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

Edward J. Pinto

DISCUSSION DRAFT DATED 11/4/2010

Abstract: The major cause of the financial crisis in the U.S. was the collapse of housing and mortgage markets resulting from an accumulation of an unprecedented number of weak and risky Non-Traditional Mortgages (NTMs). These NTMs began to default en mass beginning in 2006, triggering the collapse of the worldwide market for mortgage backed securities (MBS) and in turn triggering the instability and insolvency of financial institutions that we call the financial crisis. Government policies forced a systematic industry-wide loosening of underwriting standards in an effort to promote affordable housing. This paper documents how policies over a period of decades were responsible for causing a material increase in homeowner leverage through the use of low or no down payments, increased debt ratios, no loan amortization, low credit scores and other weakened underwriting standards associated with NTMs. These policies were legislated by Congress, promoted by HUD and other regulators responsible for their enforcement, and broadly adopted by Fannie Mae and Freddie Mac (the GSEs) and the much of the rest mortgage finance industry by the early 2000s. Federal policies also promoted the growth of over-leveraged loan funding institutions, led by the GSEs, along with highly leveraged private mortgage backed securities and structured finance transactions. HUD's policy of continually and disproportionately increasing the GSEs' goals for low- and very-low income borrowers led to further loosening of lending standards causing most industry participants to reach further down the demand curve and originate even more NTMs. As prices rose at a faster pace, an affordability gap developed, leading to further increases in leverage and home prices. Once the price boom slowed, loan defaults on NTMs quickly increased leading to a freeze-up of the private MBS market. A broad collapse of home prices followed.

I wish to thank all those who reviewed various drafts and provided so many excellent comments. Opinions and any errors contained herein are mine.

Preface:

Events of the late 1980s and early 1990s[1] joined three disparate groups in a common cause: low- and moderate-income housing:

1. Fannie Mae decided in 1986 to give up its government charter and become a private company.[2] This decision was quickly reversed in 1987 when it was decided that its funding advantages and implicit government guarantee under its charter were too valuable to surrender. Instead it would turn its focus to protecting its charter franchise privileges. Over the next 5 years Fannie would develop and begin implementing a strategy to use its low- and moderate-income housing mission as the means to "protect the franchise". Fannie would use copious amounts of low- and moderate-income housing lending to capture its regulator, Congress,[3] in an effort to assure that Congress would not change its charter privileges to its detriment. Lehman Brothers' consultant Jim Johnson was hired in 1988 to more fully develop this strategy. By 1991 Johnson was Fannie's chairman and CEO. In 1991 Johnson announced Fannie's opening bid, a commitment[4] to acquire $10 billion in affordable housing loans under a program called "Opening Doors".[5] Johnson's strategy was successful in that Fannie was able to prevent any charter changes from being enacted after 1992 (the year "The Federal Housing Enterprises Financial Safety and Soundness Act of 1992" (the "GSE Act of 1992" or "GSE Act) passed with Fannie's support) until 2008; three months before Fannie and Freddie were placed in conservatorship.[6]

2. National People's Action (NPA) and ACORN, along with other community and consumer advocacy groups concluded that Fannie and Freddie's underwriting requirements were to blame for the failure of the Community Reinvestment Act of 1977 (CRA) to gain traction. In about 1986, NPA began to meet separately with Fannie and Freddie in an effort to get them to adopt more flexible underwriting standards in an effort to expand CRA lending. While agreeing to a number of pilot programs, Fannie and

[1] From 1985-1987 the author was Fannie's Senior Vice President for Marketing and Product Management, with responsibility for single- and multi-family lending and affordable housing and from 1987-1989 was Executive Vice President and Chief Credit Officer.
[2] This decision was not made public
[3] Congress had issued Fannie's charter and was the only entity that could change it.
[4] A commitment is a pledge to acquire (in Fannie's case or originate in the case of a lender) a quantity of loans usually over an announced time period. Virtually all the commitments mentioned in this paper were fulfilled,
[5] "Fannie Mae's Johnson Says Corporation Ready to Meet Housing Goals in Legislation", PR Newswire, March 31, 1993, http://www.thefreelibrary.com/FANNIE+MAE%27S+JOHNSON+SAYS+CORPORATION+READY+TO+MEET+HOUSING+GOALS+IN...-a013133485
[6] Fannie's (and Freddie's) charter was established by congressional act. As such, only Congress could amend it. The GSE Act of 1992 was a wholesale revision of Fannie's (and Freddie's) charter; however Fannie supported the changes, including the addition of the affordable housing goals. Freddie had only emerged from being a subsidiary of the Federal Home Loan Bank Board in 1989 and more or less acquiesced with Fannie's position.

Freddie were initially dubious about many of the requested flexibilities. By the early 1990s NPA, ACORN and other groups were dissatisfied with the perceived pace of change and were concerned that Fannie, Freddie, and lenders "still viewed them as 'special programs' and have not incorporated them into standard underwriting practices."[7] Having gotten CRA passed in 1977, NPA, ACORN, and other community groups appealed to Congress in 1991 to force change at the GSEs.

3. Congress had long used HUD and its loan guarantee arm, FHA (created in 1934), as its main tools to provide low- and moderate-income housing. However, in 1990 two budgetary changes made it more difficult for Congress to expand low- and moderate-income housing through HUD and FHA. First, HUD and FHA were agencies of the federal government and included in the discretionary portion of the budget. In 1990 Congress had reached a limit in what it could do on budget:

> "In 1990, as part of a new, multiyear budget agreement, the Congress and the President adopted new procedures for deficit control. Those procedures, embodied in the Budget Enforcement Act of 1990, established statutory limits on discretionary spending and a deficit-neutral pay-as-you-go (PAYGO) requirement for new mandatory spending and tax legislation."[8]

A second change came about with the passage of the Federal Credit Reform Act of 1990. To the extent FHA's expected premiums were insufficient to cover expected losses, these amounts would need to be incorporated as a budget item. Third, at the same time, the Omnibus Budget Reconciliation Act of 1990 required FHA to establish a reserve fund and set its premiums so as to ensure actuarial soundness.[9]

As a result of these provisions, Congress had to find another means if it wanted to significantly expand financing for low- and moderate-income housing. Fannie and Freddie filled the bill perfectly. Both were off budget, could raise virtually unlimited sums in the capital markets, and could use their substantial volumes of traditional low risk lending to subsidize low- and moderate-income housing. As an added bonus, Congress was also able to meet the demands of an important constituency group - community advocacy organizations.

In 1992 the interests of Fannie, community groups, and Congress converged resulting in the passage of GSE Act. Fannie got its wish as the GSE Act formalized its strategy of using affordable housing to protect its key charter privileges – protection that would last until 2008,

---

[7] "Not in My Back Yard: Removing Barriers to Affordable Housing", Chapter 3, page 13 http://www.huduser.org/Publications/pdf/NotInMyBackyard.pdf

[8] Congressional Budget Office testimony on Budgeting for Emergency Spending, June 23, 1998 http://www.cbo.gov/doc.cfm?index=591&type=0

[9] GAO, "Credit Reform", September 1994, http://www.legistorm.com/ls_score/gao/pdf/1994/9/ful24685.pdf

two months before it and Freddie would be forced into conservatorship. The community groups got their wish now that Fannie and Freddie were required to loosen underwriting standards in support of CRA. Congress got its wish by moving the affordable housing mission largely off-budget and at the same time, placing itself in a position to take credit for the affordable housing activities of Fannie and Freddie.

Fannie's 1991 opening bid of $10 billion was called and raised by Congress' in the GSE Act of 1992. In 1994 Fannie raised its bid with a $1 trillion commitment. Over the next dozen years, additional commitments totaling $6 trillion by Fannie and Freddie, $1 trillion by Countrywide, and $4-plus trillion by big banks would follow.[10]

I have called this a forensic study because my goal was to investigate and document the motives, opportunities, and means by which the main participants (Congress, joined by the executive branch, Fannie and Freddie, and community groups) accomplished the desired loosening of loan underwriting standards. These actions would ultimately derail the world's largest economy and cost the American people untold trillions of dollars.

[10] There is some overlap among these $11 trillion in commitments. Without overlap the commitments are estimated to have totaled about $8 trillion.

I. Background:

> "'Lenders will respond to the most conservative standards unless [Fannie Mae and Freddie Mac] are aggressive and convincing in their efforts to expand historically narrow underwriting.' This point was reinforced over and over again by other [community advocacy] witnesses." U.S. Senate Committee on Banking, Housing, and Urban Affairs in 1991[11]

The very next year Congress turned this wish of these witnesses into the law of the land when it passed "The Federal Housing Enterprises Financial Safety and Soundness Act of 1992" (the "GSE Act of 1992" or "GSE Act").[12]

The major cause of the financial crisis was the accumulation of an unprecedented number of weak or Non-Traditional Mortgages (NTM) in the U.S. financial system. NTMs were characterized by low or no downpayments, increased debt ratios, impaired credit, reduced loan amortization, and other changes in underwriting standards. These NTMs were no accident. During the 15 year period after the passage of the GSE Act of 1992, trillions of dollars in ever more weakly underwritten loans would first buoy and then capsize the housing market.

This accumulation of NTMs overwhelmed a thinly capitalized and highly leveraged housing finance sector, whose high level of leverage was also the result of government policies. For example, Fannie and Freddie's minimal capital requirements were set by Congress in the GSE Act of 1992. The GSEs only needed $900 in capital behind a $200,000 mortgage they guaranteed[13] – many of which by 2004-2007 had no borrower downpayment. In order for private sector to compete with Fannie and Freddie, it needed to find ways to increase leverage.

Lack of skin in the game promoted systemic risk on both Main Street and Wall Street.

When these NTMs began to default, they triggered the collapse of the worldwide market for mortgage backed securities (MBS), which in turn triggered the instability and insolvency of financial institutions that we call the financial crisis.

Nouriel Roubini and Elisa Parisi-Capone documented a progression of loss estimates:

> "[b]y April 2008 the IMF estimated them to be $945 billion; then Goldman Sachs came with an estimate of $1.1 trillion; the hedge fund manager John Paulson estimated them at $1.3 trillion; then in the fall of 2008 the IMF increased its estimate to $1.4 trillion; Bridgewater Associates came with an estimate of $1.6 trillion; and most recently, in

[11] Allen Fishbein, "Filling the Half-empty Glass: The Role of Community Advocacy in Redefining the Public Responsibilities of Government-Sponsored Housing Enterprises", Chapter 7 of Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions, 2003, Gregory Squires, editor

[12] "The Federal Housing Enterprises Financial Safety and Soundness Act of 1992" http://www.law.cornell.edu/uscode/html/uscode12/usc_sup_01_12_10_46.html

[13] GSE minimum capital levels, "The Federal Housing Enterprises Financial Safety and Soundness Act of 1992" http://www.law.cornell.edu/uscode/html/uscode12/usc_sec_12_00004612----000-.html

> December 2008, Goldman Sachs cites some estimates close to $2 trillion (and argues that loan losses alone may be as high as $1.6 trillion and expects a further $1.1 trillion of loan losses ahead)."[14]

By January 2009 Roubini and Capone advised that:

> "We have now revised our estimates and we now expect that total loan losses for loans originated by U.S. financial institutions [alone] will peak at up to $1.6 trillion out of $12.37 trillion loans…. If we include then around $2 trillion mark-to-market losses of securitized assets based on market prices as of December 2008 (out of $10.84 trillion in securities), total losses on the loans and securities originated by the U.S. financial system amount to a figure close to $3.6 trillion."[15]

The impact on the capital positions of U.S. banks and broker dealers (not to mention Fannie and Freddie) was dire:

> "U.S. banks and broker dealers are estimated to incur about half of these losses, or $1.8 trillion ($1 -1.1 trillion loan losses and $600-700bn in securities writedowns) as 40% of securitizations are assumed to be held abroad. The $1.8 trillion figure compares to banks and broker dealers capital of $1.4 trillion as of Q3 of 2008, leaving the banking system borderline insolvent even if writedowns on securitizations are excluded."[16]

In this context, the causes were those policies and actions that led to the accumulation of so many NTMs in our financial system. It also demonstrates how federal policies, undertaken by Republican and Democratic administrations and Congresses alike, were directly responsible for mandating a vast increase in homeowner leverage (ex. low or no downpayments, increased debt ratios, impaired credit, reduced loan amortization, and other changes in underwriting standards), setting extremely high leverage levels for Fannie and Freddie, and requiring flexible (i.e. loose) underwriting standards throughout virtually the entire mortgage finance industry.

As house prices continued their unprecedented climb and delinquency rates stayed in relative check, both Presidents Clinton and George W. Bush relied on weakened underwriting standards to expand homeownership. Federal policy makers and market participants ignored the potential impact of increased leverage resulting from these standards on the housing market and on a mortgage finance system that itself was over leveraged. The focus of this paper is to describe and understand the cause and effect of federal policies on the collapse of the mortgage finance system.

---

[14] Nouriel Roubini and Elisa Parisi-Capone, RGE Monitor, "Total $3.6 Trillion Projected Loan and Securities Losses in the U.S.,$1.8 Trillion of Which Borne by U.S. Banks/Brokers: Specter of Technical Insolvency for the Banking System Calls for Comprehensive Solution", January 2009, http://media.rgemonitor.com/papers/0/RGECreditLossesEPCNRJan09.pdf

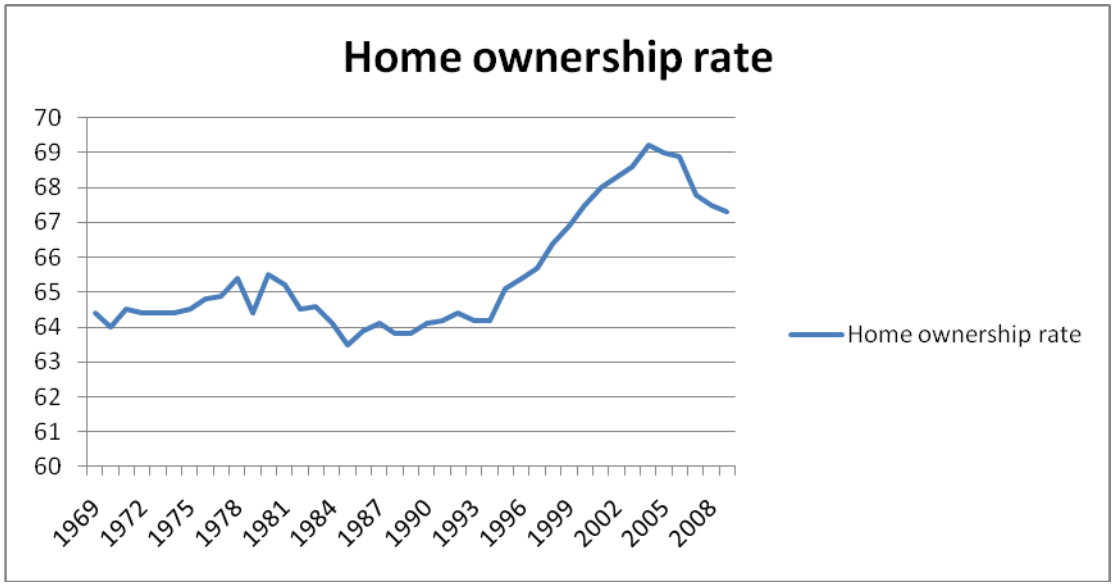
[15] Id.

[16] Id.

A. Twelve significant and unprecedented trends:

1. **Homeownership rate:** after staying within a narrow band of 64% to 65.5% over 1969 - 1994, it increased substantially (from 64.2% to 69.2%) over the period **1994**-2004.

Chart 1:



Source: U.S. Census Bureau and compiled by Edward Pinto

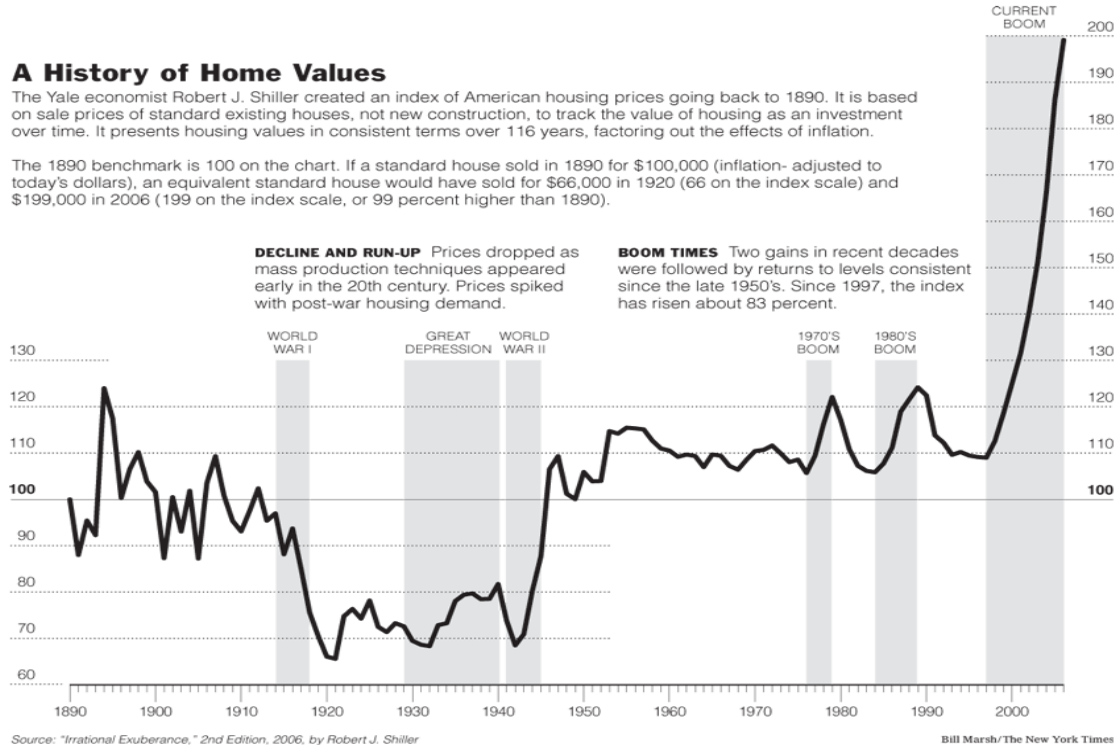
Other Group of 7 (G-7) countries have similar home ownership rates without much of the pro-housing and housing finance stimulus provided in the U.S.:[17]

G-7 country	2009 homeownership rate
Italy	81.7%
United Kingdom	73.4%
Canada	68.7%
United States	67.3%
France	65.5%
Japan	61.2%
Germany	55.6%

[17] "Homeownership Rate Declines", Wall Street Journal, February 3, 2010, p. A2

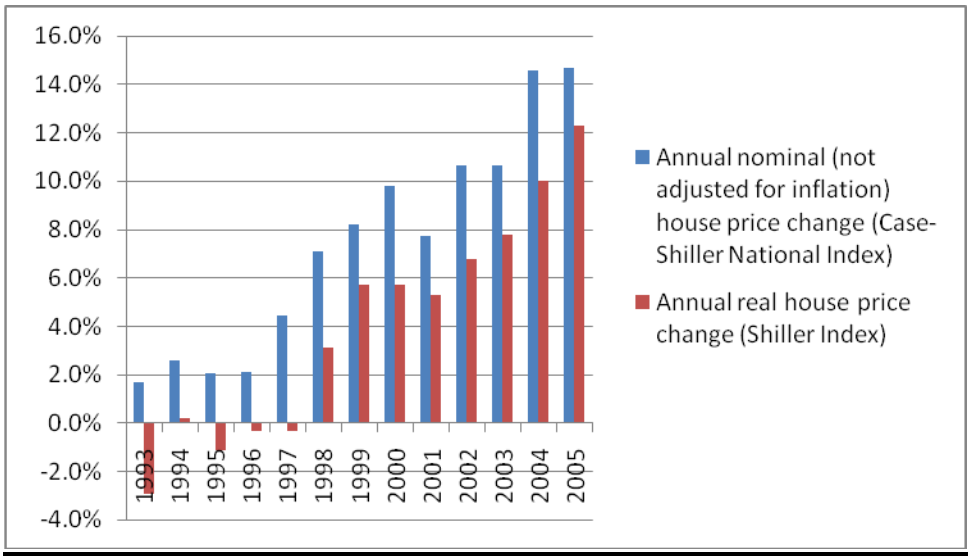
2. **Real home prices:** an unprecedented and ultimately unsustainable boom in real home prices started in **1998** and lasted 9 years, about twice as long as the booms in the late-1970s and late-1980s and 4-5 times as large in terms of cumulative percentage increase relative to each of the two earlier booms:

Chart 2: The following chart covers the period 1890-2006:



3. **Nominal home prices:** an unprecedented (in length and size) boom in nominal home prices started in **1993** and lasted 12 years, with a cumulative increase in prices of 150%.

Chart 3: Shows U.S. annual nominal and real house price increases



Source: Real house price increases - Robert Shiller, http://www.econ.yale.edu/~shiller/data.htm Compiled by Edward Pinto

Many countries experienced similar or even higher house price inflation over roughly the same period as in the United States.[18] The United States is in the middle of the selected OECD countries shown in Chart 4.

Chart 4:[19]

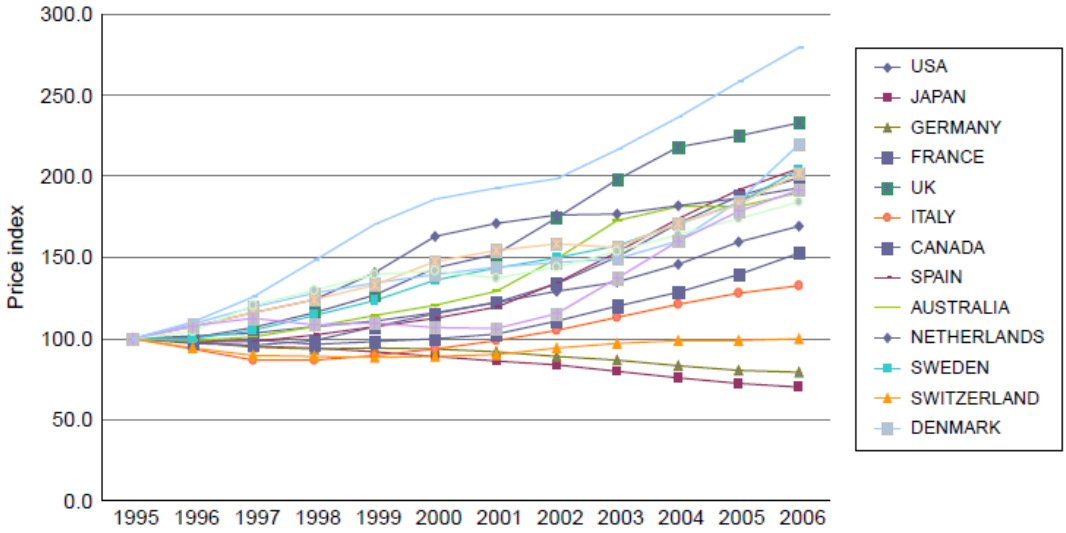


Figure 1. Real house price increases in selected OECD countries: 1995–2006

Chart 4 displays significant synchronization of house prices in industrial countries. This has been attributed to:

> "…synchronization of monetary policy and financial liberalization, integration of international financial markets as well as general business cycle linkages. In fact most industrial countries implemented financial deregulation and this led to an increased access to mortgage financing to a larger share of the population. Tsatsaronis & Zhu found that house price increases have been more marked in countries with more market-sensitive valuation methods."[20] [21]

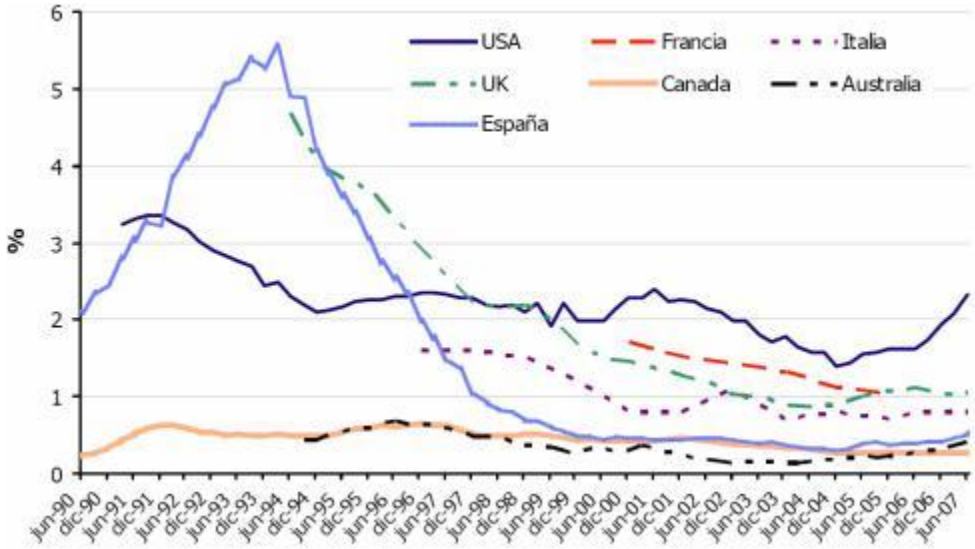
Notwithstanding the increased coincidence of real house price increases internationally, the reaction of various markets to the stress of price declines has varied substantially. In

[18] Kim,Kyung-Hwan and Renaud, Bertrand, "The Global House Price Boom and Its Unwinding", p. 8, 2009 http://www.informaworld.com/smpp/content~content=a908065595~db=all~order=page
[19] Id.
[20] Id.
[21] The United States' valuation methodology relies solely on the sales prices of comparable properties and as such is a "market-sensitive valuation method". Less market sensitive valuation methods use multiple valuation principles along with stabilized or trended sales prices. See Appendix D: The role of appraisals in the financial crisis.

particular, the U.S. is the only major country expected to experience default levels of 15% - 20% of outstanding loans (8-10 million foreclosures and other property dispositions).[22] [23] As noted earlier, the dollar cost of the losses on these loans could total $1.6 trillion.

Chart 5 shows delinquency trends over 17-plus years, 1990-2007, for 7 major countries. From the late 1990s onward the U.S. has had a seriously delinquent rate substantially higher than the other 6 countries listed. Note that the chart ends in 2007 and that serious delinquency rates in the U.S. was increasing rapidly. The serious delinquency rate for the U.S. at 12.31.09 was 9.67%.[24] This rate far eclipses the rate of 3.25% reached in the U.S. in the early 1990s, in the aftermath of the late 1980s boom.

Chart 5:[25]



The differences in loan performance in Canada compared to the U.S were attributed to the following:

---

[22] RealtyTrac's Housing Predictor, "10 Million Foreclosures Through 2012", Late 2009, http://www.realtytrac.com/contentmanagement/realtytraclibrary.aspx?channelid=8&itemid=6675

[23] Canada: data from the Canadian Bankers Association shows that the delinquency rate in Canada is much lower than the U.S. rate. 0.29% Canadian delinquency rate at 10.08 versus 7.88% in U.S. at 12.31.08. http://seekingalpha.com/article/127234-mortgage-delinquencies-in-canada-nowhere-near-as-low-as-u-s United Kingdom: Council of Mortgage Lenders: Repossessions as a proportion of all mortgages remained steady at 0.09% in the first quarter [2010], the same proportion as in the previous quarter and down from 0.12% in the first quarter of 2009. The number of repossessions was 9,800, down from 10,600 in the previous quarter and 13,200 in the first quarter of 2009. http://www.cml.org.uk/cml/media/press/2612 The U.S. had 237,052 repossessions in Q.3:09. http://money.cnn.com/2009/10/15 /real_estate/foreclosure_crisis_deepens/?postversion=2009101507 This represents 0.43% of the 55 million mortgages outstanding in the U.S.

[24] Source: Mortgage Bankers Association National Delinquency Survey

[25] http://www.eleconomista.es/economia/noticias/367237/02/08/La-morosidad-sigue-creciendo-los-bancos-cortan-el-grifo-a-las-familias.html

> "Housing markets in the United States and Canada are similar in many respects, but each has fared quite differently since the onset of the financial crisis. A comparison of the two markets suggests that relaxed lending standards likely played a critical role in the U.S. housing bust."[26]

The varied experiences in sixteen western European countries are detailed in "House Price Comparisons in Europe", an IMF Working Paper.[27] Relevant to this paper's discussion about the causes of the financial crisis in the U.S are the following observations:

> "The degree of sophistication of a country's mortgage market will affect the demand for housing. The greater the range of flexibility of the financial instruments offered, the more affordable housing can become for a given level of income. Ceteris paribus, this will increase demand for housing. The ability of financial institutions to offer more flexibility in housing finance is determined, inter alia, by collateral legislation and the extent to which mortgage loans can be securitized in order to pool and diversify risk from individual borrowers."

> "Mortgage markets in the [countries with the greatest price increases] appear to be most 'complete' in terms of range of products offered….In most continental European markets mortgage equity withdrawal is less common, and bank lending practices (e.g. relatively low LTV ratios and the use of historical rather than current property valuation) are more conservative….Overall, the less complete and therefore more conservative nature of many European mortgage markets, including the relatively strong reliance on retail (deposit) funding and the virtual absence of a market for subprime loans—apart from a relatively modest share of this market in the U.K.—has so far protected these markets from some of the problems that have occurred, e.g. in the U.S.."

Hilbers et.al. describe the differences present in the sixteen countries studied. While there are similarities, the differences are quite substantial, not unexpected given that each country has a national system of housing finance. While the population of these sixteen is about 400 million,[28] these countries do not, as a group, constitute a standardized mortgage finance system.

---

[26] James MacGee, "Why Didn't Canada's Housing Market Go Bust?" http://www.clevelandfed.org/research/commentary/2009/0909.cfm

[27] Hilbers, Hoffmeister, Banerji, and Shi, IMF Working Paper, "House Price Developments in Europe: A Comparison", October 2008, p. 34, http://www.imf.org/external/pubs/ft/wp/2008/wp08211.pdf

[28] http://en.wikipedia.org/wiki/List_of_European_countries_by_population

Contrast this with the United States with a population of 300 million.[29] Rather than a diversified system of housing finance, the U.S. had evolved into one that was largely unified and standardized around Fannie, Freddie, and HUD. The GSEs were the largest mortgage investors/guarantors, exerted great influence in setting mortgage underwriting standards, provided the automated underwriting systems used by almost all market participants, developed market-sensitive appraisal and valuation methodologies that became uniform throughout the industry, had an implicit government guarantee, were highly leveraged, offered continuous access to liquidity across all 50 states, relied on the originate to distribute model, promoted securitization, competed with virtually all other market participants (except jumbo and second mortgage products), and set interest margins on the most popular mortgage types, the 30 and 15 year mortgage. Add the central regulatory role played by HUD in orchestrating a multi-faceted weakening of underwriting standards over many years. **It does not appear that any other country had ceded the role of underwriting standard setter to a non-prudential regulator.**[30]

Compared to the United States, Western Europe's housing finance systems were neither uniform nor standardized. The absence of the equivalent of a Fannie, Freddie, or HUD throughout Western Europe goes a long way towards explaining how it avoided the worst effects of the housing decline while the U.S. did not. It is relevant that the U.S. ended up with almost half of all outstanding loans being NTMs, loans with weak loan characteristics.

In addition to the United States housing finance system's reliance not only on a) excessive leverage by both borrowers and loan funding institutions (led by Fannie Mae and Freddie Mac), b) a highly developed and increasingly more highly leveraged mortgage backed securities and structured finance transactions market, and c) implicit and explicit government guarantees, excessive leverage and a greater reliance on debt was promoted by income tax policy, the ease with which home equity could be withdrawn, and d) an ability to refinance virtually without penalty.

4. **Community Investment Act (CRA) announced commitments:** Over the 16 year period **1992**-2007, announced CRA commitments totaled $4.5 trillion. The $4.5 trillion total for the period 1992-2007 represents a 511 times increase in CRA commitment volume over the $8.8 billion total for 1977-1991. **See Chart 6 below.**

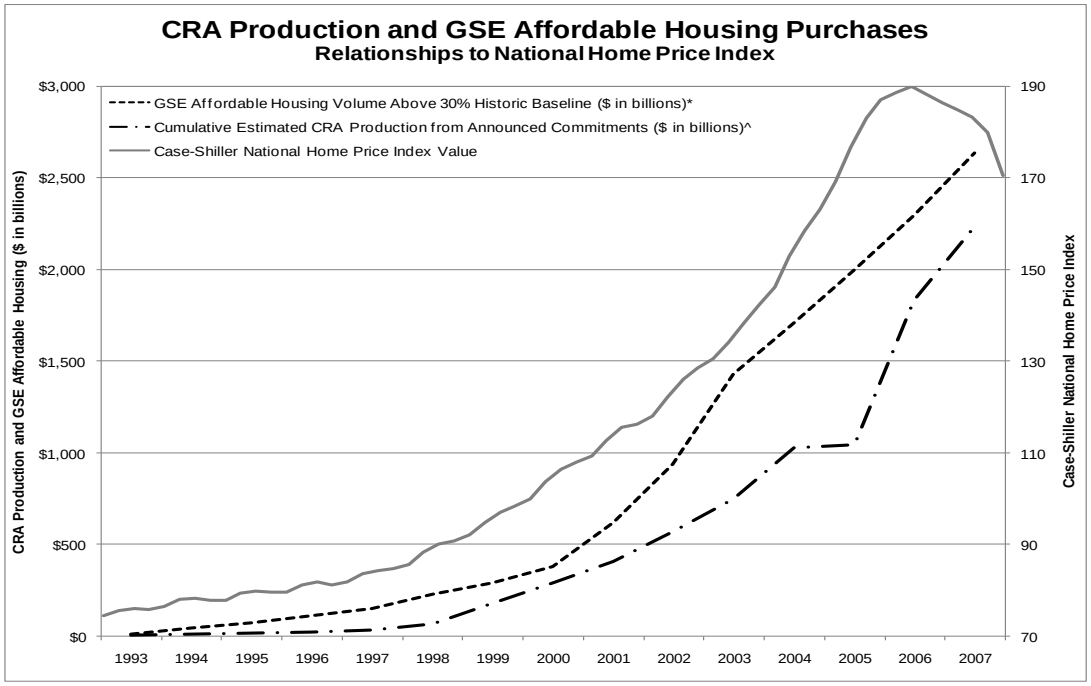
---

[29] http://www.google.com/search?q=population+of+united+states+2007&ie=utf-8&oe=utf-8&aq=t&rls=org.mozilla:en-US:official&client=firefox-a

[30] "Prudential regulation is meant to protect the banking system from [banking crises]. Traditionally, it consisted of a mixture of monitoring individual transactions (ensuring, for instance, that adequate collateral was put up), regulations concerning self-dealing, capital requirements, and entry restrictions." Thomas F. Hellmann, Kevin C. Murdock and Joseph E. Stiglitz, "Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?, forthcoming American Economic Review, p. 2, http://strategy.sauder.ubc.ca/hellmann/pdfs/aerpaper.pdf

5. **Fannie and Freddie (GSEs) affordable housing acquisitions mandated by the GSE Act:** From **1993** to 2008 the GSEs acquired $2.78 trillion more in low- and moderate-income loans than they would have acquired under their pre-1992 baseline where 30% of their acquisitions consisted of low- and moderate-income loans.[31] Pre-1992 the GSEs' low- and moderate-income loan acquisitions were underwritten to the GSEs' traditional standards. Under the pre-1992 baseline of 30%, the GSEs would have purchased only $3.5 trillion in low- and m oderate-income loans, not the $6.3 trillion they ultimately acquired over 1993-2008.

Chart 6:



Sources: HUD, FHFA, Case-Shiller Index, and compiled by Edward Pinto

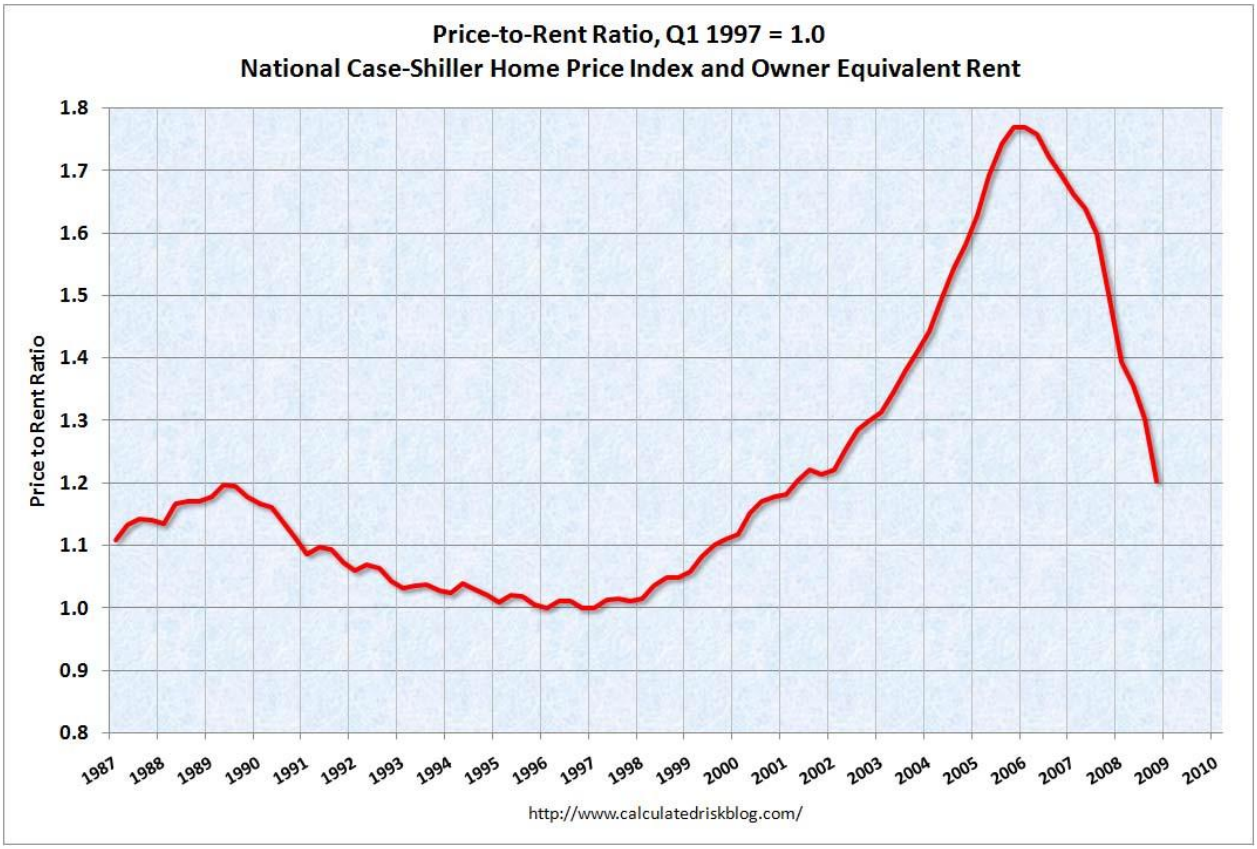
[31] While the GSEs (particularly Fannie) had single-family affordable housing programs prior to 1993, they were small. For example, Freddie's acquisitions of low- and moderate-income loans in 1993 (this is before Freddie started any significant targeted efforts in the single-family affordable housing area) amounted to about 30% as this is its level of attainment for that year as reported by HUD (see **1997-A**). This level of attainment was reached in the normal course of business.

Private mortgage insurance on loans with an LTV above 80% was one of the primary means of serving the low- and moderate-income market. While mortgage insurance brought the severity of loss on a default down to the level experienced on an 80% LTV loan, the incidence on high LTV loans was 2-4 times higher than on an 80% LTV loan. Since the GSEs in the early 1990s did not price for risk at a loan level, the higher incidence on 90% and 95% LTV loans was an implicit subsidy provided by the GSEs on these loans.

Over the period 1988 – 1990 about 50% of Fannie's home purchase loans to first time homebuyers had an LTV or combined LTV >80% (from a random sample review of Fannie Mae's single-family acquisitions for the period October 1988-January 1992, dated 3.10.1992. Document contained in the author's files).

6. **Price-to-rent ratio:**[32] The high shown for mid-1989 occurred just as a major housing price correction was beginning in the northeast and California. The high reached in mid-1989 was largely driven by extensive low doc/no doc lending along with negatively amortizing ARMs. Starting in **1998** the price-to-rent ratio begins to rise rapidly reaching an all-time high in late 2005/early 2006.[33]

Chart 7:

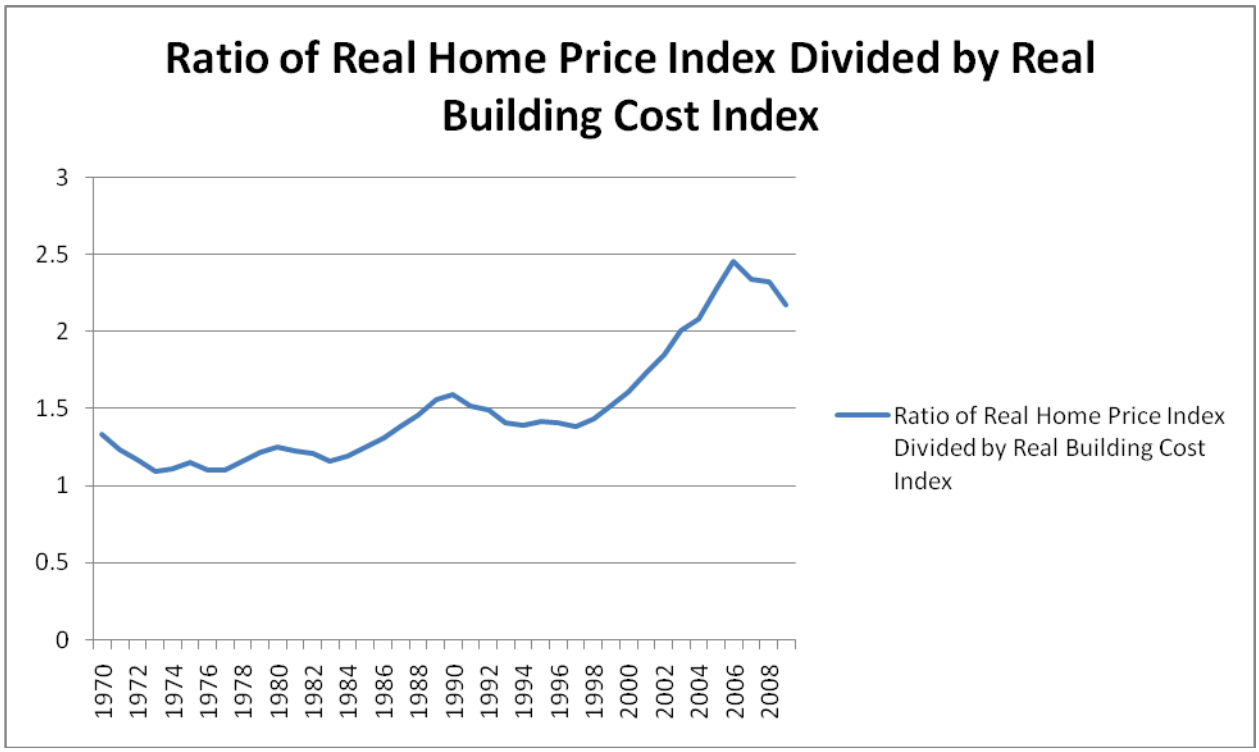


[32] The ratio between the price of a house and the annual rent the house commands as a rental property. A house selling for $200,000 and renting for $1000/month or $12,000 annually has a price-to-rent ratio of 16.67:1; The chart above sets the ratio at 1 in Q.1:1997 in order to show the prior and subsequent growth better.
[33] http://www.calculatedriskblog.com/2009/02/house-prices-real-prices-price-to-rent.html

7. Ratio of Real Home Price Index Divided by Real Building Cost Index

Total home market value to total replacement cost ratio: from 1970-1998 this ratio generally stayed within a band of 1.0-1.5. In **1999** to 2006 it increased from 1.51 to 2.45. By 2009 it was down to 2.17.[34] Smaller run ups in this ratio occurred during the 1970's and 1980's real estate booms (see **Chart 2** above).

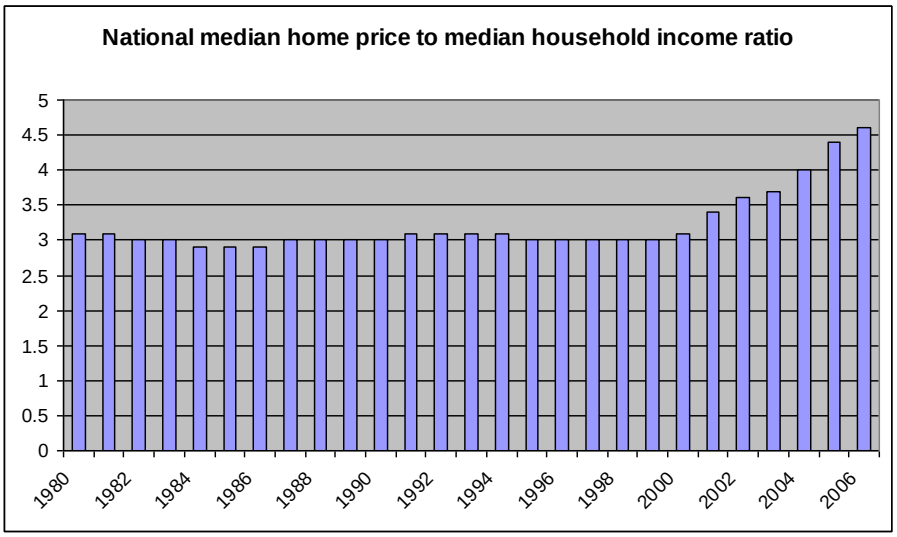
Chart 8:[35]



[34] Robert Shiller, http://www.econ.yale.edu/~shiller/data.htm
[35] Id. Compiled by Edward Pinto

8. **National median home price to median income ratio:** from 1988 to 2000, it remained in a range of 2.9 to 3.1. In **2001** it increased to 3.4, eventually increasing to 4.6 in 2006.[36]

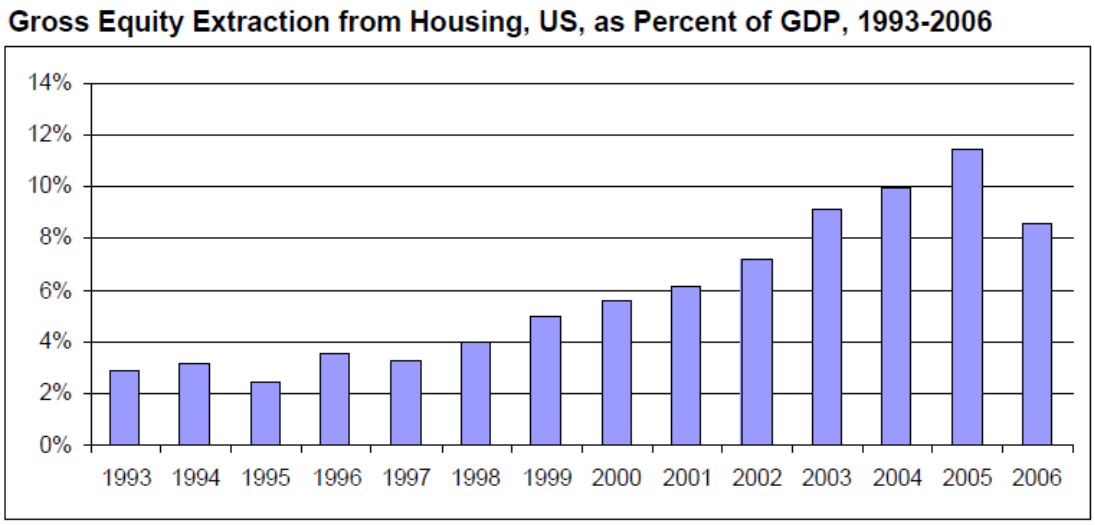
Chart 9:



9. **Gross equity extraction from housing, as a percent of GDP:** from 1993 – 1997 it ranged from 2.5% to 3.8%. In **1998** it increased to 4% of GDP and eventually reached 11.5% in 2005. Totals include both cash out refinances and home equity loans and lines.

[36] Harvard Joint Center for Housing Studies

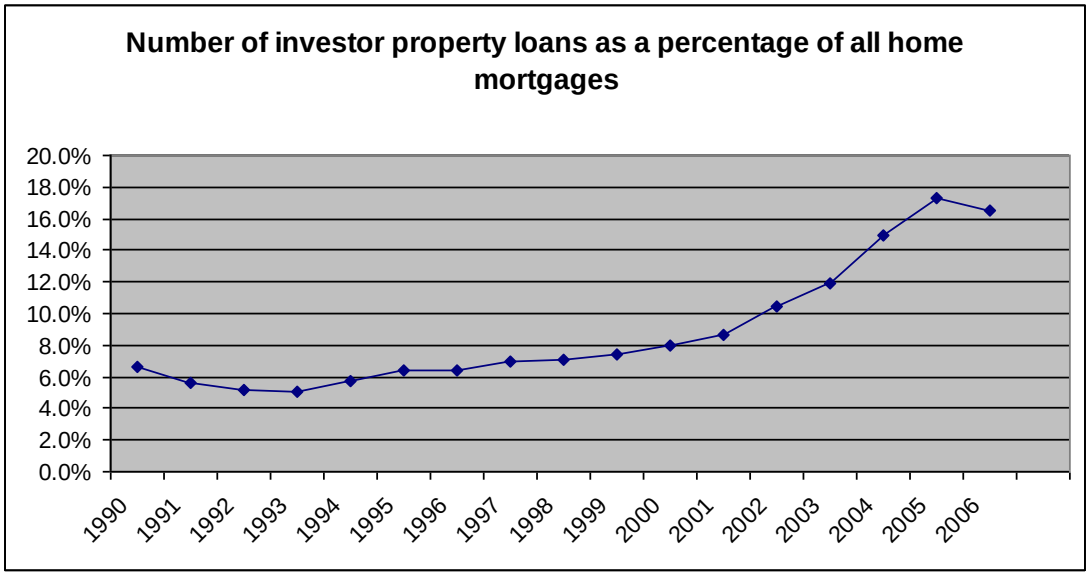
Chart 10:



Source: Greenspan and Kennedy (2007)

10. **Number of investor property loans as a percentage of all home mortgages:** from 1991-1996 it ranged from 5.1-6.6%. Starting in **1997** it increased steadily from 7% to 17.3% in 2005.

