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Report to the Chairman, Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, Committee on Banking and Financial Services, House of Representatives

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FEDERAL HOUSING ENTERPRISES

HUD's Mission Oversight Needs to Be Strengthened

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The Honorable Richard H. Baker
Chairman, Subcommittee on Capital
Markets, Securities and
Government Sponsored Enterprises
Committee on Banking and Financial Services
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we assess the Department of Housing and Urban Development's (HUD) overall housing mission oversight of the two largest government-sponsored enterprises (enterprises), which are the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). In 1992, Congress enacted the Federal Housing Enterprises Financial Safety and Soundness Act[1] (the 1992 Act), which, among other provisions, directed that HUD establish numeric housing goals that require the enterprises to purchase mortgages serving targeted groups,[2] such as low- and moderate-income borrowers[3] and those who live in central cities and rural communities. HUD's development, implementation, and enforcement of the numeric housing goals have represented the primary component of its enterprise housing mission oversight. Under the 1992 Act, HUD's enterprise housing mission oversight also includes its general regulatory, new mortgage program approval,[4] and fair lending responsibilities.[5]

As agreed with your office, our objectives were to (1) discuss HUD's legal basis, approach, and rationale for setting the numeric housing goals at their current levels; (2) report on the enterprises' compliance with the goals and HUD's assessment of the goals' impacts on promoting

[1]P. L. 102-550, Title XIII, 106 Stat 3672 (1992).

[2]In this report, the term "targeted" refers to (1) populations that have traditionally been underserved by the mortgage market or (2) mortgages serving such groups that are purchased by the enterprises.

[3]Households are defined as low income if their income does not exceed 80 percent of the area median family income. Moderate income includes household borrowers with incomes that do not exceed the area median family income.

[4]The 1992 Act defines a "new mortgage program" as being significantly different from programs that have been approved, or that represent an expansion, in terms of the dollar volume or number of mortgages or securities involved, of programs previously approved.

[5]The 1992 Act requires that HUD prohibit, by regulation, the enterprises from discriminating in any manner in the purchase of any mortgage because of the borrowers' race, color, religion, sex, handicap, familial status, age, or national origin or the age or location of the property financed.

homeownership and housing opportunities; (3) assess HUD's procedures and efforts to verify goal compliance data; (4) analyze the enterprises' multifamily mortgage purchase activities under the housing goals and HUD's assessment of these activities' effects on promoting housing opportunities; and (5) review HUD's implementation of its general regulatory and new mortgage program approval oversight authorities under the 1992 Act.

Background

Congress established and chartered Fannie Mae and Freddie Mac as government-sponsored, privately owned corporations to enhance the availability of mortgage credit across the nation during both good and bad economic times.[6] The enterprises are to accomplish this mission by purchasing mortgages from lenders in the primary mortgage market (i.e., banks, thrifts, and mortgage bankers), which can then use the proceeds to make additional mortgage loans to homebuyers. Purchasing mortgages from primary mortgage market originators and others is commonly referred to as a "secondary mortgage market" transaction. The enterprises issue debt to finance some of the mortgage assets that they retain in their portfolios. However, a majority of the mortgages the enterprises purchase are pooled to create mortgage-backed securities (MBS) that may be sold to investors. At year-end 1997, the enterprises had combined debt and net MBS obligations outstanding of about $1.6 trillion.

The enterprises are large, sophisticated financial institutions that have developed several mechanisms to finance residential mortgage purchases. These mechanisms include callable bonds[7] and MBS that tailor cash flows to different classes of investors. It is widely recognized that the enterprises' activities and sophisticated financial products have facilitated the development of a liquid, secondary mortgage market, particularly for mortgages on single-family residences.

The federal government's creation of and continued relationship with Fannie Mae and Freddie Mac have played an integral role in the enterprises' efforts to develop a secondary mortgage market. In particular, this relationship has created the perception in the financial markets that the government would not allow the enterprises to default on their debt

[6]Congress chartered Fannie Mae in 1938 as a government-held association to buy and hold mortgages insured by the Federal Housing Administration. In 1968, Congress reorganized Fannie Mae as a government-sponsored, privately owned for-profit corporation. Congress chartered Freddie Mac in 1970, and it was initially a part of the Federal Home Loan Bank System. In 1989, Congress established Freddie Mac as a government-sponsored enterprise that is owned by private investors.

[7]Callable bonds give the issuer the option of repurchasing the bond before it matures.

and MBS obligations, even though the government is not required to back these obligations. As a result, the enterprises can borrow money in the capital markets at lower interest rates than comparably creditworthy private corporations. At least a portion of these financial benefits are passed along to homebuyers in the form of lower mortgage interest rates. The enterprises also enjoy other benefits resulting from their federal ties, such as exemptions from state and local income taxes and securities registration fees imposed by the Securities and Exchange Commission.

Congress Has Enacted a Regulatory Framework Directing the Enterprises to Purchase Mortgages Serving Targeted Groups

Among other provisions, the enterprises' federal charters require them to provide a secondary market for home mortgages of low- and moderate-income borrowers as well as those who live in central cities, rural areas, and other underserved areas. The enterprises' charters also provide for the possibility that extending mortgage credit to targeted groups may involve more risks and potential losses than extending mortgage credit to other groups. Thus, the charters state that the enterprises' profitability—or rate of return—on mortgage purchases serving targeted groups must be reasonable, but the rate of return on these purchases may also be lower than on other activities.

In 1968, Congress provided the HUD Secretary with general regulatory authority over Fannie Mae and authorized the Secretary to require that a reasonable portion of the enterprise's mortgage purchases serve low- and moderate-income families. In response to this mandate, HUD established numeric housing goals for Fannie Mae that essentially required that at least 30 percent of the enterprise's purchases serve low- and moderate-income families and at least 30 percent serve families living in central cities. However, HUD did not (1) enforce the housing goals consistently or (2) collect the necessary data to monitor compliance with the goals. Before 1992, Congress had not extended the housing goals to cover Freddie Mac.

By 1992, Congress concluded that the enterprises' mortgage purchase activities did not adequately serve low- and moderate-income and minority borrowers. As a result, these potential borrowers were not sufficiently benefiting from the enterprises' secondary mortgage market operations, which can serve to lower mortgage and rental costs, thereby enhancing housing affordability. Congress also concluded that, because of the financial benefits that Fannie Mae and Freddie Mac enjoy from their federal charters and sponsorship, the enterprises had a public responsibility to reach out to targeted borrowers.

To address these congressional concerns, the 1992 Act established a comprehensive framework for HUD to (1) promulgate numeric housing goals for the enterprises and (2) obtain the necessary data from the enterprises to monitor their compliance with the goals. The 1992 Act also provided HUD with enforcement tools to help ensure enterprise compliance with the goals. Specifically, the 1992 Act directed the HUD Secretary to promulgate regulations setting annual housing goals for each enterprise for the purchase of mortgages relating to each of the following three categories:

- housing for low- and moderate-income families;
- housing located in central cities, rural areas, and other underserved areas; and
- special affordable[8] goals that targeted mortgage purchases serving very-low-income[9] and low-income families living in low-income areas.

Further, the 1992 Act (1) requires the enterprises to provide HUD with reports on their mortgage purchase activities and (2) authorizes HUD to take enforcement actions, such as issuing cease-and-desist orders, to ensure the enterprises' compliance with the goals. The 1992 Act also established calendar years 1993 and 1994 as a transition period to allow time for HUD to collect data to implement these requirements and provided interim annual purchase goals for each enterprise during that period.

The 1992 Act Also Defined HUD's General Regulatory, New Mortgage Program Approval, and Fair Lending Authorities

The 1992 Act created the Office of Federal Housing Enterprise Oversight (OFHEO) as an independent HUD office responsible for helping to ensure the enterprises' financial safety and soundness. The primary means by which OFHEO is to help ensure the enterprises' safety and soundness are that OFHEO is to establish a stress test and risk-based capital standards[10] and conduct annual, on-site examinations. Moreover, the 1992 Act ratified and

[8]In this report, the term "affordable" refers to income or location standards established in the 1992 Act or similar statutes for very-low-, low-, or moderate-income borrowers or those who live in central cities or rural communities.

[9]Very-low-income households have incomes that do not exceed 60 percent of the area median family income.

[10]Under the 1992 Act, the purpose of the stress test is to lower taxpayer risks from the enterprises' activities by computer model simulations where the enterprises are exposed to adverse credit and interest rate scenarios. The 1992 Act also requires that the enterprises hold sufficient risk-based capital levels to withstand the stress test for 10 years, plus an additional 30 percent to cover management and operations risks.

clarified HUD's general regulatory authority over the enterprises.[11] Except for the specific powers granted OFHEO, according to the 1992 Act, HUD has "general regulatory power" over each enterprise and is charged with making "such rules and regulations as shall be necessary and proper to ensure" that the act's provisions and the enterprises' charters are accomplished.

The 1992 Act also specified procedures that HUD must follow when reviewing and approving new mortgage proposals by the enterprises.[12] The 1992 Act directs the HUD Secretary to approve any new program that an enterprise proposes, unless the Secretary determines that the program (1) violates the enterprise's charter or (2) would not be in the public interest. The Secretary is also required to reject a new program proposal if the Director of OFHEO determines that the proposal would risk a significant financial deterioration of the enterprise.[13] Under the 1992 Act, the Secretary must approve or reject an enterprise's new program proposal within 45 days of its submission, although the Secretary can extend the deadline for one 15-day period if the Secretary requests additional information. New enterprise mortgage program proposals are automatically approved under the 1992 Act if the Secretary does not comply with these deadlines.

Finally, the 1992 Act under its fair lending provisions required that HUD, by regulation, prohibit each enterprise from discriminating on the basis of race and other borrower characteristics. Among HUD's fair lending responsibilities, it is required to periodically review and comment on the underwriting and appraisal guidelines of each enterprise to ensure that such guidelines are consistent with the Fair Housing Act.[14]

HUD's Enterprise Oversight Organizational Structure and Resources

HUD's enterprise oversight efforts are shared among four offices. These offices are collectively responsible for developing and enforcing the housing goal regulations and implementing HUD's general regulatory, new mortgage program approval, and fair lending authorities (see table 1). The

[11]Congress initially provided HUD with general regulatory authority over Fannie Mae in 1968 and Freddie Mac in 1989.

[12]Congress initially provided HUD with the authority to review Fannie Mae's new mortgage programs in 1970 and Freddie Mac's new programs in 1989.

[13]Under the 1992 Act, this requirement is in place until 12 months after the effective date of OFHEO's risk-based capital standards for the enterprises are issued in final form. OFHEO expects to issue the final standards in 1999.

[14]The Fair Housing Act, among other provisions, prohibits discrimination in the extension of mortgage loan credit.

Office of Government Sponsored Enterprises (GSE) Oversight coordinates HUD's oversight of the enterprises and conducts research on relevant topics. The Office of Policy Development and Research (PD&R) provides research support, both in-house and contract, for the development of the goals and other relevant issues, while the Office of the General Counsel provides legal support. In addition, the Office of Fair Housing and Equal Opportunity (FHEO) is responsible for the 1992 Act's fair lending requirements.

According to HUD officials, 16.9 full-time equivalent (FTE) positions[15] in the four offices are devoted to enterprise oversight for fiscal year 1998 (see table 1). Five of these positions are in the Office of GSE Oversight; as of April 1998, one position in the office was vacant. In addition, the Acting Director of the office was part-time while HUD conducted a search for a new Director. Since April 1997, the Acting Director said, she has also worked in the Federal Housing Administration's[16] (FHA) Office of the Comptroller as the Director of the Office of Evaluation.

Table 1: HUD Offices That Are Responsible for Enterprise Mission Oversight and Those Offices' FTE Positions

HUD office	Number of FTE positions
FHEO	1.4
General Counsel	2.9
GSE Oversight	5.1
PD&R	7.5
Total	**16.9**

Source: HUD.

In fiscal year 1998, HUD's total enterprise oversight budget was about $2.7 million, including about $687,000 in PD&R for research and computer support contracts (see table 2). Unlike other federal regulators that have housing enterprise oversight responsibilities,[17] such as OFHEO, HUD's mission oversight expenditures are funded with taxpayer dollars from HUD's congressional appropriations, rather than through assessments on

[15]The term "full-time equivalent position" is used in the federal government to specify personnel resources that are assigned to a particular function. The term does not necessarily constitute a single person because, for example, two individuals working part-time could represent one FTE.

[16]FHA is an agency within HUD that is responsible for insuring the mortgages of low- and moderate-income borrowers.

[17]OFHEO's safety and soundness activities—about $15 million in fiscal year 1997—are financed by assessments on Fannie Mae and Freddie Mac. Another federal housing enterprise—the Federal Home Loan Bank System—pays similar assessments for its housing mission and safety and soundness regulator, the Federal Housing Finance Board.

the regulated entities. In previous reports,[18] we have commented that regulatory costs should be borne by the respective federal housing enterprises to ensure effective safety and soundness and housing mission oversight.

Table 2: HUD's Budget for Enterprise Oversight in Fiscal Year 1998

(Dollars in thousands)

Obligation category	GSE Office	PD&R	General Counsel	FHEO	Total
Contracting	$0	$687[a]	$0	$25[b]	$712
Overhead[c]	111	188	67	35	401
Personnel	412	699	248	130	1,489
Space	43	65	13	15	136
Total	**$566**	**$1,639**	**$ 328**	**$205**	**$2,738**

[a]Includes $425,000 in research contracts and $261,500 in computer support contracts.

[b]Research contracts.

[c]Personnel costs (including benefits) multiplied by 27 percent.

Source: HUD.

Scope and Methodology

To meet our objectives, we reviewed HUD's final housing goal rule and associated research, interviewed HUD officials and representatives from the mortgage industry and housing community groups, and reviewed available data on the enterprises' compliance with the goals between 1993 and 1997. We also met with officials from Fannie Mae, Freddie Mac, and OFHEO to obtain their views on the housing goals and HUD's enterprise mission oversight. Appendix I provides a detailed discussion of our objectives, scope, and methodology.

We conducted our work in Washington, D.C., between October 1997 and May 1998 in accordance with generally accepted government auditing standards.

Results in Brief

The 1992 Act provides the HUD Secretary with the authority to set the final housing goals, and established six general, but potentially competing, factors to guide the Secretary's decisionmaking process. In particular, the 1992 Act directed the HUD Secretary to balance (1) the ability of the

[18]Government-Sponsored Enterprises: Advantages and Disadvantages of Creating a Single Housing GSE Regulator (GAO/GGD-97-139, July 9, 1997) and Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991).

enterprises to “lead the [mortgage finance] industry” in financing the mortgages of targeted groups and (2) the need to maintain the enterprises’ financial soundness. Available evidence from HUD’s final housing goal rule indicates that the HUD Secretary generally adopted a conservative approach to setting the final goals in December 1995[19] for the period 1996 through 1999. This conservative approach placed a high priority on maintaining the enterprises’ financial soundness. For example, in 1994 and 1995, HUD and OFHEO conducted research which found that additional mortgage purchases required under the goals were modest and would not materially affect the enterprises’ financial condition.

According to annual data that Fannie Mae and Freddie Mac provided to HUD, the enterprises have increased their share of targeted mortgage purchases since 1993 and were in compliance with the final housing goals in 1996 and 1997. For example, the percentage of Fannie Mae mortgage purchases qualifying under HUD’s low- and moderate-income housing goal[20] increased from 34 percent in 1993 to 45.5 percent in 1997. Similarly, Freddie Mac’s reported performance under the low- and moderate-income goal increased from 30 percent in 1993 to about 43 percent in 1997. Fannie Mae’s performance under the housing goals has generally exceeded that of Freddie Mac.

