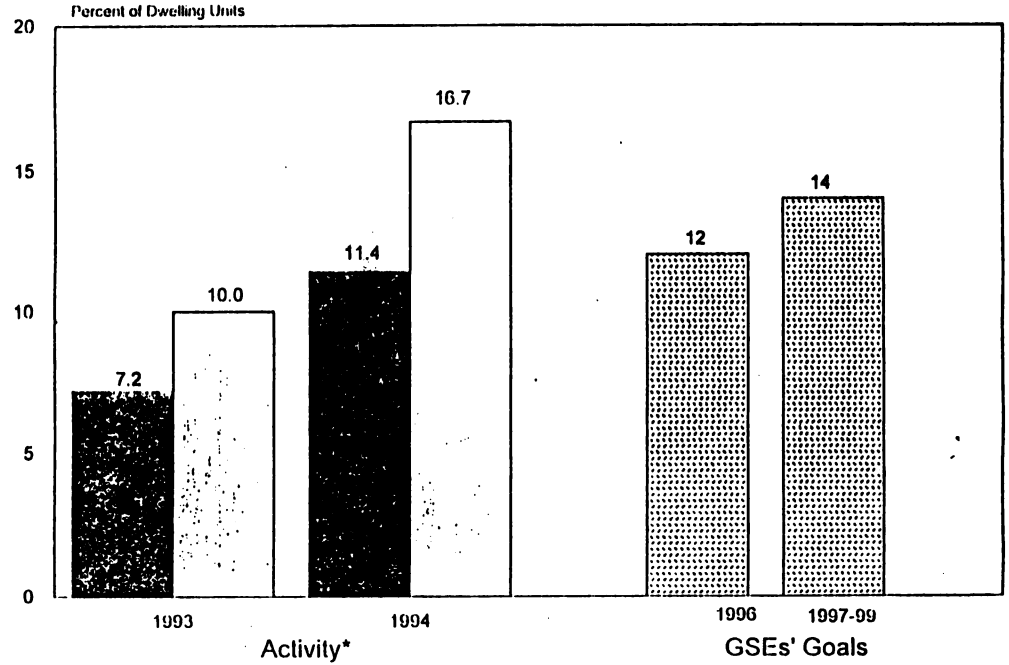
African American and Hispanic Lending by Financial Institution: 1994 HMDA



Source: HMDA owner occupied home purchase and refinance mortgages
Mortgages are not mutually exclusive within conforming market

7

Special Affordable Activity and Goals for Freddie Mac and Fannie Mae

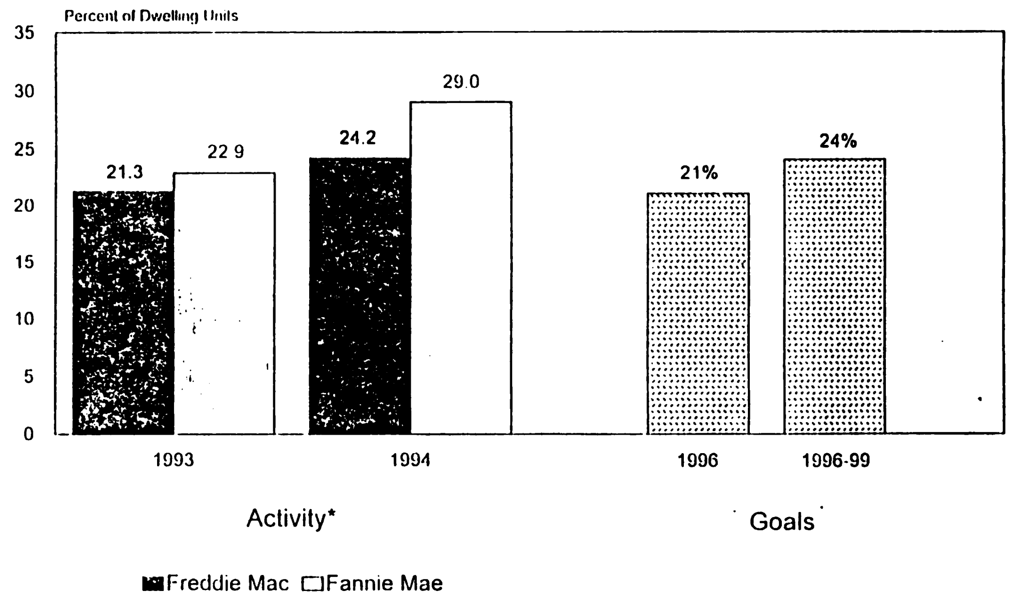


Freddie Mac Fannie Mae

*Activity based on counting requirements and definitions in the final rule.

8

Geographically Targeted Activity and Goals for Fannie Mae and Freddie Mac



9

For Release on Delivery
10:00 a.m., March 5, 1996

Testimony of

Aida Alvarez, Director
Office of Federal Housing Enterprise Oversight

on

Implementation and Effects of the
Federal Housing Enterprises Financial Safety and
Soundness Act of 1992

before the

Subcommittee on HUD Oversight and Structure
Committee on Banking, Housing, and Urban Affairs
United States Senate

March 5, 1996

I am delighted to have this opportunity to report to you, Mr. Chairman, and other Members of this Subcommittee on OFHEO's activities to carry out its responsibilities under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.

The 1992 legislation gave OFHEO a very important mission: To ensure the safety and soundness of the two largest Government-Sponsored Enterprises, Fannie Mae and Freddie Mac. These two institutions have a central role in channeling funds to finance housing for American families. Together, they own or guarantee nearly 60 percent of all the conventional single-family mortgages under their loan limit of $207,000 as well as a sizable amount of mortgages on multifamily housing properties. Their ability to continue to perform their public purposes depends on the maintenance of their financial strength, and is essential to the smooth functioning of our Nation's housing finance system, as it is currently structured.

The legislative history of the Act establishing OFHEO makes clear that Congress was particularly concerned that Federal sponsorship of Fannie Mae and Freddie Mac not result in failure costs to taxpayers. Although all debt securities they issue or guarantee must carry a disclaimer that they are not guaranteed by the U.S. Government, financial market participants have for many years perceived that Congress would not permit their obligations to default. This perception is based not only on the Enterprises' key role in housing finance, but also on a variety of other attributes and privileges not generally provided to private firms. These include their Congressional Charters; their access to as much as $2.25 billion each of Treasury funds at the Treasury Secretary's option; the special treatment of their securities, which in a number of statutes—dealing with such matters as an exemption from SEC registration and other investor protections, suitability as investments in unlimited quantity for Federally-chartered institutions, use of Federal Reserve fiscal agency services, and eligibility for Federal Reserve open market operations—receive the same treatment as Treasury debt instruments; and an exemption from State and local income taxes. In the event of a threatened default, it would be up to Congress to decide whether to appropriate taxpayer funds to prevent it. We view it to be our job to see that Congress is never forced into such a difficult decision.

The possibility of such a situation is not purely hypothetical. In 1987, another GSE, the Farm Credit System, needed and received Federal assistance. And while neither Fannie Mae nor Freddie Mac has required such assistance, Fannie Mae came perilously close in the early 1980's, when by some estimates the value of its liabilities exceeded the market value of its assets by one-fourth. Currently, Fannie Mae and Freddie Mac have $1.4 trillion of obligations outstanding, which is more than half the total volume of insured deposits at all banks and thrifts. A failure that cost even a small fraction of that amount would still be catastrophic.

OFHEO needs to be concerned with three principal sources of risk to Fannie Mae and Freddie Mac. Unanticipated changes in interest rates is one important source of risk. While interest rate risk on loans that are securitized is small, both Fannie Mae and Freddie Mac retain on their balance sheets a large and growing portion of the loans they purchase. Because the liabilities they issue to find these assets do not precisely match the maturities and options of the mortgages, they accept a degree of vulnerability to large swings in the general level of interest rates and to sharp twists in the shape of yield curves. This was the source of Fannie Mae's problems in the 1980's.

Since then, both institutions have adopted much safer funding strategies than those that led to Fannie Mae's losses. However, their retained portfolios are now much larger. Together, the two Enterprises now own more than $360 billion of mortgages, more than twice as much as they held when the law creating OFHEO was enacted and more than seven times what Fannie Mae held at the beginning of 1980.

They also are exposed to credit losses on the mortgages they own or guarantee—the second major source of risk. Sound underwriting practices have kept these losses low in recent years, but the Enterprises have also benefited from consistent house price increases in most parts of the country. A significant decline in house values would be costly. Credit risks have continued to grow rapidly in recent years. Their overall volume of assets at risk, including both mortgages they own and those they have securitized, has doubled in the past 5½ years to more than $1.4 trillion.

The third major source of risk for the Enterprises is management and operations risk. The financial well-being of large financial institutions depends critically on the strength and effectiveness of their financial controls, the reliability of their information and data processing systems, and their managements' adaptability to fundamental changes in the marketplace.

OFHEO must carefully assess all of these risks to ensure that the Enterprises maintain sufficient capital and operate in a safe and sound manner. Accordingly, the OFHEO must develop a sophisticated risk-based capital standard, conduct risk-focused examinations, and conduct sufficient research into Enterprise and industry developments to anticipate potential future risks and to properly design its capital standards and examinations.

I am happy to report that OFHEO has made excellent progress in each of these areas. When I was appointed Director in June of 1993, I became OFHEO's first employee. Assembling a top-flight staff with experience in financial markets and financial institution regulation was, of necessity, my top priority. We now have nearly a full complement of talented and experienced workers.

Another early priority was developing specific expertise about Fannie Mae's and Freddie Mac's operations, both their internal structure and practices and their external business activities. Also, these two large, well-established businesses were not used to being regulated. Over time, our regulatory relationship has been evolving to become increasingly constructive and effective. This has been a significant learning experience for all parties.

While key personnel have only been in place a short time, we have already accomplished a great deal. In the area of capital supervision, OFHEO is responsible for administering two types of capital standards. One is based primarily on leverage ratios for balance sheet assets and off-balance-sheet obligations. It establishes what is described in the legislation as a "minimum capital level" for each Enterprise. This level is intended to establish an absolute floor, below which potentially serious sanctions could apply under prompt corrective action rules. The minimum capital level is not designed to address specific credit risk exposures or the overall exposure to interest rate changes. Nor does it represent the amount of capital needed for safe and sound operations under all circumstances. OFHEO published a proposed rule for determining minimum capital levels last year and expects to publish a final rule this spring.

On an interim basis, OFHEO has evaluated the Enterprise's capital every quarter, beginning with June 30, 1993. Both Enterprises have consistently met this standard with a small margin to spare. The interim and proposed minimum capital standards both rely on statutory leverage ratios for all asset and off-balance-sheet categories except one source of off-balance-sheet risks—interest rate and foreign exchange rate contracts. The interim standard for this small, but rapidly growing area, was based on the capital adequacy guidelines for Federal depository institutions. The proposed standard modifies this approach to better conform with the risks to the Enterprises involved in these contracts.

The second capital adequacy standard is more important because it is tailored much more carefully to the specific risks of Enterprise activities. This risk-based capital standard will require the Enterprises to hold sufficient capital to withstand a 10-year stress test. The test will project credit losses on a national scale comparable to the worst mortgage credit loss experience in any region of the country. At the same time, the Enterprises' balance sheets will be subjected to large adverse interest rate movements. In addition to the capital needed to cover stress test losses, the Enterprises must hold capital to cover management and operations risk.

Such a standard is much more sophisticated than existing capital standards for other financial institutions. OFHEO is required to model Enterprise cash-flows throughout a 10-year period under different interest rate scenarios. Creating such a model is a challenging task. Let me give you just a few examples. The Enterprises' mortgages have a wide variety of attributes with diverse risk characteristics. Also, both institutions have become substantial investors in REMIC and stripped MBSs' securities. These securities divide mortgage cash flows in complex ways; projecting their behavior in response to large interest rate shocks requires detailed analysis. Together, the Enterprises now hold more than $20 billion of REMIC's and strips. Their interest rate hedging strategies are also complex, involving increased volumes of derivatives, which now amount to a notional $175 billion.

Modeling cash flows associated with these features requires a fair degree of precision. Fannie Mae and Freddie Mac are highly-leveraged businesses—their capital amounts to roughly 1 percent of their assets and guarantees—so there is a low tolerance for error.

Last spring, we published an Advance Notice of Proposed Rulemaking concerning the risk-based capital regulation. The ANPR asked for comments on a wide range of issues that must be decided in designing the regulation. Since then, OFHEO has made excellent progress. Last week, OFHEO submitted a proposed rule concerning two important pieces of the stress test to OMB for interagency clearance. We expect to be able to send to Congress and publish the proposal in 2 to 4 months.

Our statute requires that mortgage credit losses in the stress test be reasonably related to those of a historical time and place, which we describe as a benchmark loss experience. This benchmark experience will be the basis for determining credit losses in the stress test. The Notice of Proposed Rulemaking that we have just completed includes our methodology for determining the benchmark loss experience and relevant information about the benchmark experience that we have identified using that methodology. Identifying the benchmark experience required gathering, assembling, and analyzing a vast amount of historical loan level data.

The other component of this NPR is OFHEO's choice of House Price Index to use in measuring changes in mortgage loan-to-value ratios for purposes of the stress test. Changes in the values of properties securing Enterprise mortgages, as measured by the Price Index, can have a significant effect on the likelihood and size of future losses on those loans.

OFHEO has decided to publish its own House Price Index based on values of houses securing mortgages in the Enterprises' historical data files. These data include more than 6.9 million individual house price changes over the past 21 years. Later this month, we expect to begin publishing our House Price Index, which will contain results for house price changes through the end of last year. We believe this Index will be far superior for our purposes to the alternative Index mentioned in our legislation. Our Index will be based on the same data and a similar methodology to those used in the Conforming Mortgage House Price Index currently published by the Enterprises. We have developed the capability to produce and publish the Index ourselves in order to meet statutory requirements for potential use of the Index in the stress test and to modify the Index to better suit our needs.

We have also made considerable progress in the other principal areas of stress test development. These areas include a component that adapts the benchmark loss experience to the stress test, another that determines interest rates on securities other than those on 10-year Treasury notes that are specified in the statute, another that generates periodic cash flows of all assets, liabilities, and off-balance-sheet items and then translates those into pro forma financial statements, and a component that calculates required capital. We plan to have a complete stress test by the end of this year.

The other major focus of OFHEO's activities is examinations. The approach we have followed over the past 2 years concentrates on the evaluation of management and operating systems and in particular on the processes used by each Enterprise to identify and control exposure to risk. In any area, we start with a big picture appraisal of management structure, planning strategy, audits, and control systems. We then move to more detailed investigations where our appraisal indicates it is warranted. This is a relatively unobtrusive approach that concentrates our efforts in the most critical areas and minimizes the burden on the regulated institutions. Regulators of other financial institutions are moving increasingly in this direction. Recently, bank regulators have announced their intention to concentrate their exams more on the management of different types of risk and less on the condition of specific assets.

Last year in our annual report, we described the results of our first two on-site exams for each Enterprise. Unlike other regulators, we are required to report our results to Congress. That gives you an opportunity to know of any major problems shortly after we do, and before they show up in poor operating results.

Our first set of exams targeted the use of derivative contracts by the Enterprises and followed closely the disturbances in some derivative securities markets in early 1994. We determined that use of these contracts by both Enterprises poses no significant safety and soundness concerns. Both institutions use derivatives for purposes that are not speculative. Derivatives help them to reduce funding costs by permitting them to issue debt with features desired by investors, while achieving the overall liability structure they prefer.

OFHEO did, however, make a number of specific recommendations for changes with regard to risk management and internal controls, consistent with the best practices at major financial institutions. At Fannie Mae we urged greater involvement by the Board of Directors, clearer delineation of derivatives policies, and expanded internal reporting. At Freddie Mac we recommended updated and expanded policies, more comprehensive internal reporting, exposure limits for counterparties, development of in-house capacity to measure current credit exposures, and strengthening of certain internal controls. Both Enterprises complied with the recommendations in a fully satisfactory manner.

On a related issue, I expressed concern about investor risks of structured notes in the summer of 1994. Later developments in Orange County and elsewhere demonstrated some problems in the marketing of those securities. The Enterprises have been major issuers of such securities. Given the substantial losses incurred by some investors in those markets and the accompanying publicity, I was concerned that the Enterprises' reputations in financial markets could suffer if issues relating to sales practices were unaddressed, potentially affecting safety and soundness. I asked each of them to report on their marketing policies and practices for structured notes and mortgage derivative securities. After evaluating those reports and a variety of supplemental materials and analyses, I made a number of suggestions which are contained in our annual report. Since then, both have made changes responsive to those suggestions.

Our second pair of exams focused on the Enterprises' broad corporate governance structure. This gave us an opportunity to understand better how each Enterprise functions internally and was very helpful in our planning for future exams. No safety and soundness concerns were identified in either exam. However, we again made recommendations for improvements, with which they complied.

Later last year we began our most important set of exams to date. We have now nearly finished examinations of the Enterprises' risk management structures, controls, and practices. Because we have not yet completed our reports, I cannot share the results with you today, but they will be included in this year's annual report, which, as required by statute, we will deliver to you by June 15.

Very shortly we will conduct compliance reviews of the Enterprises' flood insurance responsibilities. Recent legislation mandated these reviews, and we will also include their results in our annual report. That legislation also made us a participant on the Flood Insurance Interagency Task Force, which is helping to coordinate the work of all regulators involved.

Later this year, we will conduct an examination of the Enterprises' business risks associated with changes in the underlying conditions of housing and housing finance markets affecting single-family mortgages.

OFHEO has made progress in other areas as well. Last year we issued a proposed regulation dealing with the Freedom of Information Act requirements and expect to issue a final regulation within a few months. Such regulations are required of all Government agencies and specify how we will handle information requests. Later this year we hope to issue a proposed regulation implementing our general enforcement authorities. This regulation will specify our procedures in the event of any needed cease and desist orders or civil money penalties. It is a regulation we hope we never need to use.

In the area of executive compensation, we recently issued a Request for Proposals to obtain assistance in helping us determine how to meet our statutory responsibility to prohibit excessive compensation. It follows preliminary work we have done to become familiar with current Enterprise practices and determine the type of information we need to proceed.

Among other significant activities, OFHEO participated extensively in the interagency comment process for HUD's affordable housing rule, which was adopted in final form late last year. In your letter of invitation you asked for our opinion of the impact of that rule. Both Enterprises have increased their activities in this area markedly during the legislative and rulemaking processes that produced these requirements. But it is important to note that for the past 2 years Fannie Mae has already been achieving all of these goals at the 1997 to 1999 levels. Freddie Mac is not yet at those levels, but is within 10 to 20 percent.

I do not believe the goals should force either Enterprise to sacrifice its overall safety and soundness. Each has already shown an ability to meet or approach meeting the goals with no indication that doing so will substantially reduce its rate of return on equity, which, in both cases, has been consistently more than 20 percent in recent years. I expect that they will continue to make progress in learning how to do this business successfully and keep the risks involved well within acceptable bounds. We will, however, continue to review this area by closely following their new initiatives in our examinations and off-site monitoring. We will also require them to hold adequate capital, as part of our risk-based capital standard, to protect against the risks associated with affordable housing activities.

Having described the range of OFHEO's responsibilities and achievements, I am happy to report that we remain a small and efficient regulatory agency. With 65 full-time permanent positions now filled, we are close to being fully staffed. To put that into perspective, the Enterprises have more than $20 billion of obligations for each OFHEO employee. Our Fiscal Year 1996 budget that is pending in the Conference report is just $14.9 million. Another way of looking at it is that OFHEO provides protection to taxpayers at an annual rate of only a little more than a penny for each $1,000 of Enterprise debt and guarantees. And taxpayers pay none of the cost. For the Enterprises, who do pay, the price is minimal. Our budget represents less than one-half of 1 percent of their $3 billion of profits last year. And we believe they benefit from the recommendations we make in our examinations as well as from the analytical work we are doing to identify and measure risks in conjunction with the stress test.

Right now, I believe OFHEO's budget and planned staffing levels are adequate to perform our mission. Looking ahead, I do not anticipate major changes in the foreseeable future. Any significant reductions, certainly, would be unwise. After we complete work on developing the risk-based capital standard, we will need to retain resources to implement it and to consider future modifications, including those specifically contemplated in the statute. OFHEO also needs to maintain the capacity to respond to rapid changes in the mortgage finance industry. Fannie Mae and Freddie Mac are changing with the industry and, in many respects, leading it.

In just the last year and a half, we have seen strong movements toward automated underwriting, credit scoring, and consolidation in mortgage banking. We have seen a variety of new trends in mortgage transactions at the Enterprises, including 97 percent LTV's, use of lender provided spread accounts as credit enhancement, reverse amortization mortgages, and securities involving home equity loans and B&C class mortgages. The Enterprises are also becoming more involved in the process by which credit reports, appraisals, and title insurance are provided. The recent sharp increases in the overall size of Enterprise portfolios and in the portions of those portfolios invested in REMIC securities also bear close watching. If this pace of change continues, we will need to work hard to make sure our examinations and capital standards are keeping up. The regulatory authorities we have been given are essential tools for meeting our responsibilities now and in the future. At this time, I believe they are adequate for our needs, but if that changes, I will not hesitate to recommend changes.

Mr. Chairman, I know you and others on the Banking Committee have questions about OFHEO's location in HUD. Our relationship with the rest of HUD has worked well, and I believe, to our mutual benefit. Our respective roles in regulating Fannie Mae and Freddie Mac are, of necessity, interrelated. Being in the same Department with the programmatic regulator of the Enterprises has facilitated communication and sharing of expertise. As an example, we were able to express our views on the safety and soundness aspects of HUD's affordable housing regulation more effectively by virtue of our association.

At the same time, though, we are well aware of the potential for a difference of views reflecting the different natures of our responsibilities. Congress was also cognizant of that potential in designing our structure. While we are within HUD, we are substantially independent of HUD in all our regulatory activities bearing on safety and soundness. The Secretary of HUD has no authority over our safety and soundness regulations, enforcement, or examination activities. Nor does he have any authority over our budget or the management of our office. That is well understood at both OFHEO and at other sections of HUD. To help ensure that no misunderstandings developed, I decided as one of my first acts as Director to move OFHEO out of the HUD building.

Given our mutual interests, I think the decision to place OFHEO in HUD was a wise one, and I see no reason to change it. But I think that the most important decision Congress made in designing our structure was to provide OFHEO with the same type of independent authorities that are granted to other financial institution regulators. Those measures of independence create the accountability and credibility necessary for OFHEO to do an effective job. Mr. Chairman, the structure you proposed for OFHEO in your bill, S. 435, clearly recognizes the importance of this independence.

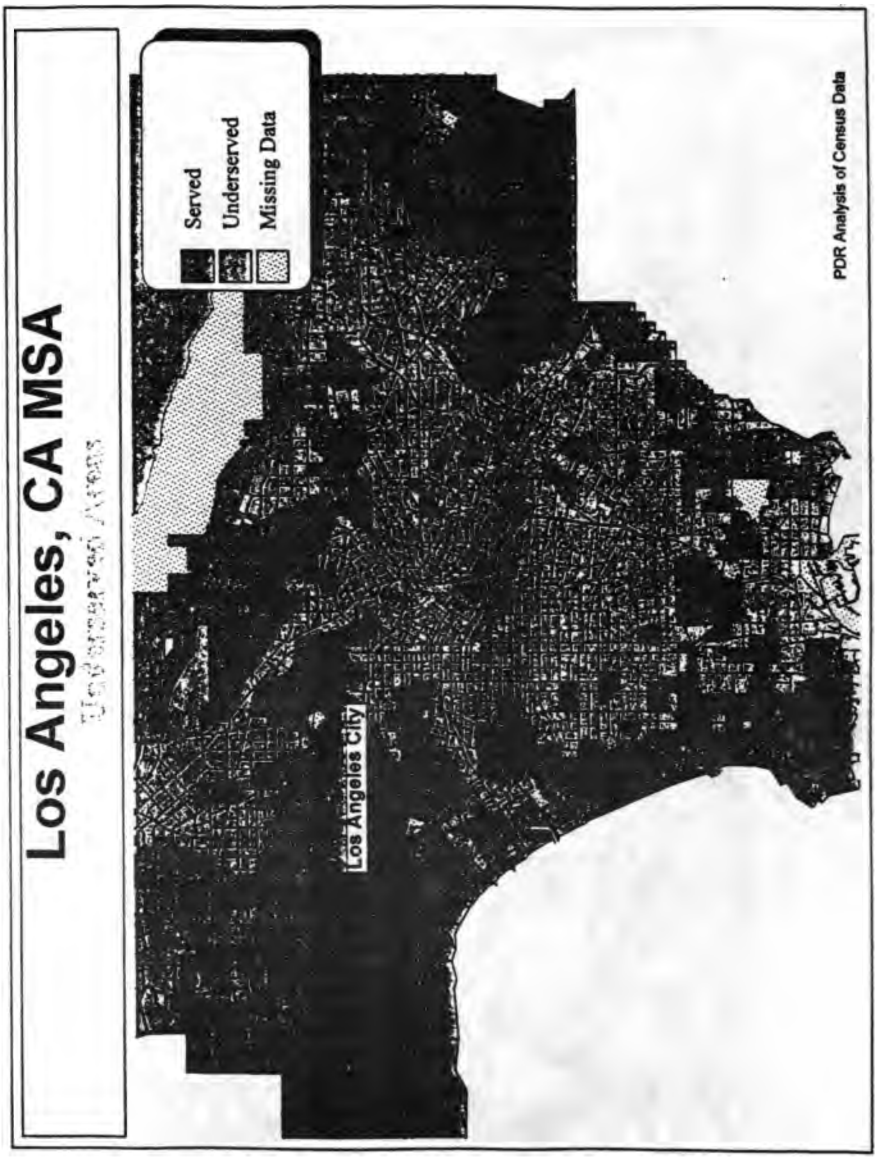
One aspect of OFHEO's independence is particularly relevant today. Like the other financial institution regulators, I am able to give you, and I am giving you, my views, which are not necessarily those of the President, the Secretary of HUD, or anyone else. You can be confident that any information I give you about Fannie Mae or Freddie Mac has not been screened or altered.

Thank you. I would be happy to answer any questions you may have.

Chicago, IL MSA
Underserved Areas

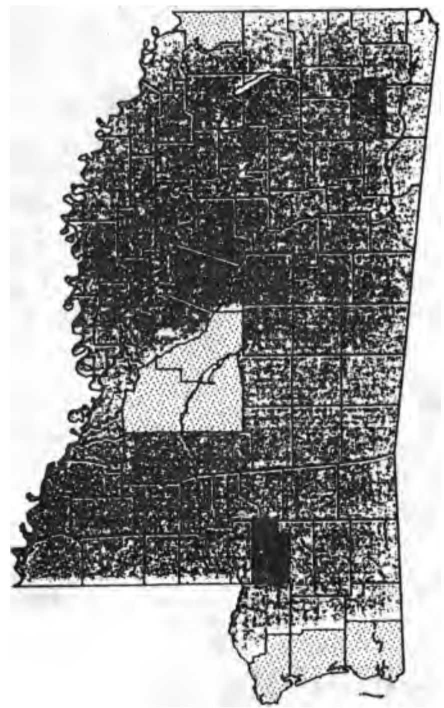

Washington D.C., MSA
Served
Underserved
Missing Data


Los Angeles, CA MSA
Underserved Areas
Served
Underserved
Missing Data
Los Angeles City


Los Angeles, CA MSA
Served
Underserved
Missing Data
Los Angeles City
PDR Analysis of Census Data

Atlanta, GA MSA
Underserved Areas
Served
Underserved
Missing Data
Cobb County
Fulton County
DeKalb County
Clayton County

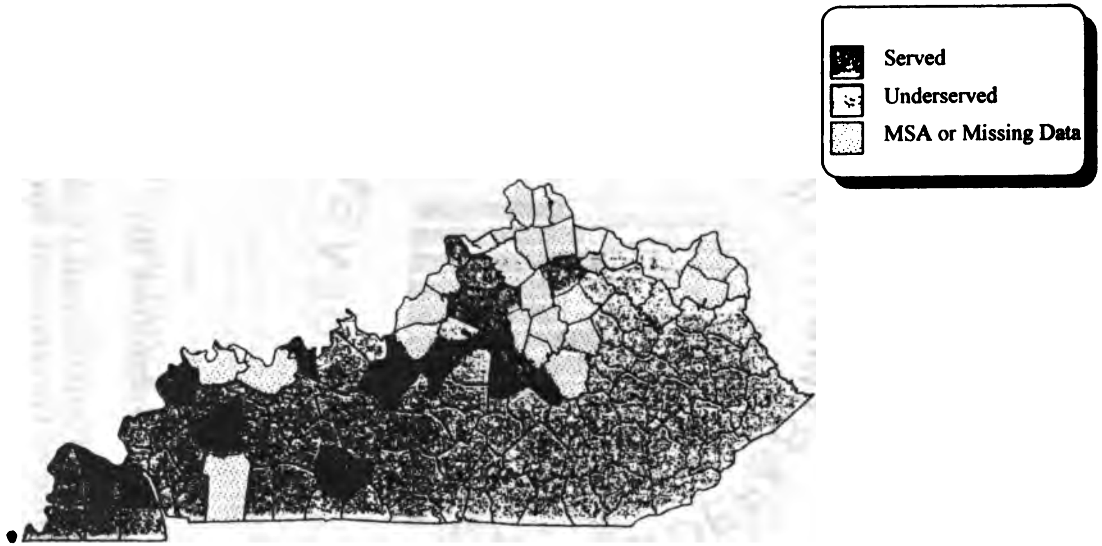
Mississippi



Served
Underserved
MSA or Missing Data

PD&R Analysis of Census Data

Kentucky



PD&R Analysis of Census Data

Questions/Answers for the Record

Senator Carol Moseley-Braun
Hearing on Government-Sponsored Enterprises

Submitted By:

Department of Housing and Urban Development
Office of Government Sponsored
Enterprises Oversight

October 1, 1996

1. REGULATORY PROCESS

Q.1.a. Have the GSE's been cooperative in HUD's efforts to establish affordable housing goals?

A.1.a. The GSE's have been very actively involved in the process of establishing affordable housing goals. As might be expected, the GSE's were strong advocates for policy positions that were the most advantageous to their business strategies but, generally, they did accommodate the regulatory process in a timely and cooperative manner.

Q.1.b. Did the GSE's provide data requested by HUD in a timely manner?

A.1.b. Yes. Occasionally at issue is the proprietary nature of certain data elements. However, in most instances, these issues have been worked through in a satisfactory manner. There are certain reporting issues outstanding that the Department is working with the GSE's to resolve. The expectation is that they will be resolved satisfactorily.

Q.1.c. Was the information requested by HUD complete and accurate?

A.1.c. Generally, yes. The Department especially appreciates the diligence with which Freddie Mac's staff worked to assure the high quality of Freddie Mac's loan-level data. The data sets revealed few errors and demonstrated that Freddie Mac staff have taken extra steps to provide a complete and accurate database. In contrast, Fannie Mae has submitted incomplete single-family and multifamily data. There are also inconsistencies between Fannie Mae's and Freddie Mac's data submissions. As inconsistencies and errors are found, Department staff is consulting with the GSEs' staff to resolve the problems. We believe that both Fannie Mae and Freddie Mac have cooperated fully in these efforts. We expect that this will be a gradual but beneficial process that will lead to the submission of data sets that provide for consistency between the GSE's.

2. AFFORDABLE HOUSING GOALS

Q.2.a. Please provide the GSEs' performance for each of the goals (using manner in which the new goals are calculated for the period 1990–present).

A.2.a. The Department's oversight of housing goals performance began in 1993 as a result of the GSE's Act which became effective in October 1992. The Department does not have data on the GSEs' mortgage purchases prior to 1993. The GSEs' goal performance for the 1993–1996 period under the housing goals defined in the final rule is presented in ATTACHMENT 1.

The definition for the Low- and Moderate-Income Housing Goal adopted in the final rule is virtually the same as that used during the transition period. Therefore, the GSEs' 1993–1995 activity is measured the same way under the transition and final goals. The level of the goal for 1996 and 1997–1999 was raised, however.

The Special Affordable Goal and the Geographically Targeted Goal both changed substantially in the final rule compared to the transitional goal definitions.

The attached table entitled "Final Rule Definitions and Goals" defines the various housing goals.

ATTACHMENT 1

Overview of the GSEs' Activity Relative to Final Rule Goal Definitions [1]

Goal [2]	1993	1994	1995	First half of 1996 [3]	1996 Goals	1997-99 Goals	Market Estimate
Low- and Moderate-Income:							
Fannie Mae	34.1%	45.1%	42.8%	44.0%	40.0%	42.0%	48-52%
Freddie Mac	30.0%	38.0%	39.6%	38.7%			
Geographically Targeted:							
Fannie Mae	22.9%	29.0%	31.2%	27.1%	21.0%	24.0%	25-28%
Freddie Mac	21.3%	24.2%	25.2%	24.1%			
Special Affordable:							
Fannie Mae	10.0%	16.7%	15.8%	16.8%	12.0%	14.0%	20-23%
Freddie Mac	7.2%	11.4%	13.2%	12.7%			

[1] Percentages of dwelling units in properties whose mortgages were purchased by the GSEs that would have qualified for each goal in 1993-95, and goals for 1996-99.

[2] Abbreviated definitions of goals:
Low- and Moderate-Income: Households with income less than or equal to area median income (AMI).
Geographically Targeted: Dwelling units in metropolitan census tracts with (1) median income less than or equal to 90 percent of AMI or (2) minority concentration of at least 30 percent with tract median income less than or equal to 120 percent of AMI. In nonmetropolitan areas counties are included if median family income does not exceed 95 percent of the greater of state or national nonmetropolitan median income.
Special Affordable: Households with income less than or equal to 60 percent of AMI or less than or equal to 80 percent of AMI and located in low-income areas.

[3] 1996 percentages reflect the GSEs' performances for the period January 1 through June 30; the percentages reflect preliminary GSE data.

FINAL RULE DEFINITIONS AND GOALS

<table>
<tr><th>GOAL</th><th>DESCRIPTION</th><th>1996 GOAL</th><th>1997-1999 GOAL</th><th>MARKET SHARE EST. **</th></tr>
<tr><td>1</td><td>Low- and Moderate Income Goal</td><td>40%</td><td>42%</td><td>48-52%</td></tr>
<tr><td colspan="5">All units (owner-occupied or rental) financed by mortgages purchased by the GSEs which are affordable to families with incomes below 100% of area median income (AMI) qualify under this goal.</td></tr>
<tr><td>2</td><td>Special Affordable Housing Goal</td><td>12%</td><td>14%</td><td>20-23%</td></tr>
<tr><td colspan="5">All mortgage purchases financing very low-income units and low-income units in low-income areas are eligible for the goal. The Special Affordable Housing Goal is directed to units occupied by low-income owners and renters in low-income areas, and units occupied by very-low-income owners and renters. The final rule provides that low-income rental units in multifamily properties where at least 20 percent of the units are affordable to families whose incomes do not exceed 50 percent of area median income or where at least 40 percent of the units are affordable to families whose incomes do not exceed 60 percent of area median income would count towards the goal.

This goal contains a floor for multifamily mortgage purchases. This floor requires that, annually, each GSE's qualifying multifamily purchases be at least equal to 0.8 percent of total dollar volume of mortgages purchased by each GSE in 1994. Accordingly, Fannie Mae's multifamily requirement is $1.3 billion and Freddie Mac's multifamily requirement is $980 million. Also, all mortgage purchases financing low-income rental units in low-income areas are eligible. Purchases financing low-income, multifamily rental units meeting Low Income Housing Tax Credit eligibility thresholds will count towards the goal.</td></tr>
<tr><td>3</td><td>Geographically Targeted Goal</td><td>21%</td><td>24%</td><td>25-28%</td></tr>
<tr><td colspan="5">Congress established the Geographically Targeted Goal to focus a portion of the GSEs's business on communities underserved by the mortgage industry including central cities, rural areas and other underserved areas. The goal covers nearly half of all metropolitan census tracts and residents where the mortgage denial rate is 21%, nearly twice the denial rate found in tracts not included under this goal. Over 60% of rural counties and 54% of rural residents are covered by the final rule. The final rule defines UNDERSERVED AREAS as:

Metropolitan Areas: Census tracts with (a) median income less than 90% of area median income <u>OR</u> (b) median income less than 120% of AMI <u>AND</u> a minority population greater than 30%.

Rural Areas: Counties with (a) median income less than 95% of the statewide non-metro or national non-metro median income, whichever is greater <u>OR</u> (b) median income less than 120% of state non-metro income <u>AND</u> a minority population greater than 30%.</td></tr>
</table>

** Market-share estimates include both single-family and multifamily activity consistent with Congress' intent that the GSEs play a greater role in the financing of rental housing

36-340 96 - 3

Q.2.b. Please provide the GSEs' performance for each of the goals (using the interim definition of the goals) for the period 1990–present.

A.2.b. The Department's oversight of the housing goal performance began in 1993 as a result of the GSE's Act that became effective in October 1992. The Department does not have data on the GSEs' mortgage purchases prior to 1993. The GSEs' goal performance for the 1993–1995 period under the transitional housing goals is presented in ATTACHMENT 2.

ATTACHMENT 2

GSEs' Activity and Goals for Transition Period [1]

Goal [2]	Activity 1993	Activity 1994	Activity 1995	Goals 1993	Goals 1994	Goals 1995
Low- and Moderate-Income:						
Excluding "Missing Data" Cases from Denominator						
Fannie Mae	35.6%	45.8%	46.2%	30.0%	30.0%	30.0%
Freddie Mac	30.0%	37.6%	40.0%	28.0%	30.0%	30.0%
Including "Missing Data" Cases in Denominator						
Fannie Mae	34.4%	45.0%	43.2%	30.0%	30.0%	30.0%
Freddie Mac	29.2%	37.5%	39.0%	28.0%	30.0%	30.0%
Central Cities:						
Fannie Mae	26.2%	31.5%	30.4%	28.0%	30.0%	30.0%
Freddie Mac	24.3%	25.3%	23.4%	26.0%	30.0%	30.0%
Special Affordable ($ billions):	1993–1994			1993–1994		
Fannie Mae	$21.4		$8.4	$16.4		$4.6
Freddie Mac	$12.7		$5.5	$11.9		$3.4

[1] For low- and moderate-income and central cities, activity and goals are measured as percentages of dwelling units in properties whose mortgages were purchased by the GSEs in each year. For special affordable, activity and goals are measured in billions of dollars in 1993-94 (two-year goal) and 1995.

[2] Abbreviated definitions of goals:

Low- and Moderate-Income: Households with income less than or equal to area median income (AMI).

Central Cities: Units in properties located in central cities, as defined by the Office of Management and Budget.

Special Affordable: Single-family units affordable to very low-income families and low-income families in low-income areas; multifamily units affordable to low-income families and very low-income families.

The definition for the Low- and Moderate-Income Housing Goal is virtually the same for the transitional period and the final rule. Mortgage purchases financing units affordable to households with income less than or equal to area median income qualify for the Low- and Moderate-Income Housing Goal. Both single-family and multifamily units, including rental units, may count toward the goal.

During the interim period, the Geographically Targeted Goal was called the "Central Cities Goal." The Central Cities Goal covered all census tracts within OMB-defined central cities, regardless of the availability or accessibility of mortgage credit in those areas.

During the transition period, the Special Affordable Goal was defined as a dollar amount. The transition goal required the GSE's to exceed by $1.5 billion (Freddie Mac) and $2 billion (Fannie Mae) the amount of business that would have been eligible under this goal in 1992. Further, the goal was based on an aggregate business volume covering a 2-year transition period beginning January 1, 1993 and ending December 31, 1994. The Special Affordable Goal was targeted at very-low-income borrowers.

Q.2.c. Please provide comparable data for other mortgage market actors—PMI's, FHA, thrifts, commercial bankers, mortgage bankers, and the mortgage market as a whole—with respect to the affordable housing goals.

A.2.c. REFER TO ATTACHMENTS 3 AND 4. These tables report borrower and census tract characteristics of home purchase and refinance mortgages originated in metropolitan areas in 1994 based on HMDA data. (1995 HMDA data comparisons are not yet available.)

Attachment 4, "FHA-Eligible Mortgage Funding by Borrower and Census Tract Characteristics," is based on conventional loans whose loan size does not exceed the FHA loan-limit for the metropolitan area in which the loan is made. Typically, the FHA loan limit is 95 percent of the area median house price, subject to a current minimum loan limit of $78,660 and a maximum of $155,250.

[Performance differences between Fannie Mae and Freddie Mac are discussed in Section 13.]

ATTACHMENT 3

Mortgage Funding by Borrower and Census Tract Characteristics 1994 HMDA

			Conforming Conventional Mortgages								
							Depository			Conforming	
Borrower Income	FHA	VA	Freddie Mac	Fannie Mae	Both GSEs[5]	Non-GSE[6]	Banks[7]	S&Ls[7]	Both	Market	Mobile Homes
Below 60% AMI [1]	18.3%	9.8%	7.9%	8.7%	8.4% (8.1%)	11.5%	13.7%	10.4%	12.5%	10.2%	28.0%
Below 80% AMI	42.2%	28.3%	20.3%	21 9%	21.3% (20.7%)	25.3%	28.3%	24.0%	26.7%	23.6%	51.0%
Below Median	64.7%	49 4%	35.9%	38.2%	37.4% (36 6%)	40.6%	43.3%	39.6%	41.9%	39.2%	69.7%
Borrower Race											
African-American	13.3%	14 6%	3.4%	4.5%	4.0% (4 0%)	5.3%	5.3%	4.0%	4.8%	4.8%	4.9%
Hispanic	11.5%	5.4%	4.9%	6.0%	5.6% (5.7%)	5.4%	4.9%	5.9%	5.3%	5.5%	6.7%
Both	24.8%	20.0%	8 3%	10 5%	9.6% (9.7%)	10.7%	10.2%	9.9%	10.5%	10.3%	11.6%
Census Tracts											
Low-Income [2]	17.2%	12.1%	8.2%	9.0%	8 7% (9.0%)	11.5%	12.8%	9.6%	11.7%	10.3%	18.3%
High-Minority [3]	25.1%	23.1%	14.7%	16 2%	15.6% (16.0%)	15.2%	14.0%	15.0%	14.4%	15.4%	19.9%
Underserved Areas [4]	38.6%	33.2%	21.7%	23 3%	22.6% (23.4%)	26.2%	28.2%	23.6%	26.5%	24.6%	42.7%
In Central Cities	45.7%	45.8%	35.5%	37.9%	36.9% (NA)	36.3%	36.6%	34.0%	35.6%	36.5%	37.0%

Note: Tabulation limited to home purchase and refinance mortgages in metropolitan areas Mortgages with loan amounts less than $15,000 (except for mobile homes) or loan-to-income ratios greater than 6 are excluded. Loans originated by 12 lenders that originate primarily B and C quality loans have been excluded Origination data for 8 lenders identified as mobile home lenders are provided separately; these data are not included in the conforming market totals

[1] AMI refers to the median income of the metropolitan area

[2] Census tract median income less than or equal to 80 percent of AMI

[3] Minority composition of census tract equal to or greater than 30 percent

[4] Metropolitan census tracts with (1) median income less than or equal to 90 percent of AMI or (2) minority concentration greater than or equal to 30 percent and tract median income less than or equal to 120 percent of AMI.

[5] The numbers in parentheses are computed from loan level data obtained from the GSEs

[6] Includes all current-year originations that were not sold to a GSE during the calendar year. Mortgages originated by Banks and Savings and Loans that were not sold accounted for approximately 83 percent of these non-GSE mortgages. Further analyses of these data suggest that a significant percentage of the remaining 17 percent of these mortgages are eventually sold to the GSEs.

[7] Depository originations (including originations of mortgage company subsidiaries) that were not sold during the calendar year. Figures do not include purchases by depository institutions.

ATTACHMENT 4

FHA-Eligible Mortgage Funding by Borrower and Census Tract Characteristics 1994 HMDA

			FHA-Eligible Conforming Conventional Mortgages								
							Depository			Conforming	
Borrower Income	FHA	VA	Freddie Mac	Fannie Mae	Both GSEs[5]	Non-GSE[6]	Banks[7]	S&Ls[7]	Both	Market	Mobile Homes
Below 60% AMI[1]	18.3%	9.8%	10.9%	11.8%	11.4% (11.1%)	15.0%	16.9%	13.9%	15.9%	13.6%	28.5%
Below 80% AMI	42.2%	28.3%	27.4%	29.2%	28.5% (28.0%)	32.5%	34.4%	31.4%	33.4%	31.0%	51.9%
Below Median	64.7%	49.4%	46.8%	49.3%	46.2% (47.6%)	50.6%	51.5%	49.9%	50.9%	49.8%	70.7%
Borrower Race											
African-American	13.3%	14.6%	3.7%	5.0%	4.5% (4.4%)	5.9%	6.0%	4.4%	5.4%	5.4%	4.9%
Hispanic	11.5%	5.4%	5.4%	6.6%	6.1% (6.3%)	6.0%	5.4%	6.4%	5.7%	6.8%	6.8%
Both	24.8%	20.0%	9.1%	11.6%	10.6% (10.7%)	11.9%	11.4%	10.8%	11.1%	11.4%	11.7%
Census Tracts											
Low-Income[2]	17.2%	12.1%	10.0%	11.1%	10.7% (11.0%)	13.8%	14.9%	11.7%	13.8%	12.5%	18.5%
High-Minority[3]	25.1%	23.1%	15.7%	17.6%	16.8% (17.1%)	16.7%	15.4%	16.1%	15.7%	16.7%	20.0%
Underserved Areas[4]	38.6%	33.2%	25.5%	27.4%	26.6% (27.4%)	30.4%	32.1%	27.5%	30.5%	28.8%	43.2%
In Central Cities	45.7%	45.8%	35.7%	38.2%	37.2% (NA)	36.9%	36.7%	35.0%	36.1%	37.0%	36.9%

Note: Tabulation limited to FHA-eligible home purchase and refinance mortgages in metropolitan areas. Mortgages with loan amounts less than $15,000 (except for mobile homes) or loan-to-income ratios greater than 8 are excluded. Loans originated by 12 lenders that originate primarily B and C quality loans have been excluded. Origination data for 8 lenders identified as mobile home lenders are provided separately; these data are not included in the conforming market totals.

[1] AMI refers to the median income of the metropolitan area.

[2] Census tract median income less than or equal to 80 percent of AMI.

[3] Minority composition of census tract equal to or greater than 30 percent.

[4] Metropolitan census tracts with (1) median income less than or equal to 90 percent of AMI or (2) minority concentration greater than or equal to 30 percent and tract median income less than or equal to 120 percent of AMI.

[5] The numbers in parentheses are computed from loan level data obtained from the GSEs.

[6] Includes all current-year originations that were not sold to a GSE during the calendar year. Mortgages originated by Banks and Savings and Loans that were not sold accounted for approximately 85 percent of these non-GSE mortgages. Further analyses of these data suggest that a significant percentage of the remaining 15 percent of these mortgages are eventually sold to the GSEs.

[7] Depository originations (including originations of mortgage company subsidiaries) that were not sold during the calendar year. Figures do not include purchases by depository institutions.

Q.2.d. Please provide data on the income distribution of borrowers who meet the GSEs' goals.

A.2.d. Tables from the GSEs' 1993–1995 Annual Reports are being held in Committee files for review due to the volume and reproduction illegibility:

ATTACHMENT 5—1993–1995:
Fannie Mae Tables for Single-Family Owner-Occupant Purchases

ATTACHMENT 6—1993–1995:
Fannie Mae Tables for Single-Family Rental Purchases

ATTACHMENT 7—1993–1995:
Fannie Mae Tables for Multifamily Purchases

ATTACHMENT 8—1993–1995:
Freddie Mac Tables for Single-Family Owner-Occupant Purchases

ATTACHMENT 9—1993–1995:
Freddie Mac Tables for Single-Family Rental Purchases

ATTACHMENT 10—1993–1995:
Freddie Mac Tables for Multifamily Purchases

Q.2.e. How do refinancings affect these goals?

A.2.e. Refinancings count as mortgage purchases with one exception: Under the Special Affordable Housing Goal, the GSE's are prohibited from receiving credit for the purchase of any refinanced mortgage or MBS already in the GSEs' portfolio.

The goals were established at a level to accommodate a wide range of economic circumstances and conditions. In a low interest rate environment where refinancing activity typically exceeds new originations, there tends to be more product available for purchase which translates into more opportunities to achieve the goals. Further, originations in a lower interest rate environment tend to be fixed-rate mortgages available for sale to the secondary market rather than the adjustable-rate mortgages preferred by portfolio lenders. While an argument can be made that affordable housing borrowers do not tend to refinance as readily as more traditional borrowers, lower interest rates also open opportunities for first-time homebuyers. These loans frequently qualify for housing goals purposes.

Q.2.f. What role does multifamily lending play in meeting the goals for each of the GSE's? What percentage of purchases are attributable to single family only?

A.2.f. The multifamily secondary market, which is in its early stages, has not yet received the full benefits of the GSEs' efforts. The goals, especially the Special Affordable Housing Goal, provide an incentive for the GSE's to maintain their presence in the multifamily secondary market.

These goals require a minimum dollar volume of multifamily mortgage purchases under the Special Affordable Housing Goal. Specifically, Fannie Mae is required to purchase $1.3 billion of multifamily mortgages targeted at low-income and very-low-income borrowers living in low-income areas. Freddie Mac's multifamily loan purchase requirement is $980 million. These dollar amounts are based on 0.8 percent of each GSE's 1994 dollar volume.

The Department is evaluating and monitoring the activities with regard to (1) establishing a secondary market for multifamily mortgage purchases and (2) the level of the GSEs' multifamily purchases particularly with regard to the multifamily component of the Special Affordable Housing Goal.

Year-end figures for 1995 disclose that 95.3 percent of goals purchases for Fannie Mae were single-family mortgages while 98.3 percent of Freddie Mac's goals were achieved with single-family mortgage purchases. (Percentages pertain to the total of all unpaid principal balances for all mortgages acquired and counted under the three housing goals during the calendar year ending December 31, 1995 as reported in Table 1 of each GSE's Annual Housing Report to HUD.)

Q.2.g. Data provided in your testimony suggests that one GSE already exceeds the Low- and Moderate-Income Goal and the other is close to meeting it. Also, the 1996 target of 40 percent is below HUD's estimate of the market. How does HUD reconcile these findings with Congressional intent that the GSE's should stretch to reach the goals and lead the market?

A.2.g. The goals that are set forth in the final rule reflect significant increases over the transitional goals and were based on statutory factors included in the GSE's Act. The 1996–1999 goals were set to accommodate a variety of market and economic conditions. For example, the goals were set to be appropriate during interest rate environments less affordable than the 1993–1995 period of near-record low-interest rates. The Department's general philosophy in setting the level of each goal is as follows:

- The goals adjust automatically to changes in the size of the market available for purchase because they are percentage based.
- The goals were set for a 4-year period so the GSE's could better plan their strategies and operating tactics.
- The goals are floors, not ceilings, and refer to a minimum level of expected performance on the part of the GSE's.
- The goals are benchmarks designed to be attainable under varying economic conditions.

The Act provides a framework for adjusting the goals at a subsequent time if performance, public need, and safety and soundness considerations warrant.

The GSE's Act presented the first opportunity to compile data relative to the GSEs' purchase activities and the size of the market as a whole. There is no one data source which the Department can consult for data on the exact size and scope of the various components of the housing market. The estimated size of the market in each housing goals category is based on the best data available at the time the final rule was published and, accordingly, is not as precisely measured as the Department would prefer.

Q.2.h. Does HUD's estimate of the market include loans that are not investment quality? Must the GSE's purchase risky loans in order to meet their goals?

A.2.h. No. As discussed in HUD's Economic Analysis of the GSEs' Rule (pp. IV–3 thru IV–5), the GSE's do not have to purchase risky loans to meet their housing goals. The Department does not expect the GSE's to purchase loans that are not investment quality in order to achieve the affordable housing goals. To our knowledge, the GSE's do not purchase any loans with LTV's greater than 80 percent without mortgage insurance regardless of the type of borrower. However, the GSE's do have to continue their outreach efforts and make prudent changes to underwriting standards, as they have over the past 2–3 years.

Loans qualifying for the housing goals are available for the GSE's to purchase without negatively impacting their financial condition. In an Urban Institute study completed for HUD, the Urban Institute concluded that there are many potential creditworthy homeowners that are now renting. In addition, HUD's analysis shows that the GSE's lag other lenders in funding affordable loans.

3. MINORITY LENDING

Q.3.a. GSE's loan purchases from minority borrowers in terms of the total loan volume and as a percentage of total business for the period 1990–present.

A.3.a. The Department's data collection of the GSEs' mortgage purchases began in 1993 as a result of the GSE's Act which became effective in October 1992. The Department does not have data on the GSEs' mortgage purchases prior to 1993. The attached chart entitled "Distribution of GSEs' Mortgage Purchases Made to Minority Borrowers 1993–1995" and related graphs provides the data requested for that time period.