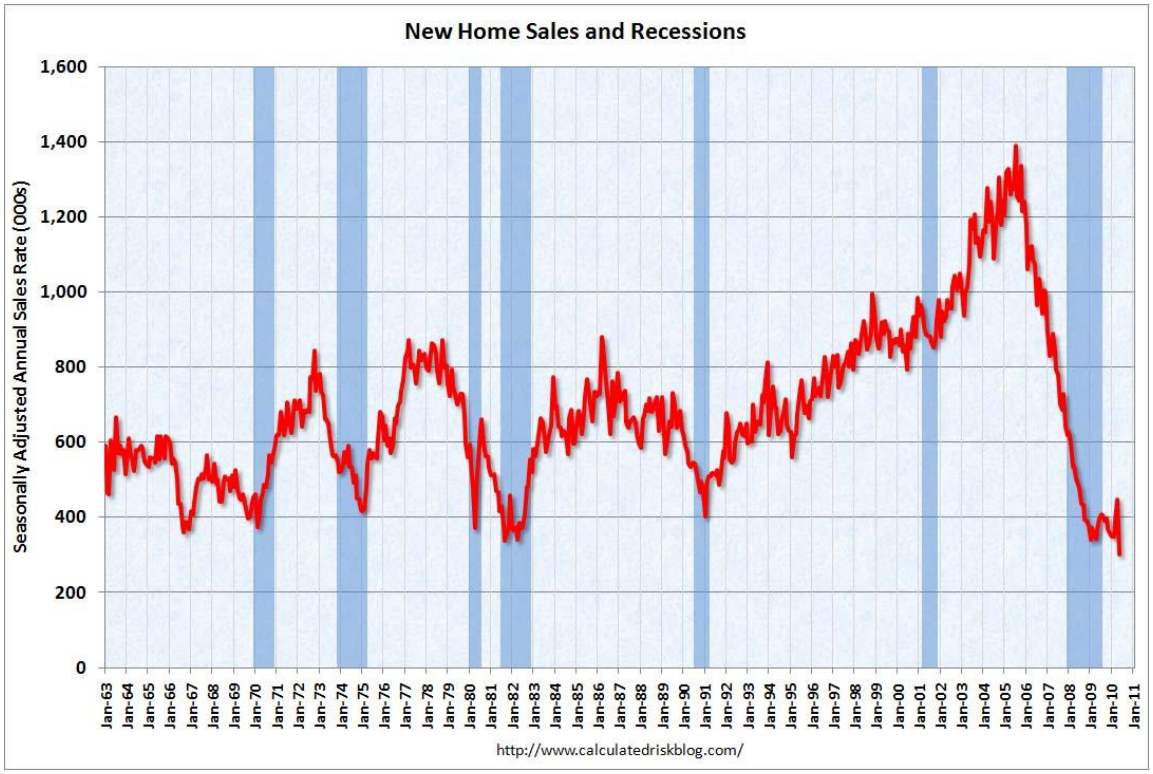
Chart 11:



Source: Fed Reserve, p. 65, http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06draft.pdf
Compiled by Edward Pinto

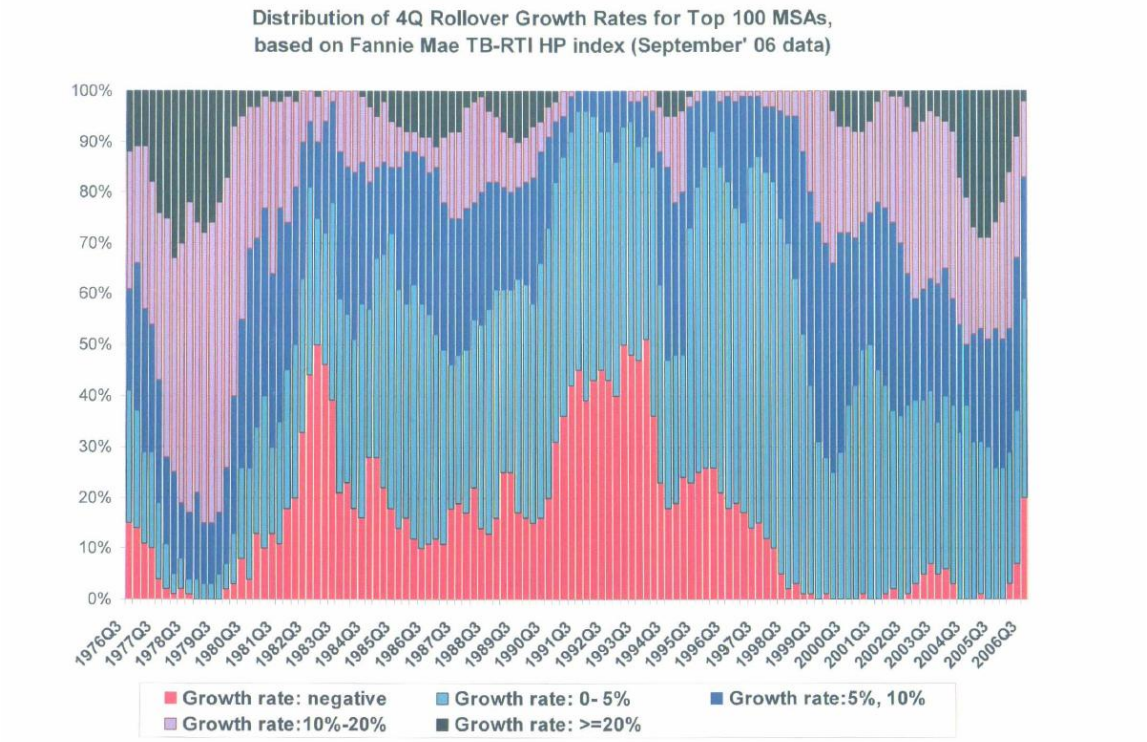
11. **New Home Sales:** Based on past experience, a correction would have been expected in about **1995**, instead the sales boom continued for 11 more years.

Chart 12:



12. **<u>Constant market stimulation mutes price corrections:</u>** As shown by Chart 13, the house price boom resulted in almost an eight year period (**<u>1998</u>**—early 2006) with an extremely low incidence of price corrections calculated with respect to the 100 largest MSAs (incidences ranged from 0 – 7, with most at 0 – 2). This 8 year period of low incidence was more than double the period experienced in 1978—early 1981 (the real estate correction that followed resulted in the Texas Depression Scenario and by late 1982 50% of the MSAs had negative growth rates). The lack of regional corrections during the 1998-early 2006 period allowed lending excesses to grow without apparent consequences as outsized home price increases served to keep delinquency rates artificially low. As a result the ensuing housing bust was more severe.

Chart 13:



These trends are noted because each is significant and unprecedented in its own right and on a combined basis are exceptional. Each started well before 2004, the year in which many analysts and commentators start their analysis of the causation of the financial crisis. Each trend continued for an unusually lengthy period of time.

While there is almost universal agreement that the financial crisis was caused by excesses in housing finance, opinions diverge as to the causes that led to these excesses. Any explanation as to what led to the accumulation of an unprecedented number of Non-Traditional Mortgages (NTMs) in the U.S. financial system, the mortgage meltdown, and the resulting financial crisis must look to events before 2004.

While low interest rates and strong demographic trends have been noted by many people as fundamentals that helped push up house prices and sustain the boom, these cannot explain the boom completely or why the U. S. was so susceptible to a collapse of the mortgage market.[37] In this paper I argue that the excesses in housing finance were the direct result of housing policy decisions made by the federal government over a 15 year period. These policies led to the accumulation of an unprecedented number of NTMs in the U.S. financial system. These NTMs

[37] House price declines do not have to cause a finance sector crisis. The combination of overleveraged borrowers and an overleveraged housing finance system is what turns a housing downturn into a finance sector crisis.

were the result of underwriting changes that were reliant on increased borrower leverage. The broad extant of this credit loosening helps explain the length and level reached by the above noted trends.

The explicit goal of these policies was to increase the homeownership rate by making more loans to moderate-, low- and very-low income borrowers. The explicit means was the promotion of lower downpayments and other loosened underwriting standards. The explicit tactic was to force the GSEs to loosen their underwriting standards so that primary lenders would in turn loosen theirs. This increased demand led to inflated house prices, and ultimately created an affordability gap, which gap required even lower downpayments and a further loosening of underwriting standards. The unprecedented increase in home prices made it appear that loan risk was decreasing, providing a rationale for additional loosening as future price increases would alleviate any underwriting weaknesses. Unprecedented price increases also created trillions in paper profits which were tapped by way of massive equity withdrawals. These withdrawals added additional fuel to the continuing price boom and widening affordability gap, creating a non-virtuous cycle. Responding to these government initiatives and mandates, the real estate finance industry, already prone to boom and bust cycles without any encouragement, went on to finance an unprecedented number of high risk loans.

B. Fannie Mae provides a significant clue:

In a March 18, 2003 press release,[38] Fannie Mae was candid about the role of federal affordable housing mandates, its own $2 trillion affordable housing commitment, and its lender partners in bringing about and extending the nation's housing boom:

> "Joining with representatives from 11 leading mortgage lenders and Fannie Mae partners, Raines applauded the mortgage finance industry for its extraordinary efforts to reach and serve 'emerging markets' of historically underserved families and communities, deliver Fannie Mae's $2 trillion in targeted capital, and extend the benefits of the nation's housing boom."
>
> "Lender partners participating in today's announcement include: Bank of America; Banc One Corporation; Charter One Bank; Countrywide Financial Corporation; Doral Financial Corporation; First Horizon Home Loan Corporation; Fleet Boston Bank; Huntington Mortgage Company; Irwin Mortgage; J.P. Morgan Chase & Co.; and Standard Mortgage Corporation."
>
> "Together, America's top lenders and Fannie Mae have made terrific progress in bringing the nation's housing boom to overlooked Americans and addressing the gaps in housing

[38] "Fannie Mae Passes Halfway Point in $2 Trillion American Dream Commitment; Leads Market in Bringing Housing Boom to Underserved Families, Communities" http://findarticles.com/p/articles/mi_m0EIN/is_2003_March_18/ai_98885990/pg_3/?tag=content;col1

opportunity,' Raines said. 'Fannie Mae applauds our lender partners for helping us surpass the halfway mark in our $2 trillion commitment to underserved families so quickly. Together, we lead the market in serving Americans of color and modest means.'"

This press release is significant for reasons beyond Fannie taking responsibility for creating and extending the housing boom in early 2003. First, Fannie states that it is halfway to fulfilling its $2 trillion commitment "in targeted capital". In actuality, this $2 trillion was backed by about $30 billion of real capital – as Fannie's was leveraged at about 70:1. Excessive leverage combined with the risky nature of the loans themselves was instrumental to the on-going boom and its subsequent bust. Second, the release documents the participation of many of the nation's largest lenders (Freddie accounted for most of the rest).

C. Generating loan demand by increased leverage – the role of weakened lending standards:

When the financial crisis hit in full force in 2008, approximately 26.7 million or 49% of the nation's 55 million outstanding single-family first mortgage loans had high risk characteristics, making them far more likely to default. Each of these high risk characteristics represented a weakening of one or more of the traditional "Three Cs of Mortgage Credit".[39] Weak or non-traditional lending has four effects. First, it helps increase demand, causing prices to rise. Second, broadly rising prices inflate the equity of all homeowners, which fuels equity withdrawals which lead to economic growth thereby generating additional demand thereby causing home prices to rise further. Third, if home price increases outstrip income growth, an affordability gap is created which can only be met by either a further weakening of credit standards or a price correction. Fourth, the higher the quantity and the poorer the quality of weak loans, the more severe the subsequent price correction.[40]

Weak lending is created by increasing leverage. As downpayments decrease, the debt-to-equity leverage ratio increases. Increasing debt-to-income ratios allows a borrower to service (leverage) a higher level of debt. Lowering monthly payments with interest only amortization, negative amortization, no doc lending, or a low start rate also allow a given amount of income to leverage a higher level of debt.

[39] Collateral, character, and capacity are the Three Cs of Mortgage Credit. The key attributes for collateral are downpayment or loan-to-value (LTV) and property use (primary residence, second home, or rental), for character are credit history and property use), and for capacity are mortgage debt ratio, total debt ratio, and sources and stability of income.

[40] The fact that loan underwriting got even weaker near the end of the cycle is entirely to be expected as it is a normal reaction by lenders to a growing affordability gap and the diminished supply of even marginally qualified borrowers. It happened at the end of both the Oil Patch (Colorado, Oklahoma, Louisiana, Texas, and Alaska) boom of the early-1980s and the boom that ended in late-1980s/early-1990s (primarily effecting the Northeast and Southern California).

The role played by weakened lending standards and increased leverage in increasing demand is straightforward. A maximum LTV of 90% and maximum housing debt-to-income ratio of 28% will create or allow for a certain amount of demand. Raise the maximum LTV to 97% and the housing debt ratio to 40% and additional demand will be created.[41] The weakened standards create demand by moving down the demand curve by making more households eligible. The additional demand causes prices to rise.

By moving down the demand curve it was possible for more people to buy homes, resulting in a larger percentage of the US population owning a home. The home ownership rate in the United State had been unchanged for 25 years and then from 1994-2004 the rate increased from 64.2% to 69.2%. The leverage boosting features of lower downpayments or higher debt ratios also meant that households could buy larger homes with little or no downpayment or qualify for a larger loan with the same income. This increased move-up and new home demand and drove further price increases. Finally, with underwriting standards loosening, prices rising, and more advantageous capital gains rules, many individuals took the opportunity to buy one or more additional homes as an investment.

This increase in homeownership rate coincides with increased homebuyer leverage that resulted from a reduction in downpayments – a trend that picked up speed in the early-1990s for FHA and in the mid-1990s for Fannie and Freddie and in the early-2000s for self-denominated subprime.

Government policies promoted the lower and lower downpayment requirements. In 1980, approximately 1 in 400 home purchase loans had a downpayment of <=3%, all provided under government lending programs.[42] By 1990 this had expanded slightly to 1 in 200, again all under government lending programs. After the passage of the GSE Act of 1992, the prevalence of home purchase loans with a downpayment of <=3% expanded rapidly. In 1994 Fannie and

[41] In this paper the following conventions will be used, conventional loans with an LTV >90% will be referred to as either a loan with an LTV>=95% or a downpayment of 5% or less, an LTV >95% will be referred to as loan with an LTV>=97% or a downpayment of 3% or less and an LTV >97% will be referred to as loan with an LTV>=100% or a zero or no downpayment. These conventions are appropriate because of the mortgage insurance premium structure applicable to loans with private mortgage insurance. Loans with an LTV of >80% and <=85% had one premium rate structure. Loans with an LTV of >85% and <=90% had a second higher premium rate structure. Successively higher premium rate structures applied to loans with an LTV >90% and <=95%, to an LTV of >95% and <=97%, and to an LTV of >97%. Given the higher premium rates that applied as LTV increased, one would generally take out a 90% LTV or a 95% LTV loan, not one with an LTV of 91% -94%. This practice is demonstrated by the GSEs' experience with loans with an LTV>90%. These would be expected to have an LTV of 95%, 97% or 100%. Fannie reports that the average LTV on its loans with an LTV>90% was 98.1% (see p. 30 of Fannie's Q.2:2008 Investor Summary, http://www.fanniemae.com/media/pdf/newsreleases/2008_Q2_10Q_Investor_Summary.pdf;jsessionid=VCHEXVQOBQRYTJ2FQSISFGQ. In the case of combined LTV, there is no mortgage insurance premium so a 97% combined LTV loan had a downpayment of 3%. FHA does not vary its insurance premium by LTV so a 97% LTV loan is just that.

[42] In the housing finance industry loans were traditionally described as "government" consisting of FHA, VA, and Department of Agriculture rural housing loans, non-investment grade or subprime loans and conventional or investment grade loans consisting of everything else.

Freddie for the first time began buying loans with downpayments of 3%. By 1999, 2003 and 2007 this had grown to 1 in 10, 1 in 7 and 1 in 2.5 home purchase loans respectively had a downpayment of <=3%.

The utilization of low downpayments had spread to all segments of the housing finance market. By 2006 the National Association of Realtors reported that 46% of first-time homebuyers and 19% of repeat buyers nationwide put down no money. The median first-time buyer put down 2% of the purchase price, while repeat buyers put down 16%.[43] In 2006 first-time buyers constituted 39% of all home purchases.[44] Based on these findings:

1. 18% of home buyers (46% x 39%) were first-time buyers that put no money down.
2. 11.6% of home buyers (19% x 61%) were repeat buyers that put no money down.
3. **As a result, an estimated 30% of home buyers put no money down.** Many more put as little as 1-3% down.

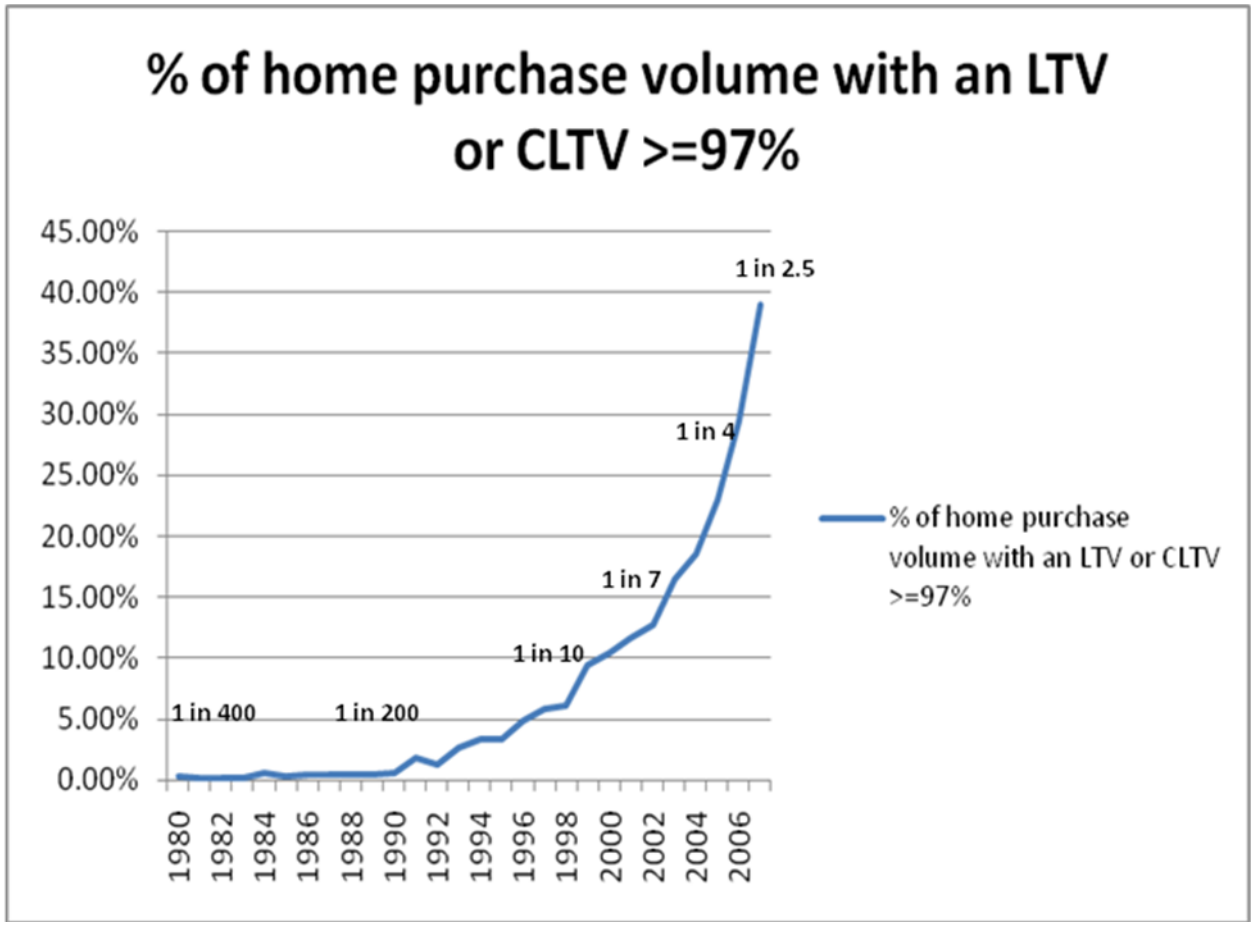
The leverage factor for the median first time home buyer was 49:1 ($2 of equity for every $49 of debt) while the half making no downpayment had infinite leverage.

[43] USA Today, "First rung on property ladder gets harder to reach", July 17, 2007 http://www.usatoday.com/money/economy/housing/2007-07-16-first-time-buyers_N.htm. The NAR report may accessed at http://www.realtor.org/prodser.nsf/products/186-45-06?OpenDocument.
[44] http://rismedia.com/2008-06-01/first-time-home-buyers-nar-survey-of-home-buyers-home-sellers-2007/

These trends are displayed in Charts 14 and 15:

Chart 14:

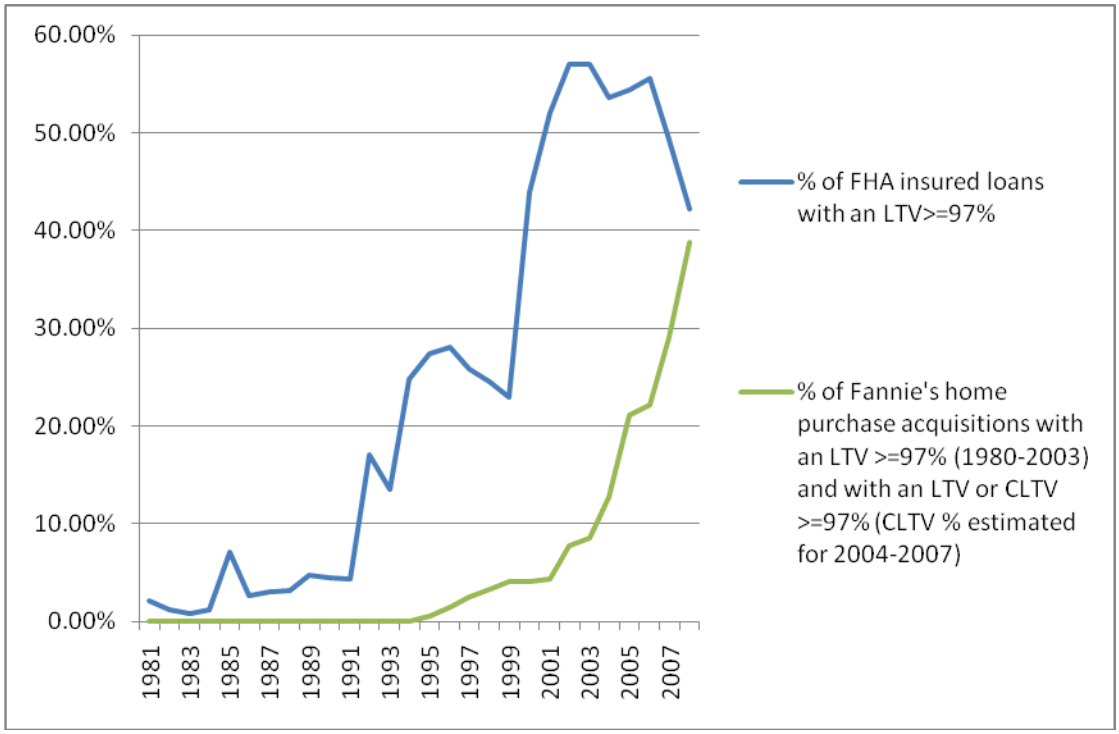
Chart 14: Estimated Percentage of Home Purchase Volume with an LTV or CLTV >=97% (Includes FHA and Conventional Loans*) and Combined Foreclosure Start Rate for Conventional and Government Loans:



Sources: FHA 2009 Actuarial Study, and HUD"s Office of Policy Development and Research - Profiles of GSE Mortgage Purchases in 1999 and 2000, in 2001-2004, and in 2005-2007, and Fannie's 2007 10-K. Compiled by Edward Pinto

*Fannie's percentage of home purchase loans with an LTV or CLTV >-97% used as the proxy for conventional loans.

Chart 15:



Sources: FHA 2009 Actuarial Report and HUD. Fannie percentages for 1994-1996 are estimated based on the fact that it first started acquiring 97% LTV loans in 1994 and the percentage of such acquisitions in 1997 was 3.3%. Combined LTV percentages for 2004-2007 are based on Fannie's disclosure in its 2007 10-K that 9.9% of its credit book (home purchase and refinance loans) had an LTV>90% (the average LTV of these loans was 97.2%), 15% of its credit portfolio had an LTV or combined LTV >90%. This increased Fannie's exposure in loans with downpayments of 5% or less by 50%. A common combination loan was an 80% first and a 20% second, yielding a combined LTV (CLTV) of 100%. Fannie purchased the first. Compiled by Edward Pinto

House prices are subject to the laws of supply and demand and are not immune from the bullish effects of leverage. As the downpayment percentage decreases, a borrower's leverage increases. Apply high leverage lending to a massive market such as housing and the effect can be quite dramatic and is almost always bullish (at least for a time). Leverage magnifies the opportunity for both gains and losses. Take a borrower making a downpayment of 10% on a $100,000 home. His home is valued at ten times the amount of the downpayment, resulting in a 9:1 leverage ratio. If the home now appreciates by 10% or $10,000 in the next year, his investment is now valued at $20,000 or double his initial downpayment.[45] Conversely a decline of $10,000 over the same time period wipes out his entire investment. If the same borrower makes a downpayment of 3% on a $100,000 home, he is now able to buy a home valued at about thirty-three times the amount of his downpayment, resulting in a 32:1 leverage ratio. If the home now appreciates by 10% or $10,000, his investment is now valued at $13,000 or more than quadruple his downpayment.

[45] For purposes of these examples the costs of sale and other transaction costs are ignored.

However, a price decline of $10,000 would not only wipe out his entire investment, it would leave the lender under-collateralized with a current LTV of 108%.

However the story does not end here. Increased leverage attracts additional buyers, thereby increasing demand and generally resulting in an upward push on house prices.[46] Consider a first time homebuyer who is attracted by a 3% downpayment loan and wants to buy before home prices go even higher. He makes a downpayment of 3% on a home now selling for $110,000 – the increase in leverage spurred additional demand which increased the home's price. Since the downpayment is only 3% or $3300, it has only gone up by $300. If the home now appreciates by 10% or $11,000, leverage still allows him to more than quadruple his investment of $3,300. However, instead of a price decline of 10%, the high level of leverage leads to a price correction of 20%. This wipes out his investment and leaves the lender under-collateralized with a current LTV of 121%. The borrower may simply walk away.

Low and no downpayment lending and other leverage enhancing underwriting changes armed a significant portion of borrowers with the ability to bid on houses using borrowed money. This removed a constraint on house prices since the great majority of home buyers no longer needed to put a substantial amount of their own money at risk in the form of a sizable downpayment. Rising prices spurred a refinance boom. Booming house prices spurred increased lending for home purchases and the extraction of burgeoning home equity through cash out refinances and home equity loans. Loan origination volumes expanded such an extent that as of 12.31.03 58% of all outstanding single family mortgages were less than a year old and all were underwritten based on the latest leverage driven market value.[47] The impact of low downpayments and other leverage enhancing underwriting changes was compounded by increasing levels of leverage of mortgage investors (like Fannie and Freddie) and structured transactions (like private MBS). This double dose of increasing leverage caused this boom to differ from earlier booms. Ultimately home values reached $23 trillion in 2006 and then rapidly declined to $16.6 trillion by 2009, a reduction of $6.4 trillion.[48] [49]

The recognition that loosened underwriting standards caused increased demand which drove up house prices was recognized in a 2005 study commissioned by HUD:

---

[46] Initially this upward push occurs because it either takes time for the housing supply to increase or supply is constrained. Over time, greater levels of leverage will promote speculation which tends to absorb added supply. For example, the investor loans as a percentage of all loans transaction steadily increased from 5% in 1993 to nearly 18% by 2006. At the same time, the upward push on house prices gets reflected both with respect to the subject house being sold, but also becomes a comparable for existing homes and creates a wealth effect across the market.

[47] 2003 total originations from Inside Mortgage Finance. Total outstanding first mortgage single-family debt as of 12.31.03 is from Fed Flow of Funds report covering the period 1995-2004. Data found at L.218. p. 87, http://www.federalreserve.gov/releases/z1/Current/annuals/a1995-2004.pdf, Compiled by Edward Pinto

[48] Data found at B.100. p. 95, line 4, http://www.federalreserve.gov/releases/z1/Current/annuals/a2005-2009.pdf

[49] The new, higher price created by leverage was not only used to support the sale of the subject property, but also new homes and the resale of existing homes (normally about 6%-7%of homes sell in a given year). It was also used to support equity withdrawals by way of cash out refinances and home equity loans.

> "The main point is that aggressive mortgage financing can boost demand for housing, and that demand can drive up house prices. As interest rates fall and loan terms relax, borrowers have more buying power to raise the offer price on home purchases. In the late 1990s, with a hot labor market and stock market, housing demand was fueled by a combination of population growth, income, wealth, supportive government policy, and easy credit."[50]

Loosened standards designed to promote affordable housing lending became counter-productive. As noted by HUD, one reason many homeowners could not afford to buy a home is that aggressive mortgage financing drives up house prices. Second, many overleveraged homebuyers do not have the ability to handle normal maintenance such as painting, replacing furnaces, or replacing roofs. Third, as the resulting boom drives prices up, property taxes and insurance go up in lock step, creating more stress on weak homeowners. . Weakened lending standards distorted everything.

D. The power of rising prices:

A powerful psychology can take hold of borrowers and lenders alike during a period of booming prices:

> "During a housing price bubble, buyers think that a home that they would normally consider too expensive for them is now an acceptable purchase because they will now be compensated by significant further price increases. They will not need to save as much as they otherwise might, because they expect the increased value of their home to do the saving for them. First-time buyers may also worry during a housing bubble that if they do not buy now, they will not be able to afford a home later. Further, the expectation of large price increases may have a strong impact on demand if people think that home prices are very unlikely to fall, and certainly not likely to fall for long, so that there is little perceived risk with an investment in a home."[51]

In testimony before the Financial Crisis Inquiry Commission, Mr. Warren Buffett made similar observations about the power of rising prices to mesmerize virtually all concerned:[52]

> "Rising prices and discredited Cassandras from the past blunt the sensitivities and judgment of even people who are very smart. A home is a sound investment…and if you believe house prices are going to go up next year you are going to stretch to buy one this year and the world enabled people to stretch. After awhile rising prices became their own rationale. People decided if buying one house is a good idea, then buying three houses is a good idea. Buying a house you can afford is a good idea, than buying a house you can't

[50] HUD PDR, May 2005, HUD Contract C-OPC-21895, Task Order CHI-T0007, "Recent House Price Trends and Homeownership Affordability", p. 46

[51] Karl Case and Robert Shiller. "Is there a Bubble in the Housing Market:", 2004 http://www.econ.yale.edu/~shiller/pubs/p1089.pdf

[52] http://www.c-span.org/Watch/Media/2010/06/02/HP/R/33689/Financial+Crisis+Inquiry+Commission.aspx

afford is a good idea because it is going to go up in price. And people who lent money said it really didn't make any difference if the guy's lying about his income. If the house goes up in price, we'll get our money back anyhow. So rising prices are a narcotic and affect the reasoning power up and down the line."

E. Another clue - where the loans with weak or non-traditional lending characteristics ended up:

As of June 30, 2008 over 70% of the 26.7 million NTMs with weak or high risk characteristics[53]—19.25 million loans--were owned or guaranteed by (a) Fannie Mae and Freddie Mac (11.9 million), (b) the Federal Housing Administration and other federal agencies (4.8 million); (c) Federal Home Loan Bank (FHLB) investments in Alt-A and Subprime Private MBS (0.3 million) or (d) banks and other lenders originating loans pursuant to CRA requirements and HUD's Best Practices program (2.2 million, net of CRA loans already accounted for in (a) and (b)[54]. These numbers suggest that government policies and requirements were the source of the loans with weak or high risk characteristics, and thus the cause of the financial crisis.

Most of the rest of the NTMs are found in private mortgage backed securities.

In a span of 15 years, the underwriting standards of virtually the entire mortgage industry changed and came to embrace the origination or acquisition of unprecedented numbers of NTMs. It was the concerted push by regulators that created a dangerously synchronized mortgage market where virtually all participants were reliant on NTMs. The only lending group that escaped the forces of regulatory lending standard liberalization was the community banks.[55] This is demonstrated by comparing the non-performing loan rate by bank asset size which shows that the top 4 institutions are at 17.36% while the thousands of community banks with less than $500 million in assets average about 2.3%. This demonstrates two influences that exacerbated the accumulation of NTMs. Too big to fail (TBTF) banks (such as Citibank, Bank of America, and J.P. Morgan Chase) along with other TBTF institutions (such as Fannie, Freddie, Merrill

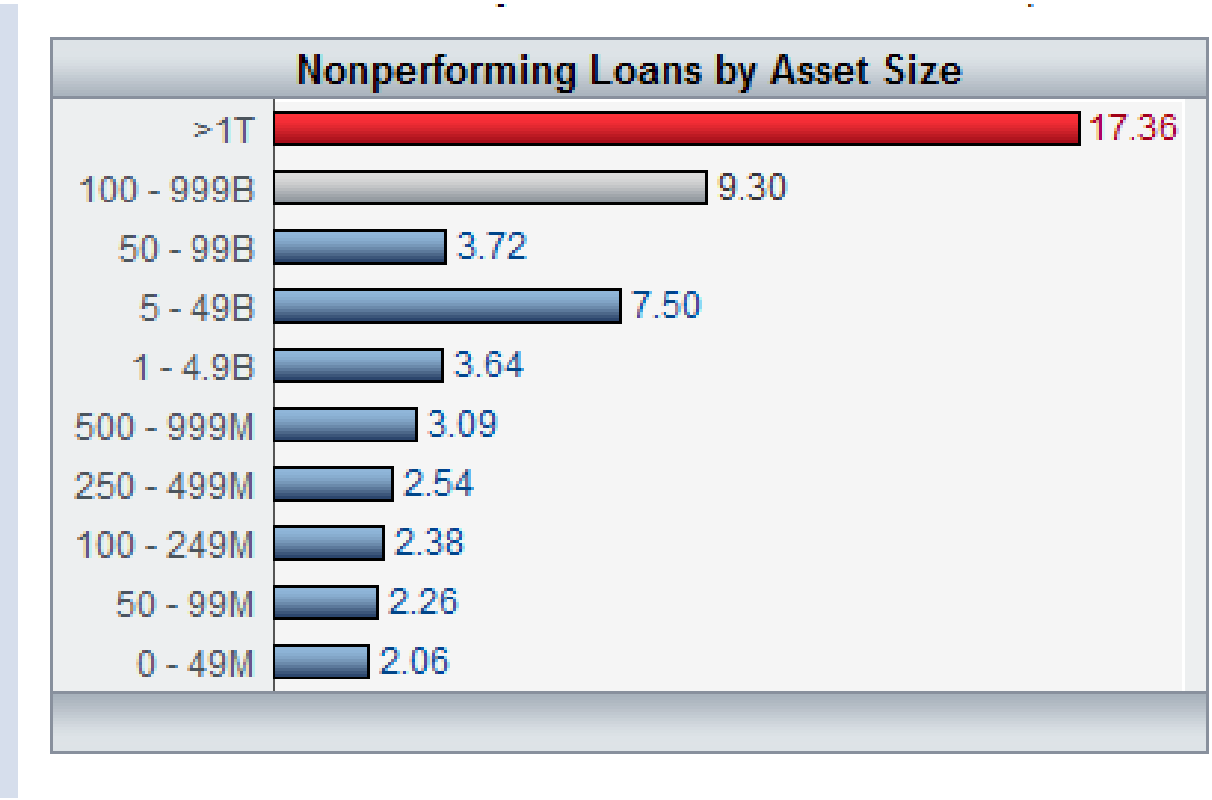
[53] Loans with weak or high risk characteristics are defined as either subprime (loans to borrowers with weakened credit histories) or Alt-A loans (loans with low or no documentation requirements or some other feature that was "alternative to agency" (hence, the term "Alt-A")—i.e., did not meet the traditional underwriting guidelines of the GSEs in such characteristics as Original LTV, Combined LTV, debt ratio, rules for loans on investment properties, rules on cash-out refinances, condominium guidelines, special income definitions, low start rates, or negative amortization ARMs). Most of these loans had non-traditional risk characteristics as compared to prime, subprime, and government loans standards prevalent in 1991. See **1991-A** below.

[54] See Appendix I for the link to "Sizing Total Federal Government and Federal Agency Contributions to Subprime and Alt-A Loans in U.S. First Mortgage Market as of 6.30.08"

[55] This group qualified under the less onerous CRA regulations applicable to small banks and was less oriented towards merger activity. Also given the large number of community banks (over 7000), changing the credit culture at such a large number of banks by regulatory action was difficult. Community banks have about 23% of all banking assets (source: http://www.icba.org/files/ICBASites/PDFs/cbfacts.pdf) and a smaller percentage of single-family mortgage assets.

Lynch, and AIG) accumulated a disproportionate share of NTMs. Non-TBTF institutions like thousands of community banks did not.

Chart 16:[56]



Overtime the ability to identify subprime and Alt-A loans became much more difficult as the GSEs increased their purchases but did not disclose all of their acquisitions of loans with subprime or Alt-A characteristics. Fannie on November 10, 2008 for the first time admitted:

> "We apply these classification criteria [for subprime and Alt-A] loans in order to determine our Alt-A and subprime loan exposures; however, we have other loans with some features that are similar to Alt-A and subprime loans that we have not classified as Alt-A or subprime because they do not meet our classification criteria."[57]

The original meaning of Alt-A was: "Alternative to Agency" or to GSE underwriting standards. Fannie and Freddie ultimately purchased nearly 60% of all known Alt-A production (see **Chart 38**).

[56] Source: Bill Moreland at bankregdata.com
[57] Fannie Q.3:2008 10-Q. p. 115, http://www.fanniemae.com/ir/pdf/earnings/2008/q32008.pdf

II. A Slow Fuse to the Big Bang: A Chronology of Events Leading to the Mortgage Meltdown:

Stage 1: Congress turns initially to FHA and then to the Community Reinvestment Act and bankers to increase low- and moderate-income housing lending

1962:

Since it was established in 1934, FHA has been reliant on low downpayments and long-term fixed rate mortgages.[58] It initially insured fixed rate loans with a maximum LTV of 80% (up from 50%-60% by non-government lenders) and a loan term of 20 years (up from a maximum of 12 years by non-government). By 1962 it would be insuring LTVs up to 95% and loan terms of 30 years.

Along with LTVs and loan terms, FHA's foreclosure rate has also been increasing, a trend that would continue for the next 58 years. In 1956 FHA's annual foreclosure start rate was up to 0.37%/year. By 1961 FHA was experiencing a tripling of its foreclosure start rate to 1.00%/year. Time magazine observed in 1962[59]:

> "Homeowners of a new and unattractive breed are plaguing the Federal Housing Administration these days. Known as "the walkaways," they are people who find themselves unable to meet their mortgage payments—and to solve the problem simply move out their belongings at night, drop their house key in the mailbox and disappear."

1977:

Community advocacy groups were the driving force behind the passage of CRA. First and foremost among them was National People's Action and its founder and leader Gale Cincotta.

> "Ms. Cincotta was known as the 'Mother of the Community Reinvestment Act…'"[60]

However, the language as passed was viewed as too weak:

> "The CRA passed without a clear statement of the reinvestment obligations and standards for which community groups had lobbied. The wording of the Act was short and in many respects vague.… Regulators were simply required in their examination to 'encourage'

[58] Thomas Herzog, "The History of Mortgage Finance with an Emphasis on Mortgage Insurance", P. 21, http://www.soa.org/library/monographs/finance/housing-wealth/2009/september/mono-2009-mfi09-herzog-history.pdf

[59] http://www.time.com/time/magazine/article/0,9171,827500,00.html

[60] The Washington Post, August 17, 2001, http://www.highbeam.com/doc/1P2-471572.html

> lending institutions to serve the needs of the local communities in which they are chartered."[61]

CRA became the common thread in the government's unprecedented and broad efforts to weaken underwriting standards. Any effort to substantially increase CRA lending required a broad based loosening of the lending industry's loan standards, including those of Fannie and Freddie. It would be years before Congress would pass additional legislation that would mandate this loosening. Defenders of CRA ask how a statute passed in 1977 could play such a central role in the financial crisis. The answer is community groups supportive of CRA successfully lobbied for a series of government policy initiatives undertaken in 1992-1995 that invigorated CRA and placed it at the center of the effort to force the housing finance industry to institute flexible and innovative underwriting standards. As a result CRA commitment volume exploded in the 1990s.

1977-1990

In the early 1970s community groups became concerned because "[T]he FHA was known in the loan business as a 'lender of last resort' Implicit in receiving government insurance on a loan is the idea that conventional private lenders choose not to offer the borrower favorable terms."[62] The solution was CRA and its requirement that in "reviewing applications for charters, acquisitions, mergers, relocations, and branches, the regulatory agencies [be] required to 'access the institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods."[63] The goal was to force conventional (non-government) lenders to adopt more flexible underwriting standards in order to make more loans to low- and moderate-income borrowers. By 1995 CRA regulations would explicitly provide that banks be evaluated on their "use of innovative or flexible lending practices in a safe and sound manner to address the credit needs of low- or moderate-income individuals or geographies."[64]

Chart 15 demonstrates the growing foreclosure problems facing FHA, problems driven by high LTV lending. The peaks in the mid-60s and mid-70s were caused by missteps taken by FHA in urban areas.

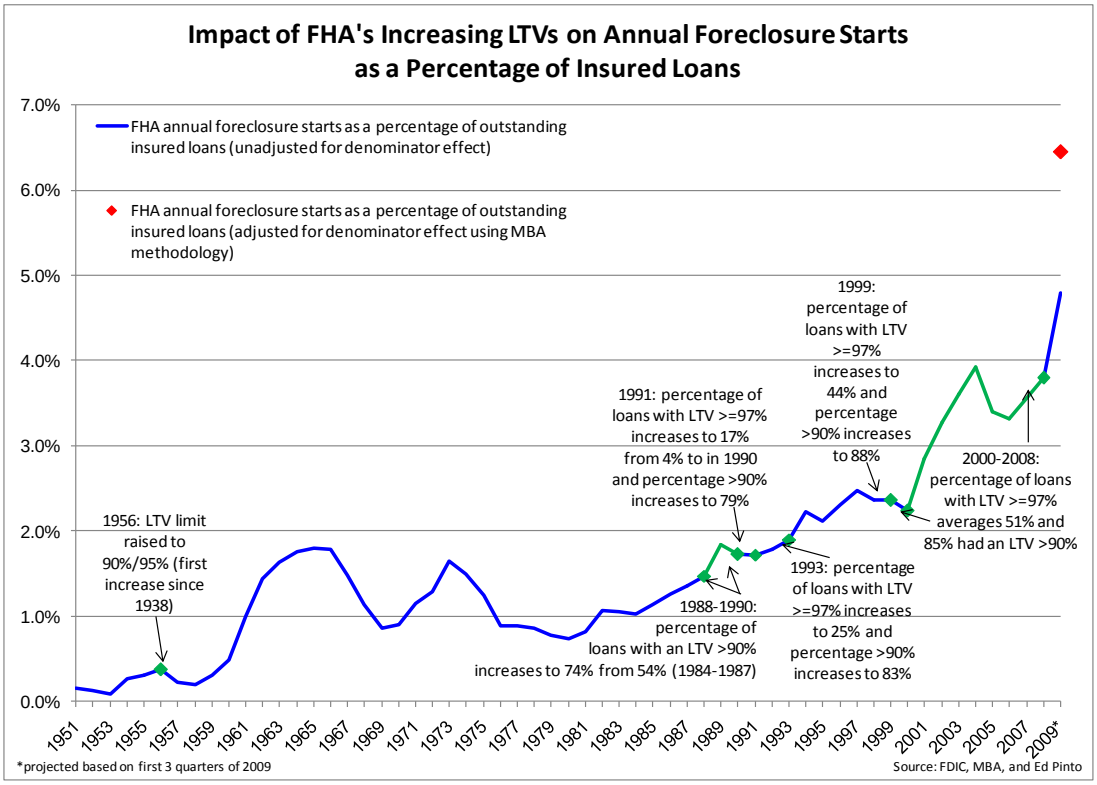
> "One of [FHA's] key functions was to guarantee mortgages for people who might not qualify under private banking guidelines. Mismanagement and fraud plagued the agency in the 1970s, creating a legacy it was never able to shake, as shown by a reform campaign that began in 1997."[65]

---

[61] Joe Mariano, "Where Did Billions of Dollars for Reinvestment Come From?", Chapter 2, p. 34 of Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions, 2003, Gregory Squires, editor
[62] Id. pp. 30-31
[63] Id. p.34
[64] FDIC regulations, Part 345, Community Investment, Section 345.22, http://www.fdic.gov/regulations/laws/rules/2000-6500.html
[65] Supra. Mariano, pp. 35-36

The campaign had little effect as FHA's foreclosure start rate continued its climb after 1997.

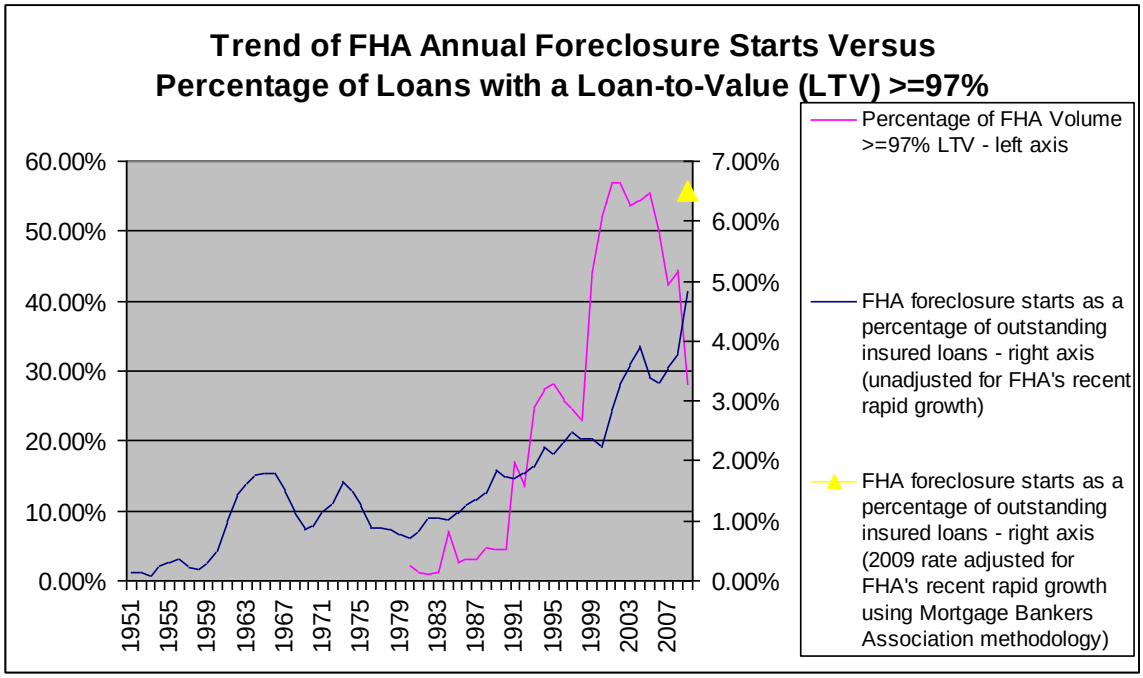
Chart 17:



Compiled by Edward Pinto

Ignored was the impact of downpayments of <=3% on FHA's foreclosure rates. The correlation between FHA's increasing reliance of loans with downpayments of <=3% which started in the early 1980s and its increasing foreclosure start rate is set out in Chart 18 below:

Chart 18:



Sources: FDIC, MBA, FHA, and compiled by Edward Pinto

Most agree that CRA had very little impact in its early years. Announced CRA commitments over CRA's first 15 years from 1977 to 1991 totaled less than $9 billion, with almost half of this total announced in 1990 and 1991.[66] This was likely due to the fact that many industry participants were reluctant to weaken underwriting standards. Also until 1995 CRA was based on the effort put forth by a bank, not results as measured by actual loan volume. Finally, regulators had minimal ability to penalize a bank for any perceived CRA shortcomings. While announced CRA commitments did not represent all CRA activity and CRA activity did not represent all low- and moderate-income lending, community groups viewed these CRA volume levels as small compared to overall origination volume (total originations were running about $500 billion/year in 1990 and 1991).

By the mid-1980s, these groups concluded that Fannie and Freddie's underwriting requirements were to blame for the perceived low level of CRA volume. In about 1986, National People's Action (NPA), a consumer advocacy group, began to meet separately with Fannie and Freddie in an effort to get them to adopt more flexible underwriting standards in an effort to expand CRA

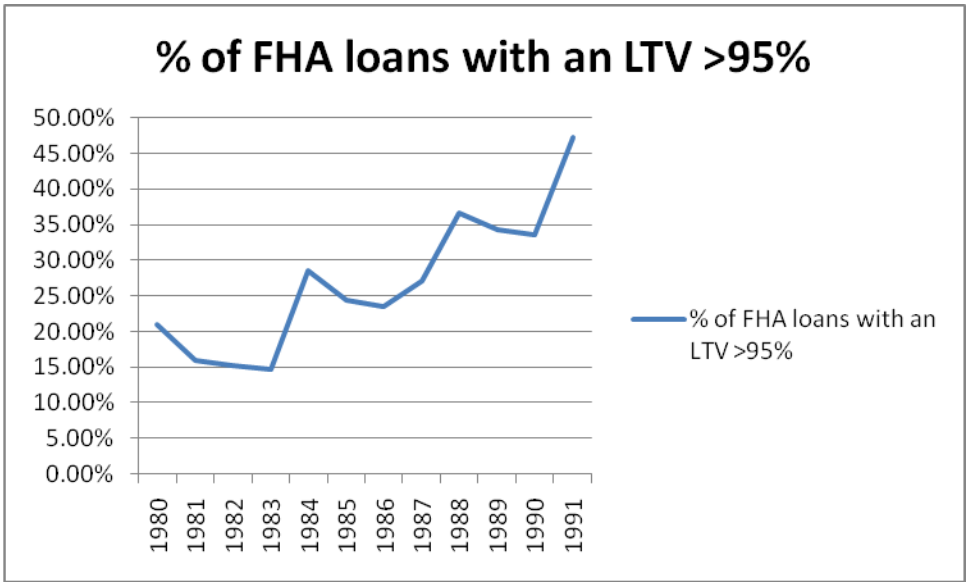
[66] Source: National Community Reinvestment Coalition's 2007 CRA Commitments report found at http://www.community-wealth.org/_pdfs/articles-publications/cdfis/report-silver-brown.pdf

lending. While agreeing to a number of pilot programs, Fannie and Freddie were dubious about many of the requested flexibilities.[67] NPA, ACORN and other groups were dissatisfied with the perceived pace of change and were concerned that Fannie, Freddie, and lenders "still viewed them as 'special programs' and have not incorporated them into standard underwriting practices."[68]

1980-1991:

Oblivious to rising default rates (see **Chart 19**), FHA steadily increases the percentage of its business represented by loans with an LTV >95%.

Chart 19:[69]



With the exception of loans made by the much smaller Veterans Administration, FHA was the only source of loans with downpayments of less than 5%, as conventional loan LTVs required at least 5% down. In 1991 FHA did over $7 billion of home purchase loans with down payments of 3% or less to the GSEs' volume of $0. These loans represented about 47% of FHA's insured loans, with another 30% having an LTV >90% and <=95%.[70] FHA's ability to fuel ever greater volumes of low downpayment lending was limited by its market share, which was 8% in 1991. Increasing its share was politically difficult as FHA was on budget and its annual volume was set by Congress.

---

[67] The author was Fannie's senior vice president of marketing and product management during the first two years of Fannie's interaction with NPA. I advised NPA that Fannie would be as ill-equipped as FHA to implement a large-scale national affordable housing program. I cited HUD and FHA's failures in this regard and noted that any such effort was fraught with problems and risks.

[68] "Not in My Back Yard: Removing Barriers to Affordable Housing", Chapter 3, page 13 http://www.huduser.org/Publications/pdf/NotInMyBackyard.pdf

[69] FHA 2009 Actuarial Study found at: http://www.hud.gov/offices/hsg/comp/rpts/actr/2009actr_exhecm.pdf,

[70] Id.

Early 1980s:

The most severe housing downturn since the Depression occurs in the aftermath of the collapse of oil prices. The hardest hit area is known as COLTA – Colorado, Oklahoma, Louisiana, Texas, and Alaska. The COLTA states had first experienced an oil-fueled boom in the late 1970s and early 1980s and then a bust as the price of oil quickly collapsed. Texas and Alaska were the hardest hit. Both had unique circumstances.[71]

Texas had a strict homestead property law that banned the withdrawal of any home equity after the initial home financing (even extending to a borrower's original down payment). For this reason real estate agents encouraged home buyers to put down as small a downpayment as possible. A 5% down payment on a conventional loan and even lower on an FHA loan became prevalent. Texas was also one of the fastest growing states in the country in terms of population and jobs in the late 1970s and early 1980s.[72] Traditionally, first time homebuyers make greater use of low downpayment lending. The combination of these two factors resulted in Texas having the highest LTVs in the nation. When the downturn hit, mass foreclosures resulted. The downturn in Texas became known as the Texas Depression default scenario.[73]

In Alaska the story had a different twist. In the early 1980s interest rates had risen to record levels. Alaska used tens of millions of dollars of its royalties from the oil pipeline to fund low interest rate mortgages through the Alaska Housing Finance Agency (AHFA). The program financed homes with very low downpayments (once again 5% on a conventional loan and less on an FHA loan). The program had mortgage and income limits. The mortgage limit was $80,000 on a two bedroom home (including condominiums). Once the economic downturn hit Alaska, prices collapsed from $80,000 to $20,000 on many of the properties financed by AHFA.

As a result of the foreclosure losses incurred in the COLTA states, 6 of the 12 mortgage insurance companies either went into liquidation or run-off.

