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FURTHERING FAIR HOUSING, THE HOUSING FINANCE SYSTEM, AND THE GOVERNMENT SPONSORED ENTERPRISES

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FURTHERING FAIR HOUSING, THE HOUSING FINANCE SYSTEM, AND THE GOVERNMENT SPONSORED ENTERPRISES

Henry Korman¹

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Introduction: Enterprises in Transition

The Federal National Mortgage Association, known as Fannie Mae, and the Federal Home Loan Mortgage Corporation, or Freddie Mac, are secondary market entities chartered by Congress to provide liquidity and stability in the residential mortgage markets.² These government sponsored enterprises (GSE) purchase homeowner and multifamily mortgage loans from lenders, who use the proceeds to make new loans. The GSEs either hold the loans in portfolio, or securitize the acquired mortgages into mortgage backed securities (MBS), selling shares of the right to the principal and interest payments to investors, and guaranteeing payment of the loans in the event the of default by borrowers on the underlying mortgages. They are both stock corporations. The GSEs also set national underwriting and appraisal standards for the conventional or “conforming” loans they purchase and securitize, based on characteristics such as borrower creditworthiness, loan-to-value ratios, the age of the dwelling, conditions in the market area of the loan location, and other factors.³ The underwriting standards are intended to facilitate consistency in prime mortgage loan products, promote efficiency in the market, and reduce costs for lenders and borrowers.⁴

Enterprise business activities are not limited to the purchase of conforming loans and MBS issues, and risky business practices proved to be their undoing. Like other financial institutions, in the run up to the financial downturn, they traded in so-called private label mortgage-backed securities (PLS) backed by subprime mortgages. By mid-2007, PLS were made worthless by foreclosures. As financial conditions deteriorated, the value of the mortgages in enterprise securities portfolios declined precipitously with an escalation in conforming mortgage foreclosures. GSE capitalization levels began to drop below safety and soundness levels as enterprise debt outstripped the value of holdings.

The downward financial spiral of the GSEs was compounded by efforts to fulfill the charter mandate of promoting stability in the mortgage market through the purchase of increasing amounts of mortgages. GSE financial condition deteriorated to such an extent that Congress overhauled oversight legislation in the summer of 2008. Facing \$5.3 trillion of losses in combined amounts of guaranteed MBS and outstanding debt, regulators determined that enterprise financial failures threatened a further collapse of financial markets. In September 2008, both enterprises were placed under the conservatorship of a new federal oversight agency,

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² The Fannie Mae charter is codified in the banking title of the U.S. Code along with the charter for another government sponsored enterprise, the Government National Mortgage Association, or Ginnie Mae. See, 12 U.S.C. §1716, *et seq.* The Freddie Mac charter is at 12 U.S.C. §1451, *et seq.*

³ Peterson, Christopher, *Subprime Lending, Foreclosure and Race: An Introduction to the Role of Securitization in Residential Mortgage Finance* (Kirwan Institute for the Study of Race and Ethnicity, September 25, 2008).

⁴ General Accountability Office, *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-term Structures* (GAO-09-782, September 2009).

the Federal Housing Finance Agency (FHFA).⁵ Propped up with trillion dollar investments from the Treasury Department, the GSEs play an important role in the Obama Administration's efforts to slow home foreclosures and support lending for affordable rental housing.

The GSEs are successors to Depression-era federal agencies that institutionalized and standardized redlining; the practice of refusing to extend home mortgage credit on the basis of the race and ethnicity of individual borrowers and the inhabitants of a neighborhood. Enterprise oversight legislation requires the U.S. Department of Housing and Urban Development (HUD) to assure that GSE activities do not discriminate based on race, color, religion, sex, disability, family status, age, or national origin. The enterprises operate under a mandate to assist HUD and other federal agencies in the investigation and enforcement of fair lending obligations under the Fair Housing Act (Title VIII) and the Equal Credit Opportunity Act (ECOA). HUD is obligated to ensure that GSE underwriting guidelines are consistent with Title VIII. The Fair Housing Act and corresponding HUD regulations forbid discrimination in the secondary mortgage market, including in the securitization of mortgages, and the purchase and sale of home loans. Equally crucial for fair housing purposes is the mandate imposed by Title VIII on all "executive departments and agencies" to "administer their programs and activities relating to housing and urban development (including any Federal agency having regulatory or supervisory authority over financial institutions) in a manner affirmatively to further the purposes of" the Fair Housing Act.⁶

At this writing (September 2010), significant questions remain about the future of Fannie Mae and Freddie Mac, including whether they should continue to do business as private corporations with dominant positions in the secondary mortgage market, whether they should be abolished and their secondary market functions left entirely to the private market, or whether their charters should be reformulated to limit their activities to specific purposes. Within these discussions are additional questions about the effectiveness and continued viability of housing goals imposed by current law that are intended to facilitate home mortgage credit for low- and moderate-income purchasers, loans for multifamily rental housing serving low-income households, and investment in single family and multifamily loans made in low-income areas and neighborhoods of color. Among the many issues open for debate is the proper balance between achieving housing goals and reclaiming and sustaining financial soundness.

More significantly, the discussions about the future of the enterprises are now taking place within the context of emerging federal proposals to reform the system of housing finance of which the GSEs are a part, and the necessity of recalibrating the role of government within that system. Despite the historic GSE link to redlining, despite the fact that oversight laws incorporate civil rights considerations, and despite the continuing persistence of discrimination in conventional mortgage lending, fair housing and fair lending issues are lacking from the debate about the future of the enterprises and the financial structures that facilitate the private secondary mortgage markets.

The purpose of this essay is to use the activities of Fannie Mae and Freddie Mac to examine, within the concept of the duty to further fair housing, the workings of the secondary mortgage market in order to highlight the civil rights considerations that require attention as

⁵ Lockhart, James B. III, Director Federal Housing Finance Agency, *Corrected Statement Before the House Committee on Financial Services on the Conservatorship of Fannie Mae and Freddie Mac* (September 25, 2008).

⁶ 42 U.S.C §3608(d).

policymakers take on both the future of the enterprises, the shape of the housing finance system, and the role of government within the housing finance system.

Affirmatively Furthering Fair Housing

The obligation to further fair housing codified in Title VIII derives from the Congressional recognition of the long and well documented history of the use of federal housing activities to create and perpetuate widespread patterns of residential racial segregation, in both homeownership and rental housing programs. As interpreted by the courts, the responsibility has several elements. Federal agencies must not engage in acts of housing discrimination, or acts that establish or perpetuate segregation, and must ensure that entities under agency supervision involved in housing activities do not engage in discrimination. Agencies must also gather information about and understand whether the actions of entities under their supervision advance housing opportunity or instead perpetuate segregation. They must take affirmative steps in funding and supervisory activities to break down patterns of residential segregation and create truly open housing markets.⁷ An agency may not disregard these duties. However, once an agency acts to carry out the responsibility, it is entitled to considerable deference.⁸

The first GSE, the Federal Home Loan Bank Board (FHLBB), was a linchpin of the efforts at establishing segregation, and there is a symmetry between the racialized origins of GSEs during the Great Depression and the current foreclosure crisis visited primarily on people and neighborhoods of color. The FHLBB was created in 1932 to provide low cost advances to member banks for home mortgage lending. A companion agency, the Homeowners Loan Corporation (HOLC) was established “to exchange government bonds for delinquent mortgages with lenders and provide homeowners with new low-interest, 15-year fully amortized mortgages and the chance to save their home.”⁹ Around the same time, the Federal Housing Administration (FHA) was created to insure similar long term, amortizing loans with standardized features.

It was the FHA, and HOLC at the direction of the FHLBB, that devised appraisal approaches that devalued properties in areas predominated by African-Americans, it was the FHA, and HOLC at the direction of the FHLBB, that created the maps that redlined the Black neighborhoods where no loans could be made, and it was the FHA that institutionalized the practice of lending to create or preserve racial homogeneity within urban and suburban communities. These acts are held responsible for establishing the patterns of residential segregation that still characterize most metropolitan areas.¹⁰

The GSES are inheritors of this legacy. Fannie Mae was created in 1938 to buy FHA’s mortgages.¹¹ Freddie Mac was created in 1970 to serve the same function for members of the

⁷ See, e.g., *NAACP v. HUD*, 817 F.2d 149 (1 Cir. 1987); *Otero v. New York City Housing Authority*, 484 F.2d 1122 (2 Cir. 1973); and *Shannon v. United States Department of Housing and Urban Development*, 436 F.2d 809 (3 Cir. 1970).

⁸ *Jones v. Office of the Comptroller of Currency*, 983 F. Supp. 197, 203 (D.D.C. 1997); *Jorman v. Veterans Administration*, 579 F. Supp. 1407, 1408 (N.D. Ill. 1984); *Debolt v. Espy*, 832 F. Supp. 209 (S.D. Ohio 1993).