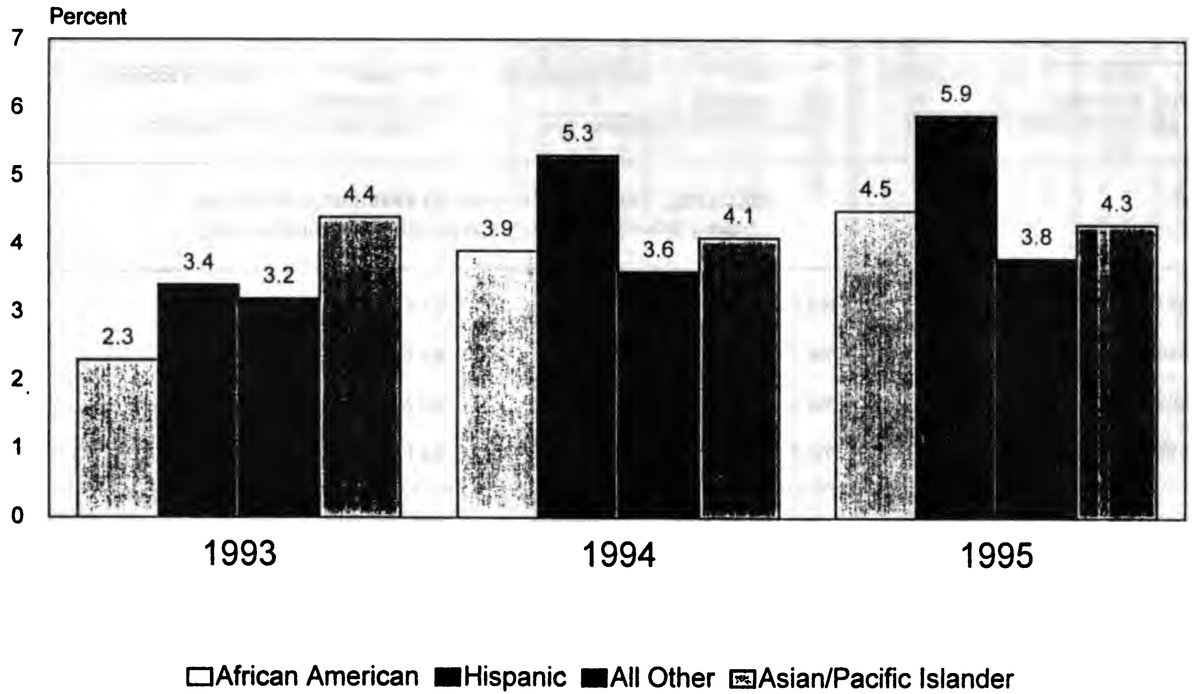
Distribution of Fannie Mae's Qualifying Single-Family
Mortgage Purchases By Race of Borrowers, 1993-1995

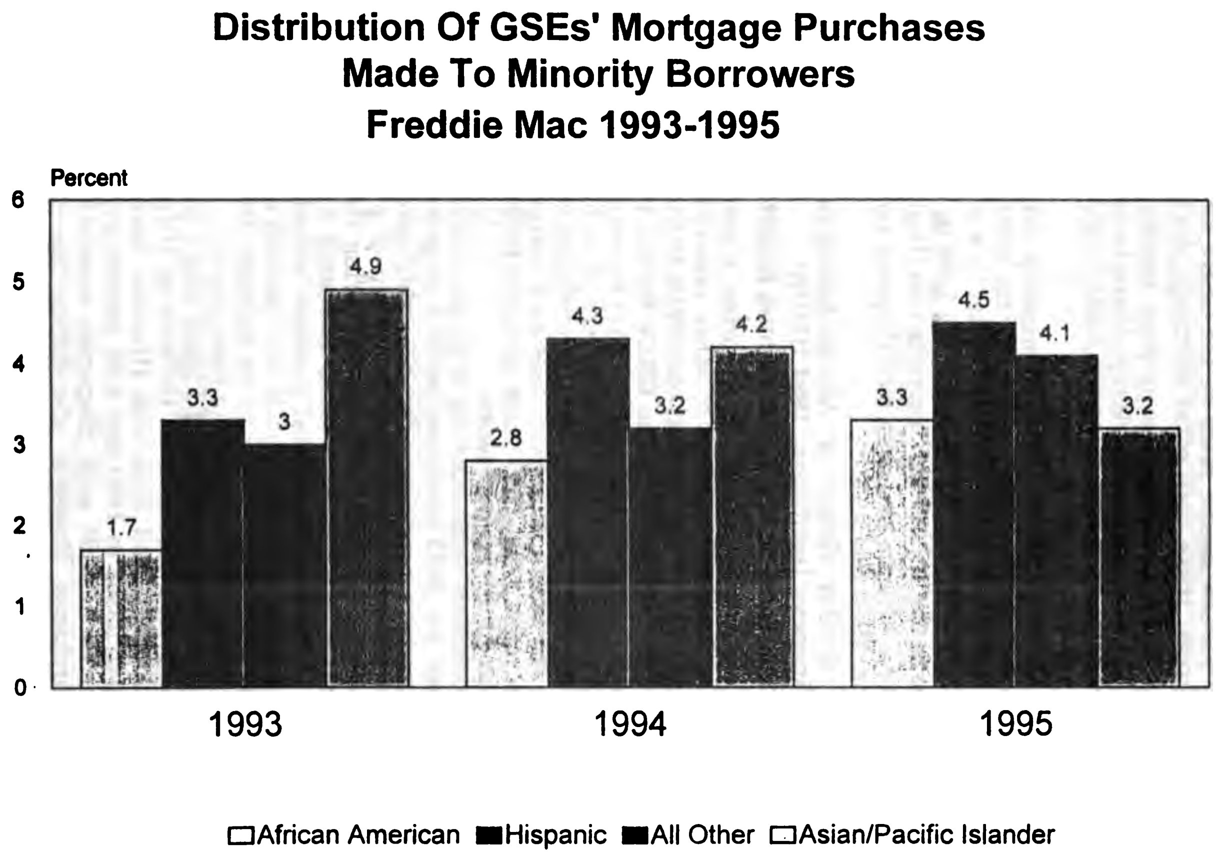
	Total Mortgages Acquired 1993		Total Mortgages Acquired 1994		Total Mortgages Acquired 1995	
	Number of Units	Percent of Total Units	Number of Units	Percent of Total Units	Number of Units	Percent of Total Units
Asian or Pacific Islander	117,629	4.4%	65,473	4.1%	50,497	4.26%
African American	60,324	2.3%	61,820	3.8%	53,310	4.50%
Hispanic	91,772	3.4%	86,012	5.3%	70,444	5.94%
All Other	85,902	3.2%	58,098	3.6%	45,259	3.8%

Distribution of Freddie Mac's Qualifying Single-Family
Mortgage Purchases By Race of Borrowers, 1993-1995

	Total Mortgages Acquired 1993		Total Mortgages Acquired 1994		Total Mortgages Acquired 1995	
	Number of Units	Percent of Total Units	Number of Units	Percent of Total Units	Number of Units	Percent of Total Units
Asian or Pacific Islander	100,399	4.9%	51,863	4.2%	26,870	3.2%
African American	35,207	1.7%	33,923	2.8%	27,496	3.3%
Hispanic	69,114	3.3%	53,167	4.3%	37,641	4.5%
All Other	62,194	3.0%	38,814	3.2%	34,819	4.1%

Distribution Of GSEs' Mortgage Purchases Made To Minority Borrowers Fannie Mae 1993-1995




Distribution Of GSEs' Mortgage Purchases
Made To Minority Borrowers
Freddie Mac 1993-1995
Percent
6
5
4
3
2
1
0
1.7
3.3
3
4.9
2.8
4.3
3.2
4.2
3.3
4.5
4.1
3.2
1993
1994
1995
African American
Hispanic
All Other
Asian/Pacific Islander

Q.3.b. Please provide denial rates by the GSE's for minority applicants and contrast these with other mortgage market participants.

A.3.b. The GSE's do not approve or deny mortgage applications. With regard to their purchase activity, there is no data available regarding the rates at which minority loans might be rejected for purchase.

Q.3.c. Provide comparable data on minority lending for other mortgage market actors—PMI's, FHA, thrifts, commercial bankers, mortgage bankers, and the mortgage market as a whole.

A.3.c. Refer to the tables which are being held in Committee files for review due to the volume and reproduction illegibility:

ATTACHMENT 1—African-American and Hispanic Lending by Financial Institution: 1994 HMDA*

ATTACHMENT 2—Bar Graph of African-American and Hispanic Lending by Financial Institution: 1994 HMDA*

ATTACHMENT 3—Table 9: 1993–1995 Annual Reports/Both GSE's

Q.3.d. Are Hispanic borrowers experiencing a greater increase in loans than the increase in loans to other minorities? If so, could you please describe the factors that contribute to this trend?

A.3.d. The data obtained from the GSE's for the transition period 1993–1995 do not support the premise that increases in loan originations are greater for Hispanic borrowers than for other groups. Although the GSE's data is limited to information on loans actually purchased by the GSE's, loan purchases as a percentage of all purchases for the years 1993–1995 track similarly for Hispanic borrowers and African-American borrowers.

Hispanic borrowers accounted for 2.92 percent of Freddie Mac's total purchases for 1993 compared with 1.49 percent attributable to African-American borrowers. By 1994 this percentage had increased by 41 percent to a total 4.10 percent of purchases attributable to Hispanic borrowers. However, during this same period, purchases for African-American loans increased by 76 percent to 2.62 percent of Freddie Mac's total purchase volume. By 1995 Hispanic loan purchases had declined to 3.91 percent of Freddie Mac's total purchase volume compared to an increase from 2.62 percent to 2.85 percent for African-American loan purchases.

In a similar manner, analysis of Fannie Mae's purchases during the transition period disclosed an increase in Hispanic loans purchased between 1993 and 1994 with Hispanic loans accounting for 3 percent of purchases in 1993 and 4.93 percent by 1994. A further increase occurred in 1995 with Hispanics accounting for 5.25 percent of all purchases. However, also during this same period, the purchases of loans made to African-American borrowers nearly doubled as a percent of total business by increasing from 1.97 percent of total purchases in 1993 to 3.97 percent by 1995.

GSE's data has not been captured for a long enough period to disclose a lending trend for Hispanics or African-Americans on an industry-wide basis. However, the significant increases that occurred by the second year of the transition period in both Hispanic

*Similar HMDA data for 1995 is not yet available. We will forward the information based on 1995 HMDA data as soon as we receive this information.

and African-American purchases as a percentage of total business are most certainly attributable to the effects of the GSE's Act and the performance goals.

The attached Table 31. Homeownership Rates by Race and Ethnicity: 1983–Present (excerpted from HUD's "U.S. Housing Market Conditions" report dated 8/96) supports this assessment.

Table 31. Homeownership Rates by Race and Ethnicity: 1983–Present

Period	Non-Hispanic White	Non-Hispanic Black	Non-Hispanic Other	Hispanic
Annual Data				
1983[1]	69.1	45.6	53.3	41.2
1984[']	69.0	46.0	50.9	40.1
1985	69.0	44.4	50.7	41.1
1986	68.4	44.8	49.7	40.6
1987	68.7	45.8	48.7	40.6
1988[']	69.1	42.9	49.7	40.6
1989	69.3	42.1	50.6	41.6
1990	69.4	42.6	49.2	41.2
1991	69.5	42.7	51.3	39.0
1992	69.6	42.6	52.5	39.9
1993[2]	70.2	42.0	50.6	39.4
1994	70.1	42.8	51.7	41.6
1995	70.8	42.2	51.0	42.4
Quarterly Data				
1995				
1st Quarter	70.4	41.5	51.5	41.8
2nd Quarter	70.9	42.3	50.6	42.8
3rd Quarter	71.1	43.3	52.0	42.5
4th Quarter	71.2	44.6	52.1	41.1
1996				
1st Quarter	71.4	44.2	51.5	41.4
2nd Quarter	71.7	44.0	50.4	43.9

Note: The source of annual data is the Current Population Survey March Supplement. The quarterly data source is the monthly Current Population Survey/Housing Vacancy Survey

['] Implementation of new March CPS processing system.

[1] CPS data from 1983 to 1992 are weighted based on the 1980 decennial census.

[2] Beginning in 1993 CPS data weighted based on the 1990 decennial census.

Source: Current Population Survey, Bureau of the Census

Q.3.e. What percent of the total population is from African-American, Hispanic, Asian, Asian-Pacific, and other identified minority groups? What percent of total new borrowers are in each of these groups? What percent of homeowners are in each of these groups? What percentage of these loans are purchased by Fannie Mae and Freddie Mac?

A.3.e. The American Indian or Alaskan Native, Asian or Pacific Islander, African-American, Hispanic, and Other minorities comprised 15.9 percent of the Conventional, FHA, and VA mortgage markets in 1994 (source HMDA). The breakdown is as follows:

	Percent of Mortgage Market Share	Percent of Total Population*
American Indian or Alaskan Native	0.4%	0.7%
Asian or Pacific Islander	3.0%	3.2%
African-American	6.2%	12.0%
Hispanic	5.7%	10.0%
Other	0.6%	—

*Minority population figures on a national basis as reported in the *1995 Statistical Abstract of the United States* are comprised of individuals, including children. The number or percentage of households potentially eligible to be homeowners cannot be discerned from these figures.

The share of total minority loans purchased by Fannie Mae and Freddie Mac is somewhat difficult to estimate. While we have data on Fannie Mae's and Freddie Mac's individual loan purchases, that data does not reflect the entire mortgage market for minority loans. Accordingly, HMDA data is the only available source of data from which reliable estimates of minority market share can be derived. However, there are some limitations on using HMDA data as a basis for evaluating the level of GSEs' purchase activity relative to the minority market.

One limiting factor is that HMDA data report all home purchase and home improvement loan applicants regardless of loan size while the GSEs' market share is limited to loans at or below the conforming loan limit. Also, because HMDA data are based on loans which were originated and sold in the same year, the data tend to understate the role of the secondary market. For example, a loan may be reported by a primary lender as originated during 1995, but the same loan would not be reported by a GSE until the year when the loan is actually purchased by the GSE. Very often the year of origination and the year of sale to the secondary are different. Additional limitations include the lack of HMDA data on loans made in non-metropolitan or rural areas by primary lenders small enough to be excluded from HMDA reporting requirements.

With regard to the percent of new borrowers in each minority population, the Department has no data source for this information. HMDA requires covered lenders to report the race, sex, and income of mortgage applicants. No further details are provided about the characteristics of the applicant, the type of loan being sought (beyond whether it is Conventional, FHA, or VA), or the number of times the applicant may have applied for or received mortgage loans in the past.

However, the Department believes that a valid estimate of GSEs' market share can be estimated from data relative to the FHA-eligible minority market which reflects the percentage of African-American and Hispanic loans that the GSEs' purchased versus those that went to FHA.

As shown in HUD's Privatization Study, the GSEs' market share of FHA-eligible home purchase mortgages was 18–20 percent for African-American borrowers and 24–26 percent for Hispanic borrowers. This compared to FHA's market share of 48–49 percent for African-American borrowers and 41–42 percent for Hispanic borrowers.

Attached is a table entitled "Mortgage Funding by Borrower and Census Tract Characteristics—1994 HMDA" which sets forth market share for African-American and Hispanic borrowers for each type of mortgage market participant based on HMDA data alone. (Similar statistics using 1995 HMDA data are not available.) These percentages include both new borrowers and those refinancing existing loans.

FHA AND GSE'S MARKET SHARES FOR FHA-ELIGIBLE MORTGAGES 1994 HMDA

	FHA	GSE's
Low-Income Borrower [1]	32–34 percent [2]	26–28 percent
African-American	48–49 percent	18–20 percent
Hispanic	41–42 percent	24–26 percent
Underserved Areas [3]	34–35 percent	26–29 percent
Total FHA-Eligible Market	27–28 percent	31–34 percent

NOTE: The figures above refer to the percentages of FHA-eligible home purchase mortgage loans in metropolitan areas (excluding refinances and VA mortgages) that were FHA's loans (column 1) or loans purchased by the GSE's (column 2). For other restrictions and qualifications, see Table 2.4 in HUD's Privatization Report. A range is provided because of the uncertainty about HMDA's coverage of FHA and non-GSE's conforming loans. The range of estimates assumes that HMDA accounts for 80 to 90 percent of FHA and non-GSE's loans. Data for the GSE's are obtained from the loan level data base that the GSE's provided to HUD.

[1] Income below 80 percent of AMI (AMI refers to the median income of the metropolitan area).

[2] That is, in 1994, FHA accounted for 32–34 percent of all FHA-eligible home purchase mortgage loans (excluding VA mortgages) made to low-income borrowers.

[3] Metropolitan census tracts with (1) median income less than or equal to 90 percent of AMI or (2) minority concentration greater than or equal to 30 percent and tract median income less than or equal to 120 percent of AMI.

FHA-Eligible Mortgage Funding by Borrower and Census Tract Characteristics 1994 HMDA

			FHA-Eligible Conforming Conventional Mortgages								
							Depository			Conforming	
Borrower Income	FHA	VA	Freddie Mac	Fannie Mae	Both GSEs[5]	Non-GSE[6]	Banks[7]	S&Ls[7]	Both	Market	Mobile Homes
Below 60% AMI[1]	18.3%	9.8%	10.9%	11.8%	11.4% (11.1%)	15.0%	16.9%	13.9%	15.9%	13.6%	28.5%
Below 80% AMI	42.2%	28.3%	27.4%	29.2%	28.5% (28.0%)	32.5%	34.4%	31.4%	33.4%	31.0%	51.9%
Below Median	64.7%	49.4%	46.8%	49.3%	48.2% (47.8%)	50.6%	51.5%	49.9%	50.9%	49.8%	70.7%
Borrower Race											
African-American	13.3%	14.6%	3.7%	5.0%	4.5% (4.4%)	5.9%	6.0%	4.4%	5.4%	5.4%	4.9%
Hispanic	11.5%	5.4%	5.4%	6.6%	6.1% (6.3%)	6.0%	5.4%	6.4%	5.7%	6.0%	6.8%
Both	24.8%	20.0%	9.1%	11.6%	10.6% (10.7%)	11.9%	11.4%	10.8%	11.1%	11.4%	11.7%
Census Tracts											
Low-Income[2]	17.2%	12.1%	10.0%	11.1%	10.7% (11.0%)	13.8%	14.9%	11.7%	13.8%	12.5%	18.5%
High-Minority[3]	25.1%	23.1%	15.7%	17.6%	16.8% (17.1%)	16.7%	15.4%	16.1%	15.7%	16.7%	20.0%
Underserved Areas[4]	38.6%	33.2%	25.5%	27.4%	26.6% (27.4%)	30.4%	32.1%	27.5%	30.5%	28.8%	43.2%
In Central Cities	45.7%	45.8%	35.7%	38.2%	37.2% (NA)	36.9%	36.7%	35.0%	36.1%	37.0%	36.9%

Note: Tabulation limited to FHA-eligible home purchase and refinance mortgages in metropolitan areas. Mortgages with loan amounts less than $15,000 (except for mobile homes) or loan-to-income ratios greater than 6 are excluded. Loans originated by 12 lenders that originate primarily B and C quality loans have been excluded. Origination data for 8 lenders identified as mobile home lenders are provided separately; these data are not included in the conforming market totals.

[1] AMI refers to the median income of the metropolitan area.

[2] Census tract median income less than or equal to 80 percent of AMI.

[3] Minority composition of census tract equal to or greater than 30 percent.

[4] Metropolitan census tracts with (1) median income less than or equal to 90 percent of AMI or (2) minority concentration greater than or equal to 30 percent and tract median income less than or equal to 120 percent of AMI.

[5] The numbers in parentheses are computed from loan level data obtained from the GSEs.

[6] Includes all current-year originations that were not sold to a GSE during the calendar year. Mortgages originated by Banks and Savings and Loans that were not sold accounted for approximately 85 percent of these non-GSE mortgages. Further analyses of these data suggest that a significant percentage of the remaining 15 percent of these mortgeges are eventually sold to the GSEs.

[7] Depository originations (including originations of mortgage company subsidiaries) that were not sold during the calendar year. Figures do not include purchases by depository institutions.

4. MULTIFAMILY LENDING

Q.4.a. What is HUD's estimate of the total multifamily market and what percentage of the multifamily lending qualifies for each of the GSE's goals?

A.4.a. In preparing the final rule, the Department, working with The Urban Institute, undertook an analysis designed to reasonably estimate the multifamily market. This was necessary in order to define and establish market share eligible to meet each housing goal. As described in Appendix C to the final rule, HUD used three principal sources—Residential Finance Survey (RFS), Survey of Mortgage Lending Activity (SMLA), and Home Mortgage Disclosure Act (HMDA) data as principal sources of information on historical multifamily origination volumes. From the data sources cited, researchers estimated at least $30 billion per year of multifamily originations had occurred in 1987–1991. After adjusting for reporting errors in 1993 data, researchers placed the 1993 lending volume in the $25–$30 billion range.

Although multifamily purchases may count under any of the housing goals, the Special Affordable Housing Goal has a specific multifamily component. The Department has estimated the market share eligible for the Special Affordable Housing Goal as 20 percent to 23 percent of total units available.

The GSEs' 1996 Special Affordable Housing Goal is 12 percent of units financed. Of this number all may be multifamily units. The final rule eliminated the 50/50 split that had been in place during the transition years. In addition, the final rule established a specific multifamily component of the Special Affordable Housing Goal which is expressed as a dollar amount. This amount is $1.3 billion per year for Fannie Mae and $980 million per year for Freddie Mac (based on .8 percent of dollars volume).

Multifamily purchases may also be counted toward the Low- and Moderate-Income Goal and the Geographically Targeted Goal.

Tables from the GSEs' 1993–1995 Annual Reports contain information regarding the GSEs' multifamily purchases and are being held in Committee files for review due to the volume and reproduction illegibility.

Q.4.b. Provide data on multifamily lending for each GSE's by year—in dollars, as percentage of total GSE's lending and as a percentage of total multifamily lending from 1990 to present.

A.4.b. The Department's data collection of the GSEs' mortgage purchases began in 1993 as a result of the GSE's Act that became effective in October 1992. The Department does not have data on the GSEs' mortgage purchases prior to 1993. However, Figure 16, excerpted from OFHEO's 1996 Annual Report, tracks multifamily purchase figures from 1990. In addition, the following tables from the GSEs' 1993–1995 Annual Reports are being held in Committee files for review due to the volume and reproduction illegibility:

FREDDIE MAC—Table 1: 1993, 1994, 1995
FREDDIE MAC—Table 5: 1993, 1994, 1995
FREDDIE MAC—Table 7: 1993, 1994, 1995
FREDDIE MAC—Table 18: 1993, 1994, 1995

FANNIE MAE—Table 1: 1993, 1994, 1995
FANNIE MAE—Table 5: 1993, 1994, 1995
FANNIE MAE—Table 7: 1993, 1994, 1995
FANNIE MAE—Table 18: 1993, 1994, 1995

Q.4.c. What contribution does multifamily lending make toward the performance of the goals for each GSE? What percentage of total low-mod/underserved areas achievements are attributable to single family and what percentage are attributable to multifamily?

A.4.c. Both GSEs' rely on multifamily purchases to meet affordable housing goals applicable to the most credit constrained borrowers. For this reason, Fannie Mae's and Freddie Mac's annual housing reports to HUD, which describe goals performance during the year, highlight multifamily business strategies that have contributed toward goals performance. Both GSEs' are well-positioned in the marketplace to create through partnerships and new product lines a stronger secondary market for multifamily loans which, in turn, will ensure liquidity and encourage continued investment in these properties.

Using data for 1995 as an example of how multifamily programs enhance goals performance, both GSEs' targeted the majority of their multifamily purchases toward units meeting the Special Affordable Housing Goal as follows:

- In 1995 Freddie Mac funded multifamily mortgages for 68,381 units of which 48,968 qualified under the Special Affordable Housing Goal. The qualifying units represented 71.6 percent of all multifamily purchases and accounted for 35.8 percent of the combined single-family and multifamily units that qualified under the Special Affordable Housing Goal.
- During this same year, Fannie Mae purchased mortgages secured by 157,327 multifamily units of which 102,886 units or 65.4 percent of total multifamily purchases qualified as Special Affordable Housing purchases. Multifamily units comprised 43.5 percent of Fannie Mae's total single-family and multifamily purchases counting under the Special Affordable Housing Goal.

Freddie Mac's 1995 Annual Report to the Secretary described the following multifamily initiatives undertaken to meet housing goals:

- *Wavecrest Gardens,* a major apartment funding in New York City, which houses 1,657 households and is affordable to low-income families earning 80 percent or less of area median income;
- *Tax Credit Mortgage,* a structured transaction involving eight apartment properties, wherein all 1,912 units are affordable to very low-income families earning 60 percent or less of area median income.

Fannie Mae's 1995 Annual Report to the Secretary also focused on multifamily activities during the year. Some of the programs that helped Fannie Mae meet its Affordable Housing Goal are as follows:

- *New Construction* product line was introduced to streamline new construction, rehabilitation financing of affordable housing for low-income renters;

- Ten *Multifamlly Negotiated Transactions* were completed for a total of $2.4 billion to provide liquidity for lenders who finance affordable rental housing in central cities.
- *Enterprise Mortgage Investment, Inc.,* was created in partnership with the Enterprise Foundation to provide mortgage financing to nonprofit developers of multifamily rental properties for very low-income families.

However, the GSE's have more to do in the area of multifamily lending. Single-family mortgages make up the vast majority of the GSEs' mortgage purchases. Year-end figures for 1995 disclose that 95.3 percent of goals purchases for Fannie Mae were single-family mortgages while 98.3 percent of Freddie Mac's goals were achieved with single-family mortgage purchases. (Percentages pertain to the total of all unpaid principal balances for all mortgages acquired and counted under the three housing goals during the calendar year ending December 31, 1995, as reported in Table 1 of each GSE's Annual Housing Report to HUD.)

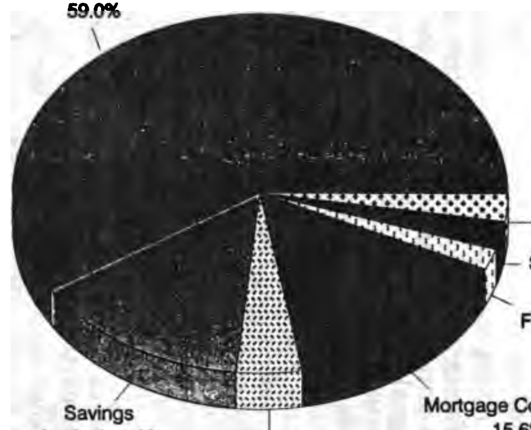
Table 1 covering the transitional years of 1993–1995 summarizes multifamily activity for each GSE and provides percentages of purchases counting toward each goal are being held in Committee files for review due to the volume and reproduction illegibility.

Q.4.d. Provide data on multifamily lending market share for other mortgage market participants.

A.4.d. The attached figure entitled "Multifamily Mortgage Origination Volume By Source 1995" compares multifamily market share activity of various participants.

Also tables for years 1980–1995 and first quarter 1996 attached entitled "Annual Gross Flows of Long-Term Mortgage Loans on Multifamily Properties by Loan Type for Eleven Major Lender Groups." This data was compiled by the Department's Office of Financial Management and published in the Survey of Mortgage Lending Activity. They are being held in Committee files for review due to the volume and reproduction illegibility.

Multifamily Mortgage Origination Volume
By Source
For 1995



Total for all groups is $39.2 billion.
Source: HUD Survey of Mortgage Lending Activity, August 9,1996.
* Private Non-Insured Pension Funds and State and Local Retirement Funds.
** Includes Savings and Loan Associations and Mutual Savings Banks.

5. CONFORMING LOAN LIMITS

Q.5.a. Provide conforming loan limits, FHA mortgage limits, and median home sales price, median existing home sales price, and median new home sales price by year for period from 1980 to the present.

A.5.a. Tables and charts are being held in Committee files for review due to the volume and reproduction illegibility.

Q.5.b. Please provide the median home sales prices, existing home sale prices, and new home sales prices for [various States] from 1980 to the present.

A.5.b. This information is not available.

Q.5.c. Provide single-family market share data for all mortgage originations for each of the mortgage market participants for the period 1980 to the present.

A.5.c. Tables from HUD's Survey of Mortgage Lending Activity are being held in Committee files for review due to the volume and reproduction illegibility.

Q.5.d. Provide single-family market share data for all mortgage originations for each of the mortgage market participants for originations below the conforming loan limits for the period 1980 to the present.

A.5.d. This information is not readily available to us. We will pursue a HMDA analysis if this particular information is still needed after reviewing the other data supplied for the record.

Q.5.e. Is the index used to adjust the conforming loan limits the appropriate index?

A.5.e. HUD has undertaken no studies to ascertain the appropriateness of the current index or the desirability of basing conforming loan limit adjustments on an alternative index. Insofar as the current measure of house price increases as reported by the Federal Housing Finance Board is a reasonable index, it may be construed to be an appropriate basis for adjusting loan limits until further analysis and research is conducted to validate its use.

Q.5.f. Under current law, if that index goes down, should the conforming loan limit also decline? Why or why not?

A.5.f. This is an issue that would require more study to determine likely impact on the housing markets. We believe that a conforming loan limit is needed to focus the GSEs' efforts. This limit was intended to serve borrowers, not the GSEs', by ensuring that increases in the conforming loan limit track house prices. However, decreasing the limit when the index declines could have unintended effects on mortgage credit and housing finance markets that cannot be adequately anticipated without further study.

Q.5.g. If the conforming loan limits were eliminated, what would be the effects on prices of mortgages above and below the conforming loan limit?

A.5.g. Nearly everyone with actual day-to-day experience in the mortgage lending industry would agree that conforming loans typically have a lower effective interest rate than do the jumbo loans, taking both the note rate and loan points into account. The three major economic studies on this issue all concurred that this is because of the GSE's and the efficiencies they bring to the conforming marketplace. However, in the absence of a distinction between the conforming and jumbo loans and provided the GSE's were not restricted in the loan amounts they could purchase, then the pricing differential becomes more difficult to determine. HUD has conducted no research or analysis of the probable effect on pricing that elimination of the conforming limit would produce.

Q.5.h. What other effects might eliminating the conforming loan limits have on mortgage markets?

A.5.h. HUD believes the conforming loan limit is needed to focus the GSEs' efforts. The GSEs' are obligated to provide liquidity to the mortgage markets, ensuring that adequate capital is accessible to all Americans, particularly the low- and middle-income families. Eliminating the conforming loan limit could have the effect of diverting more resources, including the GSEs' resources, toward the higher-end of the mortgage market.

Q.5.i. Provide historical data showing the GSEs' share of outstanding mortgages.

A.5.i. See the attached Table: "Single-Family Mortgage Debt Outstanding by Source of Funds." This table was Table 2.2 in HUD's Privatization Study (p. 42).

Single-Family Mortgage Debt Outstanding by Source of Funds
(End of Year Values)

	Dollar Values ($ Billions)						
Secondary Market*	1975	1980	1985	1987	1990	1994	1995
Fannie Mae Portfolio	25.8	51.8	91.9	93.5	113.9	220.5	252.6
Freddie Mac Portfolio	4.6	3.8	11.9	12.3	21.4	72.3	107.4
Fannie Mae MBS	0.0	0.0	54.0	135.8	288.0	486.3	513.2
Freddie Mac PCs	1.4	13.5	99.5	212.6	316.4	460.7	459.0
Ginnie Mae MBS	17.5	91.6	207.2	309.8	391.5	441.2	461.4
Farmers Home MBS	9.2	16.7	22.2	0.1	0.0	0.0	0.0
Private Pools	0.0	3.7	24.0	27.8	53.3	183.6	208.4
Subtotal	58.5	181.1	510.7	791.9	1,184.5	1,864.6	2,002.0
Portfolio Holdings							
Savings Institutions	273.9	487.3	554.3	602.4	600.2	477.5	488.2
Commercial Banks	77.0	160.4	213.4	275.6	455.9	611.7	665.1
Others**	72.7	136.3	226.1	279.5	403.1	421.5	526.9
Subtotal	423.6	784.0	993.8	1,157.5	1,459.2	1,510.7	1,680.2
Total	482.1	965.1	1,504.5	1,949.4	2,643.7	3,375.3	3,682.2

	Percent Shares						
Secondary Market*	1975	1980	1985	1987	1990	1994	1995
Fannie Mae Portfolio	5.4	5.4	6.1	4.8	4.3	6.5	6.9
Freddie Mac Portfolio	1.0	0.4	0.8	0.6	0.8	2.1	2.9
Fannie Mae MBS	0.0	0.0	3.6	7.0	10.9	14.4	13.9
Freddie Mac PCs	0.3	1.4	6.6	10.9	12.0	13.6	12.5
Ginnie Mae MBS	3.6	9.5	13.8	15.9	14.8	13.1	12.5
Farmers Home MBS	1.9	1.7	1.5	0.0	0.0	0.0	0.0
Private Pools	0.0	0.4	1.6	1.4	2.0	5.4	5.7
Subtotal	12.1	18.8	33.9	40.6	44.8	55.2	54.4
Portfolio Holdings							
Savings Institutions	56.8	50.5	36.8	30.9	22.7	14.1	13.3
Commercial Banks	16.0	16.6	14.2	14.1	17.2	18.1	18.1
Others**	15.1	14.1	15.0	14.3	15.2	12.5	14.3
Subtotal	87.9	81.2	66.1	59.4	55.2	44.8	45.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

* For Fannie Mae and Freddie Mac, MBS in Portfolio are counted in portfolio and not in MBS totals.

** Others include life insurance companies, finance companies, Farmers Home Administration, Federal Housing Administration, Veterans Administration, mortgage companies, real estate investment trusts, State and local credit agencies, State and local retirement funds, noninsured pension funds, credit unions, other U.S. Government agencies, and individuals.

Source: Board of Governors of the Federal Reserve System; HUD Office of Policy Development and Research.

6. PERFORMANCE OF AFFORDABLE HOUSING LOANS

Q.6.a. You said you were looking at default rates and delinquency rates on affordable loans by the GSE's and other financial institutions. What have you learned so far?

A.6.a. Both Freddie Mac and Fannie Mae consider their delinquency and default rates proprietary information.

In published information (Federal Reserve Bulletin, July 1996, p. 642), Freddie Mac has reported that the 60-day delinquency rate on loans originated in 1994 under its Affordable Gold Program (designed primarily for those below median area income) shows a delinquency rate about 50 percent higher than that for a peer group of traditionally underwritten mortgages. One part of the Affordable Gold Program is the 3/2 program where the loan is 95 percent loan-to-value, and the remaining 5 percent is divided, with 3 percent coming from the homebuyer and 2 percent in the form of a loan or gift to the homebuyer. According to Freddie Mac, the 3/2 program is showing delinquencies, through February 1996, about four times higher than those of comparable traditionally underwritten loans. While this performance is dramatically different from Freddie Mac's traditional portfolio, it should be noted that mortgage loans purchased by Freddie Mac under these special programs represent about one half of one percent of Freddie Mac's total purchases, and are an immaterial component of its housing goal performance.

Fannie Mae has not published any statistics on its Single-Family Affordable Housing Program (Community Homebuyers), but has reported that its experience is within its expectations for the program.

Two of the mortgage insurance companies, Mortgage Guaranty Insurance Company (MGIC) and General Electric Capital Mortgage Insurance Company have published limited statistics on affordable housing loan performance, which are not directly comparable to Freddie Mac's statistics due to different definitions of affordable housing and different time-periods covered. MGIC has identified layering of relaxed underwriting standards, particularly when combined with adverse credit records, as a contributor to the higher delinquencies than those on the traditionally underwritten book of business. The report from MGIC is entitled "Tapping Our Nations Homeownership Potential."

The Department has been briefed by Fannie Mae and Freddie Mac on the performance of affordable housing loans. Also, anecdotal evidence presented at the various affordable lending forums sponsored by the Department indicate that performance varies widely subject to whether practices, such as pre-purchase counseling, were offered to borrowers and how familiar the lender is with the local lending area. For example, a number of banks and community organizations have stated that their delinquency ratios on affordable housing loans are less than that on the standard portfolios of similar mortgages.

Materials documenting the three forums sponsored by the Department are being held in Committee files for review due to the volume and reproduction illegibility. The Department continues to follow the subject carefully.

SUMMARY OF THREE FORUMS

Best Practices in Affordable Housing Lending

Summary

The U.S. Department of Housing and Urban Development, together with the Federal Housing Finance Board, and the Federal Home Loan Banks, sponsored three forums in Washington, DC on affordable housing lending as follows:

1. "The Performance of Affordable Housing Loans"—April 24, 1996
2. "Homeownership Education and Managing Affordable Housing Loans"—May 22, 1996
3. "The Impact of Automated Underwriting on Affordable Housing Loans"—June 26, 1996

Participants represented Fannie Mae, Freddie Mac, private mortgage insurance companies, mortgage companies, banks and thrift institutions, housing finance agencies, the FHA, Ginnie Mae, and others. Approximately 30 persons, exclusive of HUD representatives, participated in each discussion.

The forums were designed to provide a framework for attendees active in industry and housing issues to exchange viewpoints and share practical experiences with representatives of HUD and other financial and regulatory institutions. One immediate outcome of these discussions was the identification of "best practices" for affordable housing lending which were compiled into the Department's recently published booklet entitled *Financing the American Dream: Best Practices in Affordable Homeownership Lending*.

These summaries provide an overview of the discussion that developed from the forums as well as the objectives set forth for each session. Based upon this information as well as each GSE's Working Group participant's day-to-day knowledge of these issues, we will explore the following discussion questions during the Working Group meeting.

Forum No. 1. "Performance of Affordable Housing Loans" April 24, 1996

This forum on the performance of affordable housing mortgage loans was concerned with the special loan programs that financial institutions, nonprofit community lenders, housing agencies, mortgage insurers, the Federal Home Loan Banks, Fannie Mae, Freddie Mac, and the Federal Housing Administration have developed in order to make homeownership possible for low- and moderate-income families.

The purpose of the forum was to determine why certain affordable housing loan programs are performing well and to identify practices that may improve the performance of affordable housing loan programs in order to enable a larger number of low- and moderate-income persons to own, and maintain ownership in, a home rather than continuing to rent.

Specific objectives were as follows:

- To establish broad parameters defining affordable housing loans for the purpose of the day's discussion.
- To identify *what* the participants' experience is with regard to affordable housing lending.

- To identify *why* certain lenders, insurers, and purchasers of loans have successfully maintained a low level of delinquencies and defaults while others are concerned about higher or unacceptable levels of delinquencies and defaults.
- To make recommendations for the best practices to improve the performance of affordable housing loans.

SUMMARY OF DISCUSSION RESULTS

The discussion by the participants of loan performance was frank and informative, with parties identifying performance problems, although why some lenders have excellent performance records and others do not is a matter to be examined further. The session led to a much better understanding of "best practices" which, accompanied by the information in the second forum, led to the publication of *Financing the American Dream.*

The participants in the secondary market reported that affordable housing loan performance was generally within an acceptable performance range, but there were areas where the risk did not appear to be acceptable over a period of years, particularly where underwriting flexibilities had been layered and where the seller had financed part of the borrower's downpayment. All lenders emphasized the preliminary nature of performance reports, given that most affordable loan programs are only a few years old. The secondary market participants discussed the use of automated underwriting as a way to set quality control guidelines on underwriting.

The primary lenders and community organizations concentrated on the value of understanding the community of affordable housing borrowers, and said that careful underwriting was successful in maintaining loss ratios at or even below the loss for the standard loan portfolio. There was strong support for homebuyer counseling programs as a way to improve performance of affordable housing loan programs.

Selected conclusions in the day's discussion include:

- Although affordable housing loans fall within several broad categories, the main focus of the discussion was on loan programs for borrowers below area median income where non-traditional underwriting guidelines are used. These usually involve one or more factors, including loan-to-value ratios of 95 percent or more, liberal debt-to-income ratios, non-traditional evaluation of credit, and waiver or partial waiver of reserve requirements.
- Affordable housing lending is an important and continuing part of today's loan programs. In general, the performance of these loans is satisfactory. Some report that their affordable housing loan portfolios perform better than the standard portfolio, but the majority, including those in the secondary mortgage market and the private mortgage insurance companies, report higher delinquency ratios for affordable housing loans than with the comparable book of standard loans.
- Where loan flexibilities have been layered one upon another, delinquencies are higher than generally acceptable in the secondary market. This is particularly true with the 3/2 programs that offered a 95 percent LTV with the remaining 5 percent consisting of 3 percent from the borrower and 2 percent in the form of a

gift, a seller contribution or an unsecuritized loan. The 3/2 programs are a small part of affordable housing loan portfolios.

- Information on claims for affordable housing loans is preliminary because most of those loans were made in the last few years which is an insufficient performance period for claims patterns to develop. Some believe that delinquencies for affordable housing loans cure more readily than the standard book whereas others see no evidence of that.
- Community-based lending by nonprofit groups may be a significant factor helping improved loan performance.
- Homebuyer education and counseling contribute to better loan performance. Some primary lenders believe that careful underwriting, plus counseling for borrowers, will prevent performance problems currently tied to credit risk or lack of reserves. (Homebuyer education and counseling was discussed in more detail in the second forum, held May 22.)

Forum No. 2. "Homeownership Education and Managing Affordable Housing Loans"—May 22, 1996

Homeownership education is often cited as an important measure to reduce the possibility of loan delinquency. The enhanced servicing of affordable housing loans is also believed to improve the performance of affordable housing loans. This forum explored both topics. Homeownership education and portfolio management were linked together in the forum because affordable housing loans, as distinct from standard loans, often benefit from both pre-purchase and post-purchase counseling as well as early intervention in servicing.

Specific objectives were as follows:

HOMEOWNERSHIP EDUCATION AND COUNSELING

- To identify the various types of homeownership education and counseling that are offered, and to determine which methods are most effective, feasible, and desirable.
- To determine the best time for homeownership education and counseling given the complexities of reaching potential borrowers and the costs involved.
- To identify the issues associated with funding homeownership education and counseling.

MANAGING AFFORDABLE HOUSING LOANS

- To identify what different or additional servicing practices are necessary to manage affordable housing loans.
- To determine when to contact a borrower who has missed a payment deadline and when post-purchase counseling is appropriate.
- To identify and assess the effectiveness of various methods of curing delinquent affordable housing loans.
- To determine the best methods for mitigating losses in cases of default on affordable housing mortgages.

SUMMARY OF DISCUSSION RESULTS

The morning was devoted to pre-purchase education and counseling and the afternoon was spent discussing servicing, including post-purchase counseling, and loss mitigation techniques. Participants emphasized the importance of counseling potential homebuyers on budgeting, often over a long period of time. While most affordable housing homebuyers turn to counseling only after they have signed a sales contract, there was a consensus that counseling was far more valuable before the applicant began to look for a house and certainly before the sales contract was signed.

The cost of counseling and education was specifically addressed, with some discussion of what would be a desirable standard for pre-purchase counseling. There was no agreement on how the costs should be borne, but distinctions were made between funding classroom education for potential homebuyers and specific counseling when the homebuyer is ready to purchase.

Guidelines were suggested for determining quickly what were the causes for a delinquent mortgage payment. Recommendations were made for the use of community organizations which would help the borrower resolve mortgage problems along with other financial problems which could be contributing to the delinquency. Specific suggestions on emergency stabilization mortgage funds ("rainy day funds") and other solutions for limiting the amount of loss were included in "best practices" in counseling and servicing.

Conclusions in the day's discussion include the following points:

- A distinction must be made between education which normally provides homebuying information in a classroom setting and counseling, which is one-on-one between the counselor and the potential homebuyer.
- The most desirable way to prepare homebuyers is through counseling provided before any sales contract is signed. About 80 percent of affordable housing loan applicants have not had that counseling prior to signing a contract on a house.
- Education comes first. At least 80 percent of those attending education sessions are not ready to buy a house, and a substantial portion consider themselves to have credit problems. Many families require long-term counseling on budget management. Concerns were expressed over counseling by telephone, although it is better than no counseling at all.
- The real estate broker might be the person to persuade the potential homebuyer to take homeownership counseling. There was discussion about whether or not a real estate agent will provide the affordable housing buyer sufficient information, particularly about repairs needed.
- Costs of counseling are usually covered through contracts, grants and fees. Costs of counseling and homeownership education were estimated, and there was a discussion about whether or not the potential homebuyer should be required to pay a fee. Where the borrower has access to a particular loan product, the provider of the product should pay the pre-purchase counseling fees. The costs can be capitalized over the life of the loan. Before there is agreement on what costs the lender should pay and what costs should be borne by others, including the borrower, there has to be a better agreement on what kind of education and counseling produces satisfactory results in loan performance.
- Community organizations can be very helpful in post-purchase counseling. The lenders must advise the community organizations about delinquencies monthly, the borrower must have

agreed to the release of the information to those involved in the mortgage transaction. The community organization must usually work with the borrower to help solve all the credit problems, not just the late mortgage payment.

- The affordable housing borrower should be called 10 days after a payment is missed, although longer intervals were also suggested. One lender's experience is that 85 percent of mortgage loans cure on their own without lender intervention other than notices.
- Of the lenders which refer delinquent homeowners for counseling, too few make provision for paying for the counseling. Only a small percentage of delinquent borrowers are willing to accept counseling.
- Monthly billings are more effective than payment books. Automated deductions are valuable.
- As workout alternatives, the creation of a "rainy day fund" is valuable to cover emergencies, such as illness or temporary loss of work. Lenders also find that forebearance is often more effective than foreclosure.

Forum No. 3. "Impact of Automated Underwriting on Affordable Housing Loans"—June 26, 1996

In this forum participants explored issues related to the compatibility of automated underwriting technology, including credit scoring, with recent gains in affordable housing lending. Automated underwriting as a technology brings certain efficiencies and cost savings to the mortgage credit market. The challenge is to determine how to marshall the potential of AUS in such a way that it can serve to expand affordable housing loan activity, not restrict it.

Specific objectives for the forum were as follows:

- To provide participants with a broad perspective on technological advances in mortgage lending and explore common misconceptions about the effects of this technology as well as opportunities for affordable housing loans.
- To identify ways in which affordable housing borrowers may benefit from or be affected by Automated Underwriting Systems, and explore ways that automated underwriting could benefit non-traditional homebuyers and/or first-time homebuyers who have avoided buying out of fear and uncertainty.
- To explore ways in which automated underwriting may or may not improve risk management and management of affordable housing loan portfolios.

Summary of Discussion Results

The morning was devoted primarily to a discussion of what mortgage scoring, as a form of Automated Underwriting Systems (AUS) could accomplish. The providers of both credit scoring and mortgage scoring services believed that the new systems would provide a much quicker, more accurate, and bias-free form of evaluating the majority of potential borrowers. By enabling a quick decision for a substantial number of borrowers who score well, there is more time for working with the borrowers whose mortgage scores are closer to the margin.

It was generally agreed that there were possibilities of using scores to reach potential first-time homebuyers who may not have realized that they could qualify for a mortgage. On the other hand, there was a concern that, since many affordable housing borrowers require as much flexibility as possible in the underwriting process, the new scoring process would eliminate them. Several emphasized the importance of having a system of referrals and override which promises a review of those affordable housing applicants turned down.

Automated Underwriting Systems can also be useful for reviewing portfolios to provide information to determine why certain loans go into default. The systems may be developed so as to be of use to counseling organizations.

In short, the participants had a positive view of probable benefits for affordable housing borrowers, although concerns about the accuracy of credit record information have to be addressed, and there must be longer-term analysis to determine if the system is fair to the affordable housing borrowers.

Selected conclusions in the day's discussion include:

- A distinction must be made between a *mortgage score* and *credit score*. The former is a system-generated numeric value based on the mortgage application data. It usually includes a weighted value for credit report data. The latter is a numeric value based only on credit report data, which is consumer loan data. It does not include application data, such as income, employment, debt-to-income ratios, etc.
- Mortgage scoring leads to more "accepts" than does credit scoring alone.
- Automated Underwriting Systems (AUS), or credit scores alone, can be used to expand outreach. For instance, a lender may acquire and use mailing lists of those with FICO scores of 620 or greater, but participants agreed that scoring parameters designed to exclude those below a certain cutoff probably did not benefit affordable housing loan initiatives. Lenders will continue to have trouble reaching the borrowers with non-traditional credit profiles.
- There is currently no way to weigh or factor in the benefits of homebuyer counseling in a mortgage score.
- AUS could be used for risk-based pricing of mortgage loans, but this contradicts the purpose of keeping affordable housing loans affordable, assuming that the non-traditional mortgage loans are likely to be more risky than the standard loan portfolio. Risk-based pricing already occurs in that mortgage insurance premiums are higher for very high loan-to-value ratio loans. Risk-based pricing for loans themselves, in addition to the mortgage premium, is not a marketing necessity at the present time.
- There was a discussion on whether or not the commissioned-based system, which favors loans that can be approved and closed quickly, is adequate for underserved areas where more borrowers require individualized attention for their loan applications, called "refer" loans. There remains considerable ambiguity about what is and what is not acceptable for approval for "refer" loans. There was some concern that, as the patterns for deciding

"refer" loans are adapted into AUS, there might be a tendency to institutionalize prior biases.

- Cross subsidization exists in the sense that AUS can lower the cost of applications which are accepted easily, leaving the lender better able to bear the costs of the more intensive "refer" loans.
- AUS has been used extensively to review loans already made. It may be able to help determine whether special intervention is necessary when a loan is delinquent. There is not enough history or data yet to determine the effectiveness of this approach.
- The AUS is still in the "stone age" of development. As systems become more sophisticated and better able to evaluate non-traditional credit and layered risks, the opportunities to include more borrowers will increase.

Q.6.b. Provide any available data on the performance of affordable housing lending relative to conventional loans. Affordable housing loans should include: 3/2 loans, and 97 percent and 95 percent loan-to-value loans. Criteria for comparison might include delinquency rates, default rates, recovery rates, origination costs, and/or total loan yields.

A.6.b. No comprehensive study on the performance of affordable housing loans is currently available. The Consumer Bankers Association published its 1995 annual report on the characteristics of Affordable Housing Programs, but did not include any information on the performance of the loans originated under these programs. The Mortgage Bankers Association of America conducted a survey on delinquency rates but did not separate out affordable housing loans from the overall data or from their findings. HUD plans to undertake a research project on the performance of affordable housing loans during FY 1997, but the results of that study are dependent on HUD's ability to collect adequate data. (The research study, itself, is subject to the availability of research funds to complete the work.) Lenders may be reluctant to share their data with the Department. Also, because many of the affordable loan programs began in the early 1990's, the period in which these loans have been active is fairly short. Performance measures on these unseasoned loans may not be indicative of long-term trends.

Q.6.c. Provide data on the relative performance of loans on low-cost housing (eg., loans < $50,000 and loans < $75,000).

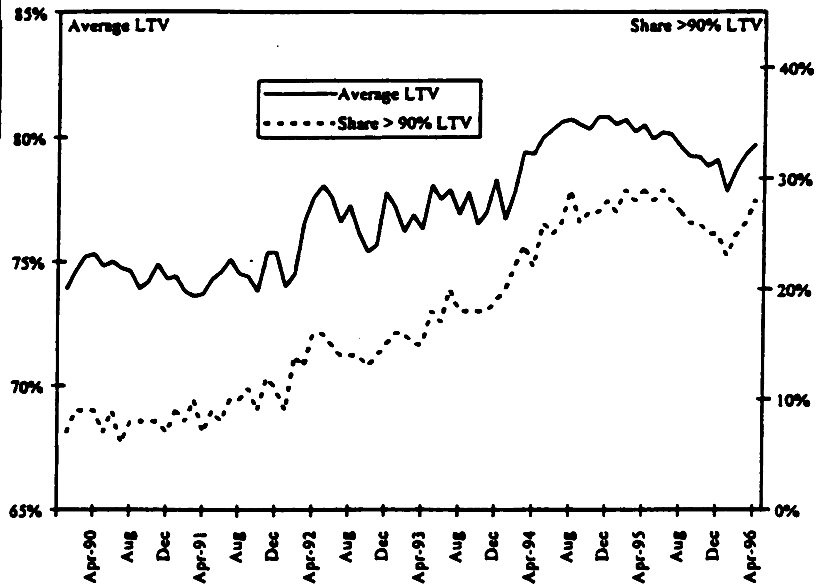
A.6.c. This data is not available for the conventional mortgage market.

Q.6.d. Provide historical trend data on average loan-to-value ratios for the mortgage market as a whole and for each of the mortgage market participants (especially GSE's and FHA).

A.6.d. See attached table (Figure 10) excerpted from OFHEO's 1996 Annual Report to Congress. Also refer to the attached table excerpted from the (1993) American Housing Survey.

Figure 10

Loan-to-Value Ratios of Conventional Single-Family Mortgages and Percentage of Originations with LTV > 90%



Source: Federal Housing Finance Board

TABLE 4.7: LOAN-TO-VALUE RATIOS OF FHA, GSE'S, AND CONVENTIONAL HOME PURCHASE LOANS, 1993

	Over 95 percent LTV	Over 90 percent LTV	Over 80 percent LTV
FHA (1993)			
Refinances and Purchases			
national**	54%	79%	94%
Purchases (in metro areas)			
First-time Buyer	63%	88%	98%
Repeat Buyer	61%	86%	97%
All	62%	87%	97%
GSE's (1993)			
Refinances and Purchases			
national	0%	6%	20%
Purchases (in metro areas)			
First-time Buyer	0%	30%	58%
Repeat Buyer	0%	16%	38%
All	0%	20%	43%
Purchases (FHA-eligible market in metro areas)			
First-time Buyer	0%	29%	55%
Repeat Buyer	0%	14%	32%
All	0%	19%	39%
AHS (national sample, 1991–1993)			
FHA			
All	50%	75%	90%
First-time Buyer	56%	82%	95%
Repeat Buyer	59%	81%	95%
Conforming Conventional			
All	16%	33%	57%
First-time Buyer	25%	48%	74%
Repeat Buyer	16%	31%	56%

SOURCE: FHA and GSE's loan-level data files maintained by HUD, and data from the 1993 American Housing Survey.

**71.4 percent of FHA refinances have missing LTV's because they are streamline refinances.

NOTE: The AHS data provide different values from the other sources, primarily due to small sample sizes. In addition, even small errors in reporting of house price or loan amount can place the loan in the wrong LTV category. Note that values are closer for wider categories, such as over 80 percent LTV.

7. NEW PROGRAM APPROVALS

Q.7.a. Number and names of programs submitted to HUD for approval. Number approved, number rejected, and names of rejected.

A.7.a. For Fannie Mae, HUD approval of new programs has been required since 1970. For Freddie Mac, HUD approval of new programs has been required since the regulation of the Company was transferred from the Federal Home Loan Bank Board to HUD in 1989.

The table on the next page entitled "Fannie Mae New Program Approvals" summarizes HUD's approval of new programs. This list is complete based upon historical information currently available. Although Freddie Mac initiated an inquiry to the Department by letter dated June 7, 1990, regarding a program to offer open-ended mortgages, no formal request for new program approval was initiated. The Department is continuing to research records for any additional information which may be archived regarding its history of reviewing and approving new programs for Fannie Mae.

Q.7.c. What has been the average time for review for each new program reviewed by HUD?