1985-A:

Fannie undertakes a top-to-bottom review of its underwriting standards in the spring and summer of 1985. This review was prompted by Fannie's adverse experience with loosened underwriting practices in the early 1980s and resulted in the announcement of new standards in August of 1985. While covering numerous topics, a significant focus was on standards relating to loans with a downpayment of 5%. Tightened restrictions on loans with a downpayment of 5% included: reduction in maximum debt ratios and seller contributions, an increase in cash reserve requirements and limitations on property usage (ex. investor loans and 2, 3 and 4 unit properties

[71] The author was Fannie's Senior Vice President for Marketing and Product Management from 1984-1987 and worked on the aftermath of the housing downturn, particularly with respect to Texas and Alaska.
[72] "The Texas Economy", pp. 6 and 9, http://www.dallasfed.org/sanantonio/news/events/2007/0709sigalla.pdf
[73] The high default rates experienced in Texas are described in Fitch Research, "Fitch Mortgage Default Model", June 28, 1993, pp. 6-8. Document contained in the author's files.

were not eligible for a downpayment of only 5%) and standards for riskier loan product types were tightened (ex. ARMs).[74] The changes made by Fannie largely bring them into sync with Freddie's guidelines.

> "[t]he conclusion is inescapable that the most central element in weighing the soundness of a mortgage loan is the amount of the homeowner's equity." David O. Maxwell, Chairman of the Federal National Mortgage Association [Fannie Mae], Address before the National Press Club, August 5, 1985[75]

1985-B:

While Fannie and Freddie both have conservative underwriting guidelines, FHA has loosened its guidelines:

> "On average, downpayments on FHA insured homes declined from 10% in 1982 to 7.8% in 1985. In 1985, 40 percent of the agency's insured mortgages had loan-to-value ratios of 96 percent or greater. There is near unanimous agreement among housing experts that the less equity homebuyers have tied up in their homes, the greater is their likelihood of default."[76]

FHA also had much higher debt ratios than the private sector. In 1982 it raised Total Debt to Income and Total Expense to Income ratios to 38% and 53% from 35% and 50% respectively, with about 30% of FHA's loans exceeding these levels. Private mortgage insurers applied 28% and 36% ratios in 1985.[77] Chart 17 above shows FHA's foreclosure start rate increasing by a factor of 5 from 1982 to 2009.

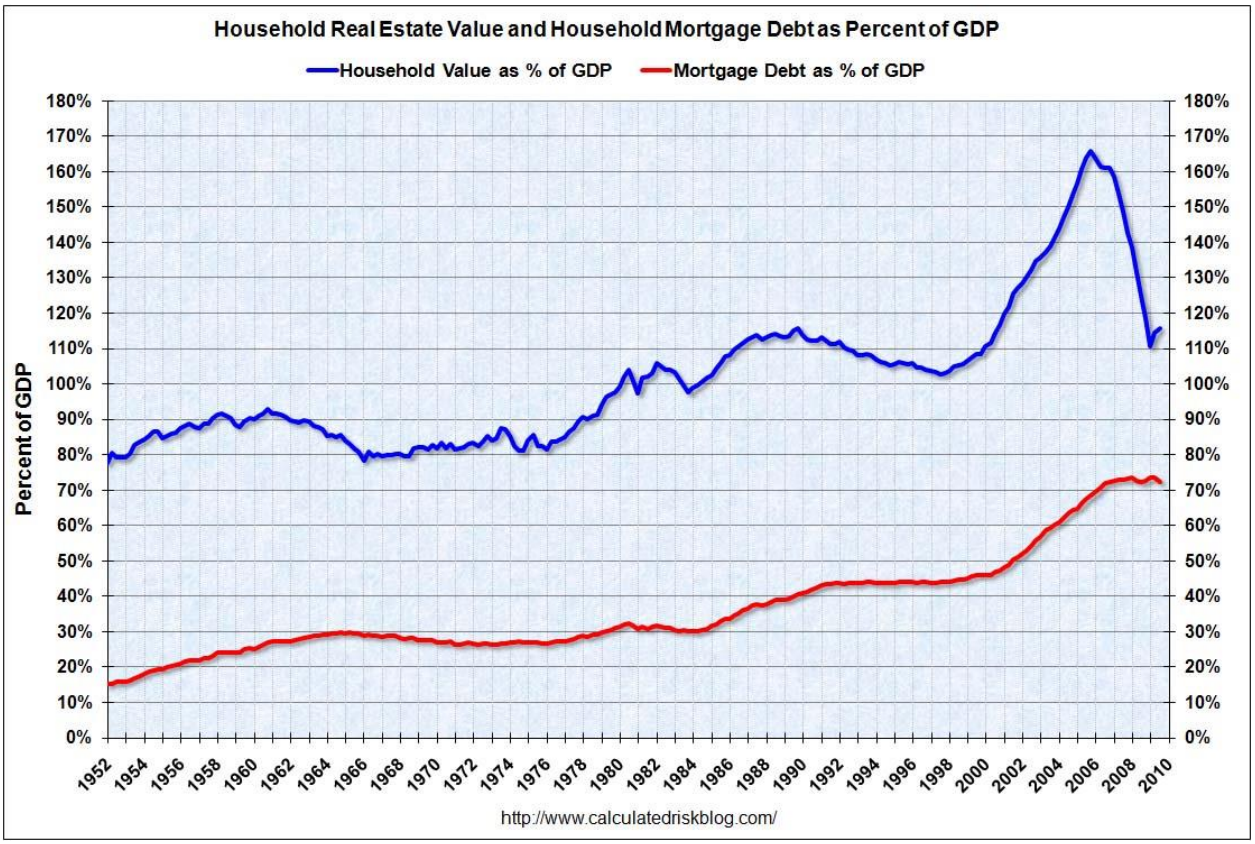
In 2005, twenty years later, as federal housing policies succeed in pushing the GSEs and the private sector to a point where they largely replace FHA, housing and total debt ratios of 38% and 53% will become the norm.

1986:

The income tax law is changed to effectively limit interest deductions to interest incurred on loans relating to primary and secondary residences. This helped encourage the use of debt over equity, larger loans, larger homes, and the extraction of home equity. While tax deductibility was not the sole cause, home mortgage debt as a percentage of GDP increases from 39% in 1986 to 50% in 1999 to 75% in 2007 (see **Chart 20** below).

[74] The author was Fannie's senior vice president of marketing and product management both during the time this review was undertaken.
[75] Stephen Moore, Heritage Foundation, "How Congress Can Diffuse the Federal Housing Time Bomb", July 29, 1986, p. 7, http://www.policyarchive.org/handle/10207/bitstreams/9281.pdf
[76] Id.
[77] Id.

Chart 20:



1988-A:

> "In 1988 the holding company for Union National Bank, a large bank headquartered in Pittsburgh, requested approval from the Federal Reserve for its merger with Pennbancorp….Through flexible loan underwriting, [Union National's CRA lending] agreement created an affordable conventional home-purchase product for homeownership in [Pittsburgh Community Reinvestment Group] neighborhoods. Union National Bank reduced the interest rate on these loans by at least one half of one percent below their rates, waived points, mortgage insurance, and minimum loan amounts, and increased the loan-to-value and qualifying debt-to-income ratios. To avoid the conservative underwriting preferred by secondary market investors, Union National agreed to keep these mortgages in portfolio."[78]

The above program is representative. It demonstrated that community groups were not really looking for equal treatment by banks; they wanted the private sector to provide subsidized

[78] Stanley A. Lowe and John T. Metzger, "A Citywide Strategy: The Pittsburgh Community Reinvestment Group", Chapter 6, page 89 of Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions, 2003, Gregory Squires, editor

loans[79] with highly leveraged loan terms. If the private sector would only provide enough interest rate subsidies and additional leverage, low and very low income borrowers could avoid FHA and still become homeowners.

1986-1992:

Union National Bank's inability to sell loans with weakened credit standards to the GSEs remained a point of contention with community groups. As noted earlier, NPA, ACORN and other groups were dissatisfied with the perceived pace of change and concerned that Fannie, Freddie, and lenders "still viewed them as 'special programs' and have not incorporated them into standard underwriting practices."[80]

> "As early as 1987[81], ACORN began pressuring Fannie and Freddie to review their standards, with modest results. By 1989, ACORN had lured Fannie Mae into the first of many "pilot projects" designed to help local banks lower credit standards. But it was all small potatoes until the serious pressure began in early 1991. At that point, Democratic Senator Allan Dixon convened a Senate subcommittee hearing at which an ACORN representative gave key testimony."
>
> "ACORN's spokesman strenuously complained that his organization's efforts to relax local credit standards were being blocked by requirements set by the secondary market. Dixon responded by pressing Fannie and Freddie to do more to relax those standards — and by promising to introduce legislation that would ensure it. At this early stage, Fannie and Freddie walked a fine line between promising to do more, while protesting any wholesale reduction of credit requirements."

By mid-1991 ACORN and other groups goal of forcing the GSEs to loosen their lending standards was getting close to reality:

> "By July of 1991, ACORN's legislative campaign began to bear fruit. As the *Chicago Tribune* put it, 'Housing activists have been pushing hard to improve housing for the poor by extracting greater financial support from the country's two highly profitable secondary

[79] Since FHA's loan limits targeted its activity to low- and moderate-income homeowners and its loans had low downpayments, it had little ability to cross-subsidize or transfer profits from lower risk borrowers to higher risk borrowers. Conventional lenders (whether a bank, Fannie, or Freddie) had a much broader range of lower risk customers which could be used to generate profits that could be used to subsidize higher risk loans by way of lower rates, reduced profit margins, and other methods..

[80] "Not in My Back Yard: Removing Barriers to Affordable Housing", Chapter 3, page 13 http://www.huduser.org/Publications/pdf/NotInMyBackyard.pdf

[81] The author represented Fannie Mae at the first and many subsequent meetings with NPA and believed that the first meeting may have occurred as early as 1986.

> mortgage-market companies. Thanks to the help of sympathetic lawmakers, it appeared...that they may succeed.'"[82]

1988-B:

Risk based bank capital standards (known as the Basel Accords) were initially implemented in 1988.[83] A risk based capital weight of 20% was set for bank holders of Fannie and Freddie MBS. Private "AAA" and "AA" MBS were set at 100%[84] and remained at this level until changed to 20% in 2001.[85] Residential mortgages were set at a 50% level. These percentages were then applied to the base capital level of 8%. This yields the following risk based capital levels:

- Fannie and Freddie MBS – 1.6% capital (8% base capital requirement x 20% risk weight)
- Residential mortgages – 4% capital (8% base capital requirement x 50% risk weight)
- Private "AAA" and "AA" MBS – 8% base capital requirement

A Fannie MBS required Fannie to hold capital of 0.45% and the bank buying the Fannie MBS to hold 1.6%, for total capital of 2.05% and a leverage ratio of 49:1.[86]

1988-C

During the presidential campaign of 1988, candidate Michael Dukakis offered a homeownership plan:

> "aimed at about five million households that now live in rental housing and have incomes ranging from $20,000 to $40,000. The program is designed to help them enter the housing market through a variety of measures, including relaxed criteria for mortgages insured by the Federal Housing Administration....The F.H.A. now insures mortgages and requires a down payment of only 3 percent of the first $25,000 of the price of the house, and 5 percent for the remainder of the price, the Dukakis campaign said. The Democratic nominee would require a flat 3 percent down payment for the entire price.... He would let the F.H.A. insure most forms of adjustable rate mortgages and eliminate the ceiling on the number of such loans that the agency can insure annually. Currently, the agency will only guarantee adjustable rate mortgages with an annual cap of 1 percent, the campaign said. The Dukakis plan would

[82] Stanley Kurtz, Planting Seeds of Disaster , p. 2, http://article.nationalreview.com/374045/planting-seeds-of-disaster/stanley-kurtz?page=1
[83] See Arnold Kling, "Not What They Had in Mind" for an excellent discussion on the impact of the Basel Accords on the financial crisis. http://mercatus.org/sites/default/files/publication/NotWhatTheyHadInMind%281%29.pdf
[84] http://www.fdic.gov/bank/analytical/fyi/2003/042103fyi.html
[85] http://www.dallasfed.org/banking/notices/2005/not0566.pdf
[86] GSE Act

> broaden that to a 2 percent cap on annual increases in interest rates and a 5 percent lifetime cap, [and] proposed revisions to F.H.A. standards on mortgage underwriting so that mortgage eligibility could take into account savings and one's history of paying rent 'in excess of otherwise rigid underwriting limits.' Currently, underwriting standards for conventional mortgages require that monthly mortgage, interest and tax payments not exceed 28 percent of one's income, the campaign said"[87]

Fresh from the lessons learned during the housing crash that had occurred just a few years before in Texas, Professor Anthony Sanders pointed out the dangers of such policy changes:

> "Ask investors in Houston how they would have liked it if they'd been stimulated to buy housing."[88]

1990-A:

As a result of the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, federal regulators and Fannie and Freddie adopt a new definition of "market value" (emphasis added):[89]

> *"Market value* means the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming **the price is not affected by undue stimulus**. Implicit in this definition are the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:
>
> (1) Buyer and seller are typically motivated;
>
> (2) Both parties are well informed or well advised, and acting in what they consider their own best interests;
>
> (3) A reasonable time is allowed for exposure in the open market;
>
> (4) **Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto**; and
>
> (5) The price represents the normal consideration for the property sold **unaffected by special or creative financing or sales concessions granted by anyone associated with the sale**."

[87] NYT "Dukakis, in Levittown, Offers a Plan To Help Young Families Buy Homes", October 11, 1988, http://www.nytimes.com/1988/10/11/us/dukakis-in-levittown-offers-a-plan-to-help-young-families-buy-homes.html
[88] Id.
[89] http://www.fdic.gov/regulations/laws/rules/6000-1700.html

While explicit in this definition is that the financing terms not affect the price, the bullish impact on demand and home prices of loosened underwriting standards was ignored by regulators and the GSEs. The underwriting changes that would shortly spread throughout much of the housing finance industry would create additional demand and act as a stimulus to prices. Loosened loan terms would constitute "financial arrangements" that were not comparable to cash. The potential for this type of price distortion was noted in a standard appraisal handbook over a half century ago.[90]

1991-A:

In the late 1980s-early 1990s, the first mortgage industry has 3 non-overlapping and well defined components:

1. The investment quality mortgage loan market alternately known as the prime, "A" or conventional lending market. Fannie and Freddie set strict lending standards as they were expected to acquire mortgages meeting the investment standards imposed by private institutional mortgage investors;[91]

2. Government loans consisting of loans that would be non-investment or non-prime quality but for their government guarantee; and

3. Non-investment quality or subprime mortgage loans were loans that did not "meet the underwriting criteria set forth by [Fannie and Freddie][92].

The investment quality, "A" or prime loan segment constitutes 79% of the market in 1991.[93] Fannie and Freddie are the biggest players in and largely set loan standards for this segment. "A" quality loans are conservatively underwritten in terms of LTV, credit history, debt ratios,

[90] This is not a new concept as this excerpt from a 1951 appraisal handbook demonstrates: "Assume that we are dealing with two residential properties in two different cities, which we shall call City *A* and City *B*. Both of these cities, we shall assume, have the same population history and trend, the same social and economic background, and the same supply and demand ratio. In each city, we have a residential property to appraise. Each of these properties is similarly environed, of the same size, quality, utilitarian capacity, and cost. The only factor of difference in the problem is the local custom concerning terms of sale, which we may assume are 25 per cent down and 5 years to pay the balance in the case of City *A*, and 10 per cent down and 15 years to pay the balance in City *B*. Does it now follow that, because of this difference in the terms of sale, the property located in City *A* may conceivably be valued at $10,000, and the property in City *B* at $12,500?, The answer is no; the value is the same in each case, but the price differs because the price as finally fixed in each case stems from the terms agreed upon." Pp. 18-19, May's "The Valuation of Residential Real Estate" copyright 1942, 1951. If you have any doubt as to the correctness of May's result, consider the last time you purchased a car. Perhaps you were offered a car with a price of $23,000 and the option of either a 60 month loan at 0% or $3000 cash back. We all know that the price of the car is $20,000 and that the $3000 is the cost of bringing the interest rate to zero.

[91] Under Fannie Mae's charter, it was restricted to purchasing loans "of such quality, type, and class as to meet, generally, the purchase standards imposed by private institutional mortgage investors." p. 14, http://www.fanniemae.com/aboutfm/pdf/charter.pdf

[92] Thomas LaMalfa, "The Market for Non-Investment Quality Loans", Wholesale Access, Vol. 1, No. 7, p..3, December 1989. Document contained in the author's files.

[93] Inside Mortgage Finance

and other risk characteristics.[94] These characteristics are quite different from both FHA and Subprime loans. The following are selected characteristics of "A" loans as represented by a sample of Fannie Mae's loans from 1988-1991:

1. Low loan-to-values predominate (78.5% have LTVs <=80% and 5.5% have LTVs >90% and <=95%). Zero percent have an LTV >95%:[95] Loans with an LTV of 95% are subject to stricter standards than those with larger downpayments.
2. Cash-out refinances have conservative LTV limits with 1% of cash out refinances having an LTV >80% and 9% having an LTV >75%;
3. Seven percent of rate and term (no cash out) refinances have an LTV >80% and 25% have an LTV >75%;
4. Forty-two percent of first time homebuyers have an LTV >=90% and <=95% compared to 24% of repeat home buyers (excludes home refinance borrowers);
5. Only 4% of loans are combination loans (a first mortgage acquired by Fannie with a second mortgage held by a third party) and only one in four of these combination loans have a first mortgage LTV >75%. The maximum combined LTV (CLTV) is 90%;
6. Past mortgage credit is near perfect (98% have no mortgage late payments and 99.5% have no or at most 1 late mortgage payment. Ninety-nine percent of borrowers with a downpayment of 5% had a perfect mortgage payment history;
7. Past revolving credit was very good (69% have no late payments, 79% have one or none, 85% had two or fewer, and 89% have 3 or fewer);
8. Ninety-one percent of borrowers have at least 2 months in cash reserves;
9. Eighty percent of borrowers have a housing debt ratio <=28% and 94%<=33%;
10. Seventy-six percent of borrowers have a total debt ratio <=36% and 86%<=38%; and
11. Few loans finance investor properties (2% of all loans) or 2-4 unit properties (3% of all loans).

The FHA loan segment constitutes 12% of the market in 1991.[96] FHA loans have much higher risk characteristics than Prime loans as evidenced by the following selected characteristics:[97]

1. Seventy-nine percent of loans have an LTV >90% and 17% have an LTV >=97%;
2. In 1997 (earliest data available) 30% of FHA borrowers had a FICO below 620 as compared to 7% for Prime loans (also in 1997).[98] Loans with a FICO below 620

[94] Fannie Mae Random Sample Review, prime loan characteristics are from a random sample review of Fannie Mae's single-family acquisitions for the period October 1988-January 1992, dated 3.10.1992. Document contained in the author's files.
[95] At the end of 2007 Fannie reported that 15% of its entire credit book had an LTV or combined LTV >95% (about half of which had no down payment). Given that combination loans are poorly reported, 15% is a conservative figure. This compares to 0% of Fannie's credit book in 1992. Source: Fannie's 2007 10-K, p. 128.
[96] Inside Mortgage Finance
[97] FHA 2009 Actuarial Report
[98] Mortgage Banking, October 1997, "The Stampede to Subprime"

corresponded to the "B"–"D" subprime grades in terms of credit.[99] No data was provided for the "A-" or 620-659 FICO category; and

3. As noted previously at **1985,** in 1982 30% of FHA's loans had debt ratios that exceeded its limits of 38% for housing debt and 53% for total debt. It is highly unlikely that this percentage had declined since 1982. Ten percent of Fannie's loans exceeded a combined 28% housing and 36% total debt ratio.

The self-denominated subprime segment constitutes 10% of the market.[100] [101]Subprime loans have much higher risk characteristics than Prime loans. They were generally graded as "A-"[102] (43% of subprime), "B" (25%). "C" (20%) or "D" (4%):

1. Twelve percent are for home purchases and 68% are for refinance (the balance had an unknown purpose);[103]
2. In 1989 cash equity of 20% or more was common on "A-" loans, with several investors setting a maximum of 75%.[104] Maximum LTVs of 70-75% and 60-70% respectively were required on "B" and "C" loans. In 1991Fannie's and FHA's medians LTVs were about 73%[105] and 95% respectively.
3. While 99.5% of Fannie's borrowers had 1 or zero mortgage late payments), the best subprime grade ("A-") allowed for two 30 day mortgage late payments in the past 12 months. "B" and "C" grade loans could have increasing amounts of delinquencies of varying types and other evidence of impaired credit.[106] As noted above the trade-off for a greater level of impaired credit was more substantial borrower equity.
4. Maximum total debt ratios were 45%, 50%, and >50%, for "A-", "B", and "C" grades respectively.[107]

Based on these underwriting characteristics, the three market segments were quite distinct. The prime market generally served borrowers with low to medium LTVs (however first time home buyers have a substantially higher usage of high LTV financing), excellent credit, and moderate debt ratios. The FHA market served borrowers (particularly home purchase and first time homebuyers) with high LTVs, approximately half with impaired credit (a FICO below 660), and high debt ratios (similar to subprime). The subprime market primarily served borrowers getting

[99] Fitch IBCA, "A New Look at Subprime Mortgages", December 16, 1996. Document contained in the author's files.
[100] Inside Mortgage Finance
[101] In those instances where data from 1995, 1996, or 1997 is used, it is believed to be generally representative of the 1991 time period.
[102] In 1989 "A" was the best grade of subprime loan, with "B" being the second best. By the mid-1990s as competition increased between the GSEs and subprime lenders, the best grade became known as "A-" to distinguish it from GSE mortgages which were called "A". In this paper, the best grade of subprime will be referred to as "A-".
[103] Supra. "The Stampede to Subprime"
[104] Supra. Thomas LaMalfa, "The Market for Non-Investment Quality Loans", p. 6
[105] Supra. Fannie Mae Random Sample Review
[106] Supra. Thomas LaMalfa, "The Market for Non-Investment Quality Loans", p. 6
[107] Id. pp. 4-5

cash out refinances with medium to low LTVs, most with impaired credit, and with high debt ratios. Not only were these markets quite separate and distinct, prime originators did not originate subprime loans and vice versa and a loan qualifying for FHA rarely met prime loan standards.[108] All of this would change in 1992 with the passage of the GSE Act. Post 1992 the GSEs would be required to substantially increase their acquisitions of low- and moderate-income borrowers – the same customer bases relied on by FHA and subprime. To accomplish this they would need to depart from the investment quality credit standards that distinguished "A" lending from FHA and subprime.

1991-B:

Karl Case and Robert Shiller had been studying housing booms for a number of years. In a 1991 interview, Case commented on the doubling of house prices in Boston over 1984-1987:[109]

> "[t]he Massachusetts economy was pushed into its current recession by the real estate boom that lasted from 1984-1987. Over that time, some $100 billion in real estate equity was 'created' in Boston by the rising prices of single-family residences. In response to the demand for housing, construction went ahead at a feverish pace. When the boom ended, tens of thousands lost their jobs. In February [1991] unemployment in Massachusetts stood at 9.3%. Case believes that in the absence of the boom, the economy would have slowed but not reached the "potentially catastrophic recession" it is now experiencing."

[108] Id.
[109] "The Analytical Economist: Bursting Bubbles", Scientific American, May 1991, Document contained in the author's files.

Stage 2: Congress turns to Fannie and Freddie in a further effort to increase low- and moderate-income housing and invigorate CRA

1991-C:

Community groups once again turn their attention to Fannie and Freddie. Unlike FHA, Fannie and Freddie were off-budget (as were banks). A key community organizer tells the U.S. Senate Committee on Banking, Housing, and Urban Affairs:

> "[i]t became increasingly clear that [Fannie and Freddie had] been a hidden loan officer at the loan origination table."[110]

1991-D:

In a similar vein, HUD's Advisory Commission on Regulatory Barriers to Affordable Housing stated in its 1991 report:

> "The market influence of Fannie Mae and Freddie Mac extends well beyond the number of loans they buy or securitize; their underwriting standards for primary loans are widely adopted and amount to national underwriting standards for a substantial fraction of all mortgage loans."[111]

The Commission also found that:

> "Fannie Mae and Freddie Mac's underwriting standards are oriented towards 'plain vanilla' mortgages."[112]

1991-E:

Congress was becoming interested in addressing what it perceived as overly conservative underwriting standards.

> "'Lenders will respond to the most conservative standards unless [Fannie Mae and Freddie Mac] are aggressive and convincing in their efforts to expand historically narrow underwriting.' This point was reinforced over and over again by other [community

[110] Allen Fishbein, "Filling the Half-empty Glass: The Role of Community Advocacy in Redefining the Public Responsibilities of Government-Sponsored Housing Enterprises", Chapter 7 of Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions, 2003, Gregory Squires, editor
[111] "Not in My Back Yard: Removing Barriers to Affordable Housing", Chapter 5, page 3 http://www.huduser.org/Publications/pdf/NotInMyBackyard.pdf
[112] Id. Chapter 3, page 13

advocacy] witnesses." (U.S. Senate Committee on Banking, Housing, and Urban Affairs 1991)[113]

This statement provides a clear indication as to Congress' intent when it passed the GSE Act of 1992 the following year. Rather than being viewed as prudent, the GSEs' standards were attacked for being inflexible and too conservative. Ignored was the fact that these standards were designed to originate sustainable loans in a safe and sound manner. They were based on the "Three Cs of Mortgage Credit". As noted previously, Fannie's underwriting standards had undergone a thorough risk based review in 1985 to address the substantial losses it had incurred on high LTV and highly leveraged loans in the early 1980s.

Community groups were determined to replace the Three Cs of Mortgage Credit with flexible and loosened lending standards as the means to invigorate the largely dormant CRA. As the above quotes demonstrate, NPA and other community groups viewed Fannie and Freddie as the central roadblock to expanded CRA lending. These groups wanted Fannie and Freddie to agree to lower downpayment requirements and other flexibilities. To accomplish this, Fannie and Freddie would either need to be convinced to support CRA voluntarily or forced to by Congress.

While the following quote is from 1994, it illustrates how the GSEs' traditional underwriting standards had been perceived:

> "Those guidelines must have been written sometime in the 1800s," says Beverly Hightower, chief lending officer and senior vice president at Family Savings Bank in Los Angeles. "In essence, the guidelines say that if a loan applicant's income-to-housing debt ratio exceeds 28%, they could be perceived as a credit risk." Hightower says the new program will allow a "qualifying flexibility" that will address the fact that black families traditionally spend a higher percentage of their incomes on living expenses."[114]

1991-F

The Federal Reserve Bank releases Home Mortgage Disclosure Act data related to approval and denial rates based on race. Notwithstanding the fact that this study did not take into account loan-to-value, credit history, property type, employment or debt-to-income data, the typical headline announced that discrimination was rampant. For example the New York Times' headline read: "Racial Gap Detailed on Mortgages":[115]

> "The most comprehensive report on mortgage lending nationwide ever issued by the Government shows that even within the same income group whites are nearly twice as

[113] Allen Fishbein, "Filling the Half-empty Glass: The Role of Community Advocacy in Redefining the Public Responsibilities of Government-Sponsored Housing Enterprises", Chapter 7, p. 113 of Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions, 2003, Gregory Squires, editor
[114] "Fannie Mae's trillion dollar giveaway; the government agency pledges money to low- and moderate-income home buyers", Black Enterprise, Nov, 1994, http://findarticles.com/p/articles/mi_m1365/is_n4_v25/ai_15891530/
[115] Michael Quint, New York Times: "Racial Gap Detailed on Mortgages", October 21, 1991, http://www.nytimes.com/1991/10/22/business/racial-gap-detailed-on-mortgages.html?scp=2&sq=&st=nyt

likely as blacks to get loans.… John P. LaWare, a governor of the Federal Reserve Board, said the higher rejection rate for minority applicants disclosed in today's report was 'very worrisome.' The data will be 'red flags for examiners' who will be 'stepping up the intensity and depth' of their reviews, he said. But Mr. LaWare added that the records compiled by the Fed were not enough to prove discrimination, even if they showed much higher approval ratings for whites. Proof of discrimination would require more detailed study of each application, including information on the house to be mortgaged, data on creditworthiness like employment history, and the size of the monthly loan payments relative to the applicant's income….Representative Henry B. Gonzalez, the Texas Democrat who is chairman of the House Banking Committee, said the report showed discrimination in lending to be so pervasive that it was inflicting great pain across the country, whether or not the discrimination was intentional….Maude Hurd, president of the Association of Community Organizations for Reform Now[ACORN], a group frequently critical of bank lending practices, said the study showed that 'if you're a minority, our nation's banks want only your deposits, not your loan application.'…The study showed that in every income category, and for every kind of mortgage loan, black and Hispanic applicants were far more likely to be rejected than whites. In the case of low-income applicants for Government-backed mortgages, which are popular because they require relatively low down payments, 29.4 percent of black and 22.4 percent of Hispanic applicants were rejected, compared with only 14.7 percent of whites. Among high-income applicants, 20.8 percent of black and 14.2 percent of Hispanic applicants were rejected, compared with 8.6 percent for whites."

1991-G:

Having gotten CRA passed in 1977, many of the same groups now appealed to Congress to force change at the GSEs. They find a sympathetic ear, particularly from Henry Gonzales, chairman of the House Banking Committee. Chairman Gonzales "informally deputized [ACORN, Consumers Union, Enterprise Foundation, and Local Issues Support Corporation] to develop workable provisions that would be broadly acceptable to Fannie Mae and Freddie Mac."[116]

In 1986 at most about 7% of all home purchase loans (conventional, FHA, and VA[117]) had a down payment of less than 3%. All of these loans were insured by FHA or VA as the maximum conventional or non-government market did not insure loans with an LTV >95%.

By 1991 the market hadn't changed much with at most 10% of all home purchase loans (conventional, FHA, and VA) having a down payment of 3% or less. FHA was the market leader in providing loans with downpayments of 3% or less with about 47% of its insured loans having such a downpayment. Once again the maximum LTV on conventional loans was 95%. While FHA was steadily moving its core business to ever smaller downpayments, the private sector had

[116] Allen Fishbein, "Filling the Half-empty Glass: The Role of Community Advocacy in Redefining the Public Responsibilities of Government-Sponsored Housing Enterprises", Chapter 7, p. 114 of Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions, 2003, Gregory Squires, editor

[117] There is no year by year LTV data for VA lending. For purposes of these calculations, 100% of VA guaranteed loans are assumed to have a down payment of 3% or less.

not followed suit as a result of its bad experience in the early 1980s. Given that the private sector financed 83% of all home purchase loans in 1991,[118] in order to make further "gains" in the expansion of the <5% downpayment market, the private sector would need to be drafted to the effort.

1991-H:

While Congress and federal agencies had no way of anticipating this, the beginning of the surge in leverage and flexible underwriting standards with respect to affordable housing lending happened to coincide with the resumption of a decline in mortgage rates that had started in the mid-1980s, as shown on Chart 21. While this interest rate decline would not have been sufficient to create the mortgage crisis[119] [120], its erratic nature drove a series of refinance booms with fixed rate mortgage as the product of choice. This played to the GSEs' strong suit – fixed rate loans, thereby helping to drive their market share growth. As Chart 21 shows, during the period 1991-2007 there were 3 periods of rate decline where rates fell below previous highs; early 1991 to early 1994, 1997-1998, and early 2001to early 2004. These periods were marked by sustained refinance booms. The GSEs' share of total outstanding residential mortgage debt increased by 6% over 1991-1993, 2.2% over 1997-1998, and 5.7% over 2001-2003. The gains averaged 1.7% per year during these 9 years compared to 0.9% for the 5 remaining years from 1991-2003. Whereas the GSEs started 1991 with 28.2% share of all outstanding mortgages, they ended 2003 with a 46.8%.[121] Once rates increased in early 2004, the loan market shifted towards adjustable rate mortgages (ARMs). This shift along with more highly leveraged securitization techniques allowed the private sector to better compete with and take share from the GSEs.

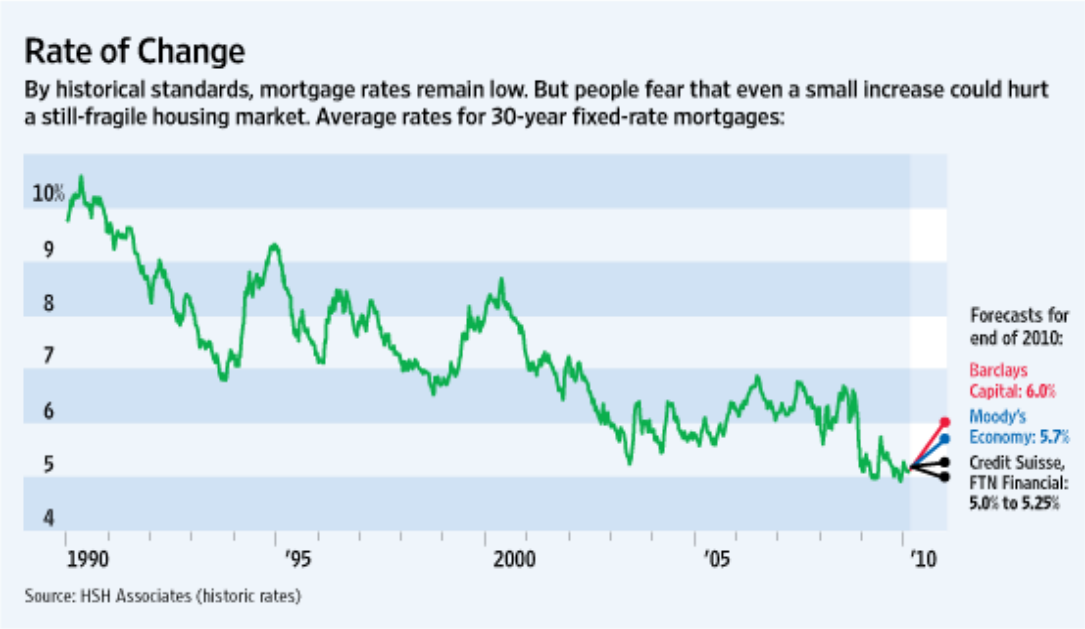
[118] FHFA

[119] Cleveland Federal Reserve Bank, "Why Didn't Canada's Housing Market Go Bust?" http://www.clevelandfed.org/research/commentary/2009/0909.pdf

[120] Long-term rates had been in a secular decline since the early-1980s. There was a much smaller housing boom that occurred in the late 1980s. It was also associated with a bout of weak lending (low doc/no doc and ARMs with potential negative amortization (see also http://www.econ.yale.edu/~shiller/pubs/p1089.pdf). The boom that started in the 1990s was much longer and fueled by much higher levels of leverage increases.

[121] The GSEs' share of total outstanding residential mortgage debt would ultimately decline to 41% by 2007. Source FHFA, http://www.fhfa.gov/webfiles/14597/SFMOutstanding1990to2009Q1.xls

Chart 21 – Interest Rate Trends:



Source: Wall Street Journal

1986-1992:

Events of the late 1980s and early 1990s[122] would join three disparate groups in a common cause: low- and moderate-income housing:

1. Fannie Mae decided in 1986 to give up its government charter and become a private company.[123] This decision was quickly reversed in 1987, when it decided that its funding advantages and implicit government guarantee under its charter were too valuable to surrender.[124] Instead it would turn its focus to protecting its charter privileges. Over the next 5 years (1987-1991) Fannie would develop and begin implementing a strategy to use its low- and moderate-income housing mission as the means to protect its charter franchise. Fannie set out to acquire copious amounts of low- and moderate-income lending in order to capture its regulator, Congress[125], with the goal of assuring that Congress would not change its charter privileges to Fannie's detriment. Lehman Brothers' consultant Jim Johnson was hired in 1988 to more fully develop this strategy.

[122] From 1985-1987 the author was Fannie's Senior Vice President for Marketing and Product Management, with responsibility for single- and multi-family lending and affordable housing and from 1987-1989 was Executive Vice President and Chief Credit Officer.
[123] This decision was not made public
[124] Author's personal knowledge.
[125] Congress had issued Fannie's charter and was the only entity that could change it.

By 1991 Johnson was Fannie's chairman and CEO. In 1991 Johnson announced Fannie's opening bid, a $10 billion affordable housing program called "Opening Doors".[126]

2. As has already been noted, National People's Action (NPA) and ACORN, along with other community groups concluded that Fannie and Freddie's underwriting requirements were to blame for the failure of the Community Reinvestment Act of 1977 (CRA) to gain traction. Having gotten CRA passed in 1977, NPA, ACORN, and other community groups appealed to Congress in 1991 to force change at the GSEs.

3. Congress had long used FHA (created in 1934) as its main tool to provide low- and moderate-income housing. However, FHA was an agency of the federal government and was included in the discretionary portion of the budget. In 1990 Congress had reached a limit in what it could do on budget:

> "In 1990, as part of a new, multiyear budget agreement, the Congress and the President adopted new procedures for deficit control. Those procedures, embodied in the Budget Enforcement Act of 1990, established statutory limits on discretionary spending and a deficit-neutral pay-as-you-go (PAYGO) requirement for new mandatory spending and tax legislation."[127]

Congress had to find another means to fund low- and moderate-income housing. Fannie and Freddie filled the bill perfectly. Both were off budget and both could raise virtually unlimited sums in the capital markets. As an added bonus, this also would meet the demands of community groups.

In 1992 the interests of Fannie, community groups, and Congress converged resulting in passage of the "The Federal Housing Enterprises Financial Safety and Soundness Act of 1992" (GSE Act). Fannie got its wish as the GSE Act formalized its strategy of using affordable housing to protect its key charter privileges – protection that would last until 2008, two months before it and Freddie would be forced into conservatorship. The community groups got their wish now that Fannie and Freddie were now required to loosen underwriting standards in support of CRA. Congress got its wish by moving the affordable housing mission largely off-budget and at the same time, placing itself in a position to take credit for the affordable housing activities of Fannie and Freddie.

---

[126] "Fannie Mae's Johnson Says Corporation Ready to Meet Housing Goals in Legislation", PR Newswire, March 31, 1993, http://www.thefreelibrary.com/FANNIE+MAE%27S+JOHNSON+SAYS+CORPORATION+READY+TO+MEET+HOUSING+GOALS+IN...-a013133485

[127] Congressional Budget Office testimony on Budgeting for Emergency Spending, June 23, 1998 http://www.cbo.gov/doc.cfm?index=591&type=0

1992-A

The Federal Reserve Bank of Boston released a statistical analysis of the 1990 and 1991 HMDA data that attempted to control for all objective indicators of applicant risk. The conclusion was that minorities were 56% more likely to be rejected than whites, down from the Federal Reserve's 1991 report of a rejection rate that was roughly double for minorities[128] (See **1991-F** above). This 1992 report was criticized for serious deficiencies and errors such as miscoded data and omitted variables. This prompted the Boston Fed to publish much of its underlying data to allow others to critique its work (see **1993-D**).[129] [130]

Notwithstanding its potential deficiencies:

> "This study appears to have been regarded by both the press and by policymakers as being decisive. Articles in the *New York Times* and *Wall Street Journal* had a spokeswoman for the Office of the Comptroller of the Currency saying "this study is definitive," the president of the Boston Fed saying "the study found discrimination in mortgage lending based on race" and "I don't think you need a lot more studies," and a reporter claiming that the study's results were "all but absolute." The study has had a tremendous impact upon public policy, with severe penalties for mortgage lenders that failed to alter their evaluation policies for minority applicants. For example, banks have been prevented from merging and have faced large civil fines in discrimination suits.[131]

1992-B:

In an unprecedented action the GSE Act of 1992 makes the community groups' desire for loosened underwriting the law of the land. It embodied a desire by Congress to break lenders of their conservative lending standards by requiring the GSEs do the same. Congress' decision to impose significant affordable housing goals on Fannie and Freddie (and expecting the GSEs' demand for CRA loans to jump start CRA) looks to be the ultimate free lunch. Unlike FHA, which was on budget, low- and moderate- income loan investments by Fannie, Freddie, and

---

[128] Alicia Munnell, et. al., Mortgage Lending in Boston: Interpreting HMDA Data, #92-7, October 1992 http://www.bos.frb.org/economic/wp/wp1992/wp92_7.pdf

[129] James H. Carr and Isaac F. Megbolugbe, Journal of Housing Research, Vol. 4, issue 2, 1993, p. 277, "The Federal Reserve Bank of Boston Study on Mortgage Lending Revisited", http://www.knowledgeplex.org/kp/text_document_summary/scholarly_article/relfiles/jhr_0402_carr.pdf

[130] "Minority applicants with the same financial, credit history, employment, and neighborhood characteristics as the white applicants in Boston would have experienced a denial rate of 17 percent rather than the actual white denial of 11 percent." Statement by Richard F. Syron, President, Federal Reserve Bank of Boston, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 24, 1993, http://findarticles.com/p/articles/mi_m4126/is_n4_v79/ai_13815155/?tag=content;col1

[131] William S. Neilson, Symposium the Mortgage Discrimination Controversy, Economic Inquiry, Vol. 36, 1998, http://www.questia.com/googleScholar.qst;jsessionid=LpkV6FhZfBJbysk53lncFwhdQ12MV12vdqvVnC0DrrYVNpj6lc1v!1094675332?docId=96521811

banks under CRA were off budget with no apparent budget impact.[132] The GSE Act effectively requires the "A" paper or Prime market (largely consisting of the GSEs and banks) to compete with the two high risk areas of market – FHA and subprime. In a study by the Fannie Mae Foundation in 2000, it was observed:

> "FHA loans constituted the largest share of Countrywide's activity, until Fannie Mae and Freddie Mac began accepting loans with higher LTVs and greater underwriting flexibilities."[133]

The mandates of the GSE Act quickly unleash actions and reactions as market competitors react to the changed landscape. Once the Prime market is forced to loosen underwriting standards in an effort to promote affordable housing, most of these same standards are made available to all borrowers regardless of income. The community groups had three goals, all of which were embodied in the GSE Act of 1992:

1. The GSE Act of 1992, for the first time, set formal affordable housing goals for Fannie and Freddie. The GSEs were expected to "lead the market" (a market which included FHA) and HUD was authorized to set annual low- and moderate-income goals which over time grow from 30% (1993) to 56% (2008). The GSE Act set a conservative interim low- and moderate-income goal of 30%, basically the level that the GSEs had already been attaining. While no interim Special Affordable goal[134] is set, the statutory minimum for this goal is 1%.[135]

2. Congress made clear that it wanted Fannie and Freddie to get much more active in high LTV lending (>=95% LTV) and other loosened underwriting. It mandated a study on "the extent to which their underwriting guidelines prevent or inhibit the purchase or securitization of mortgages for housing located in mixed-use, urban center, and predominantly minority neighborhoods and for housing for low- and moderate-income families." It was in this context that Fannie and Freddie were asked to examine the implications of implementing underwriting standards that:

   > "(A) establish a downpayment requirement for mortgagors of 5 percent or less;
   >
   > (B) allow the use of cash on hand as a source for downpayments; and

[132] For a more complete description of the role these groups had in the passage of the affordable housing provisions of the GSE Act see Allen Fishbein, "Filling the Half-empty Glass: The Role of Community Advocacy in Redefining the Public Responsibilities of Government-Sponsored Housing Enterprises", Chapter 7 of Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions, 2003, Gregory Squires, editor

[133] Fannie Mae Foundation, "Making New Markets: Case Study of Countrywide Home Loans", 2000, http://content.knowledgeplex.org/kp2/programs/pdf/rep_newmortmkts_countrywide.pdf.

[134] Applicable to the low- and very low-income group, defined as less than 80% and 60% of median income respectively.

[135] Sections 1332 and 1333 http://en.wikisource.org/wiki/Housing_and_Community_Development_Act_of_1992/Title_XIII/Subtitle_A/Part_2/Subpart_B#Subpart_B

(C) approve borrowers who have a credit history of delinquencies if the borrower can demonstrate a satisfactory credit history for at least the 12-month period ending on the date of the application for the mortgage."[136]

3. Require Fannie and Freddie to affirmatively assist banks in meeting their CRA obligations.[137]

The GSE Act of 1992 effectively forced Fannie and Freddie to loosen their underwriting standards, greatly expand their acquisitions of loans to low- and moderate-income borrowers, become competitors of FHA, and provide a ready source of demand for CRA loans so as to help the GSEs meet their affordable housing requirements as set by HUD.

The significance of the request relating to loans with downpayments of 5% or less cannot be overstated. In 1992 a conventional loan with less than 5% down did not exist. Only FHA (and VA) insured such loans. By Congress mandating the GSEs to compete directly with FHA, the development of this highly risky loan product was pre-ordained.

The GSE Act of 1992 also hard wired the GSEs' capital requirements. Capital levels were set at 0.45% (222:1 leverage) for off-balance sheet assets such as MBS and 2.5% (40:1 leverage) for on-balance sheet assets such as mortgage loans. This allowed the GSEs to operate at much higher leverage levels as compared to their competitors.

These new capital levels worked in tandem with the risk based capital requirements noted earlier (**1988-B**). For example, on a Fannie MBS, Fannie was required to hold capital of 0.45% and the bank buying the MBS to hold 1.6%, for total capital of 2.05% and a leverage ratio of 49:1. If the bank held the same loan in whole loan (not securitized) form in its portfolio, its capital requirement was 4% for a 25:1 leverage ratio. If the same loan was part of a private MBS, the capital required of a bank holding the MBS was 8% for a 12.5: leverage ratio.

By using CRA as a justification for the GSE Act of 1992, it acted like a delayed action fuse leading to its passage. The GSE Act itself was the powerful trigger that set in motion a series of the events that would lead to the mortgage meltdown and the collapse of the housing market. By 1995 all the policies central to igniting a housing boom built on weakened loan standards would be in place.

1992-C:

An element central to the GSEs was their ability to crowd out[138] their competitors. From the early 1990s until 2003, the GSEs' dominance over the mortgage market grew stronger and

[136] Section 1354, http://en.wikisource.org/wiki/Housing_and_Community_Development_Act_of_1992/Title_XIII/Subtitle_A/Part_3#Sec._1354.
[137] Id. Section 1335

stronger each year. Their combined share of all single family mortgages outstanding grew from 25.4% in 1990 to 46.8% in 2003.[139] The GSEs were able to grow so rapidly because of their advantageous charter provisions – in particular their access to unlimited amounts of low cost debt due to their implicit federal guarantee and their congressionally set high leverage levels. These government-granted advantages promoted an unrestrained appetite for growth and permitted them to aggressively protect and grow their share of the mortgage market.

Being a statutory duopsony[140], the GSEs had the ability to beat any competitor in any arena in which they chose to compete. This was the case with respect to both government (FHA) and private sector competitors. The GSEs' government advantages allowed them to dominate the market for all types of loans, be they traditional or "plain vanilla" or higher risk loans. As a result there wasn't enough spread left for the private sector to invest in these loans profitably. This helps explain why it is not surprising that Fannie and Freddie did not end up with the loans with the highest risk characteristics. Yet given that their MBS and portfolio investments were leveraged at 222:1 and 40:1 respectively, high risk loans with a single layer of risk (such as a downpayment of 3% or 0%) represented an extremely high risk for such thinly capitalized entities.

In general the GSEs' competitors were relegated to the higher risk portions of the market: subprime, Alt-A, second mortgages, jumbo lending, and ARMs. However, even in the subprime, Alt-A and ARM markets segments, the GSEs would aggressively compete for the lower risk portions of these markets. This forced the GSEs' competitors to either focus on loans with more risk layering or invent more exotic loan instruments, loans where spreads and profit margins were higher. In economic terms, these factors acted to crowd out the GSEs' competitors (largely banks, traditional subprime lenders, securities firms, and insurance companies). In response to this crowding out, their competitors moved further out the risk curve in search of higher yields.

HUD was required to consider GSEs' ability to lead the market when it set their affordable housing goals.[141] As HUD increased the GSEs' goals in response to this requirement, crowding out resulted from the GSEs' advantages which allowed them to take the lowest risks (including the lower risks among high risk loans), decrease profit margins in the industry, gain market share, and absorb most of the industry's profits.

---

[138] "Crowding out" refers to the government providing a service or good that would otherwise be a business opportunity for private industry. Wikipedia

[139] Source FHFA, http://www.fhfa.gov/webfiles/14597/SFMOutstanding1990to2009Q1.xls

[140] BusinesssDictionary.com, A duopsony is a "market situation in which only two buyers create the entire demand for a commodity supplied by many sellers, a mirror image of duopoly."

[141] http://en.wikisource.org/wiki/Housing_and_Community_Development_Act_of_1992/Title_XIII/Subtitle_A/Part_2/Subpart_B#Subpart_B

1992-D:

Chart 22 compares the growth of FHA's and Fannie's >=97% LTV business from the key date of 1992, the year the GSE Act was passed.[142] The GSE Act caused first Fannie and eventually Freddie to compete with FHA; Chart 22 illustrates this competition. The >=97% LTV business was key to helping the GSEs meet their affordable housing goals.[143] As HUD set higher goals, the portion of the GSEs' business with downpayments of 3% or less increased. Goal increases took effect in 1996, 2000, 2005, 2006, and 2007. FHA's own >=97% LTV activity about doubled from 1998 to 1999 (increasing from 23% to 44%), putting new pressure on the GSEs. The GSEs' performance was being compared to FHA. As FHA's LTVs increased, this impacted the GSEs' mandate to lead the market, a mandate enforced by HUD. Fannie's percentage of purchase loan volume with >=97% LTV increased about 8-fold from 1997 to 2007.[144]

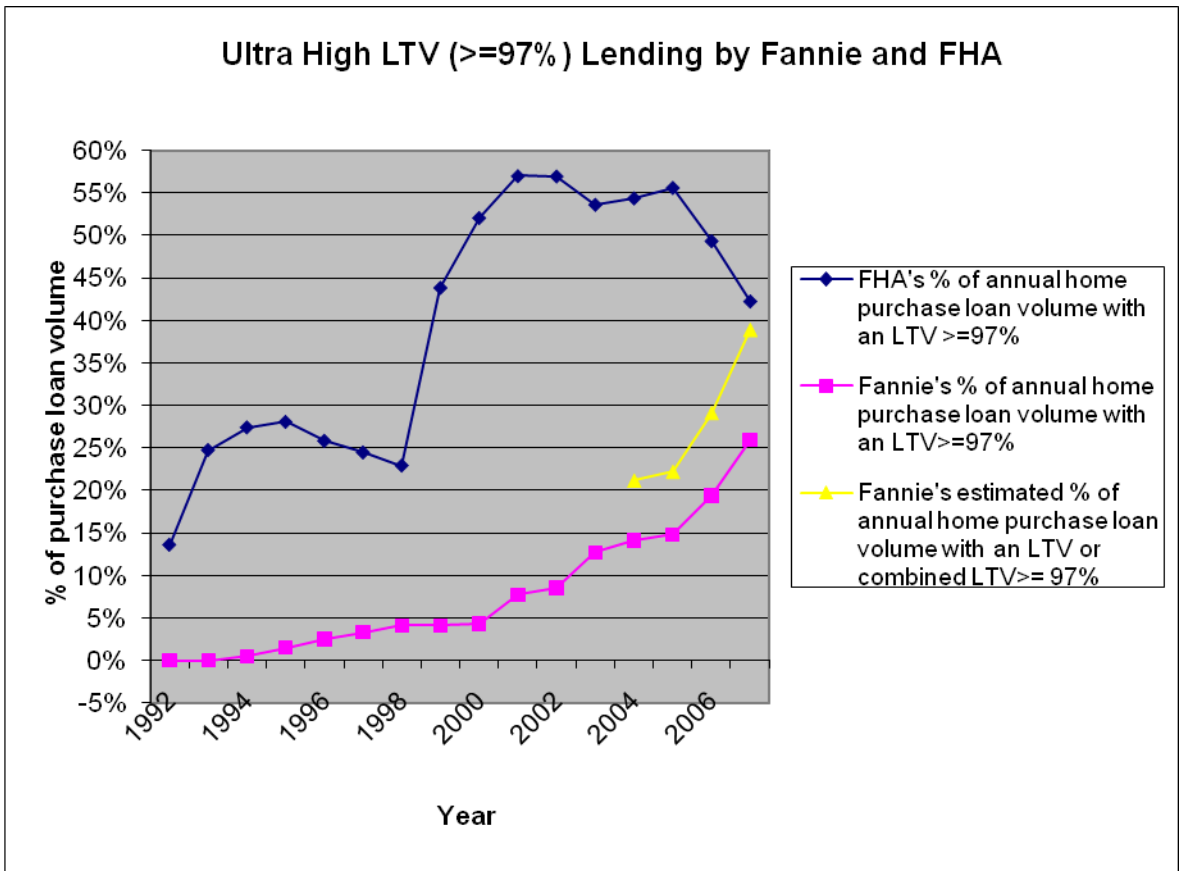
[142]In 2000 100% LTV loans with private mortgage insurance became available. In about 2002 the use of combination 1st and 2nd mortgages started taking substantial market share from the private mortgage insurance industry. By about 2004 80% first and 20% second combination loans became prevalent. By 2007 only about 2/3 of Fannie and Freddie's business with a down payment of 5% or less had mortgage insurance. The other 1/3 consisted of combination loans. (Source: Fannie and Freddie 10-Qs). An 80% first and 20% second combination loan did not require mortgage insurance since the LTV on the 1st mortgage did not exceed 80%.