⁹ Hillier, Amy E., *Residential Security Maps and Neighborhood Appraisals: The Homeowners' Loan Corporation and the Case of Philadelphia*, *Social Science History*, Vol. 29, No. 2 (2005).

¹⁰ Massey, Douglas S. and Denton, Nancy A., *American Apartheid: Segregation and the Making of the American Underclass* (Harvard University Press, 1993).

¹¹ Peterson, Christopher, *Fannie Mae, Freddie Mac, and the Home Mortgage Foreclosure Crisis*, 10 *Loyola J. of Public Interest Law* 149 (2009).

Federal Home Loan Bank system, and when first established, it was wholly owned by FHLBB members.¹²

As a legal matter, the extent to which the statutory duty to further fair housing applies to the GSEs is unclear. Judicial remedies for the violation of the duty to further fair housing are most often imposed where there is direct evidence that a federal agency or a local agency under the supervision of a federal agency engages in activities that either deliberately fosters segregation, or has a discriminatory effect,¹³ and there is no indication that the GSEs ever utilized the segregationist underwriting standards pioneered by FHA and HOLC. Moreover, Title VIII cases against federal agencies are decided under the federal Administrative Procedure Act (APA). It is less than clear that the GSEs are considered “agencies” for APA purposes, and can be held responsible for violating the Title VIII obligation to further fair housing like other grantees of federal funds.¹⁴

Even with this lack of clarity, it is beyond question that HUD and FHFA are federal agencies subject to the APA, and they must exercise their supervisory authority over the enterprises consistent with the obligation to further fair housing.¹⁵ Together with the GSEs, they are inheritors of a system for funding home mortgages that is responsible for establishing patterns of residential segregation that persist to the present day. Their supervisory duties, while defined by enterprise oversight laws, must be carried out consistent with the responsibility to further fair housing. Their record of doing so is equivocal at best.

Fair Lending Enforcement and the GSEs

The Fair Housing Amendments Act of 1988 amended the Fair Housing Act to forbid discrimination based on race, color, religion, sex, disability, familial status, and national origin in the “purchasing of loans” secured by residential real estate; that is, in secondary mortgage market transactions.¹⁶ HUD fair housing rules define prohibited conduct to include the purchase or securitization of loans in some areas but not others based on the protected characteristics of the people living in the area, pooling or securitizing loans for purchase and sale based on

¹² See, Pub. L. 91-351, §304 (July 24, 1970); 84 Stat. 454, enacting 12 U.S.C. §1453 (“The capital stock of the [Freddie Mac] shall consist of nonvoting common stock which shall be issued only to Federal home loan banks.”). Until 1989, the Federal Home Loan Bank Board also chartered and supervised thrifts. The Financial Institutions Reform and Recovery Act of 1989 abolished the Board, shifting chartering and supervision of thrifts to the Federal Home Finance Board, and oversight of a system of regionalized Federal Home Loan Banks to the Federal Housing Finance Board (FHFB). The Housing and Economic Reform Act of 2008 abolished the FHFB and assigned oversight of regional Federal Home Loan Banks to FHFA. See, Pub. L. 110-289, Div. A, §1311; 122 Stat. 2797 (July 30, 2008).

¹³ *Thompson v. United States Dep’t of HUD*, 348 F. Supp. 2d 398 (D. Maryland 2005), summary judgment denied, *Thompson v. United States Dep’t of HUD*, 2006 U.S. Dist. LEXIS 9416 (D. Maryland January 10, 2006).

¹⁴ The GSEs are APA “agencies” for purposes of the Freedom of Information Act. 5 U.S.C. §552(f)(1). Several cases hold that the Federal Home Loan Banks are “agencies” within the meaning of the APA. See, e.g., *Fidelity Financial Corp. v. Federal Home Loan Bank*, 589 F. Supp. 885 (N.D. Cal. 1983). There are also a number of cases imposing a duty to further fair housing on HUD grantees, and the outcome in these cases suggests that the duty to further fair housing extends to non-federal entities supervised by federal agencies.. See, e.g., *Langlois v. Abington Housing Authority*, 234 F. Supp. 2d 33 (D. Mass. 2002). While it is fair to conclude that these authorities impose a similar obligation on the enterprises either because the GSEs are APA agencies, or because they are supervised by federal agencies, a full exploration of the question is beyond the scope of this essay.

¹⁵ See, *Thompson v. United States Dep’t. of HUD* at note 13 (HUD); cf., *Jones v. Comptroller of the Currency* at note 7 (duty of agency with supervisory authority over financial system to further fair housing).

¹⁶ Pub. L. 100-430, §6(c), 102 Stat. 1622 (Sept. 13, 1988), amending 42 U.S.C. §3605.

protected characteristics, and the use of different terms and conditions in purchase, sale, or securitization of mortgages because of loan features related to protected characteristics.¹⁷

There appear to be few or no judicial or administrative decisions involving complaints of discrimination in secondary mortgage market transactions. It is clear, however, that Congress intended to enlist the enterprises in identifying and bringing enforcement actions. The Federal Housing Finance Regulatory Reform Act of 1992 (the 1992 Reform Act) was enacted as part of a larger effort to establish financial safety and soundness standards and to improve government oversight of the enterprises.¹⁸ Section 1325 of the 1992 Reform Act imposed fair housing responsibilities on both HUD and the enterprises:

- The enterprises are prohibited from discrimination in the purchase of any mortgage because of race, color, religion, sex, disability, familial status, age, or national origin, “including any consideration of the age or location of the dwelling or the age of the neighborhood or census tract where the dwelling is located.”
- The GSEs must submit lender data to HUD and other federal agencies to assist in investigations of failures to comply with Title VIII and ECOA.
- HUD is required to obtain information from other federal, state, and local agencies regarding violations of the Fair Housing Act and ECOA, and to direct the enterprises to take enforcement action against lenders that are found to be in violation of fair lending laws.¹⁹

Under HUD regulations, the GSEs are obliged to submit lender data only at HUD’s request.²⁰ Provisions for the exchange of information between HUD and the enterprises as part of a fair lending enforcement strategy appear to have yielded no results. That outcome is part of a pattern of widespread weaknesses among HUD, banking regulators, and the Department of Justice in efforts to carry out fair lending enforcement.

Banking regulators do review financial institution fair lending compliance as part of banking examinations.²¹ However, from 2005 through 2008, the five federal bank regulators with supervision authority over more than 16,000 financial institutions made only 118 ECOA and Title VIII referrals to the Justice Department after completing consumer compliance and so-called “outlier” examinations. Nearly half of the referrals involved discrimination based on marital status, a characteristic protected by ECOA but not Title VIII. Outlier examinations, in which Home Mortgage Disclosure Act (HMDA) data is used to identify loan pricing disparities for African-American and Hispanic borrowers, yielded only 10 referrals to the Justice Department for investigation of pattern and practice violations of Title VIII.

Of the 7 fair lending cases settled by the Justice Department between 2005 and 2009, only 2 were based on referrals from banking regulators. Structural issues within the enforcement framework such as inconsistent approaches to examination, and limitations in the content of HMDA data are obstacles to better enforcement.²² These overall weaknesses indicate that there

¹⁷ See, 24 C.F.R. §100.125 (2010 ed.).

¹⁸ Pub. L. 102-550, title XIII (October 28, 1992), 106 Stat. 3941.

¹⁹ 12 U.S.C. §4545.

²⁰ 24 C.F.R. §81.44 (2010 ed.).

²¹ Federal Financial Institutions Examination Council, *Interagency Fair Lending Examination Procedures* (August 2009).

²² General Accountability Office, *Fair Lending: Data Limitations and the Fragmented Financial Regulatory Structure Challenge Federal Oversight and Enforcement Efforts* (GAO-09-704, July 2009).

must be improvements in the enforcement activities of HUD, the banking regulators, and the Department of Justice before the enterprises can play any meaningful role in fair lending enforcement.