HUD has a basic oversight responsibility to determine whether the housing goals are resulting in enhanced housing opportunities for targeted groups because this was the intent of the 1992 Act. HUD has ongoing research projects to assess housing needs and households served by goal-oriented mortgage purchases, but its current research agenda does not address several highly relevant issues that are necessary to fully understand the goals’ impacts. For example, HUD has not initiated research to assess the goals’ effects on (1) interest rates and loan terms on targeted mortgages and (2) mortgage originators’ incentives to make targeted mortgage loans.

[19]HUD did not issue the final housing goal regulations, which are effective from 1996 to 1999, until December 1, 1995. The HUD Secretary carried over the transition goal requirements for 1993 and 1994 into 1995.

[20]HUD’s goals are based on the number of dwelling units financed by enterprise-targeted mortgage purchases as a percentage of the total dwelling units financed through mortgage purchases. Thus, a single-family residential mortgage purchase that qualifies under the low- and moderate-income goal would count as 1 dwelling unit, while a qualifying multifamily purchase containing 50 rental units would have 50 dwelling units. Assuming an enterprise purchased mortgages containing 1 million dwelling units in a particular year, and that 300,000 of these units qualified under the low- and moderate-income goal, the enterprise’s goal compliance would be 30 percent (300,000/1,000,000). In this report, we show information on the enterprises’ purchases under the goals as a percentage of their total mortgage purchases to facilitate the presentation.

HUD has implemented some limited procedures to verify the accuracy of the enterprises' reported goal compliance data. However, HUD has not implemented a program to assess the overall data collection and reporting process. Given the decentralized nature of the housing goal data and the potential for errors, it may not be possible for HUD at this time to independently draw conclusions about the accuracy of the data.

For an enterprise that is not in compliance with the housing goals, HUD's final housing goal rule may provide regulatory incentives, especially for multifamily housing, to employ risk-management strategies that help the enterprise meet or exceed the numeric goals. However, the effects of these risk management strategies on enhancing housing opportunities for targeted groups are not clear. Under the rule, the enterprises are permitted to count multifamily mortgage purchases toward full compliance with the goals where the mortgage originator—such as a bank or thrift—is required to cover most or all of the estimated future losses that may occur due to borrower defaults. According to HUD, these risk-management strategies encourage the enterprises to participate in the multifamily mortgage market, promote liquidity, and are necessary to protect the enterprises' financial soundness.

However, there is also available information suggesting that the enterprises' risk-management strategies involve offsetting trade-offs that may serve to limit lenders' incentives to originate affordable multifamily mortgages. For example, by requiring lenders to retain most or all of the expected credit risks, the enterprise risk management strategies could impede the lenders' willingness to extend mortgage credit. By contrast, when the enterprises purchase single-family mortgages, they generally relieve the lenders of the associated credit risks, which has encouraged the development of a liquid, secondary market for single-family mortgages. HUD has not conducted research to determine the effects of enterprise risk management strategies on multifamily mortgage finance and housing opportunities.

HUD has not fully implemented a procedure to assess sophisticated enterprise financial activities under its general regulatory and new mortgage program approval authorities under the 1992 Act. For example, HUD did not begin to act on its general regulatory authority until 1997, when congressional questions were raised about Freddie Mac's investments in Phillip Morris bonds and other nonmortgage investments.[21]

[21]See Government-Sponsored Enterprises: Federal Oversight Needed For Nonmortgage Investments (GAO/GGD-98-48, Mar. 11, 1998).

HUD initiated a process to assess the relationship between the enterprises' nonmortgage investments and housing mission in 1997, but this process has not been completed. HUD has approved enterprise new mortgage programs within the timeframes established by the 1992 Act. However, HUD has not yet established a process to ensure that it has sufficient expertise to review and monitor sophisticated financial products that may be associated with new mortgage program proposals.

HUD's Approach to Setting the Final Enterprise Housing Goals Was Conservative

The 1992 Act provided the HUD Secretary with the general authority to set the levels of the final housing goals and authority to define relevant terms. The 1992 Act also provided six general, but potentially competing, factors that the HUD Secretary should consider. In particular, the 1992 Act directed the HUD Secretary to balance (1) the ability of the enterprises to "lead the (mortgage finance) industry" in financing the mortgages of targeted groups and (2) the need to maintain the enterprises' financial soundness. When setting the final housing goals, the Secretary generally adopted a conservative approach that, according to a senior HUD official, was necessary to help maintain the enterprises' financial soundness.

The 1992 Act Directed That the HUD Secretary Consider Potentially Competing Factors When Setting Final Housing Goals

The 1992 Act provided six general factors[22] to help guide the Secretary's decisionmaking process in setting the final housing goals. These factors were (1) national housing needs; (2) economic, housing, and demographic conditions; (3) the performance and effort of the enterprises in achieving the goals in previous years; (4) the size of the conventional mortgage market serving targeted borrowers relative to the size of the overall conventional mortgage market; (5) the ability of the enterprises to lead the industry in making mortgage credit available to targeted borrowers; and (6) the need to maintain the sound financial condition of the enterprises.

Several of these factors can be considered to be in competition with one another. In particular, the requirement that the HUD Secretary consider the "ability of the enterprises to lead the industry" could compete with the requirement that the Secretary also maintain the enterprises' financial soundness. According to the 1992 Act's legislative history,[23] it was

[22]The 1992 Act required the six general factors for the low- and moderate-income goal and the central cities, rural areas, and other underserved areas goal. The 1992 Act specified only five general factors for the special affordable goal.

[23]See S. Rep. No. 102-282, at 34-35 (May 15, 1992). The Senate Report addresses the provisions of the Federal Housing Enterprises Regulatory Reform Act of 1992, S. 2733, 102nd Cong. (1992). Title XIII of P.L. 102-550 was based on the provisions of S. 2733, which require the HUD Secretary to set specific goals for the enterprises' mortgage purchases to address the needs of targeted borrowers.

expected that the enterprises would “lead the (mortgage finance) industry” in making mortgage credit available to targeted borrowers, and that the enterprises would have to “stretch” to meet the goals. However, neither the 1992 Act nor its legislative history specifically defined the term “lead the industry.” A potential definition of the term that HUD considered between 1993 and 1995 was that the enterprises’ targeted mortgage purchase requirements under the goals would exceed the primary market’s existing originations of such mortgages. During the rulemaking process, HUD received comments that suggested that the enterprises be required to purchase a higher percentage of mortgages than were already originated by the marketplace under each housing goal.

However, requiring Fannie Mae and Freddie Mac to purchase more targeted mortgages than were already originated in the primary market could potentially have increased the enterprises’ credit risks,[24] thereby affecting their financial soundness. The 1992 Act’s legislative history states that increases in targeted purchases could be accomplished while maintaining the financial safety and soundness of the enterprises. Similarly, the 1992 Act created OFHEO as an independent regulator with wide regulatory powers—such as the establishment of a stress test and risk-based capital standards—to help ensure that the enterprises’ mortgage purchase activities are consistent with maintaining their long-term safety and soundness. Thus, we conclude that the 1992 Act and its legislative history required the HUD Secretary to carefully weigh the trade-offs between expanding homeownership and housing opportunities for targeted groups and maintaining the enterprises’ safety and soundness in setting the final housing goal regulations.

HUD Generally Adopted a Conservative Approach When Setting the Final Housing Goals

In setting the final regulations for 1996 through 1999, the HUD Secretary identified national housing needs and found that the housing goal regulations are necessary to help meet these needs. The Secretary concluded that many Americans were unable to afford adequate housing due to insufficient incomes, high debt levels, and rising home prices. The Secretary also concluded that the enterprises lagged behind mortgage originators in meeting the credit needs of targeted groups. In addition, the Secretary found that, by establishing national housing goals, the enterprises could play a larger role in promoting affordable housing

[24]Credit risk is the possibility of financial loss resulting from borrower defaults. Requiring the enterprises to substantially increase their purchases of targeted mortgages may result in a relaxation of the enterprises’ mortgage purchase underwriting standards. Given that targeted borrowers may have weaker credit and employment histories than other borrowers, substantially relaxing the enterprises underwriting standards could result in higher default rates and associated credit losses.

opportunities, such as by promoting liquidity in the multifamily market. (See app. II for a discussion of the national housing needs, the underserved borrowers identified by HUD, and the potential influence of HUD's numeric goals in enhancing housing affordability for these groups.)

On the basis of our review of HUD's final regulations and associated research as well as our discussions with HUD officials, we determined that the HUD Secretary generally adopted a conservative approach to setting the final housing goals. The goals were conservative in that HUD (1) defined "lead the industry" to mean that the enterprises should provide technical and financial assistance to lenders to help ensure additional affordable mortgage originations rather than adopting another definition, such as, for example, requiring the enterprises to purchase a larger share of targeted mortgages than is originated in the primary market; (2) conducted research concluding that required mortgage purchases under the goals were modest and would not materially affect the enterprises' financial condition; and (3) did not consider the potential financial consequences for the enterprises of housing goals higher than those that were established. In addition, OFHEO concluded that the housing goals were modest and would not affect the enterprises' financial soundness. A HUD official said that the Department's conservative approach to developing the housing goal regulations was necessary to maintain the enterprises' financial soundness and to ensure that the goals could be met in good economic times as well as bad.

HUD Defined "Lead the Industry" as Requiring the Enterprises to Provide Assistance to Mortgage Originators

According to the final housing goal regulations, the HUD Secretary interpreted the "lead the industry" provision of the 1992 Act to mean that the enterprises should employ their dominant role in the secondary mortgage market to help ensure additional affordable mortgage originations. The Secretary concluded that the enterprises could provide financial standards and technical assistance to mortgage originators that would increase their willingness to extend mortgage credit to targeted groups. By contrast, the Secretary did not define "lead the industry" to mean that the enterprises' purchases under all three housing goals should exceed the estimated market shares of targeted mortgage lending already occurring in the primary mortgage market. In fact, the Secretary set the three final housing goals below HUD's estimates of targeted mortgage originations already occurring in the primary market (see table 3).

Table 3: Enterprise Housing Goals for 1996-1999 and HUD's Estimates of Primary Market Shares

Goal category	Percentage goal 1996	Percentage goal 1997-1999	Estimated share of primary market
Low- and moderate-income	40%	42%	48-52%
Underserved areas	21	24	25-28
Special affordable	12	14	20-23

Source: HUD.

The HUD Secretary also decided to establish a multifamily subgoal as part of the special affordable goal. Unlike the three housing goals, which are based on the number of dwelling units financed by qualified mortgage purchases, the HUD Secretary based the multifamily subgoal on the dollar volume of qualified enterprise mortgage purchases. Specifically, the goal was set at 0.8 percent of each enterprise's total mortgage purchases in 1994. According to HUD, this subgoal translates into a requirement that Fannie Mae purchase $1.29 billion in affordable multifamily mortgages annually between 1996 and 1999, while Freddie Mac is required to purchase $988 million in affordable multifamily mortgages annually. The multifamily subgoal represented a significant initial commitment for Freddie Mac because it experienced substantial multifamily losses in 1989 and 1990 and withdrew from the market completely in 1990.[25] Freddie Mac did not return to the multifamily market until 1993, and its 1994 multifamily purchases that qualified under the subgoal were only $425 million. According to HUD's final rule, the purpose of the subgoal was to help ensure the development of a liquid, secondary market for affordable multifamily properties, which may promote housing opportunities.

Further, in setting the final underserved areas goal, the HUD Secretary changed the definition of "central city" that had been established in the 1992 Act for the transition goals of 1993 and 1994. Under the 1992 Act, HUD was required to base the definition of central city on criteria established by the Office of Management and Budget (OMB) during the transition period of 1993 and 1994, but HUD decided to use a definition that was based on census tract data—published by the U.S. Bureau of the Census—when setting the final goals. According to HUD, a census tract definition was more appropriate than OMB's central city definition because the former

[25]Freddie Mac reported $278 million in multifamily mortgage losses in 1989 and 1990 combined, representing 50 percent of Freddie Mac's losses during those years. See Federal Home Loan Mortgage Corporation: Abuses in Multifamily Program Increase Exposure to Financial Losses (GAO/RCED-92-6, Oct. 7, 1991).

definition would focus the enterprises' mortgage purchase efforts on neighborhoods that have relatively high concentrations of low-income and minority residents, areas that HUD identified as being underserved by the mortgage market. By contrast, under OMB's central city definition, HUD concluded that entire cities were being treated as if they had mortgage access problems when, in fact, residents of upper-income areas in cities usually do not confront obstacles in obtaining mortgage credit.

HUD Determined That the Final Goals It Established Would Not Materially Affect Enterprise Earnings

In 1995, HUD analyzed the goals it established and estimated that the goals would not materially affect the enterprises' earnings. For example, HUD developed a simulation model,[26] which basically found that the enterprises could increase their targeted mortgage purchases to the levels established in the 1995 rule without incurring substantial additional credit risk because the additional purchase requirements under the established goals were modest.

Further, HUD estimated the enterprises' return on equity (ROE)—a common measure of profitability—under alternative economic scenarios. These analyses found that, despite the implementation of the housing goals, which would require additional purchases of targeted mortgages, the enterprises would generate ROEs generally exceeding 17 percent[27] and only fall slightly below that even if the enterprises encountered periods of severe economic stress. For example, HUD's analysis found that Fannie Mae's ROE for multifamily purchases—which are considered riskier than single-family mortgage purchases[28]—would generally be above 19 percent during a period of severe economic stress.[29] Similarly, Freddie Mac's ROE for multifamily lending would be about 17 percent during a period of economic stress. We note that multifamily mortgages represent only about 4 percent of Fannie Mae's total mortgage portfolio and 1 percent of Freddie Mac's total portfolio. During periods of normal economic activity, HUD estimated that both enterprises would achieve ROEs exceeding 20 percent on their single-family and multifamily mortgage purchases, despite the implementation of the housing goals.

[26]A simulation model is a computer model that estimates the impact of specified economic scenarios on a financial institution's financial performance.

[27]HUD assumed that the enterprises needed to achieve ROEs of at least 17 percent to attract financial investors.

[28]Multifamily loans are riskier than single-family loans because (1) multifamily loans often are not homogenous regarding the type of collateral, interest rate, and amortization; (2) underwriting standards often differ among multifamily loan originators; and (3) multifamily loans are relatively large and one defaulted loan can result in significant losses.

[29]By contrast, the U.S. commercial banking industry's ROE between 1993 and 1996, which was a period of record profitably due to an improving economy and low interest rates, averaged about 14.8 percent.

In conducting this research, HUD did not estimate the financial consequences of alternative goals to those final goals that were ultimately adopted on the enterprises' financial soundness. For example, HUD did not estimate whether setting the goals at higher levels would materially lower the enterprises' ROE under differing economic scenarios, such as those used in estimating the effects of the final goals. Further, HUD did not conduct research on the extent to which the enterprises' use of lender-provided "credit enhancements"[30]—which are used to minimize or eliminate the credit risks associated with mortgage purchases—could offset the effects of an economic downturn. We discuss the enterprises' use of credit enhancements and their potential effects on housing opportunities in more detail later in this report.