A.7.c. HUD has often found it necessary to request additional data and information from the GSE's to conduct comprehensive reviews of new program proposals. The time needed to review each proposal lengthens significantly when additional requests for data are necessary; that is, when HUD lacks sufficient information to make a determination to approve or to reject the request. Therefore, the amount of time needed to review each program has depended on the features of each program review request. Given that requests for approval of new programs are very infrequent, HUD has not maintained records of review times. However, the GSE's Act imposes specific timeframes on the Department which it intends to achieve for all future new program submissions. These timeframes are as follows:

- The approval or disapproval within 45 days from the date it is received;
- The approval or disapproval within 60 days from the date it is received if the Secretary has determined that additional information is needed to process the request and the review period has been extended by 15 days.

FANNIE MAE NEW PROGRAM APPROVALS

GSE	PROGRAM NAME/TYPE	STATUS	DATE OF FINAL ACTION
Fannie Mae	1. Single-Family Conventional Mortgages	Approved	1 /25/71
	2. Urban Loan Participation	Approved	12/ 6/77
	3. Two-to-four Family Mortgages	Approved	12/20/77
	4. Rural Loan Participation	Approved	3/12/80
	5. Multifamily Mortgages	Approved	4/23/80
	6. Participations in Single-Family Loan Pools	Approved	7/17/80
	7. Loans on Security of Conventional Mortgages	Approved	11/4/80
	8. Home Improvement and Energy Loans	Approved	2/24/81
	9. Issuance of MBS	Approved	9/23/81
	10. Second Mortgages	Approved *	9/81
	11. Multifamily Program Changes	Approved	10/4/83
	12. Issuance of REMICS	Approved	4/21/87
	13. Issuance of Collateralized Mortgage Obligations (CMOs)	Approved	5/ 1/89
	14. Loans on Security of Mortgages	Denied	12/28/90
	15. Pilot Single Family Construction Loan Program	Approved	1/24/91
	16. Community Living Demonstration Program	Approved	7/20/92
	17. Purchase of Energy Efficiency Loans	Approved	4/14/94

(* Conditional approval granted 9/81 to expire 3/31/83; approval extended to 9/30/84 and re-extended to 10/31/94 or such earlier date when superseded by grant of authority to Fannie Mae by Secondary Mortgage Market Enhancement Act of 1984.)

8. UNDERSERVED AREAS GOAL

Q.8.a. What evidence did HUD use to identify underserved areas?

A.8.a. HUD's definition of underserved areas is based on studies of mortgage lending and of mortgage credit flows conducted by academic researchers, community groups, GSE's, HUD, and other Government agencies. Consistently, the researchers concluded that low-income and minority neighborhoods have higher mortgage denial rates and lower mortgage origination rates than other neighborhoods.

Furthermore, HUD and The Urban Institute analyses showed that HUD's underserved definition predicted mortgage credit flow problems better than central city or higher income threshold definitions. In fact, the mortgage denial rate in delineated census tracts is 21 percent, nearly twice the rate of tracts excluded from the final rule definition.

Q.8.b. What percentage of the Nation's census tracts are covered by the new definition of underserved areas in the final rule?

A.8.b. Under the final rule definition for underserved areas, 47 percent of the metropolitan census tracts and 44 percent of metropolitan population are covered by the new definition. Also, HUD's definition includes 1,511 of the 2,305 counties or 66 percent in nonmetropolitan areas and accounts for 54 percent of the nonmetropolitan population. The final rule definition also targets the most disadvantaged rural counties. It covers 67 percent of nonmetropolitan poor and 75 percent of nonmetropolitan minorities.

Q.8.c. What percentage of the Nation's census tracts were covered by the underserved areas definition in the proposed rule? How many new census tracts were added to the definition with the changes from the proposed rule to the final rule?

A.8.c. In the proposed rule, the definition for "underserved areas" would have included 39 percent of metropolitan tracts. The new definition in the final rule added 3,657 tracts.

Q.8.d. What percentage of the Nation's census tracts were covered by the central cities definition? How many areas in central cities are no longer covered as a result of the change from central cities to underserved areas?

A.8.d. The "central cities" definition covered 52 percent of metropolitan census tracts and 47 percent of metropolitan population. However, no census tracts or counties located outside of the OMB-designated central cities were covered. There are a total of 22,876 central city tracts. The underserved definition adopted in the final rule eliminated 9,036 tracts that were determined to be adequately served by the mortgage markets based on low-denial rates and low-minority concentrations.

Q.8.e. What percentage of the Nation's very low-income population (below 50 percent of area median income) live in the underserved areas census tracts? What percentage of the low-income population? What percentage of the poverty population? What percentage of minority populations?

A.8.e. The statute defines "low income" as income that is equal to or less than 80 percent of area median income. "Very low income" refers to income not in excess of 60 percent of area median income. The Department uses these definitions for purposes of collecting and sorting data.

With regard to the percent of low-income and very-low-income populations living in underserved census tracts, the Department selected a definition for underserved areas that would include all low- and very-low-income populations. The result is that all of the population earning less than 90 percent of area median income, including those earning less than 80 percent and 60 percent respectively, are covered by the final rule's definition of underserved areas census tracts.

The Department estimates that other populations living in underserved census tracts are as follows:

Population	Percentage Living in Underserved Census Tracts
Poverty Level	73 percent
Minority	77 percent

Q.8.f. Please provide data on what percentage of each of the 50 largest cities are covered by the underserved areas goal.

A.8.f. The underserved areas goal covers 65 percent of the population in the 50 largest central cities. With regard to the 50 largest metropolitan areas, the underserved areas definition includes 47.8 percent of all the census tracts.

Q.8.g. What percentage of rural areas are covered by underserved areas goals? What evidence did HUD use to demonstrate the lack of credit availability in rural areas?

A.8.g. Under the final rule, 66 percent of rural counties and 54 percent of the rural population are covered by the underserved areas goals.

Because little mortgage data is available for the nonmetropolitan areas, HUD relied on the experience of the Housing Assistance Council and held discussions with rural lenders, rural housing developers, public interest groups, and the GSE's at forums on rural lending sponsored by HUD and The Urban Institute. As in metropolitan areas, these groups identified low-income and high-minority areas as having the greatest mortgage access problems.

9. GOVERNMENT-SPONSORED ENTERPRISES BENEFITS

Q.9.a. List the economic benefits.

A.9.a. Direct benefits:

(1) GSE's have conditional access to a $2.25 billion line of credit from the U.S. Treasury;

(2) GSE's are exempt from securities registration requirements of the Securities and Exchange Commission and the States.

(3) GSE's are exempt from all State and local taxes except property taxes.

(4) GSE's securities receive the same attributes and the same preferred investment status as Treasury debt.

(5) GSE's may conduct business in any State, territory, etc. without complying with any qualification or similar statute.

(6) Federal Reserve banks may act as depositories, custodians, and fiscal agents for the GSE's. Most debt and MBS issued by the GSE's can be bought and sold by the Federal Reserve and federally-insured financial institutions and members of the Federal Reserve may make unlimited investments in the GSE's.

In addition, GSEs' status lowers the GSEs' borrowing costs at the same time investors pay a slight premium for agency status obligations. This situation immediately translates into greater profitability attributable to the market's perception that the Federal Government provides an implicit guarantee to agency obligations.

Q.9.b. Estimate benefits to homeowners.

A.9.b. The GSEs' activities benefit the housing market in general, by providing liquidity to lenders and by more evenly distributing mortgage capital nationwide. The most commonly cited benefit of the GSEs' activities is the reduction in interest rates on conventional, conforming, single-family, fixed-rate, and long-term mortgages that are eligible for purchase by the GSE's. The research suggests that the size of this reduction is somewhere between 30 and 50 basis points.

Q.9.c. The GSEs' return on shareholder equity, net income, and earnings per share.

A.9.c. Tables from the OFHEO's 1996 Annual Report with this information are being held in Committee files for review due to the volume and reproduction illegibility.

Q.9.d. Comparison of the top GSEs' executive compensation.

A.9.d. The OFHEO is responsible for reviewing these figures. In accordance with the 1992 Act, OFHEO is charged with prohibiting the GSE's from providing excessive compensation to any executive officers, defined as compensation "that is not reasonable and comparable with compensation for employment in other similar businesses."

Q.9.e. Comparison of the GSEs' cost of borrowing with yields on Treasuries.

A.9.e. It is our understanding that this information has already been provided to you by OFHEO.

10. EFFECTS OF TAX POLICY CHANGES

Q.10.a. HUD estimates of impacts of flat tax on home prices and interest rates.

A.10.a. HUD has not calculated out any estimates of the financial impacts of a flat tax. Thus far, consideration of such impacts has been based only on data analysis conducted by other researchers, such as those at DRI.

As mentioned in your next question, DRI estimates that elimination of the mortgage interest deduction would result in a 17 percent decrease in mortgage interest rates and a 15 percent decrease in home values.

HUD does believe that a decrease in the value of homes, caused by elimination of the mortgage interest deduction, could lead to an increase in defaults. HUD speculates that a 15 percent decline in home prices would increase default losses across all types of homeowners. The GSE's and private mortgage insurers, in addition to lenders, could experience higher default rates.

For additional insight on the impact of a flat tax and removal of the mortgage interest deduction see articles which are being held in Committee files for review due to the volume and reproduction illegibility.

Q.10.b. DRI estimated a 15 percent decline in home values. Effects on GSE's and on FHA?

A.10.b. Again, HUD has not calculated out or estimated any impact of elimination of the mortgage interest deduction or a decline in home values. Research conducted by others suggests that both the GSE's and FHA would experience higher default rates. Additional material will be held in Committee files for review due to the volume and reproduction illegibility.

11. CHARTER ISSUES

Q.11.a. Is political advertising consistent with the GSEs' charters?

A.11.a. HUD has undertaken no legal analysis to define circumstances where political advertising may or may not be appropriate or consistent with charter restrictions.

Q.11.b. Is using the Automated Underwriting Systems for underwriting (but not purchasing) jumbo loans or "B/C" loans inconsistent with the charters?

A.11.b. The GSE's are required under their charters to purchase loans meeting "the purchase standards of private institutional mortgage investors." As a result of their charter mandate, Fannie Mae and Freddie Mac have virtually defined investment grade or prime loans for the mortgage market.

However, the distinction between A (prime) loans and B/C (subprime) loans is less clear than it has been in the past. A Freddie Mac Loan Prospector pilot program that applies automated underwriting technology to B/C loans disclosed that certain loans once classified as B or C would now be considered A-grade investment quality. Both GSEs' efforts to better understand and predict risk will continue to blur the distinctions between prime and sub-prime loans.

With regard to true B/C and jumbo loans, HUD is evaluating the issue of whether underwriting, but not purchasing, B/C and jumbo loans is prohibited by the GSEs' charters.

12. RELATIONSHIP WITH OFHEO

Q.12.a. What services does HUD provide to OFHEO?

A.12.a. From OFHEO's start-up in 1993 until the agency moved from the HUD Headquarters building in 1995, HUD provided operational/administrative services that included the following:

- Rent
- Telephone
- Office Set-up
- Mail Services
- Building Services
- Relocation Services
- Legal Services
- Administrative Accounting Services (processing payments, maintaining general ledger)
- Personnel
- Computer Systems Operations

After OFHEO moved to its present location (1700 G Street, NW), most of the above services were discontinued. However, services provided to-date during 1996 include:

- Administrative Accounting
- Computer Systems Operations
- Personnel—Human Resources

OFHEO is an independent agency of HUD with its own budget that is approved through the appropriations process. There are clear interrelationships between HUD's programmatic regulatory responsibilities and the OFHEO's safety and soundness oversight. The Department and the OFHEO work together where appropriate to achieve the goals of the GSE's Act while limiting the regulatory burden on the GSE's.

Q.12.b. What is the cost of these services? Are these costs reimbursed?

A.12.b. In accordance with the statute, operational services provided by HUD to OFHEO are reimbursable to the Department. Accordingly, OFHEO reimbursed the following amounts:

FY 1993:	$ 92,395
FY 1994:	$ 64,714
FY 1995:	$121,921
FY 1996:*	$ 40,689

As stated in HUD's Privatization Report to Congress, the Department incurs approximately $1.1 in net regulatory costs as a result of the GSE's Act. OFHEO's budget is entirely funded from fees paid by the regulatees, Fannie Mae and Freddie Mac.

Q.12.c. What is the Department's view of proposals to transfer OFHEO to the Department of the Treasury?

A.12.c. The Department can find no compelling reason for transferring the OFHEO to the Department of the Treasury. There is a synergy achieved by combining the programmatic and the financial

* Expenses incurred during first three quarters.

regulation of these two powerful GSE's, especially since both entities are experts in the areas of housing and mortgage finance issues and industry trends.

13. CONTRASTING GSE'S APPROACH & PERFORMANCE

Q.13.a. Data provided by the Department suggests that Fannie Mae is performing better than Freddie Mac on the public purpose goals and on minority lending. Is the Department concerned about these differences?

A.13.a. Yes, the Department is concerned and has expressed that concern on numerous occasions. During the transitional phase, Freddie Mac failed to meet the Central Cities Goal for three consecutive years. In addition, the Corporation also failed to meet a multifamily subgoal of the Special Affordable Housing Goal. Although enforcement remedies available to the Department were limited during the interim period, the Department did request and receive Housing Plans from Freddie Mac for 1994, 1995, and 1996 as a result of their goal performance.

Freddie Mac's performance from January 1 to June 30, 1996, is summarized below. The data indicate that Freddie Mac is currently meeting its Geographically Targeted Goal and overall Special Affordable Housing Goal. However, purchases counting toward the Low- and Moderate-Income Goal are short of the required 40 percent. Also, Freddie Mac's performance under the Multifamily Component of the Special Affordable Housing Goal during the same time period is only 40 percent of the amount required.

	GOAL	ACTUAL to June 30, 1996
Low- and Moderate-Income	40 percent	38.65 percent
Geographically Targeted	21 percent	24.13 percent
Special Affordable Housing	12 percent	12.70 percent
Multifamily Component	$988 million	$395 million

By contrast, Fannie Mae currently met or exceeded all the goals as of June 30, 1996, with the exception of the Multifamily Component of the Special Affordable Housing Goal where they were at 84.5 percent of the amount required.

As a result of Freddie Mac's goal performance through June 30, 1996, the Department has requested a written report on the Company's performance under the Low- and Moderate-Income Goal and the Multifamily Component of the Special Affordable Housing Goal for the third quarter along with a description of specific actions planned to achieve the goals. Based on third quarter performance and other information contained in Freddie Mac's Report, a determination will be made regarding the need for a Housing Plan.

The Department views achievement of the mandated housing goals to be a serious issue. With the final rule in place, the Department now has increased enforcement capability to appropriately oversee and regulate goals performance.

Q.13.b. What are the sources of these differences? Are there mitigating circumstances that would justify the differences?

A.13.b. Two reasons for the differences in performance to date are:

(1) Freddie Mac and Fannie Mae have pursued very different approaches toward meeting their affordable housing goals. Fannie Mae's approach, which has been very successful, is to develop and encourage partnerships and promote pilot programs, both of which are targeted at promoting affordable housing and first-time homebuyer loans. Freddie Mac's philosophy has been to integrate affordable housing efforts along with its traditional mortgage lending practices.

(2) As a result of substantial losses in its multifamily mortgage portfolio, Freddie Mac suspended most of its multifamily purchase activities in September 1990 and did not re-enter that market until December 1993, a total hiatus of 3 years. Since then, the company has moved slowly and deliberately to re-establish its multifamily program ensuring that adequate underwriting standards and risk management practices were in place to prevent future losses. As a result, Freddie Mac's housing goals performance with regard to multifamily mortgage purchases have lagged as they rebuilt their multifamily program.

The Department is monitoring Freddie Mac's multifamily performance in 1996 to ensure they achieve the Multifamily Component of the Special Affordable Housing Goal and that they are working to expand secondary market purchases of multifamily mortgages.

Q.13.c. What actions has the Department taken with respect to Freddie Mac's failure to meet the Central Cities Goal?

A.13.c. Freddie Mac failed the Central Cities Goal, as defined for the interim period, in 1993, 1994, and 1995. Unfortunately, the Department's enforcement authorities were limited during the transition period. The Department did request and receive a Housing Plan from Freddie Mac for 1994 and 1995. With regard to 1996, the final GSE's rule was implemented beginning January 2, 1996.

As part of the final rule, the Central Cities Goal was redefined and redesignated the Geographically Targeted Goal to focus the GSEs' mortgage purchases on communities underserved by the mortgage industry including portions of Central Cities, rural areas, and other underserved areas. The Department projected that Freddie Mac would be able to achieve the redefined goal. Rather than request a Housing Plan, the Department required Freddie Mac to provide a monthly report of its performance under the Geographically Targeted Goal. These monthly submissions allowed the Department to monitor Freddie Mac's progress toward meeting the Geographically Targeted Goal to ensure that the Department's expectations were accurate. In fact, Freddie Mac's performance under this redefined goal exceeds the required 21 percent every month through September 30, 1996.

The Department believes that the Congressionally-mandated goals are reasonable and achievable. Consequently, a failure on the part of either GSE to achieve one or more of the housing goals is viewed with serious concern. However, during the transition period, the Department had little enforcement authority. With the publication of the final rule, HUD now has the ability to impose civil money penalties and cease and desist orders to enforce the housing goal provisions and reporting requirements set forth in the final rule.

Should Freddie Mac fail to meet one of its 1996 housing goals, we will evaluate the circumstances as required by law and take the appropriate action. Question 13.a. discussed the actions taken by the Department with regard to Freddie Mac's mid-year performance under the Low- and Moderate-Income Goal.

14. CONFLICTS IN HUD'S ROLE AS REGULATOR

Q.14.a. HUD manages the FHA's and Ginnie Mae's programs which compete with Fannie Mae's and Freddie Mac's products in the marketplace. HUD is engaged in a risk-sharing relationship with Fannie Mae and Freddie Mac on multifamily housing and is proposing to initiate a single-family risk-sharing program. At the same time, HUD serves as the regulator for GSE's Affordable Housing Goals and provides approvals for new programs. Do these relationships pose any conflicts of interest for the Department?

A.14.a. As the above question states, HUD is the programmatic regulator of the GSE's. The Department employs a separation-of-duties approach to its regulatory responsibilities. The Office of Government-Sponsored Enterprises Oversight was established as a separate Office within Housing to regulate the Department's programmatic responsibilities. In addition, the Department's mandate is to work toward fulfillment of the Nation's housing needs. To that end, functions such as providing oversight of the GSEs' housing goals which contribute toward this effort, monitoring fair lending compliance in the industry, and reviewing new programs for their public impact, are parts of the financing puzzle that fit together well to create a picture that includes all groups of borrowers.

The GSE's Oversight Office's function is organized to avoid conflicts. First, the Office is separate from FHA and GNMA. Further, with regard to competitive interests, the FHA program is intended to meet the needs of more credit constrained borrowers whom the GSE's may be unable to serve from a safety and a soundness perspective. The program is not marketed in competition with conventional financing, but rather as an alternative for low- and moderate-income families with non-traditional credit needs.

Second, with regard to the partnership activities, the GSE's Act requires the Secretary to work with the GSE's to identify ways to assist them in achieving the objectives of the Act. Risk-sharing is just one vehicle the Department is pursuing to achieve those objectives. Risk-sharing is a win-win opportunity for both the Department, which must also minimize risk to the FHA's insurance fund, and the GSE's which have a statutorily mandated role to play in the availability of very-low-income and low-income housing. These interests are compatible and supportive of initiatives that benefit the public.

15. AUTOMATED UNDERWRITING & CREDIT SCORING

Q.15.a. Who determines a credit score and how is it determined?

A.15.a. Credit scores are determined by:

- Credit scoring models use data on borrower credit histories available from one or more of the three national credit bureaus—Equifax, Trans Union, and TRW.
- Examples of the types of data used in credit scoring models include the length of time a borrower's oldest line of credit has been used, the average principal balance of the borrower's total debt, the borrower's revolving debt balances as a percent of the limits on those balances, and the number of times a borrower has been delinquent 60 days or more.
- Based on statistical analysis of historical data about "good" customers and "bad" customers, certain financial variables are determined to be important in the evaluation process of a borrower's financial stability and strength. Once these variables have been identified and their predictive capability established, each variable receives a weighted value. The sum of these weighted values is the borrower's credit score. The credit score is reported as a single number.
- Because credit scores are compiled by credit bureaus and made available to lenders who request them with each applicant's credit report, they may be used as one element of a manual underwriting process by lenders that do not have AUS capability.
- Credit scores are based on consumer finance histories. They are not specific to mortgage repayment. As scoring becomes more sophisticated, there is some indication that additional variables found in mortgage scores are more predictive for single-family loans than are credit scores considered individually.
- Credit scores are different from mortgage scores which are used in most Automated Underwriting Systems. Attached is a definition sheet used in a forum on automated underwriting sponsored by the Department this summer. A summary of the discussion held at that forum was included in the response to Question 6.a.

DEFINING AUTOMATED UNDERWRITING SYSTEMS

As automated underwriting systems (AUS) continue to evolve, additional component capabilities emerge. However, for purposes of this Forum, discussion will generally focus on the capabilities described below. Particular attention should be paid to the differences between **credit scores** and **mortgage scores** since these scores are not the same.

CREDIT SCORES

Credit Scores rank borrowers in terms of their relative risk of defaulting on consumer debt.

- Credit scoring models use data on borrower credit histories available from one or more of the three national credit bureaus — Equifax, Trans Union, and TRW.

- Examples of the types of data used in credit scoring models include the length of time a borrower's oldest line of credit has been used, the average principal balance of the borrower's total debt, the borrower's revolving debt balances as a percent of the limits on those balances, and the number of times a borrower has been delinquent 60 days or more.

- Based on statistical analysis of historical data about "good" customers and "bad" customers, certain financial variables are determined to be important in the evaluation process of a borrower's financial stability and strength. Once these variables have been identified and their predictive capability established, each variable receives a weighted value. The sum of these weighted values is the borrower's credit score. The credit score is reported as a single number.

- Because credit scores are compiled by credit bureaus and made available to lenders who request them with each applicant's credit report, they may be used as one element of a manual underwriting process by lenders that do not have AUS capability.

- Credit scores are based on consumer finance histories. They are not specific to mortgage repayment. As scoring becomes more sophisticated, there is some indication that additional variables found in mortgage scores are more predictive for single family loans than are credit scores considered individually.

MORTGAGE SCORES

Mortgage scores rank specific mortgage loans in terms of their relative credit risk.

- Mortgage scoring models use data on the type of loan; the type of property; data from one or more credit bureaus or a credit score; information from the loan application such as the loan-to-value (LTV) ratio, debt-to-income ratios, cash reserves, and the applicant's years on the job; and, in some cases, regional economic data.
- Mortgage scores attempt to forecast the likelihood of default of individual mortgage loans.
- Different from credit history scores, mortgage scores encompass all or nearly all information relevant to a loan application. A credit score is just one element of an overall mortgage score. Typically, AUS mortgage scores are derived from some combination of statistical modeling and rules-based compliance analysis. An appraisal analysis may also be included.

COLLATERAL ASSESSMENT

Collateral assessment modules, also referred to as electronic valuations or automated appraisals, rely on extensive databases of property data, generally culled from land records and tax records.

- Collateral assessment offers appraisal analysis capable of validating the reasonableness of the sales price without a formal appraisal.
- When automated programs are used to confirm market value, a windshield or drive-by inspection is also conducted for the purpose of verifying computer records.

- Collateral assessment technology can cut the borrower's appraisal costs in half. Market Intelligence, Inc., a software vendor of valuation databases, puts the cost at $100 to $135 per appraisal compared to the usual $250 to $350 charged by licensed appraisers.

BEHAVIORAL SCORES

Behavioral scores rank delinquent mortgage loans in terms of their probability of going to foreclosure.

- Data used in these models may include a current credit score, the type of loan, how long the loan has been delinquent, the reasons that the borrower gives for the delinquency, and how the borrower has performed if and when the loan has been previously delinquent.

- These are considered to be "behavioral" scores because they take into account the previous payment behavior of borrowers on the specific loans being analyzed.

The preceding information was compiled from the following sources:

Office of Federal Housing Enterprise Oversight, 1996 Annual Report to Congress.

"The Impacts of Automated Lending", Comments for Symposium by Raphael Bostic, April 29, 1996.

"Eased Appraisal Rule Creates an Industry," Edward Byrd, American Banker, August 24, 1995.

"Analyzing Risk with Credit Scores," Jerry DeMuth, Secondary Marketing Executive, October 1995.

Q.15.b. What are the Department's views on the increasing use of automated underwriting and credit scoring?

A.15.b. HUD is examining the automated underwriting technology from several perspectives: As a regulator of Fannie Mae and Freddie Mac; as an insurer of FHA's single-family loan programs; and as a policy advocate for affordable housing programs. We believe that automated underwriting has the potential to expand homeownership opportunities to many deserving borrowers, providing more opportunities for loan approvals, freeing up staff resources to focus on affordable housing initiatives, and offering new business opportunities for financial institutions. However, we do recognize the potential drawbacks of automated underwriting and plan to monitor the use of the technology very carefully. In our assessment of the GSEs' Automated Underwriting Systems, we will pay particular attention to the impact of the technology on the GSEs' ability to meet the Affordable Housing Goals set forth in the 1992 Act and on any fair lending implications that may result. FHA, on the other hand, is assessing the technology to determine whether it can be used to expand opportunities and enhance portfolio management practices as well as the extent to which it may have an unintentional disparate impact on certain categories of borrowers.

Q.15.c. Is there any evidence that the technological changes and the use of credit scoring will have a disparate impact on minority borrowers?

A.15.c. Automated Underwriting Systems, in and of themselves, are benign. It is how they are used that presents the potential problems. Further research and analysis is necessary before a determination can be made about the impact on minority borrowers. Mortgagee Letter 96–34 is attached and contains FHA's guidance to lenders interested in using Automated Underwriting Systems for FHA loans. In addition, FHA announced a pilot with Freddie Mac to underwrite the FHA loans using Freddie Mac's Automated Underwriting System, Loan Prospector. A copy of the press release announcing the pilot is attached.

Proponents of AUS believe that technology will remove bias and subjectivity from the lending process, thereby creating more opportunity for traditionally underserved populations. However, this technology is too new to have accrued sufficient data for analysis.

U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

July 10, 1996

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

MORTGAGEE LETTER 96-34

TO: ALL APPROVED MORTGAGEES

SUBJECT: Single Family Loan Production - Automated Underwriting Systems

In Mortgagee Letter 95-7 (ML 95-7), we announced that FHA would permit lenders to use automated underwriting systems (AUS). Although FHA did not approve or endorse these systems per se, lenders could request permission to use them for underwriting FHA mortgages. While FHA will continue to approve such requests, under the conditions described below, we will now also offer direct approval of individual AUS with lenders permitted to simply register their use of an approved AUS and agree to any required conditions.

Since the issuance of ML 95-7, we have observed the continuing refinement and acceptance in the marketplace of various automated underwriting systems and their potential for expanding access to new borrowers, streamlining processing, and enhancing risk management. We also recognize that there are concerns about how the introduction of this technology will affect service to certain market segments, particularly those borrowers who have traditionally been underserved by the mortgage market.

FHA has developed a process by which it would consider approval of automated underwriting systems themselves. This process will allow FHA to ensure that the use of any approved system will meet FHA's policy objectives:

- To identify and approve credit-worthy borrowers that would have been excluded from homeownership under current FHA credit guidelines;

- To ensure that credit-worthy borrowers meeting existing FHA underwriting guidelines are not excluded from homeownership;

- To expand access to mortgage credit for low- and moderate-income borrowers and to prevent unlawful discrimination against borrowers protected by the Fair Housing Act and the Equal Credit Opportunity Act;

- To reduce the cost and time associated with originating FHA-insured mortgages; and

- To enhance our ability to assess risk and manage FHA's mortgage insurance fund.

This mortgagee letter sets forth basic requirements of an acceptable AUS and describes the process that we intend to follow in reaching a decision whether to approve an automated underwriting system.

Automated systems come in various forms. Some automate the rules that are embodied in underwriting criteria. Others are based on custom mortgage scorecards that are empirically-derived predictors of the risk of default based on selected components of the loan application. Some are a combination of both. Others use neural networks or case-based reasoning to enhance decisionmaking. With these systems, a provider of credit can offer additional underwriting flexibilities and lessen documentation requirements.

In addition, portfolio analysis and lender credit risk profiles can be made more accurate through such systems. Equally important, since loan performance is a combination of underwriting and servicing, automated underwriting/risk assessment systems allow lenders to concentrate their servicing activities on those loans where quick intervention may cure a default or mitigate loss.

Under the terms and conditions described below, FHA will approve automated underwriting systems that it concludes will help FHA to achieve its policy objectives. For those systems that demonstrate the predictive power of an empirically-based scorecard, we will also consider credit policy revisions as well as documentation reductions. FHA may impose different requirements on lenders using an approved system than on those who use traditional FHA underwriting. Approval will only be granted to those automated systems that meet these terms and conditions and, at this time, these approvals will relate only to mortgage scoring, not separate collateral assessment tools, but FHA reserves the right to consider such tools at a later date.

AUS Screening Process:

Only viable, operational automated underwriting/risk assessment systems that survive an initial review will be evaluated. To qualify for evaluation, a sponsor or developer of an AUS must provide to FHA's Office of Single Family Housing in Washington, D.C., the following:

o System and development process description. The system developer must first demonstrate an expertise in automated underwriting or mortgage scoring model development and explain the development process, how it tests validity, how often it refreshes data, adjusts its scorecard, etc. The developer must provide a detailed description of the system, including whether it is rules-based, relies on statistical modeling, uses neural networks or case-based reasoning, or uses combinations of these. Information provided by the system developer will be designated as confidential and will not be made available beyond the Department unless required by law.

- o Market acceptance. The AUS must be used by a substantial number of FHA-approved lenders (even if only used on conventional mortgages). Only those that have gained wide acceptance by mortgage lenders and are available for use throughout the nation will be considered.

- o Exclusion of rejecting systems. FHA will not consider for approval any system whose intended use would allow the system to make the decision to reject an application for an FHA-insured loan. The AUS must only result in mortgage approval or referral to a human underwriter.

AUS Evaluation Process:

Those systems that survive the initial screening will be subjected to an evaluation by FHA. During this process, the systems sponsor must demonstrate to FHA that the AUS is an effective predictor of the risk of default of a FHA loan and that its predictive capacity is strong for various different cohorts of borrowers. This process includes:

- o Provision of FHA loan-level data. FHA will consider written requests to provide loan-level data to the system sponsor for the purpose of developing and validating any mortgage scorecard. In exchange for the data, the sponsor must agree to certain terms and conditions including sharing of any information collected concerning the sample FHA loans and the results of testing of the predictive capacity of its scorecard.

- o Default predictability. The system must be shown to be a statistically reliable predictor of the risk of default, with the validity of the system being empirically assessed through an adequate sample of FHA mortgages. If a mortgage score is used, there must be a demonstrated relationship between that score and the risk of mortgage default across various subsets of the portfolio. Scrutiny will be given to the elements used in building a mortgage scorecard and, when appropriate, consideration given to possible alternatives.

- o "Cut-point" determination. The system sponsor must provide FHA with various analyses as requested to permit FHA to determine the appropriate level of risk it wishes to assign to different outcomes from the system (i.e., accept or refer). For a system to be approved, the establishment and adjustment of those cut-points must always be within FHA's control. Moreover, the system sponsor must be prepared to provide FHA with ongoing analyses in the form specified by FHA to monitor the appropriateness of those cut-points.

- o Credit policy revisions. Based on analyses of the system's performance, FHA may revise credit policy and/or documentation in response to the validity and predictiveness of the system. Credit policy revisions and documentation reductions will be specific to the AUS itself, i.e., depending on the demonstrated predictability of the system, FHA may offer varying levels of documentation relief and underwriting flexibility. Mortgages underwritten by rules-based automated systems must continue to meet standard FHA credit guidelines.

- <u>Compliance with Fair Housing Act and Equal Credit Opportunity Act</u>. FHA must be satisfied that use of the AUS would comply with the Fair Housing Act and the Equal Credit Opportunity Act. System sponsors may be asked to provide information to help FHA ascertain that the development of the system was consistent with those Acts' requirements. FHA may establish requirements for the AUS to ensure that its use does not result in discrimination against, or have a disproportionately adverse impact on, minority or other classes of borrowers.

<u>AUS Demonstration Process</u>:

Systems that survive the evaluation process will be required to be subject to a demonstration of their use in the origination of FHA-insured mortgages before FHA will consider system approval. Typically, a demonstration would consist of the use of the system for a limited time period, by a limited number of different lenders, for a limited number of loans. The demonstration would be structured to gather information about whether use of the system in some or all circumstances would be consistent with FHA's policy objectives. FHA may waive this demonstration requirement if it determines that other mechanisms are sufficient to make that determination.

During a demonstration, required procedures, credit policy revisions, and documentation reductions may vary among the lenders chosen to test the AUS. The demonstration will be designed to permit scrutiny of whether use of the AUS limits, maintains, or expands FHA's reach to credit-worthy homebuyers. Loan-level review of loans approved by the automated underwriting system, as well as loans referred to human underwriters, may be performed. FHA may also seek to determine how underwriter judgments may have been influenced by AUS referrals, i.e., exhibiting a decreased likelihood of approving loans that would have been made previously. Finally, interviews with lenders, counseling agencies, and others with access to the AUS may be conducted.

<u>AUS Continuous Evaluation</u>:

FHA will continuously evaluate any AUS that is approved. Once a system is approved, FHA will assign a CHUMS number identifying the AUS for loan tracking purposes. Lenders will also be required to register their use of any approved automated system, obtain a special CHUMS number and agree to whatever conditions we require in connection with that system. Approval of a system may be subject to requirements for periodic reporting and monitoring on the system, its continuing predictive power, and the results of its use. Credit policy and documentation revisions proposed by the system developer after the evaluation and demonstration process must be approved by FHA Headquarters. FHA's approval of any AUS may be revoked at any time upon notice that the AUS no longer serves FHA's policy objectives or results in unacceptable loan quality.

Lender's Use of AUS:

When FHA approves a particular AUS, it will establish guidelines for its use to which the lender must adhere if it intends to use the AUS in the origination of FHA mortgages. These guidelines may include the extent of credit policy and documentation waivers permitted in connection with the use of that system, as well as requirements to emphasize the lender's responsibilities to ensure nondiscriminatory use of the system.

* * *

FHA is committed to expanding homeownership opportunities for first-time homebuyers, low- and moderate-income families, non-traditional borrowers, minorities, women, and those that might otherwise be denied conventional financing. While FHA's current credit policies are flexible yet prudent, automated underwriting/risk assessment systems can be powerful tools in the expansion of homeownership while at the same time allowing lenders and mortgage insurers to proactively manage the risk inherent in all lending. Further, as FHA's paperwork reduction and other efforts have demonstrated, FHA seeks to make participation in FHA programs less costly for the lender as well as the homebuyer.

Additional information regarding this process and the loan-level data element layouts available to systems sponsors may be obtained from James Beavers, Underwriting Branch, Home Mortgage Insurance Division, Room 9272, HUD Headquarters, 451 7th Street, Washington, DC 20410 or by calling (202) 708-2700 Ext. 2205.

Sincerely,

Nicolas P. Retsinas

Nicolas P. Retsinas
Assistant Secretary for Housing-
Federal Housing Commissioner

Media Relations
8200 Jones Branch Drive
McLean, VA 22102

FOR IMMEDIATE RELEASE
JULY 9, 1996
CONTACT:
Deborah Anderson, Freddie Mac,
703/903-2408
Victor Lambert, HUD, 202/708-0685

Freddie Mac

FHA AND FREDDIE MAC ANNOUNCE PILOT TO TEST AUTOMATED UNDERWRITING OF FHA LOANS

WASHINGTON, D.C. -- The Federal Housing Administration (FHA) and Freddie Mac will begin a six-month pilot program using an FHA-specific version of Freddie Mac's Loan Prospector® (Loan Prospector for FHA Loans) to automate the underwriting of FHA loans.

The cooperative effort, as outlined in a Statement of Understanding signed today, is aimed at:

- studying how automated underwriting technology can help to expand markets to more creditworthy borrowers;
- making the origination of FHA loans more efficient and affordable; and
- ensuring that the use of automated underwriting technology will not adversely affect borrowers served by FHA.

"This pilot represents the National Partners in Homeownership at their best," said Henry G. Cisneros, Secretary of the U.S. Department of Housing and Urban Development. "Pooling the resources of the private sector with those of the government, we are striving to increase the nation's homeownership rate to its highest level ever. This pilot brings together Freddie Mac, mortgage lenders and FHA in a test of how new technologies can make FHA work better for more American families."

- more -

"This joint initiative offers a glimpse of the mortgage market of the future -- a future where FHA loans can be processed by lenders in days instead of weeks," said Leland C. Brendsel, chairman and CEO of Freddie Mac. "By reducing costs and bringing greater efficiencies to the mortgage market, we will enable more people to own their own homes."

Loan Prospector, Freddie Mac's automated underwriting service, provides lenders with risk evaluations, using loan application, credit and property information to evaluate a potential borrower's ability to meet a mortgage obligation. Freddie Mac is actively working to expand the uses of Loan Prospector to meet the needs of lenders.

Freddie Mac took a sample of FHA loans and built a statistically based, mortgage scoring model to predict the likelihood of default specifically for FHA loans This model was integrated into software that allows Loan Prospector to perform risk evaluations on FHA mortgages within four minutes.

"With this initiative, Freddie Mac takes a big step forward in underwriting FHA loans with Loan Prospector," said David Glenn, president of Freddie Mac. "We're well on our way to providing lenders with a single automated underwriting service to process virtually all of their mortgages."

Lenders will be able to access Loan Prospector for FHA Loans by linking directly through their loan origination system. In addition to the risk assessment, the system will evaluate the application against FHA statutory requirements (i.e., down payment, geographic loan limits, maximum loan amount), eligible product types, and additional FHA credit guidelines. The system will report its assessment to the lender, who will make the ultimate credit decision During the pilot, FHA will agree with

- more -

individual lenders to modify some of the documentation or credit requirements for loans that receive a favorable risk assessment

Freddie Mac and FHA said that they expect that eight, geographically diverse, FHA-approved lenders, including current Loan Prospector users and new users, a housing finance agency and a non-profit, will participate in the six-month pilot, with 4,000 to 6,000 loans being made under the demonstration.

FHA also is releasing a Mortgagee Letter that outlines the steps that FHA uses to evaluate requests for approval of automated underwriting systems. FHA encourages any sponsor of an automated underwriting system to obtain FHA loan data, to develop mortgage scoring models specifically for FHA loans, to demonstrate to FHA the predictive power of their system, and to demonstrate to FHA that the system can be used in a manner that helps FHA achieve its public mission and does not facilitate discrimination.

"FHA presents a unique opportunity to demonstrate to the market a responsible approach to integrating automated underwriting into the mortgage business," Federal Housing Commissioner Nicolas P. Retsinas said. "We must move forward with new technologies, but only after we carefully evaluate the impact of their use and design strategies to ensure that their use serves our mission of expanding homeownership opportunities."

The Federal Housing Administration was created in 1934 to provide mortgage insurance on home mortgage loans. For over 62 years, FHA has pioneered low-down payment and long-term mortgages, allowing over 24 million American families to achieve homeownership. Today, FHA insurance allows lenders to make loans using more flexible underwriting than they use for conventional loans, including lower down

- more -

payments, closing cost financing, and higher debt-to-income ratios. Last year, 70 percent of FHA-insured purchase money mortgages were made to first-time homebuyers.

Freddie Mac is a stockholder-owned corporation established by Congress in 1970 to create a continuous flow of funds to mortgage lenders in support of homeownership and rental housing. Freddie Mac purchases mortgages from lenders and packages them into securities that are sold to investors. Over the years, Freddie Mac has helped finance one in six American homes.

# #

Q.15.d. Provide any available data on the distribution of credit scores by race, gender, and income.

A.15.d. Credit scoring models use data obtained from consumer credit histories available from one or more of the three national credit bureaus—Equifax, Trans Union, and TRW. Credit bureaus do not receive data on a consumer's income, race, or gender so this data is not available in the credit bureau consumer databases. Also, variables such as race and gender are prohibited by law to be considered in granting credit. For these reasons, there is no data available on the distribution of credit scores according to race, gender, and income.

On the other hand, mortgage scores, which differ from credit scores, may include enough data to make it possible to track the scoring distributions by variables that are included on a borrower's application. However, even in mortgage scoring, prohibited factors, such as race and gender, cannot be used in arriving at a borrower's overall mortgage score. Due to the lack of data at this time which is attributable to the newness of Automated Underwriting Systems, mortgage score distributions by race, income, and gender are not available. In addition, once more data is made available from each Automated Underwriting System, the lack of standardization in scoring protocols and the proprietary nature of these protocols may adversely impact the aggregation of data on mortgage scores.

Although credit scoring distributions are not available, many developers of Automated Underwriting Systems continue to compile some findings relative to the predictability of scores across income and racial lines. Freddie Mac recently issued a report on its Automated Underwriting System, Loan Prospector (LP), wherein the Company had retested the validity of risk classifications assigned by LP and examined the system's predictability for all income groups and races of borrowers. One finding disclosed that, based on Freddie Mac's 1994 purchases, African-American borrowers were about three times as likely to have high-risk credit scores as were white borrowers. Hispanic borrowers were about twice as likely as white borrowers to have high-risk scores.

16. USER FEES FOR DEFICIT REDUCTION OR FICO BOND PAYMENTS

Q.16.a. Some Members of Congress have proposed user fees on the GSE's to help pay for the FICO bonds. What is the Department's view of this proposal?

A.16.a. HUD is opposed to user fees. Any discussion of user fees must address the likelihood that such fees would be passed along to the borrower by means of higher interest rates or borrower fees. At this point, HUD believes the structure level, and effects of OFHEO's risk-based capital requirements need to be implemented and evaluated before exploring options such as a user fee.

Q.16.b. What would be the impact of user fees on the GSE's and ultimately on homebuyers?

A.16.b. A user fee could interfere with the GSEs' ability to generate benefits associated with improved housing affordability and homeowership opportunities. Moreover, it is possible that user fees could affect the ability of the GSE's to conform to OFHEO's risk-based capital requirements. Also, fees increase the likelihood that borrowing costs would increase. Additional costs would adversely affect lower-income families attempting to purchase a home for the first time and could cause a reversal in recent gains in mortgage lending for minorities and low- and moderate-income families.

17. PRIVATIZATION

Q.17.a. What effects would privatization have on the GSE's, housing markets, and homebuyers?

A.17.a. In response to the GSE's Act, HUD prepared and issued a full report on privatization. This report is appended to this set of questions and answers for further review. Findings were presented to the House Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises of the House Banking and Financial Services Committee during a hearing held on Wednesday, July 24, 1996.

The major finding of HUD's report is that the benefits achieved from full privatization of the GSE's would not offset the financial uncertainties and likely increases in borrowing costs that would be associated with full privatization.

We believe the GSE's are in the process of meeting their public purpose mission of increasing homeownership opportunities for very-low, low-, and moderate-income families and families living in communities historically underserved by mortgage finance institutions. By leveraging the Government's oversight relationship to the GSE's and using the goal-setting mechanism provided by the 1992 Act as a catalyst for increased affordable housing lending initiatives, the Government gains access to significant housing resources at no direct, budgeted cost to the Government. The GSE's Act is relatively new, is already beginning to yield measurable results, and should be allowed more time to work.

Accordingly, the report finds no compelling reason to privatize the GSE's at this time. However, the report does recommend that the issue be revisited periodically because mortgage markets are dynamic and circumstances more conducive to privatization could occur at a later time.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CAROL MOSELEY-BRAUN FROM AIDA ALVAREZ, DIRECTOR OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT [OFHEO]

MARCH 5, 1996*

1. REGULATORY PROCESS

Q.1.a. Does OFHEO have the independence and the resources to regulate Fannie Mae and Freddie Mac adequately for safety and soundness?

A.1.a. We think that the Congress made good decisions in designing OFHEO's current structure in 1992. Our structure maximizes our ability to function as an independent, arm's-length safety, and soundness regulator. Our mission is very limited and very clear, so we have no potentially conflicting responsibilities. That provides strong accountability. Furthermore, our concentrated focus on two large institutions helps ensure that we will maintain our expertise in the Enterprises' operations and risks and it virtually eliminates any possibility that our attention will be distracted or diverted by other problems.

Assuming that OFHEO receives its full budget requests, we will have the resources to regulate the Enterprises adequately. We do, however, have one concern. Subjecting OFHEO's budget to the appropriations process, despite the fact that our budget has no implications for the Federal budget deficit, could provide an Enterprise with an inappropriate mechanism for contesting regulation or enforcement actions. Such an avenue of recourse is not available to other regulated financial institutions and is unnecessary, given the ample due process protections provided elsewhere by law and the careful oversight of our activities conducted by the Senate Banking Committee and its counterpart in the House.

Q.1.b, 1.c. & 1.d. Have Fannie Mae and Freddie Mac cooperated in OFHEO's efforts to date? Have the GSE's provided information in a timely manner? Is the data provided complete and accurate? Have examiners had adequate access to information when engaged in on-site examinations?

A.1.b, 1.c. & 1.d. To date, OFHEO has been able to obtain the information from the Enterprises that has been required to conduct examinations and develop the risk-based capital stress test. The timeliness and accuracy of Enterprise responses to information requests, however, have been quite mixed. At times this has caused significant and avoidable delays in the OFHEO's efforts to complete examinations and develop our risk-based capital stress test. The problem has been particularly serious with respect to major portions of the data necessary for stress test development received from Freddie Mac. Repeated efforts for the last 2 years to resolve

*These questions were received by OFHEO on September 27, 1996, and have been answered to reflect information as of that date and not the hearing date.

the issue have resulted in improvements. Nonetheless, important deficiencies remain. As a result, OFHEO has initiated a special examination of Freddie Mac's procedures and controls for providing data to OFHEO and plans to take whatever actions are warranted to ensure compliance with these essential requests.

2. OFHEO BUDGET

Q.2.a. Please provide OFHEO budgets by object class for each year since inception.

A.2.a. OFHEO began operations late in fiscal year 1993 and was appropriated $3,000,000 for start-up costs. OFHEO's first full start-up year was FY 1994. OFHEO was appropriated $10,700,000 and obligated $6,486,000 during the fiscal year. As the OFHEO evolved from a start-up operation, the yearly budget began to level off: FY 1995—$15,451,000; FY 1996—$14,895,000; and FY 1997—$15,751,000 requested and $15,500,000 appropriated. Attached is a chart reflecting the detailed breakdown of the annual budgets by object class for FY 1994–1997.

Summary of OFHEO Budget by Object Classification

Budget Classification	1993 Actual	1994 Actual[1]	1995 Actual[2]	1996 Budget[3]	1997 Budget[4]
Personal Services	$163,000	$2,690,000	$5,783,000	$8,300,000	$9,153,000
Travel	$3,000	$76,000	$196,000	$375,000	$305,000
Transportation of Things	$0	$20,000	$14,000	$60,000	$50,000
Rent, Utilities & Communications	$0	$890,000	$1,027,000	$1,742,000	$1,804,000
Printing & Reproduction	$0	$6,000	$18,000	$54,000	$74,000
Other Services	$1,956,000	$2,473,000	$5,858,000	$4,298,623	$3,949,000
Supplies & Materials	$4,000	$112,000	$141,000	$262,000	$253,000
Equipment	$0	$219,000	$1,743,000	$114,000	$163,000
Subtotal	$2,126,000	$6,486,000	$14,780,000	$15,205,623	$15,751,000
Unobligated	$874,000	$5,088,000	$1,914,000	$0	$0
USAID	$0	$0	$0	$159,000	$40,000
Total	$3,000,000	$11,574,000	$16,694,000	$15,364,623	$15,791,000

[1] Includes the FY 1994 appropriation of $10.7 million plus $874,000 carried forward from the FY 1993 start-up assessment which was not subject to the crediting provision.

[2] Includes the FY 1995 appropriation of 15.5 million minus $60,000 for the procurement reduction savings plus $1.3 million for a prior year recovery of obligations.

[3] Includes the FY 1996 appropriation of 14.9 million plus $310,623 from a prior year recovery. OFHEO also had $159,000 reimbursement authority from USAID. Does not include estimate for unobligated funds in FY 1996.

[4] This is the budget request made by OFHEO. The appropriated level is $15,500,000 and OFHEO is in the process of reallocating the funds by budget object class. OFHEO also has $40,000 reimbursement authority from USAID of which OFHEO is seeking apportionment from OMB.

10/8/96

Q.2.b. Please provide FTE's per year since inception and gross measures of compensation levels.

A.2.b. The FTE levels are provided in the attached table. OFHEO adopted a broad pay band concept with seven pay levels. The bottom of the first level is $15,876 and the top of level VII is $142,886. The pay bands are reviewed and adjusted yearly to reflect market conditions. Positions are placed in one of the seven levels based on the nature and scope of responsibility at OFHEO. Attached is a chart reflecting the distribution of positions in the seven levels.

OFHEO Staffing History

OFHEO began operations in June 1993

Year	FTE Authorized	FTE Used	FTP Authorized	FTP Filled EOY
FY 93	30	1	30	7
FY 94	45	24	45	37
FY 95	65	54	65	63
FY 96	72	65	72	66
FY 97	78	N.A.	72	N.A.

NOTE: FTE = Work Years
FTP = Permanent Positions

In FY 1997, the authorized number of work years exceeds the authorized number of permanent positions because:
- o all permanent positions are expected to be filled; and
- o intermittent experts and temporary appointments count toward work years.

Distribution of Full Time Permanent Positions by Level

Level	Pay Range	FTP 1997
I	$ 15,876 - 26,460	0
II	21,168 - 42,337	7
III	31,753 - 58,213	8
IV	42,337 - 79,381	5
V	52,921 - 105,842	21
VI	79,381 - 137,554	22
VII	89,966 - 142,886	8
EX (Level II)	133,600	1
Total		72

Q.2.c. When does OFHEO assess the GSE's for the costs of regulations? What is the cost to the Government of the current assessment dates?

A.2.c. The assessment collection dates were changed in the FY 1996 VA-HUD and Independent Agencies Appropriations Act.

Under current law, the GSE's assessment payments are due on October 1 and April 1 of each year. The annual assessment is based on the amount appropriated for the fiscal year. OFHEO collects one-half of the annual assessment on the first day of the fiscal year which funds OFHEO operating costs for the first half of the fiscal year. On April 1 of the same fiscal year, OFHEO collects the second half of the annual assessment less any credit due to the GSE's from the previous year for unobligated funds.

The original law provided for the assessment payments on March 1 and September 1. This strategy did not parallel the fiscal year operating cycle for OFHEO as the first payment was not collected until after OFHEO incurred five months of operating costs. The change in the assessment dates gave OFHEO the authority to collect the annual assessment from the GSE's in a manner that supports OFHEO's fiscal year operating cycle.

Q.2.d. What are the amounts and the sources of funds (other than GSE's assessments)?

A.2.d. OFHEO's regulatory operation is funded by the annual assessment collected from the GSE's. OFHEO also has a reimbursement agreement with the United States Agency for International Development. This agreement provides reimbursement to OFHEO for assistance provided to the government of Mexico in its development of a secondary mortgage market for housing. The USAID made $159,000 available to OFHEO during FY 1996 and $40,000 during FY 1997 for OFHEO's assistance in the Mexico project.

3. EXAMINATIONS

Q.3.a. What examinations have been carried out by OFHEO so far?

A.3.a. OFHEO completed Derivatives examinations of the Enterprises in the Fall of 1994 and Corporate Governance examinations in the Spring of 1995, the results of which were disclosed in our 1995 Annual Report to the Congress (pages 29–32).

OFHEO completed Risk Management examinations of the Enterprises for two risk components—Credit Risk and Interest Rate Risk—in the Spring of 1996. The results were reported in our 1996 Annual Report to the Congress (pages 48–54).

OFHEO is currently in the process of conducting Business Risk examinations of each Enterprise. The Business Risk examination is focusing on how the GSE's identify, measure, monitor, and control business risks associated with developing and implementing strategic business decisions in the rapidly changing mortgage market.

OFHEO has planned, scoped, and conducted the field work for a Data Integrity Examination at Freddie Mac. The objective of this examination is to assess the Enterprises' internal controls for financial data and for data deliveries to OFHEO for the Stress Test.

In addition to the above examinations, in February and March of 1996, OFHEO conducted flood insurance reviews of each Enterprise's compliance with the Flood Disaster Protection Act of 1993 as amended by the National Flood Insurance Reform Act of 1994. The results of the flood insurance reviews were disclosed in the 1996 Annual Report to the Congress (pages 54–55).

Q.3.b. What resources did OFHEO use in carrying out these examinations?

A.3.b. Consistent with Statute, Section 1317 (c) and (e) of P.L. 102–550, OFHEO has staffed its Office of Examination and Oversight with a core full-time staff experienced in examinations, capital markets, financial analysis, and accounting. Currently, this staff includes a Director, Deputy Director, eleven positions, and one support staff member (14 in total). This core full-time staff is augmented with examiners detailed from other Federal banking agencies and other technical experts or consultants on a temporary basis, as determined by the Director. For example, in the Corporate Governance examination, two examiners were detailed from the Federal Deposit Insurance Corporation (FDIC) and two from the Office of the Comptroller of the Currency (OCC). For the Risk Management examinations, three examiners were detailed from the Federal Reserve Board and one from the OCC. Nine technical experts were also hired under a Small Business Administration 8(a) minority contract with OFHEO.

Q.3.c. What have been the results of these examinations?

A.3.c. See Appendix for the relevant sections of the 1995 and 1996 Annual Reports.

Q.3.d. Based on the examinations to date, what is OFHEO's view of the treatment of management risk in the GSE statute?