Fair Lending and GSE Underwriting

HMDA data continues to report racial disparities in access to home mortgage credit by people of color, especially Blacks.²³ Denial of conventional credit is linked to the correspondingly higher rates of subprime lending to people of color, and research points to significant correlations between high rates of subprime lending to people of color and levels of segregation.²⁴

A decade ago, the GSEs underperformed the market in their purchase of loans to African-American and Latino borrowers, with especially high disparities compared to the market in purchases of loans made to African-Americans, including high-income African-Americans.²⁵ By 2008, Fannie Mae succeeded in eliminating the gap, matching the overall market's loans to Blacks, and exceeding it slightly for Latino borrowers. Freddie Mac lagged the market for African-American borrowers by 1% and also exceeded the market in the purchase of loans made to Latinos.²⁶ Annual Housing Activities Reports (AHAR) filed by the enterprises with FHFA for 2009 show dramatic reversals. The share of Fannie Mae purchases of loans to Black borrowers dropped from 5% in 2008 to 3% in 2009; the percentage of purchases of loan to Latinos dropped from 6.6% to 4.9%. Freddie Mac's purchases showed similar trends with reductions in the acquisition of Black originated loans from 4% to 2.5% of all loans, and similar reductions in purchases of loans to Latinos from 6.4% to 4.1%.²⁷

It may be that these changes reflect larger dynamics in the home mortgage market, which saw loan applications from Black borrowers drop by 48% and applications from Latinos by 55%.²⁸ Whatever the cause of the GSEs' current performance, it is indicative of a larger disregard for the availability of credit for borrowers of color, considering the chronically persistent level of racially disparate home mortgage loan denials in the private market.

The 1992 Reform Act addressed the poor performance of the GSEs in purchasing loans made to borrowers of color in part by imposing a duty on HUD to review and comment on GSE underwriting and appraisal guidelines "to ensure that such guidelines are consistent with the Fair

²³ Avery, Robert B., Bhutta, Neil, Brevoort, Kenneth P., Canner, Glenn B., and Gibbs, Christa N., *The 2008 HMDA Data: The Mortgage Market during a Turbulent Year* (Federal Reserve Bulletin, September 2009).

²⁴ Furman Center for Real Estate and Urban Policy, *The High Cost of Segregation: Exploring the Relationship Between Racial Segregation and Subprime Lending* (New York University, November 2009).

²⁵ Bunce, Harold, HF-011, *An Analysis of GSE Purchases of Mortgages for African-American Borrowers and Their Neighborhoods* (Housing Finance Working Paper Series, U.S. Department of Housing and Urban Development, December 2000).

²⁶ Fannie Mae's 2008 purchases of loans made to Blacks comprised 5% of overall purchases and its purchases of Latino loans were 6.6% of its purchases, compared to respective market shares by these borrowers of color of 5% and 6.1%. Freddie Mac's respective percentage purchases were 4% and 6.4%. See, Fannie Mae's 2008 *Annual Housing Activities Report* (March 16, 2009) and in Freddie Mac's *Annual Housing Activities Report for 2008* (March 10, 2009). Information about the 2008 market is from HMDA data compiled by the Federal Financial Institutions Examination Council's (FFIEC) and is available at: <http://www.ffiec.gov/Hmda/default.htm>.

²⁷ Fannie Mae, *2009 Annual Housing Activities Report* (March 15, 2010); Freddie Mac, *Annual Housing Activities Report for 2009* (March 16, 2010).

²⁸ Federal Housing Finance Agency, *2010-2011 Enterprise Housing Goals; Enterprise Book-entry Procedures: Final Rule* (August 26, 2010).

Housing Act.”²⁹ HUD rules turn this obligation on its head by requiring the enterprises to submit a fair housing analysis of “underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures that affect the purchase of mortgages for low- and moderate-income families, or that may yield disparate results” as part of an AHAR.³⁰

Enterprise AHAR indicate some effort to address the potential for discrimination in GSE underwriting. Fannie Mae, for example, “maintains an ongoing comprehensive fair lending risk assessment program that is designed to ensure that its underwriting standards, business practices, repurchase requirements, pricing policies, fee structures, and procedures comply with the fair lending laws and promote fair and responsible lending.”³¹ The enterprises make automated underwriting systems with manual override capabilities available to lenders that are intended to combine consistency, fairness, and flexibility in loan processing. Beyond considerations of discrimination in underwriting, lack of funds for down payments and lower credit rating scores are also barriers to access to home loans that tend to affect people of color at higher rates.³² Historically, the GSEs underwrote alternative loan products with reduced loan-to-value requirements and higher risk profiles that are targeted at such borrowers. They also purchased loans made in connection with public programs that often facilitate homeownership by people of color.

It may be that these alternative loan products are a factor in the slight progress made by the enterprises in matching the market’s share of loans to borrowers of color in 2008. As addressed in greater detail in later sections, it is equally plausible that the advances in GSE purchase of loans to households of color are tied to purchases of private label securities collateralized with subprime mortgages. In any event, the underwriting of alternative loan products is now more strict with the onset of GSE financial deterioration, and is likely to curtail access to conventional credit for borrowers of color for the foreseeable future. Beginning in 2007, both GSEs reduced acceptable loan-to-value ratios, increased credit score requirements, reduced “back end” borrower debt-to-income ratios, and took other steps that curtailed the efficacy of alternative underwriting tools. They also eliminated the more relaxed underwriting criteria for alternative loan products. These actions were taken in a larger market environment in which both the FHA and private lenders also imposed more conservative loan standards.³³

Even before the current financial crisis took hold, GSE underwriting and appraisal standards were often controversial. Fannie Mae and Freddie Mac both have been defendants in litigation alleging that their single family automated underwriting software programs unfairly deny the credit applications of borrowers of color and violate Title VIII and ECOA.³⁴ As the foreclosure crisis gained momentum in 2007, the GSEs added features to their software that identified so-called “declining markets” by zip code. Loan applications submitted to the automated underwriting systems by lenders from borrowers in declining market zip codes

²⁹ 12 U.S.C. §4545.

³⁰ See, 24 C.F.R. §81.43 and §81.63 (2010 ed.).

³¹ Fannie Mae, *Annual Housing Activities Report for 2009*.

³² Bunce, *An Analysis of GSE Purchases of Mortgages for African-American Borrowers*; Burnett, Kimberly, Cortes, Alvaro, and Herbert Christopher E., *Review of Selected Underwriting Guidelines to Identify Potential Barriers to Hispanic Homeownership* (Abt Associates, March 2006).

³³ FHFA, *2010–2011 Enterprise Affordable Housing Goals; Final Rule*, page 31 to 34.

³⁴ Both cases were dismissed without addressing the issue of whether automated underwriting violates fair lending laws. See, *Beaulialice v. Federal Home Loan Mortgage Corporation*, 2007 U.S. Dist. LEXIS 15846, 20 Fla. L. Weekly Fed. D. 656 (M.D. Fla., March 6, 2007) and *Rahmann v. Federal National Mortgage Association*, Case No. 1:02CV01822 (D.C. D.C., November 2, 2004), on file with author.

delivered a message instructing lenders to seek extra information about the market area and the quality of supporting appraisals. Borrowers in declining markets were subject to more stringent loan-to-value underwriting requirements. Amid criticism of redlining reminiscent of the past segregationist practices of the FHA, the FHLBB, and the HOLC, the enterprises abandoned the practice in favor of stricter, national, uniform loan-to-value requirements.³⁵

Enterprise multifamily underwriting has also been the subject of scrutiny. One study found evidence that GSE underwriting causes the enterprises to “lag in three sectors of the multifamily market that may have fair lending implications:

- Purchases of loans in high-minority tracts;
- Purchases of loans on small multifamily properties, which are disproportionately owned by property owners of color; and
- Purchases of loans for multifamily properties in underserved areas.”³⁶

The collapse of the financial markets has resulted in further reductions in GSE multifamily participations. However, multifamily market conditions related to vacancy rates, falling rents, and declining property values are so weak that private lenders have abandoned the market, meaning that in 2009 the enterprises, according to FHFA, “not only led the multifamily market, they effectively were the market.”³⁷ Although some private capital returned to the market in 2010, the GSEs continued to comprise “a larger than usual portion of the multifamily market.”³⁸

The Duty to Further Fair Housing and Past GSE Performance of the Affordable Housing Goals

Since at least 1989, GSE charters have directed the enterprises to include within secondary mortgage market purchases, “activities relating to mortgages on housing for low- and moderate-income families.”³⁹ The 1992 Reform Act imposed three housing goals on the enterprises: a goal for the purchase of mortgages on housing for low- and moderate-income homeowners and renters; a goal involving mortgage purchases in central city, rural, and other “underserved markets;” and a goal requiring purchases of homeowner and rental mortgages for very-low-income families and also the “special” unaddressed affordable housing needs of low-income families in low-income areas. Housing goal requirements under the 1992 Reform Act are changing in 2010 because of amendments to GSE oversight legislation in the summer of 2008. However, past performance of the enterprises under the old housing goal framework is one means of understanding the fair housing impact of the duty to expand credit to low-income people, low-income areas, and underserved markets.

Federal housing initiatives in general are plagued by a tension between the duty to comply with the mandate to further fair housing by building affordable housing in low-poverty,

³⁵ For more detail about the declining market procedures, see, Fannie Mae, *Announcement 07-11* (July 13, 2007) and Freddie Mac, *Bulletin* (November 15, 2007). The procedures were abandoned in favor of the national standards in Fannie Mae, *Announcement 08-10* (May 16, 2008) and Freddie Mac, *Bulletin* (May 29, 2008).