During the rulemaking process, HUD and OFHEO officials said that they consulted with one another and that OFHEO reviewed drafts of the proposed housing goal rule in 1994 and 1995. In an internal 1994 document, OFHEO concluded that HUD's proposed housing goal rule represented a "modest" increase in the enterprises' then existing commitment to targeted mortgage purchases and would not likely affect their financial condition. In 1995, OFHEO concluded that the enterprises' could meet the final housing goals without sacrificing their safety and soundness.[31]

HUD's Rationale for Its Approach to Setting the Final Housing Goals Was Generally Grounded in Safety and Soundness Concerns

A senior HUD official who was involved in the development of the final housing goal rule said that maintaining the enterprises' financial soundness was one of several priorities HUD emphasized during the rulemaking process. According to the HUD official, other reasons that HUD adopted a conservative approach were to (1) ensure that the enterprises could meet the goals in bad economic times as well as good and (2) adjust for Freddie Mac's initial difficulties in meeting the multifamily mortgage purchase requirement.

[30]Such credit enhancements require the loan originator to accept some or all of the estimated credit risk on a mortgage sold to an enterprise in the event of a borrower default. In its analysis, HUD assumed that all of the losses associated with multifamily defaults would be absorbed by the enterprises, rather than the lenders with whom the enterprises maintain credit enhancement agreements.

[31]OFHEO, Annual Report to Congress 1995.

The Enterprises Have Reportedly Increased Their Purchases of Targeted Mortgages, but HUD Cannot Determine Impacts on Housing Opportunities

According to data Fannie Mae and Freddie Mac reported to HUD, the enterprises have increased the shares of their overall business devoted to targeted mortgage purchases since the transition housing goals went into effect in 1993. The enterprises were in compliance with all three of the final goals in 1996 and 1997, although Fannie Mae's performance has exceeded that of Freddie Mac. According to HUD, the enterprises' purchases of targeted mortgages have also generally increased relative to the originations of such mortgages in the primary market.

However, HUD has not yet determined the extent to which the implementation of the housing goals is resulting in enhanced housing affordability and opportunities for targeted groups, which was the intent of the 1992 Act. As the federal regulator mandated by the 1992 Act to establish, enforce, and adjust the housing goals as necessary, HUD has a basic oversight responsibility to conduct research to determine the goals' impacts on housing opportunities. Although HUD has ongoing research to meet its oversight responsibilities, HUD's current research agenda does not address several important issues, such as the goals' effects on (1) interest rates and loan terms on targeted mortgage loans and (2) mortgage originators' incentives to make targeted mortgage loans.

Enterprises Increased Purchases of Targeted Mortgages Between 1993 and 1997

Table 4 shows that the enterprises' reported mortgage purchases under all three of HUD's housing goals increased as percentages of their overall mortgage purchases between 1993 and 1997. For example, Fannie Mae's purchases of mortgages under the low- and moderate-income goal increased from 34.1 percent in 1993 to 45.5 percent in 1997. Similarly, Freddie Mac's purchases under the low- and moderate-income goal increased from 30 percent in 1993 to 42.9 percent in 1997.

Table 4: Enterprise Mortgage Purchases Under the Affordable Mortgage Housing Goals, 1993-1997

Goal category	Enterprise	1993	1994	1995	1996	1997
Low- and moderate- income	Fannie Mae	34.1%	45.1%	42.8%	45.1%	45.5%
	Freddie Mac	30.0	38.0	39.6	41.3	42.9
Underserved areas goal	Fannie Mae	22.9	29.0	31.2	28.2	29.0
	Freddie Mac	21.3	24.2	25.2	25.0	26.3
Special affordable	Fannie Mae	10.0	16.7	15.8	17.4	19.1
	Freddie Mac	7.2	11.4	13.2	14.2	15.3

Source: The 1993-95 enterprise data are reported by HUD as having been recalculated to represent goal definitions in the 1995 final rule. According to HUD, the 1996 and 1997 figures were reported by the enterprises in compliance with the final rule.

The enterprises' data also show that Fannie Mae and Freddie Mac exceeded all three final housing goals in both 1996 and 1997, in some cases by significant margins (see table 5). For example, Fannie Mae's purchases qualifying under the special affordable goal exceeded the goal by 45.0 percent in 1996 and 36.4 percent in 1997. Freddie Mac also exceeded HUD's affordable housing goals in 1996 and 1997, although not by as much as Fannie Mae.

Table 5: HUD Housing Goals and Enterprise Compliance With the Goals in 1996 and 1997

Goal category	Enterprise	1996 goal	1996 purchases	Purchases as a percentage of goal	1997 goal	1997 purchases	Purchases as a percentage of goal
Low- and moderate- income	Fannie Mae	40.0%	45.1%	**112.8%**	42.0%	45.5%	**108.3%**
	Freddie Mac	40.0	41.3	**103.3**	42.0	42.9	**102.1**
Underserved areas	Fannie Mae	21.0	28.2	**134.3**	24.0	29.0	**120.8**
	Freddie Mac	21.0	25.0	**119.0**	24.0	26.3	**109.6**
Special affordable	Fannie Mae	12.0	17.4	**145.0**	14.0	19.1	**136.4**
	Freddie Mac	12.0	14.2	**118.3**	14.0	15.3	**109.3**

Source: HUD reported the goal levels and enterprise performance levels. GAO calculated the percentage differences.

Fannie Mae's relatively larger volume of affordable multifamily mortgage purchases is one reason that Fannie Mae's performance under the goals has exceeded that of Freddie Mac.[32] For example, table 6 shows that although both enterprises complied with the multifamily affordable subgoal in 1996 and 1997, Fannie Mae's multifamily purchases were higher.[33] This difference is important because, under HUD's rules, a mortgage purchase under one goal—such as the special affordable multifamily subgoal[34]—can also count towards compliance with the other goals for which it qualifies, such as the low- and moderate-income and

[32]As discussed in the previous section, Freddie Mac withdrew from the multifamily market entirely in 1990 due to large losses and did not return to the market until 1993.

[33]The multifamily subgoal's income and location criteria are stricter than the low- and moderate-income criteria. Therefore, the enterprises may purchase other affordable multifamily mortgages that do not qualify under the special affordable subgoal but may meet the requirements of the other goals. Thus, the enterprises' total affordable multifamily purchases—which consist of subgoal purchases and other goal-qualifying purchases—is larger than the special affordable subgoal purchases alone. In 1997, Fannie Mae reported $6.9 billion in total multifamily purchases, while Freddie Mac reported $2.7 billion.

[34]The special affordable subgoal is based on the dollar volume of qualified mortgage purchases. However, the enterprises also track the dwelling units financed by these mortgage purchases to determine the dwelling units' compliance towards the other housing goals.

special affordable goals.[35] According to HUD, multifamily properties house relatively large numbers of low- and moderate-income families and, by definition, house many more families than a single-family property. Consequently, Freddie Mac's smaller presence in the multifamily market meant that it had more to accomplish than Fannie Mae when the enterprises became subject to the final goals.

Table 6: Enterprise Goal Levels and Loan Purchases Under the Multifamily Subgoal of the Special Affordable Goal for 1996 and 1997

(Dollars in billions)

Enterprise	1996-1997 goal	1996 purchases	Purchases as a percentage of goal	1997 purchases	Purchases as a percentage of goal
Fannie Mae	$1.29	$2.36	182.9%	$3.19	247.3%
Freddie Mac	.988	1.08	109.3	1.2	121.5

Source: Qualifying mortgage purchases reported by Fannie Mae and Freddie Mac.

Enterprise Initiatives to Enhance Housing Opportunities for Targeted Groups

The annual reports that the enterprises submit to HUD on their mortgage purchases under the affordable housing goals also describe the programs that the enterprises have in place to improve the availability of affordable housing. For example, in its 1997 annual report, Fannie Mae attributed its success in meeting the affordable housing goals to the partnerships it has with state and local housing finance agencies, nonprofit agencies, and the mortgage industry. The Fannie Mae report also describes the enterprise's programs in the areas of home-buyer education, the development of new mortgage products to meet needs in the affordable housing market, and the efforts to ensure that its underwriting guidelines broaden access to mortgage financing for more individuals and families, including families previously excluded from the homebuying process.

Freddie Mac's 1997 annual report also describes its initiatives to expand access to mortgage credit and simplify the loan origination process. For example, the report describes initiatives to lower down-payment requirements to expand homeownership opportunities; make loans for the purchase and rehabilitation of homes more affordable by lowering the cost of these mortgages; and expand financing of affordable multifamily properties.

[35]For example, multifamily units represented 12 percent of the total housing units purchased by the enterprises in 1995, but such units accounted for 22 percent of the units meeting the low-and moderate-income goal and for 41 percent of the units meeting the special affordable goal.

Enterprises Also Generally Improved Their Mortgage Purchase Performance Relative to the Primary Market

As previously discussed, a potential definition of "lead the [mortgage finance] industry" that HUD considered between 1993 and 1995 would have required the enterprises to purchase relatively more targeted mortgages than are originated in the primary mortgage market. Although HUD did not adopt this potential definition, HUD research staff have collected and analyzed data on enterprise targeted mortgage purchases compared to primary market originations.[36] The HUD analyses show that the enterprises' targeted mortgage purchases have generally improved relative to primary market originations. The HUD research also found that (1) Fannie Mae's performance compared to the primary market has improved more than Freddie Mac's performance has improved relative to the primary market and (2) the enterprises still trail the primary market in most targeted mortgage categories. We discuss these issues in more detail in appendix III.

HUD's Research Agenda Does Not Address Several Issues Relevant to Understanding the Goals' Effects on Promoting Homeownership and Housing Opportunities

HUD has initiated research to determine the extent to which the implementation of the housing goals has resulted in enhanced housing affordability and opportunities for targeted groups. Such research is essential for HUD to effectively carry out its housing mission oversight role, determine whether the intent of the 1992 Act is being met, and identify the appropriate levels to set the goals in the future. However, HUD's current research agenda does not address several relevant issues necessary to understand the housing goals' effects.

HUD's reported data on the enterprises' compliance with the housing goals are input measures that show the annual volumes of Fannie Mae's and Freddie Mac's targeted loan purchases. The reported data do not provide information on the extent to which the enterprises' increased purchases are resulting in the 1992 Act's desired outcomes (i.e., increased homeownership and housing opportunities for targeted groups). For example, the reported data do not provide information on the extent to which—if at all—the enterprises' mortgage purchases are resulting in lower mortgage interest rates or more flexible loan terms for low- and moderate-income borrowers or those that live in underserved areas.

[36]Paul B. Manchester, Sue George Neal, and Harold L. Bunce, Characteristics of Mortgages Purchased by Fannie Mae and Freddie Mac, 1993-95 (HUD, Office of Policy Development and Research, Working Paper No. HF-003, Mar. 1998).

In this regard, a Department of the Treasury study[37] completed in 1996 found that the enterprises' targeted mortgage purchases generally had relatively high down payments. In particular, the study pointed out that in 1994 about 78 percent of Fannie Mae's housing goal loan purchases that meet the low- and moderate-income goal had loan-to-value (LTV) ratios[38] of less than or equal to 80 percent. Similarly in 1994, approximately 79 percent of Freddie Mac's mortgage purchases meeting the low- and moderate-income goal had LTV ratios of less than or equal to 80 percent. The study concluded that many of the enterprises' goal-oriented mortgage purchases likely would already have been financed by the private sector, since loans with LTVs of 80 percent or less represent relatively low credit risks to financial institutions, such as banks and thrifts. Thus, the study suggested that the goals have not materially affected the existing mortgage finance market for targeted groups.

Currently, HUD has a variety of research projects—in-house, contract, and grant—to assess a range of issues that address the impacts of the goals. For example, HUD has awarded a contract to Abt Associates, Inc., to review the enterprises' underwriting and appraisal standards and practices, specifically in reference to effects on the availability of loans on affordable housing (see table 7 for a list of HUD contracts). In September 1997, HUD also awarded 11 research grants totaling about $400,000 to study mortgage purchase activities of the enterprises. According to HUD officials, one reason HUD initiated these projects was to explore issues that may be relevant should the Department decide to revise the housing goals after 1999.

[37]U.S. Department of the Treasury, Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (July 11, 1996).

[38]In general, loans with lower LTV ratios represent smaller borrower risks to mortgage loan originators and the enterprises than those with higher LTV ratios. The LTV ratio is determined by dividing the balance of the mortgage loan outstanding by the estimated value of the residential property. Thus, the LTV ratio on an outstanding mortgage balance of $60,000 on a single-family residence with an estimated value of $100,000 would be 60 percent. The enterprises generally require mortgage insurance or other credit enhancements on mortgage loans with LTV ratios exceeding 80 percent.

Table 7: HUD's Contracts for Research Support on Housing Goals

Contractor	Task description	Award date	End date	Amount
The Urban Institute	Single-family underwriting study	September 30, 1997	July 31, 1998	$174,014
	Affordable lending program performance study	September 30, 1997	March 30, 2000	151,446
	Underserved homebuyers study	February 18, 1997	June 18, 1998	24,490
Abt Associates, Inc.	Multifamily underwriting study	September 30, 1997	August 31, 1998	121,564
	Studies on enterprises' fair lending practices	November 3, 1997	September 30, 1998	25,000

Source: HUD.

However, HUD's research agenda does not yet address several issues that are relevant to understanding the effects of the goals and enterprise activities in promoting homeownership and housing opportunities for targeted groups. For example, we previously reported that quantification of the enterprises' efforts to serve targeted borrowers generally measures resource commitments and not outcomes, such as the impacts on mortgage interest rates and housing affordability for targeted groups.[39] Therefore, we reported that understanding the impacts of goal-oriented enterprise purchases would require a determination of how mortgage originations by other lenders (namely, depository institutions that undertake portfolio lending and mortgage bankers that originate federally insured mortgages for mortgage pools guaranteed by the Government National Mortgage Association (Ginnie Mae)) are affected and respond to this change in funding.[40] HUD has not yet initiated in-house or contracted research to analyze the extent to which goal-oriented enterprise purchases may affect (1) mortgage interest rates and other loan terms and (2) mortgage lenders' incentives to initiate affordable mortgages. However, HUD officials said that they plan to initiate an analysis on the effects of the housing goals on depository institutions.

[39]Housing Enterprises: Potential Impacts of Severing Government Sponsorship (GAO/GGD-96-120, May 13, 1996).

[40]Ginnie Mae is an organization within HUD that guarantees the timely payment of principal and interest on securities backed by mortgages insured by FHA or the Department of Veterans Affairs.

HUD Has Not Initiated Inspections to Assess the Accuracy of Enterprise-Supplied Goal Compliance Data

HUD's verification of enterprise-supplied goal compliance data would have important implications on the usefulness of the information because, without verification, incorrect data could be used as the basis for policy decisions. Also, the mortgage data that the enterprises report are very complex and come from a large number of sources, increasing the potential for errors. Although HUD has checked the accuracy of the calculations that are based on the data that the enterprises provide, as of April 1998, HUD had not initiated a program to assess the overall integrity of the data collection and reporting process.

Housing Goal Data Reliability Is Important

Verification of the data HUD receives from the enterprises regarding their affordable mortgage purchases is important. The data that Fannie Mae and Freddie Mac are required to submit tell HUD whether the enterprises are meeting the affordable housing goals. As such, these data may be used to make important policy decisions about how well the enterprises are using the benefits gained from their government charters to support the nation's affordable housing goals. If these data are inaccurate or if officials do not know that they can rely on them, policymakers do not have the tools they need to make informed decisions about, for example, where affordable housing goals should be set in the future.

A key principle in the use of data from any entity being examined by the government is that appropriate steps should be taken to ensure the validity of the data collected, particularly data supplied by the entity that is under examination.[41] If steps were not taken to ensure the validity of these data, then the data may provide an unreliable basis from which to draw conclusions.