A.3.d. The treatment of management and operations risk in the GSE statute (12 USC 4611) requires an additional 30 percent of the total amount of total capital determined by applying the risk-based capital test under subsection (a) to the Enterprises. While management risk is difficult to quantify, our view is that this amount will be sufficient when used in conjunction with systematic risk-focused examinations. Management failures—e.g., Orange County, Barings, and Daiwa—illustrate that on-site and risk-focused examinations are critical in evaluating management's ability to assess, monitor, and control risks. OFHEO's examinations are structured to identify and understand effective risk-management practices and to require prompt corrective action of all identified deficiencies.

Q.3.e. How does the level of examinations undertaken in the last year compare to the level of examination that other Federal financial institutions regulators undertake with respect to similarly large financial institutions?

A.3.e. OFHEO's examination philosophy encompasses two key principles: (1) that examinations are a top down process to determine management's ability to manage risk; and, (2) that examination resources should be assigned to those areas with the highest risk. In keeping with this philosophy, OFHEO's approach focuses on risk-management controls and operating results in the six major areas of risk that bear on the safety and soundness of Fannie Mae and Freddie Mac. The six risk categories are Credit Risk, Interest Rate Risk, Corporate Governance, Business Risk, Information & Technology Risk, and Operations Risk. Instead of reviewing a large number of assets and transactions to determine the risk profile of the Enterprises, OFHEO's examination approach evaluates whether management is adequately anticipating, monitoring, and controlling risks to the Enterprises. OFHEO's risk assessment approach closely parallels the examination approaches developed recently by the Federal bank and thrift regulators.

A basic comparison of examination resources deployed at large financial institutions indicates that OFHEO's examinations are cost effective and not overly burdensome. The ratio of on-balance sheet assets examined to staff work days for Federal regulators for the largest thrifts and multinational banks is $70 million to one or less. By contrast, the ratio of on-balance sheet assets under examination to staff work days for OFHEO during 1995 was about $230 million to one for Freddie Mac and $425 million to one for Fannie Mae. At the largest multinational banks, the Federal regulators maintain an on-site staff totaling 10 or more for the entire year. During 1995, OFHEO has maintained on-site presence of, on average, 4 examiners for 3 months during the corporate Governance examination and an average of 6 examiners at Freddie Mac, and 7 examiners at Fannie Mae for 6 months for the Risk Management examination.

4. STRESS TEST

Q.4.a. What is the status of the efforts to develop a stress test?

A.4.a. OFHEO is well along in the development of the stress test. In June 1996, OFHEO published the first of two Notices of Proposed Regulation on risk-based capital, outlining two important components of the stress test: the methodology for identifying from historical data what we call the "benchmark loss experience"—the most severe regional credit loss experience; and a house price index that we intend to use to track homeowner equity, which is an important factor in credit risk. The second NPR, which will address all remaining aspects of risk-based capital regulation, will be sent to OMB next year.

Q.4.b. Why has OFHEO taken so long to develop the stress test?

A.4.b. Development of the stress test is an ambitious task, involving many different research and financial analysis projects. We have reconciled many different Enterprise databases and data structures into a master database in order to run the stress test. We are in the process of creating a detailed financial simulation model of the risk characteristics of the Enterprises as required by our statute. We have undertaken economic research to develop an interest rate model to set the rates the statute does not specify and to develop, for both single-family and multifamily mortgages, models that predict credit losses consistent with the benchmark experience and prepayments. In addition, the stress test requires the development of a major software package to generate cash flows and pro forma financial statements that are necessary to complete the capital regulations. We are not aware that any financial regulator has ever undertaken a capital regulation project of this scope.

Q.4.c. What is OFHEO's timetable for completing the model?

A.4.c. OFHEO expects to complete the stress test model that will be the basis of its second risk-based capital NPR by next spring.

Q.4.d. What assurances can OFHEO give that the GSE's are adequately capitalized in the interim?

A.4.d. Currently, the Enterprises hold capital that exceeds the minimum capital requirement by small amounts. While we believe minimum capital is not by itself sufficient, in combination with our risk-focused exams, we believe that the existing minimum standard can serve as an acceptable interim capital standard until the risk-based capital standard is completed, especially given the current profitability of the Enterprises. OFHEO does not anticipate any significant financial problems before the implementation of the risk-based capital standard. We will continue to examine the Enterprises carefully to ensure that Fannie Mae and Freddie Mac are operating in a safe and sound manner, and we are prepared to take strong supervisory actions, if necessary.

Q.4.e. What effects will the stress test likely have on GSE's capital levels?

A.4.e. We do not yet know precisely how much capital the Enterprises will be required to hold under OFHEO's risk-based capital standard. OFHEO is currently in the midst of a rulemaking process related to this standard, so it is not appropriate to speculate on the specifics. The analyses that we have performed so far, our work on the credit stress benchmark proposed in our first NPR, information obtained during our examination process, and other research that we have performed, however, suggest that our risk-based capital regulation will require each Enterprise to hold more capital than they currently hold, given their current risks.

5. ADEQUACY OF CAPITAL

Q.5.a. Please provide historical and current data on GSE's capital levels (both equity and loss reserves). Also present the data both in terms of total equity volume and in comparison with minimum capital requirements in the statute.

A.5.a. See attached tables.

Fannie Mae
Equity Capital versus Minimum Capital Requirement
$ in Billions

	Total Capital (Loss Reserves + Equity Capital)	Loss Reserves	Equity Capital	Min. Capital Requirement	Surplus/ (Deficit)
2Q96	12.52	0.77	11.75	10.79	0.96
1Q96	12.16	0.78	11.38	10.68	0.70
4Q95	11.75	0.80	10.96	10.45	0.51
3Q95	11.54	0.82	10.72	9.87	0.86
2Q95	11.14	0.82	10.32	9.68	0.64
1Q95	10.73	0.82	9.91	9.42	0.49
4Q94	10.40	0.86	9.54	9.42	0.13
3Q94	9.99	0.81	9.19	8.99	0.20
2Q94	9.65	0.82	8.83	8.66	0.17
1Q94	9.28	0.80	8.48	8.30	0.18
4Q93	8.88	0.83	8.05	7.86	0.20
3Q93	8.54	0.82	7.72	7.65	0.07
1995	11.75	0.80	10.96	10.45	0.51
1994	10.40	0.86	9.54	9.42	0.13
1993	8.88	0.83	8.05	7.86	0.20
1992	7.57	0.79	6.77	6.72	0.05
1991	6.23	0.68	5.55	5.51	0.04
1990	4.46	0.52	3.94	4.77	(0.83)
1989	3.44	0.45	2.99	4.20	(1.21)
1988	2.65	0.39	2.26	3.57	(1.31)
1987	2.15	0.34	1.81	3.20	(1.39)
1986	1.44	0.26	1.18	2.92	(1.74)
1985	1.17	0.16	1.01	2.72	(1.71)
1984	1.05	0.13	0.92	2.36	(1.44)
1983	1.14	0.14	1.00	2.07	(1.07)
1982	1.09	0.14	0.95	1.89	(0.94)
1981	1.18	0.10	1.08	1.54	(0.46)
1980	1.58	0.12	1.46	1.45	0.01

note 1: Minimum Capital Requirement estimated pre 1993, all figures based on fully-phased in requirements. Somewhat lower transitional requirements were in effect through 1994Q1.
note2: Figures may not add due to rounding.

Freddie Mac
Equity Capital versus Minimum Capital Requirement
$ in Billions

	Total Capital (Loss Reserves + Equity Capital)	Loss Reserves	Equity Capital	Min. Capital Requirement	Surplus/ (Deficit)
2Q96	7.15	0.68	6.47	**6.23**	*0.24*
1Q96	6.69	0.69	6.00	**5.76**	*0.24*
4Q95	6.51	0.68	5.83	**5.58**	*0.25*
3Q95	6.39	0.70	5.70	**5.37**	*0.33*
2Q95	6.24	0.71	5.54	**5.26**	*0.28*
1Q95	6.08	0.72	5.36	**5.04**	*0.32*
4Q94	5.90	0.73	5.17	**4.88**	*0.28*
3Q94	5.73	0.75	4.98	**4.70**	*0.28*
2Q94	5.55	0.75	4.81	**4.50**	*0.31*
1Q94	5.37	0.77	4.61	**4.35**	*0.26*
4Q93	5.18	0.74	4.44	**4.22**	*0.21*
3Q93	5.05	0.76	4.29	**4.15**	*0.14*
1995	6.55	0.68	5.83	**5.58**	*0.25*
1994	5.90	0.73	5.17	**4.88**	*0.28*
1993	5.18	0.74	4.44	**4.22**	*0.21*
1992	4.34	0.77	3.57	**3.46**	*0.11*
1991	3.29	0.72	2.57	**2.91**	*(0.35)*
1990	2.75	0.61	2.14	**2.56**	*(0.42)*
1989	2.37	0.46	1.92	**2.19**	*(0.28)*
1988	1.98	0.40	1.58	**1.88**	*(0.29)*
1987	1.53	0.34	1.18	**1.60**	*(0.42)*
1986	1.23	0.28	0.95	**1.34**	*(0.39)*
1985	1.00	0.22	0.78	**0.86**	*(0.08)*
1984	0.79	0.18	0.61	**0.64**	*(0.04)*
1983	0.57	0.15	0.42	**0.48**	*(0.06)*
1982	0.41	0.12	0.30	**0.34**	*(0.05)*
1981	0.34	0.09	0.25	**0.25**	*0.00*
1980	0.29	0.07	0.22	**0.21**	*0.01*

note 1: Minimum Capital Requirement estimated pre 1993, all figures based on fully-phased in requirements. Somewhat lower transitional requirements were in effect through 1994Q1.
note2: Figures may not add due to rounding.

Q.5.b. Is there any time in the GSE's history when capital would have fallen below the statutory minimums?

A.5.b. As shown in the tables on the preceding pages, which go back to 1980, the equity capital of the Enterprises has been sufficient to meet their current statutory minimum capital requirements only in recent years. In the second quarter of 1996, Fannie Mae had equity capital of $11.8 billion. With a minimum capital requirement of $10.8 billion, Fannie Mae held excess capital of $1.0 billion. Freddie Mac had second quarter equity capital of $6.5 billion. Freddie Mac's minimum capital requirement was $6.2 billion, leaving surplus capital of $0.3 billion.

Q.5.c. What criteria is OFHEO currently using to assess the adequacy of GSE's capital?

A.5.c. Starting with the third quarter of 1996, OFHEO will be classifying the Enterprises under a final minimum capital rule that was published in the *Federal Register* on July 8, 1996 (Vol. 61, No. 131, p. 35607–35623). The final rule incorporates most of the interim rule but slightly modifies the approach to off-balance sheet derivatives to better conform with the risks to the Enterprises. Under the final rule, the GSE's must hold capital equal to 3 percent for uncollateralized off-balance sheet derivative contracts and 1.5 percent for collateralized contracts.

From the last quarter of calendar year 1993 (the second full quarter of OFHEO's existence) through the second quarter of 1996, OFHEO classified the Enterprises using an interim minimum capital rule. The interim rule used statutory ratios for all but the treatment of off-balance sheet derivatives, where it largely followed the practice of the bank regulators.

Until one year after publication of a final rule setting forth the risk-based capital stress test, the Enterprises only have to meet the minimum capital requirement to be classified "adequately capitalized." After that they must meet both the minimum and risk-based standards to be "adequately capitalized." The minimum capital standard is ratio based; it does not reflect the specific risks that the Enterprises' face. The stress test will generate the capital requirements consistent with their actual risk exposures.

Q.5.d. How do these capital requirements compare with those of other large financial institutions?

A.5.d. Our minimum capital requirements are similar to the risk-based capital requirements of other Federally regulated financial institutions in that they are based on ratios applied to various asset balances and off-balance sheet amounts. The ratios for the Enterprises, however, are somewhat lower. For example, the other regulators apply a 4 percent capital requirement for unsecuritized mortgage investments, while our statute requires 2.5 percent for the Enterprises. The other regulators do not distinguish between off-balance sheet and on-balance sheet exposures, while our statute applies a much lower ratio to off-balance sheet mortgage security guarantees—0.45 percent. The GSE's minimum capital requirements reflect a higher quality of mortgage assets at the Enterprise, a better geographic diversification of risk, and an enhanced ability to hedge their interest rate exposure. More importantly, the Enterprises' minimum capital requirements will ultimately function only as an intermediate level trigger for enforcement actions and, therefore, that capital standard is not directly comparable to the risk-based requirements of banks and thrifts. OFHEO estimated that, at the end of 1995, Freddie Mac would have met bank and thrift leverage ratio capital requirements, while Fannie Mae would have had to add an additional $2 billion. To meet bank and thrift risk-based capital standards, Fannie Mae and Freddie Mac would each have had to hold an additional $20–$21 billion in capital.

Our risk-based capital standard, which is under development, is something completely different from existing capital standards. It is stress test-based, and it will generate a capital requirement that takes into consideration specific credit and interest rate risk exposures, and Enterprise risk-management strategies. It will be a dynamic standard that reflects the realities of our economy and the Enterprises' activities.

Q.5.e. What GSE's activities pose the greatest risk at this time?

A.5.e. For the purpose of our safety and soundness examinations, we have classified the risks facing the Enterprises into six categories:

- **Corporate Governance:** Corporate Governance determines the span of the control environment, planning, information and communications, and monitoring of risks. It involves ensuring that the organizational structure, mission, and values of the Enterprise are consistent with business practice and provide a foundation for successful risk management.
- **Interest Rate Risk:** Interest Rate Risk is defined as the vulnerability of the Enterprises' earnings and capital to fluctuations in interest rates. Interest rate risk is concentrated in the mortgage portfolios of the Enterprises. Because the retained portfolios of the Enterprises are growing rapidly and these portfolios are not perfectly hedged, the Enterprises are increasingly vulnerable to fluctuations in interest rates.
- **Credit Risk:** Credit Risk is the risk that borrowers and institutional counterparties will default on their contractual obligations. Credit risk is evident in the risk of losses on the mortgages the Enterprises' own and guarantee.
- **Business Risk:** Business Risk results from strategic planning and implementation of business processes. Business risk involves how well management addresses its strengths and weaknesses as well as strategic opportunities and threats such as customer demand, supplier relationships, and fundamental changes in the marketplace.
- **Operations Risk:** Operations Risk is the risk that the Enterprises will incur losses due to their failure to properly process transactions. Such failures may be caused by inadequate controls, employee error or malfeasance, and a breakdown in information systems and technology.
- **Information & Technology Risk:** Information & Technology Risk is the risk that automated systems and processes are not performing as intended. Such automated systems are involved in every component of the internal control and management information system due to the use of information technology in every facet of the Enterprises' operations.

Generally, these risks are difficult to quantify in a precise manner. Credit Risk and Interest Rate Risk lend themselves to a more accurate measurement and are the most significant financial risks for the Enterprises.

Structural changes in the mortgage finance industry, innovations in home mortgage delivery systems, and the increasing sophistication of technologies that underlie the operations of the Enterprises, however, also create the potential for significant risks to the Enterprises.

6. CREDIT QUALITY

Q.6.a. & 6.b. Please provide data on trends in GSE's credit quality. How are delinquencies, defaults, and loan-to-value ratios changing over time? How do these trends compare with the overall mortgage market?

A.6.a. & 6.b. See attached table.

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FANNIE MAE)			
	Charge-offs/Total Portfolio (%)	SF Delinquency Rates (%)	MF Delinquency Rates (%)
1990	0.06	0.58	1.70
1991	0.04	0.64	3.62
1992	0.04	0.63	2.65
1993	0.04	0.56	2.34
1994	0.06	0.57	1.21
1Q95	0.05	0.48	1.20
2Q95	0.05	0.48	1.02
3Q95	0.05	0.52	1.04
4Q95	0.05	0.56	0.81
1Q96	0.06	0.58	0.95
2Q96	0.06	0.56	1.00

FEDERAL HOME LOAN MORTGAGE ASSOCIATION (FREDDIE MAC)			
	Charge-offs/Total Portfolio (%)	SF Delinquency Rates (%)	MF Delinquency Rates (%)
1990	0.10	0.45	2.63
1991	0.08	0.61	3.40
1992	0.09	0.64	4.45
1993	0.09	0.61	3.45
1994	0.09	0.57	4.92
1Q95	0.10	0.55	3.99
2Q95	0.11	0.54	3.63
3Q95	0.11	0.56	3.25
4Q95	0.10	0.60	2.88
1Q96	0.11	0.60	2.75
2Q96	0.11	0.58	3.14

	FNMA SF Delinq. Rate (%)	FHLMC SF Delinq. Rate (%)	MARKET Delinq. Rate* (%)
1990	0.58	0.45	0.62
1991	0.64	0.61	0.77
1992	0.63	0.64	0.71
1993	0.56	0.61	0.64
1994	0.57	0.57	0.64
1Q95	0.48	0.55	0.62
2Q95	0.48	0.54	0.66
3Q95	0.52	0.56	0.66
4Q95	0.56	0.60	0.66
1Q96	0.58	0.60	0.64
2Q96	0.56	0.58	0.54

* The Market Delinquency Rate is calculated by the Mortgage Bankers Association and published in Inside Mortgage Finance.

Note: SF Delinquencies are comprised of loans 90 days or more delinquent or in foreclosure Reliable data Market data for multi-family delinquencies is not available.

The table below presents the data for the past two years for loan to-value ratios. The ratios for Fannie Mae and for Freddie Mac are not comparable, however, because the current methods that each Enterprise uses to estimate the LTV ratios are substantially different.

FNMA LTV Ratio (%)			FHLMC LTV Ratio (%)		
LTV Ratio Range 1/	1995	1994	LTV Ratio Range 2/	1995	1994
60% & less	46%	43%	0%-70%	60%	57%
61-70%	18	20	71-80%	19	21
71-80%	18	19	81-90%	12	13
81-90%	12	12	91-95%	4	4
90%+	6	6	95%+	5	5
Total	100%	100%	Total	100%	100%

1/ Fannie Mae data is derived by estimating home price appreciation using a repeat transactions price index and adjusting the value of the property at the time the mortgage was originated by the estimated average appreciation rate for mortgages in the same region, and comparing it with the current unpaid principal balance of the mortgage.
2/ Freddie Mac calculates the distribution of current Loan-to-value ratios by dividing the current unpaid principal balance of a mortgage by an estimate of the current value of the property that is derived by specifying a diffusion process for the appreciation rate in regional housing prices as measured by a repeat housing sales price index.

Data Sources: Inside Mortgage Finance, Dec. 15, 1995 issue- OFHEO Office of Examination & Oversight Data Base, FNMA 2Q96 Investor Analyst Report-FHLMC 2Q96 Information Statement, FNMA 1995 Annual Report-FHLMC Annual 1995 Report

Q.6.c. Please provide data on the geographic distribution of GSE's exposures.

Fannie Mae & Freddie Mac Conventional At-Risk Single-Family Mortgages Serious Delinquencies as of June 30, 1996				
		Total Number of Loans Outstanding	Serious Delinquencies /1	
			Total # Loans	Percentage
Northeast				
	Fannie Mae	1,691,936	13,987	0.83
	Freddie Mac	1,673,294	13,370	0.80
Southeast				
	Fannie Mae	1,741,674	8,091	0.46
	Freddie Mac	1,023,992	3,987	0.39
Midwest				
	Fannie Mae	1,665,117	4,799	0.29
	Freddie Mac	1,473,922	3,633	0.25
Southwest				
	Fannie Mae	1,293,409	4,525	0.35
	Freddie Mac	763,843	2,291	0.30
West				
	Fannie Mae	1,801,445	14,315	0.79
	Freddie Mac	1,683,963	15,020	0.89
TOTAL				
	Fannie Mae	8,193,581	45,717	0.56
	Freddie Mac	6,619,014	38,301	0.58

1. Serious delinquencies include loans 3 or more months delinquent or in foreclosure. Freddie Mac data includes those loans for which Freddie Mac assumed primary default risk.

Note 1: Percentages may not add due to rounding.

Note 2: The geographic regions for the Enterprises are not exactly comparable because each Enterprise has a slightly different definition of its business regions.

Fannie Mae Conventional At-Risk Multifamily Mortgages Serious Delinquencies as of June 30, 1996					
	Loans Serviced		Serious Delinquencies /1		
	# of Loans	UPB	Total # Loans	UPB	Percentage
Northeast	485	2,628.4	13	47.3	1.80
Southeast	584	3,410.3	11	31.9	0.94
Midwest	677	2,501.9	12	30.8	1.23
Southwest	932	3,703.4	2	3.0	0.08
West	2,616	5,112.6	29	60.4	1.18
TOTAL	5,294	17,356.6	67	173.4	1.00

1. Includes loans which are two or more months delinquent based on the dollar amount of such loans in the portfolio underlying MBS.

Freddie Mac Multifamily Delinquency and Foreclosure Activity					
			Seriously Delinquent /1		
	# of Loans	NCV of Loans	# of Loans	NCV of Loans	Percentage
Northeast	NA	2,153,141	NA	109,164	5.07
Southeast	NA	1,588,018	NA	43,194	2.72
North Central	NA	1,090,865	NA	16,254	1.49
West	NA	1,797,976	NA	39,376	2.19
TOTAL	5,547	6,630,000	205	207,988	3.14

1. NCV = Net Carrying Value, seriously delinquent = 60 days or more and foreclosure.
NA = Not available.

Q.6.d. Are GSE's adequately managing their credit risks?
A.6.d. Based on our Credit Risk examination, the management of credit risk at both Enterprises is strong. (See Appendix for the results of the Credit Risk examinations disclosed in the 1996 Annual Report.)

Q.6.e. In your testimony, you state that the credit risk of the GSE's has "continued to grow rapidly in recent years." What are the elements of this increased risk?

A.6.e. One element of increased credit risk is the sheer growth in the portfolios of loans that have been purchased and guaranteed by the Enterprises. The combined portfolios have grown by almost 40 percent from $1,021.9 billion in 1992 to $1,398.2 billion at the end of the second quarter of 1996.

A second element of increased credit risk is the credit quality of mortgage loans originated in 1994 and 1995. While it is premature to draw definitive conclusions concerning the long-term credit quality of these mortgages, the early delinquency and the default rates for these loans are higher than for loans originated in the prior two years.

The loans originated in 1992 and 1993 were primarily refinancings and have relatively lower LTV's. The loans originated in 1994 and 1995 were primarily purchase loans and have relatively higher LTV's. The 1994 and 1995 loans may also represent higher credit risk because of weaker credit profiles of the borrowers as compared to the 1992 and 1993 loans. A study by Freddie Mac found that the average FICO score on loans purchased in 1994 and the first half of 1995 declined, and that the percentage of FICO scores below 620 (frequently used as a low score benchmark) peaked at 8.4 percent in the first quarter of 1995.

To the extent that 1994 and 1995 loans represent riskier mortgages in general, these loans do not represent an unmanageable risk for the Enterprises. Two years ago, each Enterprise increased the amount of mortgage insurance coverage required for high LTV loans. In addition, both Enterprises recently have set forth additional guidelines for servicers to follow to reduce losses associated with non-performing loans. These efforts include steps to follow up on delinquent loans faster, and if necessary, to move toward resolution at a more rapid pace using non-foreclosure options.

7. GSE'S PORTFOLIO GROWTH

Q.7.a. Please provide the historical and current data on the size of GSE's mortgage portfolios and the rate of growth of these portfolios.

A.7.a. At the end of the second quarter of 1996, Fannie Mae had a net retained mortgage portfolio of $269.4 billion, up 72 percent from 1992 ($156.3 billion). Freddie Mac's retained mortgage portfolio was $123.9 billion, 3.7 times the level of 1992 ($33.6 billion).

Q.7.b. What volume of derivatives have the GSE's purchased for their own portfolios and do these investments pose particular risks to the safety and soundness of the GSE's? Please provide data on the amount and the rate of growth of derivatives in those portfolios, including structured debt and REMIC's.

A.7.b. As of the first quarter of 1996, the Enterprises' investment in REMIC securities, generally securities they have issued and subsequently repurchased, and stripped mortgage-backed securities was just over $25 billion, up from over $20 billion at year-end 1995

Fannie Mae's investment in REMIC and Strip securities totaled $16.4 billion in the first quarter of 1996, an increase of $14.4 billion from the $2.0 billion in December of 1993. Freddie Mac's investment in these securities has quadrupled since year-end 1993, growing from a face value of $1.6 billion to $6.4 billion in the first quarter of 1996.

On an individual basis, these securities reflect a wide range of risks. It is much more important, however, to consider the effect of these assets on the overall interest rate risk exposure of an Enterprise's asset and liability positions. OFHEO is carefully modeling these securities in our risk-based capital stress test.

Q.7.c. What risks does the rapid growth in portfolios pose for each GSE? What is the adequacy of each GSE's risk-management strategy? Are the portfolios adequately hedged? How much capital have the GSE's allocated to the portfolios?

A.7.c. The rapidly increasing size of the Enterprises' retained portfolios increases their exposure to interest rate risk and it can stress risk-management systems and processes. As the retained portfolios grow, it is incumbent upon management to ensure that the control environment develops accordingly and that risk-management systems and processes are in place to appropriately identify, measure, control, and monitor risk. Overall interest rate risk exposure can be managed through the use of derivatives and by match-funding mortgage purchases with a funding mix that optimizes management's risk-return profile. Perfect match-funding is impossible, however, because of differences in the structures of mortgage assets and nonmortgage debt securities.

Our risk-management examinations concluded that management of credit risk at both Enterprises and management of interest rate risk at Freddie Mac is strong. Management of interest rate risk at Fannie Mae is generally strong, but certain aspects need to be strengthened. At both Enterprises, management has established effective systems and processes for the identification, measurement, control, and monitoring of risk. OFHEO made a number of specific recommendations for improvements, and we will follow up to ensure satisfactory responses to all of them. (See Appendix for discussion of the Risk Management examination that was published in the 1996 Annual Report.)

Based on OFHEO's evaluation of risk management at both Enterprises, Fannie Mae and Freddie Mac have substantially hedged their risks. Nonetheless, given current risks, the capital of the Enterprises may not be sufficient under all reasonable scenarios. To protect the Government and the U.S. taxpayer further against excessive risk-taking at the Enterprises, OFHEO's risk-based capital standard will require the Enterprises to hold capital to protect against severe interest rate changes. Specifically, our risk-based capital stress test will require the Enterprises to hold sufficient capital to guard against an increase of 75 percent and a decrease of 50 percent in the 10-year Treasury note rate of interest. The model we develop for the stress test will also permit us to test the sufficiency of capital under a wide variety of alternative circumstances and perspectives.

The Enterprises allocate capital according to their perceptions of risk. As such, most of their capital is currently dedicated to their retained portfolios.

8. DERIVATIVES

Q.8.a. Please provide data on the level of the GSE's derivative contracts outstanding and the changes in GSE's derivative contracts outstanding over time.

A.8.a. As of year-end 1995, the notional value of derivatives outstanding at both Enterprises was $184.4 billion, an increase of 55 percent compared to year-end 1994 when the notional value of derivatives outstanding was $118.7 billion. From year-end 1993, when the notional value of derivatives outstanding at both Enterprises was $69.2 billion, to year-end 1995, the amount of derivatives outstanding grew by more than 2.5 times. (The notional amounts include debt and asset swaps and interest rate hedges but does not include the small amounts of short sales of Treasury securities entered into from time to time by both Enterprises.)

Q.8.b. Please describe some of the different derivative contracts and the volume of each of these contracts outstanding.

A.8.b. In general, the Enterprises use derivatives contracts to (1) reduce debt costs, (2) enhance investment yields, (3) enhance mortgage yields, and (4) reduce interest rate risk. The various types of instruments the Enterprises use include callable and non-callable fixed-pay swaps, basis swaps, step-up swaps, floating-pay swaps, amortizing swaps, interest-rate caps, interest-rate floors, interest-rate corridors, and foreign currency swaps. The specific purposes of the derivative contracts include extending short-term debt synthetically, converting floating-rate notes to fixed-rate debt, converting long-term debt to short-term debt or long-term floating-rate note debt, converting long-term investments to short-term investments, converting short-term investments to long-term investments, capping the rate paid on short-term debt, and converting foreign currency to U.S. dollars.

Enterprise Derivatives Contracts in 1995 Notional Amount at Year-End in Billions of Dollars		
	Freddie Mac	Fannie Mae
Debt-linked swaps	37.3	48.4
Asset-linked swaps	7.1	2.8
Interest-rate swaps, caps, floors, corridors, etc.	14.1	74.8
Total	44.4	51.2

Source: Fannie Mae and Freddie Mac 1995 Annual Reports

Interest-rate swaps are contracts between two parties to exchange periodic payments that are generally based on a notional principal amount and contractual fixed and variable interest rates. Some interest rate swaps are linked to specific debt issues and some are linked to specific assets (investments).

Q.8.c. Are purchasers of GSE's derivative contracts engaging in risk-reducing hedging or do some of the derivative purchases involve an element of speculation that poses threats to investors?

A.8.c. In December of 1994, as a result of OFHEO's concern about the sales of securities derivatives issued by the Enterprises, the OFHEO requested that the Enterprises report on their approaches to disclosure and investor suitability. Both Enterprises reported substantial efforts to disclose the risk of their securities, and to ensure the delivery of that disclosure to initial investors by securities dealers, consistent with the Securities and Exchange Commission's requirements for corporate issuers. Within the present regulatory framework for our capital markets, however, issuers have very little ability directly to discourage inappropriate investments.

(See Appendix for more detail on OFHEO's views and concerns on the disclosure and investor suitability of the derivative securities activities of Fannie Mae and Freddie Mac that was included in OFHEO's 1995 Annual Report on pages 58–61.)

Q.8.d. & 8.e. Is it possible that purchasers assume that Freddie Mac's and Fannie Mae's agency status confers the same low-risk profile for structured debt as other GSE's securities? OFHEO has outlined steps that Fannie Mae and Freddie Mac could take to better inform investors of the risks associated with structured debt securities. How have Freddie Mac and Fannie Mae responded to OFHEO's recommendations?

A.8.d. & 8.e. The perception that obligations of Fannie Mae and Freddie Mac are implicitly guaranteed by the Government has an effect on all purchasers of any type of the Enterprises' debt. The Enterprises have been major issuers of structured notes. Given the substantial losses incurred by some investors in those markets and the accompanying publicity, OFHEO was concerned that the Enterprises' reputations could suffer if issues relating to sales practices were unaddressed. Each Enterprise was asked to report on their marketing policies and practices for structured notes and mortgage derivative securities. OFHEO subsequently discussed the issues related to the Enterprises' derivative securities with other market participants and regulators. We concluded that while disclosure of potential risks to investors was generally adequate, enforceable sales practice rules for dealers and a number of other informational and structural market changes might reduce the number of investor casualties.

OFHEO made a number of suggestions with respect to the marketing policies and practices for structured notes and mortgage derivative securities. (See Appendix, 1995 Annual Report, pages 60–61.) Both Enterprises have made changes responsive to those suggestions. OFHEO held follow-up meetings with the Enterprises to discuss these suggestions in September of 1995. Most significantly, in response to OFHEO's first suggestion, both Enterprises have enhanced their disclosure documents to include language warning that investors should have sufficient knowledge or expertise prior to making an investment in the referenced security. The Enterprises also expressed a willingness to include an analysis of how securities might behave across a range of hypothetical market scenarios (scenario analysis) in the disclosure documents for more complex securities.

9. HUD'S AFFORDABLE HOUSING RULES

Q.9.a. Have you reviewed HUD's recent GSE's affordable housing rule? What effects will this rule have on the safety and soundness—and profitability—of the GSE's?

A.9.a. OFHEO participated extensively in the interagency review process for HUD's affordable housing rule, which was adopted in final form late in 1995. Staff considered the rule, paying particular attention to the safety and soundness ramifications of the new affordable housing goals. OFHEO also commented informally on the fair lending role that the rule required of the Enterprises. Both Enterprises have increased their activities in this area. Given the ability of the Enterprises consistently to maintain rates of return on equity of more than 20 percent and the progress they have made in expanding their affordable lending activities to date, OFHEO believes that the Enterprises can manage the additional risks posed by affordable housing goals without sacrificing financial safety and soundness. OFHEO will, however, continue to review this area by closely following the Enterprises' new initiatives in our examinations and off-site monitoring. OFHEO will also require them to hold adequate capital, as part of our risk-based capital standard, to protect against the risks associated with affordable housing activities.

It is difficult to predict what impact the new HUD rule will have on Enterprise profitability. The Enterprises are currently profitable and there is no reason to believe that the increase in affordable housing loans will cause them to become unprofitable. The impact of any increased purchase of higher risk loans by the Enterprises to meet the goals, however, will be captured by our stress test.

Q.9.b. Could these goals be higher without affecting the safety and soundness?

A.9.b. We anticipate that meeting the current requirements for financing affordable housing need not pose any safety and soundness problems for the Enterprises. It is possible that there may be room for the Enterprises to finance more affordable housing, but OFHEO has not analyzed any specific proposals.

We are currently examining the Enterprises' management of the business risk associated with their affordable housing products. Examiners are reviewing the affordable housing initiatives to develop a risk profile of the affordable housing portfolio. The risk profile will include a review of the performance of affordable housing products and the portfolio. In addition, the examiners are assessing each Enterprise's strategy to address the business risk associated with affordable housing products and evaluating the Enterprise's implementation of the strategy.

Q.9.c. What percentage of loans in GSE's portfolios are affordable loans (Please define)? Is there any evidence that these loans are of lower credit quality? Is there any evidence that these loans are unduly risky or even unprofitable books of business?

A.9.c. Last year, 46.2 percent of Fannie Mae's conventional business (as measured by dwelling units) served families whose income was at or below the median for the areas where those families lived. During the same period, 39 percent of Freddie Mac's purchases of mortgages qualified served those families.

Most of the loans that qualify under the definition of affordable housing lending do not have any special risk characteristics. There is some evidence that certain categories of affordable housing loans that are purchased under special programs may experience higher rates of defaults and delinquencies than conforming loans. In an article titled "Tapping Our Nation's Homeownership Potential," which was based on special affordable housing loans with MGIC insurance that were originated in 1992–1993 and 1994–1995, the Mortgage Guaranty Insurance Corporation concludes that many affordable housing loans have "multiple high-risk factors" that lead to exponentially higher delinquency rates. The main credit risks and resulting default rate comparisons identified by MGIC are:

- The delinquency rate for loans where the borrower's cash was only 3 percent (2 percent from a third party) was twice the rate for borrowers that paid the full 5 percent out of their own funds.
- The delinquency rate for borrowers with less than 2 months' cash reserve after closing was 50 percent higher than borrowers with more than 2 months' of cash reserve after closing.
- Borrowers whose housing and total debt to income ratios exceeded 33/38 percent defaulted 20 percent more often than borrowers with lower debt ratios.

- Loans to borrowers with adverse or little or no credit history had a significantly worse performance than loans to borrowers with excellent credit histories, even where the borrowers with excellent credit histories made reduced down payments.

(See *Federal Reserve Bulletin,* July 1996, page 642 for Freddie Mac's experience with its Affordable Gold program for loans originated in 1994.)

As part of our Business Risk examinations of the Enterprises, which are currently in progress, we are reviewing their purchases of loans under the affordable housing requirements. In the course of the examinations, we will review management reports used to track the performance of affordable housing loans and assess the portfolios' performances. At the conclusion of this examination process, we expect that we will gain substantially greater insight into the riskiness and the profitability of their affordable loan portfolios.

Q.9.d. Please provide the best available data on the performance of loans on low-cost housing (both loans < $50,000 and loans < $75,000). Please compare these with larger loans after controlling for downpayments. Please provide the data for delinquencies, defaults, and loan losses.

A.9.d. Enterprise loan data that OFHEO compiled for use in determining the Enterprises' benchmark loss experience, which comprised 30-year fixed-rate loans originated from 1979 through 1992, indicate that smaller loans have consistently higher cumulative default rates than larger loans with equivalent loan-to-value (LTV) ratios. For all the categories of loans by size, higher LTV loans have higher default rates, with the smallest loans in the highest LTV category having a significantly higher rate than any other group. The default rates experienced by the Enterprises are generally consistent with the findings in the 1990 Actuarial Review conducted by Price Waterhouse for FHA-insured mortgages and the MGIC study cited above.

It is important to note, though, that the Enterprises actually lost significantly more, in terms of total dollars, on larger loans than on smaller loans because they purchased relatively few small loans. Loans that were simultaneously in both the highest LTV and small size classes constituted less than 1 percent of the overall sample.

Combined Freddie Mac and Fannie Mae Lifetime Cumulative Loss Experience
Conventional, Single-Family, First Liens Only
Excludes Seasoned and Repurchased Loans

	Cumulative Default Rate for Original Loan Amount (Percent):		
Original Loan to Value Ratio (Percent)	Less than or Equal to $50,000	Greater than $50,000 but Less Than or Equal to $75,000	Greater Than $75,000
Less Than or Equal to 70	0.48	0.39	0.31
Greater Than 70 but Less Than or Equal to 80	1.13	0.68	0.76
Greater Than 80 but Less Than or Equal to 90	3.07	1.98	1.35
Greater Than 90	7.89	4.90	2.00

Note: Calculations are based on 30-year fixed rate mortgages originated from 1979 through 1992. Default rates are cumulative lifetime rates as of June 30, 1994 for Fannie Mae and January 31, 1995 for Freddie Mac. Totals may not add due to rounding. Delinquency rates are not available.

10. CREDIT SCORING & AUTOMATED UNDERWRITING

Q.10.a. What risks does automated underwriting pose to the safety and soundness of the GSE's? Will the rapidity of the purchase decision made possible by automated underwriting pose unmanageable risks?

A.10.a. A major reason that both Freddie Mac and Fannie Mae are developing their Automated Underwriting Systems is to improve the credit quality of the single-family mortgages that they buy. If the systems perform well, they should improve credit quality by making underwriting more consistent, more accurate, and more objective. Technology facilitates the analysis of large amounts of information pertaining to borrower creditworthiness and credit evaluations that are based on statistically reliable predictors of loan performance.

The Enterprises do not underwrite mortgage loans before purchasing them. They rely on standard underwriting guidelines and representations by lenders that they have originated loans in accordance with those guidelines. After purchase, loan samples are subjected to quality control. The Loan Prospector and the Desktop Underwriter systems potentially improve credit quality by subjecting loans to the Enterprises' credit analysis prior to purchase. The Loan Prospector and the Desktop Underwriter results do not lead directly to a purchase of the loan by either Enterprise. The results, however, identify those loans that seem to warrant greater underwriting scrutiny as part of the lender's origination process.

Automated Underwriting Systems also reduce the costs of loan origination for borrowers, lenders, and the Enterprises.

The potential risks of automated underwriting are that the analytical models are not specified correctly, that the data input to the models are not correct, or that the results are used incorrectly. The Automated Underwriting System must be developed with historical information on loans that look like the loans for which the system will be used in the future. There is also the risk that the automated system will be used to reject loan applications without applying human judgment in an underwriter review. These potential risks clearly must be managed by the Enterprises through ongoing testing and revalidation of their systems and review of underwriting decisions.

At the same time, any significant change in how loans are processed poses management and operations risks and requires good analysis and planning, especially if the change alters the role that a firm plays in the markets it serves. The growing use of scoring also presents both Enterprises with the challenge of protecting themselves from being adversely selected by lenders during a period when credit risk-management practices are evolving.

To assess the likely implications for safety and for soundness, OFHEO will continue to monitor how each Enterprise uses scoring.

Q.10.b. What is the relationship of credit scores to traditional risk measures like ratio analysis and loan-to-value calculations? How will this shift affect the credit risks faced by the GSE's?

A.10.b. Traditionally, underwriting an application for a single-family mortgage loan considered three issues: the applicant's credit payment history (assessed through a credit report that summarizes the recent history of a borrower's use of credit), the applicant's capacity to repay the loan (assessed by looking at the borrower's debt-to-income ratios, payment shock, and cash reserves available after closing), and the collateral backing the loan (assessed by the loan-to-value ratio).

Credit scores are numerical assessments that rank applicants for credit by their relative risk of defaulting on household debt, including credit cards, auto loans, revolving lines of credit, and some mortgage loans. Credit scores are calculated from the payment histories of millions of consumers collected and maintained by the three national credit bureaus—Equifax, Trans Union, and TRW. Taken together, these credit histories yield predictive patterns, which can be summarized in scores and used to forecast the likelihood of repayment.

The industry uses three types of statistical scoring. ***Credit scores*** rank borrowers in terms of their relative risk of defaulting on consumer debt. Credit scoring models use data on borrower credit histories available from one or more of the three national credit bureaus—Equifax, Trans Union, and TRW. Examples of the types of data used in credit scoring models include the length of time a borrower's revolving debt balances as a percent of the limits on those balances, and the number of times a borrower has been delinquent 60 days or more. ***Mortgage scores*** rank specific mortgage loans in terms of their relative credit risk. Mortgage scoring models use data on the type of loan; the type of property; data from one or more credit bureaus or a credit score; information from the loan application such as the loan-to-value (LTV) ratio, debt-to-income ratios, cash reserves, and the applicant's years on the job; and, in some cases, regional economic data. ***Behavioral scores*** rank delinquent mortgage loans in terms of their probability of going to foreclosure. Data used in such models may include a current credit score, the type of loan, how long the loan has been delinquent, the reasons that the borrower gives for the delinquency, and how the borrower has performed if and when the loan has been previously delinquent. These are "behavioral" scores because they take into account the previous payment behavior of borrowers on the specific loans being analyzed.

Q.10.c. How will the trend away from traditional underwriting guidelines to credit scoring affect the types of mortgages that the GSE's purchase? What types of loans would not get made if the markets relied totally on credit scoring approaches? What types of loans will now get made that would not otherwise under current approaches?

A.10.c. The implications for lenders of the Enterprises' commitment to scoring technology are fairly clear in the short-term, but harder to discern for the long-term.

In the short-term, the Enterprises' endorsements of the use of credit scores in underwriting are likely quickly to make it standard industry practice to review an applicant's credit score during the underwriting process. Last year first Freddie Mac and then Fannie Mae encouraged mortgage lenders to use credit scores in underwriting single-family mortgage loans. Both Enterprises also indicated that they would use credit scores in the post-purchase review process.

In the long-term, however, there are a lot of unanswered questions. Will the distributions of the credit scores or mortgage scores associated with the loans delivered by particular lenders affect the guarantee fees they are charged? Will the Enterprises eventually use scoring technology to move toward loan-level risk-based pricing? How will scoring affect the Enterprises' special affordable housing programs?

Several general observations may be made about the likely long-term effects of widespread use of credit scoring in the underwriting of conventional mortgages:

- Applicants with good or excellent credit histories will be able to obtain conventional loans with higher LTV ratios, have higher debt-to-income ratios, and/or have lower cash reserves than they would under traditional underwriting practices.
- Some applicants who have not used credit or have insignificant blemishes in their credit histories but who would likely have been turned down under traditional underwriting will be more likely to obtain conventional loans.
- Applicants with poor credit histories will be less likely to obtain conforming conventional loans than they would under traditional underwriting, although some applicants may be able to compensate for their credit histories by making larger downpayments, having lower debt-to-income ratios, or having higher cash reserves.

- Applicants who can no longer get conforming conventional mortgages (so-called A-quality loans) are likely to be offered credit at higher costs from lenders that specialize in making B- or C-quality loans. The market for such loans is growing rapidly and becoming more standardized and competitive. Borrowers whose loans fall under the FHA ceilings may also be able to obtain FHA insurance.

11. GOVERNMENT-SPONSORED ENTERPRISE BENEFITS

Q.11.a. Please list and quantify each of the economic benefits provided to the GSE's as part of their Government-sponsored status. What is the value of each of these benefits on a per loan and a per share basis?

The specific benefits conveyed on Fannie Mae and Freddie Mac by Federal law include the following:

- A line of credit with the Treasury, available upon appropriation of funds and at the discretion of the Secretary, of $2.25 billion;
- Exemption of corporate earnings from State and local income tax; a savings of $256 to $367 million for 1995 as calculated by the General Accounting Office (GAO) in its May 1996 report Housing Enterprises;
- Eligibility of debt obligations for Federal Reserve open-market purchases;
- Use of the Federal Reserve as fiscal agent;
- Eligibility of debt obligations as collateral for all Federal deposits and most State and local government deposits;
- Exemption from registration with the Securities and Exchange Commission under the 1933 Act; a savings of $72 to $102 million according to the GAO's calculations;
- Designation of their securities as Government securities for the purposes of the Securities Exchange Act of 1934, which exempts them from the SEC registration and investor reporting requirements imposed on securities issuers by that Act;
- Eligibility of debt obligations for unlimited investment by national banks, State bank members of the Federal Reserve, and Federally-insured thrifts;
- Favorable treatment of debt obligations and mortgage-backed securities when Federally-insured banks or thrifts calculate their risk-based capital requirements; and
- Ability to remove any civil or other action, case, or controversy from any court other than a U.S. district court to a U.S. district court.

Given these benefits of Federal sponsorship, the Enterprises' public purposes, and the Congressional support for their missions, investors assume that the Government would not allow either Enterprise to default on its debt obligations. This perception of an implicit Federal guarantee lowers the interest rates that the Enterprises must pay, conveying substantial economic benefits to the Enterprises. The recent agency privatization study estimates suggest that the benefits received by the Enterprises in 1995 totaled approximately $6 billion, $4 billion of which was passed down to homeowners in the form of lower interest rates. Of the gross subsidy of $6 billion, $5.2 billion is attributed to savings in the cost of MBS and debt issuance.

GSE Subsidy Calculation	Total Subsidy	Per Mortgage Loan Outstanding	Per Share of Common Stock
Gross GSE Subsidy	$6 billion	$402.82	$4.72
Passed to Homeowner	$4 billion	$268.55	$3.15
Net Retained Subsidy	$2 billion	$134.27	$1.57

Note: At the end of December 31, 1995, Fannie Mae had 1,092 million shares of common stock outstanding and Freddie Mac had 179 million shares of common stock outstanding. At the end of December 31, 1995, Fannie Mae had 7,803,650 conventional single-family and 5,137 conventional multi-family loans in its portfolio and underlying MBS. Freddie Mac had 7,080,208 single-family and 5,956 multi-family loans.

Q.11.b. What is the estimated benefit to homeowners as a result of GSE's participation in the mortgage markets?

A.11.b. The major benefit to homeowners from the activities of Fannie Mae and Freddie Mac is a reduction in the interest rates on the conventional, single-family, fixed-rate, long-term mortgages that are eligible for purchase by the Enterprises (so-called conforming loans). Robert F. Cotterman and James E. Pearce estimated that the presence of the Enterprises in the secondary mortgage market has resulted in a core reduction of 25 to 40 basis points in conventional single-family mortgage interest rates.* The estimate is based on a comparison of the interest rates on "jumbo" mortgage loans (loans that exceed the conforming limit) that had balances equal to or lower than the conforming limit and interest rates on conforming fixed-rate loans. The Cotterman and Pearce research was conducted on loans closed between 1989 and 1993.

Because the participation by the Enterprises in the securitization of adjustable rate mortgages has been significantly less than in the fixed-rate conventional mortgage market, Cotterman and Pearce suggest that the benefits have been lower than 25–40 basis points range for conforming single-family loans.

Q.11.c. Please provide each of the GSE's return on shareholder equity, net income, and earnings per share for each year since 1980. Please contrast these to the financial services industry as a whole.

A.11.c. See attached tables.

* "The Effects of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation on Conventional Fixed-Rate Mortgage Yields," Robert F. Cotterman and James E. Pearce, *Studies on Privatizing Fannie Mae and Freddie Mac,* U.S. Department of Housing and Urban Development, Office of Policy Development and Research, May 1996, p. 97–168.

Comparison of the Historical Financial
Performance of the Enterprises and Commercial Banks

	Fannie Mae		Freddie Mac		FDIC-Insured Commercial Banks		OTS-Regulated Thrift Institutions	
	Net Income (Millions)	Return on Average Equity	Net Income (Millions)	Return on Average Common Equity	Net Income (Millions)	Return on Equity	Net Income (Millions)	Return on Equity
1995	$2,144	20.9	$1,091	22.0	$48,838	14.7	$5,378	9.0
1994	$2,132	24.3	$983	23.2	$44,626	14.6	$4,275	7.4
1993	$1,873	25.3	$786	22.2	$43,040	15.3	$4,917	8.7
1992	$1,623	26.5	$622	21.2	$31,887	13.0	$5,103	9.3
1991	$1,363	27.7	$555	23.6	$17,935	7.9	$1,195	2.3
1990	$1,173	33.7	$414	20.5	$15,991	7.5	($3,817)	(5.4)
1989	$807	31.1	$437	25.0	$15,575	7.7	($6,783)	(9.1)
1988	$507	25.2	$381	27.6	$24,812	13.2	($13,263)	(31.2)
1987	$376	23.5	$301	28.2	$2,803	1.6	($7,407)	(18.8)
1986	$105	9.5	$247	28.5	$17,418	9.9	$610	1.6
1985	($7)	(0.7)	$208	30.0	$17,977	11.1	$4,010	12.7
1984	($71)	(7.4)	$144	52.0	$15,502	10.4	$994	3.7
1983	$49	5.1	$160	44.5	$14,931	11.1	$1,945	8.5
1982	($192)	(18.9)	$60	21.9	$14,844	12.0	($4,142)	(17.5)
1981	($206)	(17.2)	$31	13.1	$14,722	13.0	($4,631)	(15.6)
1980	$14	0.9	$34	14.7	$14,010	13.7	$781	2.4

Sources: Fannie Mae, Freddie Mac, Federal Deposit Insurance Corporation, Office of Thrift Supervision.

Q.11.d. Please provide a comparison of the top GSE's executive compensation with comparable financial services industry compensation.

A.11.d. The attached tables provide data from the 1996 proxy statements on the 1995 compensation of the five highest paid executives at Fannie Mae and Freddie Mac.

It is impossible to find organizations that are strictly comparable to Fannie Mae and Freddie Mac. While the Enterprises' have characteristics in common with both wholly private financial services firms and Government instrumentalities, no other institutions share all of their attributes. The unique nature of the Enterprises complicates the task of making comparisons of the compensation for their top executives with the compensation of top executives at other organizations.

The Enterprises are privately-owned, are profit-seeking, have publicly-traded stock, and are governed by boards of directors, the majority of which are elected by owners. In these respects, they resemble wholly private financial services firms. Fannie Mae and Freddie Mac also compete for executive talent with large financial services firms, and there is a degree of similarity between the duties and the responsibilities of top executives at the Enterprises and the top executives at such companies. For these reasons, each Enterprise looks to private financial services firms when doing comparative analysis of its compensation for top executives.

The Enterprises, however, are Federal instrumentalities that have public purposes, are limited to narrow lines of business, and have relatively few employees for privately-owned organizations of their size in dollar terms. They also enjoy special legal ties to the Government and benefit from the perception of an implicit Federal guarantee of their obligations that enables them to borrow at low interest rates, and dominate the markets in which they participate. These attributes make the Enterprises analogous, at least in some respects, to other Government instrumentalities or corporations such as the other GSE's, large State and municipal public utilities, the largest Federal Reserve Banks, and large multinational financial corporations such as the World Bank. The duties and responsibilities of top executives at Fannie Mae and Freddie Mac may also be similar to some degree to those of top executives at these or other Government instrumentalities.

With these caveats in mind, OFHEO has prepared the attached table, which compares the 1995 compensation of the CEO's of Fannie Mae and Freddie Mac and the CEO's of firms selected from samples of large, publicly-held depository institutions and insurance companies. These two types of financial institutions were selected because the Enterprises hold large portfolios of assets and function as insurers of pools of mortgage loans. Each sample was restricted to companies with assets greater than $15 billion and market value greater than $2 billion. Annual and total compensation for 1995 are shown for each Enterprise and for the 25th percentile, the median, and the 75th percentile in each sample of firms. Annual compensation includes salary, bonus, and other compensation received in the year of service. Total compensation includes annual compensation plus long-term compensation such as long-term incentive plan payouts, awards of restricted stock, and grants of stock options. The total assets, market value, and number of employees of each Enterprise and the selected firms in each sample are also shown.

The data used to construct the table were obtained from 1995 proxy statements and from estimates of the value of stock option grants calculated using a modified Black-Scholes valuation model. The total compensation figures for the CEO's of Fannie Mae and Freddie Mac do not match precisely the figures reported in each Enterprise's 1996 proxy statement because each makes different assumptions in estimating the value of stock options. Using a consistent methodology for estimating the value of stock options allows total compensation to be compared across many firms.

The data in the table on firm characteristics illustrate how the Enterprises' unique characteristics set them apart from the wholly private financial services firms. In the first place, Government sponsorship has enabled Fannie Mae and Freddie Mac to become extraordinarily huge institutions. Both were larger, in terms of assets or market value, than any of the insurance companies in the sample group used for the comparison of 1995 compensation levels provided in the table. Fannie Mae had greater assets than all, and greater market value than all but one, of the depositories, while Freddie Mac had greater assets than all but six, and greater market value than all but four, of the depositories, used for the comparison. At the same time, the restriction of the Enterprises to very narrow lines of business and their role as wholesale, secondary-market entities enabled them to have far fewer employees than nearly all the firms in each sample, especially the depository institutions, which are in many lines of business and have retail branch networks.

The data in the table on executive compensation show that the 1995 annual compensation of Fannie Mae's CEO was between the median and 75th percentile of annual compensation for the CEO's of large depository institutions and above the 75th percentile for insurance company CEO's. The annual compensation of Freddie Mac's CEO was between the median and the 25th percentile of annual compensation of the CEO's of large depository institutions and between the 75th percentile and the median for insurance company CEO's.