³⁶ Abt Associates, Inc., *Study of the Multifamily Underwriting and the GSEs' Role in the Multifamily Market: Expanded Version* (August 2001).

³⁷ FHFA, *2010–2011 Proposed Enterprise Affordable Housing Goals; Enterprise Book-Entry Procedures; Proposed Rule*, 75 Fed. Reg. 9056.

³⁸ FHFA, *2010–2011 Enterprise Affordable Housing Goals; Final Rule*, page 65.

³⁹ The low- and moderate-income directive in the Fannie Mae charter is codified in the National Housing Act at 12 U.S.C. §1716(3). The companion provision in the Freddie Mac charter is in a note to 12 U.S.C. §1451.

racially integrated areas (often in the suburbs), and the structural features of programs that direct investment of resources to deteriorated, high poverty, racially identified areas.⁴⁰ The housing goals in the 1992 Reform Act reflect similar tensions. The low- and moderate-income goal and the special affordable housing goal are directed at improving access to credit for *people*, suggesting the possibility that those goals can be directed towards furthering fair housing by expanding choice of location in homeownership to racially integrated areas.⁴¹ Such a result has been observed, for example, from lending that qualifies for credit under the Community Reinvestment Act.⁴² On the other hand, an “underserved area” is a *place*, a census tract with a median income at or below 120% of area median income (AMI) and a population of people of color of 30% or more, or a census tract where median income does not exceed 90% of AMI. With racial concentrations as part of the benchmark, this housing goal has the potential for reinforcing existing patterns of segregation.

Much of the research examining the GSE affordable housing missions questions the efficacy of the housing goals, without looking more deeply at whether or not they further fair housing. The General Accountability Office (GAO) observed that “the effects of the housing goals on affordability and opportunities for target groups have been limited.”⁴³ A different study uncovered negative interactions between GSE housing goal purchases and outcomes in FHA single family mortgage insurance programs, with GSE purchases “crowding out” FHA closings by focusing on the highest quality low-income mortgages in highest income neighborhoods qualifying under housing goal standards.⁴⁴ Other research suggests that the relatively high income levels used under the 1992 Reform Act to define low- and moderate-income purchases are “exploited” by the GSEs, “yielding effects that might diverge from the law’s intent.”⁴⁵ Similar results were observed for multifamily activity, where GSE purchases are concentrated “in the middle of multifamily market segment with regard to affordability” because the “great majority of rental units are affordable to families at 100 percent of median income.”⁴⁶

The focus of the research on the question of housing goal effectiveness misses a key consideration. The congressional interest in affordable housing goals is to expand access to credit for people and places that face historic barriers to homeownership and investment. This intent is evident from the text of the 1992 Reform Act, which instructed HUD to set the goals in part by taking into account “the ability of the enterprises to lead the industry in making mortgage credit available.”⁴⁷ Notwithstanding this directive, housing goals were administered by HUD not

⁴⁰ Julian, Elizabeth K., *Fair Housing and Community Development: Time to Come Together*, 41 Ind. L. Rev. 555 (2008).

⁴¹ Under the 1992 Reform Act, moderate-income households are families with incomes not in excess of 100% of AMI. Low-income families are those with incomes adjusted for household size that are at or below 80% of AMI, and very low-income families are households with incomes not in excess of 60% of AMI.

⁴² Friedman, Samantha and Squires, Gregory D., *Does the Community Reinvestment Act Help Minorities Access Traditionally Inaccessible Neighborhoods?* Social Problems, Vol. 52, Issue 2, pp. 209-231 (Society for the Study of Social Problems, Inc. 2005).

⁴³ GAO, *Analysis of Options for Revising the Housing Enterprises’ Long-term Structures*, page 23.

⁴⁴ An, Xudong and Bostic, Raphael, *Have the Affordable Housing Goals been a Shield against Subprime? Regulatory Incentives and the Extension of Mortgage Credit* (April 28, 2006).

⁴⁵ Bhutta, Neil, *GSE Activity and Mortgage Supply in Lower-Income and Minority Neighborhoods: The Effect of the Affordable Housing Goals* (Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, 2009).

⁴⁶ Abt, *Study of the Multifamily Underwriting and the GSEs’ Role in the Multifamily Market*, page 9.

⁴⁷ See, 12 U.S.C. §4562(b)(5) (low- and moderate-income families); §4563(a)(2)(D) (special affordable housing goal); and §4564(b)(5) (underserved areas).

to encourage the enterprises to serve as leaders in expanding fair access to credit, but rather to remedy the GSEs' history of lagging the market in providing credit to low-income families, underserved areas, and affordable housing serving low-income households, including affordable rental housing. From 1996 through 2008, housing goals were established at levels that were often less than and were never greater than the high end of HUD's forecast of market performance. In 2009, following the enactment of the Federal Housing Finance Regulatory Reform Act of 2008 (the 2008 Reform Act), FHFA assumed responsibility for administering the housing goals. At that point, FHFA adjusted "the housing goal targets to align them with FHFA's estimates of market activity in the current mortgage market environment." Under this regime, it is not surprising that the GSEs met or exceeded most housing goals from 2002 to 2007.⁴⁸

Evidence that the housing goals provide any kind of benefit to borrowers of color is equivocal. Most research in this regard is concerned with lending in racially identified areas, and not access to credit by individual people of color, nor access by people of color to integrated areas of opportunity. A 2006 study suggested a possible fair housing benefit to the affordable housing goals by observing that as the GSEs increased market share, subprime lending decreased, especially in areas with high levels of racial concentration.⁴⁹ However, one year later, the GAO reached an opposite conclusion, finding that as subprime loans grew in market share of homebuyers of color, GSE share shrank, so that by 2005, subprime lending occupied a greater share of the market for borrowers of color than either Fannie Mae or Freddie Mac.⁵⁰

The most significant civil rights issue associated with GSE housing goal performance remains to be fully explored. Through the intervention of FHFA in 2007, the enterprises were compelled to adopt policies that excluded the purchase of loans that were considered to be predatory under guidelines issued by federal banking regulators.⁵¹ Prior to that time, a significant amount of GSE acquisitions in private label securities consisted of the subprime and Alt-A mortgages.⁵² Data from FHFA indicates that for the five year period between 2003 and 2008, when enterprise purchases of subprime PLS are excluded, the GSE achievement of the housing goals falls off markedly, and for a several years during that period, it falls below federal benchmark requirements.⁵³ The data do not reveal the extent to which GSE purchases of subprime PLS involved loans to borrowers of color. Whatever its volume, it cannot possibly be

⁴⁸ Federal Housing Finance Agency, Mortgage Market Note 10-2, *The Housing Goals of Fannie Mae and Freddie Mac* (February 1, 2010).

⁴⁹ An and Bostic, *Have the Affordable Housing Goals been a Shield against Subprime?*

⁵⁰ General Accountability Office, *Federal Housing Administration: Decline in the Agency's Market Share was Associated with Product and Process Developments of Other Mortgage Market Participants* (GAO-07-645, June 2007).

⁵¹ FHFA, *2010–2011 Enterprise Affordable Housing Goals; Final Rule*, page 35, note 37, citing Office of Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Department of the Treasury, and National Credit Union Administration, *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 Fed. Reg. 58609 (October 4, 2006).

⁵² GAO, *Analysis of Options for Revising the Housing Enterprises' Long-term Structures*, page 27. See also, Jaffee, Dwight M., *The Role of the GSEs and Housing Policy in the Financial Crisis* (Financial Crisis Inquiry Commission, February 25, 2010) at page 5 (total enterprise ownership of subprime, Alt-A, and other high risk loans totaled \$1.571 billion as of September 30, 2009).

⁵³ FHFA, *2010–2011 Enterprise Affordable Housing Goals; Final Rule*, page 38. The housing goals rule for 2010 and 2011 explicitly excludes subprime PLS from the count of single family goals qualifying mortgages. See, FHFA, *2010–2011 Enterprise Affordable Housing Goals; Final Rule*, promulgating 12 C.F.R. §1282.16(d).

an activity that furthers fair housing to achieve the housing goals through activities that now plague neighborhoods of color.