In the final housing goal rule, HUD outlines the basis for its authority to

> " . . . independently verify the accuracy and completeness of the data, information and reports, including conducting on-site verification, when verification is reasonably related to determining whether the (enterprises) are complying with the law. . . . without the authority to verify the completeness and accuracy of the data, information, or reports submitted by each enterprise, the Secretary would be hampered in making the determinations that are required. Such a situation could result in the Secretary erroneously concluding that the enterprises are complying with [the 1992 Act] when they are not, or that they are not complying with [the 1992 Act] when they are."

[41]For example, see GAO's Government Auditing Standards: 1994 Revision.

Housing Goal Data Is Complex and Subject to Errors

The data that the enterprises collect and report to HUD regarding their mortgage purchases comes from many sources, are often complex, and can be subject to errors. The data are supplied to the original lenders by borrowers; the lenders, in turn, give the data to the enterprises when they sell the loans to them. The enterprises then assemble the data and provide them to HUD.

Officials from Fannie Mae and Freddie Mac told us how they perform a number of checks, both on their own processing of data and on the validity of data that they receive from lenders when they buy the mortgage loans. Both enterprises noted that it would be impossible to independently verify the millions of data records that the enterprises receive when they purchase mortgages from lenders. However, the enterprise officials said that they independently verify samples of these data to help ensure accuracy. The enterprise officials also said that they conduct audits of their own internal processing of loan data to ensure that the data submitted to HUD are accurate.

Multifamily mortgages present a number of unique challenges when it comes to accurately determining whether the mortgages meet the affordable housing criteria. For example, some enterprise purchases of multifamily mortgages are of pooled, seasoned mortgages, which tend to be older. Although older, seasoned mortgages are considered safer and more desirable on the secondary mortgage market, they also may contain out-of-date affordability data, such as reported rent levels. Ensuring the accuracy of rent-level data is essential for HUD's purposes because comparison of rent levels that are several years old with current median income data for an area would artificially inflate the apparent affordability of a property. According to HUD researchers,[42] in 1995, Fannie Mae was missing data items needed to determine affordability for 32 percent of its multifamily mortgage purchase transactions.

HUD Has Not Independently Verified the Accuracy of Enterprise-Supplied Data

To date, HUD has performed some limited procedures to assess the data supplied by the enterprises. HUD officials explained how they conducted a number of limited checks on the 1996 data the enterprises supplied in 1997. HUD has not yet implemented a program to independently verify the reported housing goal data, but HUD officials told us that they plan to increase their data verification activities in the future.

[42]See William Segal and Edward J. Szymanoski, The Multifamily Secondary Mortgage Market: The Role of Government-Sponsored Enterprises (Working Paper No. HF-002, Mar. 1997). The views expressed in this paper are those of the authors and do not necessarily represent HUD's official views.

HUD's verification of enterprise-supplied data has, to date, consisted primarily of internal validity checks (i.e., checks on the results of calculations that the enterprises used to determine which loan purchases qualify under which goals). HUD performed these checks by replicating the data tables submitted by the enterprises using the complete data sets of enterprise-supplied data, then looking for areas where its results did not match the enterprises' results. HUD officials also said that they examined the enterprise data for missing items and for noticeable "out-of-line" values, such as properties with geographic codes placing them in states, counties, or census tracts that do not exist. Where HUD found discrepancies, officials said that they discussed them with the appropriate enterprise, and the enterprise submitted revised data, where necessary.

HUD officials told us that independent verification of enterprise-supplied data has been a goal but that the verification was superseded by other priorities in 1997. The officials told us that HUD's verification processes are "evolving," and that HUD plans to conduct more detailed data verification in 1998. HUD officials said that they may review the internal controls and audit steps that the enterprises have in place to ensure the accuracy of the reported goal compliance data. For example, HUD could review the procedures that the enterprises have established to sample the data that they receive from lenders.

HUD also did not use a relevant data integrity examination conducted by OFHEO. Officials from OFHEO informed us that the organization conducts on-site verification of data systems and system controls at the enterprises, but that this activity is not regularly coordinated with HUD. For example, a 1996 OFHEO examination of financial data controls at Freddie Mac noted that controls over Freddie Mac's nonfinancial data were inadequate to ensure integrity. These nonfinancial data, which include information about the geographic location of properties and demographic information about borrowers and tenants, are key to determining whether a particular loan fits different purchase goals. However, OFHEO did not immediately inform HUD of its findings, and HUD officials responsible for enterprise oversight said that they were unaware of the examination.[43]

[43]We note that OFHEO included the information about the examination and its findings with respect to Freddie Mac's nonfinancial data controls in OFHEO's 1997 Report to Congress.

Resource Limitations Could Impede HUD's Capacity to Complete Comprehensive Data Integrity Reviews

We recognize that any data verification steps that HUD implements may require an allocation of additional resources. However, HUD's resources are limited since the Department has initiated a major downsizing from 10,500 employees in 1997 to a projected 9,000 in 2002. Similar to the situation at HUD as a whole, HUD's Office of GSE Oversight lost one FTE in fiscal year 1998, leaving the office with five FTEs.[44] As of April 1998, the Office of GSE Oversight had one vacant position and the Acting Director served in a part-time role. As discussed previously, federal oversight of housing enterprises—except for HUD's mission oversight of Fannie Mae and Freddie Mac—is financed by the respective enterprises via periodic assessments on their activities. Because HUD's enterprise oversight activities must compete with other priorities in HUD's annually appropriated budget, its capacity to implement a program to assess housing goal data accuracy may be limited.

Housing Goal Rule Provides Credit for Enterprise Multifamily Mortgage Risk-Management Practices Whose Effects on Enhancing Housing Opportunities for Targeted Groups Are Unclear

For an enterprise that is not in compliance with the housing goals, HUD's final housing goal rule may provide regulatory incentives, especially for multifamily housing, to employ credit enhancements, which help the enterprise meet or exceed the numeric goals. However, the effects that credit enhancements have on enhancing housing opportunities for targeted groups are unclear. Under the rule, the enterprises are permitted to count multifamily mortgage purchases toward full compliance with the goals, even where the mortgage originator—such as a bank or thrift—is required by credit enhancements to cover most or all estimated future credit losses. According to HUD, credit enhancements encourage the enterprises to participate in the multifamily mortgage market, promote liquidity, and are necessary to protect the enterprises' financial soundness.

However, there is also available information suggesting that the widespread use of credit enhancements also involve offsetting trade-offs that may serve to limit lenders' incentives to originate affordable multifamily mortgages. For example, by requiring lenders to retain all of the credit risks associated with multifamily mortgage financing, credit enhancements could impede the lenders' willingness to extend mortgage credit. By contrast, when Fannie Mae and Freddie Mac purchase single-family mortgages, they generally relieve the lenders of the associated credit risks. This has encouraged the development of a liquid, secondary market for single-family mortgages. Moreover, depositories—banks and thrifts—must meet federal risk-based capital

[44] Staff members from HUD's Office of Policy Development and Research as well as contractor personnel are also involved with the data verification aspects of HUD's oversight of the enterprises.

standards for mortgage loans sold to an enterprise on which the depositories retain expected credit risks, which may further serve to limit their incentives to originate multifamily mortgages. HUD has not conducted research to determine the effects of enterprise risk management strategies on multifamily mortgage finance and housing opportunities.

The Enterprises Use Credit Enhancements to Manage the Risks Associated With Multifamily Mortgage Purchases

We previously pointed out that multifamily mortgage purchases represent greater risks of default than single-family mortgage purchases. To mitigate the credit risks associated with multifamily loan purchases under the goals,[45] the enterprises use credit enhancements, which may require mortgage originators to cover up to 100 percent of actual losses from mortgage defaults over time. The credit enhancements used by the enterprises include recourse and collateralization agreements, which may require the mortgage loan seller—such as a bank—to take the "first loss" on credit defaults up to a specified percentage, such as 10 percent of the outstanding mortgage balance, or pledge collateral (e.g., in the form of high-grade securities) before the completion of the transaction.

As previously discussed, Fannie Mae purchases a relatively larger volume of affordable multifamily mortgages than Freddie Mac. Through the use of recourse agreements and other credit enhancements, Fannie Mae was fully responsible for the potential credit losses on 14 percent of the multifamily mortgages in its mortgage portfolio and MBS in 1997. According to Fannie Mae officials, Fannie Mae also shares credit risks with lenders in a large number of credit-enhanced multifamily mortgage purchases. In exchange for sharing credit risks with Fannie Mae, the lenders are permitted to use Fannie Mae's underwriting standards and make mortgage approval decisions without prior approval from the enterprise,[46] which increases the lenders' business flexibility. Fannie Mae officials added that the enterprise's purchases of multifamily mortgages that are subject to credit enhancements serve to enhance the liquidity of the market. According to a Freddie Mac official, Freddie Mac generally underwrites most of the multifamily mortgages that it purchases and assumes all of the credit risk on these purchases. However, Freddie Mac also has used recourse and

[45]The enterprises do retain exposure to losses due to fluctuations in interest rates on multifamily mortgages retained in their portfolios. The enterprises may also absorb losses if a lender subject to a credit enhancement fails, and the enterprise has not obtained sufficient collateral to cover such losses.

[46]Fannie Mae's Delegated Underwriting and Servicing program allows lenders who share credit risk on multifamily mortgages to make credit decisions without prior approval. Fannie Mae also purchases multifamily mortgages where lenders use their own underwriting standards. These mortgage purchases are subject to higher "first loss" provisions than are loans purchased under the Delegated Underwriting and Servicing program.

collateralization agreements on multifamily mortgages that it has purchased.

Credit enhancements are routinely used by the enterprises because they are an attractive method to manage credit risks. For example, recourse agreements, by subjecting the mortgage originator to credit risk, motivate the originator to follow sound underwriting practices. Such lender motivation can be especially important to the enterprises for multifamily mortgage purchases because default rates on such mortgages are generally higher than for single-family mortgages. In addition, according to a Federal Reserve study,[47] the mortgage originator may have better information on the specific risk characteristics of the financed property and its value than does the housing enterprise purchasing the mortgage. Another reason that the enterprises use credit enhancements for multifamily mortgage purchases is that private mortgage insurance[48] is generally not available for such purchases as it is for single-family mortgage purchases. As a result of these benefits, the enterprises will be more willing to purchase multifamily mortgages at more favorable terms from lenders when the lenders provide credit enhancements.

According to HUD officials we contacted, there are several benefits associated with credit enhancements in the multifamily mortgage market, including the following:

1. Credit enhancements encourage the enterprises to purchase multifamily mortgages, thereby providing stability and liquidity to the market, which is a requirement of their charters.

2. Credit enhancements, as previously discussed, promote sound underwriting standards by multifamily lenders.

3. Credit enhancements help ensure the financial soundness of the enterprises.

[47]Glenn Canner and Wayne Passmore, "Credit Risk and the Provision of Mortgages to Lower-Income and Minority Homebuyers," Federal Reserve Bulletin (Nov. 1995), pp. 989-1016.

[48]Private mortgage insurers are generally large corporations that insure but do not originate or purchase conventional mortgages, which are mortgages that do not have federal mortgage insurance or a federal guarantee. The enterprises' charters require them to obtain private mortgage insurance or alternative credit enhancements on mortgage purchases with LTVs exceeding 80 percent. According to HUD, private mortgage insurance is generally not offered on multifamily mortgage purchases.

Credit Enhancements May Also Limit Lenders' Incentives to Originate Affordable Multifamily Mortgages

While there are potential risk-management benefits associated with credit enhancements, there is also information showing that their widespread use could serve to limit lenders' incentives to originate multifamily mortgages and promote housing opportunities. In particular, credit enhancements (1) may require lenders to retain most expected credit risks, (2) limit the geographic diversification of credit risk, and (3) require depositories to continue to meet risk-based capital standards on multifamily mortgage sales to the enterprises.

By requiring lenders to retain most of the expected credit losses associated with multifamily mortgage purchases, credit enhancements may serve to limit lenders' willingness to originate such mortgages. By contrast, it is generally acknowledged that the enterprises' assumption of certain credit risks on single-family mortgages has contributed to the development of a liquid, secondary market for single-family mortgages. The development of this secondary market has resulted in lower mortgage interest rates for borrowers and helped ensure the nationwide availability of mortgage credit.

The use of credit enhancements may also limit geographic diversification of the credit risks associated with multifamily lending. When a financial institution can diversify credit risks geographically, it can offset losses in one region that may be experiencing an economic downturn with income from another region that is growing. The enterprises operate on a nationwide basis and thus have the ability to diversify the credit risks on single-family mortgages purchased from lenders in the primary market. However, a lending institution without the capacity to diversify credit risks geographically, may be unable or unwilling to finance multifamily mortgages or provide liquidity in the areas where it does business. During an economic recession, lenders' incentive to initiate affordable multifamily mortgages may be particularly limited, since such projects may represent significant credit risks.

Moreover, the HUD staff study[49] we previously discussed pointed out that regulatory risk-based capital requirements for federally insured depository institutions, such as banks or thrifts, can serve to limit multifamily mortgage originations. Under these requirements, a depository is generally required to hold risk-based capital against a mortgage loan that is subjected to a recourse agreement and sold to Fannie Mae or Freddie Mac. Consequently, the study stated that depositories' willingness to originate multifamily mortgage loans may be limited by these risk-based capital

[49]The Multifamily Secondary Mortgage Market.

requirements and questioned whether the use of recourse agreements enhances the affordable housing market. In addition, regulatory rules require that depositories hold cash reserves against loans subject to recourse agreements.

In a June 1998 HUD staff study,[50] HUD researchers reported that there is a lack of liquidity for smaller multifamily properties—that is those properties with 5 to 49 dwelling units—that tend to be affordable to targeted groups. When HUD established the multifamily subgoal, it intended that the enterprises' increased presence in the multifamily mortgage market would improve the liquidity for smaller properties, thereby enhancing housing opportunities. The reported lack of liquidity for smaller multifamily properties continued over the past 4 or 5 years when HUD's housing goals were in place and overall mortgage market liquidity was strong.

HUD Housing Goal Rule May Provide Regulatory Incentives for the Use of Credit Enhancements on Multifamily Mortgage Purchases

HUD's final rule permits the enterprises to count multifamily mortgage purchases that are subject to credit enhancements fully toward compliance with the housing goals. For example, if an enterprise purchased a multifamily mortgage in which the enterprise required the seller to accept all potential losses via a recourse agreement, the enterprise could report that purchase to HUD as complying with the multifamily subgoal and any other goals that may similarly be covered, such as the low- and moderate-income goal. By authorizing full credit for multifamily mortgage purchases subject to credit enhancements, the final rule may provide the enterprises with a regulatory incentive, in addition to market-based incentives, to require mortgage originators to retain most or all credit risks.

However, HUD's final rule also requires the enterprises to accept additional credit risks on multifamily mortgage purchases financed under FHA "risk-sharing" demonstration programs to receive full credit toward compliance with the housing goals. The enterprises are among the participants in FHA's risk-sharing programs for affordable multifamily properties, which Congress has authorized as demonstration programs.[51]

[50]William Segal and Edward J. Szymanoski, "Fannie Mae, Freddie Mac, and the Multifamily Mortgage Market," Cityscape: A Journal of Policy Development and Research, HUD, Vol. 4, Number 1 (1998), pp. 59-74. This paper represents the views of the authors and does not necessarily represent HUD's official views.

[51]Congress authorized risk-sharing demonstration programs in the Housing and Community Development Act of 1992. Congress has authorized a total of 62,000 affordable dwelling units under the risk-sharing programs.