Table 1

Compensation of the Top Five Fannie Mae and Freddie Mac Executives, 1995

Fannie Mae

	Annual Compensation			Long-Term Compensation			
	Salary	Bonus	Other	LTIP[1] Payouts	Estimated Value[2] of Stock Options	All Other	Total Compensation
James A. Johnson	$800,000	$833,263	$23,102	$2,895,004	$1,670,797	$5,330	$6,227,496
Lawrence M. Small	$638,237	$398,865	$26,582	$1,615,089	$838,059	$5,302	$3,522,134
Franklin D. Raines	$551,250	$315,794	$12,320	$1,367,512	$753,469	$4,902	$3,005,247
J. Timothy Howard	$341,250	$177,719	$188	$848,998	$374,774	$4,749	$1,747,678
Robert J. Levin	$341,250	$177,719	$126	$848,998	$374,774	$4,572	$1,747,439

Freddie Mac

	Annual Compensation			Long-Term Compensation			
	Salary	Bonus	Other	Restricted Stock Award	Estimated Value[2] of Stock Options	All Other	Total Compensation
Leland C. Brendsel	$865,000	$394,000	$100,688	$658,088	$571,106	$171,218	$2,760,100
David W. Glenn	$595,000	$229,000	$64,548	$406,706	$432,049	$104,937	$1,832,240
Richard Daniel	$364,000	$76,400	$145,254	$113,769	$185,123	$23,776	$908,322
Michael K. Stamper	$316,600	$72,800	$0	$98,781	$161,088	$52,987	$702,256
Maud Mater	$260,000	$73,000	$0	$81,750	$131,904	$39,158	$585,812

[1] Long-Term Incentive Plan

[2] Enterprise estimate of net present value of the options as of the grant date.

Source: Fannie Mae and Freddie Mac 1996 Proxy Statements

Table 2

Comparison of 1995 Compensation of CEOs of Fannie Mae, Freddie Mac, and Large Depository Institutions and Insurance Companies

	Assets (Millions)	Market Value (Millions)	Total Annual Compensation	Total Compensation[1]
Fannie Mae	$316,550	$33,495	$1,656,365	$7,509,712
Freddie Mac	$137,181	$14,881	$1,359,688	$2,735,958
Large Depository Institutions[2]				
75th Percentile Firm	$72,769	$11,377	$2,496,896	$5,123,820
Median Firm	$44,587	$5,886	$1,516,100	$3,255,094
25th Percentile Firm	$30,560	$3,330	$1,079,285	$1,843,731
Large Insurance Companies[3]				
75th Percentile Firm	$64,158	$8,691	$2,134,703	$4,485,188
Median Firm	$35,946	$5,605	$1,783,841	$2,486,116
25th Percentile Firm	$21,366	$4,457	$1,359,350	$1,727,953

Notes

[1] Total Compensation includes estimates of the value of stock option grants calculated using a modified version of the Black-Scholes valuation model.

[2] Sample of 35 banks and thrifts with assets greater than $15 billion and market value greater than $2 billion. .

[3] Sample of 19 insurance companies with assets greater than $15 billion and market value greater than $2 billion.

Source: Hewitt Associates ProxyBase software, which provides data from 1995 proxy statements and estimates of stock options and grants.

Q.11.e. Please provide a comparison of GSE's cost of borrowing with yields on Treasuries of comparable maturities and yields on AAA bonds with comparable maturities.

A.11.e. The following table shows Bloomberg data on the average spreads from June 1991 through December 1995. The data are comparable to other estimates reviewed by OFHEO.

Average Spreads Over Treasuries for 5- and 10-Year Noncallable Debt, for June 1991-December 1995 (basis points)		
Type of Issuer	5-Year	10-Year
GSEs	18	27
Bank/finance - Aaa	40	50
Aa	53	57
A	57	68

In April 1991, Standard and Poor's Corporation, relying on publicly available information, assigned both Fannie Mae and Freddie Mac to the "A" credit rating category, with the rating providing an assessment of the Federal Government's exposure to risk.

OFHEO has contracted with Standard & Poor's Rating Service to provide a credit rating of each Enterprise that evaluates the risk that each Enterprise is likely to pose to the Federal Government. The rating will assume that the Enterprises continue to benefit from their GSE's status. The preliminary written report is due in early December.

12. CHANGES IN TAX POLICY

Q.12.a. Has OFHEO made any estimates of the impacts of a flat tax (including a repeal of the mortgage interest deduction) on home prices and interest rates? If so, what is the potential impact on the GSE's? If OFHEO has not conducted such an analysis, what approach would OFHEO take in analyzing the issue?

A.12.a. Based on preliminary work done at OFHEO and published results of other research, the repeal of the mortgage interest deduction would impose significant costs on the Enterprises. It also may raise future safety and soundness issues for Fannie Mae and Freddie Mac if the Enterprises' capital bases were depleted below their statutorily required risk-based levels to meet these costs. Under these conditions, the Enterprises would be forced to raise prices or restrict portfolio growth to replenish this lost capital, constraining the earnings potential of each firm and possibly affecting their ability to fulfill their public missions.

The magnitude of the costs associated with eliminating the mortgage interest deduction would vary substantially depending on whether the repeal was accompanied by other tax code changes and on the effect of those changes on interest rates and economic growth. The risk-based capital requirements for Fannie Mae and for Freddie Mac that are currently under development, however, should enable the Enterprises to absorb losses of this magnitude. Thus, the elimination of the mortgage interest deduction should not directly threaten the solvency of either firm unless it were to be accompanied by other deleterious shocks to the housing sector of the economy. (See OFHEO Director's letter to Senator Moseley-Braun dated April 8, 1996.)

Q.12.b. DRI has estimated a 15 percent decline in home values as a result of a repeal of the mortgage interest deduction. What impact would a decline in home prices of this magnitude have on the capital levels and on the safety and soundness of the GSE's?

A.12.b. By increasing the after-tax cost of housing, the elimination of the mortgage interest deduction would lower housing values across the country. Research measuring the magnitude of this housing price decline remains preliminary. Data Resources Inc. and other private analysts examining flat tax proposals that call for the removal of the mortgage interest and property tax deductions have estimated an average house price decline ranging from 10 to 16 percent. Because higher-income households more frequently take advantage of the mortgage interest deduction and take larger deductions, the magnitude of the decline in housing values would be considerably lower for lower-income groups, less-expensive homes, and less-wealthy geographical areas. Thus, the effect on the Enterprises, which are limited to purchasing and/or securitizing mortgages at or below the $207,000 conforming loan limit, would be less than the effect on creditors of larger mortgages.

- According to estimates by urbanologist Peter Dreier at Occidental College in Los Angeles, families earning more than $100,000 account for 44 percent of the tax benefits from the mortgage interest deduction ($22 billion). Families earning between $50,000 and $100,000 benefit from another 44 percent of the savings, with families earning less than $50,000 per year accounting for the remaining 12 percent.
- Similarly, the mortgage interest deduction has differential impacts by State. The wealthier States with higher priced homes, such as California, Connecticut, Florida, Maryland, New Jersey, New York, and Virginia would experience larger housing price declines.

Homeowner equity, as reflected in the ratio of existing loan balance to the market value of the house (loan-to-value or LTV ratio), is a major determinant of mortgage defaults. As a result, any reduction in the value of housing caused by the elimination of the mortgage interest deduction would reduce homeowner equity in mortgages held or guaranteed by Fannie Mae and Freddie Mac and increase the mortgage credit losses experienced by the Enterprises. In isolation, this increase in credit losses would reduce the earnings and slow the growth of, or even deplete, the capital of each Enterprise.

Using a mortgage performance model to gauge the relative impact of a 15 percent average price decline on the default and prepayment patterns of fixed-rate single-family mortgages purchased by one of the Enterprises, OFHEO determined that a 15 percent housing price decline could double cumulative 10-year default rates from current levels in the absence of any change in interest rates. This would boost credit losses substantially for each GSE.

The risk-based capital standard that the Congress directed OFHEO to develop will require Fannie Mae and Freddie Mac to hold capital to cover adverse mortgage credit shocks on a national scale. At this point, OFHEO believes that these cushions would be sufficient to absorb the increase in losses associated with the elimination of the mortgage interest deduction. Any resulting reduction in the capital cushion at each firm could, however, cause the Enterprises to consider the need to issue new capital instruments to restore capital adequacy, raise prices, or reduce the interest rate and credit risk exposures associated with their large mortgage portfolios.

13. CONFORMING LOAN LIMITS

Q.13.a. The CEO of Freddie Mac recently called for the elimination of the conforming loan limits. What issues should Congress consider if it examines the adequacy and necessity of the conforming loan limits?

A.13.a. Elimination of the conforming loan limit would raise questions about what the role of the Enterprises is supposed to be. Such a change, however, would not appear to raise safety and soundness concerns. If the Enterprises were able to buy any size loan, they would be able to do more business. This would result in an increase in their contingent liabilities and any implicit guarantee associated with those liabilities. The risks associated with larger loans are different than the risks associated with smaller loans, but the Enterprises do have the capacity to manage large loan risk.

In assessing the adequacy and necessity of the conforming loan limits, the Congress may want to examine the original rationale for establishing conforming loan limits. Relevant questions would include: What public purpose was achieved? Have market conditions changed sufficiently to merit elimination of the limit? What are the appropriate roles for the Enterprises and other secondary market players? What would the impact be on private sector competition?

14. OFHEO REGULATION OF FHA

Q.14.a. What is OFHEO's view of proposals to require OFHEO to regulate FHA? What additional resources would OFHEO need to fulfill this mission?

A.14.a. Under the original HUD proposal to create an independent Federal Housing Corporation (FHC), OFHEO's primary role would be to function as a safety and soundness regulator of the new FHC. In this role, OFHEO would establish a risk-based capital requirement for the corporation. If the corporation was undercapitalized at any time, OFHEO would have to require it to develop and implement an acceptable recapitalization plan. If the plan failed to work and the FHC's capital continued to fall, at some point OFHEO would have to require the Corporation to take affirmative steps to correct the situation. OFHEO would have to conduct annual safety and soundness examinations of the FHC.

OFHEO would also have the job of estimating the subsidy cost of the new credit assistance that the FHC planned to provide each year and providing those estimates to the Office of Management and Budget for publication in the President's *Budget*.

OFHEO would perform a similar role under H.R. 1701, the Federal Mortgage Insurance Corporation Charter Act, introduced in the 104th Congress, although H.R. 1701 would have moved the OFHEO, more or less intact, to the Treasury Department.

OFHEO would assess the FHC for the cost of carrying out its responsibilities with respect to the corporation, but we cannot determined the resources that would be required under this proposal until the FHC publishes a more detailed business plan.

15. NATURAL DISASTERS

Q.15.a. To what extent are the GSE's exposed to natural disasters? What is the adequacy of protections that they have built in against floods, hurricanes, fires, and earthquakes? What is the exposure of the GSE's in areas with high hurricane or earthquake risk?

A.15.a. The Enterprises' exposure to natural disasters is a function of the probability that a borrower, facing a large reduction in the value of the collateral underlying a mortgage or a drop in payment capacity following a natural disaster, will default on a mortgage held or guaranteed by the Enterprise. The probability of a disaster-related claim increases with the loan-to-value ratio before the disaster, the probability and severity of the disaster, and the shortfall in private disaster insurance. Obviously, if the property is located in a high disaster-risk area and does not have disaster insurance, the likelihood of a disaster-related default, and hence the exposure of the Enterprises, is greater. Since the availability of insurance varies across the flood, earthquake, and hurricane insurance markets, however, the Enterprises' exposure to loss varies across the three types of disasters.

As a safety and soundness regulator, we have encouraged the Enterprises to take steps to reduce their potential for loss, while recognizing that any such actions must be consistent with their other obligations. OFHEO believes that any solution to these natural disaster issues must involve a comprehensive set of national reforms similar to the proposals submitted by the Administration and not arbitrary restrictions on the business practices of the two Enterprises.

Flood Exposure: Floods are one form of natural disaster to which the Enterprises are exposed. This risk, however, will be mitigated by effective enforcement of the Flood Disaster Protection Act of 1973 (1973 Act). The Act directs bank, thrift, and credit union regulators to issue regulations prohibiting regulated lending institutions from extending loans to borrowers whose collateral is located in a Special Flood Hazard Area (SFHA) without adequate flood insurance. The 1973 Act also prohibits any form of financial assistance by Federal programs, or by Federally supervised, regulated, or insured agencies (specifically defined as including Fannie Mae and Freddie Mac) to borrowers with properties located in SFHA's that do not carry adequate flood insurance.

In 1994, Congress amended the 1973 Act to improve compliance. Among other provisions, the National Flood Insurance Reform Act of 1994 (1994 Act) requires the Enterprises to implement procedures that are reasonably designed to ensure that adequate flood insurance is in place over the term of the loan for loans purchased after September 28, 1995, that are collateralized by buildings located in SFHA's. This requirement also applies to properties that are remapped into SFHA's during the term of the loan.

In February and March 1996, OFHEO conducted flood insurance reviews of each Enterprise's compliance with the 1994 Act. The reviews focused on the analysis of Enterprise's policies and procedures relating to the 1994 Act. Because the procedural requirements of the 1994 Act only became effective in September 1995, the reviews assessed the progress of each Enterprise in meeting these new requirements. OFHEO determined that Freddie Mac has established adequate policies and procedures under the 1994 Act and is complying with them and the policy and procedure framework being implemented by Fannie Mae with respect to flood insurance requirements is adequate.

Earthquake Exposure: With respect to earthquake risk, the Enterprises do face considerable exposure. Like flood insurance, earthquake shake coverage typically is written as a separate rider on a homeowners' insurance policy. In the face of mounting losses in the wake of the Northridge ($12.5 billion) earthquake, however, private insurance companies have retreated from the earthquake insurance market. As a result, earthquake insurance coverage—only 35 percent in California before the Northridge earthquake and virtually nonexistent elsewhere—has now become very difficult to obtain.

Furthermore, roughly a quarter of the mortgages held by the Enterprises are backed by property located in California, where this retrenchment in coverage is especially acute. OFHEO has estimated that the average annual earthquake loss exposure of privately-insured properties in California is just under $1 billion per year. Therefore, assuming that the housing characteristics of the uninsured portion of the market is similar to the population carrying private insurance (a conservative assumption since higher risk properties often do not carry insurance coverage), the annual expected loss for all residential properties in California could approach $3 billion. Of course, the Enterprises are only exposed to a subset of these properties and will only suffer losses in the event of an uninsured default. Nevertheless, the Enterprises face a real exposure to earthquake-related losses in California and in other earthquake-prone areas of the country.

Hurricane Exposure: Major hurricanes similar to Hurricane Andrew in 1992 ($15.5 billion) also create major economic disruptions and losses for the housing communities affected and can lead to defaults on mortgaged properties. Unlike earthquake insurance, however, protection against hurricane wind damage usually is in-

36-340 96 - 6

cluded in the standard homeowners' insurance policy. As a result, with the exception of very high-risk areas covered in the special risk pools, hurricane damage typically is insured—reducing the exposure of the Enterprises. Of course, after suffering losses from Hurricane Andrew, many insurers are now reluctant to offer hurricane protection in high-risk States like Florida as well, emphasizing the need for a national solution to the current problems being experience by the insurance industry in providing natural disaster insurance.

16. PRIVATIZATION

Q.16.a. Congress has directed several studies of GSE privatization. Is it possible to privatize the GSE's?

A.16.a. OFHEO believes that full privatization of the two Enterprises is feasible. The process of privatization, however, would be complicated, potentially expensive, and certainly risky.

As pointed out by the Department of the Treasury in its privatization study,* the secondary market for conforming, conventional mortgages would operate efficiently and effectively in the absence of Government sponsorship of the Enterprises. According to the Treasury, however, the more critical issue is whether the benefits of a change would at least balance the disruption and risk to the residential mortgage market. The Treasury study estimates the benefits of Government sponsorship of the Enterprises total about $6 billion a year, about $4 billion of which is passed on to homeowners in the form of lower mortgage interest rates. The study warns, however, that quantification of the benefits is uncertain and that the potential effect on mortgage interest rates is an important risk. Nor is it certain what the impact of the change would be on the affordable housing activities of the Enterprises. In addition, the Treasury study outlines several potential benefits of privatization: increased market competition, more efficient credit allocation, reduced U.S. Government borrowing costs, and reduced potential risk to the taxpayers. In conclusion, the Treasury states that: "Firm conclusions regarding the desirability of ending or modifying Government sponsorship of Fannie Mae and Freddie Mac are premature."

Q.16.b. What would privatization entail?

A.16.b. Before privatization could be considered, a road map for severing all Federal ties would need to be developed and reviewed. At a minimum, a workable privatization plan would have to:

- Protect the market value of the existing debt and mortgage-backed securities of each Enterprise;
- Allocate the past and future business activities of each Enterprise to separate firms (or to separate subsidiaries of a holding company), create enforceable firewalls between the separate units, and assure that each unit had adequate capital;

***Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation,* The U.S. Department of the Treasury, July 11, 1996, pages 10–11.

- Provide for continued safety and soundness regulation of each Enterprise throughout the transition to a post-privatization market structure, to protect taxpayers against any risk of loss; and
- Foster the emergence of a post-privatization market structure in which private investors no longer believed that the Federal Government is likely to take steps to prevent either Enterprise from defaulting on its obligations.

Q.16.c. What safety and soundness risks would privatization pose?

A.16.c. Privatization of the Enterprises could potentially disrupt the private mortgage and housing markets during the transition phase, which could pose safety and soundness risks for the Enterprises. The key concerns would be: (a) how a restructuring plan would work (e.g., the rules for allocation of capital between a holding company and its subsidiaries) and (b) policymakers' intentions in restructuring the firms (e.g., the successor firms would receive no preferential treatment from the Government). It would also be necessary to take steps that would gradually shift some of the business that Fannie Mae and Freddie Mac now do to the entities that would take it over in a post-privatization world—private conduits, depositories, FHA and other Government agencies, and others. The objective would be to allow everyone to expand their business volumes gradually, with minimal disruption. The privatization studies discuss options (lowering the conforming loan limit, for example) that would accomplish this objective. In addition, each Enterprise would probably have to raise additional capital by issuing stock.

17. CHANGES IN THE FINANCIAL SERVICES INDUSTRY

Q.17.a. What risks are posed for GSE's by financial services industry consolidation?

A.17.a. Consolidation in mortgage banking may benefit the Enterprises. Large, well-capitalized firms that have the technology and management expertise will likely improve their origination and servicing practices. Many such lenders will use statistical scoring to re-engineer their credit risk management, thereby improving the quality of the loans they produce and service as well as minimizing credit losses.

But industry consolidation also poses certain challenges to the industry and the Enterprises. There is uncertainty, in the event of a national economic downturn, about the performance of the very large, national portfolios created in recent years. Some large servicers have sought to cut expenses by centralizing operations in a single national servicing center or a few regional ones. In a national recession, such servicers may find it more costly than anticipated to manage geographically dispersed delinquencies. Current servicing portfolios also include a significant proportion of recently originated mortgages with high initial loan-to-value (LTV) ratios, as well as loans made as part of fairly new community lending programs that permit variances from normal underwriting guidelines. In a economic downturn, servicers might find that managing delinquencies on those loans costs more than expected. By contrast, the very large, nationally diversified portfolios created in recent years could perform better than anticipated.

Consolidation may also have implications for the guarantee fee income earned by the Enterprises. The Enterprises give a degree of favorable treatment to larger originators in the form of lower guarantee fees and waivers of some underwriting guidelines. This enables Fannie Mae and Freddie Mac to reduce marketing costs while maintaining market share. Consolidation in the origination market may, in combination with favorable pricing for large originators, tend to reduce overall guarantee fee income. This could increase competition between the Enterprises for high-quality loans and accelerate their use of scoring technology to re-engineer their credit risk management.

The broader issue of consolidation in the financial services industry, including but not limited to nationwide banking and branching, may also have some impact on how the Enterprises manage their business risks. More specifically, the Enterprises provided a channel for geographically diversifying the risk of mortgage portfolios and intermediating mortgage funding throughout the United States. By implication, nationwide banks will be able to diversify their mortgage portfolios and intermediate funds directly and much more cost effectively. The potential merger of the thrift and banking charters may also have an impact on the mortgage finance market.

Q.17.b. One Member of Congress proposed requiring the GSE's to contribute to the cost of recapitalizing the SAIF fund and assisting in the payment of FICO bond obligations. What is OFHEO's view of this proposal? Has OFHEO reviewed the possible impact of user fees on the GSE's? What would be the impact of user fees on the safety and soundness of the GSE's and on homebuyers?

A.17.b. The Congress resolved the question of who should contribute to the cost of recapitalizing the SAIF fund and who should pay the FICO bond obligations by splitting the cost between the thrifts and the commercial banks. (Fiscal 1997, Omnibus Consolidated Appropriations Act of 1996, September 30, 1996, P.L. 104–28.)

At this time, OFHEO has not conducted an in-depth analysis of any specific user fee proposal. From the perspective of safety and soundness, the main issues regarding any proposal are: (1) whether the absolute size of the proposed fees would preclude safe and sound operations; and, (2) whether the proposed fee schedule would give the Enterprises an incentive to increase or decrease their risk. In analyzing the user fee proposals, it is important to determine whether proposed fees would be levied on debt and/or MBS, and whether they would be levied on all outstanding securities or only on new issues.

The Enterprises' market power gives them considerable freedom to pass or not pass through cost increases as they choose. In all probability, user fees on new and/or outstanding MBS would be more likely to be passed through in MBS pricing than on portfolio loans. Relatively few loans are purchased and placed in the Enterprises' portfolios—currently, additions to the portfolios are most often purchases of MBS securities that the Enterprises have issued. Thus, borrowing costs have relatively little effect on purchase decisions.

The cost of a user fee on new debt, to the extent that it was higher than a fee on MBS, would be borne primarily by the Enterprises' owners. Fannie Mae and Freddie Mac might respond to a user fee on debt, or a fee on debt that was greater than a fee on MBS, by reducing the size or rate of growth of their portfolios, which would tend to reduce their risk.

In August 1996, the Congressional Budget Office (CBO) proposed imposing a user fee of 20 basis points (0.20 percentage points) on outstanding Fannie Mae and Freddie Mac debt, with no fee on the Enterprises' outstanding MBS. In the short run, it is likely that the owners of Fannie Mae and Freddie Mac would bear a large portion of the cost of such a user fee in the form of declines in stock prices. Because a user fee on debt alone would reduce the profitability of financing mortgages with debt relative to securitizing the loans, the proposed fee would probably lead the Enterprises to reduce the size or rate of growth of their portfolios. Fannie Mae and Freddie Mac might also try to increase somewhat the prices they charged lenders in order to maintain their overall profitability levels.

Q.17.c. What is the competitive relationship of the Federal Home Loan Banks and the GSE's? What are OFHEO's views of legislative changes proposed for the FHLB's and the impact of these changes on the GSE's?

A.17.c. In general, the Enterprises and the Federal Home Loan Banks are sources of liquidity and financing for residential and affordable housing. Both Fannie Mae and Freddie Mac, however, compete only peripherally with the Federal Home Loan Banks. The Enterprises purchase and securitize mortgages while the Federal Home Loan Banks provide advances to their members. In some instances for some institutions, these transactions may constitute close alternative sources of liquidity and financing. In other cases, the Enterprises' repurchase agreements may represent competitive alternatives to advances from the Federal Home Loan Banks advances as sources of liquidity. In addition, the warehousing activities of the Federal Home Loan Banks and the short-term financing activities of the Enterprises, where the Enterprises fund mortgage loans prior to the sale of the loans to the ultimate investor, are equivalent transactions.

Both the Enterprises and the Federal Home Loan Banks also actively raise funds in similar segments of the financial markets.

OFHEO's Regulatory Activities

In its second full year of operations, OFHEO moved expeditiously to fulfill its congressionally mandated mission. The Office conducted its first examinations of Fannie Mae and Freddie Mac, performed quarterly capital classifications of the Enterprises based on minimum capital standards, and made substantial progress toward development of a stress test that will be used to set risk-based capital requirements. A description of these and other activities, including research and projects to support these functions, are outlined in this section.

Examination of Fannie Mae and Freddie Mac

Authority

OFHEO's statute requires the Office to conduct annual, on-site examinations to determine the financial safety and soundness of Fannie Mae and Freddie Mac. The Act specifies that "the results and conclusions of the annual examinations" shall be submitted as part of the Annual Report to Congress.

Examination Approach

The purpose of examining Fannie Mae and Freddie Mac is to verify that their current condition is safe and sound, and that they are being managed and operated prudently. Recent regulatory experience has shown that the quality of a regulator's safety and soundness decisions, and the effectiveness of oversight activities, depend upon the examiner's first-hand knowledge of operations and management of the institution being examined.

Oversight of government-sponsored enterprises involves evaluation of management and operating systems, including the processes used by a GSE to identify and control exposure to risk. OFHEO is continuing to review and refine its examination and supervisory processes.

The examination starts with a big-picture approach. The scope is expanded when anomalies are found. The examination in a specific functional area of the Enterprise starts with a *Level I* review. Examiners in this phase evaluate senior management and its planning strategy, analyze internal and external audits, and verify records and control systems. *Level II* is broadened to include testing, statistical sampling, and additional analysis. *Level III* includes detailed review of an entire area by an examining team.

At the end of each examination, exit conferences are held to advise management of OFHEO's results and conclusions. In the case of the first examination described below, OFHEO's Director and the director of OFHEO's Office of Examination and Oversight met with the boards of directors of Fannie Mae and Freddie Mac to summarize the examination findings. Detailed presentations of the conclusions and recommendations were also made to the audit committees of each board.

In 1994 and the first quarter of 1995, OFHEO conducted its first on-site examinations of Fannie Mae and Freddie Mac. During this period, OFHEO staff conducted separate, simultaneous examinations at each Enterprise in two subject areas.

OFHEO 1994-95 Examinations

The initial examinations covered the use of derivative contracts by the Enterprises. The examinations were ordered by the OFHEO Director in light of congressional and regulatory concern over the rapid growth of the use of derivatives. OFHEO's objective was to determine the business purposes of these derivatives and to verify that these purposes were consistent with safety and soundness principles.

The second set of examinations covered issues of corporate governance. These examinations had three objectives: to assess the strength of corporate governance, to enhance OFHEO's institutional knowledge of the Enterprises, and to establish priorities for future examinations.

Overall, OFHEO's initial examinations of Fannie Mae and Freddie Mac revealed no significant concerns involving financial safety and soundness. OFHEO made recommendations to the Enterprises in each of the examination reports.

The Enterprises responded promptly to OFHEO's recommendations. The actions taken or planned by each Enterprise were deemed by OFHEO to be responsive to the recommendations of OFHEO's examination staff. The next examination will focus on risk management, which assesses the adequacy of management processes to identify, measure, monitor, and control the risk exposure of the Enterprises.

Examination of Derivative Contracts

In the spring of 1994, OFHEO's Office of Examination and Oversight began examinations of the use of derivative contracts by Fannie Mae and Freddie Mac. The examinations focused on the business purposes, oversight, and risk management of the Enterprises' derivative contracts.

During its examinations, OFHEO staff analyzed derivative contracts and strategies utilized by the Enterprises, interviewed directors and executive managers, and reviewed risk management processes and systems.

Derivative contracts are an integral component of financial management at each Enterprise. The aggregate notional amount of these contracts at the Enterprises increased to $120 billion at year-end 1994, up from $4.9 billion on Dec. 31, 1989 (see figure 2, p. 9). These notional amounts serve as a basis for the payments required under the contracts and indicate the level of activity, but do not measure risk exposure.

Fannie Mae and Freddie Mac use derivative contracts — primarily callable and non-callable fixed-pay swaps, basis swaps, and interest rate caps and floors — to reduce funding costs, manage interest rate risk exposure, enhance short-term investment yields, and facilitate other transactions with dealers. In addition, Fannie Mae uses foreign currency swaps to hedge its exposure to the risk of currency fluctuations on non-dollar denominated debt issues.

In its derivative contracts examinations, OFHEO evaluated the Enterprises relative to recommendations published by the Group of Thirty and the Basle Committee on Banking Supervision. The examinations also utilized related materials from the American Institute of Certified Public Accountants, banking regulators, and the General Accounting Office. Taken together, these recommendations and materials comprise OFHEO's "best practices" standard for derivatives activities. Within this framework, the examinations:

- Determined the business purposes of derivative contracts used by the Enterprises, and verified that those business purposes were consistent with principles of safety and soundness;

- Assessed oversight of derivatives activities, including the role of the board of directors, the adoption of a derivatives policy, and the responsibilities of senior management; and

- Evaluated the adequacy of risk management relating to derivatives activities, including market risk, credit risk, operations risk, liquidity risk, and legal risk.

Results and Conclusions

Examinations of Fannie Mae and Freddie Mac concluded that the use of derivative contracts by the Enterprises do not pose significant safety and soundness concerns.

The growth and composition of derivative contract portfolios reflect Fannie Mae's and Freddie Mac's responses to opportunities and risks associated with changing market conditions. At both Enterprises, derivative contracts are used to reduce funding costs (see discussion on pp. 8-11). The examinations found that as users of derivatives, the Enterprises employ derivative contracts for sound business purposes that are not speculative.

Effective oversight is critical in ensuring that derivatives activities are conducted in a safe and sound manner. An effective oversight framework includes these elements: strategic policy guidance from the board of directors, delegations of authority and monitoring by the board, clearly articulated policies and procedures from senior management, and active supervision of derivatives activities by senior management.

Risk management of derivatives activities requires effective processes and systems to ensure that risks are identified, measured, and controlled by senior management. Operational policies and procedures, management information systems, and internal controls are essential elements of such risk management.

Fannie Mae

The notional amount of Fannie Mae's derivative contracts portfolio rose to $89.4 billion at year-end 1994, up from $51.5 billion a year earlier, for a 74 percent increase. This substantial growth primarily reflects the increasing use of these contracts, in conjunction with short-term and structured debt instruments, as a cost-effective alternative to more traditional long-term and intermediate-term debt in funding Fannie Mae's rapidly growing retained mortgage portfolio. The examination determined that Fannie Mae employs derivative contracts to achieve sound business purposes.

OFHEO concluded that senior management involvement was active and effective. While OFHEO recognized that recent initiatives by the Board had improved its role in oversight, OFHEO recommended that the Board of Directors further expand its role. OFHEO also recommended that institutional policies on derivatives be more clearly established and internal reporting be expanded to meet fully the guidelines proposed by the Group of Thirty.

The examination found that risk exposure on current positions was minimal and that risk management practices overall at Fannie Mae were effective. OFHEO supports efforts underway to establish aggregate credit limits for all counterparties to avoid concentrations of credit. Subsequent actions taken by Fannie Mae fully complied with the recommendations of the examination.

Freddie Mac

At Freddie Mac, the notional amount of derivative contracts increased to $30.8 billion at year-end 1994, up from $19.3 billion a year earlier, for a 60 percent increase. As was the case for Fannie Mae, this substantial growth primarily reflects the increasing use of these contracts, in conjunction with short-term or structured debt instruments as a cost-effective alternative to more traditional long-term and intermediate-term debt in funding Freddie Mac's rapidly growing mortgage portfolio. The examination determined that Freddie Mac employs derivative contracts to achieve sound business purposes.

The examination found that involvement of the Board of Directors and senior management was active and effective. OFHEO determined that institutional policies were generally adequate but needed to be updated and expanded. OFHEO also recommended more comprehensive internal reporting.

OFHEO concluded that risk exposure on current positions was minimal, but recommended that exposure limits for counterparties be established, that efforts to develop in-house capacity to measure current credit exposure be continued, and that certain internal control procedures be strengthened.

At Freddie Mac, the responses to the examination recommendations fully satisfied OFHEO's standards for "best practices."

Examination of Corporate Governance

OFHEO conducted corporate governance examinations of Fannie Mae and Freddie Mac that concluded in March 1995. The objective of each was to assess the strength of corporate governance (i.e., to determine the capacity of the Boards and executive management to manage risk, to make sound business decisions, and to assure continuity of operations). Corporate governance specifically entails the review of oversight, planning, policies and procedures, management reporting, and audit and risk assessment. The examinations were also designed to enhance OFHEO's institutional knowledge of the Enterprises and to establish priorities for future examinations.

Results and Conclusions

Examinations of Fannie Mae and Freddie Mac concluded that corporate governance at the Enterprises is sound.

Fannie Mae

In this first, broad-based examination of Fannie Mae, OFHEO gained insight into the evolution of management and corporate practices used in governing operations. Discussions and document reviews revealed that, in a general sense, the mid- and late 1980s focused on building technical competencies of a new management team following several years of net losses in the early 1980s. During this rebuilding period, new senior management was recruited with emphasis on technical knowledge and the ability to return Fannie Mae to profitability. The early 1990s have been a period of establishing breadth and depth of management capability at the highest level.

Fannie Mae focuses on fulfilling its public mission through six clearly defined corporate goals while simultaneously strengthening the management of risk. Corporate activity is organized along three primary business lines: Financial Guarantee, Portfolio Management, and Financial Information Services. The business lines are further divided into business segments.

The corporate culture reflects a highly organized and performance-driven institution, with emphasis on risk control, communication, and accountability. The performance of the corporation is a critical element in determining compensation of executive managers.

Overall, OFHEO's examiners found and concluded that corporate governance at Fannie Mae is sound. The Board and executive management have established an organizational framework and corporate structure sufficient to manage risk, to make sound business decisions, and to reasonably assure continuity of operations. Oversight by the Board and management helps the Enterprise pursue its goals and objectives while creating an environment for prudent risk management. Planning, monitoring, and communicating frequently enable senior management to make timely and informed decisions. Finally, the policy and procedural framework, in concert with reporting and auditing, helps support a goal-oriented corporate culture.

No safety and soundness concerns were identified during this examination. Nonetheless, OFHEO recommended that the Board review and strengthen the existing policy framework.

Freddie Mac

The passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 changed the corporate governance structure of Freddie Mac. Since 1989, Freddie Mac has been working to re-engineer its management structure to increase its role as a customer-focused business. Freddie Mac changed its organizational structure during 1993 from the traditional hierarchical structure to one that focuses on five business areas (Sellers, Servicers, Dealer Services, Multifamily, and Portfolio), and seven support divisions (Risk Management, Finance, Information Systems and Services, Legal, Corporate Relations, Human Resources, and Internal Audit).

Freddie Mac's Board and executive management have fostered the development of a control-oriented corporate culture with a documented philosophy that is predominantly concerned with minimizing risk. This is characterized by several factors: high priority status for internal audit and control systems, maintenance of comprehensive policies and procedures, implementation of a highly-structured management reporting and formalized communications process, design of an evaluation system based on well-defined performance objectives, and the Enterprise's record of meeting its strategic and operational plan objectives.

While no safety and soundness concerns were identified during this examination, OFHEO recommended that the Board and executive management complete the management succession plan. To assure continuity of operations, it is important that Freddie Mac identify and train a core group of individuals to succeed to senior levels of management should vacancies arise.

DERIVATIVE SECURITIES ACTIVITIES OF FANNIE MAE AND FREDDIE MAC: DISCLOSURE AND INVESTOR SUITABILITY

VIEWS AND CONCERNS OF THE OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

May 1, 1995

In late December 1994, the Office of Federal Housing Enterprise Oversight (OFHEO) requested that Fannie Mae and Freddie Mac (the Enterprises) report on their approaches to disclosure and investor suitability in connection with their issuance of derivative securities (structured notes and Real Estate Mortgage Investment Conduits or REMICs). OFHEO's particular interest covers the risk that widely reported investor losses on some of these securities, and the accompanying adverse publicity, pose to the reputations of the Enterprises, and possible detrimental effects on the market for all government-sponsored enterprise securities. Congress has charged OFHEO with ensuring the financial safety and soundness of the Enterprises, and OFHEO's concerns arise from this responsibility.

Based on a review of these reports, supplementary materials and supporting research, OFHEO has (1) developed its own perspective on the market risk of derivative securities; (2) identified issues relating to available information about and investment analysis of these securities; and (3) developed suggestions for improving the derivative securities market generally and the structured notes market specifically.

Derivative Securities Market Risk

Overall, the development of derivative securities appears to have improved the efficiency of U.S. capital markets. Mortgage derivative structures, which allocate different portions of the interest rate risk of an underlying mortgage pool to different classes of securities (and investors), have greatly broadened the mortgage-backed securities market. Structured notes, some with complex risk characteristics, have permitted the Enterprises to reduce their funding costs while satisfying specific investment needs generated in the marketplace.

The risks of derivative securities are not unique. All fixed income securities are subject to interest rate risk, the principal risk associated with derivative securities. In fact, many mortgage derivative securities and structured notes entail far less interest rate risk than a 30-year Treasury bond. Furthermore, the risk characteristics of an individual security have no necessary relationship to the risk profile of an investor's portfolio. In many cases highly volatile securities may function to reduce significantly the overall risk of a portfolio.

Derivative securities as a whole are not inherently risky. The highly publicized losses involving derivative securities that have occurred since the birth of OFHEO (almost two years ago) have often resulted from speculative investment strategies or investors' lack of understanding of the risks of their investments. The latter principally seems to reflect insufficient expertise or analytical tools on the part of investors and, in some cases, inadequate dealer judgments about investor suitability, rather than a lack of adequate disclosure on the part of securities issuers.

Information and Investment Analysis Issues

The public debate over derivatives and structured notes has obscured many distinctions relating to the information and the analytic tools necessary for an investor to make an informed purchase. For fixed income securities generally, information available and analyses possible differ between the primary and secondary markets; in both the primary and secondary markets, information available and analyses possible differ between mortgage derivatives and structured notes.

Both REMICs and structured notes are designed and marketed before the disclosure document is even prepared. Thus, while the public debate has focused on the adequacy of disclosure, investors make their purchase decisions without benefit of all the caveats and analyses that might be included in a formal disclosure document. They base their purchase decisions on faxed "term sheets" describing the salient features of an offering, and other information conveyed over the telephone by dealers.

Legally, salespeople are permitted to provide no information that is not included in the disclosure document; investors who, upon reading the document (it must be delivered prior to settlement of the sale), feel they were misled may cancel their orders.

Some debate has centered on differences between disclosure for mortgage derivatives and structured notes. Many disclosure documents for structured notes do not contain the sensitivity and scenario analyses that issuers almost always include for mortgage derivatives. Such analyses are particularly important for mortgage derivatives because the performance of these instruments is a function of the complex interaction of interest rates and mortgage prepayments. On the other hand, the performance of structured notes is usually a function of market rates only, and generally can be evaluated more easily by an investor.

Disclosure documents provide information current when securities are issued; with the passage of time the value of such documents declines and their potential to mislead increases. Issuers have no responsibility to publish subsequent disclosure documents for securities as their interest rate sensitivities change over time. Investors considering the purchase of securities in the secondary market, therefore, generally rely on data available through information sources, such as Bloomberg or Dow Jones, together with analytical tools they purchase, develop internally, subscribe to, or access through market information sources.

The mortgage derivatives market is over ten years old; the structured note market is relatively new. Mortgage derivatives are heavily traded, and the information sources and analytical tools necessary to support the secondary market are well developed. Structured notes, on the other hand, were originally intended to be placed permanently with investors, and issuers and information sources have not yet fully responded to the needs of the secondary market. In particular, the analytical tools that information sources provide for mortgage derivatives are not available for structured notes. While investors can analyze most structured notes using popular spreadsheet software, the tools comparable to those available for mortgage derivatives would be helpful for more complex structured note issues.

Suggestions

Both Enterprises report substantial efforts to disclose the risk of their securities, and to ensure the delivery of that disclosure to initial investors by securities dealers, consistent with SEC requirements for corporate issuers. Within the present regulatory framework for our capital markets, issuers have very little ability directly to discourage inappropriate investments. Since issuers are unfamiliar with investor portfolios and risk profiles, they are in no position to assess the suitability of derivative or other securities for investor portfolios.

The Securities and Exchange Commission (SEC), the National Association of Securities Dealers (NASD) and the bank regulatory agencies have authority over dealer sales practices. We support the prompt adoption by the NASD and bank regulatory agencies of suitability and sales practice rules for the government securities market, as provided for in the 1993 amendments to the Government Securities Act of 1986. In view of the shortcomings reflected by widely reported losses, we also believe the oversight of the investment policies of some mutual funds and state and local government entities could be improved.

One area where new regulation or self-regulation might be helpful is the certification of the competence of managers of investment portfolios. A certifying authority might examine managers and, through varying levels of certification, qualify their abilities to evaluate securities of varying complexity. Such a certification program would provide both the owners of invested funds and dealers selling securities with greater confidence about the competence of portfolio managers.

In addition we have identified the following steps consistent with evolving industry practice that may reduce (not eliminate) the risk of inappropriate sales of structured notes, increase available information about outstanding issues, and increase secondary market liquidity.

- Disclosure documents could include explicit statements that securities are inappropriate investments for investors with insufficient knowledge and experience. (Freddie Mac currently includes language to this effect in its debt offering materials. Fannie Mae includes similar language in its disclosure for its Global Debt Facility, but not, at present, for its Medium Term Notes, the vehicle for its structured note issues.) Upon implementation of a certification program for investment portfolio managers, disclosure documents could specify a minimum certification level appropriate for a given security.

- For more complex instruments, disclosure documents could include analysis of how securities would have behaved under historic market conditions, or might behave across a range of hypothetical market scenarios. (In some instances Fannie Mae has provided such historical information; Freddie Mac believes it has not issued structures of sufficient complexity to warrant the inclusion of such analysis.)

- Issuers could cooperate with secondary market information sources such as Bloomberg to provide more complete, current and timely information on outstanding issues, and to help such sources develop applications to facilitate analysis and "stress testing" of securities by potential investors.

- To reduce further the likelihood of retail distribution, issuers could independently value proposed transactions, to estimate dealer compensation from swaps linked to structured note issues, since such incremental compensation might be used to augment published sales commissions on the notes, inducing salespeople to offer the securities to retail investors. (Fannie Mae independently values proposed transactions, but focuses on its own business interests, confident that its securities are not marketed to individual investors. Freddie Mac does no such valuation.)

- Issuers could evaluate the feasibility of requiring dealers to post bid prices for outstanding issues (perhaps regardless of original underwriter) and facilitate this requirement by being prepared to buy back securities from dealers or exchange them for more liquid securities (at no loss to the issuer), as does the World Bank. Such evaluations might take into account that: (1) dealers are increasingly making secondary markets in Enterprise structured notes on their own initiative; (2) Freddie Mac reports that it has expressed to inquiring dealers a willingness to buy back structured notes at market levels; and (3) the World Bank's securities exchange program rarely has been used, but it is relatively new.

- Issuers and regulators could encourage the development and broader application of measures of the interest rate risk of individual securities, such as the Federal Financial Institutions Examination Council high risk securities test and Fitch Investors Service' CMO market risk ratings (both of these measures presently apply only to REMICs). Such measures cannot and should not substitute for analysis of securities in a portfolio context, but potentially they do flag, for investors, dealers and regulators, securities that are risky on a stand-alone basis.

OFHEO believes that these steps could improve confidence in the markets for the Enterprises' securities, and have a positive effect on the Enterprises' financial safety and soundness. In light of continuing concern over publicized instances of losses on mortgage derivative and structured note investments, OFHEO will continue to observe developments in these markets and make recommendations as appropriate.

OFHEO's Regulatory Activities

In its third full year of operations, OFHEO conducted a variety of activities to fulfill its congressionally mandated mission. The Office completed examinations of credit and interest rate risk management at Fannie Mae and Freddie Mac, performed quarterly capital classifications of the Enterprises based on minimum capital requirements, and made substantial progress toward development of a stress test that will be used to set risk-based capital requirements. A description of these and other activities, including research and projects to support these functions, is provided in this section.

Examination of Fannie Mae and Freddie Mac

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the Act) requires OFHEO to conduct annual, onsite examinations to ensure that Fannie Mae and Freddie Mac are operating in a safe and sound manner. The Act specifies that "the results and conclusions of the annual examinations" shall be submitted as part of OFHEO's Annual Report to Congress.

The Director also is required to include in the Annual Report to Congress a description of the adequacy of flood insurance procedures established by each Enterprise to meet recently enacted requirements as well as the degree of compliance with those procedures. The description must include the results and conclusions of any examinations determined necessary by the Director to evaluate the compliance of each Enterprise. In this reporting period, OFHEO determined that examinations were not necessary, but did conduct compliance reviews. The results of the flood insurance reviews are discussed later in this section.

Congress gave OFHEO authorities similar to those o other federal regulators of financial institutions – establish a risk-based capital standard, examine the safety and soundness of the Enterprises, and take prompt corrective action when required. The risk-based capital standard will ensure that the Enterprises have appropriate capital reserves, given their exposures to risk. Examinations complement that standard by verifying that the Enterprises have effective risk management and internal controls in place.

The profitability of the Enterprises depends on their ability to assume and manage risk. Principles of sound management should apply to the entire spectrum of risk. Establishment of a management structure that adequately identifies, measures, monitors, and controls risk is essential for safety and soundness. As a safety and soundness regulator, OFHEO's primary examination tasks are to identify, understand, and assess the risk management practices of the Enterprises, and to ensure that any deficiencies in risk management practices are addressed promptly by each Enterprise's board of directors and executive management. OFHEO continues to develop and refine its examination and oversight processes to focus on risk.

Examination Approach

The serious losses experienced by Orange County, Calif.; Barings, the British merchant bank; and Daiwa Bank of Japan reinforce the essential need for an examination approach that focuses on risk management and internal controls. Such an approach includes oversight of risk activities; accountability for risk taking; adequacy of risk measurement; and segregation of transaction, execution, and record keeping functions.

1996 Annual Report to Congress

OFHEO's risk-focused approach enables the Office to assess the safety and soundness of the Enterprises' operations:

- proactively – before a breakdown in risk management results in depletion of capital;
- effectively – by concentrating efforts on risks that present critical exposures to the Enter prises; and
- efficiently – by allocating examination resources to their best advantage while mini mizing regulatory burden.

The successful implementation of this approach requires a full understanding of the current business of the Enterprises, as well as changes in the business environment in which they operate, and an accurate identification of the sources of risk to the Enterprises.

OFHEO has identified six major components of its risk-focused approach to examining Fannie Mae and Freddie Mac. These are: corporate governance, credit risk, interest rate risk, business risk, operations risk, and information technology risk. The Office recognizes the challenges posed by such dynamic and complex risks. OFHEO believes that a risk-focused approach for examinations represents a sound and effective means of assessing not only the risk management practices of the Enterprises, but also their ability to manage prospective risk exposures. OFHEO's examiners reconcile the quality of these risk management processes to the results of operations to verify that processes, systems, and controls operate as intended, within the full range of risk exposures assumed by the Enterprises.

During the 12 months ending in June 1996, OFHEO conducted onsite Risk Management Examinations covering two of the six risk components identified above: credit risk and interest rate risk. The Office also conducted Flood Insurance Compliance Reviews in accordance with the National Flood Insurance Reform Act of 1994. The results of these activities are described below.

Risk Management Examinations

The objective of the examinations was to assess the quality of risk management on a corporate-wide basis, focusing on the Enterprises' exposure to credit and interest rate risk in their operations. Risk management processes and internal controls were evaluated for their ability to identify, measure, monitor, and control credit and interest rate risk associated with new business and the existing balance sheet positions and off-balance-sheet risks.

Credit risk is the risk to earnings or capital rising from a counterparty's failure to perform as agreed under the terms of its contract. Counterparties include single-family borrowers, multifamily borrowers, and institutions. Institutional counterparties include companies that sell mortgages to, and service mortgages for, the Enterprises; mortgage insurers; and non-mortgage investment counterparties. Credit risk management was evaluated in the context of the Enterprises' ability to manage credit risk in loan purchase decisions and to mitigate and adequately reserve for loan losses.

Interest rate risk is the risk to earnings, capital, or the economic value of equity because of adverse movements in interest rates. Interest rate risk is concentrated in the Enterprises' mortgage portfolios. Interest rate risk management was evaluated in the context of asset/liability management. The review of interest rate risk management encompassed the asset, liability, and off-balance-sheet portfolios and the processes employed in the management and oversight of these portfolios.

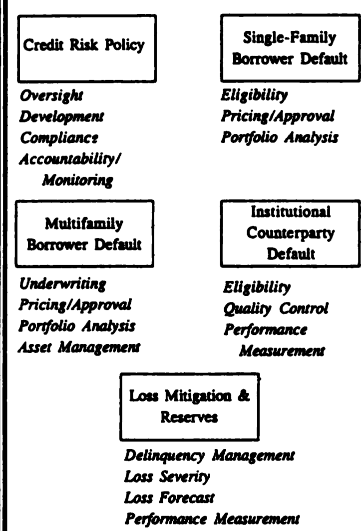
Examiners interviewed Enterprise staff responsible for risk management activities. Documentation analyzed included management reports, as well as board and management committee minutes and report packages. Examiners also reviewed and analyzed the reports and workpapers of internal and external auditors. Findings were confirmed with management.

OFHEO developed conclusions on the quality of risk management processes and internal controls. These conclusions, and comparisons with best practices within related financial industries, formed the basis for OFHEO's recommendations for correcting any deficiencies that were found. Exit conferences that reviewed OFHEO's conclusions and recommendations were conducted with the senior management of each Enterprise, and reports of examination were distributed to all members of the boards of directors. OFHEO's examinations will be discussed with each respective board at its June meeting. OFHEO will follow up to ensure satisfactory response to all recommendations.

Credit Risk Management

The credit risk portion of the examinations focused on the functional areas and associated risk management processes and controls shown in *Figure 24*.

Figure 24
Functional Areas of Credit Risk Management



Credit Risk Policy

The development of credit policy is a critical control technique that ensures consistency between the credit philosophy and vision of the board and senior management, and the actions of personnel responsible for credit decisions. The examinations verified whether the Enterprises fulfilled their oversight obligation by defining, documenting, and communicating their credit goals and objectives. Another important credit policy control element is the establishment of accountability. OFHEO determined whether the Enterprises had granted appropriate levels of authority for developing and approving mortgage credit policies. OFHEO also assessed the Enterprises' processes for monitoring compliance with credit policy.

Single-Family Borrower Default

Minimum eligibility standards for single-family borrowers limit the credit risk assumed by Fannie Mae and Freddie Mac. These standards include maximum loan sizes and guidelines for loan-to-value (LTV) ratios, borrower debt ratios, and mortgage insurance. OFHEO verified that the Enterprises maintain eligibility standards to provide a sound framework for measuring and controlling default risk on mortgage purchases. OFHEO also examined how the Enterprises refined these controls by incorporating credit scores into their risk evaluation processes.

A critical component of credit risk management is the appropriate pricing and approval of assumed risk. OFHEO reviewed the calculation of break-even guarantee fees necessary to cover anticipated mortgage defaults, operating expenses, and the costs of capital. OFHEO verified that the Enterprises maintain control systems to achieve safety and profitability in guarantee fee pricing by comparing actual price performance to estimated break-even benchmark fees.

OFHEO also examined the Enterprises' systems for monitoring credit risk embedded in their portfolios. Portfolio analysis is necessary for early detection of credit risk issues. OFHEO examined the Enterprises' systems to monitor portfolio balances of high-risk products, such as high-LTV loans, loans to self-employed borrowers, and non-owner occupied homes.

Multifamily Borrower Default

The multifamily business is managed as a separate business by each Enterprise, because the risks presented by multifamily loans differ from those of single-family loans. Effective multifamily credit risk management requires the ability to identify property characteristics and servicing activities that will result in high quality investments and collateral, and reduce overall credit risk. Both Enterprises have adopted underwriting and servicing standards that analyze the capacity of the multifamily property to service the associated mortgage debt. OFHEO evaluated both the substance of the Enterprises' underwriting standards, and the processes by which the Enterprises formulate, develop, implement, and amend such standards.

As with single-family default risk, effective multifamily borrower default risk management must ensure that the price paid for multifamily loans or the amount of guarantee fee charged will, in the long-term, be adequate to provide the investor with a desired return. OFHEO examiners analyzed developments, components, and underlying assumptions of the Enterprises' multifamily pricing models.

Multifamily portfolio analysis requires the abilities to collect, analyze, utilize, and report information pertaining to project and asset performance. OFHEO evaluated the Enterprises' abilities to manage multifamily delinquencies and mitigate losses, and to identify, monitor, and respond to potentially troublesome market trends. Effective multifamily portfolio analysis enables the Enterprises to identify and manage loans that are at risk of default and warrant increased risk management attention. In addition, the examiners assessed the Enterprises' internal policies and controls to determine whether such policies and controls ensure that asset management practices are conducted in a uniform manner and that critical asset-related information is collected, shared, and evaluated among the appropriate levels of management.

Institutional Counterparty Default

Eligibility standards and performance measures allow the Enterprises to control the credit risk associated with the institutional counterparties with which they conduct business. OFHEO verified that the Enterprises maintain effective eligibility standards for the counterparties with whom they transact business and monitor the performance of individual counterparty portfolios. For seller/servicers, these standards include both financial strength measures (e.g., minimum net worth) and loan portfolio performance requirements.

OFHEO also reviewed the Enterprises' quality control programs. Quality control programs sample the mortgage loans purchased from sellers and test for compliance with Enterprise standards and contracts. OFHEO verified that the Enterprises have established effective sanctions to deal with seller/servicer non-performance.

Loss Mitigation & Reserves

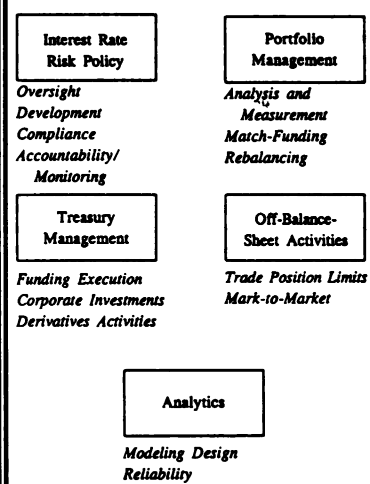
In an effort to minimize controllable losses on delinquent loans in the Enterprises' portfolios, senior management monitors and controls the risks associated with foreclosures and workout alternatives. OFHEO examined how management executes loss mitigation strategies to reduce loss severity and reviewed new programs being implemented to enhance management controls in this area.

Policies and procedures that ensure the adequacy of loss reserves are imperative. The examinations verified that methodologies and responsibilities for estimating future losses were well defined.

Interest Rate Risk Management

The interest rate portion of the examinations focused on the functional areas and associated risk management processes and controls shown in *Figure 25*.

Figure 25
Functional Areas of Interest Rate Risk Management



Interest Rate Risk Policy

Interest rate risk policy establishes the parameters within which management must optimize the risk/return trade-off. Effective interest rate risk policy establishes return objectives and quantifies risk constraints. Centralized, board approved, interest rate risk management policy development is important to obtain a common overall risk/return profile within the Enterprise. The examinations reviewed the nature and extent of board and senior management involvement in the oversight of interest rate risk management at the Enterprises. In particular, OFHEO focused on the framework used to communicate interest rate risk policies and objectives to management. In addition, the frequency, quality, and comprehensiveness of board reports relating to interest rate risk exposure and management were assessed.