[143] For example, in 2007 50.9% of Fannie's Special Affordable Purchase Loan goal was met with loans with LTVs of greater than 95% (effectively equal to or greater than 97%).

[144] FHA data found in FHA's 2009 Actuarial Review, Exhibit IV-5, the GSEs' data found in HUD document - "The GSEs' Funding of Affordable Loans: a 2000 Update", Table 9a covers 1997-2000 (http://www.huduser.org/portal/publications/pdf/workpapr13.pdf), HUD document – "Profiles of GSE Mortgage Purchases in 1999-2000", Tables 14a & b (1999 & 2000), HUD document – "Profiles of GSE Mortgage Purchases in 2001-2004", Tables 14a & b (2001-2004), and HUD document – "Profiles of GSE Mortgage Purchases in 2005-2007", Tables 14a & b (2005-2007). The last 3 HUD documents are found at http://www.huduser.org/DATASETS/gse/profiles.html.

Note: while the document entitled "The GSEs' Funding of Affordable Loans: a 2000 Update (2000 Update)" refers to an LTV ratio of "95% and over", this is incorrect and should read ">95%". This is clear because all the LTV categories shown in 2000 Update at Table 9a have this overlapping error and because the document entitled "Profiles of GSE Mortgage Purchases in 1999-2000" (Profiles 1999-2000) covers some of the same data and in Table 14a-2000 defines the category correctly as "95%<LTV". The number of >95% loans shown in this document tie precisely to 2000 Update. For example, Fannie's total home purchase loans with an LTV of >95% for 2000 is listed in Profiles 1999-2000, Table 14a (2000) as 51,855 loans and precisely ties to the total as listed in 2000 Update, Table 9a also for Fannie.

Chart 22:



Sources: FHA's 2009 Actuarial Study, Fannie's 2007 10-K, HUD"s Office of Policy Development and Research - Profiles of GSE Mortgage Purchases in 1999 and 2000, in 2001-2004, and in 2005-2007 (found at http://www.huduser.org/portal/datasets/gse/profiles.html) Compiled by Edward Pinto

The fact that by 2007 Fannie would roughly match FHA's percentage of >=97% loans in 14 years is nothing short of spectacular. In 1991 FHA did over $7 billion of home purchase loans with down payments of 3% or less to the GSEs' volume of $0. By 2007 FHA was doing an estimated $16 billion in such risky loans compared to an estimated **$140 billion** by the GSEs (includes both LTVs and combined LTVs >=97%). In 2000 the GSEs first started acquiring 0% down loans. By 2007 about half of the $140 billion in loans acquired by the GSEs with LTVs or combined LTVs of >=97% are estimated to have had down payments of 0%.[145]

While working for GE Capital's mortgage insurance subsidiary in the early 1990s I completed a research study on the relationship of house price movements and current and original LTVs in neighborhoods. Neighborhoods with high current LTVs tended to be ones with a high usage of FHA financing. These neighborhoods with high current LTVs experienced larger price declines

[145]Data noted in this paragraph was derived from Fannie's 10-Q Credit Supplement and FHA's 2009 Actuarial study.

than similarly priced neighborhoods with low current LTVs. This effect of a high level of low down payment lending on a neighborhood was dubbed the "FHA effect". Too little combined equity among owners in a neighborhood leaves little cushion to absorb the inevitable ups and downs in home prices. Prices sink as demand plummets **AND** supply soars. A stressed homeowner looks out the window and sees a sea of for sale signs and adds his (either voluntarily or by being foreclosed). Neighborhoods with high equity levels experience plummeting demand, however supply does not necessarily soar as these homeowners don't have to sell – they have staying power. This helps protect the entire neighborhood.

1992-E:

The dollar volume of announced CRA commitments announced by banks in 1992 ($33.708 billion) is nearly quadruple the **cumulative** volume over 1977-1991 ($8.808 billion). The increase is largely due to the banks announcing proposed mergers simultaneously with large new multi-state or national CRA commitments (called unilateral agreements by the National Community Reinvestment Coalition or NCRC).

1992-F:

FHA's annual foreclosure start rate hits 1.79%; almost double the 1% level in 1961. Notwithstanding this troubling foreclosure trend, government housing policies were being put in place that mandated loosened underwriting standards, as part of a well-publicized effort to increase the homeownership rate, ultimately to 70% by the end of 2006.[146]

1992-G:

Self-denominated[147] subprime loan volume accounts for a 9% share of total origination volume (combined volume of conventional and government lending). Market share declines to 8% by 2003[148] as the GSEs and FHA expand their subprime lending, almost all of which is not denominated as subprime even though the borrowers are credit impaired as they have a FICO <660.

1992-H:

Countrywide was consulted by Fannie Mae in 1992 during the design of Fannie Mae's Community Home Buyers Program.[149]

Countrywide and Fannie Mae announce a $1.25 billion commitment to originate Fannie Mae's affordable home mortgages, including reduced down payment loans:[150]

[146] HUD Issue Brief, December 2000, p. 1, http://www.huduser.org/Publications/PDF/homeownership.pdf
[147] These are subprime loans that were denominated as subprime by the originator. Subprime borrowers usually have impaired credit. There are many other types of subprime loans that were not called subprime. These include most FHA loans (those with a FICO below 660) and Fannie and Freddie loans with a FICO below 660.
[148] Source Inside Mortgage Finance
[149] Supra., Fannie Mae Foundation

> "The $1.25 billion of affordable-housing mortgages is the largest of its type to date and includes an innovative "second review" by Countrywide of mortgage applicants who do not initially qualify. Many of the affordable-housing loans will use Fannie Mae's Community Home Buyer's Program (CHBP). CHBP provides flexible underwriting criteria, including loans up to 95 percent of the home's value, with a provision for a 3 percent down payment by the borrower and a 2 percent contribution from gifts or other assistance programs."

Countrywide's founder and CEO, Angelo Mozilo, appears to have decided upon the same strategy as Fannie's Jim Johnson. In Mozilo's case he plans to use copious amounts of affordable housing to cement his relationship with the GSEs and HUD.

1993-A:

By February Fannie has approved 260 underwriting variances on nearly $5 billion of loans relating to 169 Community Home Buyers Programs (CHBP). These were just the variances to Fannie's standard CHBPs, which already benefited from loosened underwriting. Eighty percent of the dollar volume of variances was granted to banks subject to CRA. Variances included "allowing adjustable rate mortgages instead of fixed rate mortgages, three and four family properties instead of single family properties, down payments of less than 3%, combined loan-to-value ratios that exceed 100%, waiver of counseling requirements, allowing third party originations, and accepting seller contributions beyond [Fannie's] limits."[151]

The variances ACORN received in February 1993[152] were evidence that Fannie had understood Congress' intent as these variances matched up almost perfectly with the flexibilities Congress had asked the GSEs to study 5 months earlier. ACORN's request would be a portent of where Fannie, Freddie, and the mortgage industry would be pushed in terms of loosened underwriting.

---

[150] Countrywide press release, July 8, 1992, http://www.thefreelibrary.com/COUNTRYWIDE,+FANNIE+MAE+ANNOUNCE+RECORD+$8+BILLION+COMMITMENT+TO...-a012311554

[151] Fannie Mae Credit Policy document, "Variances to Community Homebuyer and Housing Initiatives Program, April 6, 1993. Document contained in the author's files. The author understands that variances from Fannie and Freddie's "standard" affordable housing programs continued throughout the housing boom period and were a significant factor in meeting affordable housing goals. See also at **2000-H** for a statement by the Fannie Mae Foundation that Fannie offered the greatest level of underwriting flexibilities to its largest customers like Countrywide. Document contained in the author's files.

Variances represent approved changes from published CHBP requirements. They are approved as a variance to the published rule. The variance might be applied to the entire commitment (example: $500 million) or limited to a portion (example: $40 million of the $500 million commitment).

[152] Id.

The approved variances allowed:

1. Downpayments of the lesser of $1000 or 3%;
2. Cash on hand acceptable as a downpayment[153]; and
3. More marginal credit history.

As these variances suggest, Fannie's growing volumes of affordable housing acquisitions had quite different underwriting standards and risk characteristics than its traditional "prime" loans (see **1991**). The line between prime and nonprime or subprime loans was no longer clear. Since these loans were being purchased by Fannie, they were presumed to meet Fannie's risk standards and thus presumed to be "prime". One thing was clear – from a risk perspective most affordable housing loans (with or without variances) were no longer "prime" loans.

1993-B:

By mid-1993 Fannie launches its Community Home Buyer Program to compete directly with FHA's core 203(b) insurance program. It had a 3% down payment provided by the borrower and 2% from other sources.[154]

1993-C:

Nominal home prices begin an unprecedented and ultimately unsustainable 13 year boom with homes experiencing a cumulative price increase of 150%.

1993-D:

In the spring the [Boston] Fed released data on the loan applications it had used for its 1992 study. This allowed others to perform a careful evaluation of the study and its conclusion that minorities had a 56% higher rejection rate than whites with similar characteristics.

Critics of the Boston Fed study based their concerns on a broad range of perceived shortcomings, ranging from data deficiencies and the omission of key variables to questions about the study's theoretical and conceptual context.[155]

One such study was done by Mark Zandi, who used the same statistical techniques the Fed used:

> "One critical factor the Fed failed to consider was the state of the economy and housing markets in Boston during 1990."

[153] Cash on hand was not accepted as a source of one's downpayment because it could not be verified as to source or duration. Without this restriction, it would be easy for the seller to increase the sales price and provide the cash for the downpayment to the buyer.
[154] Fannie Mae Credit Policy document, "Summary Comparison of Proposed 3% CHBP Requirements with FHA 203(b) Requirements", July 22, 1993. Document contained in the author's files.
[155] Supra. James H. Carr and Isaac F. Megbolugbe, p. 278

> "Home prices were declining. Homes selling at prices among the bottom third during the period fell by 19%. Mid-priced homes experienced declines of 9%, high-priced homes only 2%."
>
> "With low-priced homes falling more rapidly in value than higher-priced homes, purchasers of lower-priced homes were rejected by lenders more often."
>
> "Because black and Hispanic homebuyers generally purchase lower-priced homes. Boston lenders rejected blacks and Hispanics in greater proportion than whites. This was not discrimination per se, but simply good underwriting."
>
> "The Fed study also curiously omits other variables important in explaining mortgage-lending decisions. These include whether the applicant's credit history met the lender's guidelines; whether the borrower submitted information that could not be verified; the presence of a cosigner; and the loan amount."
>
> "Including these variables in the statistical analysis reduces the rejection rate for a black or Hispanic from 60% greater than a white applicant's to 23% greater."
>
> "Nor does the Fed study make adjustments for what appear to be obvious data encoding errors. One mortgage applicant was listed with a loan-to-value ratio of 946%. Correcting for this and other errors in the initial loan-to-value ratio further reduces the rejection rate for blacks and Hispanics -- to 14% greater than that of white applicants."
>
> "The Fed researchers elected not to use a matched sample because they did not want to prejudge the causes of rejection. But having determined the significant factors influencing mortgage lending in their unmatched analysis, it would then seem appropriate to conduct the analysis using a matched sample."
>
> Using a matched sample does away with the impact of race on mortgage lending decisions. The probability that a black or Hispanic will be rejected falls from 14% greater than a white applicant to a statistically insignificant 3% greater."[156]

Another was done by Stanley Liebowitz:

> "The banking industry stands accused and convicted, by the media and others, of engaging in lending practices that discriminate against minorities. When the New York Times reported this week that 'shamed and embarrassed' lenders were 'finally' opening their doors to minority groups, it quoted one advocacy lawyer as saying: 'It's a little hard to cheer too loudly; we are still in the early stages of overcoming decades of prejudice and neglect.'"

[156] Mark Zandi, "Boston Fed's bias study was deeply flawed", American Banker, August 19, 1993, http://www.highbeam.com/doc/1G1-14227092.html

> "The authors of the Fed study claim that they scrupulously weeded out errors by examining the data for inconsistencies. But a colleague and I performed several checks on the raw numbers and were astonished to discover literally hundreds of errors or likely errors."
>
> "The first item to catch our attention was net worth. There are 20 mortgage applicants having a net worth in the range of a negative half million dollars, meaning they already owed that amount. There are 27 mortgage applicants who, even if they devoted 50% of their incomes to paying off their debts, would need more than10 years to get out of the red."

Mr. Liebowitz goes on to cite numerous other discrepancies, including.

There is one discrepancy pointed out by Liebowitz that I can shed some light on:

> "A second problem with the Boston Fed study is its mixing of loan applications for different property types and different repayment periods. Lenders are very likely to apply different lending criteria to different types of properties. A loan for a multifamily home, for example, is more risky than a loan for a single-family home, since the multiunit homeowner has the additional burden of dealing with tenants."
>
> "When mortgages in the Fed study are grouped according to the type of property being purchased, the results run counter to the study's conclusion."
>
> "For condominiums, which constitute about a fourth of all applications in the sample, there is no relationship between race and mortgage acceptance."
>
> "For multi-unit homes, which make up approximately a seventh of the applications, there is only weak evidence of discrimination. And most of it is due to a single loan application that clearly has errors: a white individual with a yearly income of $52,000 borrowing $979,000 to purchase a house with a price of $118,000! The payments on the loan total only $633 a month, making this one of the loans with a negative interest rate. The loan was approved, causing the Fed researchers to conclude that this was an instance of whites receiving favored treatment. It is far more likely that the true loan amount was only $79,000, or some amount in that range, and that race was irrelevant."[157]

Many of the lenders in the Boston study would have applied Fannie Mae underwriting guidelines (or Freddie Mac's which were similar). As noted at 1985-A Fannie undertook a top-to-bottom review of its underwriting standards in the spring and summer of 1985. This review was prompted by Fannie's adverse experience with loosened underwriting practices in the early 1980s and resulted in the announcement of new standards in August of 1985. As part of that

[157] Stan Liebowitz, The Wall Street Journal, September 1, 1993, http://www.utdallas.edu/~liebowit/1993wsj.pdf Also see Theodore Day and Stan Liebowitz, "Mortgage Lending to Minorities: Where's The Bias?" http://www.utdallas.edu/~liebowit/mortgage/mortgages.pdf

study Fannie found that small single-family rental properties,[158] particularly those with 3 or 4 units presented a much higher risk of default than a single unit owner occupied unit or a 1 or 2 unit rental property. Fannie quite logically placed more stringent downpayment and other underwriting requirements on properties with a rental or investment component, particularly 3- and 4-unit properties. Even with these more stringent standards, in early 1992 Fannie was experiencing a serious delinquency rate of 5% on loans on 3-4 unit properties[159] compared to 0.66% on single unit properties.[160]

Boston had approximately 85,000 housing structures with 1, 2, 3, or 4 units. Sixty percent of these structures had a single unit, 18% had 2 units and an estimated 21% had 3 or 4 units.[161] The Boston Fed study consisted of 2247 white applicants and 685 minority applicants. The study found that 7.7% of white applicants were approved for a loan on a 2-4 unit structure and 18.3% were denied a loan on a 2-4 unit structure and that 24.8% of minority applicants were approved for a loan on a 2-4 unit structure and 34.4% were denied a loan on a 2-4 unit structure.[162] Minority applications were heavily skewed to 2-4 unit properties for which more stringent underwriting standards would have applied. As Liebowitz notes, looked at as a group, he found only "weak evidence of discrimination" with respect to 2-4 unit properties , which could be mostly accounted for by one application with clear errors.

Nobel Prize winner Gary Becker has pointed out that if discrimination were occurring, default rates should be lower for the group discriminated against due to the application of more stringent standards. Minorities experience default rates that are at least as high as whites.[163]

A Federal Reserve and Freddie Mac study of FHA loan performance released in 1996 but based on loans underwritten in 1987-1989 set out to test Becker's hypothesis:

> "This approach follows from the theoretical foundations of the economics of discrimination (Becker, 1971). The basic premise is that biased lenders will require higher expected profits for loans to minority borrowers and hold minority applicants to underwriting standards in excess of those required for other applicants. Thus discrimination results in lower expected default costs for loans originated for marginally qualified nonminority borrowers. This study employs a rich FHA data set, comprising a large number of individual loan records, to evaluate the performance of mortgage borrowers. Results of the analysis fail to find evidence of better performance on loans

[158] Federal lending rules define single family housing one with 1-4 units. Since a maximum of one unit can be owner-occupied, a 2, 3, or 4 unit property has 1, 2, and 3 rental units respectively. This makes the rental portion an investment or business property,

[159] However these high risk loans accounted for less that 1% of Fannie's acquisitions.

[160] Data from a random sample review of Fannie Mae's single-family acquisitions for the period October 1988-January 1992, dated 3.10.1992. Document contained in the author's files. In 1990 the Loan Performance database with 7 million loans (primarily from Freddie Mac) reported a serious delinquency rate for 2-4 unit properties that was 3.28 times the rate on 1-unit owner-occupied homes. Document contained in the author's files.

[161] U.S. Census, American Community Survey, 2003 Data Profile, Boston, Massachusetts http://www.census.gov/acs/www/Products/Profiles/Single/2003/ACS/Tabular/160/16000US25070004.htm

[162] Dennis Glennon and Mitchell Stengel, An Evaluation of the Federal Reserve Bank of Boston's Study of Racial Discrimination in Mortgage Lending, Office of the Comptroller of the Currency, Working Paper 94 -2 April 1994, http://www.occ.treas.gov/ftp/workpaper/wp94-2.pdf

[163] Supra. James H. Carr and Isaac F. Megbolugbe, p. 278

granted to minority borrowers. Indeed, black borrowers are found, all else being equal, to exhibit a higher likelihood of mortgage default than other borrowers. **These findings argue against allegations of substantial levels of bias in mortgage lending (emphasis added).**"

"**The empirical results do not support a finding of widespread racial bias in mortgage lending (emphasis added).** The main empirical finding is that, after controlling for a wide variety of loan, borrower, and property-related characteristics, default rates for black borrowers are higher than those for white borrowers."[164]

The point of the above is to demonstrate that there is substantial controversy regarding the accuracy of the Boston study, a study that was used to support a wholesale abandonment of traditional underwriting standards (e.g.**1993-E** below).

1993-E:

The Federal Reserve Bank of Boston strongly endorses the abandonment of traditional underwriting standards and favorably noted Fannie and Freddie's embrace of more flexible underwriting standards:

"Underwriting Standards

Property Standards and Minimum Loan Amounts: These standards should be checked for arbitrary rules as to the age, location, condition, or size of the property. Such standards could negatively affect applicants who wish to purchase two– to four–family homes, older properties, or homes in less expensive areas.

Obligation Ratios: Special consideration could be given to applicants with relatively high obligation ratios who have demonstrated an ability to cover high housing expenses in the past. Many lower–income households are accustomed to allocating a large percentage of their income toward rent. While it is important to ensure that the borrower is not assuming an unreasonable level of debt, it should be noted that the secondary market is willing to consider ratios above the standard 28/36.
Down Payment and Closing Costs: Accumulating enough savings to cover the various costs associated with a mortgage loan is often a significant barrier to homeownership by lower–income applicants. Lenders may wish to allow gifts, grants, or loans from relatives, nonprofit organizations, or municipal agencies to cover part of these costs. Cash–on–hand could also be an acceptable means of payment if borrowers can document its source and demonstrate that they normally pay their bills in cash.

[164] James A. Berkovec, Glenn B. Canner, Stuart A. Gabriel, and Timothy H. Hannan, Mortgage Discrimination and FHA Loan Performance, *Cityscape: A Journal of Policy Development and Research*, Volume 2, Number 1, pp. 9 and 21, February 1996
U.S. Department of Housing and Urban Development • Office of Policy Development and Research, http://www.huduser.org/Periodicals/CITYSCPE/VOL2NUM1/berkovec.pdf

Credit History: Policies regarding applicants with no credit history or problem credit history should be reviewed. Lack of credit history should not be seen as a negative factor. Certain cultures encourage people to "pay as you go" and avoid debt. Willingness to pay debt promptly can be determined through review of utility, rent, telephone, insurance and medical bill payments. In reviewing past credit problems, lenders should be willing to consider extenuating circumstances. For lower–income applicants in particular, unforeseen expenses can have a disproportionate effect on an otherwise positive credit record. In these instances, paying off past bad debts or establishing a regular repayment schedule with creditors may demonstrate a willingness and ability to resolve debts.

Employment History: It is important to distinguish between length of employment and employment stability. Many lower–income people work in sectors of the economy where job changes are frequent. Lenders should focus on the applicant's ability to maintain or increase his or her income level, and not solely on the length of stay in a particular job.

Sources of Income: In addition to primary employment income, Fannie Mae and Freddie Mac will accept the following as valid income sources: overtime and part–time work, second jobs (including seasonal work), retirement and Social Security income, alimony, child support, Veterans Administration (VA) benefits, welfare payments, and unemployment benefits.[165]

1993-F:

As reported by the New York Times, Attorney General Janet Reno put banks on notice with her November 1993 testimony before the Senate Banking Committee:

> "'In our view, the lending industry should be subjected to the type of investigation that our department has conducted for many years in other civil rights areas, including the review of all components of an institution's operation over an extended period of time,' she said. 'It is particularly important to focus on the lender's marketing, branching and advertising practices.'"

The New York Times further reported that Shawmut Bank had had its merger request turned down by the Fed that same month. It added:

> "Shawmut, knowing that it was under investigation, had already put in place a program of insured mortgages with low down payments, available to people with limited credit histories, or whose incomes were stable even though they moved from job to job. Up to 33 percent of an applicant's income can go toward housing -- a figure higher than bankers generally accept -- and the program includes other sharp departures from industry standards."

[165] Federal Reserve Bank of Boston, "Closing the Gap", April 2002, http://www.bos.frb.org/commdev/commaff/closingt.pdf

The story went on to note that Phillip (Rick) Freer, director of compliance at the comptroller of the currency's office, said:

> "'If it is a pattern or practice that we believe has been discriminatory, we feel very strongly that the regulation requires us to refer it to the Justice Department,' he said."[166]

Banks were in a quandary. Unless they could prove that their standard credit guidelines relating to downpayment, credit, and income did not have a disparate impact on minorities, they had to replace them with "innovative or flexible" guidelines.

1994-A:

CEO Jim Johnson announces Fannie's Trillion Dollar Commitment to low- and moderate-income housing. Just 3 years before Johnson had announced a $10 billion commitment[167], but the passage of the GSE Act of 1992 necessitated a much larger commitment – 100 times as large. While the sum of a trillion dollars has become commonplace today (largely thanks to the financial crisis brought on by the mortgage meltdown), this is the first time such a massive sum came into common parlance to describe a government related housing finance initiative. The total capital that would support this commitment was less than $15 billion. Ultimately, Fannie and Freddie would announce a total of $5 trillion in such commitments – most being highly leveraged and benefiting from loosened lending and all representing the off-budget "free lunch" so desired by Congress and HUD. These acquisitions were leveraged by the GSEs at about 60:1.

Fannie made clear to its employees and supporters that the Trillion Dollar Commitment and the affordable housing mission it represented was key to protecting Fannie's privileges under its charter. "Protect the franchise" became Fannie's mantra and it would do anything to achieve that end:

> "But, under Johnson, Fannie Mae had a reputation for never losing a fight. 'The old political reality was that we always won, we took no prisoners, and we faced little organized political opposition' is how Daniel Mudd, son of journalist Roger Mudd and Fannie's last real C.E.O., later described Fannie's golden years."[168]

By protecting the franchise, Fannie and Freddie, who eventually joined in, were able to generate growing profits, growing stock prices, and growing salaries and bonuses. For example, Fannie's stock price increased by 10 times from the early 1990s' to late 2000.[169]

---

[166] New York Times, "Lending-Bias Rules Create Quandary for Banks", November 28, 1993, http://www.nytimes.com/1993/11/28/business/lending-bias-rules-create-quandary-for-banks.html?sec=&spon=&pagewanted=1

[167] Having been responsible for Fannie's affordable housing program up to 1987, I can state that Fannie's 1991 $10 billion commitment was extraordinary given its size, even for Fannie Mae.

[168] Bethany McLean, "Fannie Mae's Last Stand", Vanity Fair, February 2009, http://www.vanityfair.com/politics/features/2009/02/fannie-and-freddie200902

[169] http://quote.morningstar.com/stock/chart.aspx?t=FNM&culture=en-US

1994-B:

Fannie introduces a 97% LTV with private mortgage insurance. It is implemented over the objection of Fannie's chief credit officer:

> "Some senior executives, including the company's chief credit officer at the time, were opposed to the loans, in large part because a Fannie Mae experiment with 5% down loans in Texas in the early 1980s was disastrous, with one in four borrowers defaulting."[170]

This level of defaults would be matched **nationwide** by FHA for its 2007 book year and by Fannie for its **nationwide** 2007 book year of loans with LTVs>=95% and/or a FICO<659. [171]

As noted earlier, Texas had a strict homestead property requirement that contributed to its having the highest LTVs at loan origination in the nation. The disastrous experience with 5% down loans in Texas in the early 1980s impacted Fannie, the private mortgage insurers, and FHA:[172]

1. Fannie had a 24.1% default rate with respect to 30-year fixed rate loans on 1981-1982 Texas originations with 5% down, a 14.1% default rate with 10% down, an 8.1% default rate with 20% down, and a 3.8% experience with 25% down;
2. Private mortgage insurers had a 23% claim rate with respect to 1981 Texas originations with 5% down and a 10% claim rate on loans with 10% down; and
3. FHA had a 35.6% default rate with respect to its Texas 1981 book of 30-year fixed rate loans with 0%-5% down, a 31% default rate with 6%-10% down, a 27.6% default rate with 11%-20% down, and a 13.3% e with 21-30% down.

Two lessons should have been learned. First, high LTV lending suffers disproportionately high default rates when home prices come under stress. Second, FHA lending with its broader use of loosened lending standards, experiences an even higher default rate. This level of loan defaults is evidence that the loans are not sustainable.

1994-C

Self-denominated subprime continues to lag Fannie and FHA in maximum LTV limits on home purchase loans. In a survey that covers 11 of the largest subprime originators[173], 3 have an LTV limit of 90%, 1 has 85%, 6 have 80%, and 1 has 70% on "A-" loans. In 1989 almost all had a

---

[170] WSJ, "Why Calls Are Escalating to Clip Fannie Mae's, Freddie Mac's Wings", July 14, 2000, http://online.wsj.com/article/SB963527598420670221-search.html?KEYWORDS=Freddie+Mac&COLLECTION=wsjie/6month

[171] Source: FHA 2009 Actuarial Study, p. F-3 and author's estimate for Fannie's 2007 national book of loans with LTVs >=95% and/or FICOs <660. This estimate is based on Fannie's Q.1.10 Credit Supplement, pp. 6-8, http://www.fanniemae.com/ir/pdf/sec/2010/q1credit_summary.pdf;jsessionid=N4QBC0GJYCHBJJ2FQSISFGI

[172] Supra. Fitch Mortgage Default Model" pp. 6-8. Document contained in the author's files.

[173] Inside Mortgage Finance "The 2009 Mortgage market Statistical Annual, Vol 1, p. 227. Data on top 25 originators not available prior to 1996, therefore 1996 ranking used.

maximum of 80%. On "B" loans nine have a maximum LTV of 80%, 1 has 75%, and 1 has 65%.[174]

1994-D:

HUD's Best Practices Initiative was agreed to by the Mortgage Bankers Association of America and undertaken by HUD in 1994[175] after HUD threatened to go to Congress to get CRA broadened to apply to mortgage bankers. Countrywide would be the first national lender to sign up and it would ultimately announce $1 trillion in Best Practices commitments.

> "A group of lenders not subject to CRA--and more directly under HUD's purview--are the nation's mortgage banks. In mid-September [1994], the Mortgage Bankers Association of America-whose membership includes many bank-owned mortgage companies, signed a three-year master best-practices agreement with HUD. The agreement consisted of two parts: MBA's agreement to work on fair-lending issues in consultation with HUD and a model best-practices agreement that individual mortgage banks could use to devise their own agreements with HUD. The first such agreement, signed by Countrywide Funding Corp., the nation's largest mortgage bank, is summarized on this page. Many have seen the MBA agreement as a preemptive strike against congressional murmurings that mortgage banks should be pulled under the umbrella of the CRA."
>
> "MBA used the occasion of its annual convention, held in October, as the official kickoff for orchestrating the wholesale signing of best-practices agreements. MBA officials--who stressed that signing an agreement didn't give HUD any additional regulatory power over a mortgage bank (sic). Secretary Cisneros and Assistant Secretary Achtenberg commemorated and encouraged participation in speeches--frequently pitching the voluntary nature of the agreements. Often, the agreements were spoken of as partnerships between regulated and regulator. Countrywide president and former MBA president Angelo Mozilo stated in a speech that his firm's agreement was not 'a forced march at all.'"[176]

1994-E:

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal) greatly expanded opportunities for interstate branch banking, usually to be accomplished through

---

[174] Wholesale Directory, 1994 edition, Wholesale Access. Document contained in the author's files

[175] "Since 1994, HUD has signed Fair Lending Best Practices (FLBP) Agreements with lenders across the nation that are individually tailored to public-private partnerships that are considered on the leading edge. The Agreements not only offer an opportunity to increase low-income and minority lending but they incorporate fair housing and equal opportunity principles into mortgage lending standards. These banks and mortgage lenders, as represented by Countrywide Home Loans, Inc., serve as industry leaders in their communities by demonstrating a commitment to affirmatively further fair lending." Found at: http://www.hud.gov/local/hi/working/nlwfal2001.cfm

[176] Steve Cocheo, "Fair-lending pressure builds", ABA Banking Journal, Vol. 86, 1994 http://www.questia.com/googleScholar.qst?docId=5001707340

merger. This greatly expands the opportunities for community groups to negotiate CRA commitments from banks involved in mergers. In an article entitled "Community Investment Act: Ensuring Credit Adequacy or Enforcing Credit Allocation", it is reported that there is a rule of thumb for calculating such CRA commitments - around one half of 1 percent of assets per year.[177]

1995-A:

CRA regulations are revised to be more quantitative and outcome based. A bank's performance was compared to its market competitors. Banks were measured on their use of "innovative and flexible" lending standards. As summarized by Fed Chairman Bernake in 2007, the combination of Riegle-Neal and performance based regulations joined CRA's stick (denial of a merger application) with CRA's carrot (announce a big enough CRA commitment and get your application approved). [178]

Large banks desiring an "outstanding" rating needed to outperform their competitors.[179] Since virtually all large banks desired an outstanding rating in order to facilitate merger approvals, a game of leapfrog ensued. This helps explain the dramatic growth of CRA commitments over the next 12 years. Announced CRA commitments totaled $4.5 trillion over the 1995-2006, 75 times the commitment volume for the 18 year period 1977-1994. CRA (and the GSEs' affordable housing goals) allocated credit based on mandates that were operated largely independently of

[177] Vernon McKinley, *Regulation*, 1994, No. 4, http://www.cato.org/pubs/regulation/regv17n4/vmck4-94.pdf

[178] "Further attention to CRA was generated by the surge in bank merger and acquisition activities that followed the enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. As public scrutiny of bank merger and acquisition activity escalated, advocacy groups increasingly used the public comment process to protest bank applications on CRA grounds. In instances of highly contested applications, the Federal Reserve Board and other agencies held public meetings to allow the public and the applicants to comment on the lending records of the banks in question. In response to these new pressures, banks began to devote more resources to their CRA programs. Many institutions established separate business units and subsidiary community development corporations to facilitate lending that would be given favorable consideration in CRA examinations." Fed Chairman Bernake, "The Community Reinvestment Act: Its Evolution and New Challenges", March 30, 2007, http://www.federalreserve.gov/newsevents/speech/bernanke20070330a.htm

[179] The new rules for large banks created a lending test that considers among other criteria, the number and amount of loans in low-, moderate-, middle-, and upper-income geographies in the bank's assessment area(s). Found at http://www.occ.treas.gov/fr/cfrparts/12cfr25.htm#%C2%A7%2025.21%20Performance%20tests,%20standards,%20and%20ratings,%20in%20general.

The rule also established a "performance context. An institution's performance under the tests and standards in the rule is judged in the context of information about the institution, its community, its competitors, and its peers." p. 22162, http://www.fdic.gov/news/news/financial/1995/fil9535.pdf

To achieve a rating of outstanding a bank needs to demonstrate "Extensive use of innovative or flexible lending practices in a safe and sound manner to address the credit needs of low- or moderate-income individuals or geographies." p. 22187, http://www.fdic.gov/news/news/financial/1995/fil9535.pdf

market conditions. The goal of these CRA commitments was to bring about "changes in underwriting standards to increase the flow of credit to previously underserved areas."[180]

CRA helps promote "too big to fail institutions" by rewarding banks that loosened their underwriting standards with the ability to consummate mergers. Ninety-three percent of the $4.5 trillion in post-1995 CRA commitments reported by the National Community Reinvestment Coalition[181] related to just 4 banks and banks they merged with (See Appendix . This demonstrates that bankers chose loosened underwriting in order to facilitate mergers. The four banks were Bank of America, Citibank, JP Morgan Chase, and Wells Fargo. This resulted in a cycle whereby the expansion of risky lending under CRA (and other affordable lending initiatives) placed other lenders in a situation where they had to offer similar products in order to compete. Additionally, the ideal merger candidates were other banks that had similar implemented "innovative and flexible" underwriting standards for CRA lending. The goal of invigorating CRA by forcing loosening of underwriting standards had been accomplished.

1995-B:

Significant subsidization of Fannie's affordable housing loans started in the mid-'90s. In 1995 Fannie recognized that its "average pricing of risk characteristics provides insufficient targeting of the subsidy. The majority of high LTV loans go to borrowers with income above 100% of the area median, 58% of the 91-97% LTV [loans]".[182] As a result Fannie went to great efforts to target loans with downpayments of 3% or less (one of its most risky products) to low and moderate-income borrowers.

The subsidy provided was significant. Fannie's Community Home Buyer Program (CHBP) loans had a negative net return on capital. A projected default incidence in excess of the maximum needed to achieve breakeven results in a negative net return. For example, the 1995 cohort of 91-95% LTV CHBP loans had a projected default incidence of 11.11. This was in excess of the break even default incidence rate of 8.89. Fannie's target return on capital was 15% in 1995. With respect to high-LTV community lending "an overall net return on capital of at least 3%" was expected."[183]

As part of the CHBP review undertaken in 1995, Fannie determined that:

[180] Introduction of Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions, p. 11, 2003, Gregory Squires, editor

[181] NCRC 2007 Annual Report, P. 6, http://www.community-wealth.org/_pdfs/articles-publications/cdfis/report-silver-brown.pdf

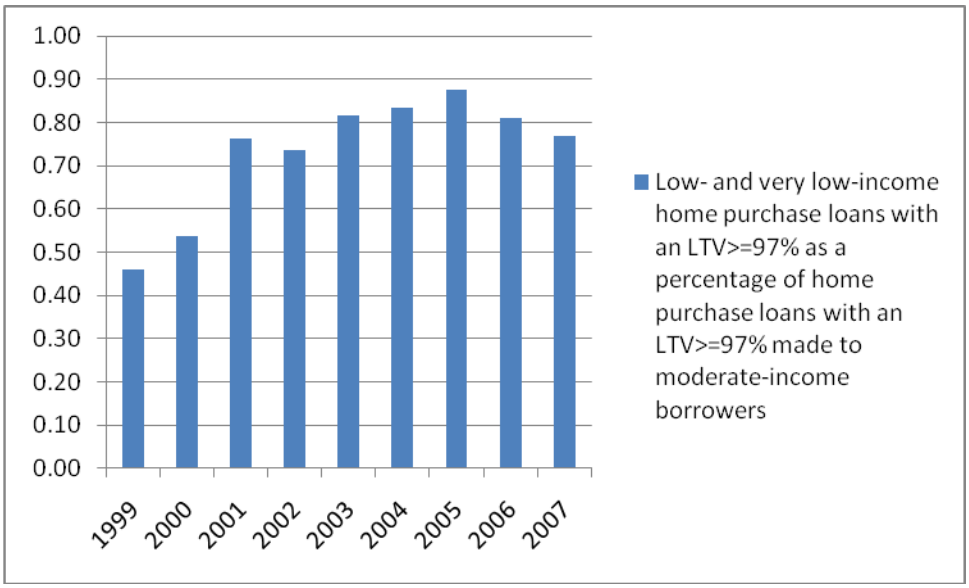
[182] Fannie Mae Credit Policy memo, "Risk Pricing – Idea for the August 3 and 4 meeting and Addressing Short-term Pricing Opportunities, July 21, 1995 Document contained in the author's files.

[183] Fannie Mae Credit Policy memo, "Community Lending Review", November 17, 1995. Document contained in the author's files. At this point in time Fannie was earning 25% return on equity.

> "the cumulative failure rate target for the high-LTV book of community lending business taken together shall not exceed 10 percent. The cumulative failure rate for no single community lending product line shall not exceed 12 percent."[184]

Chart 23 shows the increasing ratio of highly leveraged home purchase loans (LTV >95%) acquired by the GSEs that were made to low- and very low-income borrowers versus the same type of loans made to moderate-income borrowers. This is due to the low- and very low-income goals increasing faster than the moderate-income (net) goal. The ratio increased from 0.46 to an average of over .80 for 2003-2007:

Chart 23: Ratio of highly leveraged home purchase loans (LTV >=97%) acquired by the GSEs that were made to low- and very low-income borrowers versus the same type of loans made to moderate-income borrowers

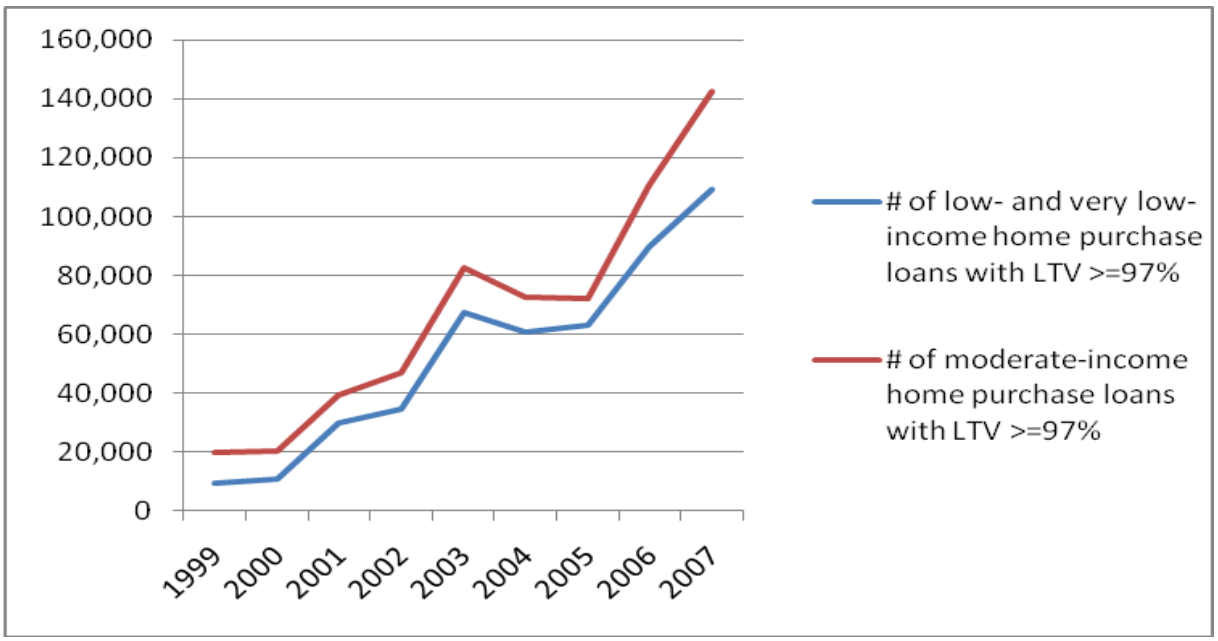


Source: HUD Office of Policy Development and Research and compiled by Edward Pinto

Chart 24 shows the rapid growth in the absolute number of Fannie's acquisition of home purchase loans with an LTV >95% made to moderate-income and low- and very low-income borrowers. In 1993 Fannie acquired virtually none of this type loan. In 2000 Fannie started acquiring 100% LTV home purchase loans and by 2007 most of its acquisitions of >95% loans had a 100% LTV.

[184] Id.

Chart 24: Fannie's annual purchases of highly leveraged home purchase loans (LTV >=97%) made to moderate-income versus and low- and very low-income borrowers



Source: HUD Office of Policy Development and Research and compiled by Edward Pinto

1995-C:

Fannie implements a long sought after goal of community groups when it mainstreams "flexible" lending standards with its public announcement of "Opening Doors with Fannie Mae's Community Lending Products".[185] Included are 97% LTV 1st mortgages, higher debt ratios, reduced or eliminated cash reserve requirements, use of nontraditional credit reports, expanded sources for closing cost assistance, and use of soft seconds. The use of higher debt ratios and reduced or eliminated cash reserve requirements harmed the most vulnerable home buyers because it left them without the necessary reserve financial capacity to meet the normal stresses encountered by homeowners, such as needing new roof, fixing a broken furnace, or paying rising real estate taxes. Lenders also could request variances allowing for even looser lending standards.[186]

> "Fannie Mae's guidelines previously limited the total obligations-to-income ratio for loans it purchases [for its Community Home Buyers Program (CHBP) and other community lending products] to 40 percent of a borrower's total income. The change

[185] "Opening Doors with Fannie Mae's Community Lending Products", p. 19, 1995 Document contained in the author's files.

[186] As noted at **1993** above Fannie had approved 260 underwriting variances related to affordable housing programs. The author knows that this practice continued for Fannie and Freddie, particularly with respect to the GSEs' largest customers.

> eliminated the limit in favor of a lender's discretion tailored to the needs of each borrower."[187]

CHBP already offered lower downpayments and more flexible underwriting.[188] The message was clear – Fannie had embraced underwriting flexibility in a big way.

1995-D:

HUD agrees to let Fannie and Freddie get affordable-housing credit for buying subprime securities that included loans to low-income borrowers.[189] Over the period 1997-2007 the GSEs purchase an estimated $707 billion in subprime MBS, about 30% of all such MBS issued and an additional estimated $154 billion in Alt-A private MBS, about 12.5% of all such MBS issued.[190]

1995-E:

In announcing its National Homeownership Strategy, HUD formalized and greatly expanded a long-standing policy goal – the reduction of downpayments:

> "Lending institutions, secondary market investors, mortgage insurers, and other members of the partnership should work collaboratively to reduce homebuyer downpayment requirements." HUD's 1995 "National Homeownership Strategy"[191]

HUD drafted the entire mortgage finance industry to implement it:[192]

> "Lending institutions, secondary market investors, mortgage insurers, and other members of the partnership should work collaboratively to reduce homebuyer downpayment

---

[187] "Fannie Mae Makes Underwriting Guidelines More Clear and Flexible to Help More Families Achieve Homeownership", PR Newswire, January 9, 1995, http://www.highbeam.com/doc/1G1-16005735.html

[188] Id.

[189] http://www.washingtonpost.com/wp-dyn/content/article/2008/06/09/AR2008060902626.html

[190] Sources are multiple FHFA annual reports entitled "The Mortgage Markets and the Enterprises" and Inside Mortgage Finance's 2009 Mortgage Market Statistical Annual

[191] HUD's "National Homeownership Strategy – Partners in the American Dream", http://web.archive.org/web/20010106203500/www.huduser.org/publications/affhsg/homeown/chap1.html

[192] In 1995 HUD announced HUD's "National Homeownership Strategy". HUD announced that it had "forged a nationwide partnership that will draw on the resources and creativity of lenders, builders, real estate professionals, community-based nonprofit organizations, consumer groups, State and local governments and housing finance agencies, and many others in a cooperative, multifaceted campaign to create ownership opportunities and reduce the barriers facing underserved populations and communities." The goal was to make "financing more available, affordable, and flexible" in order to:

> Increase ownership opportunities among populations and communities with lower than average homeownership rates;
>
> Reduce downpayment requirements and interest costs by making terms more flexible, providing subsidies to low- and moderate-income families, and creating incentives to save for homeownership; and
>
> Increase the availability of alternative financing products in housing markets throughout the country.

Found at: http://www.huduser.org/publications/txt/hdbrf2.txt

requirements. Mortgage financing with high loan-to- value ratios should generally be associated with enhanced homebuyer counseling and, where available, supplemental sources of downpayment assistance."

"The amount of borrower equity is an important factor in assessing mortgage loan quality. However, many low-income families do not have access to sufficient funds for a downpayment. While members of the partnership have already made significant strides in reducing this barrier to home purchase, more must be done. In 1989 only 7 percent of home mortgages were made with less than 10 percent downpayment. By August 1994, low downpayment mortgage loans had increased to 29 percent." [193]

And this HUD "action item" on "Flexible Mortgage Underwriting Criteria":[194]

"The partnership should support efforts to increase local lender awareness and use of the flexible underwriting criteria established by the secondary market, FHA, and VA."

"In recent years many mortgagees have increased underwriting flexibility. This increased flexibility is due, at least in part, to local lender community reinvestment strategies and liberalized affordable housing underwriting criteria established by secondary market investors such as Fannie Mae and Freddie Mac. Yet, many prospective homebuyers still cannot qualify for a conventional mortgage."

In the 3 short years since passage of the GSE Act of 1992, the federal government had drafted virtually the entire housing finance industry into implementing its National Homeownership Strategy, a task made easier by the fact that:

1. *The GSEs' affordable housing mission was under HUD's regulatory control pursuant to the GSE Act;*
2. *Banks' CRA activities were under the control of their safety and soundness regulators, who announced new CRA performance based regulations in 1995;*
3. *Mortgage bankers had voluntarily agreed to HUD's Best Practices initiative in late-1994; and*
4. *FHA was, of course a part of HUD.*

It was self-described by HUD as "an unprecedented public-private partnership to increase homeownership to a record-high level over the next 6 years"[195] and the means would be widespread use of flexible and innovative underwriting standards to increase the homeownership rate for low- and moderate-income families.

[193] HUD's "National Homeownership Strategy – Partners in the American Dream", http://web.archive.org/web/20010106203500/www.huduser.org/publications/affhsg/homeown/chap1.html
[194] Id.
[195] Id.

The goal of loosened lending standards would now be acted upon by FHA, which until 1992 had been the federal government's main vehicle for high risk and high leverage home lending, the GSEs following the mandates of the GSE Act, mortgage banks following the dictates of HUD's Best Practices Initiative, and banks following the new outcome based CRA regulations. These policy initiatives allowed loosened lending standards to take root and change credit cultures.

The goal previously noted from the 1991 Senate Banking, Housing, and Community Development committee report was now well on its way to being accomplished - lenders were abandoning lending guidelines meeting safety and soundness standards and following the lead of the GSEs as they moved aggressively and convincingly to expand what were perceived by Congress and HUD to be historically narrow underwriting standards.

In a classic case of leap frog, large banks would need to out-perform each other in terms of flexible underwriting to get an outstanding CRA rating, HUD would push the GSEs to lead the primary market in low- and very low-income (consisting of large banks, mortgage bankers, and FHA all working to implement the National Housing Strategy) and traditional subprime lenders would be forced further out the risk curve as the competition was slowly shrinking their traditional market.

CRA and HUD's Best Practices Initiative would ultimately provide trillions of dollars in low- and moderate-income loan supply and Fannie and Freddie trillions of dollars in corresponding demand. All of these programs targeted low- and moderate-income families, particularly those with incomes below 80% of median.

1995-F:

HUD announces permanent goals to replace interim goals set out in the GSE Act. The low- and moderate-income goal is raised to 40% (applicable to 1996) substantially above the GSEs' baseline level of 30% that they had experienced prior to passage of the GSE Act. The low- and moderate-income baseline may be inferred by looking at Fannie and Freddie's goal attainment in 1993 of 34.1% and 30.0% respectively.[196] It is not surprising that Fannie's attainment in 1993 was somewhat higher than Freddie's. Fannie's attainment in 1993 had already increased over the level earlier in the decade due to the 1991 announcement of a $10 billion 'Opening Doors' affordable housing program:

> "[Fannie's CEO Jim Johnson] also pointed out the acceleration of the company's housing efforts through the creation of Fannie Mae's National Housing Impact Division in 1991 and its $10 billion 'Opening Doors' affordable housing program to serve low-income families and those with special housing needs. 'The $10 billion goal will be achieved by

[196] Statement of Ira G. Peppercorn, General Deputy Assistant Secretary for Housing U.S. Department of Housing and Urban Development, House Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, Committee on Banking and Financial Services, July 30, 1998, http://financialservices.house.gov/banking/73098hud.htm

> the middle of 1993, a year and a half ahead of schedule, and will help put a total of 180,000 families into affordable housing,' Johnson said."[197]

Also for the first time, a Special Affordable (low- and very low-income) goal of 12% (applicable to 1996) is added (note: loans meeting the Special Affordable goal also counted towards the low- and moderate-income goal). The statutory minimum for the Special Affordable goal was 1%. The baseline may be inferred to be 7% by looking at Fannie and Freddie's actual attainment in 1993 (while HUD tracked performance, there was no formal goal) of 10.0% and 7.2% respectively.[198] Once again, Freddie's attainment is the best indicator of the level experienced prior to 1992.

As a result the GSEs are required to develop and implement additional underwriting flexibilities in order to serve these higher goals. The new Special Affordable goal would be particularly challenging given its focus on 1. very low-income families (<60% of median) and 2. low-income families living in low-income neighborhoods (<80% of median).[199]

1995-G:

The percentage of conventional (all sources) and government loans with an LTV>90% (effectively >=95%) is 26%, more than triple the level of 7% in 1992 (the year the GSE Act was passed).[200]

1995-H:

The GSEs give their best pricing and the greatest underwriting flexibilities to their largest lenders. The top 10 lenders' share increases from 25.8% in 1995 to 71.8% in 2007[201].

1995-I:

Countrywide was an independent mortgage banker, the largest of a vanishing breed. Originator market share had been shifting either to banks directly or to bank or insurance company subsidiaries. In 1995 the top 10 originators had a market share of 25.8% with only 6.1% represented by independent mortgage bankers, almost all of which was accounted for by Countrywide. By 2007 Countrywide's share would grow to 16.8% - more than 1 out of every 6 mortgages.[202]

---

[197] "Fannie Mae's Johnson Says Corporation Ready to Meet Housing Goals in Legislation", PR Newswire, March 31, 1993, http://www.thefreelibrary.com/FANNIE+MAE%27S+JOHNSON+SAYS+CORPORATION+READY+TO+MEET+HOUSING+GOALS+IN...-a013133485

[198] Supra. Statement of Ira G. Peppercorn

[199] See fn. 2, Table 1 of HUD's Profiles of GSE Mortgage Purchases in 1999 AND 2000, http://www.huduser.org/portal/datasets/GSE/profiles19_00.pdf

[200] OTS Mortgage Market Trends, First Quarter 1997, Table 1, http://files.ots.treas.gov/19710.html

[201] Inside Mortgage Finance, "The 2009 Mortgage Market Statistical Annual"

[202] Id.

Countrywide recognized early on that affordable housing could be the means for making itself indispensible to the GSEs and growing its market share. In 1995 Countrywide was Fannie's largest customer and "very aggressive in its origination practices, and they like to test the limits of investment quality underwriting."[203] Groundbreaking variances included a 95% LTV ARM, 2 unit properties up to 95% LTV, and an ARM HELOC [home equity line of credit].[204] In 1994 Countrywide was the largest participant in Fannie's Community Home Buyer Program originations accounting for a 30% share of CHBP (about double its share of Fannie's overall business) and its performance was 30% worse than the control group.[205] Countrywide's early embrace of the GSEs' affordable housing initiatives provided the glide path for its future growth.