Housing Goals Under the 2008 Reform Act

Housing goals under the 1992 Reform Act were mostly concerned with the incomes of borrowers or renters, and the income and racial characteristics of the locations of rental and homeowner units financed with GSE purchases mortgages. The low- and moderate-income and underserved area goals focused on the type of housing, that is, on whether a purchased mortgage involved for-sale housing or rental housing only through subgoals which by statute could not be the basis of an enforcement action by HUD in its capacity as overseer of housing goal compliance.⁵⁴

The 2008 Reform Act, enacted in July 2008 as part of economic stimulus legislation, made several changes to this framework. The goals are reorganized to establish four single family goals and one multifamily special affordable housing goal. The new approach targets lower income households and areas. The 1992 Reform Act's low- and moderate-income goal was aimed at moderate-income households at 100% of AMI, and low-income families at 80% of AMI. That goal was administered as single goal, effectively targeting it at households with incomes at or below 100% AMI. The 2008 Reform Act establishes separate single family goals for low-income purchasers at 80% of AMI, and another for very low-income buyers at 50% of AMI. The new structure redefines low-income areas from 90% of AMI under the previous underserved area goal, to 80% of AMI. It retains the measure of a racially concentrated area as a census tract with minority population of 30% or more, but reduces the income limit for such locations from 120% AMI to 100% AMI. The multifamily goal under the 2008 Reform Act is aimed at households at or below 80% of AMI, and the legislation creates a multifamily subgoal for very low-income families with incomes at or below 50% AMI.⁵⁵

Several aspects of the new goals methodologies remain unchanged. Like the predecessor law, the 2008 Reform Act requires FHFA to set the housing goals in part so that the enterprises lead the market.⁵⁶ FHFA's goals for 2010 and 2011 retain HUD's previous approach, setting goals that match, but do not exceed the market.⁵⁷ HUD rules in effect from 2001 to 2003 established incentives for enterprise purchase of loans secured by multifamily properties with less than 50 units. Small multifamily properties are "disproportionately located in high minority areas and... ownership of multifamily properties by African Americans is concentrated among such properties."⁵⁸ When HUD abandoned the incentives in 2004, GSE purchases of small multifamily properties dropped by over 300%.⁵⁹ The 2008 Reform Act requires the enterprises to report on small multifamily purchases, and permits but does not FHFA to set small

⁵⁴ See, 24 C.F.R. §81.12 (2010 ed.) (low- and moderate-income goal with home purchase mortgage subgoal) and §81.13 (2010 ed.) (underserved area goal with single family subgoal). HUD was prohibited from enforcing compliance with subgoals by 12 U.S.C. §4562(a) and §4564(a).

⁵⁵ Pub. L. 110-289, §1128; 122 Stat. 2696.

⁵⁶ Id., 122 Stat. 2699 (single family goals) and 122 Stat. 2700 (multifamily).

⁵⁷ FHFA, *2010–2011 Enterprise Affordable Housing Goals; Final Rule*, page 55. The Final Rule is more lenient with GSE housing goal compliance than HUD. Like HUD's old rule, the new rule measures enterprise performance against a benchmark prediction of the market, but allows for adjustment based actual outcomes in the market. See the new 12 C.F.R. §1282.12.

⁵⁸ Abt, *Study of the Multifamily Underwriting and the GSEs' Role in the Multifamily Market*, page 116.

⁵⁹ FHFA, *2010–2011 Proposed Enterprise Affordable Housing Goals*, 75 Fed. Reg. 9055.

multifamily goals.⁶⁰ The housing goal rule for 2010 and 2011 declines to impose a small multifamily goal.⁶¹

New Concepts of Underserved Markets

Under the 1992 Reform Act, the housing goal concept of the underserved market was intended to facilitate the provision of credit to low-income places, and areas of racial concentration. The 2008 Reform Act retains a similar targeting objective as part of the single family goals by defining a low-income area in part by reference to the extent of its racial concentration.⁶² In a new definition of “underserved market,” the 2008 Reform Act imposes an obligation on the GSEs to develop flexible loan products to facilitate a secondary mortgage market in financing for manufactured housing, rural markets, and for the preservation of HUD subsidized multifamily housing, properties assisted with Low-Income Housing Tax Credits (LIHTC), and comparable state and local programs serving moderate, low, and very low-income families.⁶³

This new concept is in recognition of enterprise activities that do not always qualify for housing goal credit, but still have a significant impact on affordable housing. For example, prior to conservatorship, the enterprises made large purchases of LIHTC, and of tax-exempt single family mortgage revenue and exempt facility multifamily bonds. Fannie Mae’s 2007 AHAR reported the purchase of \$1.18 billion in LIHTC that year, plus an additional \$1.32 billion in LIHTC associated with \$934 million in multifamily tax exempt bond mortgages. Freddie Mac reported \$458.3 million in LIHTC purchases, increasing its overall tax credit investments to more than \$7 billion, involving 376,740 apartments in over 5,000 projects. Freddie Mac’s tax exempt bond activities were also extensive. They included \$2.2 billion in multifamily tax exempt bond purchases, and \$1 billion in mortgage revenue bond purchases financing housing for victims of Hurricanes Katrina and Rita as part of an overall purchase of \$1.8 billion in single family bonds.⁶⁴ The GSEs also provide credit enhancements in connection with tax-exempt bond financing such as payment guarantees. While single family mortgage revenue bond purchases and multifamily bond credit enhancements count for housing goal purposes under FHFA’s new housing goal rules, tax credit investments and purchases of multifamily tax-exempt bonds received no credit.⁶⁵

It is difficult to overstate the extent to which the enterprises dominated the bond and tax credit markets, especially the market for purchase of LIHTC. Many commentators attribute the recent precipitous drop in tax credit pricing to the fact that the GSEs stopped making LIHTC

⁶⁰ Pub. L. 110-289, §1128; 122 Stat. 2700.

⁶¹ FHFA, *2010–2011 Enterprise Affordable Housing Goals; Final Rule*, page 70 to 71.

⁶² Pub. L. 110-289, §1128(d); 122 Stat. 2702 (definition of “low-income area”).

⁶³ Pub. L. 110-289, §1129; 122 Stat. 2704.

⁶⁴ Fannie Mae, *2007 Annual Housing Activities Report* (March 17, 2008); Freddie Mac, *Annual Housing Activities Report for 2007* (March 14, 2008).

⁶⁵ See, FHFA, *2010–2011 Enterprise Affordable Housing Goals; Final Rule*, promulgating 12 C.F.R. §1282.16(b)(1) (excluding LIHTC); §1282.16(b)(2) (excluding multifamily bonds); and §1282.16(c)(8) (counting single family mortgage revenue bond purchases to the extent that the bond proceeds are traceable to otherwise goal qualifying mortgages). The 2008 Reform Act provides discretion to FHFA to count bond purchases by allowing multifamily bond purchases to count towards the multifamily housing goal, unless FHFA determines “that such purchases do not provide a new market or add liquidity to an existing market.” Pub. L. 110-289, §1128; 122 Stat. 2701.

investments as they began their own decline into conservatorship.⁶⁶ Enterprise participations in these activities offer an illustration of the tensions between financial safety and soundness and the public purpose of facilitating the production of affordable housing. In the fall of 2009, both GSEs stated in public securities filings that the value of their tax credit holdings was declining, further weakening already severely impaired balance sheets. The enterprises sought to sell their tax credit interests to two private investment companies at discount rates, a transaction that many feared would add more steep declines to dropping LIHTC prices. FHFA, as the enterprise safety and soundness supervisor, approved the sales. The Treasury Department ultimately blocked the deal because of the disproportionate tax benefits that would accrue to the buyers of the credits, and also, some say, to arrest the expected impact on LIHTC pricing.⁶⁷

The focus of the new concept of “underserved markets” on preservation of existing affordable housing implicates crucial fair housing concerns. HUD multifamily programs and the LIHTC program are often criticized for engaging in siting practices that locate family housing in racially segregated, high poverty locations.⁶⁸ The 2008 Reform Act did nothing to change HUD’s responsibility to ensure that GSE underwriting guidelines “are consistent with the Fair Housing Act.”⁶⁹ Despite this civil rights imperative, FHFA’s proposed approach to regulating the duty to serve underserved markets says nothing about whether enterprise underwriting standards for multifamily preservation will perpetuate existing patterns of segregation in assisted housing, or will instead promote activities that expand housing choice.⁷⁰

The Use of the Enterprises to Stabilize Housing Markets

The FHFA conservatorships of Fannie Mae and Freddie Mac are not the end of the government’s direct involvement in the affairs of the enterprises. Section 1117 of the 2008 Reform Act gave the Treasury Department the authority purchase GSE issued mortgage backed securities, GSE purchased private label securities, enterprise debt, and preferred stock in the GSEs in order to remove the weakest assets from their balance sheets, and to provide infusions of cash for ongoing operations.⁷¹ As of July 2009, the Treasury Department committed to the purchase of \$200 billion in outstanding GSE debt and \$1.25 trillion in MBS and PLS owned by the enterprises.⁷² The Federal Reserve also plays a role in propping up the enterprises with commitments for the purchase of \$1.25 trillion in GSE securities, and another \$175 billion in GSE debt.⁷³

The Treasury Department has used its senior preferred stock position to enlist the GSEs in systemic efforts to stabilize homeownership against threats of foreclosure, and also to provide

⁶⁶ Joint Center for Housing Studies, *The Disruption of the Low-Income Housing Tax Credit Program: Causes, Consequences, Responses, and Proposed Correctives* (December 2009).