Portfolio Management

Interest rate risk management is one of the primary responsibilities of the Portfolio Management departments at both Enterprises. OFHEO reviewed several dimensions of interest rate risk management in these departments. The examinations assessed the processes involved in the identification, analysis, control, and decision-making for mortgage-related asset purchases and the related funding/derivative transactions (i.e., "match-funding" decisions). OFHEO's interest at this level was in understanding how interest rate risk is managed on individual transactions ("tactical" interest rate risk management), including how the Enterprises identify and analyze funding alternatives. In addition to mortgage purchase transactions, the examinations analyzed the REMIC portfolio, the decision process for exercising debt calls, and non-mortgage derivative activities.

The processes involved in the measurement and management of interest rate risk in the Enterprises' mortgage portfolios ("strategic" or "global" interest rate risk management) also were reviewed. The primary risk measures used by each Enterprise, and the limits that are specified to control risk, were evaluated. OFHEO assessed the processes used to "rebalance" interest rate risk exposure as changes or potential changes in interest rates cause the risk position of the mortgage portfolios to shift.

Treasury Management

The Treasury management functions of both Enterprises are oriented to funding individual transactions. OFHEO assessed the processes for the identification and execution of transactions associated with funding the mortgage and non-mortgage investment portfolios. This included an evaluation of the use of derivatives in managing these portfolios. The examinations also evaluated the interest rate risk exposure presented by the Enterprises' non-mortgage investments and related funding.

Off-Balance-Sheet Activities

OFHEO reviewed the strategies, processes, and controls employed in the mortgage securities trading activities of the Enterprises. In addition, customer and dealer repurchase agreement activities, mortgage commitment processes, and risks associated with the securitized mortgage-backed securities (MBS) portfolios were analyzed.

Analytics

The interest rate risk management decision-making processes at the Enterprises are centered around quantified measurement of the risk/return profile. OFHEO reviewed the models employed in the analysis of interest rate risk in the Enterprises' mortgage portfolios. The models used to generate the primary risk measures at both Enterprises were studied in detail. The examinations also assessed the models that generate the supporting assumptions for the interest rate risk models, including term structure models and prepayment models. Also evaluated were the models used in the Enterprises' processes to determine optimal funding mixes at both the transaction and portfolio levels. Finally, OFHEO assessed the nature and quality of the internal control environments of the analytics functions at both Enterprises.

Results of the Risk Management Examinations

Freddie Mac

Freddie Mac's management of both credit risk and interest rate risk is strong. Management has established effective systems and processes for the identification, measurement, control, and monitoring of risk; and no material weaknesses were identified. The Board actively oversees credit and interest rate risk management activities. OFHEO made recommendations to improve controls in certain areas. Such improvements can be made in the normal course of business.

Credit Risk

The credit risk policy framework at Freddie Mac results in a comprehensive and consistent approach to credit risk management. Appropriate policies and controls are in place, and the policy development process provides an effective means of identifying and reacting to critical credit issues.

The risk management practices applied to default exposures on single-family loans provide for appropriate identification, measurement, control, and monitoring of risk. Multifamily risk management systems and processes effectively measure and control default risk. While Freddie Mac has, in general, effectively identified multifamily borrower default risk, OFHEO recommended minor improvements in systems to monitor credit risk in the multifamily portfolio.

Eligibility standards, financial performance monitoring, quality control, and onsite audits effectively control default risk of institutional counterparties. OFHEO recommended improved monitoring and reporting for credit enhancements provided by institutional counterparts. Freddie Mac effectively identifies and monitors non-performing loans, and the loss mitigation program has been improved to reduce the loss severity of loans that default. In addition, the process for establishing loan loss reserves is effective.

Interest Rate Risk

The interest rate risk policy and oversight framework at Freddie Mac results in a comprehensive and consistent approach to interest rate risk management. OFHEO made recommendations to enhance the policy framework and reporting structure. The portfolio and treasury management functions generally are effective. OFHEO made recommendations to strengthen data verification, to improve controls on certain types of transactions, and to expand internal reporting.

Off-balance-sheet activities are well-managed and associated controls are effective. Trading and mortgage securitization activities present minimal interest rate risk. Freddie Mac's analytic models used for interest rate risk management are methodologically sound and provide conservative estimates of interest rate risk. However, OFHEO made recommendations to strengthen the scope and timeliness of some of the models.

Fannie Mae

The quality of credit risk management at Fannie Mae is strong. While the quality of interest rate risk management is generally strong, certain aspects need to be strengthened. Management has established effective systems and processes for the identification, measurement, control, and monitoring of risk; and no material weaknesses were identified. OFHEO concluded that the Board of Directors, however, should require expanded reporting by management, and the Board should be more involved in setting broad policies. OFHEO also made recommendations to improve specific areas of oversight, risk management processes, and internal controls. Such improvements can be made in the normal course of business.

Credit Risk

The credit risk policy framework at Fannie Mae results in a comprehensive and consistent approach to credit risk management. Appropriate policies and controls are in place, and the policy development process provides an effective means of identifying and reacting to critical credit issues.

Management effectively oversees and controls the Enterprise's exposure to the risk of single-family borrower default. Comprehensive policies and systems are in place to identify, measure, and control the risk of default of multifamily borrowers. Management effectively applies these policies and systems in the conduct of multifamily business activities.

Institutional counterparty default risk is effectively controlled through eligibility standards, monitoring of financial condition, quality control procedures, and onsite inspections of counterparties' business operations. Fannie Mae's loss mitigation program has been effective in controlling the severity of credit losses and the process for establishing loan loss reserves also is effective.

Interest Rate Risk

Management has established effective operational policies and procedures for managing interest rate risk. However, the Board should formalize its guidance on the conduct of interest rate risk management, including the scope and frequency of reporting. The Board also should clarify the roles and responsibilities of its committees with respect to interest rate risk.

Senior management effectively manages mortgage portfolio operations. Internal controls, however, should be strengthened by establishing an independent review process for certain key functions in the management of the mortgage portfolio, and by completing the documentation of critical functions and processes. Expanded analysis would strengthen the measurement of portfolio sensitivity to large interest rate movements. Mortgage purchase and funding transactions are well-managed.

The interest rate risk in treasury operations, which includes the management of the non-mortgage investment portfolio, derivatives, and funding executions, is well-managed, resulting in minimal risk to Fannie Mae. The interest rate risk resulting from off-balance-sheet activities, including trading operations and securitized mortgages (MBS), presents minimal interest rate risk exposure. Finally, the analytical models used in the management of interest rate risk are adequate. OFHEO recommended that management fully implement its corporate initiatives to strengthen analytical capability.

Flood Insurance Compliance Reviews

The Flood Disaster Protection Act of 1973 (1973 Act) directs bank, thrift, and credit union regulators to issue regulations prohibiting regulated lending institutions from extending loans to borrowers whose collateral is located in a Special Flood Hazard Area (SFHA) without adequate flood insurance. The 1973 Act also prohibits any form of financial assistance by federal programs, or by federally supervised, regulated, or insured agencies (specifically defined as including Fannie Mae and Freddie Mac) to borrowers with properties located in SFHAs that do not carry adequate flood insurance.

Losses sustained during Hurricane Andrew in 1992 and the serious floods along the Mississippi River in 1993 demonstrated that improved compliance with the 1973 Act was needed. Congress amended flood insurance law to improve compliance. Among other provisions, the National Flood Insurance Reform Act of 1994 (1994 Act) requires the Enterprises to implement procedures that are reasonably designed to ensure that adequate flood insurance is in place over the term of the loan for loans purchased after September 28, 1995 that are collateralized by buildings located in SFHAs. This requirement also applies to properties that are remapped into SFHAs during the term of the loan. The amount of flood insurance required is the lesser of the outstanding principal balance of the loan or the maximum limit of coverage made available under the Act with respect to the particular type of property.

Results of the Flood Insurance Compliance Reviews

In February and March of 1996, OFHEO conducted flood insurance reviews of each Enterprise's compliance with the 1994 Act. The reviews focused on analysis of Enterprise policies and procedures relating to the 1994 Act. OFHEO also reviewed documentation of pertinent processes and reports and assessed each Enterprise's internal audit program for testing controls. Because the procedural requirements of the 1994 Act only became effective in September 1995, the reviews assessed the progress of each Enterprise in meeting these new requirements.

Freddie Mac

OFHEO determined that Freddie Mac has established adequate policies and procedures under the 1994 Act and is complying with them. Freddie Mac's policies and procedures are effective for communicating requirements related to flood insurance. Additionally, internal controls established by Freddie Mac for flood insurance compliance provide the Enterprise with reasonable assurance that appropriate insurance is in place where required.

The 1994 Act states that the Enterprises shall not purchase a loan secured by a property in a SFHA unless that loan has insurance in an amount specified by the National Flood Insurance Plan. In response to our review, Freddie Mac recently has incorporated into its quality control procedures a process to independently verify that sufficient coverage is maintained on loans that require flood insurance. OFHEO will follow up on Freddie Mac's efforts in this area.

Fannie Mae

OFHEO determined that the policy and procedure framework being implemented by Fannie Mae with respect to flood insurance requirements under the 1994 Act is adequate. Fannie Mae's policies and procedures are effective for communicating requirements related to flood insurance. Additionally, internal controls currently being developed by Fannie Mae appear adequate to provide the Enterprise with reasonable assurance that appropriate insurance is in place where required.

Fannie Mae is implementing its flood insurance program by creating mechanisms to test for, and correct, seller/servicer noncompliance. The results of this testing, and of Fannie Mae's follow-up procedures, are not yet available. OFHEO will monitor the implementation of the compliance program and follow up on the results of the Enterprise's efforts in this area.

THE FEDERAL HOUSING ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1992

THURSDAY, MARCH 21, 1996

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HUD OVERSIGHT AND STRUCTURE,
Washington, DC.

The Subcommittee met at 10:07 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Lauch Faircloth (Chairman of the Subcommittee on HUD Oversight and Structure) presiding.

OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Good morning. The Subcommittee will come to order.

Two weeks ago, the Subcommittee held the first of two hearings on oversight of Fannie Mae and Freddie Mac. Our witnesses were essentially regulators for the two companies.

This hearing today will give us a chance to hear first-hand from Fannie Mae and Freddie Mac. I especially want to thank Mr. Raines and Mr. Brendsel for being here with us today. Both of these companies are extremely well represented by these two individuals. I had an opportunity to visit with them yesterday and certainly, they are impressive administrators.

At the last hearing, I noted my concern that the contingent liability of the Federal Government is nearly $7.3 trillion.

These two hearings are about making sure that contingent liabilities remain contingent and don't become actual liabilities.

Under HUD's jurisdiction are the two largest Government-Sponsored Enterprises—Fannie Mae and Freddie Mac. Together, they have outstanding obligations of nearly $1.4 trillion. During this decade, Fannie Mae is likely to become a trillion-dollar company and the first of its kind in the world, I assume. To put their size into perspective, the sums that flow through Fannie Mae and Freddie Mac, on a daily basis, exceed the gross domestic product of Germany.

These two companies are certainly large and they certainly need oversight. I have concerns, however, about the impact of HUD's Affordable Housing Goals. HUD has raised the ante high, very high—I believe even rejecting Fannie Mae's high number of 38 percent.

This Congress has to be concerned about the best interest of the taxpayer and the safety and soundness of the two companies. HUD doesn't necessarily have that concern. So the question has to be asked—if HUD's new rules might adversely affect the financial stability of the two companies with these very high Affordable Housing Goals?

Further, the Subcommittee also has to probe if the capital standards for the two companies are adequate. Some have suggested, like Jim Leach, that it is too low. In the alternative, others have called the "stress test," being developed by OFHEO, simply too extreme and too complicated. And certainly, it has taken almost 2 years to develop and I don't think it's completed yet.

Finally, another option is the complete privatization of the two companies so there's no Government role, no taxpayer exposure.

I look forward to the testimony so that we can look into some of these issues.

With that, let me turn to my Ranking Member, Senator Carol Moseley-Braun, for an opening statement, if she has one.

OPENING STATEMENT OF SENATOR CAROL MOSELEY-BRAUN

Senator MOSELEY-BRAUN. I do. Thank you very much, Mr. Chairman. I will read my opening statement. I was going to put it into the record, but I think it's important to read the entire statement—given the kind of different perspectives that we bring to the issues.

Several weeks ago, we heard testimony from the Department of Housing and Urban Development and the Office of Federal Housing Enterprise Oversight on the safety and soundness of the Federal National Mortgage Association, Fannie Mae, and the Federal Home Loan Mortgage Corporation, Freddie Mac.

We also heard testimony on the new Affordable Housing Goals for these Government-Sponsored Enterprises and how well they are meeting those goals.

What we were talking about at that hearing and what we will be talking about today is no less than the American dream—about the ability of every hard-working American to obtain a mortgage to buy a home.

Today, we have Fannie Mae and Freddie Mac here with us, and they are real success stories. They save Americans thousands of dollars in interest costs over the life of a home mortgage by lowering mortgage interest rates. They play a critically important role in over 60 percent of all mortgages under $207,000. Together, they are responsible for over a trillion dollars in outstanding mortgages.

These institutions are essential to just about every American who wants to buy a home. At the same time, they are enormously profitable themselves. Last year, Fannie Mae made over $2 billion and Freddie Mac earned almost $1 billion in profits.

A major part of the reason they can save American homebuyers money, while earning such enormous sums themselves, is that they enjoy substantial Government benefits. Fannie Mae and Freddie Mac have a $2.25 billion line of credit with the Treasury. They enjoy an implicit Federal guarantee of their activities that allows their securities to trade at rates just slightly above Treasury bond rates. In addition, they are exempt from the securities registration fees charged by the SEC and they are exempt from State and local taxes.

These benefits provide the Federal Government with an obligation to oversee their activities. This oversight is essential to ensure that Fannie Mae and Freddie Mac are not engaging in high-risk activities that could cost the Federal taxpayers enormous amounts of money. But just as importantly, Government oversight is essential to ensure that the enormous public benefits that Congress has provided to Fannie Mae and Freddie Mac are passed along to the American homebuyers—particularly the low- and moderate-income homebuyers.

To provide the necessary safety and soundness oversight on an ongoing basis, in 1992 Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act. That Act created the Office of Federal Housing Enterprise Oversight—OFHEO—a permanent oversight agency.

We heard from OFHEO in our last hearing on the oversight process and on the financial soundness of the GSE's. I look forward to the perspectives today from Fannie Mae's and Freddie Mac's leadership on safety and soundness issues.

In order to protect and enhance the access to affordable mortgages for moderate- and low-income working Americans, the Act also established Affordable Housing Goals for the two mortgage GSE's and empowered HUD to set these goals. Using this authority, HUD has recently issued three Affordable Housing Goals—requiring the GSE's to purchase mortgages: One, from low- and moderate-income borrowers in specified percentages; two, covering housing in underserved areas; and three, covering very-low-income units and low-income units in low-income areas.

Three years of effort went into the creation of the Rule. I am pleased that both Fannie Mae and Freddie Mac have either already met these goals or are in a position to meet them this year. In fact, both Fannie Mae and Freddie Mac met or came close to meeting the 1996 goals, in 1995.

This does raise the issue of whether or not the Affordable Housing Goals are high enough and of whether we could do more to help working families, minority families, inner-city and rural families to realize the dream of homeownership.

I look forward to hearing from Fannie Mae and Freddie Mac on this and the other important issues before us today.

I would like to thank Mr. Leland Brendsel, Chairman and Chief Executive Officer of Freddie Mac, and Mr. Frank Raines, Vice Chairman of Fannie Mae, for appearing at today's hearing. This hearing addresses concerns that are central to the American family: Will they have the opportunity to buy a home? Will they be included in the American dream?

That is why the safety and soundness of Fannie Mae and Freddie Mac and their increasing role in the affordable housing market are so important, and that is why we are here today.

I look forward to the testimony. Thank you very much, Mr. Chairman.

Senator FAIRCLOTH. Thank you, Senator Moseley-Braun.

Since you and I are the only two here today, I assume there is no one else to make a statement. So we will begin by hearing from our witnesses.

Mr. Leland Brendsel is Chairman and CEO of Freddie Mac, and Mr. Franklin Raines is Vice Chairman of Fannie Mae. Let me assure both witnesses that their entire statement will be made part of the record, and Mr. Brendsel, we will hear from you first, if we may.

OPENING STATEMENT OF LELAND C. BRENDSEL CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER FEDERAL HOME LOAN MORTGAGE CORPORATION [FREDDIE MAC]

Mr. BRENDSEL. Good morning. Thank you, Mr. Chairman and Senator Moseley-Braun. It is a pleasure to be here.

As you said, I am Leland Brendsel, Chairman and Chief Executive Officer of Freddie Mac. Let me also say that it's a pleasure to be here this morning with Frank Raines, from Fannie Mae.

I certainly do want to thank you for this opportunity to discuss the vital role that Freddie Mac plays in financing housing for American families, and our firm commitment to make the dream of decent, accessible housing a reality.

I am going to summarize my testimony for the Subcommittee. I have submitted a written statement for the record. I want to leave plenty of time to discuss the important issues that both of you have raised this morning in your opening statements.

Senator FAIRCLOTH. Your entire statement will be put in the record.

Mr. BRENDSEL. Thank you.

Today, Americans do enjoy the best housing finance system in the world. For the first time in our Nation's history, homebuyers can count on a reliable, low-cost source of mortgage credit everywhere and everyday.

Congress succeeded in creating this strong and stable system for one reason—it chartered privately-owned companies, Freddie Mac and Fannie Mae, to achieve a public purpose.

Freddie Mac creates a secondary market primarily by buying mortgages from lenders and packaging the mortgages into securities and selling the securities to investors around the globe. Lenders use the proceeds to make new mortgages and in this way the secondary market constantly replenishes the pool of funds available for lending to homebuyers in local communities across the countries.

While Freddie Mac's efforts in the secondary market may not be seen by most Americans, the tremendous benefits that we provide are felt and realized by homeowners and renters every day.

Freddie Mac and the secondary market make housing more affordable by lowering mortgage rates. A good estimate is that they lower mortgage rates on average by one-half of 1 percent, but in some communities it is much larger than that. While a half of 1 percent doesn't sound like a lot, that means that American homeowners save about $1 billion in mortgage interest payments each year as a result of our efforts.

Freddie Mac provides a reliable supply of mortgage credit in good times and in bad. And despite the extraordinary upheavals in the mortgage industry during the past decade, like the savings and loan crisis in the late 1980's, the credit crunch in the early 1990's, the refi boom in 1993 and 1994, the funds that Americans needed to buy a home were there.

For 25 years, Freddie Mac has made the dream of decent, accessible housing a reality for millions of Americans.

Freddie Mac was chartered in 1970 by Congress, and since that beginning we have purchased more than $1.2 trillion in residential mortgages. This means that we have financed homes for more than 16 million American families since our beginning. Every year, we help Americans at all income levels, in all kinds of communities, in all parts of the country.

In 1995 alone, Freddie Mac purchased over $90 billion in single-family and multifamily mortgages, representing homes for one million American families. And a substantial share of these 1995 mortgage purchases met the Affordable Housing Goals established by HUD. They were good loans. They were sound loans.

Freddie Mac financed housing for 375,000 low- and moderate-income families, 241,000 families living in central cities, and 137,000 very-low-income families.

To help us accomplish our mission, our Congressional Charter provides certain tools, as Senator Moseley-Braun has mentioned. Freddie Mac uses these tools to continuously maintain and improve the Nation's mortgage finance system. A number of Government studies have concluded that American homeowners and renters are the ultimate beneficiaries of this.

Because Freddie Mac is privately owned, we provide these benefits at no cost to the Government. There are no appropriated funds. There are no Federal loans. There are no explicit Government guarantees. And let me emphasize—there are no risk to taxpayers.

Instead, Freddie Mac is one of the country's largest Federal income taxpayers. We have paid more than $2 billion in Federal income taxes over the past 5 years.

In October of 1992, Congress enacted the Federal Housing Enterprise Financial Safety and Soundness Act. And on balance, the Act is good. The Act requires Freddie Mac to meet dynamic, state-of-the-art, risk-based capital standards. It's the kind of stress test that will provide Congress the assurance that we are safe and strong. This is the toughest capital standard in the financial services industry.

The Act also establishes Affordable Housing Goals. Freddie Mac worked with HUD to develop these goals, including better ways to identify underserved areas. We will continue to work with the Department of Housing and Urban Development, Members of this Subcommittee, and others to ensure that these goals provide a meaningful measure of Freddie Mac's performance in meeting this important part of our public purpose.

We have built the best housing finance system in the world, but this is, let me emphasize, still a work in progress.

The path to homeownership is too intimidating, costs too much, and at times is too subjective. Today, some borrowers who are not ready for the financial responsibility of homeownership, get loans which result in the tragedy of foreclosure. And others who are ready and deserve to achieve the American dream are turned away.

Freddie Mac is pushing open the doors to homeownership by reducing costs, breaking down barriers, and reaching out to people in their neighborhoods and communities. We are reducing costs by harnessing technology to make housing more affordable. Automated underwriting offers the promise of reducing the cost of getting a loan, we think, by up to $1,000. These savings can be the key to the door for a first-time homebuyer, stretching to reach the American dream.

We are breaking down barriers to homeownership by improving underwriting decisions. Freddie Mac is working to make underwriting fairer, more consistent, and more accurate.

We need to make sure that Americans are getting all the mortgage credit they deserve. And Freddie Mac is finding new ways to reach out to bring homeownership opportunities to families by working with local communities. A recent example is our new alliance with two national church-based organizations representing 12 million African Americans. Through the churches, we will provide counseling, education, and mortgage-lending services to potential homebuyers.

I think that Freddie Mac is truly a Congressional success story, as is Fannie Mae. We, however, will not rest on our substantial accomplishments. We will continue to make the world's best mortgage finance system even better. And as we enter a new century, we continue to face the challenges to improve every aspect of this system. We want to make the mortgage finance system faster, fairer, and take it farther than it has ever gone before.

With that, I will be happy to answer any questions you may have when the time arises.

Senator FAIRCLOTH. Thank you, Mr. Brendsel.

Mr. Franklin Raines is Vice Chairman of Fannie Mae, and we would be delighted to hear from you at this time.

OPENING STATEMENT OF FRANKLIN D. RAINES VICE CHAIRMAN FEDERAL NATIONAL MORTGAGE ASSOCIATION [FANNIE MAE]

Mr. RAINES. Thank you.

Good morning, Mr. Chairman and Senator Moseley-Braun. My name is Frank Raines and I am Vice Chairman of Fannie Mae.

Thank you for the opportunity of appearing before you today to provide an overview of Fannie Mae's mission and accomplishments since Congress adopted the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.

Fannie Mae is a private company owned entirely by its shareholders. Our 1.1 billion shares of common stock and 7.5 million shares of preferred stock are widely held by individuals, commercial banks, mutual funds, and pension funds. In fact, depository institutions purchased the vast majority of the 7.5 million new shares of preferred stock we issued in March of this year. All of our stock is actively traded on the New York Stock Exchange.

Fannie Mae uses the private-risk capital provided by its shareholders to help low-, moderate-, and middle-income families achieve homeownership. And Fannie Mae's presence in the housing market reduces mortgage rates by as much as one-half percentage point, saving American buyers billions of dollars each year. Today, more than 10 million American families live in homes that Fannie Mae helped finance. That number continues to grow, as the company provides greater homeownership opportunities to families and communities that have not been well served in the past. Last week, we celebrated the second anniversary of the commitment our Chairman and CEO, Jim Johnson, made to provide $1 trillion in targeted housing finance by the year 2000. Our commitment is designed to help low-, moderate-, and middle-income families, minorities, new immigrants, residents of central cities and rural communities, and people with special housing needs. As a result of this effort, we have provided $186 billion over the past 2 years to finance homes for 2.6 million families who are most in need.

Let me review some of the highlights.

In 1995, 12 percent of our single-family business was in rural communities, up from 11 percent in 1994. And we expect our business in rural areas to continue to grow in the years ahead.

In the past 2 years, we have financed homes for 1 million residents of central cities and 500,000 first-time homebuyers.

We have provided $47 billion to finance homes for more than 450,000 minority families.

We exceeded the Affordable Housing Goals Congress set for us in both 1994 and 1995. Last year, more than 46 percent of all the homes we financed were for low- and moderate-income families, and more than 30 percent were located in central cities.

In the past 2 years, we have committed over $255 million of financing and close to $40 million in equity investments to help more than 4,400 families with special housing needs.

We have opened 20 new partnership offices to establish long-term working partnerships with underserved communities around the country, including offices in Charlotte, Chicago, Baltimore, and Boston. We will open five more by September of this year, and we have comprehensive investment plans totalling $40 billion underway in 16 cities.

We have provided over the past 2 years $11.4 billion of the $50 billion in affordable multifamily housing finance we pledged to deliver by the year 2000.

And we have expanded the Fannie Mae Foundation by making a contribution of $350 million in common stock to the Foundation to finance its philanthropic activities in housing and community development. As a result, Foundation giving will grow substantially.

Fannie Mae carries out its important homeownership mission at no cost to the taxpayer. The company receives no Federal appropriations, our debt is not guaranteed by anyone else, and all of our debt instruments are required by law to state plainly that they are not backed by the full faith and credit of the Federal Government. In fact, the company is one of the Nation's largest corporate taxpayers, having paid over $4 billion in Federal income taxes in the past 5 years.

In addition to being one of the Nation's top taxpayers, Fannie Mae is one of the Nation's largest and most effective private corporations. Since 1985, Fannie Mae has been rated by Forbes Magazine as the Nation's most productive financial services company, and is number two on Fortune Magazine's list of the most admired diversified financial institutions. As of the end of 1995, Fannie Mae is the largest corporation in America, measured by assets, and the top supplier of residential mortgage credit in every one of the 50 States. In addition, we are also one of the Nation's most efficient private corporations. Fewer than 3,300 employees manage more than $775 billion in mortgage loans in our portfolio or covered by our guarantee.

As Fannie Mae's strength has grown, the company's management has worked to ensure that the company is effectively capitalized for the risks it faces. Since 1990, the company has more than doubled its capital reserve. And today, Fannie Mae has over $11 billion in equity capital. Our financial safety and soundness regulator, the Office of Federal Housing Enterprise Oversight—or OFHEO—has certified in every quarter since June 1993 that Fannie Mae meets the minimum capital standards set up pursuant to the 1992 Act.

As you noted, Mr. Chairman, OFHEO is currently working on developing a risk-based capital standard that we also must meet. This standard is based on a stress test that measures our performance during extreme interest rate changes and severe nationwide credit losses that last a decade. This approach is consistent with how Fannie Mae has assessed risk for many years.

We believe when OFHEO comes out with a regulation, they should find that Fannie Mae has enough capital on hand to survive this stress test and still have capital remaining. No other type of financial institution is subject to a standard that captures risk better or more dynamically than the risk-based standard mandated in our charter.

Fannie Mae uses a variety of techniques to manage the credit and interest rate risk posed by our mortgage portfolio. These include: The use of underwriting standards that have proven to be very reliable predictors of creditworthiness; a nationally diversified portfolio that insulates us from the risk of regional downturns; risk-sharing on high loan-to-value loans with mortgage insurers; a focus on low-, moderate-, and middle-income markets that typically experience the most stable home prices—the average size of the loans that we own or guarantee is $77,000; a loss mitigation program that works with families to cure delinquencies and avoid foreclosure; and the use of callable [illegible]t, which gives us the flexibility to match our debt to our assets w[illegible]n interest rates rise or fall.

These risk-management techniq[illegible]s, along with our capital reserve, ensure that [illegible]nnie M[illegible] [illegible]ectively capitalized to handle the most severe stress [illegible] [illegible]nnie Mae will never impose a cost on the American [illegible]yer, [illegible]ich is exactly what Congress intended to ensu[illegible] [illegible]ssed t[illegible] 1992 Act.

In fact, one o[illegible] our [illegible] priori[illegible] is to reduce the costs American families face when t[illegible] to buy [illegible]me. One of my major responsibilities at Fannie [illegible]ae [illegible] to [illegible] our new technology development efforts. We [illegible]t to [illegible]gy to save time and money in the m[illegible] appro[illegible]ss. [illegible] mortgage finance system h[illegible] been [illegible] behind t[illegible] curve in the technological revolution, [illegible] is [illegible] changi[illegible]

[illegible] loan [illegible]gination and underwriting technologies [illegible] to [illegible]prove [illegible]orrower's loan application in a matter [illegible] in just a few days. When fully imple[illegible] [illegible]our [illegible]nologies will cut the out-of-pocket costs [illegible] by $1,000. And when applied to all the home mortgages originated each year, these savings amount to $7 to $8 billion per year of a downpayment assistance program, the benefits of which flow directly to homebuyers.

We're using technology to help lenders provide better service to areas of the country who have not had full access to the mortgage finance system in the past. We're helping small lenders succeed in a very competitive marketplace, by giving them the tools they need to provide the same service as large lenders.

Let me tell you about some of our technology products.

Desktop Home Counselor is a sophisticated software tool that provides personal and financial information, including credit and affordability analyses, to potential homebuyers to help them identify the steps that they need to take to purchase a home. Fannie Mae provides Desktop Home Counselor free of charge to nonprofit groups that provide homebuyer education programs.

Desktop Originator offers lenders and originators a set of time-saving tools to help them process mortgage loans. They can use Desktop Originator to access product and pricing information, take applications, conduct comprehensive borrower affordability analyses, lock in mortgage rates, and communicate electronically.

Desktop Underwriter is an automated underwriting system that allows lenders to underwrite loans faster, easier, and more accurately than ever before. Problem-free loans can be routinely processed on-line in a matter of minutes. And as a result, underwriters can spend time working on more difficult applications.

Fannie Maps is a software mapping product that helps our affordable housing partners implement community lending programs and identify untapped markets.

We can use Fannie Maps to access precise income, demographic and housing stock data for every metropolitan area in the country.

And Mr. Chairman, I might also note that beginning next month, we'll be expanding Fannie Maps to include non-metropolitan and rural areas as well. For example, in Raleigh, North Carolina, or Chicago, Illinois, Fannie Maps can target underserved areas at the MSA, Central City, or zip code level. The map on the screen now shows a neighborhood in Raleigh in the 27601 zip code.

We would be delighted to demonstrate any of these applications to the Members of the Subcommittee or the staff after the hearing or during the question period.

I have outlined just a few examples of what Fannie Mae is doing to fulfill the mission Congress gave us to help make the American dream of homeownership come true for working families of modest means.

The 1992 Act drafted by this Subcommittee reaffirmed the importance of our mission and the essential value of our franchise. It recognized that American homebuyers, particularly first-time buyers, are the beneficiaries of the careful balance of obligation, restrictions, and benefits that defines Fannie Mae's unique role in the housing finance system.

What that means is the system Congress designed is working. Fannie Mae, which for nearly 30 years has been a model of successful privatization, is efficiently and effectively delivering substantial benefits to low- and moderate-income homebuyers that Congress intends to help at absolutely no cost to the taxpayer.

Now, some have suggested that it's time to change or restructure Fannie Mae's special role and responsibility in the marketplace. And we're always willing to consider any idea that will improve the housing finance system for families seeking to buy homes. But before we abandon the current system in favor of something new, I believe we must first ask those advocating change the following questions: Does a new system reduce costs for homebuyers the way that Fannie Mae does? Does it do more to help low- and moderate-income families buy homes than Fannie Mae does? Does it eliminate the risk to taxpayers the way Fannie Mae does? And does it produce more tax revenue for the Treasury than Fannie Mae does?

The current system of delivering benefits to millions of low-, moderate-, and middle-income homebuyers, the system that Fannie Mae leads, does all these things and more. Fannie Mae lowers interest rates for homebuyers. It makes housing finance available in all markets, under all economic conditions. It provides billions of dollars each year to finance homeownership and affordable housing for low-, moderate-, and middle-income families. It also invests in technologies to reduce the cost of getting a mortgage for every homebuyer. It is a constant source of innovation and outreach for the entire housing finance industry. It poses no cost or risk to the taxpayer. And adds billions to the Federal Treasury in Federal income tax payments.

We believe this system maximizes homeownership opportunities in the United States, especially for first-time homebuyers and low- and moderate-income families. Fannie Mae is proud to lead this system and to carry out the homeownership mission that Congress has given us.

And I look forward to answering any questions that the Committee might have.

Thank you.

Senator FAIRCLOTH. Thank you, Mr. Raines.

Certainly, it is an enlightening and happy experience to be here this morning and hear of two Government successes, and as great a success that has meant this much to this many people, particularly in view of the many, many failures that we have seen in the Federal Government.

Number one, let me ask something that I'm sure I should know, but I don't. Exactly what does Fannie Mae—how did you arrive at that? Did somebody before you arrive at that as an acronym?

[Laughter.]

Mr. RAINES. Well, Mr. Chairman, we actually prefer the acronym to the official name.

Senator FAIRCLOTH. What is the official name?

Mr. RAINES. Federal National Mortgage Association. We were created in 1938 to be the buyer for what was then the brand new idea of a 30-year self-amortizing mortgage that the FHA was going to be insuring and no one knew if anybody would buy them. The Government did the prudent thing and created a buyer for them.

But the initials, FNMA, on Wall Street got shortened to Fannie Mae. As they talked to each other as they're trading, that then became the name throughout the industry. And again, as I say, it's the preferred name as far as we're concerned.

Senator FAIRCLOTH. I never had really understood, I mean, I knew what it was, but I didn't know how it was arrived at.

Mr. Brendsel, Freddie Mac—what is it?

[Laughter.]

Mr. BRENDSEL. We were chartered, as I mentioned, in 1970 by Congress. By that time, of course, Fannie Mae had been established with that acronym. The founders of the Federal Home Loan Mortgage Corporation felt that since we were chartered really for a similar purpose, although, at that time, to make a secondary market in conventional mortgage, it would be appropriate and desirable to also have an acronym. And so, in the back room of the founders' offices, they came up with the name, or acronym, of Freddie Mac. I am not quite certain how they came up with that, but it was about the time we were chartered.

Senator FAIRCLOTH. Yours was just dreamed up.

Mr. BRENDSEL. Yes.

[Laughter.]

Senator FAIRCLOTH. All right. The first question I have, and it is for both witnesses and I would like for you both to answer. Is there anything on the horizon—economic, housing, or demographic trends—that pose a threat to the viability of your respective companies that Congress needs to be aware of?

I'll start with you, Mr. Brendsel.

Mr. BRENDSEL. No.

Senator FAIRCLOTH. I think this is very important because if there is a problem, we need to know about it early.

Mr. BRENDSEL. Right. No, Mr. Chairman, I do not believe so. We are in the business of buying conventional residential mortgages. Our ability to do this depends on our ability to finance ourselves in the capital markets worldwide and to establish the appropriate policies. But I am comfortable that we are in a sound position to do that and there is nothing on the horizon that I can see that really would threaten in any way our safety and soundness or viability.

Senator FAIRCLOTH. Mr. Raines.

Mr. RAINES. I think Fannie Mae believes that the opportunities for homeownership in the single-family and multifamily businesses are outstanding and going forward. The trends are very good. We're very optimistic that we'll be able to move up the homeownership rate in this country that has declined in the last decade. We believe the conditions for multifamily housing are favorable.

So from an economic standpoint, I think the conditions are good and I don't see anything on the horizon that will pose a danger to the safety and soundness of Fannie Mae. I must say that, from our standpoint, the greatest risk factor that we see has more to do with regulation than it has to do with the environment that we work in.

Senator FAIRCLOTH. What do you mean by regulation?

Mr. RAINES. Over a period of years, we have established a wide range of partnerships with our customers, with community groups, with mayors, with everyone who we work with on housing.

The one thing I think that could disrupt that would be if our regulatory regime were to change into one that was trying to micromanage the companies, trying to tell us which products we could introduce and when we could introduce then, that got too far into allocating credit.

36-340 96 - 7

So that there is a concern with any regulated company that if the regulators cease to focus on the goals and on safety and soundness and attempt to run the company, then that could be a concern. But I would say that, so far, our relationship with our regulators has been very good and they have been very responsive to our concerns about interfering in our ability to perform our mission.

Senator FAIRCLOTH. Thank you.

Mr. Brendsel, HUD increased the Affordable Housing Goal from 30 to 40 percent this year, and to 42 percent in the year after. This is a one-third increase in the goal and Freddie Mac did not meet the goal in 1995. Do you think the steep increase in the goal will impair the safety and soundness of Freddie Mac? Is this increase more than you can do and still assure safety and soundness, which is the primary thing which it's all based on?

Mr. BRENDSEL. I do not believe the increase in the goal will impair the safety and soundness of Freddie Mac, Mr. Chairman.

First, as you mentioned, in 1996, the goal for low- and moderate-purchasers of Freddie Mac is 40 percent. In 1995, our purchases were 39 percent. And so, we obviously came very close. But beyond that, it's also, I think, important to emphasize that the regulation and the legislation passed in 1992 contemplates and provides that all of our purchases of loans should be sound loans and they should be profitable loans for the company.

It's our efforts and our outreach to attempt to expand our reach into the communities to find more good loans that haven't been made in the past that will, hopefully, enable us to reach the goal that HUD has set for us.

I might add, though, that I think in looking at the process for establishing the Affordable Housing Goals, there is some room for improvement in the process. To develop reasonable Affordable Housing Goals, the way they're established now, HUD's approach must be to have a good crystal ball to forecast what the market is going to be like. In some sense, they must have the ability to have a vote at the Fed, since interest rates determine a lot of what gets originated in the market.

So, for example, if housing becomes more affordable because interest rates fall, it is harder to meet the goal because at the same time there is a large volume of refinances that influence the share of low- and moderate-income loans available in the market. But that's dealing more with the process.

It is appropriate and important that Congress really have the ability to measure how well Freddie Mac is performing and meeting its public purpose. We certainly look forward to working with Congress and with the Department of Housing and Urban Development to make certain you have the appropriate ways to do that.

Senator FAIRCLOTH. If HUD has a crystal ball, it is the most unused piece of equipment in Federal Government.

Senator Kerry has joined us. If I may, before we go to Senator Moseley-Braun, let me ask Senator Kerry if he has an opening statement he would like to make.

OPENING STATEMENT OF SENATOR JOHN F. KERRY

Senator KERRY. Well, Mr. Chairman, thank you very much. I'll be very, very brief.

First of all, I apologize for my delay in getting here. I also want to apologize that I will not have a lot of time to spend here today because there are two other hearings going on in Committees on which I serve. It's a little crazy.

Senator FAIRCLOTH. Not an unusual day.

Senator KERRY. Not unusual. I would like to say that I think it's important for us to take a look at the structure that we put into place, the Federal Housing Enterprise Safety and Soundness Act, to determine just how well it's working. I think the judgment of most is that the structure in that Act is working pretty well.

I appreciate the job particularly that Fannie Mae has done in exceeding the Affordable Housing Goals. Fannie Mae has hit 46 percent in 1995, while the goal for 1996 is 40 percent. Obviously, we would like to see Freddie Mac achieve the same performance. Hopefully, we will have the opportunity to quiz Mr. Brendsel today on why Freddie Mac is not performing as well as Fannie Mae.

There is a legitimate question to be asked: How should we measure the overall commitment to low- and moderate-income housing against the profitability of both institutions.

While we all celebrate the successes of the Government-Sponsored Enterprises—and the GSE's have been extraordinarily successful, examples of Government intervention that has enormous positive benefits to the population—the level of GSE's profitability also raises the question whether those goals might not now be increased. We might be able to do more.

Mr. Chairman, I thank you for having this hearing.

Senator FAIRCLOTH. Thank you, Senator Kerry.

Now we will move to Senator Moseley-Braun for questions.

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman.

At the outset, I want to associate myself with Senator Kerry's opening remarks. These institutions have been success stories. I was delighted to meet with Mr. Brendsel yesterday at some length to discuss Freddie Mac's activities, and to learn more about their achievements.

Before I get to the specific questions, I want to explore the whole notion of the GSE's mission because, obviously, in terms of how these agencies function, how their mission is perceived at the outset is of vital importance.

In that regard, I would like to address my friend, Frank Raines. I knew Frank before I came to the Senate. I was really kind of concerned that in a couple of instances in your testimony, you referred to Fannie Mae as a private corporation, and certainly, that is how it is perceived in the market and traded on the stock exchange.

At the same time, Fannie Mae is a private corporation in a partnership with the Government. I think it's important that we not lose sight of this partnership aspect because this is an instance where the Federal Government—which is made into the poster child of everything that's wrong in America by some—has created a very successful partnership with the private sector.

If anything, when listening to the testimony referring to Fannie Mae as a private corporation over and over again, it sounds like the successful businessman who has a wife at home who keeps the home and makes sure that his socks are matched and his suit is pressed. When he goes off to the job, he takes all the credit for being able to perform.

I think that the partner's contributions, and the partner's goals and the reasons for the partner's involvement are very important. In this case, the public partner has provided private-sector benefits by virtue of a Treasury line of credit, tax exemptions, and freedom from filing fees.

I would like for a moment, Mr. Raines and Mr. Brendsel, for you to talk about that aspect of the partnership.

Mr. RAINES. If I could begin, I would be happy to. And I couldn't agree more with you.

Throughout Fannie Mae, we hire people, and any time we talk to our own people internally and externally, we always emphasize that Fannie Mae is a private company with a public purpose.

We were created by Congress. We weren't created by shareholders who decided this was a good idea. Congress created us. And ultimately, the Federal Government made us a private company, as opposed to a Government agency, because Congress believed that we would be more effective with our public purpose, not because Congress was trying to pursue a private purpose.

We are quite proud of that public purpose. It's something that animates our entire company. When we talk about being successful, we talk about being successful in meeting our housing purpose. And that's why we set goals like a trillion-dollar commitment. Not because it's a good advertising slogan, but because it embodies what our real purpose is.

Our purpose is to expand the availability of homeownership to low-, moderate-, and middle-income people. That's what we're about and that's how we measure ourselves internally.

The importance of the private side is that I think this is an instance and again, I believe this is something that Congress can take credit for, is that Congress has chosen a vehicle which it gives the best of all worlds. It uses a mechanism that has all the tools available to a private company to pursue this public purpose. So, having those tools has been instrumental in our success. And indeed, our profitability is an instrumental part of that as well.

Seventy cents of every dollar of profit that we make is poured back into the company to support more mortgages. So that the profits are not something that go off into the ozone somewhere. They are retained in the company and reinvested to enable us to do more in meeting our public purpose.

I totally identify with your characterization. One of the reasons that we always mention our origins is so that people don't forget that. We are not a diversified financial company. We are a private company with a public mission of helping homeownership. And we don't seek any expansion beyond that mission. That's what we're dedicated to and something we're quite proud of.

Mr. BRENDSEL. Senator, let me respond as well.

As I said earlier in my opening remarks, we are a privately-owned company with a public purpose, in our case, established in 1970, chartered by Congress in 1970.

We would not exist were it not for the need to facilitate the availability of residential mortgage money, so that people can buy their homes. I think Congress showed great wisdom in structuring us in this way.

I would also emphasize, in creating two companies really in the same business because it is the competitive forces between the two companies that result in many of these benefits ultimately being realized by homebuyers.

The private structure of Freddie Mac is advantageous in two important ways to the public. First, we have the freedom to operate, the flexibility, the freedom to innovate. We are not dependent on budgetary dollars to do so, as if we were a Government agency. That, on a daily basis, means a lot for the types of innovations we can bring to the market and how we can respond to increases in mortgage demand. Second, the profitability of the company is good. The returns are comparable to the returns of the top-managed financial institutions in the country and I think that's appropriate. We are well managed. We are successful.

But most of that money that we make, in fact, is plowed back into the company and plowed back into the mortgage loans that we purchase. For example, in 1995, we retained over $700 million of the billion dollars in income of the company. That $700 million was leveraged into about $90 billion of mortgage purchases.

Senator MOSELEY-BRAUN. Well, certainly your stock prices do not suggest that anyone has a concern that the Affordable Housing Goals and the required investment in low- and moderate-income housing has in any way impaired the safety and soundness of the investment.

Looking at the numbers, in 1991, Fannie Mae's stock was trading at $34 and Freddie Mac at $49. In 1996, Fannie Mae is $125 and Freddie Mac is at $83, after a split, which is pretty phenomenal. Right? Did you have a split in 1992?

Mr. RAINES. No. After the split, we're not quite—those numbers I think are correct on a presplit basis.

Senator MOSELEY-BRAUN. OK. These numbers are presented on a presplit basis. Well, the performance of the stock is still not too shabby.

Mr. RAINES. Still, it's very good.

Senator MOSELEY-BRAUN. Mr. Chairman the red light is on.

Senator FAIRCLOTH. Is Senator Kerry coming back? He is not? All right.

Senator MOSELEY-BRAUN. May I take my next round now? Is that all right with you?

Senator FAIRCLOTH. It's all right with me. You want to go ahead and do two for one?

Senator MOSELEY-BRAUN. I would. Thank you.

Senator FAIRCLOTH. All right. Go right ahead.

Senator MOSELEY-BRAUN. Your performance has been good on the private side. But, looking at the public side of the Charter, that's where the concerns come in. Again, both agencies reached or exceeded HUD's Affordable Housing Low- and Moderate-Income Goals for 1995. That's the good news. The question is whether or not you have exceeded the private-sector performance with regard to this particular part of the portfolio.

It is my understanding that you do closely mirror what the private sector is doing. Given all the benefits you have on the public side, should you not be leading the way in terms of low- and moderate-income housing and central cities, as opposed to following where the private sector is?

Mr. RAINES. Senator, if I may respond to that.

Fannie Mae, as you know, doesn't originate any mortgages.

Senator MOSELEY-BRAUN. Yes, of course.

Mr. RAINES. So all the mortgages that we acquire have to come from someone.

Senator MOSELEY-BRAUN. Right.

Mr. RAINES. We acquire our mortgages from savings and loans, from mortgage bankers, from a variety of housing finance agencies, and others.

We have been a leader within the industry in expanding the opportunities for low- and moderate-income families to obtain housing. Our products, particularly our community homebuyer product, is the signature product for affordable housing in the country.

Indeed, if you look at the announcements by a number of regulated institutions as to how they're going to meet their CRA requirements, you will see that in fact they are offering our product as their affordable housing product which they intend to sell to us.

We have been a very strong leader in expanding the availability of mortgages to low- and moderate-income families, as well as pushing the envelope in individual communities where we have special rules that are based for that community, that are tied to that community.

In the city of Chicago, we have a housing investment plan that we have announced there that is a specialized program, House Chicago, focused on the particular needs of Chicago, and we have now done that in 20 different communities around the country, to take these broad products and make them even more specific.

And we keep experimenting on the edges of what has been done in the past. We now have a 3 percent downpayment mortgage, known as the Fannie 97. It's the only 97 percent conventional mortgage purchased in the secondary market, that we have launched, or are having success in rolling out.

We have been a leader in affordable housing across the range and have worked with thousands of partners, public and private, providing that leadership, and we would hold our record, whether it's lending in central cities, low moderate, special affordable, minority lending, rural lending, against anyone. We are the largest lender for residential housing in every State.

Senator MOSELEY-BRAUN. Mr. Raines, you are just making it harder for Mr. Brendsel to answer my question.

[Laughter.]

You make it hard because you have a 46 percent rate and he has only a 39 percent rate.

So, I want to ask the question, then, of your colleague/competitor: Mr. Brendsel, it is the same question with regard to the GSE's responsibility to lead the way.

Mr. BRENDSEL. Certainly, Senator Moseley-Braun. And I would agree with you that we should lead and we do lead in many ways.

We lead in the development, I think, of new ways to underwrite mortgages, development of new ways to finance mortgages worldwide in the worldwide capital markets, and ultimately, development of new types of mortgage-purchase programs that will reach people, Americans in communities.

If you want to compare, our low-moderate numbers are 39 percent to their 46 percent. In fact, probably a big part of that is due to our multifamily program, which we have been in the process of redeveloping, redesigning, so that it can be a leader in the mortgage market in providing money for rental housing. And I would like to emphasize that over the course of the last 2 years, our multifamily program has been the fastest growing program in providing money for rental housing in the Nation.

Senator MOSELEY-BRAUN. Thank you.

Now, I would like to ask a question that I raised last time we met with HUD and with OFHEO. The question had to do with automated underwriting and the use of credit scoring, and I raised that with you again yesterday, Mr. Brendsel. I think it would be nice if you would, in your response, share what you shared with me yesterday in terms of your efforts.

To both of you, I want to raise a more general question first, and then a more specific question.

There was an article in the New York Times Magazine last week that said the computer is eating our jobs. I don't know if you saw the article. It talked about the fact that all of the computerization gains, the productivity gains, and technology gains that we have achieved have had a cost associated with them.

My question with regard to automated underwriting has to do with what those costs may be. What do you see those costs as being, both in terms of the loss of flexibility for lending activity—with regard to the potential for exacerbating discrimination—and frankly, I can't think of a better word—but exacerbating discrimination with respect to employment. And finally, with regard to our efforts as a national community in behalf of fair housing.

I saw your presentation on the video screen there, Mr. Raines. Can you pull out HMDA data from your computer systems? If not, why not?

Again, what are the costs associated with automation? You've already told us it's a savings of $1,000 on every mortgage. That's wonderful. But there is no free lunch. What's the cost associated with that? Has there been a downsizing associated with that? Are you tracking whether or not there is a loss of flexibility in lending and an exacerbation of discriminatory tendencies in the market?

Mr. RAINES. Let me give you an answer, both with regard to Fannie Mae itself and our customers.

We have over the past 5 years invested an enormous amount in technology within Fannie Mae. We are very dependent on technology. During that same time, our employment has increased. And we have continued to be the most efficient corporation in America in terms of use of our people and our assets.

What we have done with the technology is provide better service, which then has allowed us to build up our housing impact division, which is solely focused on low- and moderate-income people, while maintaining our efficiency as a company. So, in that case, technology has permitted us to do more within our mission, and we are trying to do the same thing with our lenders.

That's why I emphasized in talking about our technology, we want to use our automated underwriting system to approve loans faster so that the human underwriters can then spend more time working on the harder loans where machines simply can't make those judgments.

So we look at the use of things like credit-scoring and automated underwriting as how do we get to yes? If we can't get to yes with the machine, we then go to a human. Can they get to yes? If they can't get to yes, we have other programs—for example, our Home-path Initiative—which then works with people, well, then, what do they need to do in order to be qualified?

We don't believe in no in the process. We think we have to give one variation of yes to everyone, and we need to provide the support that makes that real. And tools like Desktop Home Counselor, which helps nonprofits work with families to become qualified, are part of that.

We don't believe in having hard and fast cut-offs. We don't use credit scoring and say, at this level alone is good and one point below it, that's a bad loan, because we don't think that you can take the life of a family and put that in one number. And that's why, in our technology, we always have a mix of use of numbers, of looking at offsetting factors, and the technology never turns down a loan. It takes a human being to turn down a loan.

The last one I would mention, when you mentioned HMDA data and Fannie Maps, one of the things—we have nothing to do directly with HMDA and HMDA regulation. However, what we have found with these maps is that many depository institutions are using them now to target their own efforts. And it answers again one of the questions—well, we can't do this because we don't know this or we don't know that.

We have given them a tool now that has helped them be able to target. With Fannie Maps, you can identify where a low-income community is, where a minority community is, what's the overlap between them, and they can then position that against their own marketing efforts, and it's a tool that we give for free to nonprofits and it's very inexpensive, virtually free, for lenders.

So they can do all of those things with that and we are putting out new versions of it all the time as they ask us, can you do this and can you do that, with the technology.

These are tools, in our view, to help us get to yes for more people. The current paper process is a process that I believe is fraught with opportunities for unfairness, unevenness of application, and for discrimination.

Indeed, the Boston Fed study said that minority potential borrowers were not given the same effort and were not given the same access to the flexibilities of the secondary market as non-minority borrowers. But one of the things that our technology—one of the bents of our technology is it doesn't know whether or not an applicant is black or white or Asian or Hispanic. It gives equal opportunities to everyone. And that, we hope, will be a significant benefit from our very large investment.

Mr. BRENDSEL. Thank you, Senator.

Let me focus my remarks, in answering your question, on one particular aspect of the question that I know is of concern to you, and that is the use of mechanistic rules or credit scoring and how that could impact borrowers, although I understand that your question went beyond that in terms of loss of flexibility and other ways, although I would frankly agree with most of what Frank Raines has already said.

If automated underwriting, if credit scoring is done in the wrong way, it will have negative impacts. There will be costs. There are a variety of automated underwriting systems out there developed by lenders, developed by mortgage insurers. Fannie Mae has their own. We have our own. Depending upon how that is developed, depending upon how that is used, it could be used to major benefit to people or it could have costs, net costs to people.

We have done a lot of research and development on automated underwriting systems. I think we have been the leader in this—we started on it back in the late 1980's in some early versions.

We have compared automated underwriting systems and our own system that we have developed to the performance of human underwriters. We have looked at how well it predicts people's ability to repay loans and bring new people into the system. And I am very encouraged by its ability to do that, particularly when combined in conjunction with human underwriters that would look at the more difficult loans that, frankly, a scoring system or an automated underwriting system cannot deal with today.

Let me illustrate the benefits that we have already concluded are possible.

We know that there are a lot of borrowers today that either get rejected flat out or they are forced to turn to another mortgage lender, a sub-prime lender, as we might call it, that offers a B or C quality loan, carrying a much higher rate.

We have looked at many of those loans that have been made by some lenders and concluded that with the appropriate technology, with the appropriate automated underwriting system used to underwrite those loans, that 40 percent, upward of even 50 percent of those loans in fact could have been purchased by Freddie Mac through our automated underwriting system.

Now that is significant, very significant. Particularly when you consider that the average interest rate on those B and C quality loans was probably about 2½ percent higher on the loans than if they had been sold to us. That means that if you're talking about a $75,000 loan, there's a difference in a monthly payment of $135. That makes a lot of difference to people.

And so, I am very encouraged by our ability to bring new people into the system with the appropriate use of technology like we are bringing to the market.