In addition to Countrywide's commitment under HUD's Best Practices initiative, it was indirectly subject to the affordable housing goals of Fannie and Freddie, an initiative designed to spur CRA and CRA-like lending. Throughout the 13-year period 1995-2007, Countrywide was Fannie and Freddie's (on a combined basis) largest (1995, 1996, 1998, 2002, 2003, 2005, 2006, and 2007) or second largest customer (1997, 1999, 2000, 2001, and 2004). In 2007 Countrywide was by far Fannie's largest customer (3 times larger than #2) and Freddie's second largest customer (not far behind #1) and accounted for 29% and 16% of Fannie's and Freddie's business respectively.[206]

Given Fannie and Freddie's escalating affordable housing goals, much of the $789 billion in Countrywide's "Best Practices" originations would have gone towards fulfilling these goals. Being in a preferred position as one of Fannie and Freddie's most significant customers had many perks, including highly advantageous pricing and underwriting flexibilities. Countrywide needed to originate huge amounts of HUD's "Best Practices" loans in order to maintain its #1 position and attendant perks with the GSEs.

1995-J:

The national homeownership rate increases from 64.2% in 1994 to 65.1% in 1995, on its way to a high of 69.2% in 2004.

1995-K:

Home sales continue to increase for the 5th straight year. Based on past experience, a correction would have been expected in about 1995, instead the sales boom continues for 11 year more years.

---

[203] Fannie Mae document, Countrywide Credit Variance document dated August 24, 1995. Document contained in the author's files. Document contained in the author's files.
[204] Id.
[205] Fannie Mae Credit Policy memo, "Community Lending Review", November 17, 1995, Document contained in the author's files. Document contained in the author's files.
[206] Inside Mortgage Finance, "The 2009 Mortgage Market Statistical Annual"

1995-L:

Securitization usage is most advanced in the FHA/VA market, which is not surprising as securitization began with Ginnie Mae in 1970.[207] The conventional market is second, led by the GSEs. The jumbo and self-denominated subprime markets are the least advanced in the use of securitization (through 2003).

Chart 25:[208]

Securitization Rates

	Loan type			
Year	FHA/VA	Conventional	Jumbo	Subprime
1995	101.1%	45.6%	23.9%	28.4%
1996	98.1%	52.5%	21.3%	39.5%
1997	100.7%	45.9%	32.1%	53.0%
1998	102.3%	62.2%	37.6%	55.1%
1999	88.1%	67.0%	30.1%	37.4%
2000	89.5%	55.6%	18.0%	40.5%
2001	102.5%	71.5%	31.4%	54.7%
2002	92.6%	72.8%	32.0%	57.6%
2003	94.9%	75.9%	35.1%	58.7%

NOTE: Subprime securities include both MBS and ABS backed by subprime loans. Securitization rate = securities issued divided by originations in dollars.

SOURCE: *Inside MBS & ABS*.

1996-A:

The state of the subprime market before the GSE and conforming lenders (including commercial banks) entered the market in a big way was described as follows:[209]

> "One the of the burning questions in the minds of many conforming market lenders is: Should we be joining the ranks of the nonconforming lenders like ContiMortgage, Ford Consumer, Option One Mortgage, Beneficial Finance, The Money Store and others?"
>
> "Returns on equity (ROEs) are generally high the thinking goes and it's viewed as far less of a commodity business than Fannie/Freddie lending. Hopefully, that means substantially better margins. And, importantly, prevailing wisdom is that we mortgage bankers understand credit risk, having dealt with it forever."

[207] http://www.ginniemae.gov/issuers/issuers.asp?Section=Issuers

[208] Souphala Chomsisengphet and Anthony Pennington-Cross, January-February 2006, "The Evolution of the Subprime Mortgage Market", ABS stands for asset backed security. http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf

[209] Thomas LaMalfa and David Olson, "Market efficiencies and nonconforming lending", Mortgage Banking, April 1, 1996, http://www.allbusiness.com/government/government-loans/551822-1.html

> "The market has shifted significantly from the decades when finance companies ruled the nonconforming market. In the 1970s, finance companies had nearly the entire market; today they have perhaps 20 percent. This would include such firms as Household Finance, Beneficial and Avco."
>
> "There were very few independent mortgage brokers in the market and no asset-backed or mortgage-backed securities."
>
> "During the 1980 to 1985 period we witnessed the emergence of Fannie Mae and Freddie Mac as significant players in the secondary mortgage market. There was a substantial increase in the average loan size because of inflation and greater willingness to lend larger amounts secured by liens on real estate. Mortgage pricing became more closely tied to national rates. The market shifted from thrifts originating loans and holding them in portfolio funded by saving accounts to tradable securities held by banks, insurance companies, mutual funds and others. We also saw the debut of wholesale mortgage companies that bought mortgages from smaller firms and turned them into securities."
>
> "During the 1985 to 1993 period more wholesalers emerged that only bought loans from mortgage brokers, companies like Advanta and ContiMortgage."

LaMalfa and Olson concluded that pricing reflects costs:

> "From other research we have conducted, charge-offs of nonconforming lenders over a business cycle average 12 basis points for A loans, 33 basis points for B loans, 55 basis points for C loans, and 100 to 150 basis points for D loans. Other niches such as nonowner-occupied properties, less- documentation loans, and loans with higher LTVs add to losses. In addition to the losses themselves, there are extra costs involved in underwriting these loans and the extra cost of attempting to collect payments on delinquent loans."[210]

They also found a competitive market, but not one without risks:

> "Going back to the criterion for a competitive market, one of the pieces of evidence to explore is whether firms fail in the market being examined. And we found that not all firms automatically earn profits in the nonconforming mortgage industry. Some examples of casualties of higher-risk mortgage lending include Citicorp Mortgage (substantial losses from no-income-verification loans and high LTV mortgage programs), Dartmouth Plan (high losses from third-party paper), ITT Consumer Finance (losses from high bankruptcies) and Landmark Equity (high delinquency rates). Other anecdotal evidence

[210] Id.

includes the fact that HFC and American General withdrew from the closed-end mortgage market because of insufficient profits."[211]

1996-B:

The subprime market as described by LaMalfa and Olson was about to change dramatically as the GSEs train their sights on this market since it is key to meeting their growing affordable housing goals as mandated by HUD.

Prior to the mid-1990s, the mortgage loans fit into a series of well-defined risk categories based on the past credit performance of the applicant. Traditionally, prime loans had a grade of "A" and subprime loans had grades ranging from "A-minus", to "B", "C", and "D". It was a fairly orderly market with Fannie and Freddie and other prime investors acquiring "A" loans, leaving the "A-minus" to "D" subprime grades to others. There was minimal overlap between the two sectors. Even the lenders for the two segments were different, with the subprime market being serviced by lenders that specialized in subprime lending and servicing.

The GSE Act disrupted this traditional structure. The GSEs were, for the first time, expected to compete with FHA and other subprime lenders for the lower risk ("A-minus" and "B") segments of the subprime market. In the mid-1990s the GSEs began to see the "A-minus" subprime segment as fertile ground for expansion. By the late 1990s the GSEs were expanding into the "B" segment. "A-" and "B" loans constituted 87% of the subprime market in 1998.[212] From the GSEs' perspective this allowed them to turn what they judged to be lower risk "subprime" loans into "prime" loans acceptable to the GSEs. From the point of view of competitors, the GSEs were cherry-picking. In the end, the GSEs' expansion into subprime turned out to be a much higher risk than they had anticipated.

Given the affordable housing goals rich nature of "A-minus" and "B" subprime borrowers, the GSEs used the same cross-subsidy approach already noted with respect to high LTV and Community Home Buyer Program loans. This combination of cross-subsidization and the GSEs' government conferred advantages led to narrower spreads on this lower risk, but huge slice of the subprime market. In order to protect their market share and profits, the traditional subprime lenders moved out the risk curve where risk premiums and spreads were higher and competition from the GSEs was less. Over time this included the remainder of the subprime market ("C" and "D" loans) and "A-minus" and "B" loans with higher risks due to risk layering (e.g. a combination of two or more risks on the same loan, such as high LTV, adjustable interest rates, reduced loan documentation, reduced or eliminated cash reserves, and higher debt ratios).

By 1996 FICO scores, which were invented in 1989, had become the common means for evaluating a borrower's credit history. FICO scores, in combination with automated

[211] Id.

[212] http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2000_register&docid=page+65093-65142

underwriting systems, accelerated the GSEs' shift into subprime since it allowed them to be more precise in their efforts to cherry pick the better subprime loans.

Fannie and Freddie's funding advantages not only allowed them to seek out the lower risk end of these high risk categories, it also allowed them to garner the lion's share of the industry's profits. In 1996 this was described as follows:

> "The real culprit in the demise of the thrifts is the tax and regulatory preferences given the duopoly, Fannie Mae and Freddie Mac. They grew strong on the thrifts' lunch (breakfast and dinner too). Fannie and Freddie currently account for more than 40% of all secondary market activity. Between them they extract more than $3 billion of net income from the mortgage finance business. Based on what we saw occur in the conforming market, we fear their market share is on the road to becoming the lion's share. [Proposed] entry into the jumbo and B-D [subprime] markets will give the agencies renewed growth prospects well into the 21st century."
>
> "In the end, everything is driven by the bottom line. He who has the cheapest unit costs and highest return on equity wins the game."[213]

In October 1996 the same warning was delivered to the Mortgage Bankers Association at its national convention:

> "Here's the premise, it's simple and straight forward: the GSEs, Fannie Mae and Freddie Mac, are eating your companies' and the industry's breakfast and lunch. They are siphoning its revenues and profits. They commoditize the market. They increase the cost of credit. **They create mega-liabilities with miniscule capital to support it** [emphasis added]**.**"[214]

From the mid-'90s onward the GSEs were moving out the risk curve, to higher LTV loans, "A-minus" and "B" subprime loans and Alt-A loans. Their competitors were crowded into the shrinking pool of loans remaining. However, as the efficiency of private mortgage backed security issuance increased in late 2003 through 2006 (as evidenced by the percentage of "AAA" and "AA" securities obtained from a given pool of loans), banks and Wall Street became more adept at competing with Fannie and Freddie and allowed them to expand the shrinking pool.

The affordable housing goals, which provided Fannie and Freddie with permanence and market preeminence in exchange for a mission, moved the GSEs into the higher risk segments of subprime and Alt-A markets. Clear evidence exists relating to the GSEs crowding out of

[213] Tom LaMalfa, "Revelations on the B-D and Jumbo Markets from Freddie Mac's Chairman and CEO", 1996. Document contained in the author's files.
[214] Tom LaMalfa, speech delivered to the Mortgage Bankers Association at its national convention. Document contained in the author's files.

subprime lenders from the mid-1990s through the early-2000s and, ultimately HUD would formally encourage these efforts (see **2000-E**):

Freddie indicates that in 1996 about 10% to 35% of borrowers who obtained mortgages from the subprime market could have qualified for a conventional loan through Loan Prospector, its automated underwriting system;[215] At America's Community Bankers annual Secondary Market Conference, Freddie CEO Leland Brendsel telegraphed Freddie's intention to take "about half" of the non-conforming ("B-D") market when he noted that with credit scoring, it is finding that about half the loans called "B-D" qualify for purchase by Freddie.[216]

1996-C

The new CRA regulations herald major changes:

> "In January 1996, the Community Reinvestment Act (CRA) regulation, revised to reward performance, not process, became effective for thousands of community banks in the United States. Regulators and bankers alike entered this new CRA arena with some degree of trepidation. New rules to learn and new concepts to understand presented challenges to everyone."[217]

1996-D

In a study entitled "Credit Risk, Credit Scoring, and the Performance of Home Mortgages" by the Fed's Division of Research and Statistics[218] is the canary in the coal mine, as it pulls together from multiple sources unequivocal evidence as to the high risks posed by "innovative or flexible" loan features such as low down payments and impaired credit/low FICOs. The full study is so compelling, it should be read by anyone attempting to understand the disconnect between mortgage default risk and the government's insistence on loosened and flexible lending.

Notwithstanding the overwhelming evidence presented from multiple sources as to the high risk nature of loans with such underwriting, the authors literally miss the forest because of the trees, a view that will confuse and mislead succeeding researchers.

- The authors cite a massive seasoned loan study, observing that "delinquency rates are low for each loan type" and note a 4% rate on government-backed seasoned loans. They

[215] OCC Working Paper – Economic Issues in Predatory Lending http://www.occ.treas.gov/workingpaper.pdf
[216] Tom LaMalfa, "Revelations on the B-D and Jumbo Markets from Freddie Mac's Chairman and CEO", 1996
[217] Office of Comptroller of the Currency, New Opportunities to Excel Outstanding CRA Actions for Community Banks, December 1996,
http://www.occ.treas.gov/cra/excel.htm
[218] Federal Reserve, Division of Research and Statistics, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages", http://www.federalreserve.gov/pubs/bulletin/1996/796lead.pdf

neglect to point out that this rate is 10 times the rate on conventional loans with a FICO of >=660.[219]

- They provide and then ignore Freddie Mac's experience that loans made in early 1994 to borrowers (regardless of credit) with less than 80% of median income and a down payment of less than 20% have a foreclosure rate after 1.5-2 years of 51.4 times that of a loan to a borrower (regardless of income) with a FICO >660 and a down payment of 20% or more. Freddie would be forced by HUD's implementation of the affordable housing goals to raise the percentage of its business going to borrowers with <80% of median income from 7% in 1993 to 27% in 2008.

- The authors favorably and casually point out the growing prevalence of affordable housing lending, but ignore the fact that borrowers with income below 80% of median have much higher usage of high risk innovative or flexible underwriting features than higher income borrowers.

[219] On Chart 24 FICOs of >660, 621-660, and <621 are denominated as "high", "medium", and "low" respectively. This is misleading given that in 1989 the median FICO for individuals with mortgages was about 730, with only 18.3% having a FICO below 660 (8.4% were >= 620 and <660 and 9.9% were below 620). In 1989 the 620-660 group would have roughly translated into the "A-" subprime grade and the <620 group into the "B", "C", and "D" grades. With respect to first time homebuyers taking out a mortgage, data from both 1989 and 1994 indicate that 13.3% and 14.5 % respectively of these new homebuyers had a FICO below 660. Source: Equifax. Documents contained in the author's files.

By 2008 approximately 25% of individuals with mortgages had a FICO below 660, with approximately 7% being >=620 and <660 and 18% being below 620 (data unavailable regarding first time homebuyers). Source: Moody's/Economy.com, which document is contained in the author's files. All of the increase from 1989 to 2008 is concentrated in homeowner-borrowers with FICOs below 620 (subprime grades of "B", "C", and "D"). Fannie and Freddie increased their share through whole loan acquisitions of the "A-" and "B" grades and through private MBS purchases of "AAA" tranches made up of "A"-"D" grade subprime loans.

However, there was much more dramatic growth in the ratio of homebuyers purchasing with a downpayment of <=3%. In 1989 only 1 in 230 homebuyers made a downpayment of 3% or less. From this fact it may be concluded that in 1989 virtually none of the borrowers with a FICO below 660 made a down payment of <=3%. The ratio of homebuyers of any FICO making a downpayment of <=3% steadily increased over the next 18 years so that by 2003 and 2007 respectively it stood at 1 in 7 and 1 in 3 (see Chart 55).

Chart 26:[220]

Relative foreclosure rates for selected categories of mortgage loans, by credit score range

Indexed values (1 = any income and LTV <81% and FICO >660)

Loan-to-value ratio and borrower income	*Credit score*		
	Low *<621 FICO*	Medium *621-660 FICO*	High *>660 FICO*
All loans			
Borrower income			
(percentage of area median income)			
Less than 80	36.8	13.9	2.2
80 to 120	35.3	10.2	1.7
120 or more	31.1	8.9	1.1
All	33.9	10.3	1.5
Loan-to-value ratio less than 81 percent			
Borrower income			
(percentage of area median income)			
Less than 80	32.0	11.0	1.8
80 to 120	29.0	7.4	1.1
120 or more	22.0	6.7	0.7
All	26.9	7.9	**1.0**
Loan-to-value ratio 81 percent or more			
Borrower income			
(percentage of area median income)			
Less than 80	51.4	23.0	4.4
80 to 120	47.4	15.8	3.6
120 or more	46.7	12.9	2.8
All	47.6	15.3	3.3

Note. The loans are for single-family owner-occupied properties and were purchased by Freddie Mac in the first six months of 1994. Index of foreclosure rate covers loans foreclosed by December 31, 1995; the index sets the average foreclosure rate equal to 1 for loans with borrower generic credit bureau scores of more than 660 and loan-to-value ratios of less than 81 percent. The credit score ranges correspond to generic credit bureau scores as follows: low = less than 621, medium = 621–660, and high = more than 660. Area median income is the median family income of the property's MSA or, if location is not in an MSA, the median family income of the property's county. Borrower income is as of the time of loan origination.
Source. Freddie Mac.

[220] Supra. Federal Reserve, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages"

Succeeding studies quote the misleading statements contained in this Fed study, but fail to look at the actual data. For example, a congressionally mandated Fed study in 2000 entitled "The Performance and Profitability of CRA-Related Lending"[221] concludes based on the Freddie data shown above that:

> "Affordable home loans that did not feature layering of risk performed similarly to loans in the rest of Freddie Mac's portfolio."[222]

"Missed" is the fact that low FICO (<620) loans made to low income borrowers with a **greater than 20% down payment** were 32 times more likely to foreclose than high FICO (>660) loans to borrowers of any income with a greater than 20% down payment. For downpayments of less than 20% the foreclosure rate increases to 51.4 times.

1997-1999

The GSEs inroads into the "A-minus" and "B" subprime market threaten the existing subprime players. In 1997-1999, subprime grades "A-minus" accounted for 55.1%, B for 25.7%, C for 17.1% and D for 2.2% (by count and excluding loans not graded) of subprime loans[223] and the distribution of subprime mortgages by borrower FICO score indicates that the range of the 25th to 75th percentiles for A-minus was 590-670 (630 average) and for B was 550-610 (570 average).[224], [225] These closely match the FICO ranges most sought after by the GSEs.

1997-A:

HUD begins a practice with the GSEs' affordable housing goals that will continue until 2008 – goals increases are heavily skewed towards lending to low-income in low-income areas and very low-income borrowers located anywhere rather than the moderate-income borrower.[226] In 1996 the moderate- income component was 28% (the difference between the 40% low- and moderate-income goals and the 12% low- and very low-income goal). By 2007 it was 30% (the difference between the 55% and the 25% low- and very low-income goal), a modest increase over 11 years of 2%. Over the same period, the low- and very low-income component increased from 12% to 25%, more than doubling. **Eighty-seven percent of the increase in low- and moderate-income**

[221] Federal Reserve, "The Performance and Profitability of CRA-Related Lending", 2000 http://www.federalreserve.gov/boarddocs/surveys/craloansurvey/cratext.pdf
[222] Id.
[223] OTS Mortgage Market Trends: What About Subprime Mortgage?" http://files.ots.treas.gov/19010.pdf
[224] Id.
[225] As noted earlier, Fannie and Freddie had a strategy to actively compete for A- and B subprime. However, once such a loan was pulled into Fannie or Freddie's acquisition totals, it was no longer denominated subprime. In order to create an appropriate market share comparison, Fannie and Freddie's acquisitions of loans to borrowers with 620-659 FICO corresponded to A- subprime loans and loans to borrowers with <620 FICO (average of about 585-590) corresponded to B subprime loans.
[226] Moderate-income borrowers were defined as those with incomes between 80% and 100% of the area median; low-income borrowers were those with incomes between 60% and 80% of the area median with a property located in a low-income (<80% of median income) census tract or non-metropolitan county; and very low-income borrowers were those with incomes below 60%.

goals from 1996 to 2007 was due to increases in the Special Affordable goals (low- and very low-income group). Doubling the acquisition percentage for loans to low- and very low-income borrowers necessitated that the GSEs reach much further down the demand curve.[227] This required a major expansion of their efforts to ease home purchase requirements by further lowering downpayments, accepting smaller cash reserves, reducing closing costs, and developing numerous other leverage increasing flexibilities.

Chart 27 – GSE Affordable Housing Goals:[228]

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Low & Mod Housing Goal	40%	42%	42%	42%	42%	50%	50%	50%	50%	52%	53%	55%	56%
Fannie actual	45%	45%	44%	46%	50%	51%	52%	52%	53%	55%	57%	56%	54%
Freddie actual	41%	43%	43%	46%	50%	53%	50%	51%	52%	54%	56%	56%	51%
Special Affordable Goal	12%	14%	14%	14%	14%	20%	20%	20%	20%	22%	23%	25%	27%
Fannie actual	15%	17%	15%	18%	19%	22%	21%	21%	24%	24%	28%	27%	26%
Freddie actual	14%	15%	16%	18%	21%	23%	20%	21%	23%	26%	26%	26%	23%
Underserved goal	21%	24%	24%	24%	24%	31%	31%	31%	31%	37%	38%	38%	39%
Fannie actual	25%	29%	27%	27%	31%	33%	33%	32%	32%	41%	43%	43%	39%
Freddie actual	28%	26%	26%	27%	29%	32%	31%	33%	34%	43%	44%	43%	38%

Compiled by Edward Pinto

1997-B:

HUD commissioned the Urban Institute in 1997 to study Fannie and Freddie's credit guidelines.[229] It advised:

> "Almost all the informants said their opinion of the GSEs has changed for the better since both Fannie Mae and Freddie Mac made substantive alterations to their guidelines and developed new affordable loan products with more flexible underwriting guidelines." …
>
> "Informants did express concerns about some of the GSEs' practices. The GSEs' guidelines, designed to identify creditworthy applicants, are more likely to disqualify borrowers with low incomes, limited wealth, and poor credit histories; applicants with these characteristics are disproportionately minorities."

[227] In 1998 the low- income and very low-income groups had a 55% and 50% homeownership rate respectively. This compared to a 64% rate for moderate-income homeowners.http://www.owlnet.rice.edu/~econ461/papers/w9284.pdf

[228] FHFA Mortgage Market Note 10-2, http://www.fhfa.gov/webfiles/15408/Housing%20Goals%201996-2009%2002-01.pdf.pdf

[229] Urban Institute, http://www.urban.org/publications/1000205.html

Translation – do away with the Three Cs of Mortgage Credit entirely and mortgage lending practices would be greatly improved. By 2000 the GSEs had done away with downpayments, had raised debt ratios, entered the "A-minus" and "B" subprime market and re-entered the low doc/no doc market.

1997-C:

Total home market value to total replacement cost ratio increases from 1.34 to 1.65 by 2005. By 2008 it declines back to 1.34.

1997-D:

The number of investor property loans as a percentage of all home mortgages increases to 7% (from 1991-1996 it ranged from 5.1-6.6%) eventually reaching 17.3% in 2005.

1997-E:

An income tax law change in 1997 made speculating in homes a vocation for many homeowners. A married couple could live in a home for 2 years and pay zero tax on the first $500,000 of capital gains upon sale.[230]

1997-F:

No thought was given by HUD as to the unintended consequences which would result as the private sector got crowded out of their traditional subprime business. The large commercial banks and thrifts were also being squeezed by Fannie and Freddie across a broad array of loan products. They were forced to move further out the risk curve and were attracted to the subprime sector by the higher margins on the portion of subprime not being taken by the GSEs. The banks had a competitive advantage over traditional subprime lenders - lower funding costs. This was cited as a reason for First Union's acquisition of The Money Store in March, 1998:

> "First Union will be able to finance Money Store's loans more cheaply than Money Store could on its own."[231]

The commercial bank share of the self-denominated subprime market went from 0% in 1997 to 25.8% in 2006 (comprised of HSBC, Citi, Wells, WaMu, and Chase). Include Countrywide, which was relying more and more on its thrift charter by 2006, and bank market share percentage increases to 32.6% of the self-denominated subprime market in 2006.

During the period 1997-2003 Fannie, Freddie, and FHA's share of tracked subprime lending[232] increased from 51% to 67% - evidence that the government's strategy was working.[233] Said

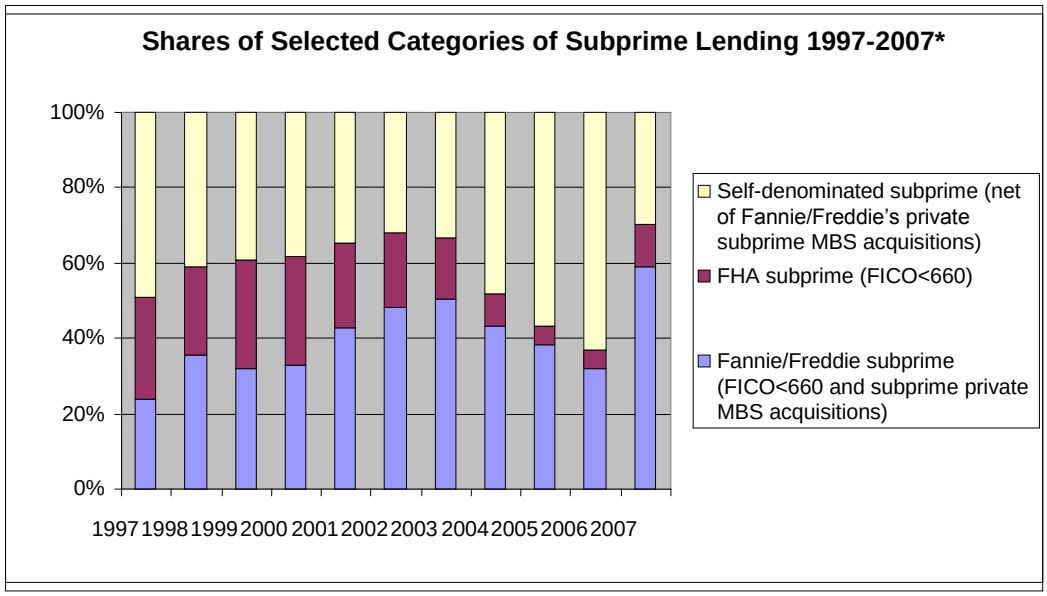
[230] http://www.nytimes.com/2008/12/19/business/19tax.html
[231] NYT, "First Union to Acquire Money Store for $2.1 Billion", "http://www.nytimes.com/1998/03/05/business/first-union-to-acquire-money-store-for-2.1-billion.html
[232] Data is not available to create a year-by-year total for all subprime loans (both Self-denominated Subprime and loans with a FICO less than 660). Tracked subprime uses the available data which consists of Self-denominated

another way, the private sector's share shrank from 49% to 33%, a reduction of 33%. Much of this increase occurred in 2001-2003, post-HUD's encouragement in 2000 (see 2000-**E** below). This doubled the pressure on the traditional lenders in the self-denominated subprime market as the government entities took share from this market segment and the large commercial banks and thrifts increased their share of the self-denominated subprime market as noted earlier.

Subprime (whether or not acquired by the GSEs), GSE acquisitions with a FICO less than 660, and FHA insured loans with a FICO less than 660.

[233] Subprime loans are defined as ones to borrowers with "weakened credit histories that include payment delinquencies and possibly more severe problems such as charge-offs, judgments, and bankruptcies." There are two varieties of subprime loans: those initially denominated as such and those not so classified but with a FICO below 660. Tracking total subprime by year is difficult. For purposes of this analysis tracked subprime consists of self-denominated subprime as reported by Inside Mortgage Finance and loans with a FICO below 660 that were acquired by Fannie or Freddie or insured by FHA. Setting the subprime demarcation line at a 660 FICO is appropriate both in terms of objectively defining a credit impaired loan and because Fannie and Freddie had a policy of peeling off the lower risk "A-" and "B" subprime business. It is illogical to exclude loans previously considered subprime only because the loans were acquired by Fannie and Freddie. The default experience of Fannie and Freddie on loans with a FICO <660 supports this conclusion. For example, as **of 3.31.10 Fannie's serious delinquency rate on loans with a FICO<620, >=620 and <660, and >=660 was 17.9%, 13.2% and 4.2% respectively. The default risk imbedded in loans with a FICO below 660 was excessive given Fannie and Freddie's 222:1 statutory leverage ratio on their MBS guarantees and 30:1 on their portfolio investments.**

Chart 28:[234]



Sources: Inside Mortgage Finance, FHA's 2009 Actuarial Study, HUD data, and OFHEO data. Compiled by Edward Pinto

* Fannie and Freddie had a strategy to actively compete with subprime lenders for A-minus and B subprime loans, which constituted 87% of the traditional subprime market in 1998. However, once such a loan was pulled into Fannie or Freddie's acquisition totals, it was no longer denominated subprime. In order to create an appropriate market share comparison, the total of Fannie and Freddie's acquisitions of loans to borrowers with 620-659 FICO (corresponds to A-minus subprime loans) and loans to borrowers with <620 FICO (average of about 585-590 and corresponds to B subprime loans) along with their purchases of subprime private MBS is compared to the volume of loans denominated as subprime (net of Fannie and Freddie's purchases of subprime private MBS) and FHA insured loans to borrowers with <660 FICO.

1997-G:

After the passage of the GSE Act of 1992, FHA faced competition from Fannie and Freddie for both the low downpayment and low FICO segments of the market. Much like the private sector, FHA responded by shifting to higher risk loans, as noted by this 1997 commentary.

> "The advent of credit scoring has put FHA behind the eight ball. Adverse selection is occurring and accelerating. Since 1980 the FHA foreclosure rate has been on an upward trend, from an annual rate of 0.7% to 2.5% today. With Fannie, Freddie, and nonprime

[234] Important note: There is a lack of year by year disclosures on <660 FICO loan acquisitions pre-2000 for Fannie and pre-2001 for Freddie (whole loans only and excluding Fannie and Freddie's acquisitions of subprime "AAA" private MBS). A reasonable estimate for the missing years back to 1997 was able to be made by extrapolating backwards based on published total book levels of these types of loans at 2001 (Fannie) and 2000 (Freddie) along with a comparison to the acquisition levels for 2001 only (Fannie) and 2000 only (Freddie).

lenders using credit scores to pick off the mortgages with the best investment characteristics, FHA is finding it necessary to increase risk to maintain market share."[235]

1998-A:

The goals of HUD's best Practices Initiative (now encompassing over 117 mortgage bankers) was described as follows:[236]

> "The companies and associations that sign "Best Practices" Agreements not only commit to meeting the responsibilities under the Fair Housing Act, but also make a concerted effort to exceed those requirements. In general, the signatories agree to administer a review process for loan applications to ensure that all applicants have every opportunity to qualify for a mortgage. They also assent to making loans of any size so that all borrowers may be served and to provide information on all loan programs for which an applicant qualifies…. The results of the initiative are promising. As lenders discover new, untapped markets, their minority and low-income loans applications and originations have risen. Consequently, the homeownership rate for low-income and minority groups has increased throughout the nation. However a near 30% gap currently exists between the homeownership rate of white Americans and their African-American and Hispanic counterparts. In an effort to reduce this disparity, HUD signed "Best Practices" Agreements with an additional 7 lending institutions in FY 1998. Furthermore, 10 expired agreements were re-signed."

See Fannie Mae Foundation's review of Countrywide's affordable housing lending activities at **2000-H**.

1998-B:

The National Community Reinvestment Coalition (NCRC) graphically describes the link between mergers and CRA dollars:

> "The rise of unilateral [CRA] agreements also accounts for the fluctuation in dollar amounts on an annual level. For example, 1998 was a year of mega-mergers that included the Bank of America and Nations Bank merger as well as Citigroup's acquisition of Travelers; CRA pledges totaled $812 billion as a result. The following years saw fewer mega-mergers and considerable less reinvestment dollars. CRA pledges shot up again in 2003 and particularly 2004. The year 2004 experienced watershed mega-

[235] Tom LaMalfa, "Holm Mortgage Finance Report", January, 1997. Document is contained in the author's files.
[236] HUD, "Building Communities and New Markets for the 21st Century", FY 1998 Report , p. 75, http://www.huduser.org/publications/polleg/98con/NewMarkets.pdf

> mergers as Bank of America acquired Fleet, JP Morgan Chase acquired Bank One, and Citizens gobbled up Charter One."[237]

Total CRA commitment volume for the year 2004 was $1.631 trillion.[238]

1998-C:

Real home prices begin an unprecedented and ultimately unsustainable boom which lasts 9 years, about twice as long as the booms in the late-1970s and late-1980s and 4-5 times as large in terms of cumulative percentage increase relative to each of the two earlier booms.

1998-D:

Gross equity extraction from housing, as a percent of GDP breaks out from its range of 2.5% to 3.8% from 1993-1997. It increases to 4% of GDP and eventually reaches 11.5% in 2005.

1998-E:

Price-to-rent ratio begins to rise rapidly reaching an all-time high in late 2005/early 2006.

1998-F:

Leveraged lending exerts constant market stimulation, muting price corrections. A nine year period begins with virtually no MSA price corrections, more than double any such period since 1976 (earliest data available).

1998-G

Once again concerns are raised about the impact on borrowers who purchase a home as a result of "flexible underwriting standards" (see **1988-B**):

> "After the warm and fuzzy glow of 'flexible underwriting standards' has worn off, we may discover that they are nothing more than standards that led to bad loans. Certainly, a careful investigation of these underwriting standards is in order. If the 'traditional' bank lending processes were rational, we are likely to find, with the adoption of flexible underwriting standards, that we are merely encouraging banks to make unsound loans. If this is the case, current policy will not have helped its intended beneficiaries if in future years they are dispossessed from their homes due to an inability to make their mortgage payments. It will be ironic and unfortunate if minority applicants wind up paying a very heavy price for a misguided policy based on badly mangled data."[239]

[237] NCRC 2007 Annual Report, P. 6, http://www.community-wealth.org/_pdfs/articles-publications/cdfis/report-silver-brown.pdf
[238] Id.
[239] Theodore Day and Stanley Liebowitz, "Mortgage Lending to Minorities: Where's The Bias?" p. 25, January, 1998, http://www.utdallas.edu/~liebowit/mortgage/mortgages.pdf

1998-H

Bear Stearns begins packaging CRA loans into Fannie, Freddie and private securities.[240] It reported the average CRA portfolio has:

- at least 30 percent loans with 5% down or less;
- a high percentage of loans with less than a 660 FICO score (20-25%). A disproportionately large percentage can be below a 620 FICO score; and
- A high percentage of loans with "favorable" (flexible) underwriting standards.

Banks were advised:

- "Forget about FICO scores and high LTV levels. Almost everyone evaluating your portfolio assumes that the scores will be low (many 660 and less) and LTVs will be high (90 percent and greater);" and
- "Mortgage insurance is a "nice to have" amenity, but not a "need to have;" credit enhancements can be added later through subordinated securities."[241]

Notwithstanding FHA's poor experience over decades with respect to similar loans, Bear Stearns, the GSEs, and others adopted the view espoused by community groups:

> "To many lower-income homeowners and CRA borrowers, being able to own a home is a near-sacred obligation."[242]

[240] Dale Westoff, Bear Stearns, Packaging CRA loans into securities, Mortgage Banking, May 1, 1998, http://www.allbusiness.com/personal-finance/real-estate-mortgage-loans/677967-1.html
[241] Id.
[242] Id.

Stage 3: HUD uses all of its policy levers along with FHA in an effort to force the housing finance industry to undertake a major leap in low- and very low-income home lending. Unprecedented increases in homeowner leverage follow, along with the continued expansion of over-leveraged loan funding institutions and more highly leveraged mortgage backed securities and structured finance transactions.

1999-A:

FHA doubles its percentage of loans with a downpayment of <5% in one year, from 23% in 1998 to 44% in 1999[243] and increases its home purchase share from 12% to 15%.[244]

1999-B:

Ultra-low down payment loans (LTV>95%) were affordable housing goals rich and contributed disproportionately to meeting affordable housing goals, particularly the Special Affordable goals (low- and very low-income borrowers). The GSEs' reliance on ultra-low down payment loans increases significantly after 2000 due to HUD's substantial increase in the GSEs' Special Affordable goal from 14% to 20% (this goal was raised further after 2004):

[243] FHA's 2009 Actuarial Study, Exhibit IV-5, p.42

[244] Sources: FHA's 2009 Actuarial report (found at: http://www.hud.gov/offices/hsg/comp/rpts/actr/2009actr_exhecm.pdf), Exhibits III-4, IV-4, and HUD's PDR Historical Data Table 16, found at http://www.huduser.org/portal/periodicals/ushmc/spring10/hist_data.pdf

Chart 29 - Affordable Housing Goals and Fannie and Freddie's Acquisition of Loans with LTVs >95% (Green highlight indicates richer in goals contribution relative to low- and moderate-income goal):

LTVs >95%	1999	2000	2001	2002	2003	2004	2005	2006	2007
Fannie									
% of all home purchases	4.1%	4.3%	7.1%	7.7%	11.5%	12.9%	14.8%	19.4%	25.9%
% of low and mod	7.1%	7.4%,	12.7%	12.7%	19.3%	21.7%	23.4%	31.0%	40.7%
% of geograph. targeted	6.9%	7.2%	12.4%	12.4%	18.9%	21.0%	22.9%	28.5%	37.1%
% of special affordable	7.2%	8.4%	15.7%	14.7%	22.9%	25.3%	30.9%	39.6%	50.9%
Freddie									
% of all home purchases	5.1%	5.9%	5.3%	7.9%	10.3%	6.5%	8.0%	9.8%	19.3%
% of low and mod	6.2%	10.1%	10.7%	8.5%	12.7%	9.0%	13.2%	15.0%	33.2%
% of geograph. targeted	5.6%	9.4%	10.1%	7.5%	12.2%	8.5%	12.8%	14.2%	29.3%
% of special affordable	7.2%	12.6%	15.5%	9.7%	15.4%	11.5%	18.2 %	20.3%	39.4%

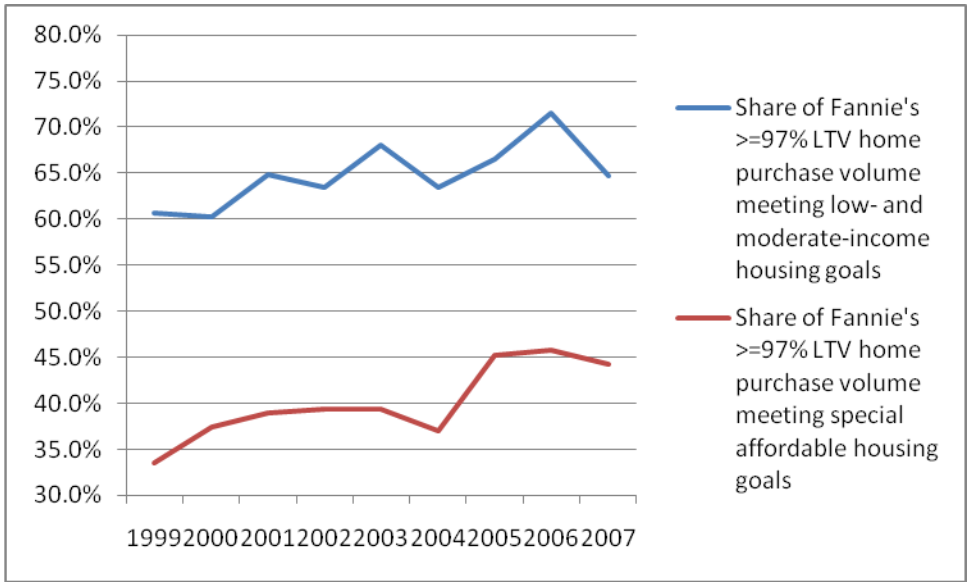
Source: HUD Office of Policy Development and Research and compiled by Edward Pinto

Note: Similar data is not available for other goals rich loan categories such as FICOs below 660 and the "AAA" tranches of private MBS. It is believed that each of Fannie's seven high risk attributes loan groupings (euphemistically called key loan risk attributes by Fannie)[245] were goals rich (yielded an above average percentage of loans meeting affordable housing goals).

The GSEs focused on the "affordable housing yield" of a particular product category. As noted in Chart 29, loans with LTVs >95% (effectively meaning downpayments of <=3%) came to be relied on more and more by the GSEs because of their contribution to meeting affordable housing goals. Chart 30 elaborates on this point. In 1999 about 60% of loans with downpayments of less than 3% met low- and moderate-income goals; however by 2006 this had increased to over 70%. High affordable housing yields were important because as the goals increased, the loans not meeting goals counted in the denominator, which necessitated offsetting acquisitions that would count in the numerator. By the early 2000s the GSEs were exercising care not to acquire too many loans not meeting affordable housing goals since these loans would inflate the denominator and not count in the numerator.

[245] Fannie 2010 First Quarter Credit Supplement, p. 6, http://www.fanniemae.com/ir/pdf/sec/2010/q1credit_summary.pdf;jsessionid=N4QBC0GJYCHBJJ2FQSISFGI

Chart 30:



Source: HUD Office of Policy Development and Research and compiled by Edward Pinto

1999-C:

In July, HUD Secretary Cuomo announced:[246]

> "[a] policy to require the nation's two largest housing finance companies to buy $2.4 trillion in mortgages over the next 10 years to provide affordable housing for about 28.1 million low- and moderate-income families."
>
> "Cuomo said the historic action by HUD raises the required percentage of mortgage loans for low- and moderate-income families that finance companies Fannie Mae and Freddie Mac must buy from the current 42 percent of their total purchases to a new high of 50 percent - a 19 percent increase - in the year 2001. The percentage will first increase to 48 percent in 2000 [while the planned 2000 increase was not promulgated, both Fannie and Freddie exceeded the planned increase with a 50% attainment]."
>
> "Commenting on the action, President Clinton said: 'During the last six and a half years, my Administration has put tremendous emphasis on promoting homeowners and making housing more affordable for all Americans. Our housing programs and institutions have been a success. Today, the homeownership rate is at an all-time high, with more than 66 percent of all American families owning their homes. Today, we take another significant

[246] HUD Press Release, "CUOMO ANNOUNCES ACTION TO PROVIDE $2.4 TRILLION IN MORTGAGES FOR AFFORDABLE HOUSING FOR 28.1 MILLION FAMILIES", July 29, 1999, http://archives.hud.gov/news/1999/pr99-131.html

step. Raising the GSEs goals will help us generate increased momentum in addressing the nation's housing needs.'"

"Under the higher goals, Fannie Mae and Freddie Mac will buy an additional $488.3 billion in mortgages that will be used to provide affordable housing for 7 million more low- and moderate-income families over the next 10 years. Those new mortgages and families are over and above the $1.9 trillion in mortgages for 21.1 million families that would have been generated if the current goals had been retained."

"Fannie Mae Chairman Franklin D. Raines joined Cuomo at the news conference in which Cuomo announced the HUD action. Raines committed Fannie Mae to reaching HUD's increased Affordable Housing Goals."

HUD's mid-1999 announcement, made in concert with Fannie's CEO Frank Raines, of dramatically higher goals likely explains the GSEs' introduction of the no down payment mortgage in 2000. FHA doubled the percentage of its loans with an LTV >=97% from 23% in 1998 to 44% in 1999, also adding additional pressure on the GSEs to go to the zero downpayment loan.

1999-D:

Self-denominated subprime lending enters a new phase as subsidiaries of commercial bank and thrift holding companies become major originators of subprime loans for the first time and account for significant market share.

This is a reaction to crowding out by the GSEs. The GSEs have commoditized the plain vanilla 30-year first mortgage market with a resultant reduction in spreads. HUD favorably cites this trend in its 2000 affordable housing goals rulemaking (see **2000-E** below). Moving out the risk curve to self-denominated subprime, banks and thrifts find wider spreads compared to traditional prime loans. Bank holding companies also have lower borrowing costs than non-depository subprime lenders. At the same time the GSEs' so called prime acquisitions now extend to "A-" and "B" subprime loans, as the GSEs look to meet increasing affordable housing goals. HUD also favorably cites this trend in its 2000 affordable housing goals rulemaking (see **2000-E** below).

In 1997 there are no bank holding companies among the top 25 subprime originators.[247] In 1997 KeyCorp (holding company for Key Bank) purchases Champion Mortgage, a smaller subprime lender not among the top 25.[248] In March 1998 First Union becomes the second bank entrant

[247] Inside Mortgage Finance reports the top 25 self-denominated subprime ("B" & "C") lenders for the years 1995-2006. References to subprime originator rank and market share ar5e from Inside Mortgage Finance.
[248] http://www.thefreelibrary.com/KeyCorp+Completes+Acquisition+of+Champion+Mortgage+Co.,+Inc.-a019727811

with its purchase of The Money Store[249] (ranked #2 in subprime originations in 1997 with a 4.8% share and #5 in 1998 with a 4.2% share). By 1999 seven bank holding companies are pursuing are among the top 25 with a combined market share of 23.1% of subprime originations (Bank of America - 9.1% share, Citibank[250] – 3.9% share, First Franklin (purchased by National City Bank in 1999) – 2.8% share, First Union/The Money Store – 2.7%, Long Beach Mortgage (purchased by Washington Mutual in 1999) – 2.0% share, Chase Manhattan – 1.7% share, and Norwest Bank (purchased by Wells Fargo in 1998) – 0.9% share).

In 2000 Key Corp and Old Kent[251] make it into the top 25. In 2000 the total subprime share of these eight[252] bank holding companies increases to 36.3%. In 2005 Regions Bank makes it into the top 25 (#23 with a 1.3% share) through its Equifirst subsidiary that it purchased in 1999.[253]

The attractiveness of wider spreads is exemplified by National City purchase of First Franklin:

> "In the late 1990's, under former CEO David Daberko, National City began a strategy to increase the yields on it assets. In 1999, the company purchased First Franklin Financial Corp., a large subprime mortgage lender. Instead of selling the loans, as most mortgage companies do, National City retained many of the loans to enhance its net interest spreads. It also aggressively originated loans brought to the company by third-party mortgage brokers, as well as originating a large number of home equity loans."[254]

Two things are striking about the late 1990s expansion of retail bank holding companies into self-denominated subprime. First, prior to entering the subprime market nine of the ten retail bank holding companies[255] had a lengthy and substantial history of CRA lending as demonstrated by their cumulative announced CRA commitments totaling $1.086 trillion prior to 1999 (see **Chart 31** below). Second, the nine subprime related banks (including banks they acquired) were responsible for 96% of the $1.169 trillion in CRA commitments announced prior to 1999.

---

[249] NYT, "First Union to Acquire Money Store for $2.1 Billion", "http://www.nytimes.com/1998/03/05/business/first-union-to-acquire-money-store-for-2.1-billion.html

[250] Citicorp purchased Associates First Capital in 2000. Associates ranked #3 with a 6.9% share in 1999.

[251] Old Kent entered the subprime market in about 1997. In an article entitled "Bad Loans Made Good", Business Week reports: "Old Kent, the 18th-largest mortgage banker in the country, generates more than $11 billion of mortgages--most of which is of the highest credit quality. It recently started targeting so-called subprime, or "b and c," mortgage customers who have spotty credit records. The subprime market offers higher profit margins…." October 26, 1998, www.businessweek.com/1998/43/b3601155.htm

[252] The ninth, First Union, exited subprime in 2000 when it shut down The Money Store. http://www.highbeam.com/doc/1G1-63029428.html

[253] "Barclays to Acquire EquiFirst from Regions Financial Corporation", January 19, 2007 http://www.thefreelibrary.com/Barclays+to+Acquire+EquiFirst+from+Regions+Financial+Corporation.-a0157931579

[254] Wikipedia, National City Corp, http://en.wikipedia.org/wiki/National_City_Corp.

[255] Other than the ten retail bank holding companies already mentioned, only three additional banks eventually made it onto Inside Mortgage Finance's top 25 subprime lenders list. None were a traditional retail bank. The three were: NetBank, an Internet bank, IndyMac, a thrift relying on wholesale and non-branch based deposits, and HSBC, an international bank.

These same nine banks (including banks they acquired) were responsible for 94% of all announced CRA commitments through 2008 (includes Bank of America's $1.5 trillion commitment announced in conjunction with its acquisition of Countrywide in 2008).[256]

Could the explanation be CRA and its reliance on flexible and innovative lending?

Chart 31: Announced CRA Commitments by Banks with Major Involvement in Subprime Lending (million = m. billion = b. trillion = t.):[257] [258]

Bank	Acquired banks/entity	CRA commitments announced prior to 1999	CRA commitments announced in 1999 or later
Key Bank		1987 ($5.5 m.) 1991 ($100 m.)	2000 ($400 m.)
First Union - acquired by Wachovia in 2001, which was acquired by Wells Fargo in 2008 Wachovia acquired SouthTrust in 2004		1985 (no $ amt.) 1989 ($48 m.) 1991 ($10 m.) 1993 ($200 m.) 1995 ($319.4 m.) 1996 ($500 m.) 1997 ($3 b.) 1998 ($13 b.) 1998 ($45 m.)	1999 ($1 b.) 2001 ($35 b.) 2004 ($75 b.) 2006 ($150 b.) 2006 ($8 b.)
Wells Fargo	Norwest First Interstate First Fidelity Corestates Meridian	1986 ($41 m.) 1987 ($2 m.) 1987 ($28 m.) 1989 ($3 m.) 1989 ($33.8m) 1989 ($18 m.) 1990 ($18 m.) 1991 ($25 m.) 1993 ($2 b.) 1993 ($13.5m) 1993 ($59 m.) 1994 ($15 m.) 1994 ($2 b.) 1994 ($272 m.) 1994 ($32 m) 1994 ($124 m.) 1995 ($40 m.) 1996 ($45 b.) 1998 ($15 b.)	

[256] "Bank of America Completes Countrywide Financial Purchase", July 1, 2008 http://investor.bankofamerica.com/phoenix.zhtml?c=71595&p=irol-newsArticle&ID=1171009&highlight=
[257] Supra., NCRC 2007 Annual Report
[258] Supra., "Bank of America Completes Countrywide Financial Purchase"

Washington Mutual – acquired by Chase in 2008	Home Savings Dime	1994 ($20 m.) 1995 $36.2 m.) 1997 ($75 b.) 1998 ($2 b.) 1998 ($35 b.) 1998 ($120 b.)	1999 ($2.5 b.) 2001 ($375 b.)
Chase	Chemical Bank One Texas Commerce Manufacturers Hanover First Chicago NBD	1984 ($120 m.) 1986 ($7.5 m.) 1986 ($2 m.) 1987 ($5 m.) 1987($6 m.) 1987 ($26 m.) 1987 ($25 m.) 1989 ($1 m.) 1989 ($200m) 1989 ($1.5 b.) 1990 ($2 m.) 1991 ($72.5 m.) 1991 ($250 m.) 1993 ($66 m.) 1993 ($1 b.) 1995 ($18 b.) 1995 ($2 b.) 1995 ($2 b.) 1995 ($656 m.) 1996 ($3 b.) 1998 ($3 b.) 1998 ($6.7 b.) 1998 ($350 m.)	2001 ($350 m.) 2003 ($3.1 b.) 2003 ($500 b.) 2004 ($800 b.)
Old Kent		1990 ($2.5 m.) 1992 ($10 m.)	1999 (no $ amt.)
Regions	AmSouth	None	1999 ($3.5 billion) 2006 ($100 billion)
Bank of America/ NationsBank	Continental Citizens & Southern Sovran MNC Seafirst Barnett Fleet Boatmen's	1983 (no $ amount) 1983 ($1 m.) 1984 (no $ amount) 1985 (no $ amount) 1985 ($50 m.) 1985 ($2 m.) 1985 ($8.6 m.) 1986 ($50 m.) 1986 ($80 m.) 1986 ($20 m.) 1986 ($50 m.) 1988 ($43 m.) 1990 ($4 m.) 1990 ($2 m.) 1990 ($12 m.) 1990 ($17 m.) 1990 ($2 m.)	1999 ($14.6 b.) 1999 ($70 b.) 2000 ($1.2 b.) 2004 ($750 b.) 2008 $1.5 t.)