⁶⁷ Fannie Mae, Form 8K (filed with the Securities and Exchange Commission, November 9, 2009).

⁶⁸ Abt Associates, *Are States Using the Low-income Housing Tax Credit to Enable Families with Children to Live in Low Poverty and Racially Integrated Neighborhoods?* (July 28, 2006); Gray, Robert and Tursky, Steve, “Location and Racial/Ethnic Occupancy Patterns for HUD-Subsidized Family Housing in Ten Metropolitan Areas” from *Housing Desegregation and Federal Policy* (John Goering, ed., Univ. of North Carolina Press, 1986).

⁶⁹ 12 U.S.C. §4545.

⁷⁰ FHFA, *Duty to Serve Underserved Markets for Enterprises: Advance Notice of Proposed Rulemaking and Request for Comment*, 74 Fed. Reg. 38572 (August 4, 2009).

⁷¹ 122 Stat. 2683.

⁷² FHFA, *Mortgage Market Note 10-1 (Update of Mortgage Market Notes 09-1 and 09-1A)* (January 20, 2010).

⁷³ U.S. Department of the Treasury, *Data as of March 4, 2010 on Treasury and Federal Reserve Purchase Programs for GSE and Mortgage-Related Securities*. The actual government investment in the enterprises by the end of 2009 was \$1.4 trillion.

badly needed assistance to the development of multifamily affordable rental housing. In many ways, these efforts are an extension of previous enterprise activities. Under the “Homeowner Affordability and Stability Plan,” Treasury purchased bundles of state housing finance agency (HFA) mortgage revenue bonds to assist in single family financing, and exempt facility multifamily bonds from the GSEs to facilitate loans to tax exempt bond financed rental projects. The Treasury Department also participated with the GSEs in credit instruments that allow HFAs to repay high cost and maturing bonds in order to ease current financial strains.⁷⁴ The GSEs are also central to programs that allow loan modifications and loan refinancing for homeowners facing foreclosure, providing over 2,300 lenders and servicers with automatic program access.⁷⁵

The Treasury Department’s stock ownership of Fannie Mae and Freddie Mac means that the federal government now has a direct financial interest in affordable homeowner and rental housing. There is no indication that civil rights considerations about the owners and tenants of that housing, or the location of the housing play any role in these initiatives.

Title VIII, the Secondary Mortgage Market, and Securitization: “It could be structured by cows, and we would rate it.”

HUD Title VIII rules forbid the use of race, color, and other protected characteristics in the purchase, sale, and securitization of “loans, or other debt or securities which relate to, or which are secured by dwellings.”⁷⁶ A great deal of recent attention is focused on the role of securitization of mortgages, including subprime mortgages, in causing the current financial crisis. Like fair lending, it appears that discrimination in the secondary mortgage market receives scant attention and enforcement resources.

It is the enterprises that originated the concept of bundling and selling shares in pools of mortgages.⁷⁷ They perform all the functions for GSE-issued securities that are spread among multiple parties in the issuance of private label securities. The GSEs typically own the mortgages that are the collateral for MBS. Conforming loan underwriting requirements serve as a form of rating that offers securities buyers some level of confidence in the quality of the underlying collateral. The enterprises also guarantee the return on the MBS.

In contrast, PLS issues often created on a “shelf” basis, where the underlying mortgages are traded in and out of the pool, and are not generally owned by the issuer.⁷⁸ A significant volume of private label securities are collateralized by subprime loans that when underwritten did not document buyer income, were based on questionable appraisals, had high loan-to-value ratios, ballooning interest rates, and early maturity dates that insured default. The quality of PLS are rated by rating agencies that are paid by the issuers to rate the securities, and whose

⁷⁴ Memorandum of Understanding Among the Department of the Treasury, the Federal Housing Finance Agency, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation (October 19, 2009).

⁷⁵ Department of Treasury, *Making Home Affordable Program: Servicer Performance Report Through January 2010* (February 17, 2010).

⁷⁶ 24 C.F.R. §100.125(b) (2010 ed.).

⁷⁷ Peterson, *The Role of Securitization in Residential Mortgage Finance*; Reiss, David, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 Fla. St. U. L. Rev. 985 (Summer 2006). See also, Securities and Exchange Commission, *Asset-Backed Securities; Final Rule*, 70 Fed. Reg. 1506, 1510, note 45 (January 7, 2005) (“For a number of years, mortgage-backed securities were almost exclusively a product of government sponsored entities.”).

⁷⁸ SEC, *Asset-Backed Securities; Final Rule*, 70 Fed. Reg. 1512.

procedures and standards for issuing the ratings are opaque, and on occasion, non-existent.⁷⁹ PLS are not guaranteed by the issuers. Instead, third party insurers supply credit default swaps that promise to make interest and dividend payments to investors in the event of borrower default.⁸⁰ For all intents and purposes, the system for issuance of PLS is an unregulated house of cards that purports to separate almost all participants from the risk of default. As one rating agency employee put it at the height of the subprime PLS frenzy, a PLS issue “could be structured by cows and we would rate it.”⁸¹ It is no surprise that when subprime mortgages fell into foreclosure, the entire system collapsed.

A fundamental feature of mortgage backed securities is the way the characteristics of individual loans affect how they are bundled by investors, rated by rating agencies, and priced by securities purchasers for both the cost of the security and the expected return. Some of those characteristics implicate fair housing considerations, including the location of the property, the number and characteristics of any tenants, local and regional vacancy rates and rents, the property's physical condition, the property's management, the terms of the leases of the property's tenants, the strength of the local economy, and possible hazards.⁸²

Regulation of asset-backed securities issues and rating agencies is the primary responsibility of the Securities and Exchange Commission (SEC). The SEC's “degree of due diligence” with respect to asset-backed securities “falls short of the more extensive HUD review of the ‘affordable lending’ initiatives of the GSEs or [FHFA's] review of whether newly developed mortgage products pose safety and soundness risks.”⁸³

Existing SEC rules for asset-backed securities and for rating organizations do require a certain level of public disclosure on matters like the regional location of the asset comprising the securities, and on the effects of legal or regulatory requirements such as consumer protection and predatory lending laws. The rules provide for no meaningful SEC oversight of whether the characteristics used to bundle and rate mortgages in a securities pool suggest the possibility of discrimination, such as a targeting of subprime lending at communities or people of color.⁸⁴ Proposed SEC rules would require a much more detailed level of disclosure, including information about individual loans making up a mortgage-backed security. However, the proposed rules would require disclosure of information about the location of a loan only at the

⁷⁹ Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission's Staff's Examinations of Select Credit Rating Agencies* (July 2008).

⁸⁰ McCoy, Patricia A., Pavlov, Andrey D., Wachter, Susan M., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 Conn. L. Rev. 1327 (May 2009); Reiss, David, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 Fla. St. U. L. Rev. 985 (Summer 2006).

⁸¹ SEC, *Staff's Examinations of Select Credit Rating Agencies*, page 12.

⁸² See, SEC, *Asset-Backed Securities; Final Rule*, 70 Fed. Reg. 1544 to 1545 (discussing disclosure requirements for asset-backed securities, including those consisting of residential mortgages, and those consisting of commercial mortgages). The SEC rule is concerned also with securities consisting of consumer debt, such as car loans and credit card debt. The term “asset-backed security,” or ABS, is used to describe the universe of securitized debt instruments that are regulated by the SEC, including mortgage backed securities, commercial mortgage backed securities, and consumer debt.

⁸³ Joint Center for Housing Studies, *Mortgage Market Channels and Fair Lending: An Analysis of HMDA Data* (April 25, 2007).

⁸⁴ See, e.g., SEC, *Asset-Backed Securities; Final Rule*, 70 Fed. Reg. 1506; Securities and Exchange Commission, *Amendments to Rules for Nationally Recognized Statistical Rating Organizations; Proposed Rules for Nationally Recognized Statistical Rating Organizations; Final Rule and Proposed Rule*, 74 Fed. Reg. 63832 (December 12, 2009).

metropolitan area level, making it virtually impossible to identify patterns in securitization at a level of geography that might reveal patterns of discrimination, such as a census tract or zip code. The SEC's proposal about the geographic level of reporting is based in part on considerations of privacy.⁸⁵ In that regard, it is worth observing that under HMDA, lenders are required to gather and disclose information about the racial and ethnic characteristics of borrowers, and the census tract location of individual loans in a manner that protects individual privacy. Under the authority of the 2008 Reform Act, FHFA requires the same type of disclosures for loans purchased by the GSEs.⁸⁶

The extent of SEC involvement in securities transactions that affect housing means that it is an “agency having regulatory or supervisory authority over financial institutions” engaged in activities related to housing, thus requiring the SEC to act “in a manner affirmatively to further the purposes of” Title VIII. In light of the disproportionate impact of subprime lending and foreclosures on homeowners of color and racially identified neighborhoods, it is apparent that SEC must become part of any reinvigorated fair lending strategy, both through improved civil rights-related reported requirements, and through enforcement of fair housing principles regarding securitization and the secondary mortgage market. Such an outcome is especially necessary for the regulation of private label syndicators outside of FHFA oversight, and would be doubly required in the event that the GSEs are privatized entirely or terminated, with their functions left to the private market.