In these demonstration programs, FHA may enter into an agreement with an enterprise to accept half of the credit risk on multifamily mortgages under the program, and FHA collects an insurance fee from its partner for this guarantee. The final housing goal rule only permits enterprise mortgage purchases under the risk-sharing programs to count toward full compliance with the goals when the enterprise agrees to accept significant additional credit risk, defined as 50 percent or more.[52] According to the final rule, the assumption of additional credit risk "serve(s) to increase available housing opportunities." In a recently issued report, we found that FHA's risk-sharing programs generally offer alternatives and encourage the financing of affordable multifamily properties.[53]

HUD Has Not Conducted Research to Determine the Effects of Credit Enhancements on Multifamily Mortgage Finance and Housing Opportunities

HUD has not conducted research to determine the effects of credit enhancements on multifamily mortgage finance and housing opportunities. For example, HUD has not analyzed whether credit enhancements promote liquidity by encouraging the enterprises to participate in multifamily mortgage finance or limit liquidity due to (1) the inability of lenders to diversify credit risks and (2) the effects of recourse agreements and risk-based capital standards on depositories' incentives to sell multifamily mortgages to the enterprises. In addition, HUD has not conducted research on the extent to which the housing goal rule may provide the enterprises with incentives to use credit enhancements. HUD officials told us that they do not collect data on the extent to which the enterprises use credit enhancements on multifamily mortgage purchases that are reported as in compliance with the housing goals.

We recognize that there are important safety and soundness issues associated with multifamily mortgage purchases and that the enterprises use credit enhancements to manage those risks. However, under their charters, the enterprises also have an affirmative obligation to meet the credit needs of targeted borrowers, which may be accomplished at a lower, though reasonable, rate of return than other activities.

Further, it is important to note that HUD took into account the financial soundness consequences of the special affordable multifamily subgoal by setting it at a "reasonable" level. Specifically, Fannie Mae's annual subgoal

[52]Fannie Mae—which participates extensively in FHA's risk-sharing programs—uses credit enhancements on multifamily mortgages that are purchased under the FHA programs. After 3 years, Fannie Mae may relieve the lender of the credit risks associated with a mortgage purchase if the loan is performing according to preestablished criteria, such as cash flow. Fannie Mae's assumption of credit risks relieves the lender of risk-based capital and cash reserve requirements.

[53]Housing Finance: FHA's Risk-Sharing Programs Offer Alternatives for Financing Affordable Multifamily Housing (GAO/RCED-98-117, Apr. 23, 1998).

requirement of $1.29 billion represented about 0.7 percent of the enterprise's approximate total of $174 billion in mortgage purchases in 1996. Similarly, Freddie Mac's annual multifamily subgoal purchase requirement of $988 million represented about 0.8 percent of Freddie Mac's total mortgage purchases of about $125 billion in 1996.[54] About 4 percent of Fannie Mae's and 1 percent of Freddie Mac's total mortgage portfolios are comprised of multifamily mortgages.

Finally, we note that HUD has not conducted sufficient research to determine the level at which the housing goals could be set in the future. According to HUD, the possibility exists that credit enhancement use may provide meaningful support and liquidity without subjecting the enterprises to credit risk. In addition, the enterprises may be more willing to purchase multifamily mortgages at more favorable terms with credit enhancements. If so, the potential exists that the enterprises could purchase more multifamily mortgages than are currently required without significantly affecting the enterprises' financial soundness. However, as previously discussed, the possibility also exists that the housing goal rule provides the enterprises with incentives to use credit enhancements, which, according to the HUD staff study,[55] may not meaningfully enhance existing housing opportunities.

HUD Has Not Yet Fully Implemented a Process to Monitor Enterprise Financial Activities

In the legislative history of the 1992 Act, Congress cited our 1990 report[56] that concluded that HUD lacked experience as a regulator of financial firms and traditionally had dedicated few staff members to such functions. Although HUD's staff have significant expertise in housing and related issues, we remain concerned about HUD's capacity as a regulator of financial institutions. On the basis of our March 1998 report,[57] we conclude that HUD has not yet fully implemented a process under its general regulatory and new mortgage program approval authorities to ensure the activities' consistency with the enterprises' housing mission. In addition, HUD has determined that enterprise automated underwriting systems warrant further oversight under the fair lending provisions of the 1992 Act.

[54]Freddie Mac did incur substantial losses on its multifamily mortgage portfolio in the late 1980s and early 1990s, but its overall net income rose to record levels each year between 1990 and 1993, and its ROE exceeded 20 percent.

[55]The Multifamily Secondary Mortgage Market.

[56]Government-Sponsored Enterprises: The Government's Exposure to Risks (GAO/GGD-90-97, Aug. 15, 1990).

[57]GAO/GGD-98-48.

HUD Did Not Begin to Exercise Its General Regulatory Authority for Enterprise Nonmortgage Investments Until 1997

In our March 1998 report, we found that HUD had not used its general regulatory authority provided under the 1992 Act until 1997 to ensure that the enterprises' nonmortgage investment practices were consistent with their housing mission. We pointed out that such oversight by HUD is important because the enterprises have incentives to use the funding advantage associated with their federal sponsorship to make nonmortgage investments that may result in arbitrage profits.[58] Consistent with a recommendation in our March 1998 report, HUD has initiated actions that, if effectively carried out, have the potential to help ensure more effective enterprise oversight.

Under their charters, the enterprises have broad authority to make investment decisions. The enterprises have established investment policies that specify permissible credit ratings, maturities, and concentration limits, and that describe the relationship of such investments to earnings and to achievement of the enterprises' housing finance mission. Nonmortgage investments constituted about 15 percent of the on-balance sheet assets at Fannie Mae and 10 percent at Freddie Mac, as of June 30, 1997. The enterprises' nonmortgage investments included cash and cash equivalents, asset-backed securities, corporate debt, and state and municipal bonds. According to enterprise officials, about 70 percent of these nonmortgage assets had maturities under 1 year, and all were investment grade securities. The officials said that the enterprises hold short-term nonmortgage investments to meet liquidity needs for residential mortgage purchases.

However, the enterprises also hold longer-term nonmortgage assets whose relationship to their housing mission is less clear, and these assets could be used to generate arbitrage profits. For example, in March 1997, Freddie Mac authorized up to $10 billion over a 5-year period to be used for long-term nonmortgage investments. By investing in long-term corporate bonds, the enterprises may earn higher profits than on alternative mortgage investments.[59]

[58]We defined the term "arbitrage" to mean that the enterprises use their funding advantage from government sponsorship to raise funds for making nonmortgage investments.

[59]The enterprises generate income on the difference between their debt servicing costs and the income they receive from their mortgage and nonmortgage assets. At least some of the financial benefits that the enterprises receive from their federal charters are passed along to borrowers in the form of lower mortgage interest rates, which reduces the enterprises' income from mortgage investments. Because this mechanism is not present for enterprise nonmortgage investments, certain nonmortgage investments may be more profitable to the enterprises.

Although each enterprise has broad investment authority, their investment practices are subject to regulatory oversight under the 1992 Act. OFHEO has clear authority to regulate the enterprises' investments in both mortgage and nonmortgage assets to help ensure that such investments are consistent with maintaining the enterprises' financial safety and soundness. To date, OFHEO has determined that the enterprises' investments in nonmortgage assets do not constitute a significant risk to the enterprises' financial condition. Except for the specific powers granted OFHEO, according to the 1992 Act, HUD has "general regulatory power" over each enterprise and is charged with making "such rules and regulations as shall be necessary and proper to ensure" that the enterprises' activities, such as their nonmortgage investments, are consistent with the charters and the 1992 Act.

The 1992 Act does not specify any criteria, other than the charters themselves, as the basis for HUD to monitor and evaluate the appropriateness of the enterprises' nonmortgage investments. HUD did not attempt to collect information on the enterprises' nonmortgage investments or define the scope of its regulatory authority until 1997, which was nearly 5 years after the passage of the 1992 Act. HUD officials told us that they began to focus attention on the enterprises' nonmortgage investments in April 1997 as a result of the publicity surrounding the disclosure that Freddie Mac had invested in long-term Phillip Morris corporate bonds.

In 1997, HUD requested for the first time that the enterprises provide basic information about their nonmortgage investment policies and holdings. Moreover, in December 1997, HUD issued an Advance Notice of Proposed Rulemaking (ANPR), which solicited public comments on how HUD should carry out its general regulatory authorities regarding nonmortgage investments by the housing enterprises. HUD officials said that during 1998, they plan to begin collecting quarterly information from the enterprises on their nonmortgage investments and discuss the issues relating to these investments with OFHEO officials. The HUD officials said that if a decision to develop a Notice of Proposed Rulemaking is made, they plan to draft the notice by year-end 1998.

HUD's decision to publish the ANPR was consistent with the recommendation in our March 1998 report on the enterprises' nonmortgage investments. Specifically, we recommended that the HUD Secretary develop written criteria, through the appropriate rulemaking processes, to help ensure that the housing enterprises' nonmortgage investments are consistent with the purposes expressed in their charters.

HUD's Capacity to Monitor Sophisticated Financial Products That May Be Associated With New Mortgage Proposals Is Limited

The 1992 Act prescribed the conditions under which HUD must review and consider the approval of enterprise new mortgage programs. Specifically, HUD must find that a proposed new mortgage program is consistent with the enterprises' charters and not contrary to the public interest. Further, the OFHEO Director must certify that the proposed program would not jeopardize the enterprises' financial condition. Since the passage of the 1992 Act, HUD has approved four[60] new enterprise mortgage program proposals within the 45-day deadline established by the 1992 Act (see table 8). However, our March 1998 report found that HUD lacked the financial expertise necessary to fully evaluate Fannie Mae's Mortgage Protection Plan (MPP). Subsequently, HUD gave both enterprises the approval to create Financial Asset Securitization Investment Trusts (FASIT), which are sophisticated financial vehicles that can include nonmortgage assets. We have no basis to question HUD's decision to approve FASIT authority for the enterprises. However, we note that HUD will need to develop an effective oversight process to ensure that the enterprises use FASITs in accordance with their housing mission.

[60]We counted HUD's approvals of Fannie Mae's and Freddie Mac's Financial Asset Securitization Investment Trust programs as two separate approvals in determining that HUD had approved four programs.

Table 8: New Enterprise Mortgage Programs Approved by HUD

Program name	Program description	Submission date	Final action date	Days in review
Fannie Mae				
Single Family Energy Loan Purchase Program	Purchase energy loans made to single family homebuyers by banks, housing finance agencies, and utility companies.	March 4, 1994	April 14, 1994	41
Mortgage Protection Plan (MPP)	Obtain life, disability, and involuntary unemployment insurance on first-time homebuyers.	May 23, 1997	June 23, 1997	31
Financial Asset Securitization Investment Trust (FASIT)	Issue asset-backed securities using the FASIT tax election.	July 30, 1997	September 12, 1997	44
Freddie Mac				
Financial Asset Securitization Investment Trust (FASIT)	Issue, purchase, service, sell, and lend on asset-backed securities using the FASIT tax election.	October 10, 1997	November 24, 1997	45

Source: HUD

HUD officials who reviewed Fannie Mae's MPP proposal in 1997 did not have expertise in the intricacies of the cash-value life insurance industry. Such expertise was important because, under the MPP, Fannie Mae proposed that it would purchase a cash-value life insurance policy on a first-time homebuyer after the selected borrower's residential mortgage was purchased by Fannie Mae. During the course of our work on the March 1998 report, we did not see evidence that HUD provided Fannie Mae's MPP proposal to anyone with experience in evaluating cash-value life insurance. A Treasury attorney with expertise in life insurance provided basic information about life insurance products to HUD, and HUD determined that providing information on the MPP to Treasury was not necessary because HUD had obtained sufficient information and analysis to complete its work. In our March 1998 report, we also noted that tax consequences were a major factor in Fannie Mae's MPP proposal, but that tax consequences had not been included in HUD's analysis.[61]

[61]Since HUD's approval, a new tax bill was signed into law that, according to Treasury, substantially reduced the tax benefits that were available to Fannie Mae under the MPP. Fannie Mae officials told us that Fannie Mae has decided not to go forward with the MPP.

Since HUD's approval of the MPP in June 1997, both enterprises have received HUD approval for the creation of FASITs. FASITs are sophisticated and new financial vehicles that are intended to provide issuers of pass-through securities[62] with greater flexibility (i.e., in relation to other pass-through securities, such as those issued through Real Estate Mortgage Investment Conduits (REMIC))[63] in the financial assets that can be used to support the security issue. For example, a FASIT can be partially supported by financial instruments that help hedge cash-flow risks associated with mortgage investments.[64] FASITs can also be supported with both mortgage and nonmortgage financial instruments, such as credit card or automobile receivables. However, the enterprises' proposals to HUD contained assurances that the financial instruments used to support a FASIT would consist primarily of cash and cash equivalents, government securities, certain corporate debt obligations, qualifying hedging contracts, and other assets consistent with their charters. HUD found that the creation of FASITs by the enterprises would benefit the public interest by promoting greater efficiency in the mortgage-related securities market and enhancing mortgage market liquidity. As of May 1998, the enterprises had not created any FASITs.

We have no basis to question HUD's decision to approve the enterprises' FASIT authority or that the enterprises will issue FASITs in accordance with their agreements with HUD. However, we note that as the enterprises' mission regulator, HUD has an ongoing responsibility to monitor the enterprises' FASIT use to ensure compliance, particularly with the requirement that the enterprises use FASITs in accordance with their charters. In our view, such oversight requires the ability to analyze sophisticated financial products and a regulatory focus on the enterprises' financial activities. In the past, HUD has not always demonstrated either the financial expertise or regulatory focus, which was the case with nonmortgage investments. Moreover, HUD's current list of contractors for enterprise oversight activities have not contracted with HUD to provide such ongoing financial expertise and focus.

[62]A pass-through security passes payments from borrowers to investors as loan payments are collected. The cash flow is from a pool or pools of underlying loans. The issuer remits, or passes through, to the investor monthly payments of principal and interest.

[63]REMICs are multiclass mortgage securities that assign cash flows to different classes of investors. For example, some classes may receive cash flows that are largely based on principal payments, while other classes may receive cash flows that are largely based on interest payments. REMICs may be issued by the enterprises or private companies that specialize in real estate finance.

[64]For example, when interest rates decline, mortgage refinancings tend to increase, which reduces future cash flows to mortgage investors. This situation is commonly referred to as "prepayment risk." The enterprises purchase financial instruments, such as options on financial contracts, to help offset—or "hedge"—prepayment risks.

HUD Has Determined That Enterprise Automated Underwriting Systems Warrant Further Oversight

The enterprises have developed and implemented automated underwriting systems that have generated significant changes in the traditional mortgage application and review process, which has relied on mortgage originators to make credit decisions and to process the associated paperwork. However, HUD has also considered whether the enterprises' use of automated systems constitute new mortgage programs or raise fair lending concerns on the basis of HUD's authorities provided under the 1992 Act. HUD concluded in 1996 that the enterprises' automated underwriting systems did not represent new mortgage programs, but warranted further oversight under the fair lending provisions of the 1992 Act.