Bank of America/ NationsBank (continued)	U.S. Trust LaSalle Bank of New England Shawmut Bank of Boston Bay Bank Summit	1991 ($1.5 b.) 1992 ($100 m.) 1992 ($316 m.) 1992 $2 b.) 1992 ($10 b.) 1992 ($8 b.) 1993 ($50 m.) 1993 ($200 m.) 1993 ($400 m.) 1993 ($5 m.) 1994 ($15 m.) 1994 ($1 m.) 1994 ($29.8 m.) 1994 ($15 m.) 1994 ($25 m.) 1994 ($1 b.) 1996 ($502 m.) 1996 ($237.3 m.) 1997 ($140 b.) 1998 ($350 b.)	
Citibank	Cal Fed Travelers	1997 ($430m) 1998 ($25.1 b.) 1998 ($115 b.) 1998 ($115 b.)	2002 ($120 b.) 2003 ($200 b.) 2003 ($3 b.)
National City	Integra Union National	1990 ($248 m.) 1992 ($125 m.) 1994 $1.7 b.) 1995 ($267 m.) 1998 ($540 m.)	

Compiled by Edward Pinto

2000-A:

In order to protect its market share, FHA increases the percentage of its loans with FICO scores below 660 from 42% in 1994 to 71% in 2000 and increases the percentage of its loans with an LTV>=97% from 14% in 1992 to 52% in 2000.[259] This allows it to maintain its share at about 9% over 1993-2000, the same as its average share for 1990-1992.

2000-B:

FHA keeps the pressure on conventional and subprime lenders to further reduce downpayments and otherwise loosen lending standards (emphasis below in original):[260]

[259] FHA's 2009 Actuarial Report

[260] Quicken press release, "Quicken Loans First To Offer FHA Home Mortgages Nationally On The Internet With HUD´s approval, Intuit expands home ownership nationwide, offering consumers widest variety of home loan options", January 20, 2000, http://web.intuit.com/about_intuit/press_releases/2000/01-20.html

"Borrowers can purchase with a minimum down payment. Without FHA insurance, many families can't afford the homes they want because down payments are a major roadblock. FHA down payments range from 1.25% to 3% of the sale price and are significantly lower than the minimum that many lenders require for conventional or sub-prime loans."

"With FHA loans, borrowers need as little as 3% of the "total funds" required. In addition to the funds needed for the down payment, borrowers also have to pay closing costs, prepaid fees for insurance and interest, as well as escrow fees which include mortgage insurance, hazard insurance, and months worth of property taxes. A FHA-insured home loan can be structured so borrowers don't pay more than 3% of the total out-of-pocket funds, including the down payment."

"The combined total of out-of-pocket funds can be a gift or loan from family members. FHA allows homebuyers to use gifts from family members and non-profit groups to cover their down payment and additional closing costs and fees. In fact, even a 100% gift or a personal loan from a relative is acceptable."

"FHA's credit requirements are flexible. Compared to credit requirements established by many lenders for other types of home loans, FHA focuses only on a borrower's last 12-24 month credit history. In addition, there is no minimum FICO score - mortgage bankers look at each application on a case-by-case basis. It is also perfectly acceptable for people with NO established credit to receive a loan with this program."

"FHA permits borrowers to have a higher debt-to-income ratio than most insurers typically allow. Conventional home loans allow borrowers to have 36% of their gross income attributed to their new monthly mortgage payment combined with existing debt. FHA program allows borrowers to carry 41%, and in some circumstances, even more."

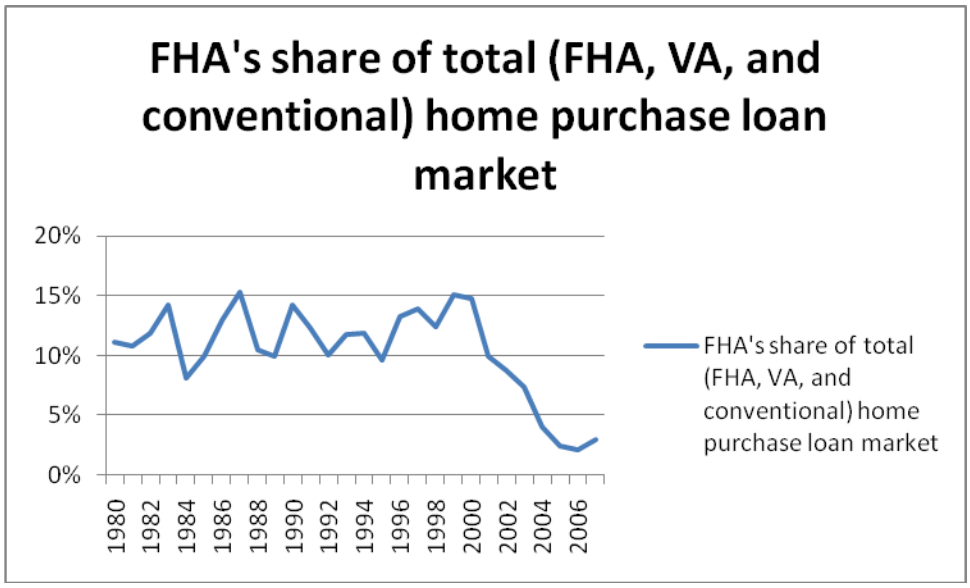
Given the January 2000 date of the Quicken press release, it is reasonable to assume that the above represented FHA's standards in 1999. FHA was setting the loosened underwriting standard with its greatly expanded reliance on minimal downpayments[261], raised the total debt-to-income bar to 41% and beyond on very low downpayment loans[262] [263] and it had no minimum FICO score. The GSEs and the private MBS sectors would not only emulate and expand upon FHA in these three regards, they would add their own loosened standards. For example, Fannie and Freddie would come to dominate the Alt-A- low doc/no doc market. The private MBS market would add ARMs to the mix (the GSEs and FHA had the funding/pricing advantage on 30 years fixed rate, fixed payment loans).

---

[261]It had doubled its percentage of loans with a downpayment of <=3% from 23% in 1998 to 44% in 1999.
[262] It was 38% in 1985, up from an earlier 35%.
[263] Fannie had raised its total debt ratio to 40% in 1995. Total debt ratios generally ran 5-8% higher than the housing debt maximum.

As Chart 32 demonstrates, over the period 1980-2001 FHA's market share of home purchase mortgages was in the range of 10 to 15%. It accomplished this by loosening it underwriting standards (see **Charts 19 and 22** above for its increasing reliance on lower and lower down payments). By 2002 it began to lose out to unrelenting competition from the GSEs (see Fannie's CEO Frank Raines' comment at **2002-A** below) and by 2004 to the added competition from the private self-denominated subprime market (see **Chart 27** above).

Chart 32:



Sources: Inside Mortgage Finance, FHA's 2009 Actuarial report, Exhibits III-4, IV-4, and HUD's PDR Historical Data Table 16. Compiled by Edward Pinto

FHA's parent, HUD, was the cause of this competition with its substantial increases in the GSEs' low- and very low-income goals and its insistence that the GSEs increase their competition with the self-denominated subprime market.

2000-C:

Self-denominated subprime continues to lag Fannie, Freddie and FHA in maximum LTV limits on home purchase loans. In a survey that covers 14 of the 25 largest subprime originators[264] on "A-" loans only 1 has an LTV limit of 100%, 11 have 90%, and 2 have 85% on "A-" loans. On "B" loans 1 has a maximum of 90%, 10 have a maximum LTV of 85%, 2 have 80%, and 1 has 75%.[265]

[264] List of top 25 subprime lenders is from Inside Mortgage Finance "The 2009 Mortgage market Statistical Annual, Vol. 1, p. 223.
[265] Wholesale Directory, 2000 edition, Vol. 12, No. 1, Wholesale Access. Document contained in the author's files

2000-D

The National Community Reinvestment Coalition states:

> "In 2000 The Federal Reserve released a survey on the profitability of CRA-related loans made by the nation's five hundred largest banks, as required by the Gramm-Leach-Bliley Act. The survey found that the great majority of banks reported CRA loans made to low- and moderate-income borrowers to be as profitable as their overall lending. In addition, the CRA loans did not exhibit higher foreclosure rates."[266]

The Fed's survey actually found that on an institution basis, 44% either reported "somewhat lower" (25%) or "lower" (19%) profitability on CRA single-family loans as compared to non-CRA loans. When analyzed on a dollars basis, the difference was even less favorable for CRA lending. On a dollar weighted, 63% reported either "somewhat lower" (43%) or "lower" (20%) profitability on CRA single-family loans as compared to non-CRA loans. In fact 13% of CRA-related loans are break even or worse, versus 1% of all loans.[267]

NCRC also had similar wishful thinking with respect to default losses. On a dollar weighted basis, CRA loans had a reported 90+ day delinquency or non-accruing rate of 1.57% compared to 0.79% for non-CRA loans. Charge-offs on CRA loans were 0.23% compared to 0.15% on non-CRA loans.[268]

The Fed's 2000 study confirmed an earlier 1996 study by the Federal Reserve Bank of Kansas City, which found that 76% of CRA loans were less profitable, substantially less profitable, or not profitable. This report also documented a litany of loan subsidies and loosened credit undertaken by banks in order to facilitate CRA lending.[269]

In addition to reduced margins on CRA loans, bank margins were also squeezed on regular loans due to competition with the GSEs. As a result big banks moved further out on the risk curve in search of higher margins.

2000-E:

After a lengthy period of development, HUD Secretary Andrew Cuomo issues the final rule on affordable housing goals for Fannie and Freddie. HUD raises the GSEs' Low- and Moderate-income Goal from 42% applicable for 2000 to 50% for 2001-2003. At the time of this increase, it was noted that "HUD's recent increases in goals for 2001-2003 will encourage the GSEs to

---

[266] John Taylor and Josh Silver, "The Essential Role of Activism in Community Reinvestment", Chapter 11, pp. 184-185 of Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions, 2003, Gregory Squires, editor

[267] Supra. Federal Reserve, "The Performance and Profitability of CRA-Related Lending"

[268] Supra. Federal Reserve, "The Performance and Profitability of CRA-Related Lending"

[269] Federal Reserve Bank of Kansas City, "Community Reinvestment Act lending: Is it profitable?", Appendix B, p. 32 http://www.kansascityfed.org/PUBLICAT/FIP/prs96-2.pdf

further step up their support for affordable housing."[270] As a result of this and earlier increases, the GSEs' affordable housing goals were 67% higher than those in effect as recently as 1995.

HUD's desire for the GSEs' to "further step up their support for affordable housing" essentially meant an increase in support for the Special Affordable Goals (low- and very low-income) and the Underserved/Geographically Targeted Goals[271]. While the Low- and Moderate- income Goal increased by 8%, virtually all of it was the result of an increase in the Special Affordable Goal which increased from 14% to 20%, representing a percentage increase of 43%. As noted earlier, placing most of the increase in housing goals on the Special Affordable (low- and very low-income) category required the GSEs to reach much further down the demand curve. This necessitated a major expansion of their efforts to ease home purchase requirements by further lowering downpayments and developing other leverage increasing flexibilities. It also required deeper subsidies as compared to the moderate-income group. For example, Special Affordable home purchase loans increased from 25% to 37% of all low- and moderate-income home purchase loans with an LTV>95%.

HUD's published regulation provided this justification for the substantial increase in the affordable housing goals:

> "(5) A-minus Loans. Industry sources estimate that subprime mortgage originations amounted to about $160 billion in1999, and that these loans are divided evenly between the more creditworthy ('A-minus'') borrowers and less creditworthy ('B', 'C', and 'D') borrowers. Based on HMDA data for 200 subprime lenders, the Department estimates that 58 percent of the units financed by subprime loans qualified for the Low- and Moderate-Income Housing Goal in 1998, 29 percent qualified for the Special Affordable Housing Goal, and 45 percent qualified for the Geographically Targeted Goal."
>
> "Freddie Mac has estimated that 10 to 30 percent of subprime borrowers would qualify for a prime conventional loan. Fannie Mae Chairman Franklin Raines has stated that half of all mortgages in the high cost subprime market are candidates for purchase by Fannie Mae. Both Fannie Mae and Freddie Mac recently introduced programs aimed at borrowers with past credit problems that would lower the interest rates for those borrowers that were timely on their mortgage payments."
>
> "Freddie Mac has also purchased subprime loans through structured transactions that limit Freddie Mac's risk to the 'A' piece of a senior-subordinated transaction."

---

[270] HUD's Affordable Lending Goals for Fannie Mae and Freddie Mac, http://www.huduser.org/publications/pdf/gse.pdf

[271] "Families living in low income census tracts (or counties in nonmetro areas, prior to 2005; nonmetro underserved areas are now also defined at the tract level) and in high-minority, middle-income census tracts (also defined in terms of counties in nonmetro areas prior to 2005), excluding high income, high-minority census tracts." http://www.huduser.org/Publications/PDF/AREUEA_Presentation.pdf.

"However, there may be ample room for further enhancement of both GSEs' roles in the A-minus market. A larger role by the GSEs might help standardize mortgage terms in this market, possibly leading to lower interest rates."[272]

And:

"The subprime borrower typically is someone who has experienced credit problems in the past or has a high debt-to-income ratio. Through the first nine months of 1998, 'A-minus' loans accounted for 63 percent of the subprime market, with 'B' loans representing 24 percent and 'C' and 'D' loans making up the remaining 13 percent."[273]

And

"Because the GSEs have a funding advantage over other market participants, they have the ability to under price their competitors and increase their market share. This advantage, as has been the case in the prime market, could allow the GSEs to eventually play a significant role in the subprime market. As the GSEs become more comfortable with subprime lending, the line between what today is considered a subprime loan versus a prime loan will likely deteriorate, making expansion by the GSEs look more like an increase in the prime market [emphasis added]. Since, as explained earlier in this chapter, one could define a prime loan as one that the GSEs will purchase, the difference between the prime and subprime markets will become less clear. This melding of markets could occur even if many of the underlying characteristics of subprime borrowers and the market's (i.e., non-GSE participants) evaluation of the risks posed by these borrowers remain unchanged."

"Increased involvement by the GSEs in the subprime market might result in more standardized underwriting guidelines. As the subprime market becomes more standardized, market efficiencies might possibly reduce borrowing costs. **Lending to credit-impaired borrowers will, in turn, increasingly make good business sense for the mortgage market [emphasis added]."**[274]

The default experience Fannie and Freddie experienced on loans with a FICO <660 demonstrates the fallacy of this conclusion. As of 3.31.10 Fannie's serious delinquency rate on loans with a FICO<620 was 17.9%, >=620 and <660 was 13.2%, and >=660 was 4.2%.[275] The default risk imbedded in loans with a FICO below 660 was excessive given Fannie and Freddie's 222:1 statutory leverage ratio on their MBS guarantees and 40:1 on their portfolio investments.

[272] http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2000_register&docid=page+65043-65092
[273] http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2000_register&docid=page+65093-65142
[274] Id.
[275] Fannie's Q.1:2010 Credit Supplement

Before HUD encouraged the GSEs to push further into subprime, two trends developing from 1996 onward were impacting the self-denominated subprime market. First, the GSEs began to move aggressively to acquire "A-minus" and "B" quality subprime loans. Second, banks being crowded out by the GSEs had little choice but to move further out the risk curve into self-denominated subprime. While banks were at a funding disadvantage relative to the GSEs, they were at a funding advantage relative to traditional subprime lenders. Much like the FHA market which was quite distinct from the conventional/GSE market until the passage of the GSE Act of 1992, the self-denominated subprime market was also distinct from the conventional/GSE market. In 1996 the top 20 self-denominated subprime originators had a 43% share of the self-denominated subprime market. None of these 20 was among either Fannie or Freddie's top 50 sellers. By 2002 this had changed dramatically with 7 of the top 20 self-denominated subprime originators or affiliated companies, with a 39% subprime market share, now among the GSEs' top 50 customers. The subprime market was shifting from one consisting of lenders that specialized in subprime to a group of broader based mainstream lenders that offered a range of products including subprime. This was a logical response to the GSEs' aggressive foray into the "A-minus" and "B" grades of subprime. Now that the GSEs were more comfortable with subprime, it made sense for subprime share market to shift to originators who were large customers of the GSEs so as to be in a position to work both the traditional and GSE sides of the subprime market. The wide spread use of the GSEs' proprietary automated underwriting platforms in the late 1990s helped promote this trend. One underwriting system could be used to evaluate a broad spectrum of loans of varying quality grades. Those acceptable to one or both GSEs would be directed there with the remainder destined for a private execution.

The 7 subprime sellers to the GSEs were Countrywide (owned a bank), Wells Fargo (bank), Washington Mutual (bank), Chase Manhattan (bank), GMAC, Citigroup (bank), and Ameriquest Mortgage and accounted for 44% of total sales to the GSEs. [276] As HUD had expected, the line between so called prime and subprime loans did "deteriorate" and the difference between prime and subprime did "become less clear". Ameriquest is an excellent example. It was the 6th largest self-denominated subprime lender and Freddie's 17th largest customer in 2002.[277] [278] This opaqueness misleads the market since the extent of weakened or NTM lending taking place is hidden

In its rulemaking, HUD also described the affordable housing regulatory regime as established by Congress:

> "To fulfill the intent of [the GSE Act of 1992], the GSEs should lead the industry in ensuring that access to mortgage credit is made available for very low-, low- and moderate-income families and residents of underserved areas. HUD recognizes that, to lead the mortgage industry over time, the GSEs will have to stretch to reach certain goals and close the gap between the secondary mortgage market and the primary mortgage market. This approach is consistent with Congress' recognition that 'the enterprises will need to stretch their efforts to achieve' the goals."[279]

[276] Inside Mortgage Finance's The 2009 Mortgage Market Statistical Annual

[277] Ameriquest's sales to Fannie that year were $0 and it was not among the GSEs' 100 largest customers in any year prior to 2002.

[278] Inside Mortgage Finance's The 2009 Mortgage Market Statistical Annual

[279] http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2000_register&docid=page+65043-65092

At the same time, other policy initiatives supporting HUD's National Homeownership Strategy were also mandating that virtually all segments of the industry stretch their efforts to increase lending to very low- and low-income families and residents of underserved areas. In order for industry to move further down the demand curve, ever more flexible and innovative underwriting standards were necessary.

HUD, a social policy agency, plays a central regulatory role in orchestrating a multi-faceted weakening of underwriting standards over many years. **It does not appear that any other country had ceded the role of underwriting standard setter to a non-prudential regulator.**

HUD's regulatory regime drove a race to the bottom:

1. *Numerous federal policies are pushing all market participants in the same direction at the same time – increase lending to very low- and low-income families and residents of underserved areas. HUD was at the center of these efforts, responsible for setting the GSEs' affordable housing goals, operating FHA, and implementing its National Homeownership Strategy and Best Practices Initiative. While it was not HUD's direct responsibility, CRA operated in tandem with HUD's initiatives. HUD's actions mandated dangerous leverage increases for the sole purpose of forcing the housing finance industry to create demand. By pushing all these levers simultaneously, few areas of the housing finance industry escaped HUD's impact.*
2. *As noted above in the Intuit/FHA announcement, HUD aggressively uses FHA to lead the market in loosening underwriting standards.*
3. *HUD sets higher GSE goals to force the GSEs to lead the conventional industry in providing access to mortgage credit for very low-, low- and moderate-income families and residents of underserved areas. HUD relies on the fact that the GSEs have the ability to underprice their competitors and that this will work to increase their market share. HUD finds ample room for further enhancement of the GSEs' role in the A-minus subprime market. In order to create demand to meet the higher goals, the GSEs are forced further down the demand curve necessitating further loosening of their underwriting standards.*
4. *The actions by the GSEs and FHA lead to crowding out forcing the rest of the industry further down the demand curve. To compete and maintain share, they respond by further loosening their underwriting standards.*
5. *This process was repeated multiple times.*

HUD's expectation that "[l]ending to credit-impaired borrowers will, in turn, increasingly make good business sense for the mortgage market" would unfold with calamitous results. For the above reasons along with other circumstances yet to unfold, subprime, Alt-A and other NTM lending expand in ways that HUD does not anticipate.

2000-F:

Fannie announces $2 trillion American Dream Commitment.[280] Announcement made to comply with increases in affordable housing goals being planned by HUD: "Cuomo Announces Action to Provide $2.4 Trillion in Mortgages for Affordable Housing for 28.1 Million Families."[281]

2000-G:

Increasing affordable housing goals (especially special affordable goals) and a corresponding need to capture share from FHA (in 2000 over 52% of FHA's loans have an LTV>=97%[282]) force Fannie and Freddie to introduce the no downpayment (100% LTV) mortgage. By 2007 about 38% of Fannie's purchase loans had an LTV or combined LTV (CLTV) >=97%, with about half of these having no downpayment. (See **Chart 22** above)

2000-H:

The Fannie Mae Foundation completes its "Making New Markets: Case Study of Countrywide Home Loans.[283] Notable findings include (all are quotes):

1. "Countrywide formed a Fair Lending Task Force to implement the Declaration of Fair Lending Principles and Practices.
2. By 1999 Countrywide had opened House America retail branches in 19 inner city locations across the nation.
3. [While not covered by CRA] it has pledged itself to be a leader in the affordable and fair lending arena.
4. FHA loans constituted the largest share of Countrywide's activity, until Fannie Mae and Freddie Mac began accepting loans with higher LTVs and greater underwriting flexibilities.
5. …Countrywide was consulted by Fannie Mae in 1992 during the design of Fannie Mae's Community Home Buyers Program.
6. Most of Countrywide's lending activity is shaped around the affordable housing programs of Fannie Mae, Freddie Mac, FHA, and the major private mortgage insurance companies.
7. Countrywide's "We House America Program" featured conventional loans with a 97% LTV along with maximum front- and back-end ratios of 28% and 36% with no exceptions. Note: in 1999 FHA was offering 98.75% LTV loans with a 41% back end-ratio with exceptions.

[280] "Fannie Mae's $2 Trillion 'American Dream Commitment' On Course with Over $190 Billion in 2000..." http://www.allbusiness.com/legal/banking-law-credit-regulation/6045369-1.html
[281] HUD press release, July 29, 1999, http://archives.hud.gov/news/1999/pr99-131.html
[282] FHA's 2009 Actuarial Study
[283] Supra., Fannie Mae Foundation

8. Countrywide tends to follow the most flexible underwriting criteria permitted under GSE and FHA guidelines. Because Fannie Mae and Freddie Mac tend to give their best lenders access to the most flexible underwriting criteria, Countrywide benefits from its status as one of the largest originators of mortgage loans and one of the largest participants in the GSE programs.
9. When necessary—in cases where applicants have no established credit history, for example—Countrywide uses nontraditional credit, a practice now accepted by the GSEs.
10. Countrywide performs a monthly statistical analysis of loan activity by retail branch that generates a denial disparity index, or DDI. This index is the ratio of denial rates for minority applicants to denial rates for white applicants. Generally, the overall DDI range for Countrywide is between 1.3 and 1. The industry average generally ranges between 2 and 1, which suggests that Countrywide's denial rates have a significantly weaker correlation with race and ethnicity than do those of other lenders. In cases in which a Countrywide branch has a high DDI, management closely examines the branch's activities to determine the reason for the denial disparity."
11. Although Countrywide is impressive in its outreach and efforts to help potential borrowers qualify for its loan products, it largely lacks programs for potential borrowers who cannot meet the requirements of the secondary market. The reason is that Countrywide is a mortgage banker, currently sells approximately 99 percent of its loans to the secondary market. Countrywide has, however, played a significant role in extending the reach of the secondary market by working with the GSEs to develop new affordable lending products. An example was the partnership with Fannie Mae to develop Fannie Mae's Community Home Buyer's program."

2001-A:

National median home price to median income ratio breaks out of narrow range of 2.9 to 3.1 (1988 to 2000) as it increases to 3.4, eventually increasing to 4.6 by 2006. (See **Chart 9**)

2001-2003:

The increases in the GSEs' affordable housing goals announced by HUD in late 2000 take effect in 2001. While the moderate-income component had a modest increase from 28% in 2000 to 30% in 2001, the low- and very low-income component increased dramatically from 14% to 20%. This change is magnified by the start of a refinance boom in 2001 due to lower interest rates. As a result of this boom:

1. Annual first mortgage origination volumes increase dramatically from $995 billion in 2000 to $2,100 billion in 2001, $2,720 billion in 2002, and $3,725 billion in 2003.[284]
2. At the same time the GSEs' share of this origination volume also increases dramatically from 28% in 2000 to 37% in 2001, 41% in 2002, and 44% in 2003.[285]

[284] Inside Mortgage Finance

As a result, while the overall market grew 375% over 2000 to 2003, the GSEs' acquisitions grew by 585%. The impact of higher goals for 2001-2003 was magnified by the refinance boom that also started at the beginning of 2001. As a result the GSEs' had to replace their rapidly turning over existing single-family credit portfolio (totaling over $2 trillion at year end 2000[286]) with new acquisitions subject to the higher low- and very low-income mandates.

2001-B:

> "And, speaking of Fannie Mae and Freddie Mac, let it be said that they now control the subprime market, having through their Alt A, "A-" [and "B"] programs absorbed the largest and best parts of the 'old' subprime world. What are left are the "C" and "D" segments. Combined, they only account for 20 to 30 percent of all subprime mortgages. (The old subprime market was about 15 percent of the total market.) Fannie/Freddie programs using risk-based pricing now encompass most mortgages with FICO scores of around 540 and up."[287] [288]

In 2001 Josh Rosner[289] observed:

> "[I]t appears a large portion of the housing sector's growth in the 1990's came from the easing of the credit underwriting process. Such easing includes:
>
> - The drastic reduction in minimum down payment levels from 20% to 0%
> - A focused effort to target the "low-income" borrower
> - The reduction in private mortgage insurance on high loan to value mortgages
> - The increasing use of software to streamline the origination process and modify/recast delinquent loans in order to keep them classified as "current"[290]
> - Changes in the appraisal process which led to widespread over-appraisal/over-valuation problems."

---

[285] Id.
[286] FHFA
[287] Tom LaMalfa, "Holm Mortgage Finance Report", January, 200. Document contained in the author's files.
[288] While the GSEs applied risk-based pricing to high LTV and low FICO loans, the pricing adjustments were insufficient and still required cross-subsidies. This was well documented by the FHFA in its analysis of loans acquired by the GSEs in 2007 and 2008. See "Fannie Mae and Freddie Mac Single-family Guarantee Fees in 2007 and 2008", http://www.fhfa.gov/webfiles/14700/GFees72009.pdf
[289] Josh Rosner, "Housing in the New Millennium: A Home Without Equity is Just a Rental With Debt", June, 2001 found at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1162456
[290] The result is to reduce the chance of foreclosure conditional on 90 days of delinquency at which point the borrower qualifies for a modification. This new encouragement for workouts started in the mid-1990s and became a further magnet for bad credit. Increasing delinquency rates and foreclosures are signals of weak lending. With prevalent recasts, these signals are muted. FHA started its loan modification program in May 1996. See ABT, "An Assessment of FHA's Single-Family Mortgage Insurance Loss Mitigation Program", p. 2, http://www.abtassociates.com/reports/ES-20007197399621.pdf

Rosner warned in the same article:

> "The virtuous cycle of increasing homeownership due to greater leverage has the potential to become a vicious cycle of lower home prices due to an accelerating rate of foreclosures."[291]

Also in 2001, James Grant observed: [292]

> "What could explain a bull market[293] in a non-earning asset in a non-inflationary era? Ample credit is the first answer…. In the first quarter, Fannie Mae, Freddie Mac and the Federal Home Loan Banks together expanded their book by $84.7 billion, or 12.7% annualized."

At about the same time Rosner and Grant were observing a bull market based on easy credit, a very different message came from Fannie's vice chair, Jamie Gorelick:

> "As it has for the past five decades the trend of increasing debt-to-value [LTV] ratios will continue in the current decade. Back in the '50s, the average ratio was just 20%—today it is 47%.[294] Where might it go? … [a]s more lenders bring more low down-payment mortgages to the market, that will also boost the debt-to-value-ratio."[295]

2001-2006:

Since the mid-1980s the charter advantages enjoyed by Fannie and Freddie made it virtually impossible for the private sector to compete head to head. In the origination market the GSEs' advantages resulted in commoditization of the plain vanilla mortgage. This drove spreads down and pushed originators/portfolio lenders out the risk curve. Overcoming the GSEs' benefits of high leverage, low borrowing cost, and implicit government guarantee had proved insurmountable. It was not for lack of trying. Companies with "AAA" ratings, such as GE Capital, Wells Fargo, AIG, and FGIC, had tried and failed. In general they found that their "AAA" rating was insufficient as Fannie and Freddie's implicit government guarantee and resulting high leverage gave the GSEs a pricing advantage that they could not overcome.[296] The only entities that had modest success in competing against Fannie and Freddie were another

---

[291] Id.
[292] James Grant, "Mr. Market Miscalculates, The Bubble Years and Beyond", 2008, Axios Press
[293] Id. Earlier in the article Grant made note of the fact that house prices had just increased by 8.8% over the year ending Q.1:01
[294] This percentage includes the approximately 30% of homeowners without a mortgage. Netting this group out, increases the debt-to-value (LTV) ratio to about 62%. After the market collapse the average LTV of homeowners with a mortgage(s) reached about 90% in 2009.
[295] Supra., James Grant, Ms. Gorelick's remarks made in November 2001 at a convention of community bankers.
[296] This can be illustrated with a simple example. If a bank holds whole home mortgage loans in its portfolio, its risk based capital requirement is 4% (whole loans are given a 50% risk weighting). This results in a 25:1 leverage ratio. Now the bank takes the exact same loans, has Fannie or Freddie issue their MBS (requires 0.45% capital by the GSE) and buys back the MBS. Now the bank is required to hold 1.6% capital due to the 20% risk weighting for GSE MBS. Total capital required is 2.05% resulting in a leverage ratio of 49:1.

group of GSEs, the Federal Home Loan Banks (FHLBs). The FHLBs began setting up programs to compete with Fannie and Freddie in 1998.

HUD took notice of the effect this pricing advantage had had in the prime market and speculated that this "could allow the GSEs to eventually play a significant role in the subprime market."[297] Given the likely cross-subsidization that the GSEs would utilize to meet the recently increased affordable housing goals, HUD was expecting that this same distortion would now extend to the pricing on subprime loans.

> "As the subprime market becomes more standardized [commoditized], market efficiencies might possibly reduce borrowing costs."[298]

This same commoditization was occurring in the MBS market. In 1995 the GSEs had 30% of the mortgage market and private MBS had 8%. By 2003 the GSEs' share had risen to 49% while private MBS accounted for 15%. Big losers in share were the portfolio mortgage holders (mostly banks and thrifts) for the reasons noted above. Their share declined from 50% in 1995 to 30% in 2003. The buy/sell spread received by a broker-dealer (Wall Street) selling handling the trade on agency MBS was narrow as compared to private MBS and CDOs. Like originators, Wall Street moved out the risk curve to private MBS and CDOs backed by NTMs where the spreads were higher.

On November 1, 2001 banking regulators issued a final rule amending bank risk based capital rules to provide a 20% weight for "AAA" and "AA" tranches of private MBS, the same weight established in 1988 for Fannie and Freddie MBS. The new rule takes effect January 1, 2002[299] and provided validation of the low risk level presented by these tranches not only for banks, but for all investors.

Coinciding with this regulatory change was a greater reliance on collateralized debt obligations (CDOs) and CDOs squared.[300] CDO volume was low prior to 2001 with cumulative volume totaling about $120 billion over 1998-2000 and the volume represented by single-family (SF) CDOs only totaling about 8% or $10 billion over the same period. CDOs represented an infinitesimal portion of the U.S. mortgage market, which totaled $2.8 trillion over 1998-2000. By 2004 annual CDO volume totaled $100 billion with single-family (SF) CDOs totaling 40% or $40 billion.[301] While only CDOs and CDOs squared volume equated to 1.3% of the total

---

[297] http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2000_register&docid=page+65093-65142

[298] Id

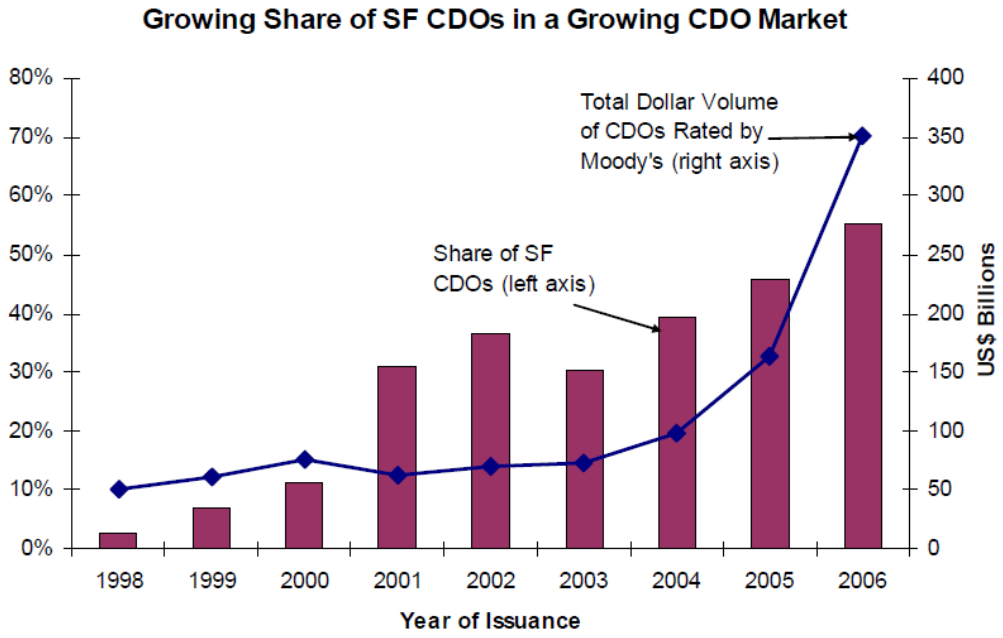
[299] "In November 1, 2001 the Agencies revised their risk-based capital standards to permit banking organizations to rely on external credit ratings by Nationally Recognized Statistical Rating Organizations (NRSROs) to assign risk weight to certain...asset- and mortgage-backed securities. For example, subject to the requirements of the rule, mortgage-backed securities with a long-term rating of AAA or AA may be assigned to the 20 percent risk- weight category...." http://www.dallasfed.org/banking/notices/2005/not0566.pdf

[300] CDOs were securities comprised of rated tranches from private MBS. CDOs squared were securities comprised of rated tranches from CDOs.

[301] Jian Hu, Senior Vice President, Structured Finance – CDOs/Derivatives, Moody's Investors Service, "Assessing the Credit Risk of CDOs Backed by Structured Finance Securities: Rating Analysts' Challenges and Solutions", August 31, 2007 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1011184.

mortgage market in 2004, CDOs and CDOs squared volume represented about 5% of private MBS issuance volume., Most importantly, 78% of all private MBS tranches below "A" made their way into CDOs (see **Chart 33** below).

Chart 33: [302]



Note: The data in this chart does not include non-US$ denominated tranches and wrapped tranches.

CDOs and CDOs squared were a significant help to the private sector in leveling the leverage playing field versus the GSEs.[303] The credit support for the "AAA" and "AA" tranches was provided by the lower rated and unrated tranches. While these lower rated tranches had higher yields than the "AAA" and "AA" tranches, finding buyers was still problem. Increasing the yields to attract more buyers would have made private MBS less competitive as compared to Fannie and Freddie's MBSs. CDOs and CDOs squared solved this problem by allowing MBS issuers and underwriters to create additional "AAA" and "AA" tranches out of the lower rated tranches – at lower yields and without providing any new credit support. By creating CDOs from these harder to sell tranches, additional tranches of the more desirable "AAA" and "AA" securities were created. Since these had narrower spreads, private MBS became more

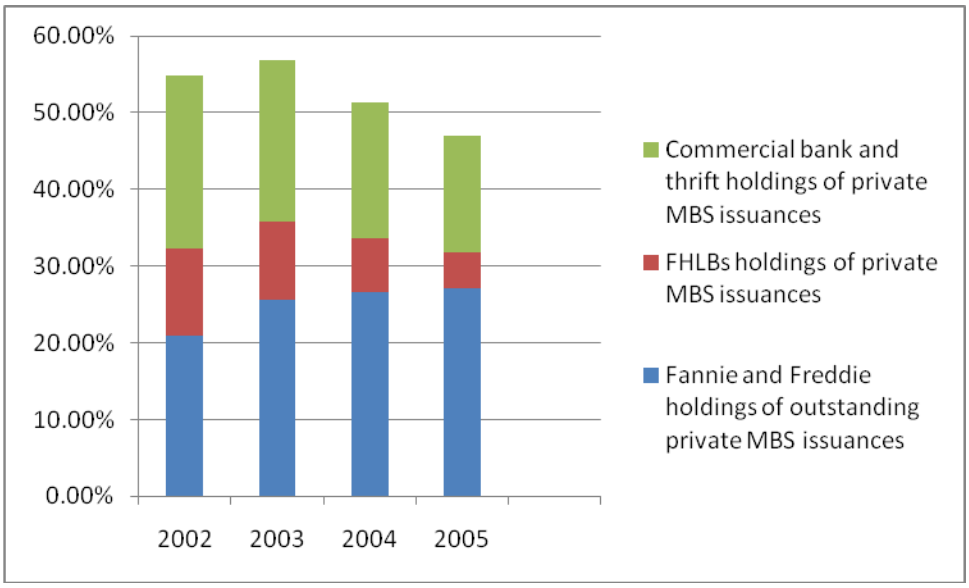
[302] Jian Hu, Senior Vice President, Structured Finance – CDOs/Derivatives, Moody's Investors Service, "Assessing the Credit Risk of CDOs Backed by Structured Finance Securities: Rating Analysts' Challenges and Solutions", August 31, 2007 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1011184.

[303] The idea that CDOs opened the door for "AAA" private MBS to much more effectively compete with Fannie and Freddie for the very first time ever is not well known. However, the above analysis was confirmed on 8/7/10 by a principal of a hedge fund, with longstanding participation in the CMO, CDO and CDOs squared markets. This window of opportunity opened in 1H03 and closed by 2H05.

competitive with the GSEs' MBS. In effect the newly minted "AAA" and "AA"CDO tranches were now backing the old "AAA" and "AA" private MBS tranches.

Fannie, Freddie and the Federal Home Loan Banks (FHLBs) were major drivers of the demand for the "AAA" tranches of private MBS (primarily subprime and to a lesser extent Alt-A).[304] As the private MBS market (measured by issuances outstanding) tripled in size from 2002-2005, going from $414 billion in 2002, to $586 billion in 2003, $864 billion in 2004, and $1.191 trillion in 2005. Fannie, Freddie and the Federal Home Loan Banks maintained a consistent 1/3 share throughout the 2002-2005 period. The next largest identifiable buyer group consisted of commercial banks and thrifts. Their share declined from about 20% to 15%.[305]

Chart 34:



Source: Inside Mortgage Finance's The 2009 Mortgage Market Statistical Annual and compiled by Edward Pinto

The following simplified example illustrates how CDOs and CDOs squared boosted leverage. Subprime MBS consisted of tranches with ratings ranging from "AAA" to unrated. The "AAA" and "AA" tranches accounted for about 80% and 11% respectively, with the remaining 9% made up of lower rated ("A", "BBB", and "BB") and unrated tranches. This yields $10 in "AAA" and "AA" rated tranches versus $1 in lesser rated and unrated tranches. Create a CDO using the rated tranches of a private MBS and the percentage of "AAA" and "AA" rated tranches increases to 95.4%.[306] This yields $21 in high rated tranches versus $1 in lesser rated and unrated tranches. Create a CDO squared using the rated tranches of a CDO and the percentage of "AAA" and "AA" rated tranches increases to about 98%; yielding $49 in high rated tranches versus $1 in lesser rated and unrated tranches. The credit support for the "AAA" and "AA"

[304] Fannie, Freddie and the Federal Home Loans Banks (FHLBs).invested exclusively in "AAA" tranches.
[305] Inside Mortgage Finance, The 2009 Mortgage Market Statistical Annual, Vol. 2, p. 278
[306] http://www.mhhe.com/economics/cecchetti/Cecchetti2_Ch07_StructuredProducts.pdf

tranches has been reduced from 9% to 2%, increasing leverage relative to the "AAA" and "AA" tranches from 10:1 to 49:1. Move the CDO into a structured investment vehicle (SIV) and leverage can be increased even further.

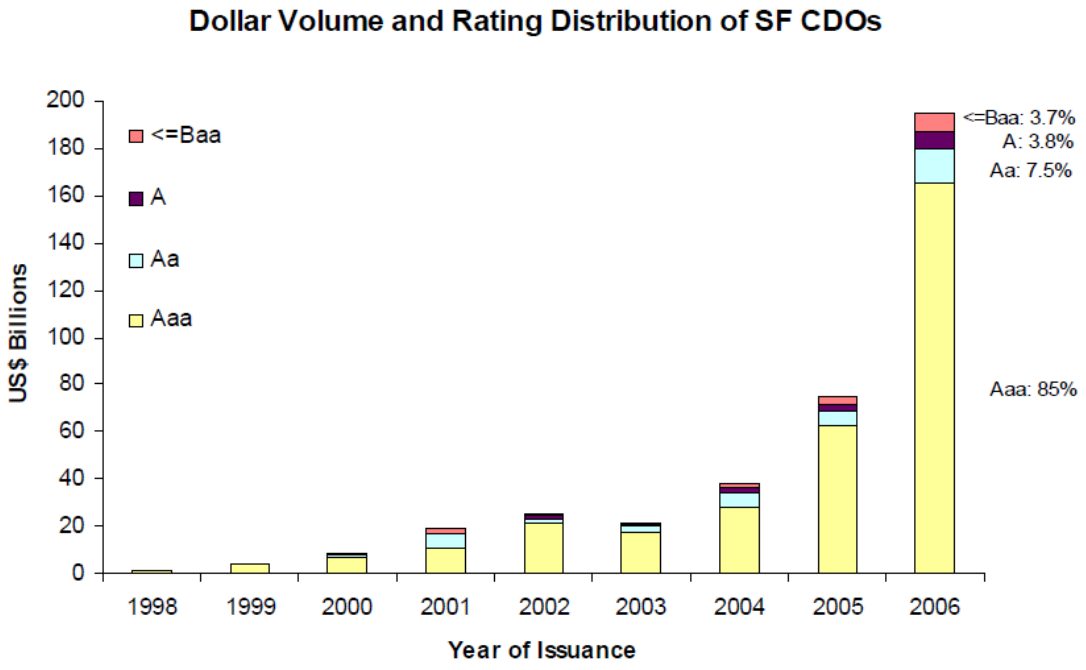
CDOs and CDOs squared did not directly increase the supply of private MBS since the raw materials for CDOs were tranches from private MBS. Likewise for CDOs squared, whose raw materials were tranches of CDOs. This was a zero sum relationship. However, due to the additional leverage CDOs and CDOs squared provided, they had a tremendous indirect impact on increasing the supply of private MBS. An apt analogy would be the development of new methods to "crack" petroleum.[307] This process did not add one barrel to the supply of petroleum. Yet the various by-products made available by the cracking process created explosive demand for the raw material – petroleum.

Chart 35 shows the dollar volumes and rating distribution of single-family CDOs.[308]

[307] Wikipedia: Cracking is the process whereby complex organic molecules such as heavy hydrocarbons are broken down into simpler molecules (e.g. light hydrocarbons such as gasoline, diesel fuel, and liquefied petroleum gas) by the breaking of carbon-carbon bonds. This process was first developed in the 1890s. http://en.wikipedia.org/wiki/Cracking_%28chemistry%29

[308] Jian Hu, Senior Vice President, Structured Finance – CDOs/Derivatives, Moody's Investors Service, "Assessing the Credit Risk of CDOs Backed by Structured Finance Securities: Rating Analysts' Challenges and Solutions", August 31, 2007 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1011184.

Chart 35:



Note: The data in this chart does not include non-US$ denominated tranches and wrapped tranches. "<=Baa" represents securities rated Baa or below.

Fannie and Freddie's MBSs did not need to be structured with tranches having different ratings since their MBSs benefit from the implicit government guarantee. A Fannie MBS required Fannie to hold capital of 0.45% and the bank buying the MBS to hold 1.6%, for total capital of 2.05% and a leverage ratio of 49:1. While the private MBS/CDO/CDO squared execution still had a lower leverage ratio than a GSE MBS, the gap had been substantially closed. Again use of a SIV (Structured Investment Vehicle) could increase leverage further. Since the loans being securitized had higher margins, the overall execution was financially viable. So viable that Countrywide and other private MBS issuers were now in a position to offer pricing that allowed for an all-in execution for both GSE-conforming and non-GSE-conforming loans.

This impact may be illustrated by looking at the GSEs' share of Countrywide's business. From 2000 to mid-2003 (before the advent of heavy use of CDOs and CDOs squared), Fannie's and Freddie's share of Countrywide's prime conventional and total business averaged about 88% and 70% respectively. Their share of Countrywide's business declined dramatically as CDOs and CDOs squared, with the benefits of increased leverage, came into common usage. By early-2005 Fannie's and Freddie's share of Countrywide's prime conventional and total business had dropped by more than half, averaging about 37% and 27% respectively.[309]

[309] Fannie Mae document released by the U.S. House Committee on Oversight and Government Reform, "Single Family Guarantee Business – Facing Strategic Crossroads", June 27, 2005

In July 2005 Fannie noted "[S]trong CDO demand for subordinate bonds means lenders have a steady investor source for riskiest credit" was one of the "key drivers of growth in subprime."[310] The benefit of an all-in execution is illustrated by the following:

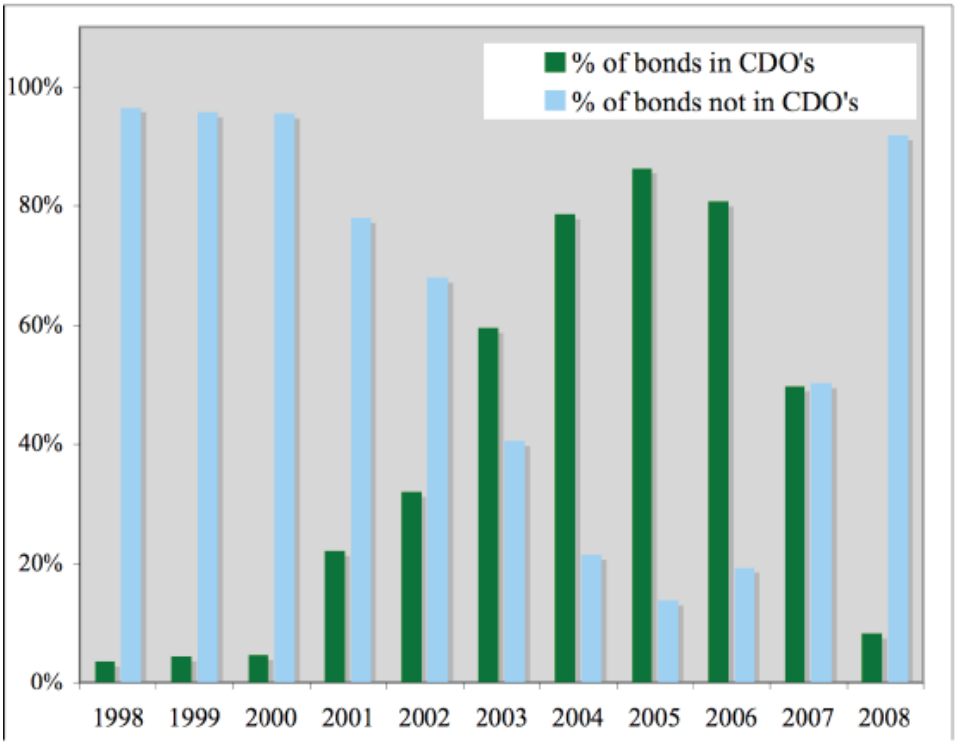
- Over the period April 2004 - January 2005, 90% of the conforming loans (based on size) in prime fixed and ARM private MBS met Fannie's standards and comprised 17% of collateral backing these MBS. These loans had a weighted average combined LTV of 92.4%, 40% were low doc/no doc, and 79% were interest only;
- Over the period April 2004 - January 2005, 62% of the conforming loans (based on size) in Alt-A private MBS met Fannie's standards and comprised 36% of collateral backing these MBS. These loans had a weighted average combined LTV of 95.8%, 56% were low doc/no doc, 60% were interest only, 24% were investor loans, and 21% were cash out; [311]

Adding to the pressure on Fannie was that Alt-A and Subprime "scored high relative to [its] core products – Alt-A: 30% total minority score [and] Subprime: 52% total minority score."[312] Alt-A also had a high score for 1-4 unit rental (investor) properties, providing the GSEs with another means of meeting their escalating goals.

CDOs provided the most benefit when comprised of tranches rated below "A". Since these tranches typically accounted for about 4% of a private MBS, CDOs quickly absorbed an increasing percentage of the lower rated tranches. By 2003, CDOs were utilizing 60% of lower rated tranches on subprime private MBS, up from 30% in 2002. By 2004 CDOs were absorbing 80%.[313]

[310] Id.
[311] Id.
[312] Id.
[313] http://www.hks.harvard.edu/m-rcbg/students/dunlop/2009-CDOmeltdown.pdf

Chart 36: Percent of mezzanine tranches (tranches rated below "A") from subprime MBS either in and not in CDOs



The policy justification for the GSEs' low capital requirement and risk based weight rested on the concept that since they only invested in low risk mortgage assets (generally true prior to passage of the GSE Act of1992) and were large holders of those assets, their risk was well diversified.[314] In an interesting parallel, similar logic was used by the rating agencies in rating CDOs. Using Moody's as an example, a separate area within Moody's was responsible for rating CDOs. This group relied on the underlying ratings given to the tranches by the residential MBS (RMBS) area of Moody's. These assets were viewed as a type of asset with limited downside risk:

> "As a new kind of asset sourced from the consumer sector, subprime RMBS were also perceived to yield substantial benefit of diversification."[315]

In both instances the fact that a lengthy period of loosened lending could cause a downturn in the housing market to turn into a broad and deep decline in home prices was missed. This turned the perceived benefit of diversification into an albatross.

[314] Congress made the following finding in the GSE Act:"[c]onsidering the current operating procedures of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal Home Loan Banks, the enterprises and the Banks currently pose low financial risk of insolvency." http://en.wikisource.org/wiki/Housing_and_Community_Development_Act_of_1992/Title_XIII

[315] Supra. Jian Hu

The risk based capital standards for mortgage securities were the regulatory equivalent of the Heisenberg Uncertainty Principle, which holds that it is impossible to measure simultaneously both position and velocity of a microscopic particle with any degree of accuracy or certainty, since measuring one will invariably change the value of the other. The same principle may be applied to asset classes – – it is impossible to determine simultaneously both the credit risk of an asset and its appropriate risk weight with any degree of accuracy or certainty. Whenever an asset class is signaled out with a low risk designation thereby allowing for a low risk capital weight (i.e. greater leverage), forces are unleashed (such as increased demand and efforts to meet that demand) causing the category to morph to higher risk.

2002-A:

In April, Fannie's Chairman Franklin Raines described the competitive landscape for public funding for housing:[316]

> "As a result of both congressionally mandated lending requirements and its own $2 trillion American Dream Commitment, Fannie Mae has not-so-quietly become the largest single provider of mortgage funds to minority and low-income families, its chairman declared last week."
>
> "Not only is Fannie Mae 'by far' the largest supplier of mortgage money in the private sector, Franklin Raines proclaimed, the federally-chartered corporation is running 'neck and neck' with the Federal Housing Administration as the chief source of public funding for housing."
>
> 'The government is our only competitor,' Mr. Raines said."

The absurdity of a government sponsored enterprise viewing the government as its competitor was lost on Mr. Raines. Congress intended this competition in passing the GSE Act of 1992.