Senator MOSELEY-BRAUN. Mr. Chairman, I would like to ask if it is possible for us to request that these two agencies report back to us regarding the experience the GSE's have had so far with automated underwriting and credit scoring, especially with respect to the issues that we raised this afternoon. Could we do that?

Mr. RAINES. Yes.

Mr. BRENDSEL. Yes, we would be happy to.

Senator FAIRCLOTH. I would be delighted to ask that.

Senator MOSELEY-BRAUN. Thank you very much.

Senator FAIRCLOTH. Thank you.

Mr. Raines, what is the minimum capital for Fannie Mae?

Mr. RAINES. We are required to have for assets on our balance sheet 2.5 percent in equity capital behind every dollar on our balance sheet.

Senator FAIRCLOTH. Do you exceed the standards now?

Mr. RAINES. Yes, we do, substantially.

Senator FAIRCLOTH. Would Fannie Mae have doubled their capital in the last 5 years if it had not been for the law that Congress passed?

Mr. RAINES. I believe we would have doubled our capital. We had been increasing our capital at a very rapid rate. We had internally been managing our capital according to standards that are similar to the ones that were ultimately included in the Act. And so, the actual impact for us has been more an identification that our internal standards were, in fact, the appropriate standards, and the Act, I think, did that.

Senator FAIRCLOTH. Mr. Raines, although it's not certain what it's going to be yet, but you certainly have some good ideas—do you think that Fannie Mae has enough capital now to meet the so-called "stress test" that OFHEO will hopefully be developing soon?

Mr. RAINES. I believe that the stress test, as developed, should turn out in the way that we currently have sufficient capital to meet that test and more.

We run internally our own version of that stress test and have for the last 5 to 7 years. We have been exceeding that throughout a variety of interest rate scenarios over the last couple of years, where rates have gone up and rates have gone down, and the structure of our balance sheet has changed. And through all those scenarios, we have exceeded the kind of stress test that OFHEO was trying to develop.

Senator FAIRCLOTH. Mr. Brendsel, do you think it's something we need to develop, a capital standard for your company? And should the company have the same standard as commercial banks?

Mr. BRENDSEL. I think that a capital standard that relates the capital to the risk of the company is the right type of capital standard, and I think the one that was adopted in the legislation of 1992 was absolutely the right approach to take. It is the most dynamic capital standard. Whenever the risks of the company increase, particularly interest-rate risks or credit risks, it requires automatically that the capital of the company would be increased.

There is no other capital standard for banks or for thrifts that are as dynamic as that for Freddie Mac and Fannie Mae. I am confident that Freddie Mac will meet those capital standards, risk-based capital standards, once they are finally adopted. We currently, of course, meet in addition the minimum capital standards of OFHEO.

Senator FAIRCLOTH. What are the capital standards between Freddie Mac and Fannie Mae now? Are they about the same percentage?

Mr. BRENDSEL. The minimum capital requirements are the same.

Senator FAIRCLOTH. They are the same?

Mr. BRENDSEL. Yes.

Senator FAIRCLOTH. OK. How would the capital requirements or reserves or whatever, for Fannie Mae and Freddie Mac compare with the FDIC bank capital requirements?

Mr. BRENDSEL. It's difficult to make comparisons because they really are very different.

But take the case of the minimum capital standard, for example. We have a requirement of 2½ percent on balance sheet assets and a half percent for off balance sheet assets. There is no comparable kind of capital requirement for banks and thrifts. They have a capital requirement only on the assets that are on the balance sheet.

Senator FAIRCLOTH. So you can't really make——

Mr. BRENDSEL. You can't really make that comparison.

With regard to the risk-based capital requirements, again, ours are far more sophisticated than those that are applied to banks and thrifts, in part because these were developed and applied for two companies and the banking and thrift regulators have to apply them to thousands of institutions so they need more simplistic approaches than what we have.

Just to give you an example, we are required to maintain capital to cover our interest rate risk. And in particular, we are required to have enough capital to withstand a 6 percentage point increase in interest rates. If you finance a portfolio of fixed-rate mortgages with shorter-term liabilities, like liabilities that mature in 1 year, that would require capital of about 30 percent—a very, very tough capital standard.

In addition, for credit risk, we are required to maintain enough capital to withstand a very serious real estate depression nationwide, something comparable to what was experienced just in the Southwest in the 1980's, but occurring nationwide.

A very, very tough standard. And again, there's nothing like that with regard to banking or thrift regulators.

Senator FAIRCLOTH. I'll ask this question of both of you, if I may.

Two weeks ago, Ms. Alvarez testified that derivative exposure of the two companies is roughly $175 billion. Two years ago, derivatives were considered a problem. Is this the case today with your companies?

Mr. RAINES. No, Mr. Chairman. We use what are called derivatives, but really, risk-management tools, in order for us to actually reduce risk in our portfolio.

Sometimes, if you add a lot of big numbers together, you end up with a very large number that does not really reflect the actual economics.

Our use of derivatives has to do with managing interest rate risk of our portfolio. The actual economics is a much smaller number of what would happen, for example, if our counter-parties didn't perform. The number is more like a billion dollar as opposed to the hundreds of billions of dollars.

Senator FAIRCLOTH. Explain that.

Mr. RAINES. Well, if we enter into a transaction, the most typical use of a derivative for us would be if we believe we could get a lower interest cost by issuing a variable-rate debt instrument, swapping that for a fixed-rate stream with a major institution on the other side.

So we are here in fact getting the benefit of fixed rate. They are getting the benefit of variable-rate debt. That is the most common derivative that exists in the marketplace, very common for all financial institutions and for a lot of commercial firms to use.

If you add up all each side of that transaction, you get a very large number. The real risk is, well, what happens if they don't pay me and I have to get somebody else to pay me?

Well, that's a much smaller number, what it would take to go out into the market and replace them.

But we use a variety of tools to reduce our risk. Many of the very public cases where derivatives were found to have caused losses were people who were using derivatives to expand their risk. They were speculating. They were unrelated to the business they were. They thought they knew where interest rates were going. The easiest way to bet is to bet on a leveraged basis. And so they bet on a leveraged basis. When interest rates went the other way, they lost a lot of money.

But there are very few cases that I know of that have been in the public arena where someone was using a derivative in their business to manage risk that caused a large loss.

I think our experience with the use of these securities has been outstanding and it has allowed us to reduce mortgage rates and do that in a very prudent fashion without any of the concerns that have been in the paper.

I might finish with, one of the earliest examinations our regulator did was looking at the use of derivatives by the company. They have had a full look at that and they monitor it on an ongoing basis. We make very extensive disclosures in our financial statements about our use of these risk-management tools. And so we feel very comfortable that we, like every other major financial institution in the world, are able to use these tools to meet our business purposes.

Senator FAIRCLOTH. Mr. Brendsel.

Mr. BRENDSEL. Derivatives can be used in the right way and they can be used in the wrong way.

In our case, we use derivatives to reduce risk of the company as well as to reduce costs. I think derivatives overall give much needed flexibility for us to be able to do this. It means that, as a result of our use of them, that Freddie Mac is more safe and sound. In addition, ultimately mortgage rates are lower in the marketplace.

If derivatives were used to speculate, then, clearly, that would be not an appropriate use of derivatives for a company or any financial institution, for that matter, but we don't do that.

Senator FAIRCLOTH. Again, this is more protecting investors.

Mr. Brendsel, with HUD regulating your purchases of affordable mortgages, what assurance do investors have that the value of mortgage-backed securities at Freddie Mac will maintain high-quality underwriting standards and that the securities investors are buying are still solid paper? After all, you're not subject to SEC registration. So what protection or barometer do the investors have that they are buying good paper?

Mr. BRENDSEL. First, they have the assurances based on a company of 25 years that has been in the business of buying mortgages and pooling them and issuing mortgage-backed securities. Investors have seen over that time the performance of the mortgages backing those mortgage-backed securities.

Second, I would also emphasize that they have the assurance that the laws of the country in this regard, the 1992 legislation requires that the mortgages that we purchase be sound mortgages and be safe for the company.

Third, they have the information that we provide through disclosure about the mortgages that we purchase, about the mortgages that are backing the pools that they issue. We provide extensive disclosures of information, frankly, disclosure of information that exceeds the SEC's own requirements of other securities issuers.

Finally, if all of that fails, they have, of course, the financial soundness of the company, our capital, to back up any securities that we issue.

Senator FAIRCLOTH. Mr. Raines, at Fannie Mae, your Chairman, Jim Johnson, pledged $1 trillion in affordable housing. Rather than HUD deciding numbers and details, which they like to do, why not just have a general housing goal? It could be one-paragraph long. We wouldn't need any HUD regulation. Why not this approach rather than what we have now with HUD passing out numbers?

Mr. RAINES. Well, Mr. Chairman, we very strongly believe that we should set very-high standards for ourselves in performing our housing mission. That's why we undertook the $1 trillion initiative, along with 11 other parts of that initiative that called for transforming the mortgage industry and how it responds to everyone in the country.

We take on that challenge very willingly and it is one that we are quite proud of. We will always set high standards for ourselves, regardless of what any regulatory standards there may be.

In our view, the regulatory standards established by HUD are to give the public assurance that the companies are, no matter what their leadership, going to meet certain minimum standards of performance. And as such, we don't have an objection to such minimum standards of performance being in the public process. But our own internal standards are always going to be high regardless of the Governmentally-determined standard. We will work diligently and will succeed in achieving our $1 trillion initiative. I shudder to think what the initiative will be after we finish the $1 trillion. The next large number is quite substantially above that.

Senator FAIRCLOTH. One more question and I would like each of you to give me an answer on it. And I'll start with Mr. Brendsel. Give me your views on the privatization of Freddie Mac.

Mr. BRENDSEL. I think privatization would be a mistake. It would be a travesty to the Nation's homebuyers. I think we have a system that is the best housing finance system in the world and you certainly don't want to change that system in any way. You only want to make it better. And I think that we are on track to make it even better.

Mr. RAINES. First, Mr. Chairman, I note that we were privatized. Perhaps the Federal Government should have kept a few shares of stock, but it chose to sell them all in 1968. Second, I would say the major question——

Senator FAIRCLOTH. Excuse me, Mr. Raines. What year were you privatized?

Mr. RAINES. In 1968. By 1970, we had bought back all of the Federal Government's stock. But 1968 was the date of the official privatization.

I set forth in my testimony four questions I would ask, and I can summarize those into one question. Which is what's in it for the consumer? That seems to be the unanswered question in all the discussions of privatization. Why is this better for homebuyers?

I have not seen one proposal under the guise of privatization in which homebuyers are better off the day after Fannie Mae was privatized than they were the day before.

I have seen lots of discussions about whether or not other entities might be better off, but I haven't seen anything about what's in it for the consumer.

So if there is a better way of helping the consumer, then we think that ought to be explored. But if it can't pass that threshold question—what's in it for the consumer?—then I think we ought to pause and be very careful about changing a structure that is universally recognized to be working.

Senator FAIRCLOTH. Well, certainly, I could not agree more. If it will not be beneficial to the consumer—that's what they were established for and that's the reason for their being.

Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you.

I just want to congratulate the witnesses, particularly with regard to the last response. I very much appreciate your enunciating the question: How is the public interest best served here?

Obviously, there is a public interest in having these institutions to begin with. But, I have a question that was raised in a response. The question goes to your response, Mr. Raines, to my question about the mapping system and how it helps lenders with their fair housing activities.

How do you verify the requirement that a rejected loan is revisited by a lender? You were saying that you try to get to "yes" and if the credit scoring turns a loan down, then there's a live body, a human person, that actually gets a chance to revisit the situation. How do you verify that?

Mr. RAINES. Our underwriting system is established so that the answers that we give are approved and referred. In our system, when we are unable to approve a loan, we refer it back to that lender and we give them the reasons why it was referred.

For example, if everything is OK, except there's a question about do they have enough money to close, we will tell them everything else is fine. You simply have to assure yourself on this one issue. Then we have a tracking system as to how they have disposed of that loan. And so we can keep track of what was the ultimate disposition with regard to that loan.

Our lenders, we find, are very eager to make these loans. But one of the concerns that they have had is the expense for them to try to sort through, is this a good loan or a bad loan? One of the things that our system does is it reduces that expense sufficiently that they don't have to worry about what they call the fat file problem and the skinny file problem. Everything is a skinny file for them when they use our system. And so, any economic reason for them not to move forward with that loan is removed.

In the end, it is up to the lenders. In the end, the lenders have to obey the law. The lenders have to do what they are supposed to do. But we have done everything that we can to position that loan so it can be approved that is within the information that is been made available to us.

Senator MOSELEY-BRAUN. I want to ask a follow-up question to that, but first I would like Mr. Brendsel to respond to the previous question.

Mr. BRENDSEL. When you compare automated underwriting systems to the current process, I think we have to consider that there are today probably several thousand human underwriters across the country that are making decisions that affect people's lives as to whether or not they should get a loan. Some of them are excellent underwriters. Some of them are very well trained. But others are not.

I personally believe that based on developments so far, that our automated underwriting system will exceed the performance of the human underwriters out there today in making decisions that are more consistent, more fair, give better service to customers, make more loans available, bring new people into the system, and at the same time, frankly, help ensure that those people that are not yet ready for homeownership don't get a loan and are forced to undergo the tragedy of foreclosure.

We also think that an automated underwriting system should be used in conjunction with human underwriters to assure that the appropriate information is considered and any special circumstances that a borrower has are considered. But by using an automated underwriting system, that might be able to qualify three-quarters of the applicants, the human underwriters can focus on the other 25 percent to ensure that the right decision, the appropriate decision, is made.

Senator MOSELEY-BRAUN. I am going to let both of you off the hook with this next question, but I would like it to be part of your report. The question is whether or not, and if so, what tests or what protocols, are used to monitor the possibility of discriminatory outcomes from the group of cases that are referred back to the lenders? I don't think it's appropriate to go into that level of detail here today, but if you could address this issue in your report to the Chairman, I would appreciate the response.

Mr. RAINES. We would be happy to.

Mr. BRENDSEL. Sure.

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman.

Senator FAIRCLOTH. Thank you.

Senator MOSELEY-BRAUN. And here is the real Mr. Chairman. [Laughter.]

Senator FAIRCLOTH. We have been joined by the distinguished Chairman of the Senate Banking Committee, Senator D'Amato.

Would you like to make a statement for us?

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

The CHAIRMAN. Mr. Chairman, let me ask that my full statement be placed in the record as if read in its entirety to save time.

Senator FAIRCLOTH. So ordered.

The CHAIRMAN. Let me commend you and Senator Moseley-Braun for holding these hearings. I think it's important to see how our GSE's are responding, and I do have two questions.

I would like to welcome both Mr. Raines and Mr. Brendsel here. I think, overall, both Fannie Mae and Freddie Mac are moving in the right direction very strongly.

I think there are some major problems in some of the loan portfolio that Freddie is still working on. I want to commend Mr. Brendsel for really attempting to make a difference because it's a very fragile thing that holds some of these multifamily complexes together. And there's no sense going back, but some years ago, I think some rather horrendous loans were made. They just were.

So they have this potential for multi-millions of dollars and you have to work out of them. I think they are beginning to work out and I see a better effort now in many areas.

Hopefully, we have overcome a good part of that and we are in a pretty sound financial position. I would like to hear from both of you on this, but I am interested in whether or not you believe that in terms of Affordable Housing Goals, number one, and it may be inappropriate for me to ask, but do you think they're realistic?

If you want to answer that, you can.

And second, do you believe that you will be able to attain or come close to these goals? Again, they are goals. In the event, how do you deal with economic and market conditions changing?

Mr. Brendsel.

Mr. BRENDSEL. Thank you, Mr. Chairman, and Senator D'Amato.

I think that it is appropriate and proper that Congress have a means to kind of evaluate and measure how well Freddie Mac is doing in meeting the public purpose for which it was chartered.

One dimension of that public purpose is the amount of activity that we have that is directed toward low- and moderate-income families and people in underserved areas.

Congress attempted to provide for that in the 1992 legislation. And I think that in the years since the legislation, there has been work by the Department of Housing and Urban Development to improve the way those goals are established. For example, the old Central City Goal, which was based on a flawed measure of underserved areas, was replaced with a new and better measure.

And in terms of the current goals for low- and moderate-income housing, as well as underserved areas that are in place for 1996, for example, 40 percent of our purchases must be directed toward low- and moderate-income housing, I think that Freddie Mac has a realistic shot and certainly we're committed to try to achieve that. I think we will be able to do it in a safe and sound way.

I am concerned overall that with the process by which these annual goals are set, I do think that there is some room for improvement. The way they are now set, as I commented earlier in the hearing, to develop reasonable and appropriate Affordable Housing Goals, ones that measure appropriately for companies that are attempting to be leaders in the market, that HUD's approach must be to have a good crystal ball, be able to forecast what interest rates in the markets are going to do, and in some sense, they must have a vote at the Federal Reserve to be able to do that.

Well, HUD has neither.

For example, if housing becomes more affordable because interest rates fall, it's going to be harder to meet the 40 percent goal. And I don't think that's what Congress had in mind when they established those goals back in 1992. But we would certainly like to be able to participate in a process for ways to improve how these goals are set.

The CHAIRMAN. So let me ask both you and Mr. Raines, do you now participate with HUD as it relates to setting up these goals? Do they factor in your thinking, your views, market conditions, et cetera? Is there any process by which you are involved in arriving at these goals?

Mr. RAINES. Under the current process, Senator, it's very hard for us to have an ongoing dialogue with them. They construe the law and their own regulations to mean that they can't speak to us any more than they could speak to anyone who came to them.

The CHAIRMAN. OK.

Mr. RAINES. We try very hard to have that dialogue. They have tried very hard within their interpretations of the rules and regulations to have that. But I think that we could have a more open discussion that would be more fruitful if we could just simply sit down and actually compare notes as to what they're thinking about and what our information may be.

In terms of your question about the goals, we at Fannie Mae have made a corporate commitment to meet these goals in each year. We have met each of the goals in every year—the Central City Goal, the Low- and Moderate-Income Goal, and the Special Affordable Housing Goal. We believe we will meet the new goals.

The only concerns I would express with regard to the goals really are two. The first point is to remember that Fannie Mae is chartered to assist the low-, moderate-, and middle-income families in achieving homeownership. I think sometimes we forget about the middle. I think the goal should never be construed in a way that would cause us to do less for middle-income families in our effort to do more for low- and moderate-income families.

The second point I would mention is that although we have met the goals in each year, we hope that the purpose of the goals isn't to raise them to the level that we finally fail. We don't think that's the purpose of the goals. The goals should be to ensure that the company has an adequate focus on these target areas. But it shouldn't be to find that number that will cause the company to fall short.

The CHAIRMAN. Or to become marginal in terms of its attractiveness for people to invest in, and thereby, make it more difficult for you to do your job.

Mr. BRENDSEL. Yes.

The CHAIRMAN. One observation, and I mentioned this to the Chairman and to the Ranking Member. That it might behoove us to attempt to see if we can't bring about better cooperation, and maybe if they need a rules change, so that HUD can get, without them being concerned, greater input from Fannie and Freddie as it relates to the kind of goals that should be set and be attainable, and more realistic than just—I'm not going to suggest that they pull a number out. But I'm saying that the more information, it would seem to me, the more data available, particularly from those people in the field, it would seem that that would be desirable.

And if, as Mr. Raines and Mr. Brendsel, I've heard from some of your people as well, they have this problem where HUD legitimately feels it may not be allowed to speak to them, maybe we could deal with that in a way——

Senator MOSELEY-BRAUN. Well, that is kind of a problem, Mr. Chairman, because, as I understand it, the last set of reforms set up this Berlin Wall.

The CHAIRMAN. This wall, sure.

Senator MOSELEY-BRAUN. And that is part of the difficulty. Frankly, I would agree with you. I think that, if anything, closer collaboration and increased cooperation between HUD and these entities makes more sense in terms of achieving all of the public purpose goals that we have been discussing all day.

How we achieve that in light of where we have been—the past is always prologue in these things. But, I think your point is very well taken.

Senator FAIRCLOTH. Mr. Raines, you had suggested a goal of 38 percent, Fannie Mae had and it was rejected by HUD. Is that not right?

Mr. RAINES. We were all over the place in terms of numbers with them. Probably the biggest disagreement we had with HUD was the changing from the Central City Goal.

Senator FAIRCLOTH. I noticed that you had a suggested goal of 38 percent and HUD rejected it.

Mr. RAINES. I don't remember the entire path of those discussions. But whether it's 38 or 40, our performance would have met either goal in the last 2 years.

More crucial, I believe, was what we thought was a dilution of the focus on central cities. We still maintain that goal, that it's not, as currently structured, is not the best goal.

The CHAIRMAN. I am just going to make an observation.

It seems to me that we ought to attempt to find a way that will permit better dialogue so that you can share these thoughts, those that you have mentioned as it relates to, let's say, central city and other areas, so that, eventually, they are going to make their own determination, but at least they can have a candid and thorough review of what your thinking is prior to their determination.

They are going to have to come down with their determination. I don't know if there's some way in which they are better served, obviously. It doesn't seem to me that there are competing interests, but they will be better served with more information. The more information you can give them, and not just by sending them material, but by being able to sit and to alk professional manner.

I would just suggest maybe to t C n and the Ranking Member that if our staffs, in conju the staffs of Fann and Freddie, might be able to sit en our HUD p all of us together could work t which we reasonable dialogue to make tr f less t can you jump today? And if y we are going to——

In other words, the goal s be at the expense of inner city, if they have your input as to where you're at and what the market conditions look like, then they can say, OK, this is where we—let's go as high as we can.

Senator MOSELEY-BRAUN. And you know, Mr. Chairman, in that vein, when the goals were published in December at 40 percent, the market for GSE's stocks did not fall at all. In fact, the stock prices did better. The GSE's are consistently doing very well in the market. I think, if anything, we ought to look at these goals as a floor and not a ceiling.

The CHAIRMAN. That's not bad.

[Laughter.]

I thank the Chair and I thank the Ranking Member.

Senator FAIRCLOTH. Do you have any more questions?

Senator MOSELEY-BRAUN. No, sir.

The CHAIRMAN. No, Mr. Chairman.

Senator FAIRCLOTH. Well, I want to thank both of you for coming today. Let me say that it will be in order to submit any questions in writing that any Member of the Committee might have.

So, with that, the Subcommittee stands adjourned.

Mr. RAINES. Thank you.

Mr. BRENDSEL. Thank you.

[Whereupon, at 11:47 a.m., the Subcommittee was recessed.]

[Prepared statements submitted for the record follow:]

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Good morning, Chairman Faircloth, Ranking Minority Member Moseley-Braun, Members of the Subcommittee, and distinguished panelists. Chairman Faircloth, I would like to commend you for holding this important oversight hearing today. Congressional oversight of the Department of Housing and Urban Development (HUD) and Government-Sponsored Enterprises is of the utmost importance as Congress assesses legislative proposals to reform or eliminate HUD. With today's tight budget constraints, it is imperative that every dollar allocated for the promotion of affordable housing be stretched to the fullest.

Today's hearing focuses on the implementation and effects of the "Federal Housing Enterprises Financial Safety and Soundness Act of 1992." I welcome Mr. Franklin Raines, Vice Chairman of Fannie Mae and Mr. Leland Brendsel, Chairman and Chief Executive Officer of Freddie Mac and look forward to hearing your testimony today.

This hearing is very timely. As we analyze HUD's future mission and how it should be fulfilled it would be helpful to learn from Fannie Mae and Freddie Mac their views of their respective missions. Specifically: What role do you expect to play within the mortgage finance system in the future? What are your comments on privatization of your companies? What innovations might be utilized to leverage resources to provide *more* housing even though the Federal Government is spending *less?*

I am also interested in testimony on the effects which the "Federal Housing Enterprises Financial Safety and Soundness Act of 1992" and HUD's final rule on Affordable Housing Goals have had on Fannie Mae and Freddie Mac.

In closing, I look forward to the Subcommittee's continued analysis of the future of Government-Sponsored Enterprises. Thank you, Mr. Chairman, for providing this important opportunity today.

PREPARED STATEMENT OF LELAND C. BRENDSEL

CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER
FEDERAL HOME LOAN MORTGAGE CORPORATION [FREDDIE MAC]

MARCH 21, 1996

Good morning, Chairman Faircloth, Senator Moseley-Braun, and Members of the Subcommittee. It is a pleasure to be here. My name is Leland Brendsel and I am Chairman and Chief Executive Officer of the Federal Home Loan Mortgage Corporation, commonly known as Freddie Mac.

I want to thank you for the opportunity to appear before you to discuss Freddie Mac, our vital role in the Nation's mortgage finance system, and our commitment to making the American dream of decent, accessible housing a reality.

Since our beginning in 1970, Freddie Mac has purchased more than $1.2 trillion in residential mortgages. Freddie Mac has financed homes for more than 16 million American families.

Because of the high level of support provided by Freddie Mac and the secondary market, Americans enjoy the world's best housing finance system. In fact, our Nation's mortgage finance system works so well that most Americans take for granted its key benefits: A reliable supply of low-cost mortgage credit in communities across the Nation, every day. The development of America's mortgage finance system, with Freddie Mac as a key participant, is a tremendous—and generally unheralded—public policy and business success. Maintaining this system will ensure that Americans in the future continue to receive its many benefits.

Freddie Mac plays an essential role in creating and maintaining today's housing finance system. At the same time, we place a high priority on continually improving the system and further extending the benefits of the secondary market to underserved borrowers and neighborhoods. Our vision is to tap the vast potential of worldwide capital markets to finance housing in America, to make the cost of housing credit as low as an efficient market can make it, to wring unnecessary costs and barriers from the housing finance system, and to help put people into homes they can afford and keep.

The Best Mortgage Finance System in the World

THE UNITED STATES MORTGAGE FINANCE SYSTEM

The United States has the best mortgage finance system in the world. Every single day Americans are served by a system that works to make their housing dreams a reality.

The mortgage finance system works so well, its infrastructure is virtually invisible to most Americans. This system reflects a highly competitive, intricate network that links together thousands of mortgage lenders, loan servicers, mortgage insurers, and secondary market entities.

A wide range of lenders compete daily to originate mortgage loans in the primary market. Federally-insured banks, savings and loan associations and credit unions and mortgage bankers, finance companies and other financial services companies compete to attract homeowners and homebuyers who want a mortgage loan. Private insurance companies compete with Federal agencies such as the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA) to provide coverage for the risks attendant with certain mortgage loans. Secondary market entities, such as Freddie Mac and Fannie Mae compete against each other as well as against Ginnie Mae, the Federal Home Loan Banks, Federally-insured depository institutions, and other financial service providers to fund mortgage credit.

Fierce competition and changing market conditions work to create a dynamic and fluid system, where the relative roles of the different participants can, and do, change dramatically from period to period.

The type and amount of mortgage loans originated in the primary market can vary widely from year to year. Mortgage originations rise during periods of low interest rates and strong economic conditions, and fall when interest rates climb and the economy is relatively weak. Between 1980 and 1995, total mortgage originations have ranged from $97 billion in 1982 to more than $1 trillion in 1993. During that period, the FHA/VA proportion of mortgage originations has varied from 25 percent in 1983 to 8 percent in 1992. In turn, the size of the conventional mortgage market has fluctuated from $75 billion in 1982 to $895 billion in 1993.

The types of mortgage products originated also vary from year to year. When interest rates rise, the share of adjustable-rate mortgages (ARMs) tend to increase. When interest rates fall, the proportion of fixed-rate mortgage originations starts to rise. Between 1982 and 1995, the percentage of fixed-rate mortgages originated has ranged from a low of 38 percent in 1984 to a high of 80 percent in 1993.

Not only do the amount and type of mortgages change from year to year, but the proportion of mortgages sold by lenders to the secondary market also fluctuates significantly from period to period. Lenders, particularly Federally-insured depository institutions, find ARMs attractive to hold in their portfolios rather than sell into the secondary market. Consequently, in years with large proportions of ARM originations, sales of loans to the secondary market have fallen as low as 21 percent in 1985.

The constantly changing and intensely competitive mortgage market environment in which Freddie Mac operates is reflected in dynamic changes in our market share. For example, in 1990, Freddie Mac's purchases as a share of total conventional single-family mortgage originations were 15 percent; they rose to 25 percent in 1993 as millions of homeowners refinanced their mortgages. Since 1993, Freddie Mac's share of the conventional market has dropped. In the third quarter of 1995, Freddie Mac's share of total fixed-rate originations was 18 percent, while fixed-rate mortgages were 67 percent of the total single-family mortgage originations.

During the past 10 years, Freddie Mac's purchases of new originations as a share of total originations has ranged from 7 percent in 1988 to 22 percent in 1993. Our share of conventional mortgage originations has ranged from 8 percent in 1988 to 25 percent in 1993, during the same period.

While Freddie Mac is only part of the mortgage finance system, we are at the very heart of the mortgage finance system. Freddie Mac continuously pumps a steady and reliable supply of low-cost mortgage credit throughout the system by tapping new supplies of mortgage capital and channeling those funds to mortgage lenders. The secondary market creates this vital link between worldwide capital markets and American homebuyers. Just as stock and bond markets have put investor capital to work for corporations, the secondary mortgage market puts investor capital to work for homebuyers and renters.

THE ROLE OF THE SECONDARY MORTGAGE MARKET

Freddie Mac does not make mortgage loans. Rather, Freddie Mac creates a secondary market by buying mortgages from lenders, packaging the mortgages into securities and selling the securities to investors. Mortgage lenders use the proceeds from selling loans to fund new mortgages, constantly replenishing the nationwide pool of funds available for lending to homebuyers and apartment owners. In this way, the secondary market creates a continuous flow of funds to the primary mortgage market.

While Freddie Mac and the secondary market are nearly invisible to most Americans—homeowners and renters benefit every day.

Freddie Mac and the secondary market lower mortgage rates and make housing more affordable for all borrowers. On average, interest rates on conforming mortgages (i.e., mortgages of a size eligible for purchase by Freddie Mac) are approximately one-quarter to one-half percentage point lower than on loans with amounts that exceed the conforming loan limit. As a result of lower mortgage rates, American homeowners save $6 billion to $8 billion in mortgage interest each year.

Freddie Mac and the secondary market provide a reliable flow of mortgage credit. We serve every market every day, in good times and in bad. Despite extraordinary upheavals in the mortgage and real estate industries during the past decade, Americans enjoyed an uninterrupted flow of mortgage credit.

- During the savings and loan crisis from 1986 through 1989 when the Nation's primary source of mortgage credit was failing, Freddie Mac and Fannie Mae provided $583 billion to meet the credit needs of American homebuyers.
- When commercial banks tightened lending standards in 1990 to 1992 in the wake of commercial real estate losses and the Nation's small businesses experienced a "credit crunch," housing credit was readily available. Freddie Mac and Fannie Mae pumped $849 billion into the primary market to finance housing.
- When interest rates fell in 1993 and 1994, creating record demand for mortgage refinance, Freddie Mac and Fannie Mae provided $794 billion to enable American families to reduce their mortgage rates.

Freddie Mac and the secondary market provide mortgage credit at nearly the same mortgage rates nationwide. When it comes to getting a home loan, Americans are unaffected by local economic conditions or the availability of deposits at their neighborhood bank or thrift. Mortgage funds flow freely all over the country to meet the needs of American homebuyers.

Freddie Mac and the secondary market ensure that there is a wide selection of loan products available—including the widely used low-down-payment, long-term, fixed-rate mortgage that is unavailable to homebuyers in many other parts of the world.

Systemic Problems in the Mortgage Finance System Are a Thing of the Past

Because of Freddie Mac and the secondary mortgage market, systemic weaknesses that historically plagued the mortgage finance system have become a thing of the past.

Before Freddie Mac and the establishment of a secondary mortgage market for conventional loans, depository institutions—primarily savings and loans—were the principal providers of mortgage credit. Local deposits were the main source of funds available for mortgage loans. This system left mortgage borrowers vulnerable to credit shortages resulting from changes in interest rates. For example, when interest rates rose in the late 1960's, depositors withdrew their funds in search of higher yields. As a result, homebuyers became the victims of a shortage of mortgage credit brought about by disintermediation.

A mortgage finance system reliant on local deposits also left homebuyers vulnerable to geographic mismatches between the supply and demand for residential mortgage funds. In the late 1960's, problems developed when the supply of deposits did not match the mortgage demand. In older, more settled regions of the country, there was an excess supply of household savings and low mortgage demand. In fast-growing regions of the country, the demand for mortgage money outstripped the supply as young baby boomers formed households.

Geographical imbalances in supply and demand resulted in substantial regional differences in the cost of mortgage credit. Disparities of more than 100 basis points in mortgage interest rates between older, established markets and newer, rapidly growing markets were not uncommon.

To deal with geographic imbalances and disintermediation, thrifts bought and sold mortgages among themselves. However, the mortgage market was too illiquid to correct the mismatch in mortgage credit supply and demand.

Freddie Mac: A Private Company with a Public Mission

Congress Chartered Freddie Mac 25 years ago to achieve a goal that the mortgage finance system had never been able to accomplish—to provide a reliable low-cost supply of conventional mortgage credit nationwide by creating and maintaining a liquid and stable secondary mortgage market. Today, the smooth functioning of the

Nation's mortgage finance system is abundant proof that Freddie Mac is fulfilling this goal.

Congress succeeded in providing Americans with the best mortgage finance system in the world for one reason: It harnessed the private sector to achieve a public purpose. Freddie Mac is not a housing program. It is a privately-owned, publicly-traded corporation. Freddie Mac is funded by private investors, not the American taxpayers.

As this Committee observed in 1992: "Congress created [Freddie Mac] under private ownership and management to bring the entrepreneurial skills of the private sector to bear on the accomplishments of public purposes relating to housing."[1]

FREDDIE MAC'S CHARTER

Freddie Mac's unique combination of private-sector structure and public-purpose mission is reflected in our Congressional Charter. Through our Charter, Congress not only gave us the tools we need to do our job, but also restricted our activities so that we would focus on our one and only job. To paraphrase Vince Lombardi, providing reliable, low-cost mortgage credit isn't everything—for Freddie Mac, it's the only thing.

Unlike other private companies that are free to engage in any lawful activity, enter and exit markets, Freddie Mac has essentially one permissible line of business—the purchase and sale of investment-quality mortgages and related securities. In addition, all loans that Freddie Mac purchases must either have a loan-to-value ratio of at most 80 percent, or carry private mortgage insurance or some other form of credit enhancement. In addition, Freddie Mac may not purchase mortgages that exceed the current conforming loan limit of $207,000 for one-unit properties.

To enable Freddie Mac to achieve its statutory mission, Congress provided the necessary statutory tools. In order to encourage the development of the secondary mortgage market and increase the supply of mortgage credit by broadening the investor base, Congress authorized depository institutions and the Federal Home Loan Banks to invest in Freddie Mac securities. Congress also permitted securities issued by Freddie Mac to serve as collateral for fiduciary trust and public funds under the control of the United States. At the State level, Congress authorized fiduciaries to purchase investment grade mortgage-backed securities, including Freddie Mac securities, to the same extent as obligations of the United States.

To provide an additional potential supply of liquidity, Congress authorized the Treasury Department—in its sole discretion—to purchase up to $2.25 billion in Freddie Mac securities. The Treasury Department has never used this authority. Although this provision has been described as a line of credit, Freddie Mac has no authority to tap this source of funds.

To facilitate an efficient and liquid secondary mortgage market, Congress authorized the Federal Reserve to act as Freddie Mac's fiscal agent in order to permit our securities to trade through the Federal Reserve Bank's book entry system. To enable us to issue our securities nationwide without unnecessary delay, Congress granted Freddie Mac's securities an exemption from Federal and State registration requirements. However, Congress made certain that the investor protections provided under the antifraud provisions of the Federal securities laws apply.

Congress exempted Freddie Mac from State and local income taxes. However, Freddie Mac is subject to property taxes in every State.

Freddie Mac uses the tools provided by our Congressional Charter to maintain and improve the Nation's mortgage finance system. American homeowners and renters are the ultimate beneficiaries.

THE MEANING OF GOVERNMENT SPONSORSHIP

Collectively, the responsibilities and benefits provided in our Congressional Charter are essential to Freddie Mac's success in helping to create and maintain the world's best mortgage finance system. The Charter not only details the terms of Freddie Mac's unique relationship with the Government, but is also emblematic of the overwhelming public interest in a strong and reliable mortgage finance system to support the American dream of homeownership.

The Nation's commitment to the stability of the mortgage finance system is reflected in the level of confidence that investors place in Freddie Mac securities. Our Charter explicitly states that Freddie Mac's securities are not guaranteed or otherwise backed by the full faith and credit of the United States. Nonetheless, investors have been willing to purchase Freddie Mac's securities at lower rates than comparable securities.

[1] Senate Report No. 282, 102nd Cong., 2nd Sess. at 25 (1992).

Mortgage borrowers—not Freddie Mac—are the principal beneficiaries of this so-called implied Government guarantee. Various studies, including reports by the Congressional Budget Office, the Treasury Department, and the Office of Management and Budget have all concluded that Freddie Mac passes these lower costs on to homebuyers by reducing mortgage rates.

FREDDIE MAC'S PUBLIC MISSION

For 25 years, Freddie Mac has made the dream of decent, accessible housing a reality for millions of Americans. This is what we do and what we do well. It's a commitment that gives our Nation's homebuyers and renters a chance to live their dreams.

However, it is not enough merely to help put Americans into homes. For us to succeed, the people we serve must be able to stay in those homes. The American dream can turn rapidly into an American nightmare for a family saddled with a huge financial obligation they cannot hope to repay.

By lowering mortgage rates through efficiencies and access to capital markets, Freddie Mac and the secondary market make housing more affordable for all borrowers. We've taken a simple yet successful approach to doing business: Building on the strengths of the housing finance system we helped create to extend the benefits of that system to reach the broad diversity of our Nation's homebuyers and renters. As a result, Freddie Mac serves all types of Americans, at all income levels, in all kinds of communities, in all parts of the country.

Building on the strengths of the housing finance system to expand markets—constantly improving it—allows us to reach the entire spectrum of America's borrowers, not just niches here and there. By operating this way, we will continue to make the housing finance system more inclusive with lasting benefits.

Freddie Mac Serves Diverse Communities Nationwide

In 1995 Freddie Mac published *Financing Homes for a Diverse America*, which provides a significant amount of detail about Freddie Mac's service to American households nationwide. This publication demonstrates that Freddie Mac brings the benefits of the secondary market to a wide and diverse range of borrowers and communities throughout the Nation. The report shows that Freddie Mac's general business activities finance housing across all segments of the conventional mortgage market. In fact, Freddie Mac's purchases closely mirror the activities of the primary market in terms of the share of business from central cities, suburbs and rural areas, as well as by the distributions of borrower income and census tract income.

Freddie Mac takes great satisfaction in these accomplishments. At the same time, we are continuously improving our business activities to make homeownership attainable for more families. Furthermore, Freddie Mac has an important role to play in financing multifamily housing needs. Freddie Mac is committed to continuing improvements and innovations so that the benefits of the secondary market can be extended to more families and neighborhoods.

Freddie Mac's 1995 Affordable Housing Goal Performance

The principal means by which Freddie Mac has accomplished—and continues to accomplish—our statutory purposes is through our general business activities. By extending the benefits of an efficient and innovative secondary market to a growing number of Americans, Freddie Mac has benefited families targeted by the housing goals. In 1995 alone, we financed housing for one million American families.

Throughout 1995, Freddie Mac continued to fulfill our mission by providing the Nation with a reliable and low-cost source of mortgage credit and bringing the benefits of the secondary market to a wide and diverse range of Americans. By offering lenders profitable, sound programs we are able to expand the market and create housing opportunities in a way that is sustainable for the long term.

Freddie Mac purchased $91.7 billion in single-family and multifamily mortgages in 1995—more than three times HUD's total annual appropriations. A substantial share of these 1995 mortgage purchases financed housing targeted by the housing goals: Freddie Mac purchased $22.6 billion of mortgages that financed housing for low- and moderate-income families (39.0 percent of all housing units financed); $18.9 billion of mortgages that financed housing in central cities (23.4 percent of all housing units financed); and $5.5 billion of mortgages that financed housing for very-low-income families or low-income families living in low-income areas.

Freddie Mac's multifamily mortgage purchases increased dramatically in 1995. The total funding volume was more than $1.6 billion, up nearly 75 percent over 1994. Of the more than 68,000 multifamily units financed by our mortgage purchases in 1995, nearly 95 percent were affordable to low- and moderate-income families, and more than one-half were located in central cities. Furthermore, more than $1 billion of our purchases met the multifamily portion of the Special Affordable

Housing Goal, financing affordable rental housing for approximately 49,000 very-low- and low-income families.

Multifamily Initiatives

Freddie Mac's multifamily performance in 1995 demonstrated our reemergence as a preeminent provider of financing for rental housing. Last year, we purchased $1.6 billion in multifamily mortgages, nearly two-thirds of which ($1.09 billion) qualified under the multifamily component of the Special Affordable Housing Goal. Freddie Mac's multifamily performance is the story of a commitment made and a commitment fulfilled.

Our performance affirms the strategy we adopted to avoid the mistakes of the past, which proved costly not only to us but to renters and neighborhoods ill-served by imprudent lending. One of the key lessons from that experience was that sound multifamily financing requires well-designed programs that recognize the unique nature of multifamily financing. Freddie Mac now underwrites multifamily loans individually, treating them more like commercial business loans than single-family mortgage loans. We believe that this approach will ensure that multifamily mortgage purchases will play a consistent and long-term role for Freddie Mac in financing rental housing for very-low-, low-, and moderate-income families, and families in underserved areas.

Affordable housing and multifamily are synonymous at Freddie Mac. Nearly all of our multifamily purchases finance rental housing for low- and moderate-income families through programs that maintain high credit and quality standards.

Expanding Markets Initiatives

Freddie Mac is focused on eliminating barriers to homeownership and expanding the reach of mortgage credit to all qualified borrowers. These efforts will enhance Freddie Mac's ability to finance homes for very-low-, low-, and moderate-income borrowers, and borrowers in central cities and other underserved areas. Freddie Mac has adopted a three-pronged approach:

- *Community Development Lending:* Supporting the revitalization of America's neighborhoods by partnering with public, private, philanthropic, and community-based organizations.
- *Affordable Lending:* Expanding the reach of affordable mortgage credit to all potential borrowers by making individual mortgages more attainable.
- *Fair Lending:* Promoting the fair and equal treatment of all potential borrowers in decisions to extend credit in an accessible mortgage system.

In order to be sustainable, an affordable housing business should be profitable for all participants and achieved through broad-based programs. Freddie Mac's strategy, therefore, has been to incorporate affordable housing lending into our standard purchase programs. Additionally, Freddie Mac experiments with pilot programs; provides tools to lenders to better assess credit quality; and identifies and removes inappropriate and artificial barriers to homeownership.

THERE IS NO COST TO THE GOVERNMENT

Because Congress harnessed the private sector to fulfill a public purpose Freddie Mac benefits homebuyers and renters at no cost to the Government. There are no appropriated funds. There are no Federal loans. There are no explicit Government guarantees.

Instead, Freddie Mac is one of the country's largest Federal taxpayers. Freddie Mac has paid more than $2 billion in Federal income taxes over the past 5 years. Freddie Mac also pays the Federal Government for the cost of our safety and soundness regulation. Freddie Mac has paid $12.6 million to the OFHEO since its inception in 1993.

Freddie Mac uses private capital to achieve its public purpose at no cost to the Government. Freddie Mac has approximately $6 billion in private capital. More than 135,000 investors, including mutual funds, pension funds, and other institutional investors representing hundreds of thousands of individual investors own 179 million shares of Freddie Mac common and 34.5 million shares of preferred stock.

Freddie Mac competes with all other private sector companies for investor capital. Investors demand a sufficient rate of return on their capital. And in 1994, Freddie Mac provided a 19 percent return on equity to investors—comparable with the 19.9 percent return on equity reported by the top ten performing commercial banks. However, Freddie Mac competes with all companies—not just banks—for capital. According to *Fortune* magazine, the "top ten" well-managed firms averaged a 27 percent return on equity for their shareholders. The top ten firms, ranked by income, returned more than 24 percent to shareholders.

Providing a sufficient return to our shareholders is the only way to ensure that investors will return their capital to Freddie Mac. Putting private capital to work for investors is the only way Freddie Mac can work for American homebuyers.

The Federal Housing Enterprise Financial Safety and Soundness Act of 1992

In 1991, the Department of the Treasury, the Office of Management and Budget, the Congressional Budget Office, and the General Accounting Office submitted reports to Congress on the financial safety and soundness of Freddie Mac and other secondary market entities. The reports uniformly concluded that Freddie Mac is well managed and operates safely and soundly. However, in light of the critical role that Freddie Mac plays in the mortgage finance system, Congress concluded that legislation to ensure Freddie Mac's continued safety and soundness was appropriate. In October 1992, Congress enacted the "Federal Housing Enterprise Financial Safety and Soundness Act" (the 1992 Act).

STATE-OF-THE-ART CAPITAL STANDARDS

In adopting capital requirement for Freddie Mac, Congress developed capital standards that reflect the unique risks that we undertake. Congress rejected the imposition of capital standards based on bank or thrift capital ratios because Freddie Mac is not a bank or thrift. Banks and thrifts have lines of business that invest in everything from Third World debt to car loans. We have one line of business—investment quality home mortgages. Banks and thrifts do not operate nationwide—so their risks are dramatically greater than ours.

Instead of traditional bank and thrift capital requirements, Congress adopted dynamic state-of-the-art risk-based capital requirements that are custom-tailored to address the risks that we confront in our business.

The 1992 Act requires Freddie Mac to pass a stringent economic stress test. Under this test, Freddie Mac must hold sufficient capital to withstand a 10-year period during which credit losses equal, on a nationwide basis, the worst actual 2-year regional experience. In addition, capital must be sufficient to survive interest-rate fluctuations more volatile than any previously experienced by Freddie Mac in its entire 25-year history. Beyond this, Freddie Mac must hold capital of an additional 30 percent above the stress test level to absorb any possible management and operations risk.

In our view, the stress test in the 1992 Act is tougher than any other Federally-imposed capital requirement. Freddie Mac is confident that we will pass this test.

OFHEO'S ROLE

Congress created the Office of Federal Housing Enterprise Oversight (OFHEO) to carry out the safety and soundness requirements under the 1992 Act. Congress gave OFHEO an important but focused job. Specifically, OFHEO is authorized to examine Freddie Mac to ensure compliance with our capital requirements and to take the prompt corrective action specified in the Act to address capital that is deficient or eroding. Under the Act, as long as Freddie Mac is adequately capitalized, OFHEO has no role to play in Freddie Mac's business affairs.

Congress established OFHEO as an independent safety and soundness regulator. Freddie Mac believes OFHEO's independence is essential and should be retained.

HUD'S ROLE

The 1992 Act also gave HUD certain regulatory responsibilities with respect to Freddie Mac. Generally, we think that the 1992 Act struck an appropriate balance between oversight of Freddie Mac and our need to operate in an extremely competitive environment without unwarranted interference and micromanagement.

HUD's primary responsibility under the 1992 Act is to develop and to monitor Freddie Mac's performance against certain Affordable Housing Goals. Congress established Affordable Housing Goals to provide reasonable benchmarks against which to measure Freddie Mac's activities in serving certain segments of the mortgage market. Accordingly, the 1992 Act requires the Secretary of HUD to establish an annual goal for mortgage purchases relating to three areas: (1) low- and moderate-income housing; (2) central cities, rural areas, and other underserved areas; and (3) special housing needs of low-income families in low-income areas and very-low-income families.

HUD issued final rules establishing and implementing the Affordable Housing Goals effective in January 1996.

In order to establish reasonable goals, HUD must predict, among other things, the future size of the overall conventional mortgage market, the relative share of different segments of the market, as well as future economic conditions. The accuracy of these predictions is critical to setting goals that Freddie Mac can reasonably be expected to meet. Any single year's achievements are grounded in market conditions. Shifts in the mortgage market affect the housing decisions and characteristics of mortgage borrowers reflected in our purchases.

Market conditions affecting the pool of mortgages available for sale to the secondary market may vary from year to year. Interest rates and general economic conditions affect the types of mortgage products being used by the borrower (such as fixed-rate versus adjustable-rate), the level of Federally-insured mortgages originated, the relative number of refinanced mortgages in the market, the size and composition of the housing market, and the propensity of lenders in the primary market and other investors to increase or shrink their mortgage portfolios.

Interest-rate variations, alone, have a profound impact on the mortgage market, both on its size and its composition. Declining interest rates draw in more borrowers, as the relative cost of homeownership (or investment property debt service) declines, making homeownership accessible to families with lower-income levels, and causing existing borrowers to consider refinancing to a lower rate. Rising interest rates have the opposite effect. Higher interest rate levels and larger differences between fixed-rate and adjustable-rate mortgages affect the overall ARM share of the market. The difference in rates can have a major impact on Freddie Mac's performance because ARM's are less likely to be offered for sale in the mortgage market.

The rapidity with which economic conditions can change the character of the mortgage market was evident in 1994. In that year, the economy expanded; the unemployment rate fell; there were high levels of consumer confidence during much of the year and the rate of price inflation remained low. Most importantly, interest rates during the first part of 1994 were at levels lower than they had been for nearly 25 years, making housing more affordable than it had been in years.

However, as increasing economic activity fueled additional business and consumer credit needs, the Board of Governors of the Federal Reserve System ("the Fed") became concerned about a possible acceleration of inflation. The Fed raised interest rates six times during 1994 totaling three-quarters of a percent, resulting in a higher cost of funds for the primary and secondary mortgage markets.

In the single-family market, 30-year fixed-rate mortgage rates rose from an average of 7.17 percent in December 1993 to 9.18 percent 1 year later, and initial rates on 1-year, Treasury-indexed adjustable-rate mortgages increased from 4.23 percent to 6.71 percent over the same period. This dramatic rise in rates quickly ended the unprecedented mortgage refinance boom that fueled the record volumes of single-family originations in 1992 and 1993. While refinances accounted for roughly 60 percent of originations in early 1994, their share fell to only 10 to 15 percent in the last few months of the year. The end of the refinance boom directly resulted in a 25 percent decline in total residential originations in 1994 from the previous year.

Nonetheless, the single-family housing market enjoyed an excellent overall performance as family-income growth, declining unemployment rates, heightened consumer confidence, and an increase in residential real estate returns offset the dampening effect of the mortgage rate increases for most of the year. Housing starts reached their highest level in 6 years. Home sales were up 4 percent and home purchase originations rose over the previous year. The primary mortgage market recorded its third largest annual level of activity in 1994, following the record-setting volume of the previous year.

As 1994 illustrates, realistic predictions of future mortgage market activity and economic conditions are virtually impossible to achieve.

In this regard, the Affordable Housing Goals assume that the favorable economic conditions that have made mortgage lending affordable in the past 2 years will not only continue but improve. This is reflected in the escalation of our Affordable Housing Goals from 30 percent in 1995 to 40 percent in 1996 and increasing to 42 percent in 1997 through 1999. We are very proud of our performance in serving low- and moderate-income homebuyers and renters, but Congress and HUD should recognize that this in large measure reflects low-interest rates and other important economic factors that led to favorable conditions for affordability. As the last couple of weeks in the bond and stock markets have demonstrated, those conditions can change, literally overnight.

Freddie Mac will exert every effort to meet our commitment to Congress and to homebuyers across the country. I believe that our strategies to expand the reach of the mortgage finance system to those who are currently underserved will succeed. Affordable housing goals that seem reasonable when issued can be rendered unrealistic by changes in economic and mortgage market conditions that were unanticipated and unforeseen.

The vulnerability of the goals to changing market conditions is particularly unfortunate in light of the tremendous resources devoted to their development. HUD spent an enormous amount of time and money preparing massive studies of the his-

- In the past 2 years, we have committed over $255 million of financing and close to $40 million in equity investments to help more than 4,400 families with special housing needs.
- We have opened 20 new Partnership Offices to establish long-term working partnerships with underserved communities around the country, including offices in Charlotte, Chicago, Baltimore, and Boston. We will open 5 more by September of this year. We have comprehensive investment plans, totalling $40 billion, underway in 16 cities.
- We have provided, over the past 2 years, $11.4 billion of the $50 billion in affordable multifamily housing finance we pledged to deliver by the year 2000.
- We have expanded the Fannie Mae Foundation by making a contribution of $350 million in common stock to the Foundation to finance its philanthropic activities in housing and community development. As a result, Foundation giving will grow substantially.

Fannie Mae carries out its important homeownership mission at no cost to the taxpayer. The company receives no Federal appropriations, our debt is not guaranteed, and all of our debt instruments are required by law to state plainly that they are not backed by the full faith and credit of the Federal Government. In fact, the company is one of the Nation's largest corporate taxpayers, having paid over $4 billion in Federal income taxes in the past 5 years.

In addition to being one of the Nation's top taxpayers, Fannie Mae is one of the Nation's largest and most effective private corporations. Since 1985, Fannie Mae has been rated by *Forbes* magazine as the Nation's most productive financial services company, and is number two on *Fortune* magazine's list of most admired diversified financial institutions. As of the end of 1995, Fannie Mae is the largest corporation in America, measured by assets, and the top supplier of residential mortgage credit in each of the 50 States. We also are one of the Nation's most efficient private corporations. Fewer than 3,300 employees manage the more than $775 billion in mortgage loans in our portfolio or covered by our guarantee.

As Fannie Mae's financial strength has grown, the company's management has worked to ensure that the company is effectively capitalized for the risks it faces. Since 1990, the company has more than doubled its capital reserve. Today, Fannie Mae has nearly $12 billion in equity capital. Our financial safety and soundness regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), has certified in *every* quarter since June of 1993 that Fannie Mae meets the minimum capital standards set pursuant to the 1992 Housing Act.

OFHEO is currently working on developing a risk-based capital standard that we also must meet. This standard is based on a "stress test" that measures our performance under severe interest rate and nationwide credit stresses that last a decade. This approach is consistent with how Fannie Mae has assessed risk for years. We believe when OFHEO comes out with their regulations, they should find that Fannie Mae has enough capital on hand to survive this stress test, *and still have capital remaining*. No other type of financial institution is subject to a standard that captures risk better or more dynamically than the risk-based standard mandated in our charter.