The Fair Housing Future of the Secondary Mortgage Market

Criticism of the combined private ownership and public purpose characteristics of the GSEs is not new, and is fueled by a history of questionable accounting practices, insufficient capital reserves to support enterprise debt obligations, and purchases of risky MBS and PLS, including securities consisting of bundled subprime mortgages. The debate about the future of the GSEs now centers on the continued creditability and viability of their role in providing liquidity and underwriting consistency in the residential mortgage lending market, and also on whether the enterprises should carry out affordable housing goals, and if so, then in what shape and form. In many respects, the debate is as much about the future of the secondary mortgage market as it is about the enterprises.

In broad terms, policymakers are at this writing considering four possible options: (1) converting the enterprises to one or more government corporations or agencies, with activities limited to affordable housing initiatives and liquidity and stability functions, such as issuance of mortgage backed securities consisting only of conforming loans; (2) restoring the enterprises to financial stability through the conservatorship, and allowing them to continue to do business as GSEs, but under more rigorous public utility-like regulation; (3) privatizing the enterprises by allowing them to do business along with other PLS issuers without the tax benefits and government guarantees available under their current charters; and (4) terminating the enterprises altogether, turning secondary market functions over to the private market.⁸⁷

⁸⁵ Securities and Exchange Commission, *Asset-Backed Securities; Proposed Rule*, 75 Fed. Reg. 23327, 23357 (May 3, 2010).

⁸⁶ See, 12 U.S.C. §2803(j)(2)(D) (HMDA data collection at the census tract level); see also, section Pub. L. 110-289, §1127, amending 12 U.S.C. §1326 (FHFA data collection). For additional discussion about how to protect the privacy of individual borrowers in loan level data gathered for HMDA and by the GSEs, see, FHFA, *Notice of Order: Revisions to Enterprise Public Use Database*, 75 Fed. Reg. 41180, 41181, note 1 (July 15, 2010).

⁸⁷ GAO, *Analysis of Options for Revising the Housing Enterprises' Long-term Structures*, page 28.

The risky business practices that led to the enterprise conservatorships are not distinguishable from many of the abuses that characterized the downfall of the market for private label securities. GSEs did use the advantages associated with their public role to enhance profit taking, including access to a Treasury Department line of credit that preceded the conservatorship, exemption from and local taxes, and a now repealed exemption from SEC registration requirements. Those advantages, however, were applied to the same kind of activities that characterized the PLS industry, including trades in subprime PLS.⁸⁸ On matters that bear on furthering fair housing- eliminating racial disparities in access to credit and attending to the civil rights impact of underwriting; standardizing loan products that not only promote liquidity but also diminish the viability of subprime loans to borrowers of color; engaging in credit activities that expand housing choices for people of color outside locations of poverty and racial concentration, and inside areas of opportunity; combating discrimination in the making of home mortgage loans; understanding and acting on the fair housing effects of the purchase and securitization of mortgages; promoting a flow of capital for affordable housing development, especially in places that enhance housing choice for low-income people of color- in all these areas, the GSEs do no better job than the private market. Thus, the key considerations for the fair housing future of the enterprises are no different than the matters that ought to inform the future of the secondary mortgage market:

1. Underwriting and Access to Single Family Credit. The consensus view is that if the enterprises have accomplished anything, they have brought a measure of consistency and predictability to the home mortgage market through standardized underwriting criteria, and as a consequence they have improved access to credit. Enterprise underwriting standards are shaped by financial safety and soundness considerations that dictate the acceptable risk features of purchased loans. Considerations of that sort were missing in the private label securities market, leading to the current economic crisis. A secondary mortgage market that is entirely privatized could easily abandon standardized underwriting, leading to less predictability, greater risk, and curtailed access to credit.

Beyond that issue is the question of whether GSE underwriting criteria contribute to loan denials for people of color. HMDA data shows continuing disparities in home mortgage loan denials for people of color. The enterprises do no better than to match that market. The advent of stricter underwriting standards both in the loans purchased by the enterprises and in the private market has sharply reduced the number of loan applications from households of color. While it is easy to reach the conclusion that an end to standardized underwriting will encourage more subprime lending targeted at borrowers of color, too little is understood about how conventional underwriting activities like automated underwriting result in redlining or disparate outcomes based on protected characteristics.

The 1992 Reform Act made it HUD's responsibility to review GSE underwriting and appraisal guidelines, but implementing regulations turn this duty on its head, and require the enterprises to provide HUD with an annual self-assessment.⁸⁹ There were press reports in 2004 indicating that a HUD-sponsored study of the fair lending impact of GSE underwriting was near completion. HUD refused to release the report because of questions about the methodology.

⁸⁸ Geithner, Timothy, *Written Testimony to the House Committee on Financial Services* (TG-603, March 23, 2010), posted at <http://www.treas.gov/press/releases/tg603.htm>. GSE exemptions from state and local taxes are codified at 12 U.S.C. §1452(e) (Freddie Mac) and 12 U.S.C. §1723a(c) (Fannie Mae). Exemption from securities registration was repealed in the 2008 Reform Act. See, Pub. L. 110-289, §1112; 122 Stat. 2677.

⁸⁹ 24 C.F.R. §81.43(a) (2010 ed.).

There are ready templates for gauging the GSE performance in this area, including the fair lending examination procedures utilized by the Federal Financial Institutions Examining Council (FFIEC) for banks under its supervision.⁹⁰ A fair housing future for both the enterprises and the secondary mortgage market must include features that lead to a better understanding of underwriting and its affect on access to credit, and adjustments in underwriting criteria to achieve equal access to credit.

2. *Improving Fair Lending Enforcement.* The unfulfilled prospect that the close relationship between lending institutions and the GSEs could be used to enhance fair lending practices is almost entirely overshadowed by the apparent failure of HUD, banking regulators, and the Department of Justice to engage in any meaningful, coordinated, visible, enforcement effort. There is no fair housing future for a secondary mortgage market that reflects any of the options under consideration without a system that directly connects examinations of underwriting practices, lending outcomes, and actual, comprehensive enforcement.

Activities in this area should include multifamily lending. FFIEC's interagency fair lending examination procedures currently examine bank records for discrimination against both home purchasers and the commercial borrowers who are likely to construct multifamily rental housing. However, to the extent that enforcement actions are undertaken, they appear to be focused solely on single family loan products. A refusal to lend to a multifamily borrower based on the protected characteristics of the likely occupants of an apartment complex is as much a violation of the Fair Housing Act as a loan denial to a single family homeowner.⁹¹ Given the common experience of opposition to multifamily housing in high opportunity areas, a revitalized fair lending enforcement effort might address systemic patterns of discrimination in the single family market, and also engage in targeted activities in the multifamily sector.

3. *Title VIII and Securitization.* Homeowners facing foreclosure sometimes directly experience the securities markets. Foreclosure deeds often state that the originating mortgage lender is the registration company that tracks ownership and servicing obligations for assets that are traded in and out of private label mortgage pools, and they often show the foreclosing entity as the company that services the mortgage for the loan pool.⁹² Under the current system for regulating asset-backed securities, there is no mechanism for examining whether the characteristics of the loan pool implicate fair housing considerations that affect homeowners. Oversight of issuers and rating agencies lacks meaningful fair housing content, and unlike the nominal provisions of GSE oversight legislation there is no apparent means of linking the fair housing enforcement system to securities regulation.

Financial services reform legislation recently enacted in Congress would improve oversight of the security issuers and rating agencies that are the subject of current regulation, and would require oversight of other key components of the system for issuing asset-backed securities, such as issuers of credit default swaps. The legislation offers no new oversight authority, and no new resources for enforcing Title VIII's non-discrimination requirements.⁹³ It rejects approaches offered in early proposals to improve interagency coordination of

⁹⁰ Federal Financial Institutions Examination Council, *Interagency Fair Lending Examination Procedures* (August 2009).

⁹¹ *U.S. v. Massachusetts Industrial Finance Agency*, 921 F. Supp. 21 (D. Mass. 1996).