Enterprise Automated Underwriting Systems Can Reduce Mortgage Transaction Time and Costs

Requiring borrowers to meet certain underwriting standards is an important step that lenders take to manage mortgage credit risk. Lenders undertake the underwriting process to assess the possibility that a prospective borrower may default on a mortgage. The assessment includes analyzing sources of income, debt-payment-to-income ratios, credit history, and proposed down payment on a home purchase. The enterprises have both developed automated underwriting systems that have a number of benefits. One of these benefits is that, by using computers, automated systems can reduce the processing time of traditional underwriting, which has relied on labor-intensive manual reviews of mortgage applications. Consequently, automated underwriting systems may also reduce the costs associated with the mortgage application and review process.

HUD Has Analyzed Enterprise Automated Systems Under Its New Mortgage Program Authority

Despite the potential benefits of the enterprises' automated underwriting systems, HUD has also reviewed the use of these systems as part of its oversight responsibilities provided in the 1992 Act. In 1996, HUD conducted an analysis of the enterprises' automated underwriting systems and concluded that they were not new mortgage programs under the 1992 Act. In this analysis, HUD determined that the enterprise systems represented alternative business processes, rather than new mortgage programs. Therefore, HUD concluded that the enterprises did not have to submit official new mortgage program proposals for their automated underwriting systems.

HUD's 1996 analysis also reviewed issues relating to enterprise charter compliance that may be associated with automated underwriting systems. For example, because of the speed at which automated underwriting systems can process a mortgage application, the potential exists that the enterprise may, at some point, bypass the mortgage originator and interact more directly with the borrower and make credit decisions as to whether an applicant should receive a mortgage. However, the enterprises' charters prohibit them from originating mortgages in the primary market. According to the 1996 analysis, HUD concluded that the systems do not remove mortgage originators from the mortgage application and approval process entirely. For example, HUD found that underwriters who work for mortgage originators must still reconcile borrowers' application documentation to the systems' analysis for all loans. Further, underwriters must manually underwrite certain mortgage loan applications that are referred to them by an automated system for further review.

There Are Fair Lending Implications Associated With Automated Underwriting Systems

According to HUD's 1996 analysis and our August 1996 report,[65] automated underwriting systems have implications for enterprise and mortgage originator compliance with the fair lending laws under the 1992 Act. Under the 1992 Act, HUD is required to issue regulations that prohibit each enterprise from discriminating in any manner in the purchase of mortgages. In addition, HUD is responsible for periodically commenting on the enterprises' underwriting guidelines to ensure their compliance with the Fair Housing Act.

In our August 1996 report, we stated that the use of automated underwriting systems could potentially result in disparate impacts on minority borrowers. Under federal policy, a disparate impact occurs when a seemingly neutral policy or practice is applied equally to all credit applicants but with the result that the policy or practice has a disparate impact on applicants from a targeted group, such as minorities. For a prohibited disparate impact to occur, it must be the case that the policy or practice is not justified by a business necessity. If a business necessity does exist, the institution may still be held liable if it could have adopted a less discriminatory policy than the one that was adopted.

The possibility exists that the use of automated underwriting systems—which rely on uniform underwriting criteria—could result in a disparate impact on minority borrowers. For example, the use of automated underwriting systems could, according to a HUD official, result in relatively low mortgage acceptance rates for minority borrowers. According to mortgage industry representatives we contacted, originators are concerned that they will be held accountable for potentially discriminatory decisions that are based upon analyses provided by the enterprises' automated underwriting systems.

[65]Fair Lending: Federal Oversight and Enforcement Improved but Some Challenges Remain (GAO/GGD-96-145, Aug. 13, 1996).

Enterprise officials we contacted stated that their automated underwriting systems do not result in discrimination against minority borrowers. Rather, the officials argued that the use of automated underwriting systems promotes mortgage lending to minority borrowers and ensures fair and equal treatment.

HUD Plans to Review Enterprise Automated Underwriting Systems

In HUD's 1996 analysis, HUD officials stated that they planned to review the enterprises' automated underwriting systems under the fair lending provisions of the 1992 Act. Since 1996, HUD has continued to provide for the review of the enterprises' automated underwriting systems. For example, in 1997, HUD hired a contractor to review the potential implications of the enterprises' automated underwriting systems on fair lending issues. In addition, a HUD official told us that HUD has the authority under its enforcement authority to review the enterprises' automated systems if a fair lending complaint is filed.

In February 1998, FHA entered into a statement of understanding with Freddie Mac, under which the enterprise is to provide automated underwriting services to FHA to assist in the provision of FHA mortgage insurance. To enable Freddie Mac to provide these services, FHA is to give the enterprise loan data on FHA-insured mortgages. According to HUD, FHA's agreement with Freddie Mac has the potential to reduce the processing time and credit losses associated with FHA-insured mortgages. According to the Acting Director of the Office of GSE Oversight, her office was informed but not consulted as FHA developed and implemented its approach to evaluating and approving automated underwriting systems. The Acting Director told us that while she participated in discussions regarding the evaluation of the automated underwriting systems, to help avoid a conflict with HUD's oversight role, she was not included in FHA's decision to approve Freddie Mac's system.

Conclusions

HUD completed a substantial amount of in-house and contract research in establishing the final enterprises' housing goal rule in 1995. HUD set the housing goals conservatively because, among other reasons, HUD had concerns about the goals' potential impacts on the enterprises' financial safety and soundness. Since 1996, the enterprises have been in compliance with the final goals and have improved their performance in targeted mortgage purchases when compared to the primary market, although Fannie Mae's performance has generally exceeded that of Freddie Mac. Despite the enterprises' increased purchases of targeted mortgages, there is little information currently available on the extent to which the housing goals have resulted in increased housing affordability for targeted borrowers.

Our review identified several weaknesses in HUD's enterprise oversight activities that limit its effectiveness as a housing mission regulator. The following summarizes these weaknesses:

1. HUD has not yet verified the accuracy of the mortgage purchase data that it receives from Fannie Mae and Freddie Mac. The recalculation steps that HUD performed on the enterprises' data constitute an important element of the validation process, but recalculation alone cannot support conclusions about the accuracy of the data upon which the original calculations were based.

2. HUD's research agenda does not focus on all of the key issues that are necessary to evaluate the impacts of the enterprises' housing goals. In particular, HUD's research does not currently evaluate the goals' effects on mortgage interest rates and other loan terms for targeted borrowers and lenders' incentive to originate targeted mortgages. In addition, HUD has not conducted research to determine the effects of credit enhancements on affordable multifamily mortgage finance and housing opportunities or whether the housing goal rule provides the enterprises with regulatory incentives to use credit enhancements. Consequently, HUD cannot adequately determine the extent to which the goals promote housing opportunities or at which levels to set the goals in the future.

3. HUD has not fully implemented a procedure to monitor sophisticated enterprise financial activities under its general regulatory and new mortgage program approval authorities. Consequently, HUD may not have the ability to ensure that these financial products—such as nonmortgage investments—are consistent with the enterprises' housing mission.

Other federal regulators that have the responsibility for regulating housing enterprises, such as OFHEO, are financed by the regulated entities. However, HUD's capability to strengthen its enterprise housing mission oversight may be limited because resources that could be used for that purpose must compete with other priorities for HUD's appropriated funds. For example, HUD's capacity to implement a program to verify housing goal data, which would necessarily involve a commitment of additional resources, may be limited.

Moreover, HUD's capacity to obtain the expertise to monitor the enterprises' financial activities may also be limited, particularly since HUD's traditional housing research focus may continue to command a significant share of HUD's available resources. In our previous reports on housing enterprise oversight, we recommended that enterprise regulators have the authority to assess the enterprises for the costs of federal oversight.[66] This practice would help ensure that the costs of regulation are borne by the enterprises that benefit from ties to the government. Further, imposing assessments helps ensure that funding for oversight is not constrained by competing responsibilities.

Recommendations

To strengthen HUD's capacity as the enterprises' housing mission regulator and enhance, to the extent consistent with financial soundness concerns, housing affordability and opportunities for targeted borrowers, we recommend that the HUD Secretary take the following actions:

1. Develop and implement a program to assess the accuracy of housing goal compliance data. The HUD Secretary should also coordinate any such reviews with OFHEO.

2. Develop a better understanding of whether the housing goals are enhancing housing affordability and opportunities for targeted groups as intended by the 1992 Act by conducting research on the following issues: (1) the goals' effects on mortgage interest rates and associated loan terms for targeted groups, (2) the effects of credit enhancements on enhancing housing opportunities, and (3) the extent to which the housing goal rule may provide the enterprises with regulatory incentives to use credit enhancements.

3. Continue implementing the existing process to monitor the enterprises' use of nonmortgage investments. Ensure that expertise is available to help ensure that the enterprises' financial activities are consistent with their housing mission.

4. Collect information on the necessary costs for effectively overseeing the enterprises, including the necessary costs to implement the recommendations in this report, and develop a proposal for congressional consideration that would require the enterprises to reimburse HUD for these costs.

[66] GAO/GGD-97-139 and GAO/GGD-91-90.

Agency Comments and Our Evaluation

We requested and received written comments on a draft of this report from HUD and OFHEO. These written comments are provided in appendixes IV and V. Overall, HUD was in general agreement with our report findings, conclusions, and recommendations. OFHEO agreed with our recommendation that the enterprises should bear the costs of HUD's mission oversight. We also discussed our draft report findings with Fannie Mae and Freddie Mac officials, and provided the officials sections of the draft report that pertained directly to the enterprises' operations (i.e., the sections on multifamily mortgage finance and automated underwriting). A Fannie Mae official commented on our conclusion that imposing assessments on the enterprises would help ensure effective oversight. Enterprise officials also provided technical comments on our findings that have been incorporated where appropriate.

HUD's General Deputy Assistant Secretary for Housing generally agreed with the draft report's conclusions and stated that HUD planned to implement our recommendations. He stated that HUD planned to (1) submit a legislative proposal to Congress for the Department's fiscal year 2000 budget that would assess the enterprises for the costs of HUD's oversight, (2) independently verify the housing goal compliance data and coordinate these reviews with OFHEO, (3) consider the housing goals' impacts on mortgage interest rates for targeted groups, and (4) consider the appropriate counting requirements for multifamily mortgage purchases that are subject to credit enhancements.

HUD's letter commenting on our draft report also contained two comments that we believe warrant further discussion. First, the letter stated that HUD had considered the consequences for the enterprises of alternative housing goals. Second, the letter stated that HUD has in-house expertise and contracting vehicles in place to assess new enterprise financial activities.

On the basis of our review of HUD's economic research supporting the final rule and discussions with HUD officials, we did not see evidence that HUD considered the financial consequences for the enterprises of alternative goals. For example, HUD did not estimate the enterprises' potential ROE under differing economic scenarios for higher housing goals than those that were established in the final rule. Regarding the second comment, we recognize that HUD staff have significant expertise in housing and housing-related issues. However, our review of HUD's oversight of the enterprises' nonmortgage investments and HUD's review of Fannie Mae's MPP new mortgage proposal suggested a lack of focus on financial activities and a lack of expertise, such as in cash-value life insurance. In addition, HUD has not yet contracted to obtain such expertise.

OFHEO's Acting Director agreed with our recommendation that HUD should develop a proposal requesting that Congress consider requiring that the enterprises bear the costs of HUD's housing mission oversight. The Acting Director also said that the draft report understated the extent to which HUD and OFHEO communicated with one another in the development of the housing goals. In addition, the Acting Director said that OFHEO did not inform HUD of the findings of its 1996 data integrity examination at Freddie Mac before the publication of its 1997 Report to Congress. However, the Acting Director said that early in 1998, OFHEO agreed to a HUD request that OFHEO provide technical assistance to HUD in ensuring the accuracy of data submitted by the enterprises.

We have revised the report text to reflect the coordination between HUD and OFHEO on the development of the housing goals. We also support efforts by HUD and OFHEO to ensure, where possible, the accuracy of data submitted by the enterprises.

A Fannie Mae official commented that it would be difficult for HUD to separate its enterprise mission oversight responsibilities from its other activities. The official expressed concern that HUD may use enterprise assessments to fund other housing related research that is not directly related to enterprise oversight.

We recognize that determining HUD's expenditures for housing mission oversight may pose challenges, but continue to believe that the enterprises should bear the relevant expenditures as do other federal housing enterprises. We believe that HUD should clearly itemize and justify its mission oversight resource requirements to ensure accountability.

We are sending copies of this report to the majority and minority Members of the House and Senate Banking Committees and to other interested parties. We will also make copies available to others upon request.

Major contributors to this report are listed in appendix VI. Please call me or Bill Shear, Assistant Director, at (202) 512-8678 if you or your staff have any questions.

Sincerely yours,

Thomas J. McCool

Thomas J. McCool
Director, Financial Institutions
and Markets Issues

Contents

Abbreviations

ANPR	Advance Notice of Proposed Rulemaking
FASIT	Financial Asset Securitization Investment Trust
FHA	Federal Housing Administration
FHEO	Office of Fair Housing and Equal Opportunity
FTE	full-time equivalent
GSE	Government Sponsored Enterprise
HMDA	Home Mortgage Disclosure Act of 1990
HUD	Department of Housing and Urban Development
LTV	loan-to-value
MBS	mortgage-backed securities
MPP	Mortgage Protection Plan
OFHEO	Office of Federal Housing Enterprise Oversight
OMB	Office of Management and Budget
PD&R	Office of Policy Development and Research
REMIC	Real Estate Mortgage Investment Conduit
ROE	return on equity

Objectives, Scope, and Methodology

Our objectives for this report were to (1) discuss the Department of Housing and Urban Development's (HUD) legal basis, approach, and rationale for setting the numeric housing goals at their current levels; (2) report on the government-sponsored housing enterprises' (enterprises) compliance with these goals and HUD's assessment of the goals' impacts on promoting homeownership and housing opportunities; (3) assess HUD's procedures and efforts to verify goal compliance data; (4) analyze the enterprises' multifamily mortgage purchase activities under the housing goals and HUD's assessment of these activities' effects on promoting housing opportunities; and (5) review HUD's implementation of its general regulatory and new mortgage program oversight authorities under the 1992 Act.

To provide HUD's legal basis, approach, and rationale for setting the goals at their current levels, we reviewed the 1992 Act and its legislative history, the final housing goal rule, and supporting research and documentation. In addition, we interviewed senior officials from HUD as well as officials from the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). We also interviewed officials from the Office of Federal Housing Enterprise Oversight (OFHEO).

We reviewed the enterprises' reported data to HUD to provide statistics on the enterprises' compliance with the housing goals between 1993 and 1997. We also reviewed a March 1998 HUD report[67] that provided information on the enterprises' purchases of targeted mortgage loans relative to the primary market's originations of such mortgage loans. To assess HUD's analysis of the goals' impacts on homeownership and housing opportunities, we reviewed our previous reports and HUD's research on these issues and HUD's research contracts and grants. We also met with representatives from the mortgage finance industry and housing community groups.

We reviewed HUD's efforts to verify the enterprises' reported goal compliance data by reviewing our standards on federal auditing requirements[68] and HUD's final housing goal rule. We also discussed the enterprise data collection process with HUD and enterprise officials and reviewed relevant documents. Further, we reviewed an OFHEO examination and its supporting workpapers regarding Freddie Mac's data integrity process, and we discussed this examination with OFHEO officials.

[67] Characteristics of Mortgages Purchased.

[68] Government Auditing Standards: 1994 Revision.

We obtained information about the housing goals' effects on the enterprises' multifamily mortgage financing activities and housing opportunities by reviewing reports issued by HUD staff researchers on these issues. We also discussed HUD's research on these issues with senior officials. Moreover, we compared the housing goal rule's counting requirements for recourse agreements and similar credit enhancements with the rule's treatment of risk-sharing agreements, which are partnerships between the enterprises and the Federal Housing Administration (FHA). We also discussed these issues with enterprise and OFHEO officials as well as representatives from the mortgage industry.