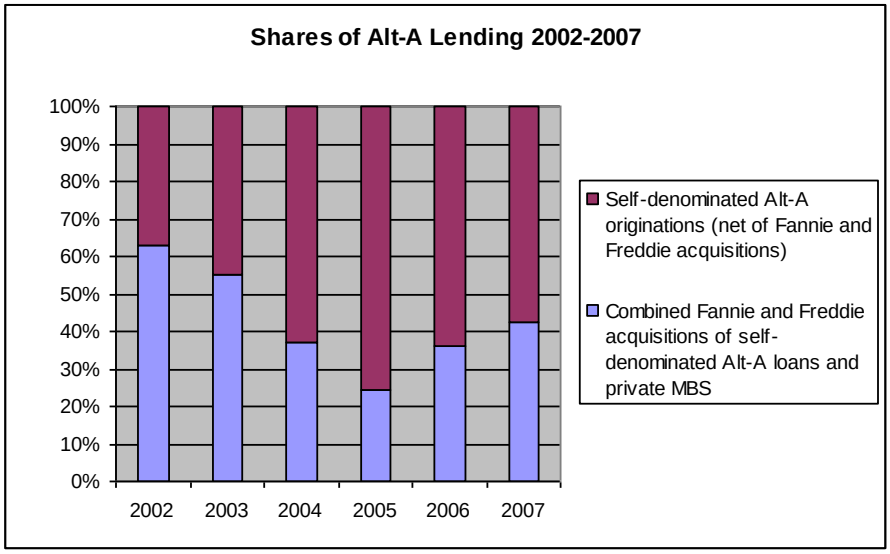
2002-B:

Alt-A volume as a percent of the overall market stayed quite small until 2004, equaling 5% or less through 2003. While there is little hard data on Fannie and Freddie's involvement in the Alt-A market prior to 2002, anecdotal evidence dates their re-entry to the late-1990s. This is supported by the fact that by 2002 they were the dominant purchasers of Alt-A loans (see **chart 36** below). The GSEs acquired an $84 billion in combined Alt-A whole loans and private MBS, amounting to 63% on a dollar and 75% on a loan count basis of Alt-A loans originated in 2002.

As shown above in **Chart 29**, the GSEs' share of Alt-A on a dollar basis declined to below 50% for 2004 and the years following.

[316] "Fannie Mae Declares Itself a Leader In Reaching Out to the Underserved", National Mortgage News, April 1, 2002, http://www.encyclopedia.com/doc/1G1-84313517.html

Chart 37: Share of Alt-A Lending 2002-2007 (on a dollar basis)



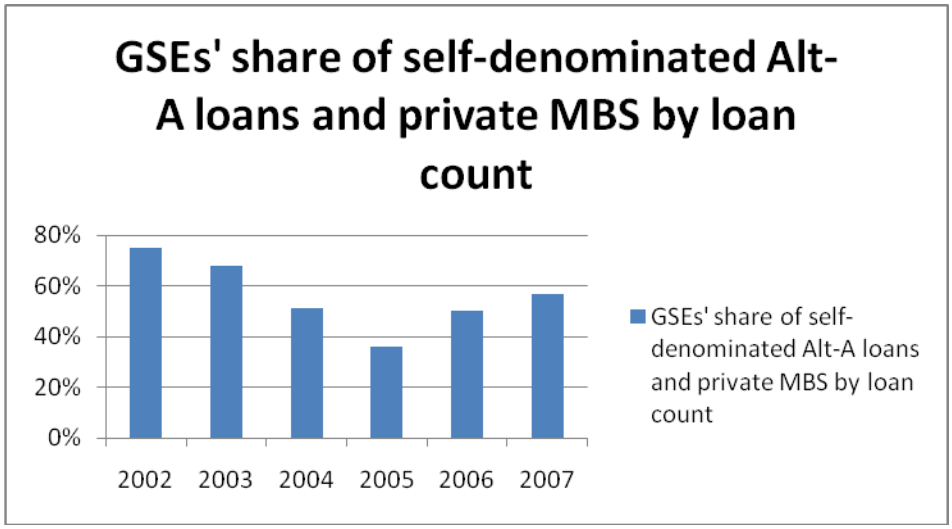
Sources: Inside Mortgage Finance, OFHEO's "Mortgage Markets and the Enterprises" annual reports and Fannie and Freddie Information Statements and Annual Reports. Compiled by Edward Pinto

It is important to note that the average loan size of the Alt-A loans and securities acquired by the GSEs was a little more than half that of those they did not buy. As a result their share on a number of loans basis dropped below 50% only in 2004 (see **Chart 38** below). Thus the GSEs accounted for an estimated 60% of the 5.5 million self-denominated Alt-A loans outstanding as of 6.30.08.[317] These 5.5 million loans had an outstanding balance of $1.3 trillion.[318]

[317] Self-denominated Alt-A loans are either ones reported as Alt-A by Inside Mortgage Finance or acquisitions reported as Alt-A by Fannie and Freddie. Based on the totals reported by each there does not appear to be overlap. For example, Inside Mortgage Finance reports Alt-A originations in 2003 of $85 billion of which $74.2 billion ended up in Alt-A private MBS. For the same year, FHFA (formerly OFHEO) reported that Fannie and Freddie acquired $77 billion in Alt-A whole loans. GSE acquisitions of $77 billion do include $12 billion of Alt-A private MBS tranches purchased by the GSEs. See OFHEO's Mortgage Markets and the Enterprises in 2003. p. 14, http://www.fhfa.gov/webfiles/2253/MME2003.pdf. Similarly for 2005 Inside Mortgage Finance reports $380 billion of Alt-A originations of which all but $48 billion ended up in private MBS. Fannie reports in its Q1:2008 Investor Summary on p.30 that it had $59.4 billion in Alt-A credit risk left from 2005 acquisitions (excludes any Alt-A private MBS acquisitions). http://www.freddiemac.com/investors/er/pdf/supplement_031109.pdfLikewise, Freddie reports in its 2008 Investor Supplement on p. 16 that it had $31.5 billion of Alt-A loans left from 2005 acquisitions (excludes any Alt-A private MBS acquisitions). http://www.freddiemac.com/investors/er/pdf/supplement_031109.pdf).

[318] Derived from Fannie, Freddie, Inside Mortgage Finance, and New York Federal Reserve data

Chart 38:



Sources: Inside Mortgage Finance, OFHEO's "Mortgage Markets and the Enterprises" annual reports and Fannie and Freddie Information Statements and Annual Reports. Compiled by Edward Pinto

The GSEs' purchased large quantities of Alt-A loans in both whole loan and securitized forms. Alt-A whole loans were purchased in bulk transactions acquired from Wall Street firms and loan originators.

The GSEs' dominance of the Alt-A market on a loan count basis provided a seal of approval for Alt-A loans and paved the way for Alt-A's surge in popularity in 2004-2007. Over much of this period the GSEs were buying bulk whole loan Alt-A packages directly from lenders and Wall Street investment bankers.

Alt-A loans were affordable housing "goals rich" in non-owner occupied (NOO) single-family (1-4 unit) rental units and minority [underserved] borrowers which helped drive the GSEs' appetite for these loans. The following statement from Freddie confirms the role Alt-A played with respect to the affordable housing goals (particularly the underserved goal):

> "The Alt-A business makes a contribution to our HUD goals. This year [2004] the Alt-A bulk [whole loan] transactions contribute 2 basis points towards achieving our Low/Mod goals, 5 basis points to our Special/ Affordable goals, and 40 basis points to our underserved GSE goals. During 2003, the Alt-A bulk business contributed 10 basis points to our Low/Mod and Special/Affordable goals. However, the NINA {no income/no assets] business by themselves have a negative impact to goals due to the fact that borrower income is not disclosed." Internal Freddie Mac email from Mike May to Dick Syron, dated October 6, 2004 FMAC0013695 (contained in materials disclosed to the House Oversight and Government Reform Committee).

Also:

> "[since] NINA [no income/no asset] loans are minority rich, it will make it even more difficult to match the private market level of minority and underserved mortgage production." Internal Freddie Mac email from Donna Cogswell to Dick Syron, et. al. dated September 7, 2004 FMAC0013739 (contained in materials disclosed to the House Oversight and Government Reform Committee).

Also on page 11 of Mortgage Market Note 10-2, FHFA noted:

> "As the Alt-A market collapsed and underwriting standards tightened in 2008, the Enterprises' underserved areas goal performance suffered and, for the first time, one of the Enterprises, Freddie Mac, failed to meet the goal."[319]

OFHEO documented Alt-A whole loan purchases by Fannie and Freddie in 2002 and 2003:

> "Fannie Mae reported purchasing approximately $73.2 billion of low-documentation loans—mortgages to borrowers with good credit who chose to avoid the normal paperwork associated with getting a mortgage—in 2003, up from $51.8 billion in 2002....Freddie Mac purchased $3.9 billion of Alternative A loans in 2003, down from $14.5 billion in 2002."[320]

See Appendix E for further information on the contribution of Alt-A NOO single-family rental units to affordable housing goals.

2003-A:

The GSE Act of 1992 mandated the GSEs to dramatically increase the primary market's supply of affordable housing loans. The only means to accomplish this was by means of lower downpayments and the progressive weakening of underwriting standards through flexible underwriting. The GSEs subsidized high risk lending with their low risk business. The MBS guaranty portion of their businesses was low margin and did not yield sufficient subsidy for the task. The portfolio had much larger margins and could provide the needed subsidies. Growing the portfolio was the solution. The GSEs' combined mortgage portfolios increased from $136 billion in 1990 to $1.58 trillion in 2003.[321] Over time the high risk portion of the business grew and as the downpayment requirement shrunk, the cross subsidies needed became larger and the mispricing of risk became more unsustainable. As a result, the GSEs seriously under priced the risks they were taking on, thereby compounding the problem posed by their high level of leverage.

[319] http://www.fhfa.gov/webfiles/15408/Housing%20Goals%201996-2009%2002-01.pdf.pdf
[320] http://www.fhfa.gov/webfiles/15408/Housing%20Goals%201996-2009%2002-01.pdf.pdf
[321] Source: FHFA

2003-B:

The GSE Act of 1992 required the GSEs to take affirmative steps to assist banks in meeting their CRA obligations. In an early 2003 press release,[322] Fannie notes that for the period 2000-2002, it purchased $394 billion in CRA lending. It also noted that after having stepped up its CRA efforts, more than half of these CRA acquisitions ($201 billion) occurred in 2002. This constituted about 50% of Fannie's low and moderate affordable housing acquisitions for 2002.[323]

2003-C:

Helped by CDOs and CDOs squared, Countrywide and its subsidiaries were able to achieve a position envied by other market participants due to its successful vertical integration of the entire mortgage value chain from retail, correspondent, and wholesale lending[324] to securities underwriter.

In addition to being the nation's largest originator, largest wholesale originator, largest loan servicer, Fannie's largest customer, and the nation's second largest retail originator, Countrywide was both a major issuer (through Countrywide Financial) and underwriter (through Countrywide Securities) of non-Agency or private MBS (PMBS):

- Countrywide Financial's market share of private MBS issuances grew from 1.9% in 1996 (with a rank of #13) to 10.1% in 2003 (with a rank of #1) and 13.4% in 2006 (again with a rank of #1).

- Countrywide Securities' underwriting market share of PMBS grew from 1.4% in 1997 (with a rank of #13) to 8% in 2003 (with rank of #4) and 10% in 2006 (with rank of #2).[325]

[322] "Fannie Mae Passes Halfway Point in $2 Trillion American Dream Commitment; Leads Market in Bringing Housing Boom to Underserved Families, Communities" http://findarticles.com/p/articles/mi_m0EIN/is_2003_March_18/ai_98885990/pg_3/?tag=content;col1

[323] In 2002 Fannie acquired about $804 billion in single family mortgages (FHFA's 2008 Report to Congress, http://www.fhfa.gov/webfiles/2331/FHFAReportToCongress2008final.pdf) and had achieved a 52% low and moderate-income goal (see Chart 27 above). This resulted in $418 billion in low- and moderate-income purchases.

[324] Retail originations are those made directly by the lender. Correspondent originations are those purchased from another lender that directly made the loans. Wholesale originations are those involving a loan broker.

[325] Inside Mortgage Finance

Chart 39 demonstrates that Countrywide was the largest source for private MBS tranches used to create CDOs for 9 of the 10 largest CDO underwriters:[326]

Chart 39: Top CDO underwriters, number of issues and largest residential MBS supplier:

Bank underwriting CDO	# 0f CDOs issued	Largest Residential MBS supplier
Merrill Lynch	107	Countrywide
Citigroup	80	Countrywide
Credit Suisse	64	Countrywide
Goldman Sachs	62	Countrywide
Bear Stearns	60	Countrywide
Wachovia	52	Countrywide
Deutsche Bank	50	Countrywide
USB	46	Bear Stearns
Lehman	35	Countrywide
Bank of America	32	Countrywide
Total # of issues	697	

2003-D:

Countrywide's CEO, Angelo Mozilo, gives the prestigious Dunlop Lecture sponsored by Harvard's Joint Center for Housing Policy. This annual address is made "by a housing leader to highlight the importance of housing as a policy and research area at the university and in business."[327] Mozilo stated:

> "One of the more obvious resolutions to the 'Money Gap' is the elimination of downpayment requirements for low-income and minority borrowers. Current downpayments of 10% or less add absolutely no value to the quality of the loan. It is the willingness [credit history] and the ability of the borrower to make monthly payments that are the determinants of loan quality."[328]
>
> "From my point of view, if 80% of the sub-prime borrowers are managing to make ends meet and make the mortgage payments on time, then, shouldn't we as a Nation, be justifiably proud that we are dramatically increasing homeownership opportunities for those who have been traditionally left behind."[329]

[326] Chart 30 found at http://www.hks.harvard.edu/m-rcbg/students/dunlop/2009-CDOmeltdown.pdf
[327] 2003 Dunlop Lecture, Harvard's Joint Center for Housing Policy, http://www.jchs.harvard.edu/publications/homeownership/M03-1_mozilo.pdf
[328] Id.
[329] Id.

The significance of Mozilo's 80% comment is that 20% of borrowers are not paying.

A 20% default rate with a 50% severity (the percentage of the loss relative to the mortgage balance) results in a 10% loss rate. Losses of this magnitude require an annual default risk premium of 2.5%-3%. This default incidence is unsustainable at the family level – loosened underwriting sets up many home owners for failure. It is unsustainable at the neighborhood level – as foreclosures spread they destroy neighborhoods.

In 2003 Countrywide was the nation's 8th largest subprime lender with a 6% market share. By 2006 it was #3 with a 6.8% share of a subprime market that was twice the size in 2003.[330]

2003-E:

While the self-denominated subprime market has grown in dollar volume, it has lost market share due to Fannie and Freddie in 2001-2003 (see **Chart 28** above and **Chart 40** below). This result was expected by HUD when it issued the GSEs' higher affordable housing goals in 2000. At the same time, substantial consolidation occurred with the top 25 lenders now having over twice the market share as in 1995:[331]

Chart 40:*

Total Originations—Consolidation and Growth

Year	Total B&C originations (billions)	Top 25 B&C originations (billions)	Top 25 market share of B&C	Total originations	B&C market share of total
1995	$65.0	$25.5	39.3%	$639.4	10.2%
1996	$96.8	$45.3	46.8%	$785.3	12.3%
1997	$124.5	$75.1	60.3%	$859.1	14.5%
1998	$150.0	$94.3	62.9%	$1,450.0	10.3%
1999	$160.0	$105.6	66.0%	$1,310.0	12.2%
2000	$138.0	$102.2	74.1%	$1,048.0	13.2%
2001	$173.3	$126.8	73.2%	$2,058.0	8.4%
2002	$213.0	$187.6	88.1%	$2,680.0	7.9%
2003	$332.0	$310.1	93.4%	$3,760.0	8.8%

SOURCE: *Inside B&C Lending*. Individual firm data are from *Inside B&C Lending* and are generally based on security issuance or previously reported data.

* B&C stands for "B" and "C" grade subprime lending.

Chart 41 provides further evidence of the effects of crowding out by the GSEs with respect to self-denominated subprime lenders. The GSEs' subprime loan acquisitions were almost entirely fixed rate. Virtually all of the GSEs' subprime loan (FICO <620) acquisitions were fixed rate.[332]

[330] Inside Mortgage Finance

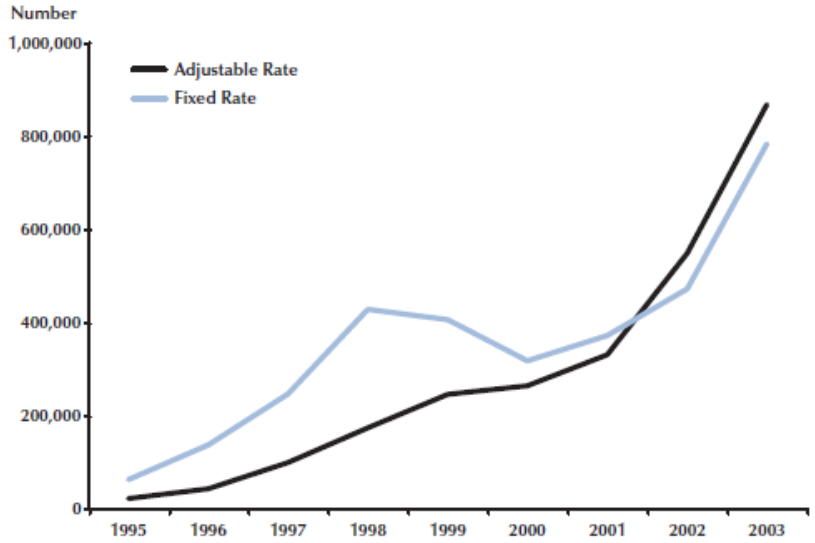
[331] Souphala Chomsisengphet and Anthony Pennington-Cross, January-February 2006 , "The Evolution of the Subprime Mortgage Market" http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf

[332] The earliest available data is from Fannie's Q.3:07 Credit Supplement. It shows that 91.5% of Fannie's acquisitions with a FICO <620 were fixed rate. It is believed that this percentage was applicable similar acquisitions

As the GSEs gained market share in 2001-2003, the subprime market responded by moving out the risk curve to ARM loans. In 1996-7 more that 2/3 of securitized self-denominated subprime loans were fixed rate. By 2002, subprime ARMs outnumbered fixed rate ones.[333]

Chart 41:

Number of Loans Originated



SOURCE: LoanPerformance ABS securities data base of subprime loans.

2004-A:

Piggyback or combination 1st and 2nd mortgage lending has been around for decades. It involves a borrower taking out two simultaneous or near-simultaneous mortgages. Usually the 1st is for 80% and the 2nd is for 10, 15, or 20% of the sales price or appraised value. The motivation is usually to either avoid the mortgage insurance requirement placed on the GSEs in their charters or to reduce the size of the 1st to the GSE conforming loan limit. The use of piggyback lending surged in the late 1990s. By 2004 over 34% of all purchase transactions had a piggyback loan and 71% had a downpayment of <=5%.[334] [335]

---

made in earlier years. Found at p. 3, http://www.fanniemae.com/ir/pdf/earnings/2007/credit_supplement.pdf;jsessionid=RISU2ZKEYOXSHJ2FECISFGA

[333] Souphala Chomsisengphet and Anthony Pennington-Cross, January-February 2006 , "The Evolution of the Subprime Mortgage Market" http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf

[334] "Piggyback Mortgage Lending, SMR Research Corporation, 2004, pp. 6-7

[335] Piggyback transactions were generally structured as an 80/10/10 (80% 1st, 10% 2nd, and 10% equity), an 80/15/5 (80% 1st, 15% 2nd, and 5% equity) or an 80/20 (80% 1st, 20% 2nd, and 0% equity). Therefore, piggyback lending with a combine LTV>90% effectively meant a downpayment of 5% or zero.

Chart 42:

	2001	2002	2003	2004
% of home purchase transactions (units) with piggyback loans[336]	14.1%	17.53%	22.59%	32.76% (1st half)
% of piggyback home purchase transactions (units) with downpayment of <=5%[337]	50.05%	62.19%	66.65%	71.00% (1st half)
% of all home purchase transactions (units) attaining a downpayment of <=5% using piggyback financing	**7.06%**	**10.90%**	**15.06%**	**23.26%** (1st half)
% of all conventional home purchase transactions/all home purchase transactions (adjusted to account for government home purchase loans) with a downpayment of <=5% using private mortgage insurance[338]	21%/**19%**	21%/**20%**	20%/**19%**	18%/**17%**
% of all home purchase transactions (units) with a downpayment of <5% using FHA or VA financing[339] [340]	17% x82%= **14%** (FY)	15.6%x81%= **12.6%** (FY)	12.8x78%= **10%** (FY)	8.8%x78%= **6.9%** (FY)
% of all home purchase transactions with a downpayment of <=5% using any means above.	**40%**	**44%**	**44%**	**47%**

[336] Supra, SMR Research Corporation, p. 18
[337] Id. p. 32
[338] Federal Housing Finance Board. This data series tracks conventional (non-government) home purchase loans with an LTV >90% (effectively a downpayment of <=5%) and excludes presence of a 2nd mortgage, if any. Conventional lending totals adjusted downward to reflect all originations using Inside Mortgage Finance data on government loan originations.
[339] Supra. FHA 2009 Actuarial Study, p. 42, Exhibit IV-5. Based on the percentage of FHA loans with an LTV>95% (downpayment of <5%). Assumes VA has the same percentage. This methodology is believed to be conservative. Also "FHA Single-Family Activity in the Home-Purchase Market through November 2009", Table 1. http://www.hud.gov/offices/hsg/comp/rpts/fhamktsh/fhamkt1109.pdf
FHA share of home purchase loans increased by 27%, 28%, 40%, and 37% in each of 2001, 2002, 2003, & 2004 to account for VA loans (Inside Mortgage Finance 2009 Mortgage Market Statistical Annual, vol. 1, p.3).
[340] Few piggyback loans are used on government loans. See p. 28 SMR research Corporation

The percentage 2004 home purchase loans with a downpayment of <=5% totaled 47%, well over double the level of 21% in 1991.[341] However this understates the full impact. In 1991 only 1.24% of home purchase loans had a downpayment of <=3% and all were insured by FHA. By 2004 over 20% or 1 in 5 home purchase loans had a down payment of <=3% with FHA accounting for 1 in 10 of these loans (see **Chart 14**). HUD's goal of broadly reducing downpayments was being accomplished.

SMR's piggyback lending report contains a warning of the many factors aligning that could lead to "A Perfect Storm" of delinquencies by the end of 2005:[342]

1. Ten trillion dollars in home mortgage were originated over 2002-2004.[343] This has resulted in a largely unseasoned portfolio[344] which has dampened delinquency rates. As these loans season, rates will go up.
2. High LTV lending correlates with higher delinquency and default levels;
3. The volume of ARMs that will be re-pricing higher and the attendant payment shock;
4. The impact of interest only and other new exotic loans;
5. A much greater number of borrowers with high debt-to-income ratios;
6. The impact of subprime loans;
7. A expected rising bankruptcy rate in 2006;
8. "A strong possibility of home price depreciation in selected or regional markets, and maybe even in the national market."

About the same time as the SMR report was released, HUD released its affordable housing rules for 2005-2008. HUD noted:

> "Over the past ten years, there has been a 'revolution in affordable lending' that has extended homeownership opportunities to historically underserved households. Fannie Mae and Freddie Mac have been a substantial part of this 'revolution in affordable lending'. During the mid-to-late 1990s, they added flexibility to their underwriting guidelines, introduced new low-downpayment products, and worked to expand the use of automated underwriting in evaluating the creditworthiness of loan applicants. HMDA

[341] Based on Federal Housing Finance Board data series, FHA 2009 Actuarial study, and VA share data from Inside Mortgage Finance. Piggyback lending in 1991 had a maximum combined LTV of 90%, therefore it did not add to the total (see **1991-A**).
[342] Supra. SMR Research Corporation, pp. 36, 38-39
[343] Inside Mortgage Finance, The 2009 Mortgage Market Statistical Annual, vol. 1, p. 4
[344] Home mortgages outstanding at the end of 2004 totaled $7.835 trillion. Fed Flow of Funds, 1995-204, L.218, p. 87, http://www.federalreserve.gov/releases/z1/current/annuals/a1995-2004.pdf

> data suggest that the industry and GSE initiatives are increasing the flow of credit to underserved borrowers. Between 1993 and 2003, conventional loans to low income and minority families increased at much faster rates than loans to upper-income and non-minority families."[345]

This "revolution in affordable lending" had created a dangerously synchronized mortgage market with an unprecedented numbers of overleveraged loans made to an unprecedented number of overleveraged borrowers. HUD had fashioned a housing finance market ill-equipped to absorb the potential shock of declining prices.

2004-B:

A 300-plus page rulemaking by HUD is a veritable how-to-manual designed to force the GSEs onto a market leadership position with respect to the use of even greater levels of loosened lending.[346] The rule is issued by HUD Secretary Alphonso Jackson mandates increased goals for the GSEs. The Low- and Moderate- income Goal is raised from 50% in 2004 to 52% for 2005, 53% for 2006, 55% for 2007 and 56% in 2008.[347] While the Low- and Moderate- income Goal increases by 6% over a 5 year period, the Special Affordable Goal (low- and very low-income) increases from 20% to 27%. Thus HUD effectively decreases the moderate-income portion of the goal by 1%, while implementing a 7% increase in the harder to serve low- and very- low income component of the goals. Placing the entire increase in housing goals on the Special Affordable (low- and very low-income) category required the GSEs to once again reach further down the demand curve. To create this new demand necessitated another major expansion of efforts to ease home purchase requirements by further lowering downpayments and developing other leverage increasing flexibilities. It also required deeper subsidies as compared to the moderate-income group. For example, Special Affordable home purchase loans account for about 42% of all low- and moderate-income home purchase loans with an LTV>95% for 2005-2007.

> "These new affordable housing goals will help the GSEs achieve the standard that Congress intended-leading the mortgage finance industry in helping low- and moderate-income families afford decent housing," said HUD Secretary Alphonso Jackson. "These new goals will push the GSEs to genuinely lead the market."[348]

HUD was clear in its expectations of the GSEs

> "Millions of Americans with less than perfect credit or who cannot meet some of the tougher underwriting requirements of the prime market for reasons such as inadequate income documentation, limited downpayment or cash reserves, or the desire to take more cash out in a refinancing than conventional loans allow, rely on subprime lenders for

[345] Final Rule, p. 63645, http://fdsys.gpo.gov/fdsys/pkg/FR-2004-11-02/pdf/04-24101.pdf
[346] Final Rule, http://fdsys.gpo.gov/fdsys/pkg/FR-2004-11-02/pdf/04-24101.pdf
[347] http://www.huduser.org/Datasets/GSE/gse2007.pdf
[348] "HUD FINALIZES RULE ON NEW HOUSING GOALS FOR FANNIE MAE AND FREDDIE MAC", press release dated November 1, 2004, http://archives.hud.gov/news/2004/pr04-133.cfm

> access to mortgage financing. If the GSEs reach deeper into the subprime market, more borrowers will benefit from the advantages that greater stability and standardization create."[349]

Notwithstanding the GSEs' introduction of no downpayment lending in 2000, HUD was insistent that they increase their acquisitions of these high risk loans.[350] This is notwithstanding that 47% of all homebuyers in 2004 had a downpayment of <=5% and 19% Fannie's home purchase loans had a downpayment of <=3%.

HUD was continually evaluating the GSEs on the basis of how far they had to go before they would be "leading the market". However, achieving leadership as defined by HUD was always a stretch:

1. It was difficult for the GSEs to exceed the average in terms of the parameters HUD was measuring, since they were such a large portion of the market.
2. Given their charter advantages, they had a virtual lock on the lower risk "plain vanilla" business, which was not "goals rich" but counted in the denominator.
3. At the same time, crowding out by the GSEs pushed its competitors towards "goals rich" loans because they had higher risks with higher yields.
4. HUD's and other government initiatives (ex. CRA) also mandated large amounts of "goals rich" lending, not all of which was available for purchase by the GSEs. For example, much CRA business was done at below market rates and therefore was difficult to sell without taking a loss.[351]

If one were to look instead at how far the GSEs had come since 1993, particularly with respect to expanding low- and very low-income lending, the picture is quite different. Using Freddie as an example, in 1993 it had a baseline achievement of 22.8% for moderate-income and 7.2% for low- and very low-income lending.[352] Chart 43 shows the percentage point increase above these two baselines. While the moderate-income attainment shows only a minimal increase after 1994, the low- and very low income attainment increased dramatically and continuously.

---

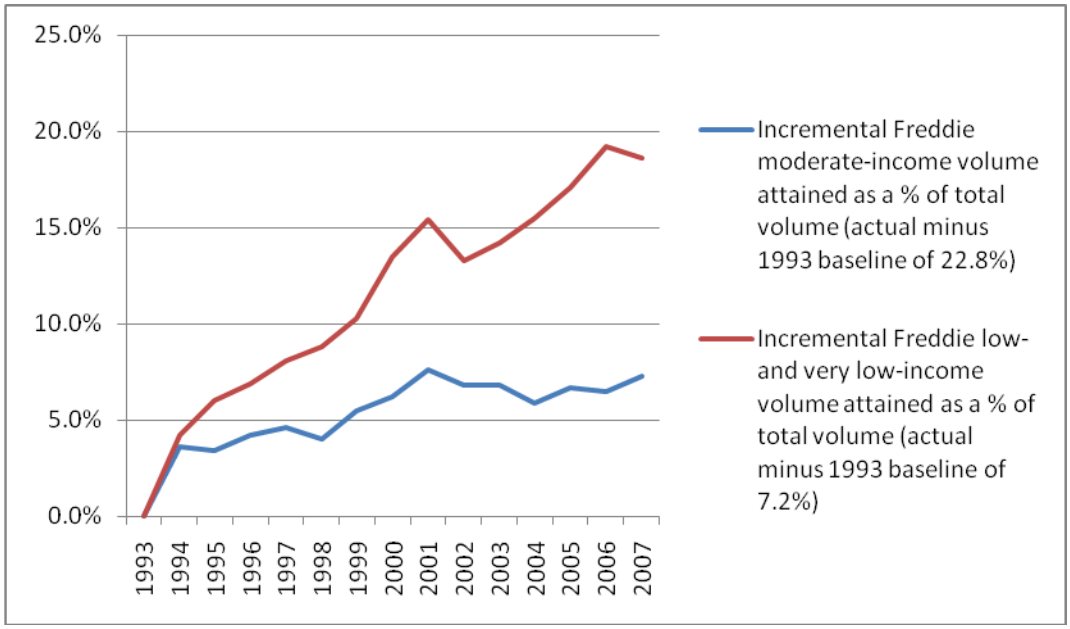
[349] Final Rule, p. 63601, http://fdsys.gpo.gov/fdsys/pkg/FR-2004-11-02/pdf/04-24101.pdf

[350] Id. In HUD's rule making, the word "downpayment is mentioned over 50 times, almost always in the context of them still being too high.

[351] Federal Reserve Bank of Kansas City, "Community Reinvestment Act lending: Is it profitable?", Appendix B, p. 32 http://www.kansascityfed.org/PUBLICAT/FIP/prs96-2.pdf. This 1996 study found that 76% of CRA loans were less profitable, substantially less profitable, or not profitable. This report also documented a litany of loan subsidies and loosened credit standards undertaken by banks in order to facilitate CRA lending.

[352] Source HUD. Freddie achieved a level of 30% low- and moderate-income lending in 1993, with a low- and very low attainment of 7.2%, for a moderate-income attainment of 22.8%. The goals process was more complicated that this example makes out. However, it illustrates the large increase in low- and very low-income lending attained by the GSEs.

Chart 43:[353]

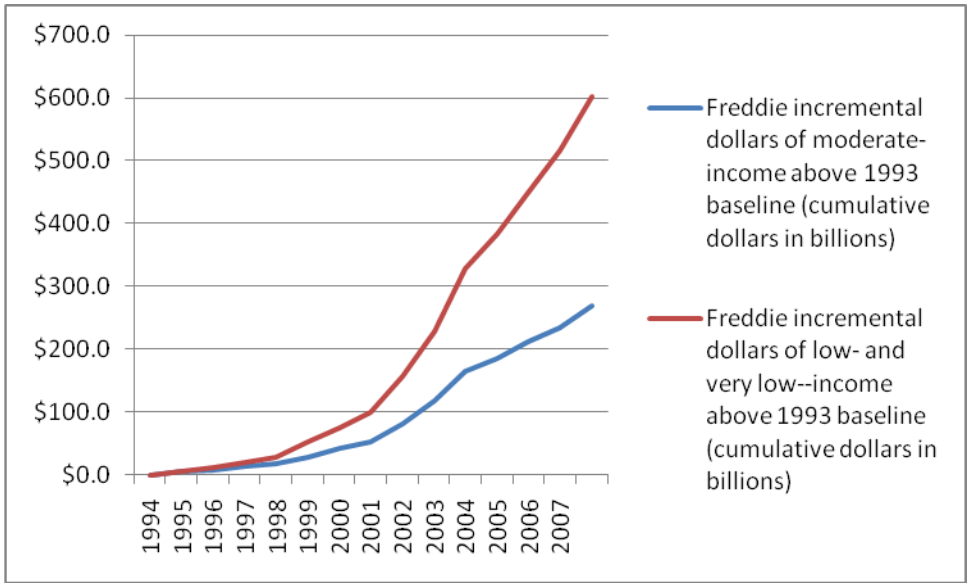


Compiled by Edward Pinto

Chart 44 converts the incremental increases shown in Chart 43 into cumulative dollar increases (in billions) of moderate- and low- and very low-income loans acquired.[354] HUD's policy of increasing the low- and very low-income goal while keeping increases in the moderate-income component modest caused Freddie's low- and very low-income acquisitions to grow much faster. Fannie's trend is similar, except with substantially larger volumes given its larger size. To generate the large volume of low- and very low-income loan acquisitions necessitated by HUD's increased goals, the GSEs needed to implement additional loosening of their credit standards. See **Chart 22** above for Fannie's growth trend for loans with an LTV>95%.

[353] Source: HUD"s Office of Policy Development and Research - Profiles of GSE Mortgage Purchases in 1999 and 2000, in 2001-2004, and in 2005-2007
[354] Id.

Chart 44:



Compiled by Edward Pinto

The impact of escalating affordable housing goals on the GSEs was dramatic. They would continue to loosen underwriting standards in an effort to meet the goals. Higher risk loans (e.g. loans with little or no downpayment or reduced amortization and borrowers with impaired credit, high debt ratios, or little or no documentation) would become a greater portion of the GSEs' credit risk portfolio. The mispricing[355] of the higher risk goals compliant business combined with the added default risk represented by these loans was a dangerous combination for any lender, but all the more so for ones as highly leveraged as the GSEs. For the most part the GSEs were not acquiring high risk loans and private MBS to increase profits; they were doing it in meet affordable housing goals. The GSEs' net interest margin and income decreased after 2003. But like Sisyphus in the myth, each time they would reach the latest goals, higher ones would apply for the following year.

[355] HUD saw the GSEs' expansion into subprime as a means to correct what HUD perceived to be mispricing or predatory pricing by subprime lenders. HUD noted in its 2004 rulemaking: "families living in inner-city, high-minority neighborhoods often have to rely on subprime lenders as their main source of mortgage credit. Studies indicate that many of these borrowers obtaining high cost loans could qualify for lower-cost, prime mortgage credit." p. 63601, http://fdsys.gpo.gov/fdsys/pkg/FR-2004-11-02/pdf/04-24101.pdf

To some significant extent this appearance of mispricing was created by the GSEs' inherent pricing advantages along with their ability to cross-subsidize their subprime-like loans with the profits from their low risk loans. Besides the obvious problems associated with mispricing risk, it sent a false pricing signal to the GSEs' competitors – subprime lenders. The mispricing of high risk credit features has been well documented by the FHFA in a July 30, 2009 report entitled "Fannie Mae and Freddie Mac Single-family Guarantee Fees in 2007 and 2008", http://www.fhfa.gov/webfiles/14700/GFees72009.pdf

Charts 45 and 46 from OFHEO (now FHFA) document trends of declining income, net interest margin, and return on common equity from 2003 through 2007.[356] Guarantee fees stay relatively level for Fannie while declining for Freddie, not a good sign given the increasing credit risk posed by affordable housing loans:

Chart 45:

Table 1. Fannie Mae Financial Highlights

SELECTED FINANCIAL HIGHLIGHTS[1]
(Dollars in Billions)

EARNINGS PERFORMANCE:	2003	2004	2005	2006	2007
Net Income ($)	8.1	5.0	6.3	4.1	-2.1
Net Interest Income ($)	19.5	18.1	11.5	6.8	4.6
Guarantee Fees ($)	3.4	3.8	4.0	4.3	5.1
Net Interest Margin (%)[2]	2.12	1.86	1.31	0.85	0.57
Average Guarantee Fee (bps)[3]	21.9	21.8	22.3	22.2	23.7
Return on Common Equity (%)[4]	27.6	16.6	19.5	11.3	-8.3
Dividend Payout Ratio (%)[5]	20.8	42.1	17.2	32.4	N/M

Source: Fannie Mae
N/M – Not Meaningful
[1] Data for 2003 are based on restated and revised financial results.
[2] Taxable equivalent net interest income divided by average earning assets.
[3] Guarantee fees divided by average MBS outstanding net of MBS held in portfolio.
[4] Calculated as annualized net income available to common stockholders divided by average common stockholders' equity.
[5] Paid common dividends as a percentage of net income available to common stockholders.

[356] Source: OFHEO, "Mortgage Markets and the Enterprises in 2007. pp. 33-34, http://www.fhfa.gov/webfiles/1164/MME2007revised.pdf

Chart 46:

Table 2. Freddie Mac Financial Highlights

SELECTED FINANCIAL HIGHLIGHTS[1]
(Dollars in Billions)

EARNINGS PERFORMANCE:	2003	2004	2005	2006	2007
Net Income ($)	4.8	2.9	2.1	2.3	-3.1
Net Interest Income ($)	9.5	9.1	4.6	3.4	3.1
Guarantee Fees ($)	1.7	1.4	2.1	2.4	2.6
Net Interest Margin (%)[2]	1.27	1.24	0.66	0.47	0.44
Average Guarantee Fee (bps)[3]	23.3	17.5	16.6	17.1	16.6
Return on Common Equity (%)[4]	17.7	9.4	8.1	9.8	-21.0
Dividend Payout Ratio (%)[5]	15.6	34.9	56.9	63.9	N/M

Source: Freddie Mac
N/M – Not Meaningful

[1] Data for 2003 are based on restated and revised financial results.

[2] Taxable equivalent net interest income divided by average earning assets.

[3] Guarantee fees divided by average MBS outstanding net of MBS held in portfolio.

[4] Ratio computed as annualized net income available to common stockholders divided by the simple average of beginning and ending stockholders' equity, net of preferred stock (at redemption value).

[5] Paid common dividends as a percentage of net income available to common stockholders.

HUD suggested:

> "While the GSEs can choose any strategy for leading the market, this leadership role can likely be accomplished by building on the many initiatives and programs that the enterprises have already started, including: (1) Their outreach to underserved markets and their partnership efforts that encourage mainstream lenders to move into these markets; (2) their incorporation of greater flexibility into their purchase and underwriting guidelines, (3) their development of new products for borrowers with little cash for a downpayment and for borrowers with credit blemishes or non-traditional credit histories; (4) their targeting of important markets where they have had only a limited presence in the past, such as the markets for minority first-time homebuyers; (5) their purchases of both newly-originated and seasoned CRA loans; and (6) their use of automated underwriting technology to qualify creditworthy borrowers that would have been deemed not creditworthy under traditional underwriting rules"[357]

[357] HUD Final Rule, p. 63606, http://fdsys.gpo.gov/fdsys/pkg/FR-2004-11-02/pdf/04-24101.pdf

HUD codified the Urban Institute's observation from 1998 regarding the need to gut the Three Cs of Mortgage Credit (see **1997-B** above) when it included the following as a formal finding upon which its rulemaking was based:

> "In addition to low incomes, barriers to homeownership that disproportionately affect minorities and immigrants include lack of capital for down payments and closing costs, poor credit history…."[358]

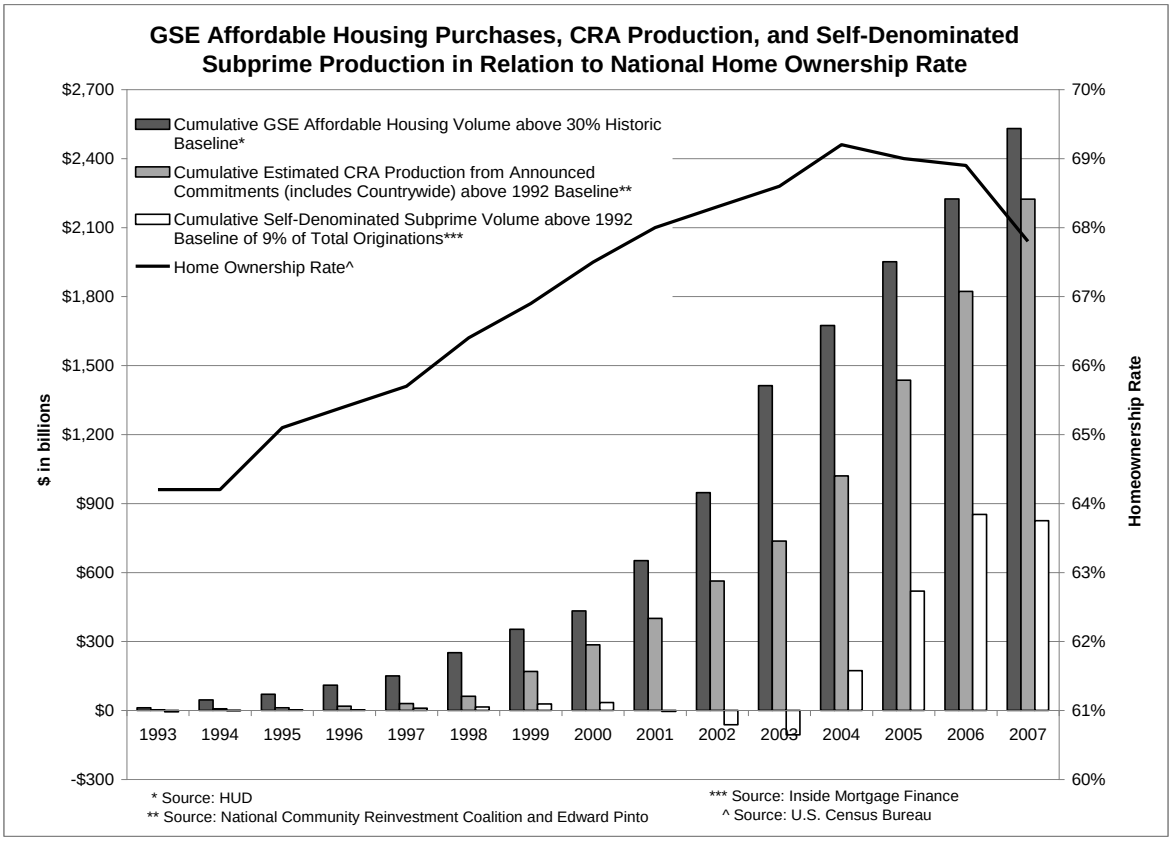
2004-C:

Chart 47 confirms that it was CRA and GSE affordable housing lending, not Self-denominated Subprime loans, that drove the homeownership rate upward for 10 years, reaching its peak in 2004. As Chart 47 demonstrates, subprime share had not grown during the period 1993-2003, declining modestly in 2001-2003. During this period the GSEs' and CRA's affordable housing share exploded. This conclusion is echoed by a former Office of Thrift Supervision Director:

> "Our record homeownership rate [increasing from 64.2% in 1994 to 68% in 2001], I'm convinced, would not have been reached without CRA [Community Reinvestment Act] and its close relative, the Fannie/Freddie requirements." - Ellen Seidman, Office of Thrift Supervision Director, before the Greenlining Institute on 10.2.01

[358] Id. p. 63645

Chart 47:



Compiled by Edward Pinto

* The calculation for subprime production is based on the cumulative surplus or deficit based on subprime's market share of 9% in 1993.

From 1993 to 2007 the GSEs acquired $3.6 trillion in additional low- and moderate-income loans than they would have acquired under their pre-1992 baseline where 30% of their acquisitions consisted of low- and moderate-income loans.

The impact of this expansion of highly leveraged lending on other market participants cannot be overestimated. Under HUD's National Housing Strategy virtually all market participants were under a mandate to use "flexible underwriting" on their low- and moderate-income lending. Once implemented, many of these flexibilities were made available to all borrowers. In a market place increasingly dominated by the GSEs and Countrywide, the GSEs' introduction of 97% LTV lending, followed by 100% LTV lending in 2000 was nothing short of cataclysmic. The market response was: if it's OK with Fannie and Freddie (the de facto standards setters) it must be OK for us. Over time, the growth of the GSE's flexible lending standards was reinforced by the widespread use of Fannie and Freddie's automated underwriting systems, even on loans not acquired by the GSEs. As the GSEs rolled out more flexible underwriting parameters in their systems, lenders were able to adjust their own standards on business not sold to the GSEs.

At the same time, Countrywide, one of the nation's largest originators, the GSEs' largest customer, and the largest originator of non-prime mortgages (i.e. subprime, Alt-A, and interest only/pay option ARMS), was constantly introducing new leverage increasing features, features that many of its competitors felt compelled to match. These included ever lower downpayments and higher debt ratios, greater use of interest only loans and pay option ARMs and the expansion of low doc/no doc lending. Countrywide's success and influence is evidenced by its market share of all originations increasing from 5.9% in 2000 to 16.8% in 2007.[359]

> "[The GSEs] were in many ways the fulcrum on which the financial crisis was leveraged. As the housing bubble inflated, Fannie and Freddie were there to buy up mortgages by the boatload, and their implicit government backing allowed them to raise money at bargain rates to fuel the binge."[360]

2004-D:

The GSEs' role in promoting the return of low doc/no doc lending has already been noted (**2002**). In the early 1990s Fannie and Freddie publicly announced they were no longer buying low doc/no doc loans because they were too risky.[361] Bad decisions over the objections of risk officers go back to Fannie's implementation of the 95% LTV mortgage over the objection of its chief risk officer in 1994. **(See 1994-B)**

In April 2004 David Andrukonis, Freddie's chief risk officer, expressed his concern to a colleague about the credit message being sent by Richard Syron, Freddie's CEO:

> "While you, Don and I will make the case for sound credit, it's not the theme coming from the top of the company and inevitably people down the line play follow the leader"[362]

Later in 2004 Freddie's CEO will make a bad decision contrary to its risk officer's advice that contributes substantially to its accumulation of non-traditional mortgages (NTMs):

> "In 1990 we called this product [low doc/no doc] 'dangerous' and eliminated it from the marketplace."[363]

Andrukonis went on to add:

> "We are less likely to get the house price appreciation we've had in the past 10 years to bail this program out if there's a hole in it."[364]

---

[359] Inside Mortgage Finance
[360] Jacquelyn Smith, "Fannie And Freddie Bid Farewell To NYSE", June 16, 2010, http://www.forbes.com/2010/06/16/fannie-freddie-delist-nyse-markets-equities.html?partner=alerts
[361] "Haste makes…Quick Home Loans Have Quickly Become Another Banking Mess", Wall Street Journal, July 5, 1991, Document contained in the author's files.
[362] Internal Freddie Mac email from David Andrukonis to Tracy Mooney, dated April 1, 2004 FMAC0013656
[363] Internal Freddie Mac email from David Andrukonis to Paul Peterson, dated April 5, 2004 FMAC0013672

He also warned:

> "The potential for the perception and reality of predatory lending with this product [No Income No Assets] is great."[365]

However meeting the affordable housing goals trumped concerns about dangerous risks and predatory lending:

> "The Alt-A [(low doc/no doc] business makes a contribution to our HUD goals."[366]

2004-E:

Fannie announces its next $2 trillion commitment.

> "Fannie Mae Launches Major Initiative to Tackle America's Toughest Housing Problems; Pledges to Help Raise Minority Homeownership Rate to 55 Percent over Next Ten Years."
>
> "Fannie Mae, the nation's largest source of financing for home mortgages, today joined its partners to announce its pledge to help 6 million families -- including 1.8 million minority families -- become first-time homeowners over the next decade. The pledge boosts the company's commitment to President George W. Bush's Minority Homeownership Initiative and will help raise the minority homeownership rate from 49 percent currently to 55 percent, with the ultimate goal of closing the gaps between minority homeownership rates and non-minority homeownership rates entirely."
>
> "Fannie Mae's new commitment to first-time home buyers is part of the next stage of the company's "American Dream Commitment," a plan announced in 2000 to provide $2 trillion in private capital for 18 million minority and underserved Americans to own or rent a home by the end of the decade. Having met the $2 trillion goal and the company's previous Trillion Dollar Commitment launched in 1994, Fannie Mae, along with many others -- including its lender, mortgage insurer, non-profit, real estate, home builder, housing finance agency, and other federal, state, and local government partners -- has now provided over $3 trillion in funds for over 28 million underserved families in 10 years. In 2003 alone, these strong partnerships allowed Fannie Mae to achieve a record level of more than $240 billion in mortgage purchases serving minority families."

---

[364] Id.
[365] Internal Freddie Mac email from David Andrukonis to Dick Syron, dated September 7, 2004 FMAC0013766
[366] Internal Freddie Mac email from Mike May to Dick Syron, dated October 6, 2004 FMAC0013694

2004-F:

Fannie and Freddie are the only market participants with knowledge of virtually the entire mortgage market (particularly the high risk market) and the accumulating levels of NTMs:[367]

1. **GSE market:** the GSEs closely tracked each other's business. They also had detailed information about many if not most of the conforming (based on loan size) loans they did not acquire.
2. **FHA market:** The GSEs tracked FHA volume since it was goals rich.
3. **Alt-A market:** the GSEs were not only the largest purchasers of Alt-A loans (in whole loans and securitized form), they had detailed information about many if not most of the Alt-A loans and securities that they did not acquire. This is because they were shown many packages (along with transaction details) that they declined to acquire.
4. **Subprime market:** the GSEs were not only the largest purchasers of loans with a FICO <660 that were not denominated subprime, they were also the largest purchasers of self-denominated subprime tranches. They had detailed information about many other subprime loans and securities that they did not acquire. This is because they were shown many packages (along with transaction details) that they declined to acquire.
5. **Option ARM market:** While the GSEs had systems constraints that limited their purchases of option ARMS, they did purchase both whole loans and private MBS tranches. They were presented with many packages that they did not acquire.

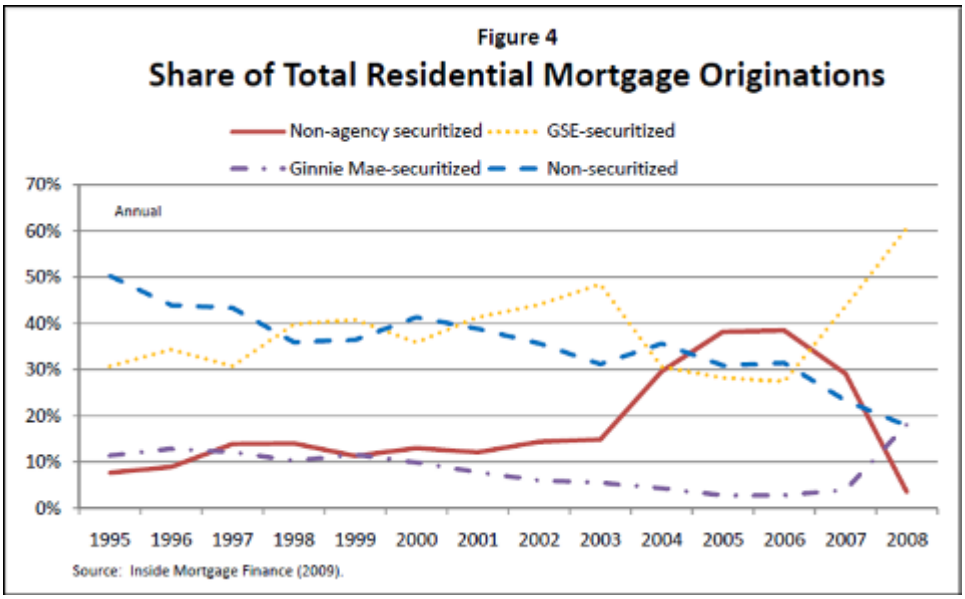
[367] Supra., "Single Family Guarantee Business – Facing Strategic Crossroads", June 27, 2005, In this summary document, Fannie sets forth the lengths it went to track the entire market, its various segments, and the risk characteristics by segment. See examples at pp. 29, 33, and 45.

III. The Perfect Storm:

Some argue that the substantial decline in the GSEs' market share in 2004 -2006 demonstrates that the private sector caused the mortgage meltdown. This argument fails for a number of reasons already mentioned – most particularly that government policies pushed the entire mortgage market to loosen lending standards. As predicted by community advocacy groups in 1991, Fannie and Freddie would need to be forced to loosen their underwriting standards before the originating lenders would do the same.