Fannie Mae uses a variety of techniques to manage the credit and interest rate risks posed by our mortgage portfolio. These include:

- The use of underwriting standards that have proven to be very reliable predictors of creditworthiness.
- A nationally diversified portfolio that insulates us from the risk of regional downturns.
- Risk-sharing on high loan-to-value loans with mortgage insurers.
- A focus on low-, moderate-, and middle-income markets that typically experience the most stable home prices (the average size of the loans we own or guarantee is $77,000).
- A loss mitigation program that works with families to cure delinquencies and avoid foreclosure.
- The use of callable debt, which gives us the flexibility to match our debt to our assets when interest rates rise or fall.

These risk-management techniques, along with our capital reserve, ensure that Fannie Mae is effectively capitalized to handle the most severe stress scenarios. Fannie Mae will never impose a cost on the American taxpayer, which is exactly what Congress intended to ensure when it passed the 1992 Housing Act.

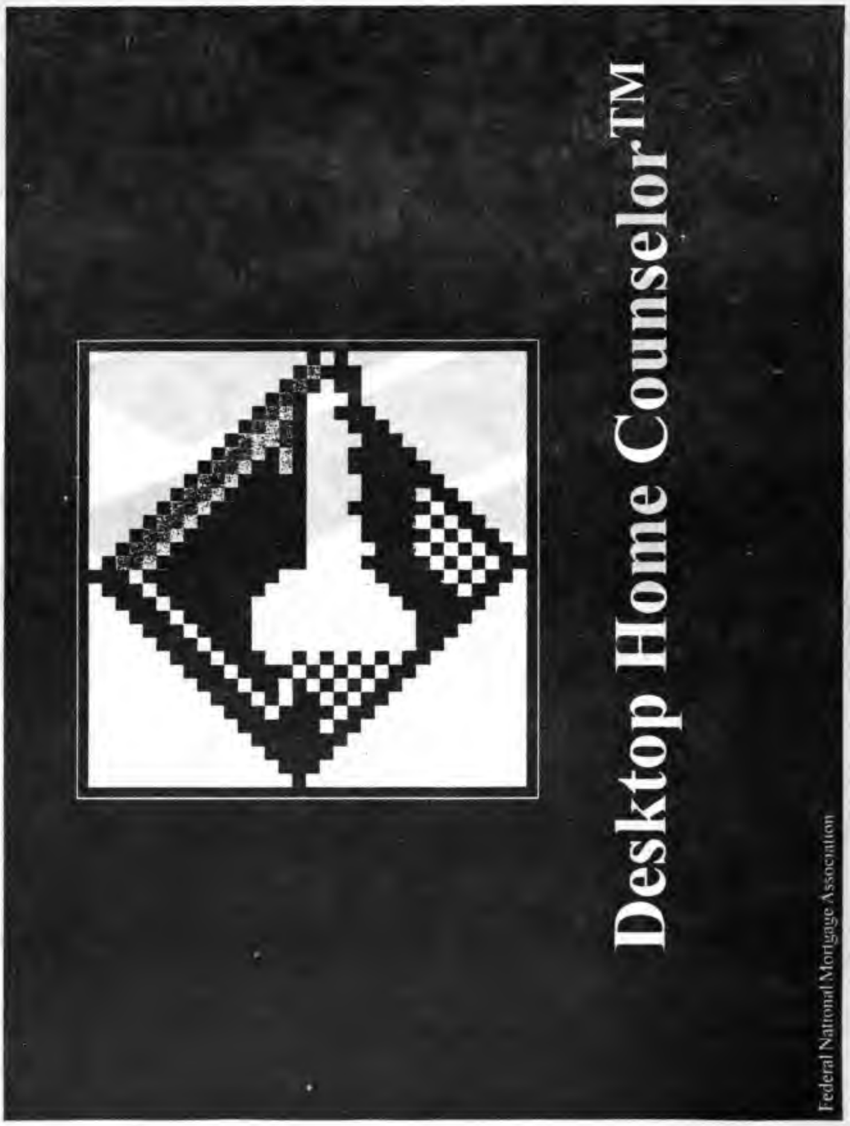
In fact, one of our top priorities is to *reduce* the costs American families face when they go to buy a home. One of my major responsibilities at Fannie Mae is to oversee our new technology development efforts. We want to use technology to save time and money in the mortgage approval process. The mortgage finance system has

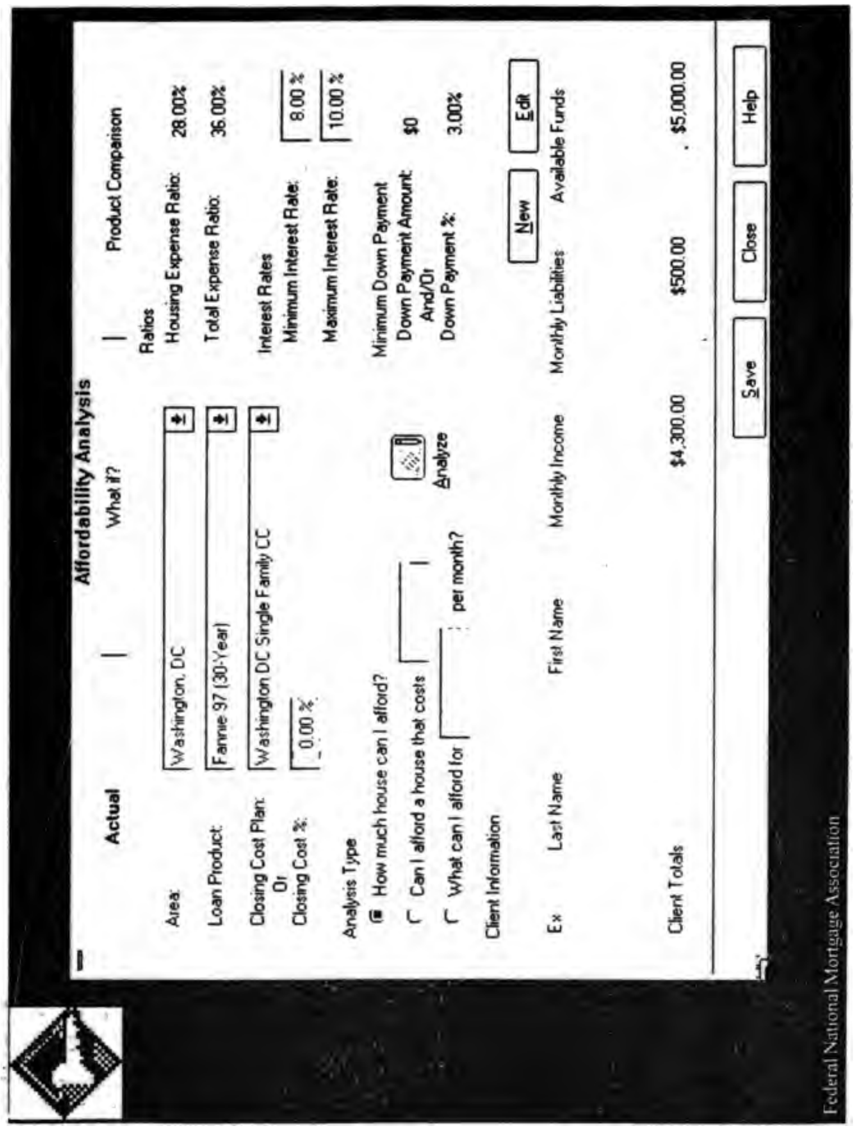
- Is a constant source of innovation and outreach for the entire housing finance industry.
- Poses no cost or risk to the taxpayer.
- Adds billions to the Federal Treasury in Federal income tax payments.

We believe this system *maximizes* homeownership opportunities in the United States, especially for first-time homebuyers and low- and moderate-income families. Fannie Mae is proud to lead this system and to carry out the homeownership mission Congress has given us. I look forward to answering your questions.

Fannie Mae

36-340 96 - 8


Desktop Home Counselor™
Federal National Mortgage Association


Affordability Analysis
Actual
What if?
Product Comparison
Area:
Washington, DC
Loan Product:
Fannie 97 (30-Year)
Closing Cost Plan:
Or
Closing Cost %:
Washington DC Single Family CC
0.00 %
Ratios
Housing Expense Ratio:
28.00%
Total Expense Ratio:
36.00%
Interest Rates
Minimum Interest Rate:
8.00 %
Maximum Interest Rate:
10.00 %
Analysis Type
How much house can I afford?
Can I afford a house that costs
What can I afford for
per month?
Analyze
Minimum Down Payment
Down Payment Amount:
$0
And/Or
Down Payment %:
3.00%
Client Information
New
Edit
Ex
Last Name
First Name
Monthly Income
Monthly Liabilities
Available Funds
Client Totals
$4,300.00
$500.00
$5,000.00
Save
Close
Help
Federal National Mortgage Association


Desktop Originator™
Federal National Mortgage Association

How much house can I afford?

Area:

Washington, DC

Product:

Fannie 97 (30-Year)

Closing Cost Plan:

Washington DC Single Family CC

Amortization Term:

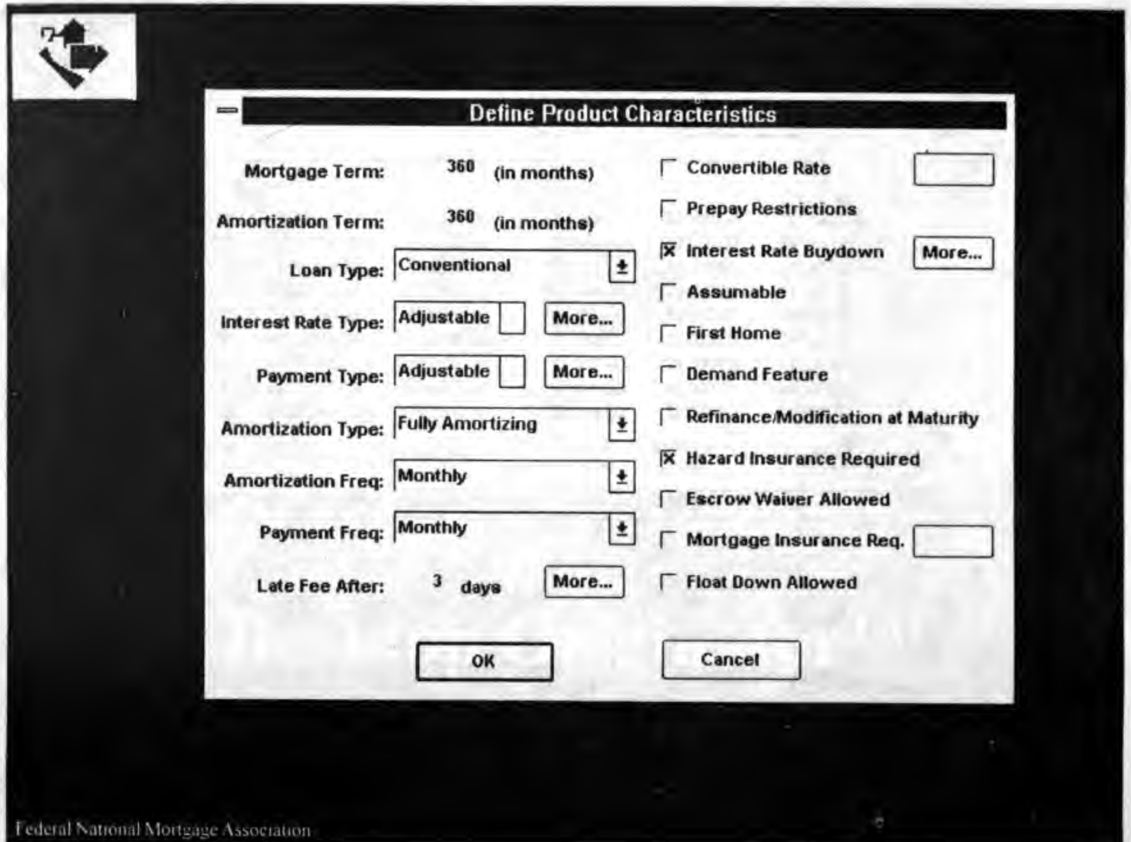
360

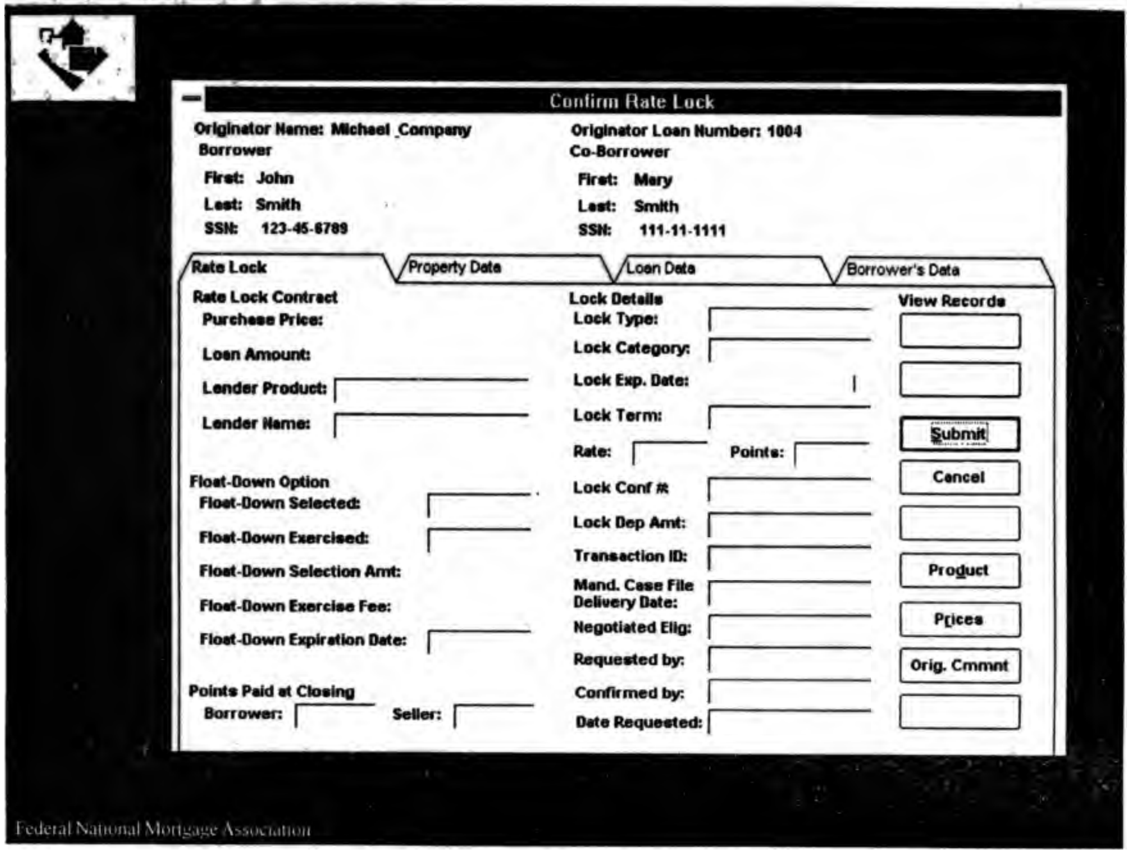
Income, Liabilities, and Available Funds | Income and Liabilities | Income

Interest Rate	Sales Price	Loan Amount	Monthly Payment You Can Afford	Funds Available	Funds Needed	Funds Surplus/ (Shortage)
8.00%	$108,968.00	$105,699.00	$1,048.00	$5,000.00	$4,862.00	$138.00
8.25%	$107,078.00	$103,865.00	$1,048.00	$5,000.00	$4,796.00	$204.00
8.50%	$105,237.00	$102,080.00	$1,048.00	$5,000.00	$4,731.00	$269.00
8.75%	$103,445.00	$100,342.00	$1,048.00	$5,000.00	$4,669.00	$331.00
9.00%	$101,700.00	$98,649.00	$1,048.00	$5,000.00	$4,607.00	$393.00
9.25%	$100,000.00	$97,000.00	$1,048.00	$5,000.00	$4,548.00	$452.00
9.50%	$98,346.00	$95,395.00	$1,048.00	$5,000.00	$4,490.00	$510.00
9.75%	$96,734.00	$93,832.00	$1,048.00	$5,000.00	$4,434.00	$566.00
10.00%	$95,165.00	$92,310.00	$1,048.00	$5,000.00	$4,379.00	$621.00

Print | Close | Help

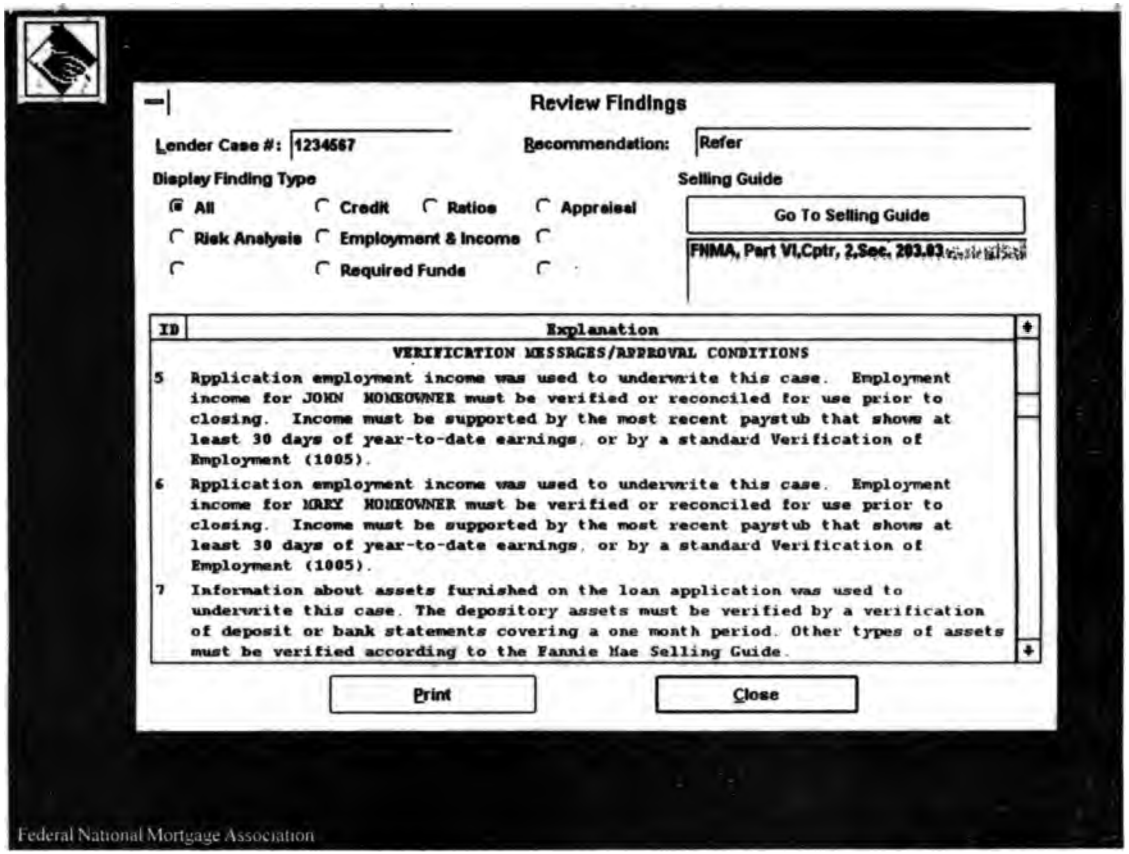
Federal National Mortgage Association


Define Product Characteristics
Mortgage Term: 360 (in months)
Amortization Term: 360 (in months)
Loan Type: Conventional
Interest Rate Type: Adjustable
More...
Payment Type: Adjustable
More...
Amortization Type: Fully Amortizing
Amortization Freq: Monthly
Payment Freq: Monthly
Late Fee After: 3 days
More...
Convertible Rate
Prepay Restrictions
Interest Rate Buydown
More...
Assumable
First Home
Demand Feature
Refinance/Modification at Maturity
Hazard Insurance Required
Escrow Waiver Allowed
Mortgage Insurance Req.
Float Down Allowed
OK
Cancel
Federal National Mortgage Association


Confirm Rate Lock
Originator Name: Michael Company
Borrower
First: John
Last: Smith
SSN: 123-45-6789
Originator Loan Number: 1004
Co-Borrower
First: Mary
Last: Smith
SSN: 111-11-1111
Rate Lock
Property Data
Loan Data
Borrower's Data
Rate Lock Contract
Purchase Price:
Loan Amount:
Lender Product:
Lender Name:
Float-Down Option
Float-Down Selected:
Float-Down Exercised:
Float-Down Selection Amt:
Float-Down Exercise Fee:
Float-Down Expiration Date:
Points Paid at Closing
Borrower:
Seller:
Lock Details
Lock Type:
Lock Category:
Lock Exp. Date:
Lock Term:
Rate:
Points:
Lock Conf #:
Lock Dep Amt:
Transaction ID:
Mand. Case File Delivery Date:
Negotiated Elig:
Requested by:
Confirmed by:
Date Requested:
View Records
Submit
Cancel
Product
Prices
Orig. Cmmnt
Federal National Mortgage Association

Desktop Underwriter™

Federal National Mortgage Association


Review Findings
Lender Case #: 1234567
Recommendation: Refer
Display Finding Type
All
Credit
Ratios
Appraisal
Risk Analysis
Employment & Income
Required Funds
Selling Guide
Go To Selling Guide
FNMA, Part VI,Cptr, 2,Sec. 203.03
ID
Explanation
VERIFICATION MESSAGES/APPROVAL CONDITIONS
5 Application employment income was used to underwrite this case. Employment income for JOHN HOMEOWNER must be verified or reconciled for use prior to closing. Income must be supported by the most recent paystub that shows at least 30 days of year-to-date earnings, or by a standard Verification of Employment (1005).
6 Application employment income was used to underwrite this case. Employment income for MARY HOMEOWNER must be verified or reconciled for use prior to closing. Income must be supported by the most recent paystub that shows at least 30 days of year-to-date earnings, or by a standard Verification of Employment (1005).
7 Information about assets furnished on the loan application was used to underwrite this case. The depository assets must be verified by a verification of deposit or bank statements covering a one month period. Other types of assets must be verified according to the Fannie Mae Selling Guide.
Print
Close
Federal National Mortgage Association


Federal National Mortgage Association

Explore new housing markets and increase your business volume with easy-to-use FannieMaps®

What is FannieMaps?
FannieMaps is a computerized mapping software that can be a valuable tool to help you create new housing opportunities in minority and lower income communities. It can expand your lending market by providing easy access to detailed demographic market data typically compiled by census tracts, with marketing plans that are more likely to rely on zip code information. FannieMaps translates census tract geography into more familiar zip codes.

Let FannieMaps 1.2 help you expand your lending market and increase your business by:

- ***Showing you where to lend*** to achieve your affordable housing goals and meet the needs of your community;
- ***Giving you the tools you need*** to expand into untapped markets;
- ***Showing you three geographical levels of maps*** that help you define the exact boundaries of your target market; and
- ***Providing easy access*** to 1990 Census demographic data.

FannieMaps 1.2 can help you meet your affordable housing objectives
Use the following three options to determine where to lend to meet your fair lending and affordable housing goals. You can also use FannieMaps to find areas that are eligible for FannieNeighbors®, a neighborhood-based mortgage option available under Fannie Mae's Community Home Buyer's Program, our signature affordable housing product.

As illustrated in Figures 1 and 2, cross-hatchings on the maps highlight:

- **Low- and moderate-income census tracts**
  Identifies census tracts where the area median income is less than 80 percent of the area median income for that Metropolitan Statistical Area (MSA).
- **Minority census tracts**
  Locates census tracts where the minority population is 50 percent or greater.
- **Central city census tracts**
  Highlights central city boundary lines in ***bold*** to help you identify areas eligible for the FannieNeighbors mortgage option.

FannieMaps 1.2 gives you the tools to expand into untapped markets
Within the "Variables" menu, you can choose from five options to access more demographic data for ***all*** of your markets, including those where you currently lend, and those that you'd like to explore.

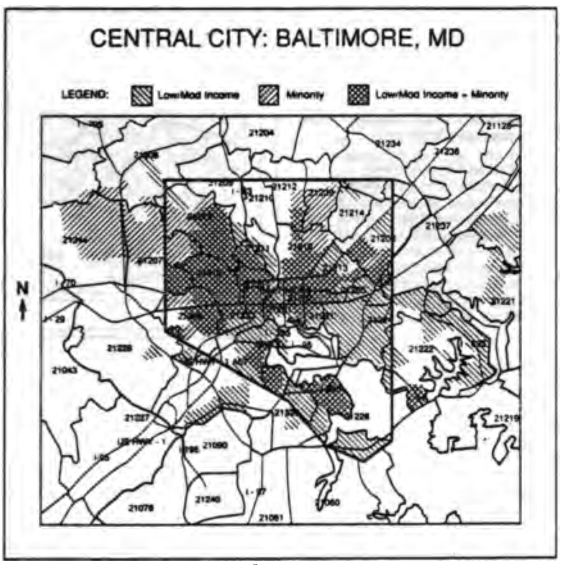


Figure 1

- **Income**
  By selecting one of the five choices under the "Income" option, you can determine the needs of your potential new market and the mortgage products suited to potential borrowers.

- **Age/Population**
  Within the "Age/Population" option, you can select from six age groups. By mapping the age of the population in a specific market area, you can target specific mortgage products to that area. For example, market areas that have a large population that is 25 or younger might be good candidates for mortgage products designed for first-time home buyers. Areas that have a large 65 and over population might be potential markets for Home Equity Conversion Mortgages (HECMs), a reverse annuity mortgage product available to senior citizens who are house rich and cash poor.

- **Race/Ethnic Group**
  By choosing "Asian/Pacific Islander" or "Hispanic" from the list of six "Race/Ethnic Groups," you can identify areas with large Hispanic or Asian populations where sales can be enhanced by adding staff and marketing materials to those neighborhood branches that address customers in their own language.

- **Housing Distribution**
  By choosing "Owner Occupied" from the five choices under the "Housing Distribution" option, you can find areas that have low owner-occupancy rates and, thus, new home buyer potential. Figure 3 highlights owner-occupancy rates in zip code 21229. Or map a type of housing stock (i.e., "1-unit") to develop a mix of products and services to suit that market.

- **Family/Household size**
  Map average family size or average household size to assess the needs of your market.

Use FannieMaps to market other financial products
While developed specifically to support residential community lending strategies, FannieMaps is also an effective tool for marketing other financial products in underserved areas, including:

- Home improvement loans;
- Loans to small businesses;
- Student loans;
- Commercial loans; and
- Consumer loans.

Demographic data can be viewed at three geographic levels
FannieMaps offers three levels of color-coded maps and accompanying demographic reports that you can use to plan your market strategies. The three map levels show you:

- **An overview of the MSA**
  Maps at this first level show counties, cities, and major roads within that MSA.

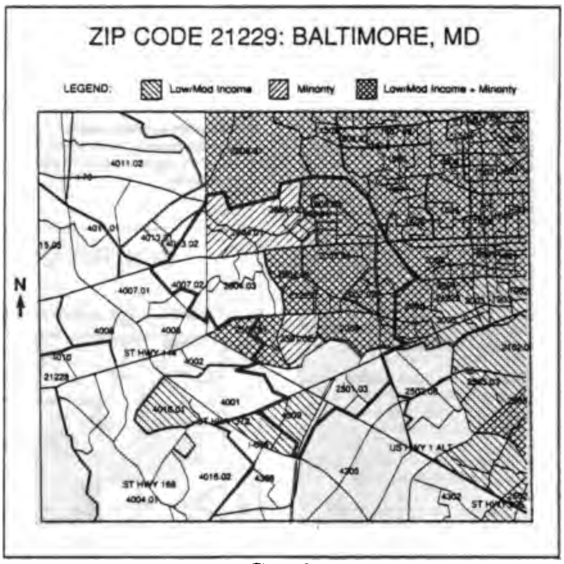


Figure 2

- **Central city or county**
  The second map level lets you focus on a specific central city or county within that MSA. At this level, you will see zip code borders and numbers, as well as major roads. The central city screen ***bolds*** central city boundary lines for easier viewing on printed maps. The county screen includes a "zoom" feature allowing you to focus on a specific area within the county that can be enlarged for easier viewing. This feature is especially helpful within large, complex MSAs. (See Figure 1.)

- **Zip code**
  This third geographic level is the most detailed, and can help you define your exact market boundaries. At this level you will see census tract numbers contained within that specific zip code, as well as the names of primary roads. (See Figure 2.) If you're looking for a specific zip code, and you're not sure where it is, you can use the built-in FannieMaps "locator" feature to find it quickly. Just type in the zip code or post office name, and FannieMaps finds the area for you.

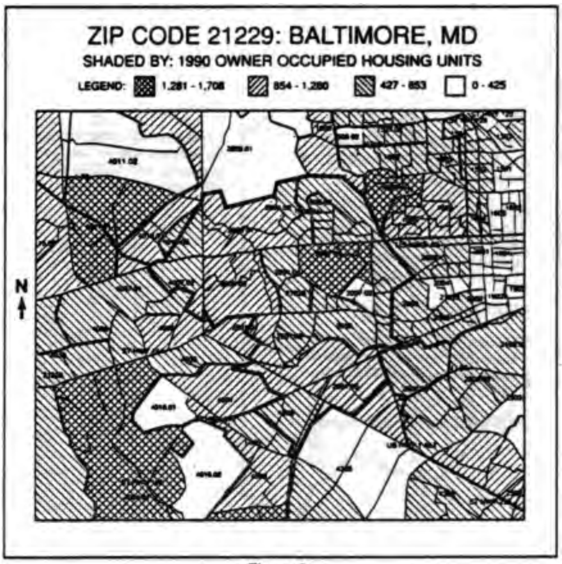


Figure 3

Geographical boundaries
Access updated geographical boundaries that correspond to the June 1993 Office of Management and Budget's list of MSAs and central cities. FannieMaps accesses maps and demographic reports for all 310 MSAs in all 50 states and the District of Columbia. This feature is especially convenient if you lend in multiple MSAs.

Easy-to-access FannieMaps demographic data
FannieMaps data is compiled from 1990 Census data for all 310 MSAs. FannieMaps provides this census data in a concise, easy-to-read format that helps you assess the needs of your market.

After installing the software, FannieMaps gives you the flexibility to retrieve data in three ways:

1. ***Via MORNET®*** (Fannie Mae's communications network), using a modem, downloading individual MSA data and storing it on your PC's hard drive. There is a charge for download time;

2. ***From a diskette*** which is available from the FannieMaps Fulfillment Center (1-800-235-5947) at a reasonable charge; or

3. ***Using a CD-ROM reader***—the most economical choice—which accesses the demographic data from a CD ***at no cost***. You save money by eliminating connection fees and transmittal charges. Additionally, the CD option saves both time—data is available almost instantaneously—and valuable storage space on your PC's hard drive, because the data is stored on the CD.

FannieMaps software and compact discs are available ***free of charge*** to Fannie Mae's community lending partners.

Use FannieMaps flexibility to export data
The ability to export data from FannieMaps for use in other reports, presentations, or formats is one of the most powerful features of FannieMaps. You can create unique reports by exporting and customizing data using a commercial spreadsheet software package.

FannieMaps-related services

- If you know the zip code, post office, central city, or county you wish to explore, but you don't know which MSA it appears in, MORNET Manager® can help you find it quickly. Simply type in the zip code, post office, or central city or county name, and MORNET Manager will lead you to that MSA. MORNET Manager is used by all MORNET subscribers as a menu program to access various MORNET software packages (including FannieMaps) as well as useful, on-line bulletin boards.

- FannieMaps data and report information is available to you via MORNET without downloading maps, by using the "FannieMaps Reports" menu selection in MORNET Manager.

- Also on-line via MORNET Manager, you can access current HUD median income information, as well as income limits for Fannie Mae's community lending products—for every MSA and non-metropolitan county in the United States, the District of Columbia, and three US territories.

- You receive discounted rates on customized geographic lending analysis through the FannieMaps Fulfillment Center (CACI Marketing Systems), at 1-800-235-5947. Loans can be geocoded and analyzed to meet your affordable housing and fair lending needs.

To use FannieMaps, the following equipment is needed:

- IBM PC or compatible (Model 386 or better);

- A math co-processor (highly recommended);

- 640 K RAM;

- Hard disk with sufficient available storage space—10 Megabytes will accommodate the mapping software and at least one MSA (if the CD option is not available);

- EGA color monitor or better (VGA color monitor is highly recommended);

- Laser printer or printer plotter (16 printers are supported including Epson FX-100, HP DeskJet, HP PaintJet, HP LaserJet, and Toshiba 351);

- DOS version 3.3 or higher;

- Modem with 2400 Baud minimum (9600 Baud recommended) —not needed with CD option; and

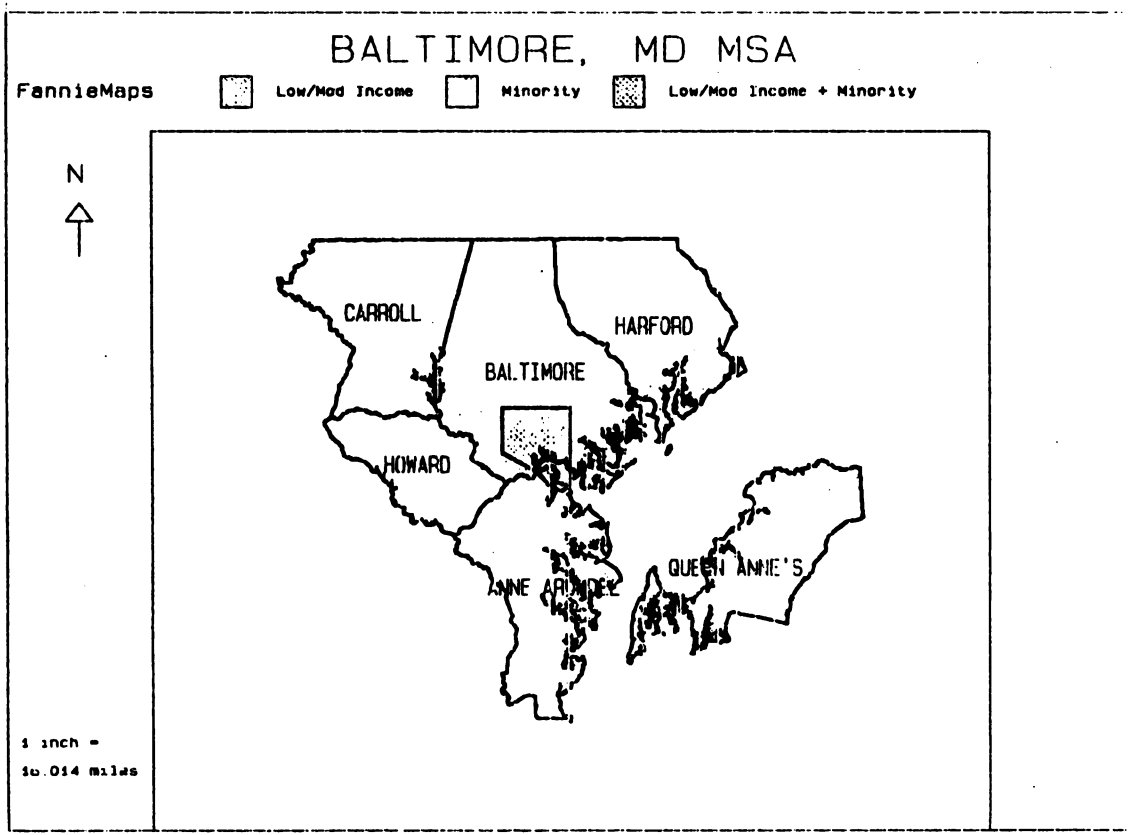
- CD-ROM reader (recommended).

FannieMaps gives you the tools to identify new business opportunities

Order FannieMaps today to get:

- Detailed demographic maps and reports to help expand your business by customizing the best mix of products and services for current and newly targeted market areas.
  - Low- and moderate-income areas;
  - Minority population distribution;
  - Owner occupancy rates;
  - Family income levels;
  - Population and income trends; and
  - Housing stock characteristics (condominiums, one-family homes, two- to four-family homes, or multifamily properties).

- A tool that can expand your lending market and be used in designing and documenting affordable housing plans.


BALTIMORE, MD MSA
FannieMaps
Low/Mod Income
Minority
Low/Mod Income + Minority
N
CARROLL
BALTIMORE
HARFORD
HOWARD
ANNE ARUNDEL
QUEEN ANNE'S
1 inch =
10.014 miles

FannieMaps
Market Area Summary

Area: MSA 0720 BALTIMORE, MD

To access current HUD Median Incomes,
select "HUD Services" from the
Origination menu on MORNET Manager.

Summary Profile	80 Census	90 Census	80-90 Chg	Ann % Chg
Population	2199531	2382172	182641	0.80
Households	765830	880145	114315	1.40
Families	567840	620591	52751	0.89
Average Household Size	2.80	2.64	-0.16	-0.60
Average Family Size	3.36	3.13	-0.23	-0.68
Median Age	30.6	33.4	2.8	0.86
Per Capita Income	7543	16596	9053	8.20
Median Household Income	18996	36550	17554	6.76
Median Family Income	21810	42206	20396	6.82

	1980 Census		1990 Census	
Age Distribution	Number	Percent	Number	Percent
< 25	884424	40.21	821472	34.48
25 to 44	636784	28.95	823146	34.56
45 to 64	455777	20.72	458863	19.26
65+	222546	10.12	278691	11.70
Race/Ethnic Distribution	Number	Percent	Number	Percent
White	1590305	72.31	1691039	70.98
Black	556948	25.32	611990	25.69
American Indian	3960	0.18	6121	0.26
Asian/Pacific Islander	21183	0.96	41717	1.75
Other Races	5501	0.25	1145	0.05
Hispanic*	21634	0.98	30160	1.27
Housing Units Distribution	Number	Percent	Number	Percent
1 Unit	558025	70.11	675478	73.56
2-4 Units	82335	10.34	69145	7.53
5+ Units	155592	19.55	173663	18.91
Owner Occupied	461280	60.23	560406	63.67
Condominiums**	15262	1.99	35031	3.98

* Persons of Hispanic origin may be of any race. Totals for race do not include the Hispanic origin population.

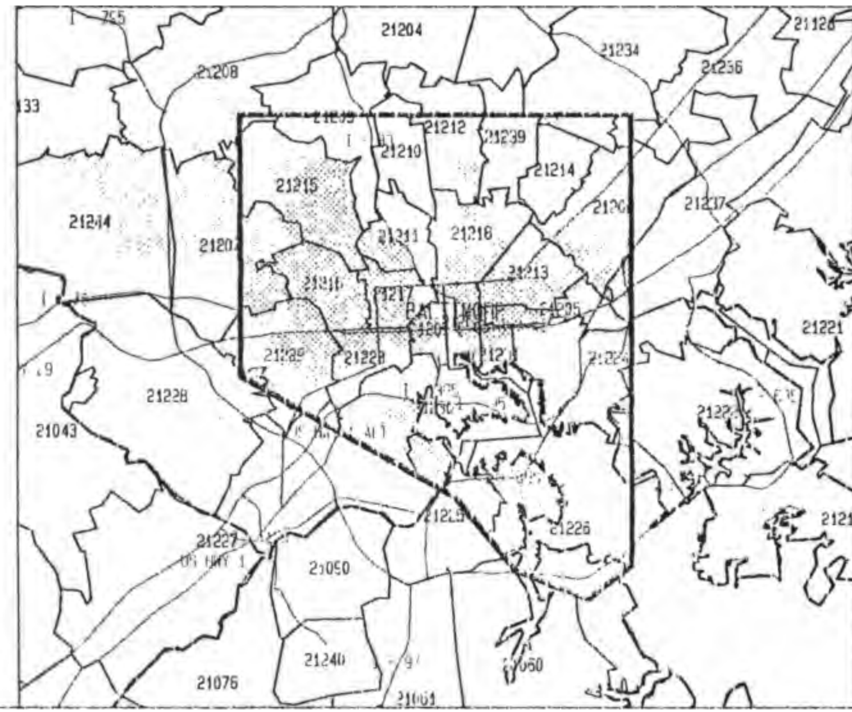
** A condominum defines a type of ownership, not a housing unit. It entails individual ownership of an apartment or house in a development of like units and joint ownership of common areas and grounds. Owner occupancy of the unit is not necessary.

Source: 1990 Census of Population & Housing, Summary Tape Files 1 & 3

CENTRAL CITY : BALTIMORE, MD

FannieMaps Low/Mod Income Minority Low/Mod Income + Minority

N



1 inch = 2.776 miles

FannieMaps
1990 Census Tract Population Analysis

Area: ZIP CODE 21213 BALTIMORE, MD

To access current HUD Median Incomes, select "HUD Services" from the Origination menu on MORNET Manager.

Census Tract			Dominant ZIP Code & P.O. Name	1990 Families	1990 Median Income	1990 Percent Minority Total	Black	Hisp	Asian	Other
801.01	*		C 21213 BALTIMORE	917	32593	11.8	9.1	1.4	1.2	0.1
801.02	*	+	C 21213 BALTIMORE	663	29868	84.2	82.3	0.6	0.9	0.4
802.00	*	+	C 21213 BALTIMORE	960	20114	98.7	97.4	1.0	0.2	0.1
803.01	*	+	C 21213 BALTIMORE	922	22417	99.1	98.1	0.5	0.3	0.2
803.02	*	+	C 21213 BALTIMORE	959	25816	98.8	98.5	0.2	0.0	0.1
804.00	*	+	C 21213 BALTIMORE	677	21554	99.0	98.4	0.4	0.1	0.1
805.00	*	+	C 21213 BALTIMORE	675	23472	99.3	98.3	0.7	0.2	0.1
806.00	*	+	C 21213 BALTIMORE	1270	17254	99.4	98.1	0.6	0.5	0.2
807.00	*	+	C 21213 BALTIMORE	816	12518	99.3	97.9	0.9	0.3	0.2
808.00	*	+	C 21213 BALTIMORE	744	18821	99.2	98.6	0.1	0.2	0.3
909.00	*	+	C 21202 BALTIMORE	1025	17586	99.3	98.7	0.3	0.2	0.1
1001.00	*	+	C 21202 BALTIMORE	647	21632	99.2	98.9	0.0	0.3	0.0
2603.01	*		C 21213 BALTIMORE	1046	32594	20.2	17.4	1.7	0.8	0.3
2603.02			C 21213 BALTIMORE	1731	36400	42.5	39.8	2.1	0.5	0.1
2603.03	*	+	C 21213 BALTIMORE	535	7530	71.7	70.8	0.4	0.1	0.4

* = Low/Moderate Income Flag
+ = Minority Flag
C = Central City Flag

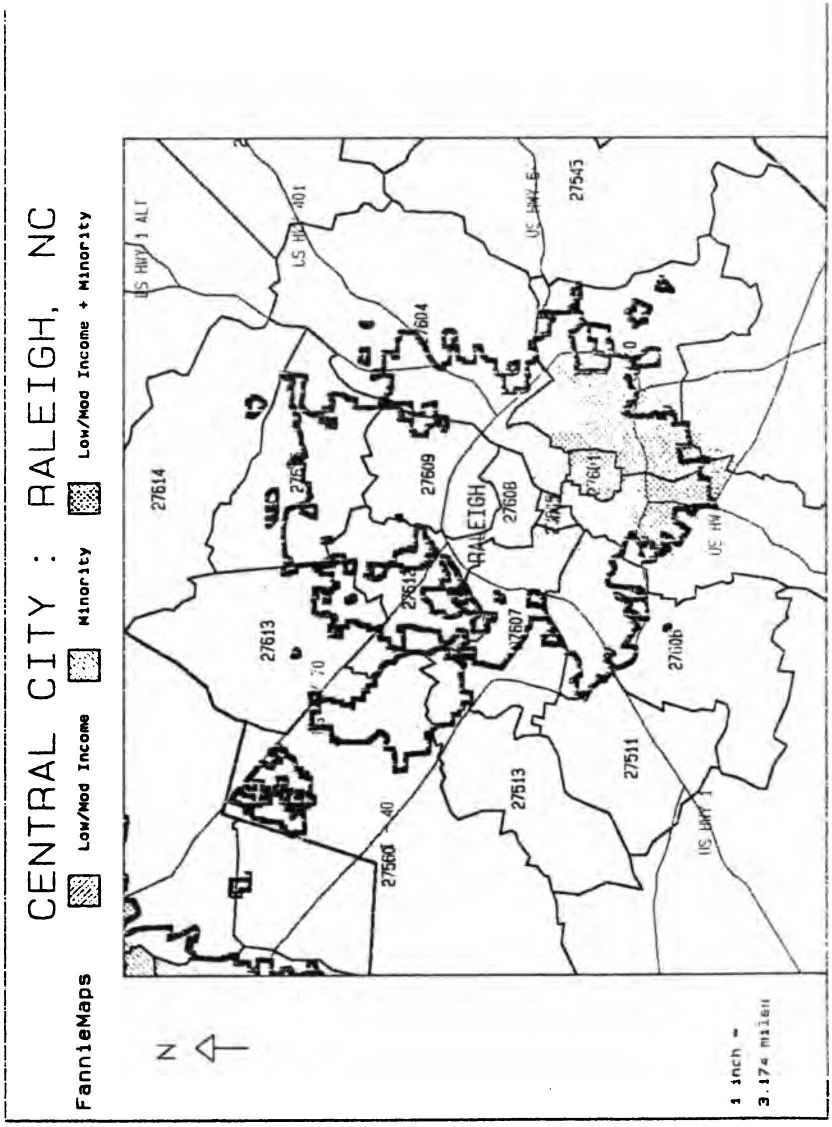
FannieMaps
1990 Census Tract Housing Stock Analysis

Area: ZIP CODE 21213 BALTIMORE, MD

To access current HUD Median Incomes, select "HUD Services" from the Origination menu on MORNET Manager.

Census Tract			Dominant ZIP Code & Post Office Name	1990 Median Income	1990 Perc Owner Occup	1990 Condos	1990 Housing Stock: 1 Unit	2-4 Units	5+ Units
801.01	*		C 21213 BALTIMORE	32593	84.0	0	1321	127	[illegible]
801.02	*	+	C 21213 BALTIMORE	29868	67.6	0	856	52	[illegible]
802.00	*	+	C 21213 BALTIMORE	20114	29.5	0	1242	52	4
803.01	*	+	C 21213 BALTIMORE	22417	40.2	9	1136	62	4
803.02	*	+	C 21213 BALTIMORE	25816	66.9	0	1085	169	100
804.00	*	+	C 21213 BALTIMORE	21554	24.7	0	905	32	30
805.00	*	+	C 21213 BALTIMORE	23472	50.2	0	791	28	34
806.00	*	+	C 21213 BALTIMORE	17254	36.1	0	1608	182	115
807.00	*	+	C 21213 BALTIMORE	12518	30.8	17	1144	106	9
808.00	*	+	C 21213 BALTIMORE	18821	28.9	0	1073	193	136
909.00	*	+	C 21202 BALTIMORE	17586	26.1	9	1282	147	182
1001.00	*	+	C 21202 BALTIMORE	21632	34.5	23	785	119	80
2603.01	*		C 21213 BALTIMORE	32594	82.2	0	1562	177	1
2603.02			C 21213 BALTIMORE	36400	82.7	0	2246	336	1
2603.03	*	+	C 21213 BALTIMORE	7530	11.6	23	666	21	198

* = Low/Moderate Income Flag
+ = Minority Flag
C = Central City Flag



CENTRAL CITY : RALEIGH, NC
FannieMaps
Low/Mod Income
Minority
Low/Mod Income + Minority
N
1 inch = 3.174 miles
27614
27613
27609
27608
27607
27606
27604
27601
27545
27511
27513
RALEIGH
US HWY 1 ALT
US HWY 401
US HWY 1
40

FannieMaps
Market Area Summary

Area: MSA 6640 RALEIGH-DURHAM-CHAPEL HILL, NC

To access current HUD Median Incomes,
select "HUD Services" from the
Origination menu on MORNET Manager.

Summary Profile	80 Census	90 Census	80-90 Chg	Ann % Chg
Population	665236	855545	190309	2.55
Households	236386	334506	98120	3.53
Families	168772	221142	52370	2.74
Average Household Size	2.66	2.45	-0.21	-0.82
Average Family Size	3.21	3.00	-0.21	-0.68
Median Age	28.7	31.7	3.0	1.01
Per Capita Income	6812	15629	8817	8.66
Median Household Income	16251	32047	15796	7.03
Median Family Income	19565	39723	20158	7.34

	1980 Census		1990 Census	
Age Distribution	Number	Percent	Number	Percent
< 25	283113	42.55	310939	36.34
25 to 44	204273	30.71	315109	36.84
45 to 64	118646	17.84	147942	17.29
65+	59204	8.90	81555	9.53
Race/Ethnic Distribution	Number	Percent	Number	Percent
White	485017	72.92	622546	72.77
Black	167989	25.25	205713	24.04
American Indian	1005	0.15	2163	0.25
Asian/Pacific Islander	4152	0.62	13890	1.62
Other Races	1520	0.23	388	0.05
Hispanic*	5553	0.83	10845	1.27
Housing Units Distribution	Number	Percent	Number	Percent
1 Unit	172333	74.07	223735	69.65
2-4 Units	21205	9.12	31375	9.77
5+ Units	39096	16.81	66097	20.58
Owner Occupied	143542	60.72	203305	60.78
Condominiums**	2649	1.12	15909	4.76

* Persons of Hispanic origin may be of any race. Totals for race do not include the Hispanic origin population.

** A condominum defines a type of ownership, not a housing unit. It entails individual ownership of an apartment or house in a development of like units and joint ownership of common areas and grounds. Owner occupancy of the unit is not necessary.

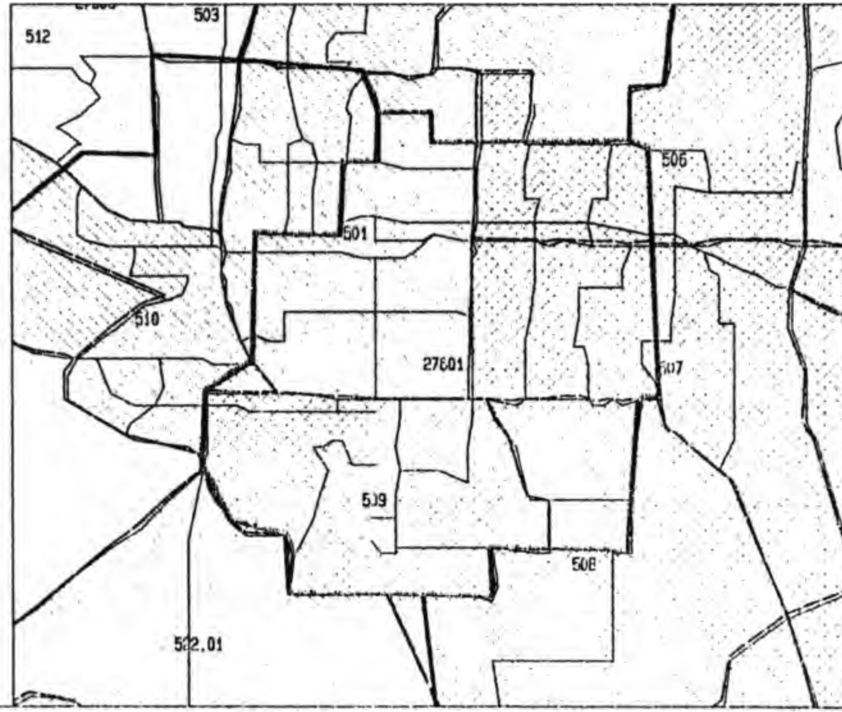
Source: 1990 Census of Population & Housing, Summary Tape Files 1 & 3

ZIP CODE 27601 : RALEIGH, NC

FannieMaps

Low/Mod Income | Minority | Low/Mod Income + Minority

N



1 inch = 0.36 miles

FannieMaps
1990 Census Tract Population Analysis

Area: ZIP CODE 27601 RALEIGH, NC

To access current HUD Median Incomes, select "HUD Services" from the Origination menu on MORNET Manager.

Census Tract				Dominant ZIP Code & P.O. Name	1990 Families	1990 Median Income	1990 Percent Minority Total	Black	Hisp	Asian	Other
501.00	*		C	27601 RALEIGH	210	31094	47.8	45.6	1.5	0.4	0.3
506.00	*	+	C	27610 RALEIGH	743	21222	89.4	88.3	0.7	0.1	0.3
507.00	*	+	C	27601 RALEIGH	711	21316	99.0	98.5	0.3	0.0	0.2
508.00	*	+	C	27610 RALEIGH	667	8693	89.1	87.3	0.7	0.1	1.0
509.00	*	+	C	27601 RALEIGH	686	9225	98.3	97.6	0.4	0.0	0.3
510.00	*		C	27603 RALEIGH	254	28897	29.7	26.3	2.1	0.7	0.6

* = Low/Moderate Income Flag
\+ = Minority Flag
C = Central City Flag

FannieMaps
1990 Census Tract Housing Stock Analysis

Area: ZIP CODE 27601 RALEIGH, NC

To access current HUD Median Incomes, select "HUD Services" from the Origination menu on MORNET Manager.

Census Tract		Dominant ZIP Code & Post Office Name	1990 Median Income	1990 Perc Owner Occup	1990 Condos	1990 Housing Stock 1 Unit	2-4 Units	5+ Units
501.00	* C	27601 RALEIGH	31094	25.0	18	278	166	30[illegible]
506.00	* + C	27610 RALEIGH	21222	27.3	11	755	697	13[illegible]
507.00	* + C	27601 RALEIGH	21316	34.0	0	805	301	22[illegible]
508.00	* + C	27610 RALEIGH	8693	16.1	0	331	362	52[illegible]
509.00	* + C	27601 RALEIGH	9225	15.3	0	547	370	37[illegible]
510.00	* C	27603 RALEIGH	28897	14.6	30	289	337	55[illegible]

* = Low/Moderate Income Flag
\+ = Minority Flag
C = Central City Flag

O

ISBN 0-16-053951-X

90000

9 780160 539510