We assessed HUD's implementation of its general regulatory and new mortgage program authorities by focusing on HUD's oversight of enterprise financial activities and these activities' consistency with the enterprises' housing mission. To conduct this assessment, we reviewed our August 1990[69] and March 1998[70] reports. We also reviewed HUD's files on its approval of the enterprises' new mortgage program proposals to issue Financial Asset Securitization Investment Trusts (FASIT) and discussed FASITs with HUD and enterprise officials. Regarding HUD's oversight of the fair lending provisions of the 1992 Act, we reviewed internal HUD analyses on the enterprises' automated underwriting systems and discussed the systems with HUD and enterprise officials.

We conducted our work in Washington, D.C., between October 1997 and May 1998 in accordance with generally accepted government auditing standards.

We provided copies of a draft of this report to HUD and OFHEO for review and comment. HUD's General Deputy Assistant Secretary for Housing and OFHEO's Acting Director provided written comments on the draft report's analysis and recommendations, which are summarized at the conclusion of the report text and reprinted in appendixes IV and V. HUD and OFHEO also provided technical comments, which have been incorporated where appropriate. In addition, a Fannie Mae official provided oral comments, and the enterprises provided technical comments on draft sections of the report dealing with multifamily mortgage finance and automated underwriting systems. These technical comments have been incorporated where appropriate.

[69] GAO/GGD-90-97.

[70] GAO/GGD-98-48.

The Role of HUD's Numeric Goals in Enhancing Housing Affordability for Targeted Groups

Congress established and chartered the enterprises as government sponsored, privately owned corporations with public purposes to enhance the availability of mortgage credit across the nation during both good and bad economic times. The enterprises' secondary market activities and sophisticated financial products have facilitated the development of a liquid, secondary mortgage market, particularly for single-family residences. However, by 1992, industry participants had the perception that the enterprises were lagging behind conventional mortgage originators in extending mortgage credit serving low- and moderate-income borrowers and borrowers in underserved areas.

Congress concluded that the enterprises had a responsibility to reach out to borrowers that have traditionally been underserved by the mortgage markets because of the financial benefits that the enterprises enjoy from their federal charters and sponsorship. To address these congressional concerns, the 1992 Act established a comprehensive framework for HUD to promulgate numeric housing goals for the enterprises, obtain necessary data from the enterprises to monitor their compliance with the goals, and enforce enterprise compliance with the goals through the newly created enforcement tools.

The enterprises' charters list the following public purposes:

(1) to provide stability in the secondary market for residential mortgages;

(2) to respond appropriately to the private capital market;

(3) to provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and

(4) to promote access to mortgage credit throughout the nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

In carrying out their public purposes, the enterprises have made important contributions to the residential mortgage market, including (1) standardizing loan documents, underwriting standards, and estimation of the value of single-family housing serving as collateral for the mortgage loan and (2) taking on and management of credit risks. These contributions helped establish and maintain a link between the primary mortgage market and national financial markets, thereby increasing the supply of residential mortgage credit. In a previous report, we indicated that mortgage interest rates on single-family, fixed-rate, conforming mortgages were reduced on average by 15 to 35 basis points due to the contributions of Fannie Mae and Freddie Mac.[71]

Although the enterprises had generally made important contributions to the residential mortgage market, by 1992, industry participants had the perception that the enterprises' distribution of conventional, conforming loan funding serving low- and moderate-income borrowers and borrowers in underserved areas was lagging behind the primary mortgage market's funding of such mortgages. In 1994, a Federal Reserve Board study[72] using 1992 data collected under the Home Mortgage Disclosure Act of 1990 (HMDA)[73] supported this perception. In passing the 1992 Act, Congress also reached the finding that the enterprises "have an affirmative obligation to facilitate the financing of affordable housing for low- and moderate-income families in a manner consistent with their overall public purposes, while maintaining a strong financial condition and a reasonable economic return."

The 1992 Act specified interim low- and moderate-income, special affordable housing, and central city[74] goals to be effective in 1993 and 1994. HUD retained low- and moderate-income and special affordable housing goals. The 1992 Act provided HUD with discretion in defining underserved areas in promulgating numeric goals beginning in 1995. Thus, HUD was given the authority to help determine what geographic areas would be targeted. Rather than relying on location in a central city, the new underserved area goal is based on concentrations of low-income and minority residents in the census tract. According to HUD officials, this

[71]GAO/GGD-96-120. A basis point is 1/100 of a percentage point.

[72]Glenn B. Canner and Wayne Passmore, "Residential Lending to Low-Income and Minority Families: Evidence From the 1992 HMDA Data," Federal Reserve Bulletin (Feb. 1994), pp. 79-108.

[73]HMDA data are collected by the government from residential mortgage lenders to provide the public with information for determining whether financial institutions are serving the housing needs of their communities and to assist regulatory agencies in identifying possible discriminatory lending patterns and enforcing antidiscrimination statutes.

[74]The central city, or cities, of a Metropolitan Statistical Area receive that designation by the Office of Management and Budget on the basis of population and employment-to-residence and commute-to-residence ratios. Central city designation is not based on housing needs or economic conditions in a geographic area.

substitution was based, in part, on research conducted at HUD. This research relied on HMDA data on mortgage flows and U.S. Bureau of the Census data on housing and demographic conditions across census tracts. The results indicated that mortgage applications and originations in a census tract, in relation to the housing stock in the census tract, tended to be lower in census tracts that had concentrations of minority and low-income households. HUD concluded that these results provided more support for its underserved area definition than a definition that is based solely on central city location.

The general purpose of the goals is to increase the total supply of residential mortgage funds serving targeted households, which, in turn, could lower mortgage interest rates, create more flexible underwriting standards, and improve homeownership and housing opportunities for low- and moderate-income households and residents of underserved areas. Just as enterprise specialization and the taking on and management of credit risk in the secondary market for residential mortgages has generally helped facilitate such benefits for single-family borrowers in general, the numeric goals can help facilitate an increase in the supply of residential mortgage funds serving targeted households.

The impact of the numeric goals on targeted households depends on (1) the direct impact of the goals on enterprise purchases serving targeted households and (2) the impact of the enterprise purchases on mortgage originations by primary mortgage market lenders. Such lenders include depository institutions that undertake single-family portfolio lending, multifamily lenders, and mortgage bankers who originate both conventional and federally insured residential mortgages. As discussed in the body of this report, multifamily mortgage purchases by the enterprises are a fairly low proportion of their overall purchases.[75] However, multifamily purchases play a greater role in helping the enterprises meet HUD's numeric goals. For example, about 95 percent of the units in multifamily properties qualify as low- and moderate-income housing.[76]

We also note that the impact of increased enterprise goal purchases on mortgage originations serving targeted households by primary mortgage market lenders is much less understood than the impacts of enterprise activities on the overall conforming, conventional mortgage market. For

[75]About 4 percent of Fannie Mae's and 1 percent of Freddie Mac's total mortgage portfolios are composed of multifamily mortgages.

[76]HUD, Economic Analysis for the Secretary of HUD's Regulation of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (Nov. 1, 1995), p. II-3.

example, in the overall market, the enterprises generally provide corporate guarantees in which the credit risks associated with mortgages they purchase are taken on and managed by the enterprise, rather than by mortgage originators or mortgage-backed securities (MBS) investors. The enterprises' corporate guarantees have contributed to the link between the overall primary mortgage market for single-family housing and national financial markets because (1) the enterprises can diversify their credit risks by purchasing mortgages across the nation while mortgage originators generally cannot and (2) MBS investors do not have the data and tools that the enterprises have to evaluate credit risks.

However, the risks associated with purchasing certain mortgages counting toward the numeric goals and regulatory treatment of those purchases may have created a regulatory incentive for the enterprises to enter into agreements where mortgage originators provide credit enhancements such as recourse arrangements, thus assuming credit risk. The impacts of such arrangements on the supply of mortgage credit by conventional mortgage originators serving targeted households are not understood. For example, HUD has not analyzed whether enterprise multifamily purchases with lender-provided credit enhancements have been made representing mortgages (1) from across the nation rather than from limited geographic areas, or (2) from regions of the country undergoing relative economic declines as well as those experiencing relative prosperity, thereby providing a cushion in declining markets.

As previously stated, the enterprises' charters call upon them to increase the liquidity of mortgage investments and improve the distribution of investment capital available for residential mortgage financing serving targeted households. We have concluded that HUD has not conducted sufficient research to determine whether providing increased liquidity to help serve targeted households across the nation under different economic conditions can be achieved without the enterprises taking on greater credit risks than they currently do on certain purchases now qualifying toward achievement of the numeric goals.

Enterprise-Targeted Mortgage Purchases Compared to the Primary Market's Originations of Targeted Mortgages

In March 1998, HUD published a study[77] that, among other issues, compared the enterprises' performance in serving the mortgage credit needs to that of the primary market in 1992 and 1996.[78] According to the study, such comparisons are important because they provide a means of evaluating the enterprises' efforts to serve the credit needs of targeted groups. The study found that (1) the enterprises' performance has generally improved compared to the primary market's, (2) Fannie Mae's performance has exceeded that of Freddie Mac, and (3) the enterprises still trail in most affordable lending categories.

A number of factors may account for the enterprises' generally improved performance, such as the implementation of HUD's goals and a generally growing U.S. economy. There are also several factors that may explain why the enterprises continue to trail the primary market in most affordable lending categories. For example, the enterprises may lack detailed knowledge about the risk characteristics of targeted borrowers in local markets. Therefore, to manage credit risks, the enterprises may establish stricter mortgage purchase underwriting standards than the underwriting standards that lenders establish to originate targeted mortgages in local markets.

The Enterprises Have Generally Improved Their Mortgage Purchase Performance Relative to the Primary Market

Table III.1 provides HMDA data on enterprise purchases of targeted mortgages and primary market originations of such mortgages in 1992 and 1996.[79] Specifically, the table shows the share of (1) each enterprise's purchases of conventional conforming mortgages for various targeted borrowers as a percentage of its total mortgage purchases and (2) mortgage originators'—that is, banks, thrifts, and mortgage banks—originations of targeted, conforming mortgage loans as a percentage of their total mortgage originations. In addition, the table shows each enterprise's share of targeted mortgage purchases as a percentage of the primary market's share of originations of such mortgages. This analysis provides a comparison of the enterprises' performance relative to the primary market over time.

[77]Characteristics of Mortgages Purchased.

[78]The HUD study focused on the enterprises' mortgage purchase performance between 1993 and 1995. HUD provided data to us for 1996.

[79]HMDA data differ from the housing goal data collected by HUD. HMDA data are based on the number of mortgages originated and are collected from a subset of institutions that originate mortgage loans: commercial banks, thrifts, and mortgage banks in metropolitan areas. HMDA data also report more categories of targeted mortgage groups than do the housing goal data. The housing goal data consist of the number of dwelling units financed by all enterprise mortgage purchases.

Table III.1 shows that both the enterprises and originators in the primary market generally increased their commitments to targeted mortgages during the period, although both the primary market and Freddie Mac's share in high-minority census tracts declined. Overall, the enterprises' performances generally increased compared to the primary market's. For example, in each of the seven categories, Fannie Mae's performance improved compared to the primary market's, and Fannie Mae exceeded the primary market in two areas (Hispanic borrowers and high-minority tracts) by 1996. Freddie Mac's performance improved relative to the primary market's in three areas, declined in three areas (underserved areas, low-income census tract, and high-minority census tract), and stayed the same in one area (Hispanic).

Table III.1: Share of Conventional Conforming Mortgage Loans by Fannie Mae, Freddie Mac, and the Primary Mortgage Market Serving Targeted Groups

Targeted borrower group	Share of Fannie Mae mortgage purchases	Share of Freddie Mac mortgage purchases	Primary market origination share	Fannie Mae share as a percentage of primary market share	Freddie Mac share as a percentage of primary market share
Very-low income					
1992	5.1%	5.2%	7.6%	67%	68%
1996	8.6	8.0	10.8	80	74
African-American					
1992	2.8	2.2	3.1	90	71
1996	4.4	3.6	4.7	94	77
Hispanic					
1992	3.9	3.6	4.4	89	82
1996	6.6	4.7	5.7	116	82
Underserved areas					
1992	18.7	18.9	21.9	85	86
1996	21.3	18.9	23.3	91	81
Low-income census tract					
1992	7.0	7.3	9.2	76	79
1996	8.5	7.4	10.0	85	74
High-minority census tract					
1992	12.9	12.0	13.1	98	92
1996	14.0	10.9	12.9	109	84
High African-American census tract					
1992	3.2	2.6	3.7	86	70
1996	3.6	3.0	4.1	88	73

Source: HUD.

HUD's housing goals may have contributed to the enterprises' performance relative to the primary market. However, other factors may have played a role as well. Between 1992 and 1996, the United States experienced steady economic growth and mortgage interest rates were generally favorable. According to the National Association of Realtors, housing was more affordable in 1995 than in any year during the 1975 to 1992 period. With a generally favorable economic environment and increased housing affordability, more targeted borrowers, such as low-income households and those living in underserved areas, may have been able to qualify for mortgages, and the enterprises may have found it profitable to increase their purchases of such mortgages without prompting from HUD's housing goals.

The Enterprises Continue to Trail the Primary Market

Despite their relative improvements, the enterprises continued to trail the primary market in most categories identified in table III.1. There are several potential reasons for these differences, including the following:

- According to a Federal Reserve study,[80] mortgage originators have a better understanding of the risks associated with lending in the areas where they do business than the enterprises. Thus, the enterprises may establish mortgage purchase underwriting criteria that are stricter than the underwriting criteria of mortgage originators.
- Banks and thrifts—major originators in the primary mortgage market—are subject to the Community Reinvestment Act, which requires them to serve the needs, including mortgage credit needs, of targeted groups in areas where they do business.[81]
- HUD set the housing goals below the estimated shares of targeted mortgage lending in the primary market.

[80]Credit Risk and the Provision of Mortgages.

[81]See Characteristics of Mortgages Purchased.

Comments From the Department of Housing and Urban Development

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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

JUL 14 1998

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

Mr. Thomas J. McCool
Director, Financial Institutions
and Market Issues
General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. McCool:

We appreciate the opportunity to provide comments on the draft report prepared by the General Accounting Office (GAO) and entitled "*Federal Housing Enterprises: HUD's Mission Oversight Needs to Be Strengthened*" (the "Report"). Overall, HUD believes that this report offers useful suggestions for the Department's general regulatory oversight. We also appreciate the professionalism, competence and cooperation of the GAO team assigned to this project.

The Department believes that since enactment of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act), following in the spirit and the letter of the Act, it has created an efficient and effective regulatory framework for Fannie Mae and Freddie Mac (collectively referred to as the GSEs). While there are ways this framework for overseeing the public purpose responsibilities of the GSEs may be improved and enhanced, the basic structure and approach of HUD's regulation is sound.

The Report focuses on five areas of HUD's mission oversight of Fannie Mae and Freddie Mac: (1) HUD's approach in setting the housing goals; (2) HUD's assessment of the goals' impact on homeownership and housing opportunities; (3) HUD's procedures and efforts to verify goal compliance data; (4) HUD's assessment of GSE multifamily activities on housing opportunities; and (5) HUD's general regulatory oversight including non-mortgage investment activity, new program reviews and fair lending issues. The Report also makes four specific recommendations. HUD agrees with the Report's basic recommendations and will detail in Part A the specific initiatives undertaken to implement them. Part B will elaborate on the five areas examined by GAO and offer HUD's perspective in each area.