⁹² Peterson, *The Role of Securitization in Residential Mortgage Finance*, page 15.

⁹³ See, Pub. L. 111-203, *Wall Street Reform and Consumer Protection Act of 2009*, §4108(c) (new consumer protection agency may coordinate with other federal agencies in the investigation of Fair Housing Act violations).

investigative and enforcement activities across a number of areas related to home mortgage finance, including fair lending.⁹⁴

Insuring fair housing in a reformulated secondary mortgage market with or without the GSEs requires meaningful reporting structures that allow oversight agencies to assess the civil rights affect of the characteristics that are the basis for bundling mortgages and other forms of credit. There will be no real impact of any such provision until HUD, the Department of Justice, FHFA, and the SEC contribute resources to a meaningful and comprehensive enforcement strategy.

4. *The Mandate to Create Open Housing Markets and GSE Affordable Housing Goals.* Enterprise housing goals focus on access to credit and housing by people, and also on investment in low- and moderate-income, and racially concentrated places. The goals have the potential to strike a balance between creating meaningful choice for people of color to live in high opportunity locations, and activities that remedy the effects of past discrimination through investments in previously disinvested areas.

Some research suggests that the GSEs accomplish their housing goals by creaming; that is, by purchasing qualifying loans in higher income places. Other sources indicate that past housing goal compliance was achieved largely through purchases of private label, subprime mortgage backed securities. Less well known is whether GSE affordable housing activities have the same integrative effect observed in connection with CRA single family lending, or whether enterprise underwriting criteria deprive homebuyers of color of both credit and housing opportunities. The same questions apply to affordable housing activities in the multifamily context. The redefined concept of “underserved” markets, with its emphasis on the preservation of the kinds of assisted housing that are too often a tool for establishing patterns of segregation, is empty of the kind of civil rights imperatives that derive from the duty to further fair housing: understanding the civil rights impact of funding activities, and taking steps so that over time, segregation is dismantled.

In considering the structures for a reorganized financial system for housing finance, policy makers must consider the role of the system in facilitating homeownership and affordable rental housing for low-, very low-, and extremely low-income people.⁹⁵ The duty to further fair housing imposes the additional responsibility to shape policies and initiatives so that over time, affordable housing activity opens up markets for people of color, dismantles residential segregation, and allow for true housing choice. These responsibilities will adhere whether they are carried out by FHFA, or some other regulatory successor in any of the strategies under discussion for reformulating the secondary mortgage market, either in an entirely privatized form without the GSEs, or in some approach that includes restructured enterprises.

5. *Fair Housing and the Use of the Enterprises to Stabilize Housing Markets.* The use of the GSEs by the Treasury Department to stabilize the single family and affordable multifamily housing markets implicates other civil rights issues. At the threshold, all the issues about site selection and housing opportunity in affordable housing are present in discussions about the affordable housing goals and the effect of GSE participations in LIHTC and tax-exempt bond rental projects.

⁹⁴ Restoring American Financial Stability Act of 2010 (Senate Banking Committee, Chairman’s Mark); http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf, last accessed March 27, 2010.

⁹⁵ Geithner, *Written Testimony to the House Committee on Financial Services*.

More immediate issues include disposition of foreclosed properties financed with mortgages held by the enterprises. The Neighborhood Stabilization Program (NSP) is a HUD program designed to stabilize areas affected by foreclosures and abandonment.⁹⁶ Anecdotal reports indicate that the GSEs often fail to cooperate in neighborhood-based stabilization strategies devised by NSP grantees. Additional reports center on enterprise refusal to provide certifications to NSP buyers about GSE compliance with NSP environmental criteria, and new federal requirements that limit the ability of foreclosing financial institutions to evict tenant occupants of foreclosed housing. These failures can have the effect of accelerating the deterioration of already disinvested locations, places that are predominantly racially identified neighborhoods.

Foreclosures are not limited to high poverty, racially identified locations. A great deal of foreclosed property is in higher income areas with access to good schools and jobs. To the extent the enterprises are the foreclosing institutions for properties in these places, the disposition of the properties through NSP and similar programs creates opportunities to expand housing choice for families of color. Although HUD NSP guidance encourages non-profit grantees to acquire housing in opportunity locations, there are few incentives in the program to carry out that objective.⁹⁷

6. *Multifamily Foreclosures on the Horizon.* While a great deal of attention is focused on single family homeowners, foreclosures also affect renters.⁹⁸ Racial disparities in homeownership mean that disproportionate numbers of people of color are renters who are the most likely to be affected by multifamily foreclosures. Evidence of distress in the multifamily market is growing, with significant increases in delinquencies related to decreasing rents and the inability to secure financing to pay for short term commercial debt.⁹⁹ The enterprises hold almost 40% of outstanding multifamily debt, and problems with loan defaults are expected to increase from 2010 through 2013 as over \$600 billion in commercial loans mature.¹⁰⁰ Distress in multifamily markets may also affect enterprise housing goals. Both GSEs invest in commercial mortgage-backed securities (CMBS), which face the same exposure to collapse in value already visited on residential mortgage-backed securities. Freddie Mac's past special affordable housing goal performance was accomplished primarily through CMBS purchases.¹⁰¹ As consequence, the same stress factors in the single family market that resulted in GSE conservatorship are likely to continue through problems in the multifamily market. These conditions further cloud the future of the enterprises.

Multifamily foreclosures may have a special impact on owners and investors of color. The small multifamily properties that are so predominated by African American ownership are also at the highest risk of default because of higher credit costs. In the past, some of the

⁹⁶ NSP is authorized by other sections of the same legislation that created FHFA and reformulated the housing goals. See, Pub. L. 110-289, §2301, *et seq.*; 122 Stat. 2850.

⁹⁷ U.S. Department of Housing and Urban Development, *Notice of Fund Availability (NOFA) for the Neighborhood Stabilization Program 2 under the American Recovery and Reinvestment Act, 2009*, Appendix I, par. S.1 (May 4, 2009).

⁹⁸ Wardrip, Keith E. and Pelletiere, Danilo, *Properties, Units, and Tenure in the Foreclosure Crisis: An Initial Analysis of Properties at the End of the Foreclosure Process* (National Low-income Housing Coalition, Research Note #08-01 (May 6, 2008, revised May 8, 2008)

⁹⁹ U.S. Department of Housing and Urban Development, *U.S. Housing Market Conditions* (November 2009).

¹⁰⁰ Congressional Oversight Panel, *February Oversight Report: Commercial Real Estate Losses and the Threat to Financial Stability* (February 10, 2010).

¹⁰¹ FHFA, *2010–2011 Enterprise Affordable Housing Goals; Final Rule*, page 64.

enterprises' alternative loan products were aimed at meeting the needs of the small multifamily market. These products were largely abandoned and it is unlikely that they will be made available as multifamily credit risks are magnified in the next several years.

Conclusion

The policy discussions now beginning about the future of Fannie Mae and Freddie Mac implicate wider questions about the furtherance of fair housing within the context of the system for financing residential mortgages. Oversight legislation presumes that the GSEs will serve as foot soldiers in a wider fair lending enforcement effort, yet there is a lagging commitment to fair lending enforcement among the federal agencies responsible for carrying it out. Mandates for housing goals call on the enterprises to lead the market in facilitating access to credit for the most vulnerable borrowers, yet the GSEs merely match continuing racial disparities in the private market. In an environment where subprime lending was targeted at homeowners and communities of color and was fueled by the securities industry, there remains little evidence of an acknowledgment of the fair housing, fair credit dimensions of asset-backed securitization among policy makers in Congress, or the federal regulators with overlapping oversight responsibilities. Responding to these conditions requires attention not only in the reformulation of the GSEs, in whatever form, but also in the wider financial markets. It is this challenge that remains to be taken up.

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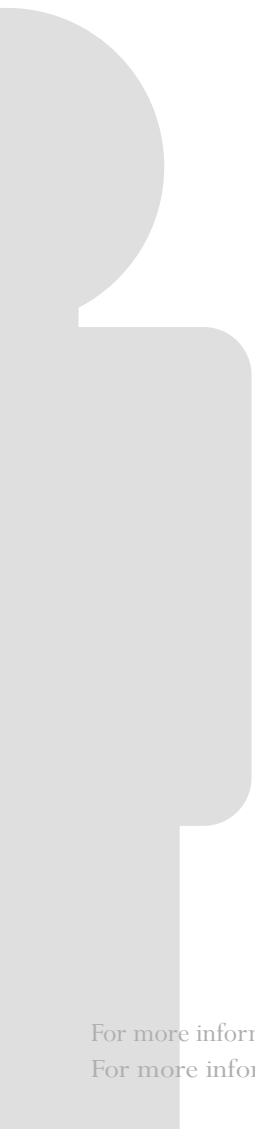
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