A. HUD's Initiatives to Implement GAO Recommendations

The four recommendations in the Report are consistent with HUD's identified initiatives for GSE Regulatory Oversight during 1998 and 1999. Many of the Department's approaches and plans to achieve these initiatives have been provided to GAO.

1. Collect information on the necessary costs for effectively overseeing the GSEs and develop a proposal for Congressional consideration that would require the enterprises to reimburse HUD for these costs.

HUD agrees with GAO's recommendation that its mission oversight of the GSEs should be financed by periodic assessments on the GSEs, as is the case for all other Federal oversight of housing enterprises and financial institutions, including that carried out by the Office of Federal Housing Enterprises Oversight (OFHEO), the Federal Housing Finance Board, the Federal Reserve Board, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the National Credit Union Administration. As GAO notes, it is appropriate that the GSEs bear the costs of regulation by the government since they receive substantial benefits due to their ties to the government.

HUD has developed a legislative proposal for inclusion in the Department's budget submission for FY2000 authorizing the Secretary to establish and collect from the GSEs an amount equal to the costs and expenses related to carrying out all of the Secretary's regulatory oversight responsibilities under the 1992 Act. Adoption of this proposal would ensure that the Department had adequate resources to carry out its oversight responsibilities.

2. Develop and implement a program to assess the accuracy of housing goal-compliance data. Coordinate any such reviews with OFHEO.

HUD agrees with the need to expand its assessment of the accuracy of the GSEs' housing goal compliance data. A plan to independently verify the GSEs' compliance with counting rules and the accuracy of the data submitted has been developed and is being implemented. A copy of this plan has been provided to GAO. In preparing the plan, HUD discussed its approach and will coordinate its activities with OFHEO to ensure consistent oversight.

3. Assess impacts of housing goals on housing affordability and opportunities for targeted groups.

HUD believes it is making a substantial effort to critically and objectively assess the impacts of the housing goals on housing affordability and opportunities for targeted groups and that effort will continue. Comprehensive understanding of the GSEs' mortgage purchase activities is essential to setting the goals and to ensuring that the

GSEs meet their public purpose responsibilities. Many of the studies prepared by HUD were relied upon by GAO in the preparation of the Report.

Further, HUD is continuing its research to assess the effects of the housing goals in the mortgage market to provide reliable analysis for future rulemaking with respect to the housing goals. Assessing the impact of the housing goals on housing affordability and opportunities for targeted groups is an important component of that research agenda. GAO's suggestions for research on the effects of the goals on mortgage originators' incentives to make targeted mortgage loans and on interest rates and loan terms will be evaluated and implemented, if feasible.

4. Monitor GSE non-mortgage investments and ensure expertise is available to ensure consistency with the GSEs' housing mission.

HUD is committed to increasing its general regulatory oversight of the GSEs' non-mortgage investments. HUD has provided GAO with a work plan detailing its approach. The work plan includes on-going monitoring of the GSEs' non-mortgage investment policies and portfolios and analysis and evaluation of the need for specific regulations governing non-mortgage investments.

HUD has the required expertise available to it for monitoring and evaluating both new mortgage programs and non-mortgage activities. The Department has a staff of employees devoted to GSE oversight who are experienced and knowledgeable with regard to housing finance, mortgage markets and the regulation of financial institutions. The Department also has contracting vehicles in place to obtain outside expertise to assist in reviewing both the mortgage and non-mortgage activities of the GSEs or other regulatory matters, as needed.

B. HUD's Perspective and Work Progress in the Five Areas Examined

The following section contains additional information on the five areas addressed in the Report that HUD believes is appropriate for GAO consideration in evaluating the Department's oversight of Fannie Mae and Freddie Mac.

1. HUD's Approach to Setting the Housing Goals

The Department believes its methodology and approach for setting the housing goals has been fundamentally sound. Although HUD established goals for the 1993-95 transition period, the Department was constrained by the 1992 Act in establishing these goals. The 1992 Act essentially established ceilings for the transitional goals based on HUD's pre-1992 goals for Fannie Mae. Moreover, prior to 1993, little information was available about the GSEs' mortgage purchases. After the 1992 Act, HUD was authorized to collect and analyze extensive data in order to better understand the characteristics of the GSEs' mortgage purchases.

The goals for 1996-99 were the first goals based on extensive research, carried out by HUD and HUD's contractors. In setting the housing goals for the GSEs for 1996-99, HUD considered the six factors mandated by the 1992 Act, and carefully weighed possible tradeoffs among these factors as the Act required. HUD also evaluated the consequences of alternative goals in its Economic Analysis, and intends to do so in any future rulemaking concerning the housing goals.

The Report noted that in the proposed rule HUD considered "the ability of the GSEs to lead the industry" (one of the six statutory factors). GAO observes that HUD's proposed approach would have required the GSEs to purchase a greater share of targeted mortgages than were already originated in the primary conventional mortgage market but that HUD did not adopt this approach in the Final Rule. As appropriate in a rulemaking process, comments received suggested that the Department consider additional ways in which the GSEs lead the market. In considering the factor, HUD analyzed this issue, as discussed in the preamble to the Final Rule, and concluded that the level of the GSEs' mortgage purchases, alone, was not the only measure of leadership. The preamble pointed out that "[t]he GSEs' efforts to create liquidity and stability in the mortgage markets, as well as the introduction of innovative products, technology, and processes, clearly demonstrate their leadership role within the industry." The Department believes its approach and conclusion with regard to its consideration of this factor were appropriate to the 1995 rulemaking. In rulemaking establishing future housing goals, HUD will reconsider this factor and, in that connection, GAO's views.

HUD also believes that setting the 1996-99 goals for a four-year period was appropriate under that rulemaking. These goals were the first goals established under the new law and were set for four years "to provide the GSEs the predictability needed to manage their operations." In establishing future goals, HUD will evaluate the appropriate period for which the goals should be set.

Finally, the Department is undertaking substantial additional research which will be utilized in considering the appropriate level of the goals for the post-1999 period, including consideration of all major issues relevant to the goals which have arisen since the Final Rule was published in December 1995. This research includes three contract studies of the GSEs' single family and multifamily underwriting guidelines and two proposals being processed to study a variety of issues related to single family and multifamily mortgage markets to support the development of a revised rule governing the housing goals.

2. HUD's Assessment of Housing Goal Effects

HUD has completed a significant body of research relating to the GSEs, the mortgage market, and the housing goals and thus has helped fill the "information vacuum" surrounding the GSEs that was noted by Congress during consideration of the 1992 Act. Topics investigated during the previous rulemaking included GSE performance relative to the market, the demographic characteristics of geographic areas underserved by mortgage markets, and effects of proposed housing goals on the financial safety and soundness of the GSEs.

The Department's research efforts subsequent to publication of the Final Rule include publishing the Department's report on the desirability and feasibility of privatizing the GSEs; releasing the GSE public-use loan-level database; issuing numerous analytical papers on GSE-related issues; awarding 11 grants for research related to GSE performance in local markets; and commissioning three contract studies pertaining to GSE underwriting. Many of the studies prepared by HUD were cited by GAO in the Report and, together with studies currently underway, will assist the Department when it considers future changes to the housing goals.

With regard to assessing the goals' effects on interest rates and loan terms on targeted mortgages and on mortgage originators' incentives to make targeted mortgage loans, HUD will explore the feasibility of GAO's research suggestions. Concerning the first suggestion, it should be noted that the GSEs currently obtain data on contract interest rates, but not on points; thus, collection of the latter from the GSEs' sellers would be necessary to determine effective mortgage rates. Nevertheless, it might be possible to conduct some useful research if information on effective interest rates were obtained by the Department.

Based on its accomplishments to date, the Department believes that it can, with reasonable accuracy, determine the extent to which the goals promote housing opportunities and how to structure the goals in the future. The main purpose of the goals is to encourage the GSEs to increase their purchases of those loans made to the groups and communities which the goals target. The exact extent to which there have been changes in GSE purchase patterns during the period since the housing goals took effect has been a major theme in a growing body of research released by HUD. The single family and multifamily contract studies, mentioned previously, will explore these issues.

3. HUD's Procedures and Efforts to Verify Goal Compliance Data

HUD undertakes extensive analyses to verify the accuracy of the enterprises' reported goal compliance data. In addition, HUD analyzes other data on the GSEs' mortgage purchases; *e.g.*, the data provided under the Home Mortgage Disclosure Act; and thus has a basis for evaluating the overall accuracy of the loan-level data provided to the Department by the GSEs. However, we agree with GAO that HUD should take further steps to independently ensure the accuracy and completeness of the data and has provided GAO with a description of the Department's plans to do so. These plans include a review of GSE data quality and counting rule issues by independent auditors and HUD's on-site review of the GSEs' data collection processes and application of counting rules.

See comment 1.

4. HUD's Assessment of GSE Multifamily Activities on Housing Opportunities

The Report discusses the difference in HUD's treatment under the housing goals of multifamily mortgage purchases with credit enhancements and those multifamily mortgages purchased through FHA's risk sharing program. We appreciate GAO's extensive discussion of the subject. HUD furnished details on why it concluded in the Final Rule that credit enhancements should be treated differently than risk sharing arrangements. HUD agrees with GAO's conclusion that additional research on multifamily credit enhancements is needed. In the absence of private mortgage insurance for multifamily mortgages, seller provided credit enhancements appear to serve as a viable means by which secondary market purchasers may delegate certain underwriting responsibilities and share risks. The appropriate treatment of multifamily credit enhancements in counting toward the housing goals was considered during the previous round of GSE rulemaking, and the Department intends to consider it again in any subsequent rulemaking governing the housing goals.

5. HUD's Review of General Regulatory Oversight including New Programs, Non-Mortgage Investments, and Fair Lending

a. New Programs

As noted in the Report, HUD has reviewed and approved four new mortgage programs of the GSEs, each within the 45-day period mandated by the 1992 Act. GAO reviewed the extensive analyses undertaken by HUD in each of the new program reviews and did not question HUD's evaluations and determinations. At the same time, the Report questions HUD's financial expertise to conduct mortgage program and other financial reviews. HUD's oversight responsibilities are assigned to a multi-disciplinary team composed of attorneys, economists, fair lending specialists, financial and program analysts, and mortgage industry experts. A number also have expertise and experience in regulating financial institutions. HUD staff also works with OFHEO on common issues and has contracting vehicles in place to allow the Department to consult with other relevant specialists, as necessary and appropriate.

b. Non-Mortgage Investments

With regard to non-mortgage investments, the Department has taken clear, decisive and focused regulatory action and has the necessary expertise to provide this oversight. The Department exercised its general regulatory responsibilities once certain non-mortgage investments raised questions with regard to the GSEs' public purpose mission. Reports from the GSEs were requested and an Advance Notice of Proposed Rulemaking was published. HUD is currently evaluating the responses to the ANPR and conducting additional research to determine whether a proposed rule should be promulgated. A work plan detailing this activity and the Department's approach to on-going oversight of the GSEs' non-mortgage investments was provided to GAO.

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See comment 2.

c. Fair Lending and Automated Underwriting

The Report notes HUD's concerns about the fair lending implications of the automated underwriting systems that the GSEs are marketing to primary mortgage lenders. This is a major concern as these systems may have the potential to impact minority borrowers nationwide. The Department is reviewing the use and evaluating the impact of automated underwriting systems. HUD takes its duty to oversee the GSEs' automated underwriting systems, as well as any GSE activities that could impact minority borrowing, very seriously.

GAO's description of the disparate impact standard omits a critical third component which the federal courts and the Federal enforcement and regulatory agencies recognize: Even if a business necessity would justify the disparate results, the lender is still liable if that lender could have adopted a less discriminatory policy than the one they in fact adopted. A Federal interagency task force worded the disparate impact standard this way:

> "When a lender applies a policy or practice equally to credit applicants, but the policy or practice has an adverse impact on applicants from a group protected against discrimination, the policy or practice is described as having a "disparate impact." Policies and practices that are neutral on their face and that are applied equally may still, on a prohibited basis, disproportionately and adversely affect a person's access to credit...[w]here the policy or practice is justified by "business necessity" and there is no less discriminatory alternative, a violation of the FH Act or the ECOA will not exist." Policy Statement on Discrimination on Lending, 59 *Fed. Reg.*, 18,266 at 18,269 (1994).

We note that GAO's report GAO/GGD-96-145 (p. 22) mentioned a less discriminatory alternative component to the standard, and we urge that this wording, or other wording very similar to it, be substituted for the current wording in the Report.

We hope that these comments will be helpful in completing the Report. If we can provide further information, please do not hesitate to contact me or Janet Tasker at (202) 708-2224, ext. 2535.

Sincerely,

Ira G. Peppercorn
General Deputy Assistant
Secretary for Housing

The following are GAO's comments on the Department of Housing and Urban Development's letter dated July 14, 1998.

GAO Comments

1. In a letter to GAO, HUD provided an explanation of the differences in counting requirements under the final rule. HUD stated that the enterprises are required to accept additional credit risks on mortgage purchases under the FHA risk-sharing programs because such risks are mathematically quantifiable and agreed before the purchase of loans. By contrast, HUD said that it is difficult to determine the risks that the enterprises incur on multifamily mortgage purchases subject to recourse agreements that are not made under the FHA risk-sharing programs.

As HUD agrees in its comment letter, additional research on multifamily credit enhancements is needed. Thus, we would expect HUD to assess the risks that the enterprises incur on multifamily mortgage purchases subject to credit enhancements.

2. We have added language to the report consistent with the accepted definition of a prohibited disparate impact under federal policy (see p. 38).

Comments From the Office of Federal Housing Enterprise Oversight

OFHEO **OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT**
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

July 13, 1998

Via Transmittal

Mr. Thomas J. McCool
Director, Financial Institutions and Markets Issues
General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. McCool:

We appreciate the opportunity to provide formal comments on your draft report entitled Federal Housing Enterprises: HUD's Mission Oversight Needs to be Strengthened.

As the safety and soundness regulator for Fannie Mae and Freddie Mac, the Office of Federal Housing Enterprise Oversight (OFHEO) has a considerable interest in the quality of mission regulation of these two institutions. While I believe HUD has performed its responsibilities well, given the resources available to it, more resources would help. Accordingly, OFHEO supports your proposal that Congress consider permitting HUD to assess the Enterprises for the costs of their regulation. Reimbursement of regulation costs is appropriate and standard for regulated financial institutions.

Because OFHEO and HUD share regulatory responsibility for the Enterprises, good communication between regulators is essential. On the whole, such communication has been quite good. Our coordination on three new program approval requests in the last year is an excellent example. With respect to HUD's role on affordable housing goals, your report notes only that HUD provided OFHEO with its proposed rule for review and mentions our internal and public conclusions. That greatly understates the degree of communication between regulators. In fact, OFHEO reviewed several drafts of HUD's rule and discussed each of them with HUD, giving careful consideration to a wide range of issues.

With respect to our data integrity examination of Freddie Mac, we notified HUD in October of 1996 that we were conducting such an examination, and in January of 1997 that we had completed it. As the focus of the examination was financial data deliveries to OFHEO, we did not discuss the results with HUD before publishing them in our Annual Report. However, earlier this year, at HUD's request, we offered to provide technical assistance to HUD in their efforts to further evaluate the quality of the data submissions it receives from the Enterprises.

Mr. Thomas J. McCool
July 13, 1998
Page 2

We hope these comments will be helpful in the preparation of your final report.

Sincerely,

Mark Kinsey

Mark Kinsey
Acting Director

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