While the GSEs' share did decline in 2004-2006, many observers underestimate this decline. For example, economist and Nobel Laureate Paul Krugman relied on Chart 48 which was prepared by the Financial Crisis Inquiry Commission (based on data from Inside Mortgage Finance) when he observed: "During [2004-2005, the years with the greatest price increases], Fannie and Freddie were sidelined by Congressional pressure, and saw a sharp drop in their share of securitization."[368]

Chart 48:



Source: FCIC

Krugman came to the wrong conclusion as to why Fannie and Freddie lost share, particularly in 2004. Those reasons are detailed below. One thing is certain; it was not due to congressional pressure or a lack of effort to acquire the business that would allow them to attain their rising affordable housing goals. In late 2004 Fannie and Freddie made clear their intentions with

[368]Paul Krugman, "Things Everyone in Chicago Knows: Which happen not to be true", NYT, June 3, 2010 http://krugman.blogs.nytimes.com/2010/06/03/things-everyone-in-chicago-knows/

respect to the subprime and nonprime markets,[369] markets that were rich with loans needed to meet these goals.[370] They informed their largest customers, which now included many of the top subprime originators:[371]

> "The top executives of Freddie Mac and Fannie Mae made no bones about their interest in buying loans made to borrowers formerly considered the province of nonprime and other niche lenders. …Richard Syron, chairman and [CEO] of Freddie Mac, said, 'Our success in the future depends on our ability to serve emerging markets; they will become the 'surging markets.'"…
>
> "Meanwhile, Fannie Mae Chairman and [CEO] Franklin Raines told mortgage bankers [at the October 2004 annual Mortgage Bankers' convention] in San Francisco that his company's lender-customers 'need to learn the best from the subprime market and bring the best from the prime market into [that the subprime market].' He offered praise for nonprime lenders that, he said, 'are some of the best marketers in financial services.'… We have to push products and opportunities to people who have lesser credit quality," he said."[372]

While the GSEs' share numbers shown on Chart 48 are correct as far as they go, they do not give the entire picture. By limiting the GSEs' business to just their own securitizations, their share is substantially understated, particularly for the Professor Krugman's key years of 2004-2005. Instead of dropping below 30% as Chart 48 shows, it averaged about 42% for these two years. This is because:

1. Fannie, and to a lesser extent Freddie, purchased whole loans that were not ultimately securitized by them. These loans are included in the "non-securitized" category, but should be added to the GSEs' total share.
2. The GSEs were substantial purchasers of "non-agency securitized" subprime (see **Chart 33** above) and Alt-A MBS. **Over 2003-2007 their purchases totaled $641 billion for subprime and $154 billion for Alt-A, representing 33% and 12% of all such subprime and Alt-A issuances.** These securities need to be added to the GSEs' total share and deducted from the "non-agency securitized" share. The FHLBs were also major purchasers of such securities (see **Chart 33** above for their subprime acquisitions). Fannie, Freddie, and the FHLBs only purchased "AAA" tranches of non-agency

[369] Alt-A and Subprime "scored high relative to [its] core products – Alt-A: 30% total minority score [and] Subprime: 52% total minority score." Alt-A also had a high score for 1-4 unit rental (investor) properties, providing the GSEs with another means of meeting their escalating goals. Source: Fannie Mae document released by the U.S. House Committee on Oversight and Government Reform, "Single Family Guarantee Business – Facing Strategic Crossroads", June 27, 2005

[370] Alt-A and Subprime "scored high relative to [its] core products – Alt-A: 30% total minority score [and] Subprime: 52% total minority score." Fannie Mae document released by the U.S. House Committee on Oversight and Government Reform, "Single Family Guarantee Business – Facing Strategic Crossroads", June 27, 2005

[371] Neil Morse, "Looking for New Customers," *Mortgage Banking*, December 1, 2004

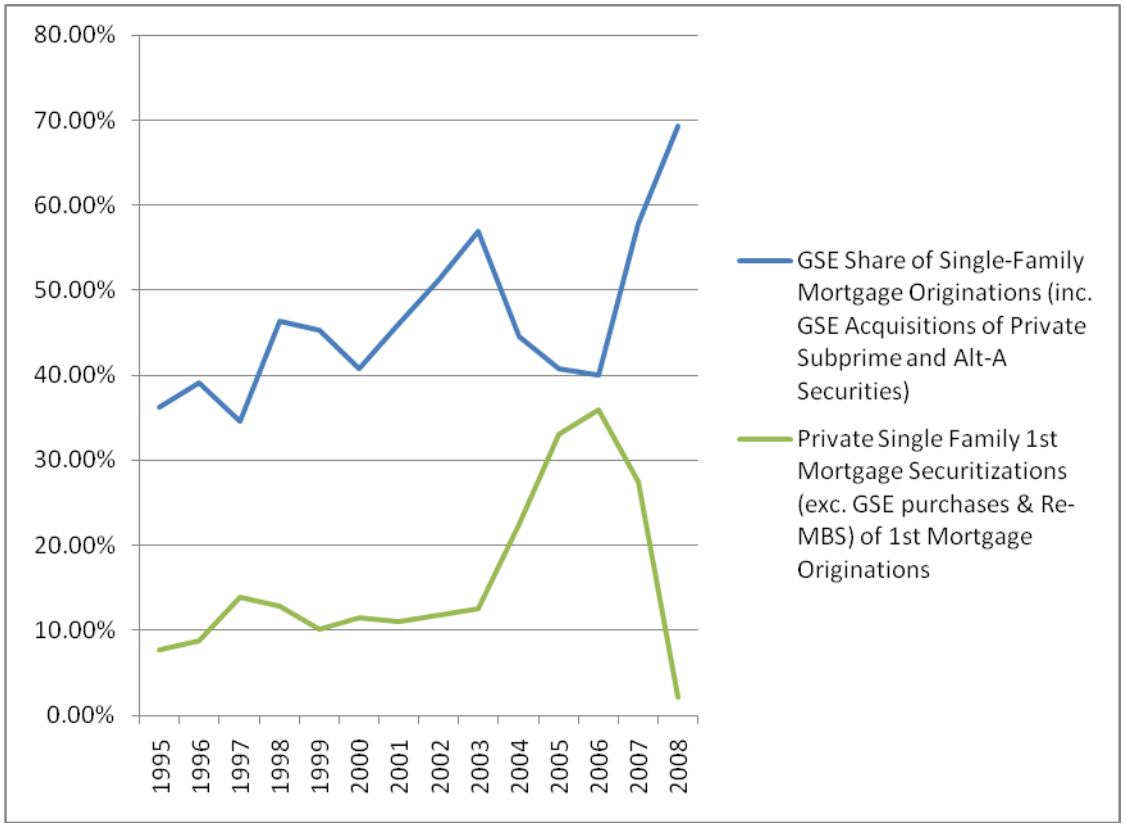
[372] Id.

securities and, given the combined volume of their purchases, created demand for such tranches. As has already been described, CDOs and CDOs squared were extensively used to convert the less desirable lower rated MBS tranches into "AAA" and "AA" tranches, thereby facilitating the private or non-agency securities market's rapid expansion.

3. Total mortgage originations and the "non-agency securitized" amount include second mortgage originations. Fannie and Freddie were extensive buyers of first mortgages made as part of a piggy back first and second. These loans were usually high risk and generally had combined LTVs of 95% and 100%. As a result the GSEs' lending (as were subprime and Alt-A non-agency securities) was dependent on these loans. It is more accurate to compute the various shares using only total first mortgage originations.
4. Total "non-agency securitized" includes a small amount of re-MBS of existing issuances that do not represent new originations. These need to be deleted from the "non-agency securitized" share.

Chart 49 shows the GSEs' total and non-agency securitized shares adjusted as noted above:[373]

Chart 49:

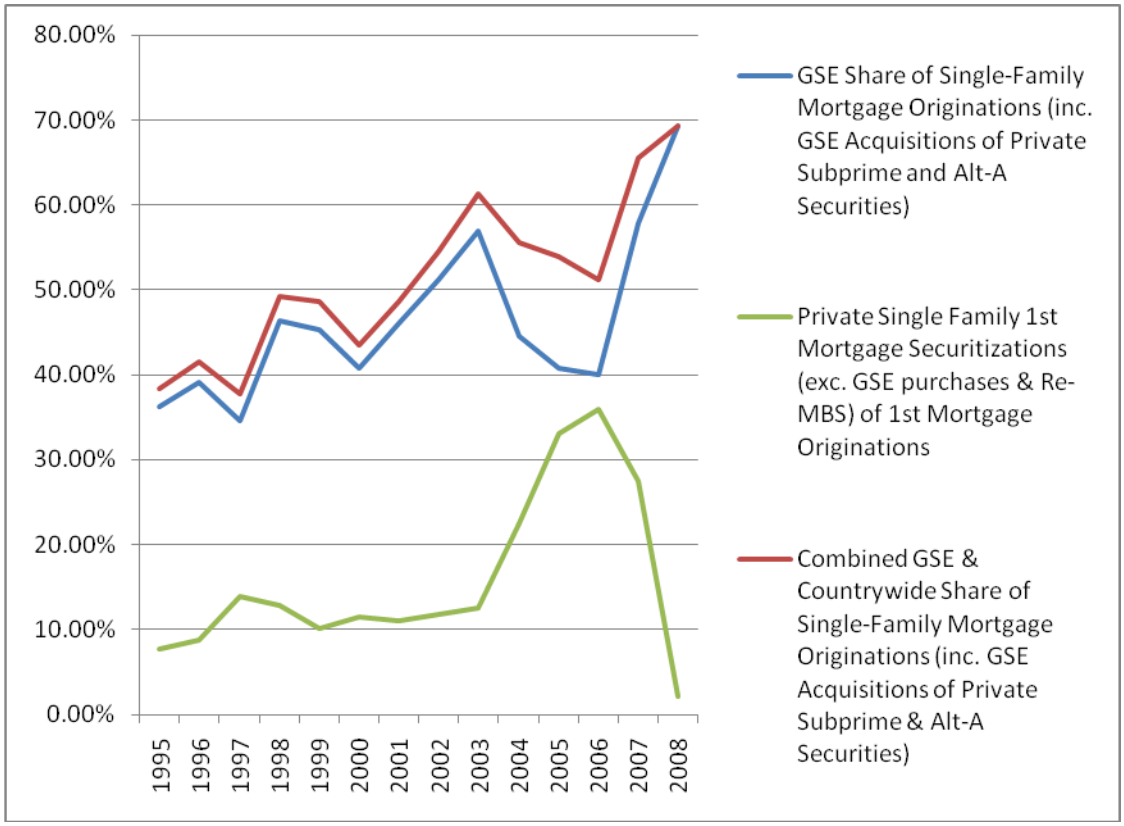


Source: Inside Mortgage Finance and compiled by Edward Pinto

As has already been noted, Countrywide operated as the GSEs' alter ego for many years. In 2004 and 2005 Countrywide moved a substantial portion of its business away from the GSEs. Chart 50 adds an additional line as compared to Chart 34 – the share of total single-family 1st mortgage originations represented by combining the GSEs' business with Countrywide's volume not sold to the GSEs:

[373] Fannie and Freddie data from FHFA 2008 Report to Congress found at: http://www.fhfa.gov/webfiles/2335/FHFA_ReportToCongress2008508rev.pdf and non-agency securitizations and total 1st mortgage origination volume from IMF.

Chart 50:



Source: Inside Mortgage Finance and compiled by Edward Pinto

Over the period 1993-2004 the government implemented what it viewed as a successful 12-year long effort to force the adoption of loosened credit standards:

> "The main point is that aggressive mortgage financing can boost demand for housing, and that demand can drive up house prices. As interest rates fall and loan terms relax, borrowers have more buying power to raise the offer price on home purchases. In the late 1990s, with a hot labor market and stock market, housing demand was fueled by a combination of population growth, income, wealth, supportive government policy, and easy credit."[374]

But the housing market had become highly leveraged and vulnerable to price declines.

After 12 years of government policies imposing unrelenting pressure on the housing finance market to throw out the Three Cs of Mortgage Credit and implement vastly weakened underwriting standards, 2004 became the year of the perfect storm.

[374] HUD PDR, May 2005, HUD Contract C-OPC-21895, Task Order CHI-T0007, "Recent House Price Trends and Homeownership Affordability", p. 46

The Self-denominated Subprime and Alt-A segments quickly morphed from lagging backwaters of housing finance to hot markets taking some share from Fannie and Freddie, although as noted above the GSEs' all-in decline was not as large as generally thought, particularly given that the GSEs were the largest purchasers of Subprime and Alt-A private MBS. The Self-denominated Subprime and Alt-A segments experienced a dollar volume increase of 85% over 2003, their market share increasing from 10% to 18%.[375] It is notable that in 2004 the GSEs purchased $180 billion or 45% of all private subprime MBS issued versus $82 billion and 40% in 2003.

The Self-denominated Subprime and Alt-A segments grew for many reasons:

- As loosened lending standards were introduced to meet affordable housing mandates, they quickly spread through much of the mortgage industry;

- Government housing policies had long stoked demand with high leverage and loosened underwriting standards – a trend that played to subprime and Alt-A's strong suit.

- These policies (including the GSEs' unfettered growth) and low interest rates had driven first mortgage origination volume to unimaginable levels (quadrupling from $995 billion in 2000 to $3.725 trillion in 2003). The origination industry was left with sizable excess capacity as origination volume declined[376] by 30% to $2.590 trillion in 2004 compared to 2003.[377] However, instead of declining in volume like the overall market, self-denominated subprime and Alt-A volume increased by 85% in 2004 over 2003.[378] **Originators were in a scramble for market share and a further loosening of underwriting standards was the means.**

- A yawning affordability gap brought on by the resulting decade long bull market in housing;[379]

- An up-tick in mortgage rates resulted in a shift to ARMs, interest only loans, and loans with lower qualifying rates, all of which increased the amount a borrower could borrow on a given amount of income. As a result these loans were generally utilized the most in those markets with the greatest affordability gaps due to price run-ups.[380] ARMs were

[375] Inside Mortgage Finance, The 2009 Mortgage Market Statistical Manual, Volume 1, p. 3
[376] Largely due to refinance burnout as 30 year fixed rates had dropped from an average of 8.05% in been 2000, to 6.54% in 2001, to 6.54% in 2002, to 5.83% in 2003. Thirty year rates averaged 5.84% in 2004 and 5.87% in 2005. Source: Inside Mortgage Finance, The 2009 Mortgage Market Statistical Manual, Volume 1, pp. 10-11
[377] Inside Mortgage Finance, The 2009 Mortgage Market Statistical Manual, Volume 1, p. 3
[378] Id. p. 4
[379] According to the S&P/Case-Shiller 10 city home price index, home prices increased by 112% over the 10 1/2 year period from April 1993 to December 31, 2003. Home prices would go on to increase by a further 40% over the period January 1, 2004 to June 30, 2006.
[380] Fannie Mae document, "Single Family Guaranty Business – Facing a Strategic Crossroads, 6.22.05

also a product where the GSEs' funding advantages were less, resulting in a shift to their competitors;[381]

- The GSEs were hit even harder by the volume drop from 2003 to 2004. Their core market consisted of non-jumbo conventional fixed rate loans. This market dropped by about 42% from 2003 to 2004;[382]

- A private sector anxious to regain share after having been increasingly marginalized by the GSEs since the mid-1980s;

- A risk-based capital regulatory structure that over-incented the creation of "AAA" and "AA" securities and helped spur the creation of CDOs and CDOs squared.[383]. After years of frustration, private MBS executions are finally able to compete with the leverage levels long enjoyed by the GSEs. A traditional private MBS consisted of about 91% "AAA" and "AA" tranches. Combine with a CDO and the percentage of "AAA" and "AA" tranches goes to about 95%.[384] Repeat with a CDO^2 and the percentage goes to about 98%. Overly aggressive ratings were handed out by rating agencies particularly on collateralized debt obligation (CDOs) and CDOs squared[385];

- The private sector's development of an integrated loan origination and securitization process that could compete with the GSEs in terms of both price and efficient execution[386]. This development was led by Countrywide and emulation attempts were being undertaken by Lehman and Bear Stearns;

---

[381] One of the GSEs' strengths was their ability to fund fixed rate loans. Their charter advantages allowed them to borrow long-term at low rates, something banks and many other investors could not match. ARMs were a better match to banks' and other investors' funding sources. The GSEs had much less of a funding advantage on ARMs.

[382] FHFA

[383] Risk-based capital regulations set 8% as a risk-adjusted capital requirement. A 20% weight is placed on both "AAA" and AA" private MBS and Fannie and Freddie MBS, thus requiring 20% x 8% or 1.6% in risk based capital, resulting in a 62.5:1 leverage ratio. An unsecuritized mortgage loan held on a bank's balance sheet had a 50% weight thus requiring 50% x 8% or 4% in risk based capital, resulting in a 25:1 leverage ratio. This created a tremendous financial incentive to maximize "AAA" and "AA" tranches of private MBS and minimize tranches with ratings below "AA".

[384] http://www.mhhe.com/economics/cecchetti/Cecchetti2_Ch07_StructuredProducts.pdf

[385] CDOs were securities comprised of tranches from private MBS. CDOs squared were securities comprised of tranches from CDOs. CDOs (and CDO squared) are leverage boosters. A plain subprime RMBS yielded about 91% "AAA" and "AA" - these tranches got 20% risk based capital weighting. Create a CDO using the private MBS tranches and the percentage of "AAA" and "AA" goes to 95+%. Do a CDO squared and it goes up to around 98%. The growth of CDOs increased dramatically in 2003. For the first time in 2003, more RMBS go into CDO than not. In 2003 the CDO market took up 60% of RMBS up from 30% in 2002. By 2004 CDOs were taking up 80%. The advent of CDOs and CDOs squared finally allowed for real competition with Fannie and Freddie. This was bad news for Fannie and Freddie. With a yield of 95%-98% "AAA" and "AA", Countrywide and Wall Street could finally compete with Fannie and Freddie. Countrywide's sold 61% of its originations to Fannie and Freddie in 2003 (marginally down from 64% in 2002). This drops to 20% in 2004.

[386] The GSEs were limited by charter to the secondary market; therefore they could not undertake their own integrated loan and securitization platforms.

- The attractiveness of the higher yields that "AAA" and "AA" private MBS offered over Fannie and Freddie's MBS;
- A growing amount of world-wide liquidity looking for safe "AAA" (both GSE and private MBS) and "AA" securities (private MBS) to invest in; and
- The GSEs' accounting scandals[387] which left them politically weakened. Protecting the charter franchise took on an even more heightened urgency. A combination of growing affordable housing goals and a shift of goals rich loans to subprime/nonprime forced them to more heavily cross subsidize affordable housing loans and increase their acquisition percentages of these loans.

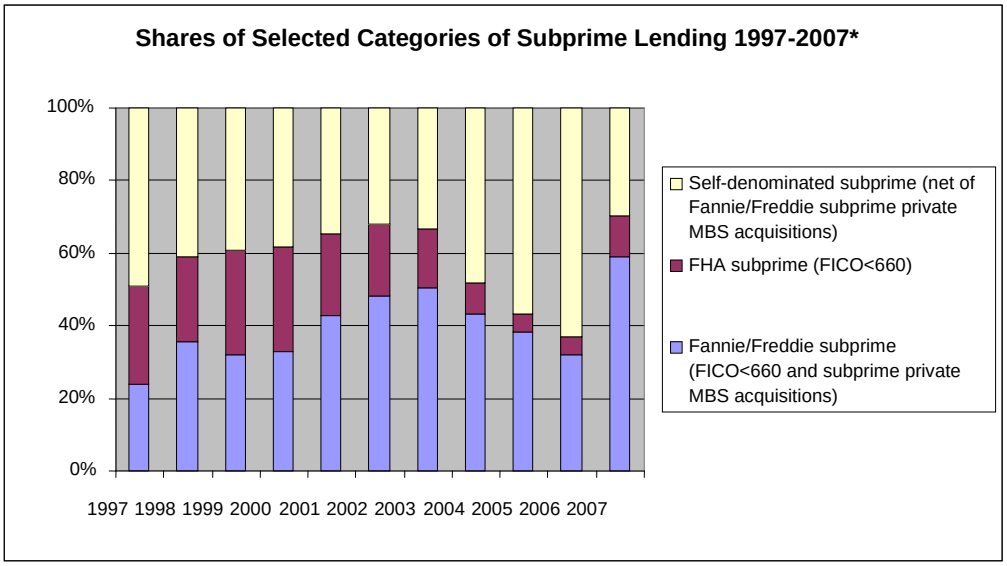
HUD had noted in its 2000 rulemaking (see **2000-E** above) that:

> "As the GSEs become more comfortable with subprime lending, the line between what today is considered a subprime loan versus a prime loan will likely deteriorate, making expansion by the GSEs look more like an increase in the prime market."

Chart 51 (same as Chart 28) takes this effect into account by displaying three categories of subprime: (1) self-denominated subprime (excluding the GSEs' acquisitions of subprime private MBS), (2) FHA loans with a FICO below 660 and (3) GSE acquisitions considered as prime but with a FICO of <660 along with their acquisitions of subprime private MBS. In 1997 self-denominated subprime had about 50% of the market. Self-denominated subprime share shrank to about 40% by 2000 as the GSEs' share grew and FHA maintained its share and shrank to about 33% by 2003 with the GSEs taking share from both self-denominated subprime and FHA. The GSEs were growing their share in response to the much higher goals imposed by HUD for 2001-2003. By 2003 FHA was well on its way to being marginalized by the GSEs. For the reasons noted above, starting in late 2003 and continuing through 2004-2006 the self-denominated subprime sector is able, for the first time, to compete aggressively against the GSEs and expand share dramatically. After the private MBS market collapses in early 2007, the GSEs more than regain their lost share.

[387] Freddie's and Fannie's scandals broke in 2003 and 2004 respectively.

Chart 51 (same as Chart 28):



* Selected categories include loans originated as subprime (self-denominated subprime), FHA insured loans with a FICO of <660, and Fannie and Freddie loans with a FICO<660. Compiled by Edward Pinto

The cumulative effect of HUD's unrelenting efforts to increase affordable housing goals is set out in Chart 52:

Chart 52: GSE Purchases of Subprime and Alt-A loans

$ in billions	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**1997-2007**
Subprime PMBS	$3*	$18*	$18*	$11*	$16*	$38	$82	$180	$169	$110	$62	$707
Subprime loans**	$37	$83	$74	$65	$159	$206	$262	$144	$139	$138	$195	$1,502
Alt-A PMBS	Unk.	Unk,	Unk.	Unk.	Unk.	$18	$12	$30	$36	$43	$15	$154
Alt-A loans***	Unk.	Unk,	Unk.	Unk.	Unk.	$66	$77	$64	$77	$157	$178	$619
High LTV loans****	$32	$44	$62	$61	$84	$87	$159	$123	$126	$120	$226	$1,124
Total*****	$72	$145	$154	$137	$259	$415	$592	$541	$547	$568	$676	$4,106

*Total purchases of PMBS for 1997-2001 are known. Subprime purchases for these years were estimated based upon the percentage that subprime PMBS constituted of total PMBS purchases in 2002 (57%).
**Loans where borrower's FICO <660
*** Fannie and Freddie used their various affordable housing programs and individual lender variance programs (many times in conjunction with their automated underwriting systems once these came into general use in the late-1990s) to approve loans with Alt-A characteristics. However, they generally did not classify these loans as Alt-A. Classification as Alt-A started in the early-1990s. There is an unknown number of additional loans that had higher debt ratios, reduced reserves, loosened credit requirements, expanded seller contributions, etc. The volume of these loans is not included.
****Loans with an original LTV or original combined LTV >90% (given industry practices, this effectively means >=95%). Data to estimate loans with CLTV.>90% is unavailable prior to 2003. Amounts for 2003-2007 are grossed up by 60% to account for the impact of loans with a CLTV >90%. These estimates are based on disclosures by Fannie and Freddie that at the end of 2007 their total exposures to loans with an LTV or CLTV >90% was 50% and 75% percent respectively higher than their exposure to loans with an LTV >90%. Fannie reports on p. 128 of its

2007 10-K that 15% of its entire book had an original combined LTV >90%. Its OLTV percentage >90% (without counting the impact of any 2nd mortgage simultaneously negotiated) is 9.9%. Freddie reports on p60 of its Q2:2008 10 Q that 14% of its portfolio had an original combined LTV >90%. Its OLTV percentage >90% (without counting any simultaneous 2nd) is 8%. While Fannie and Freddie purchased only the first mortgage, these loans had the same or higher incidence of default as a loan with an LTV of >90%.
*****Since loans may have more than one characteristic, they may appear in more than one category. Totals are not adjusted to take this into account.

Chart 53 demonstrates that it NTMs performed poorly as compared to traditional loans or loans that were truly prime.[388] The fact that almost 50% of all loans were NTMs and that these loans had delinquency rates many times that for truly prime loans explains both the depth and length of the mortgage crisis.

Chart 53: Delinquency rates on Non-Traditional Mortgages (NTMs) and Prime Mortgages

Loan Type	Estimated # of Loans	Total Delinquency Rate (30+ Days and in Foreclosure)
1. High Rate Subprime (inc. Fannie/Freddie private MBS holdings)	6.7 million	45.0%
2. Option Arm	1.1 million	30.5%
3. Alt-A (inc. Fannie/Freddie/FHLBs private MBS holdings)	2.4 million†	23.0%
4. Fannie Subprime/Atl-A/Nonprime	6.6 million	17.3%
5. Freddie Subprime/Alt-A/Nonprime	4.1 million	13.8%
6. Government	4.8 million	13.5%
Subtotal # of Loans	**25.7 million**	
7. Non-Agency Jumbo Prime	9.4 million ‡	6.8%
8. Non-Agency Conforming Prime*		5.6%
9. Fannie Prime (traditionally underwritten)**	11.2 million	2.6%
10. Freddie Prime (traditionally underwritten)***	8.7 million	2.0%
Total # of Loans	**55 million**	

* Includes an estimated 1 million subprime (FICO<660) and non-prime CRA and HUD Best Practices Initiative loans.
** Traditionally underwritten loans. Therefore Freddie subprime/Alt-A/nonprime mortgages are excluded.
*** Traditionally underwritten loans. Therefore Freddie subprime/Alt-A/nonprime mortgages are excluded.
† Excludes loans owned or securitized by Fannie and Freddie.
‡ Non-agency jumbo prime and conforming prime counted together.
Total delinquency data sources:
1, 2, 3, 6, 7 & 8: Lender Processing Services, LPS Mortgage Monitor, June 2009.
4 & 9: Based on Fannie Mae 2009 2Q Credit Supplement. Converted from a serious delinquency rate (90+ days & in foreclosure) to an estimated Total Delinquency Rate (30+ days and in foreclosure).
5 & 10: Based on Freddie Mac 2009 2Q Financial Results Supplement. Converted from a serious delinquency rate (90+ days & in foreclosure) to an estimated Total Delinquency Rate (30+ days and in foreclosure).

[388] For example, while virtually all of Fannie's loans were reported as being "prime", 37% were actually NTMs (line 4). One can see the impact by comparing the delinquency rate of 17.3% on Fannie's NTMs (line 4) as compared to 2.6% on traditional mortgages (the 63% of the prime loans that were truly prime).

B. The Perfect Storm is magnified by many existing and new pro-cyclical policies and a lack of counter-cyclical policies:

FDIC Chair Sheila Bair noted:

> "For 25 years federal policy has been primarily focused on promoting homeownership and promoting the availability of credit to home buyers." FDIC Chair Sheila Bair, June 7, 2010:[389]

All lending, including home lending, is by definition leveraged, naturally pro-cyclical, and prone to alternating periods of boom and bust. The current real estate bust is the worst in over 75 years because leading up to the mortgage meltdown, numerous pro-cyclical policy elements were added to the many pro-cyclical elements already in place, all in an effort to promote housing finance. From 1992 on, federal policies, in the name of promoting very low, low, and moderate-income homeownership, promoted ever greater levels of leverage. These flexible and innovative underwriting standards spread throughout much of the entire housing finance industry. Compounding matters was the fact that the revenue of most market participants was percentage based and thus grew as home prices boomed. Fannie and Freddie's revenues, loan limits, and, ironically, affordable housing mission urgency were all fed by higher home prices. At the same time, no counter-cyclical elements were added. When former Fed chairman William McChesney Martin, Jr. (1951-1970) famously observed that the Fed's job is to "take away the punch bowl just as the party gets going"[390] he had not anticipated that federal housing policy would be to spike the punch with a flood of zero down loans. While the housing finance industry was susceptible to bouts of lending excesses – for at most a few years at a time,[391] government policies would create an unprecedented period of policy enforced excess, lasting some 15 years.

Lending used to rely on real or earned equity either from a down payment or paying the loan off through scheduled amortization. Government pressure made down payments largely passé. Affordability was enhanced with interest only and negatively amortizing loans, with scheduled amortization the casualty. Add waves of cash out refinances that treated homes as ATMs. This set up a cycle whereby each boost in home prices induced both speculative buying and enabled equity removal spurred by a home's new higher value. By the end of 2003, 58% of all outstanding single family mortgages were less than a year old and each had an appraisal justifying the loan amount based on the latest boom-driven market value.

To the extent appraisals have been considered at all, their contribution to the financial crisis has focused on fraud. The facts are much more nuanced and significant, with the major shortcoming being that the U.S. appraisal process was simply not up to the challenges of a housing boom fed by ever increasing leverage. The Collateral Risk Network, representing many of the largest

[389] Sheila C. Bair to the Housing Association of Non-Profit Developers Annual Meeting, June 7, 2010, http://www.loansafe.org/sheila-c-bair-to-the-housing-association-of-non-profit-developers-annual-meeting
[390] Wikipedia, http://en.wikipedia.org/wiki/William_McChesney_Martin,_Jr.
[391] Examples: The mid-1970s, early-1980's, and late-1980s.

financial institutions in the United States,[392] pointed out in a white paper entitled "Reengineering the Appraisal Process":[393]

> "[Appraisers] did help create fictitious equity and were complicit in facilitating trillions of dollars of loans that never should have been made. There are varying degrees of valuation inflation performed by appraisers. On the lighter side, there was just the gray area where appraisers hit the highest possible value as opposed to the most probable value. On the dark side, there was blatant fraud. **And then, somewhere in the mix, was the failure to recognize an overheated market and report trends and risk to their clients....If we had credibly valued the underlying collateral, I would submit that there would be an active MBS market.**" [Emphasis added]

Over a period of many years, appraisal methods changed from ones based on multiple valuation techniques and inputs to one with only a sales price-sensitive input, the latest house prices. This single input was being driven upward by the demand created by loosened lending standards.

See Appendix D for a detailed description on how appraisal methods developed over the last 20 years by Fannie, Freddie, and regulators became less rigorous and resulted in property appraisers failing to recognize an overheated market and report trends and risks to their clients.

By the end of 2003 the home ownership rate, inflation adjusted home price increases, the gross rent to home price ratio, the total replacement cost to total home market value ratio, and national median home price to median income ratio, and other trends were already well outside of normal trends. This was before the volume of private subprime and Alt-A MBS surged in 2004.

The following is a list of pro-cyclical/pro-leverage elements that helped drive the boom in home prices and housing finance. Virtually all were the result of government policy and the list is certainly not exhaustive. There were no counter-cyclical policies introduced over the same period:

a. Interest deductions under the income tax code were effectively limited to interest incurred on loans relating to primary and secondary residences (1986). This promoted the use of higher LTV loans as these became more generally available and the purchase of larger homes by homeowners itemizing deductions, along with encouraging tax-advantaged equity extraction.
b. Continued growth of the GSEs' market share (ongoing) – spreads continued to narrow and the GSEs' competitors were crowded out. All efforts to rein in the GSEs during the boom period failed. Since only Congress could change the GSEs' charter advantages, this growth was essentially on auto-pilot.
c. GSEs' affordable housing mandates implemented by HUD pursuant to the GSE Act of 1992. HUD periodically increased the goals from 1993-2008. Percentages were set in

[392]Members include collateral valuation experts from such institutions as The Appraisal Foundation, Morgan Stanley, Freddie Mac, Fannie Mae, the Appraisal Institute, US Bank, Wachovia, FHFA, and BofA.
[393] Joan N. Trice, Collateral Risk Network, "Reengineering the Appraisal Process", 2009 http://www.columbiainstitute.org/Reengineering%20the%20Appraisal%20Process.pdf

2004 for 2005-2008, effectively leaving mandates on auto-pilot through this key period.[394]

d. Capital requirements for the GSEs were effectively hard wired into the GSE Act of 1992. Capital levels were set at 222:1 for off-balance sheet and 40:1 for on-balance sheet assets. This allowed the GSEs to operate at much higher leverage levels as compared to their competitors.
e. The GSEs had the implicit guarantee of the federal government. This along with high leverage helped fuel their growth. As the GSEs grew, private competition was crowded out.[395] Crowding out drove their competitors to develop ways to increase their leverage levels, such as CDOs and CDOs squared.
f. Risk-based-capital requirements heavily favored home mortgages, the GSEs' MBS and agency debt, and "AAA" and "AA" private MBS.
g. CRA was amended in 1995 to provide for outcome based performance reviews. A large bank desiring an "outstanding" rating needed to quantitatively demonstrate that it had outperformed its competitors. Since virtually all large banks desired an outstanding rating in order to facilitate merger approvals, a game of leapfrog ensued. With no real market-based governor in place, CRA lending, like the GSEs, was effectively placed on auto-pilot. Both CRA and the GSEs' affordable housing goals allocated credit in a manner that largely operated independently of market conditions. They artificially created demand by increasing leverage.
h. Affordable housing and CRA mandates led to both the subsidization and mispricing of higher risk loans.
i. Loan loss reserving process was based on actual delinquencies. Low defaults during a boom period leads to an accumulation of low levels of reserves at the point when the boom ends and defaults accelerate. This leads to incorrect capital determinations and helps explain why virtually every bank taken over by the FDIC had positive capital immediately prior to takeover, yet resulted in a loss of 10%-30%. Fannie presents an excellent example. At 12.31.03 Fannie had $797 million in its allowance for losses representing a miniscule .036% of on- and off- balance sheet credit liabilities of $2.2 trillion. This was down from 0.066% at 12.31.99 and 0.13% at 12.31.92. The perverse manner in which loss provisioning worked over the 12 year period 1992-2003 is demonstrated by the fact that at 12.31.92 its allowance for loan losses was $780 million, about the same dollar total as at 12.31.03, yet the dollars at risk were 3.5 times higher. As home price increases accelerated, both charge-offs and the allowance for loan losses as a percentage of exposure shrank. At 12.31.03 53% of Fannie's single-family credit exposure had been seasoned 1 year or less.[396]
j. In 1995 FDIC, due to the low level of bank failures then occurring, reduced the variable portion of deposit premiums to zero for "well-capitalized banks", leaving only a flat charge of $2000 per year for such banks.[397]
k. FHA continued its long-standing practice of reducing down payments.
l. For the first time the GSEs and the private sector offer loans with 3% down (1994) and zero down (2000). The volume of these loans expands rapidly.

[394] This shortcoming was acknowledged in FHFA's new affordable housing regulations (2010).
[395] This shortcoming was acknowledged in the Housing and Economic Recovery Act of 2008.
[396] Data from various Fannie 10-Ks and annual reports.
[397] http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3606

m. Substantial increases in other high leverage lending features such as higher debt ratios, interest only and negative amortization, new definitions of income, lending to impaired borrowers, reduced upfront costs, and low doc/no doc lending.
n. An increased appetite for risk (accompanied with underestimation of risks) causes credit to grow at a faster rate. This is aided by the home interest tax deduction. Home mortgage debt as a percentage of GDP increased from 39% in 1986 to 50% in 1999 to 75% in 2007.
o. Mortgage interest rates continue their declines from the highs of the early 1980s. Rates decline from 10% in 1991 to about 5.5% in 2003-4.[398]
p. Property valuations are based solely on a single input - comparable sales. The GSEs were the effective standard setters for appraisals.
q. Federal efforts to reduce downpayments and otherwise loosen lending standards spur both demand and price increases.
r. Notwithstanding the lowest interest rates in over a generation, an affordability gap develops, as the house prices continued their unprecedented rise upward. This reinforces calls for loosened lending standards to eliminate or reduce the gap and effectively puts CRA, affordable housing and other loosened lending initiatives on steroids.
s. Loosened underwriting on investor loans on 1-4 unit property (spurred in part by 1-4 unit rental affordable housing requirements).
t. An income tax law change in 1997 made speculating in homes a vocation for many homeowners. A married couple could live in a home for 2 years and pay zero tax on the first $500,000 of capital gain.[399]
u. Loosened underwriting on cash out refinances. Higher prices led to wealth effect (and reduced savings). Easy access to equity fueled the private spending boom – in downturn, the opposite happens. Relying on comparable based appraisals during periods of rapid price increases allows a large percentage of outstanding loans to "revalue" based on current values. At the end of 2003 55% of mortgages had been outstanding less than a year and equity extraction during the year totaled $400 billion, with even higher amounts extracted in 2004-2006.
v. Nationalization of lending/underwriting/appraisal standards by the GSEs. In a market where the three most important things are location, location, location, the GSEs and their automated underwriting systems applied national standards regardless of local conditions.
w. The GSEs gave the best pricing and greatest flexibilities to large lenders. The top 10 lenders went from a market share of 25.8% in 1995 to 71.8% in 2007.[400] These national lenders largely relied on the originate-to-distribute rather than the originate-to-hold model.
x. Virtually all participants in the mortgage process get paid more if home prices/mortgage amounts increase.
y. The increased use of loan modifications reinforced the suppression of delinquency rates caused by rising home prices. This masked the need for higher charge-offs and the building up of loss reserves, which are based on delinquencies.

[398] http://mortgage-x.com/general/historical_rates.asp
[399] http://www.nytimes.com/2008/12/19/business/19tax.html
[400] Inside Mortgage Finance

FDIC Chair Sheila Bair addressed the impact of a number of these pro-cyclical elements as follows:[401]

> "For 25 years federal policy has been primarily focused on promoting homeownership and promoting the availability of credit to home buyers. While tax deductions for interest on most forms of consumer debt have been curtailed, the home mortgage interest deduction lives on. Local property taxes are also deductible, as are capital gains up to $250,000.…
>
> In the end, these public and private efforts [also referring to Fannie and Freddie] helped to briefly push the homeownership rate as high as 69 percent. That's a level that ultimately proved unsustainable, and that may not be reached again for many years, if ever….
>
> It is estimated that when you add up the mortgage interest deduction, local property tax deductions, and exclusions on capital gains realized on the sale of owner-occupied housing … the taxpayer subsidies for homeowners are about three times the size of all rental subsidies and tax incentives combined.
>
> In fact, you can argue that this huge subsidy for homeowners has helped push up housing prices over time, making affordability that much more of a problem for the very groups you're trying to serve."

If all of the elements surrounding housing finance are pro-cyclical, they will tend to induce an increase in demand, an expansion of lending, an increase in leverage, and increasing asset price inflation (home prices). This will tend to occur regardless of market fundamentals. Once the boom ends, many of these same policies serve to reinforce the down-cycle.

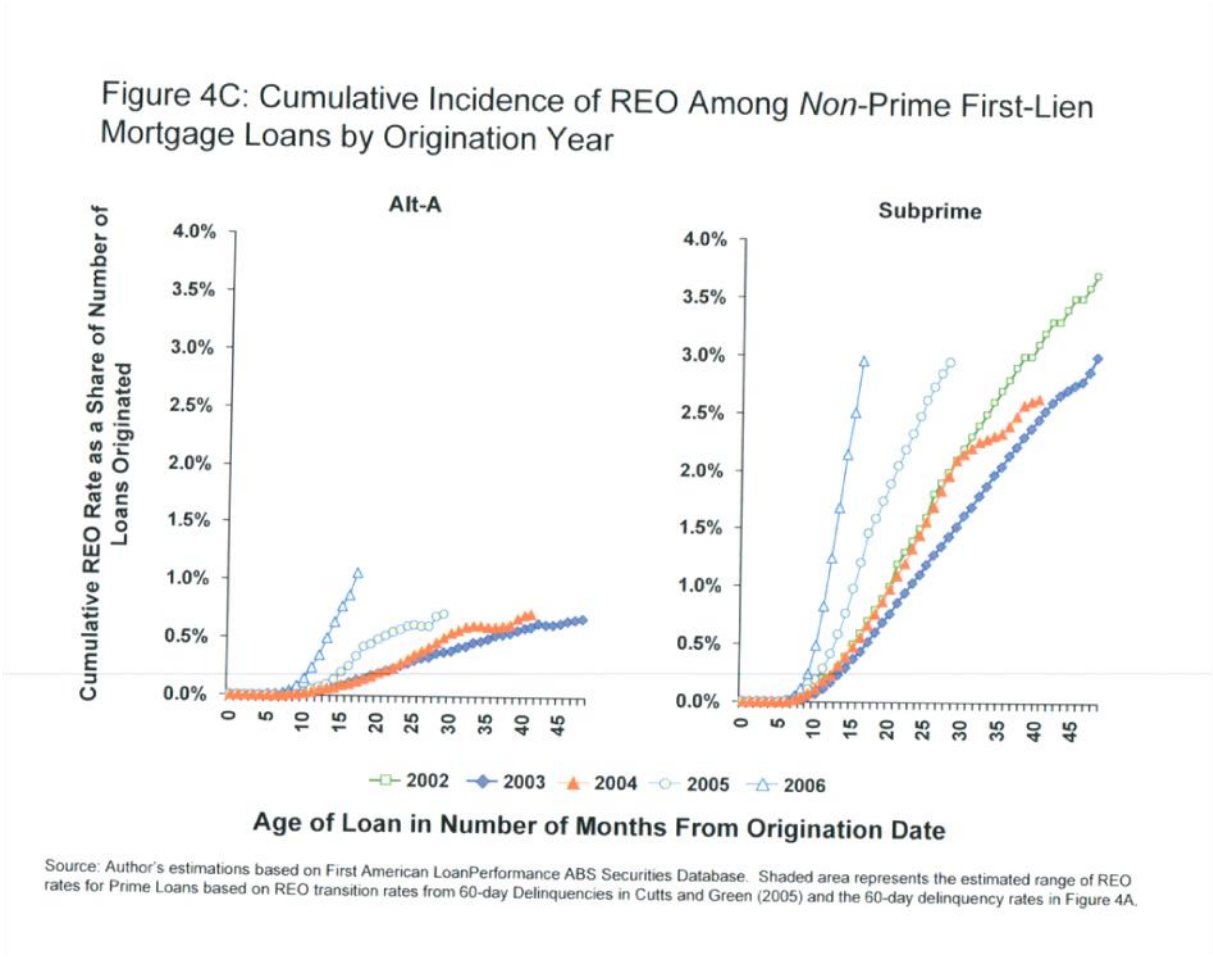
IV. The Collapse of the private MBS and CDO market

By late-2006, developing delinquency trends were roiling the private MBS market (see Chart 54):

> "'Delinquency trends and home prices' show a weakening real estate market, said Scott Eichel, head of credit trading for New York-based Bear Stearns & Co., the biggest underwriter of bonds backed by mortgages. 'A lot of investors that have concerns about the housing market' are using the ABX index to speculate on a continued drop, he said." **"**Housing in U.S. Poised to Worsen, Derivatives Show" Bloomberg.com October 23, 2006[402]

[401] Sheila C. Bair to the Housing Association of Non-Profit Developers Annual Meeting, June 7, 2010, http://www.loansafe.org/sheila-c-bair-to-the-housing-association-of-non-profit-developers-annual-meeting
[402] http://www.bloomberg.com/apps/news?pid=20601103&sid=adbsVAhN68TM&refer=us

Chart 54:*

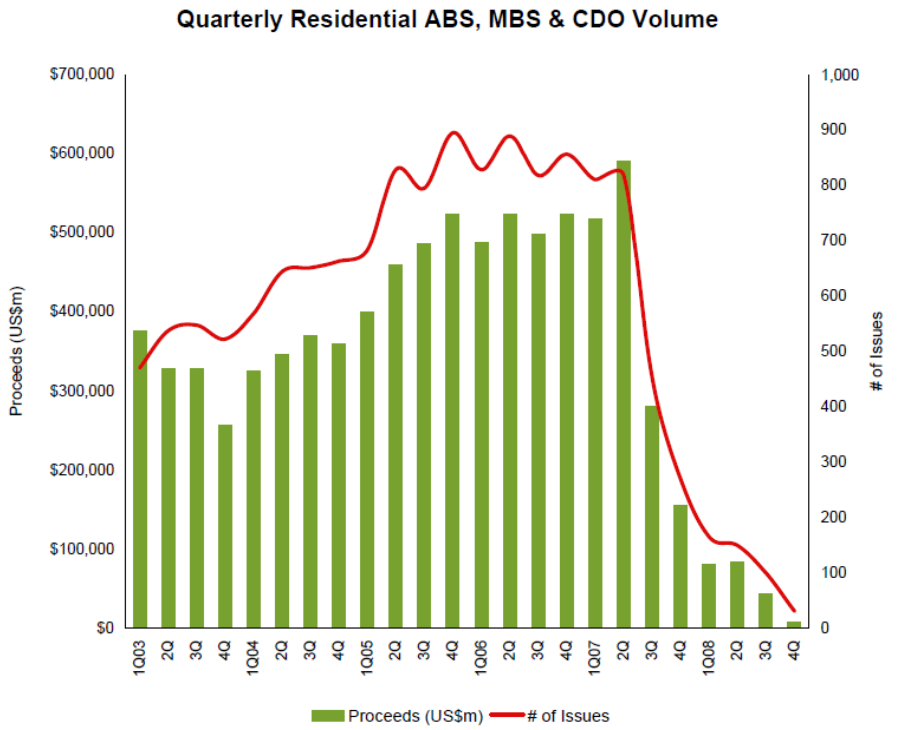


*REO means real estate owned (repossessed properties).

As shown in Chart 55[403] below, the volume of private MBS declined dramatically during -the 3d quarter of 2007, and eventually the asset-backed market collapsed entirely as investors lost confidence in AAA ratings that were clearly based on invalid data. The collapse of this market was unprecedented, and caused enormous losses to financial intermediaries that could no longer carry their MBS at the previously assumed value. This raised doubts about the financial condition of many of the world's major financial institutions, initiated an investor panic and caused the rescue of Bear Stearns and the bankruptcy of Lehman Brothers. The world-wide freeze-up in lending between financial institutions that followed the failure of Lehman Brothers in September 2008 is what is generally referred to as the financial crisis.

[403] Source: Thompson Reuters *Debt Capital Markets Review*, Fourth Quarter 2008, available at http://thomsonreuters.com/products_services/financial/league_tables/debt_equity/ (accessed July 30, 2009).

Chart 55:



V. Conclusion:

There have been a number of studies which cite the role relaxed lending standards played in the financial crisis.

A recent Cleveland Fed study concluded that their "Canada and U.S. housing market comparison suggests that relaxed lending standards played a crucial role in the U.S. housing bust."[404]

HUD, without a hint of irony, stated in its 2010 "Report to Congress on the Root Causes of the Foreclosure Crisis":

> "…the sharp rise in mortgage delinquencies and foreclosures is fundamentally the result of rapid growth in loans with a high risk of default—due both to the terms of these loans and to loosening underwriting controls and standards. **Mortgage industry participants appear to have been drawn to encourage borrowers to take on these riskier loans due to the high profits associated with originating these loans and packaging them for sale to investors (Emphasis added).** While systematic information on borrowers' motivations in obtaining these loans is not available, existing evidence suggests that some borrowers did not understand the true costs and risks of these loans while others were

[404] Id.

willing to take on these risks to tap accumulated home equity or to obtain larger homes."[405]

FDIC Chair Sheila Bair in a speech given on June 18, 2010 stated:

> **"Underwriting: Back to Basics"**
>
> "First, we must recognize that the financial crisis was triggered by a reckless departure from tried and true, common-sense loan underwriting practices."
>
> "Traditional mortgage lending worked so well in the past because lenders required sizeable down payments, solid borrower credit histories, proper income documentation, and sufficient income to make regular payments at the fully-indexed rate of the loan. Not only were these bedrock principles relaxed in the run-up to the crisis, but they were frequently relaxed all at once in the same loans in a practice regulators refer to as "risk layering."
>
> "As all of you know, the long-term credit performance of a portfolio of mortgage loans can only be as sound as the underwriting practices used to originate those loans."[406] [407]

HUD Secretary Donovan at an April 14, 2010 hearing of the U. S. House Financial Services Committee testified:

> "Seeing their market share decline as a result of this change of demand, the GSEs made the decision to widen their focus from safer prime loans and begin chasing the non-prime market, loosening long-standing underwriting and risk management standards along the way. This would be a fateful decision that not only proved disastrous for the companies themselves - but ultimately also for the American taxpayer."

Before home prices crashed, HUD was much less reticent about acknowledging its and regulators' roles in liberalizing underwriting standards. In 2005 a HUD commissioned report noted:

---

[405] Report to Congress on the Root Causes of the Foreclosure Crisis , January 2010, pp. vii-viii, http://www.huduser.org/portal/publications/hsgfin/foreclosure_09.html

[406] Remarks by FDIC Chairman Sheila C. Bair to the Wharton School, University of Pennsylvania International Housing Finance Program; Philadelphia, Pa.
June 18, 2010, http://www.fdic.gov/news/news/speeches/chairman/spjun1810.html

[407] Sheila Bair's advice was not followed in the recently enacted Financial Reform Bill. In Section 941, Congress charges regulators with defining the characteristics of a "qualifying residential mortgage". Such a mortgage should have "underwriting and product features that historical loan performance data indicate result in a lower risk of default." Conspicuous in their absence from the list are LTV and borrower credit history. This is a repeat of the identical error made by Congress when it passed then GSE Act of 1992 and pushed the GSEs into reduced downpayment and other loosened lending standards (see **1992-B**). p. 529, http://banking.senate.gov/public/_files/Rept111517DoddFrankWallStreetReformandConsumerProtectionAct.pdf

> "More liberal mortgage financing has contributed to the increase in demand for housing. During the 1990s, lenders have been encouraged by HUD and banking regulators to increase lending to low-income and minority households. The Community Reinvestment Act (CRA), Home Mortgage Disclosure Act (HMDA), government-sponsored enterprises (GSE) housing goals and fair lending laws have strongly encouraged mortgage brokers and lenders to market to low-income and minority borrowers. Sometimes these borrowers are higher risk, with blemished credit histories and high debt or simply little savings for a down payment. Lenders have responded with low down payment loan products and automated underwriting, which has allowed them to more carefully determine the risk of the loan. Other factors that have facilitated liberal financing include low and falling interest rates, low default rates, rising house prices, competition from subprime lenders and strong investor demand for mortgage-backed securities (MBS). The net effect has been a booming mortgage market that has generated strong demand for housing, which, in turn, has boosted house prices."[408]

Or in 2004 when HUD announced increased affordable housing goals applicable for 2005-2008:

> "Over the past ten years, there has been a 'revolution in affordable lending' that has extended homeownership opportunities to historically underserved households. Fannie Mae and Freddie Mac have been a substantial part of this 'revolution in affordable lending'. During the mid-to-late 1990s, they added flexibility to their underwriting guidelines, introduced new low-downpayment products, and worked to expand the use of automated underwriting in evaluating the creditworthiness of loan applicants. HMDA data suggest that the industry and GSE initiatives are increasing the flow of credit to underserved borrowers. Between 1993 and 2003, conventional loans to low income and minority families increased at much faster rates than loans to upper-income and non-minority families."[409]

Or in 2000 when HUD announced that it was "significantly increasing [the GSEs' housing goals] for the years 2001-03:[410]

> "Lower-income and minority families have made major gains in access to the mortgage market in the 1990s. A variety of reasons have accounted for these gains, including improved housing affordability, enhanced enforcement of the Community Reinvestment Act, more flexible mortgage underwriting, and stepped-up enforcement of the Fair Housing Act. But most industry observers believe that one factor behind these gains has been the improved performance of Fannie Mae and Freddie Mac under HUD's affordable

[408] HUD PDR, May 2005, HUD Contract C-OPC-21895, Task Order CHI-T0007, "Recent House Price Trends and Homeownership Affordability", p. 85,
[409] Final Rule, p. 63645, http://fdsys.gpo.gov/fdsys/pkg/FR-2004-11-02/pdf/04-24101.pdf
[410] Supra., HUD's Affordable Lending Goals for Fannie Mae and Freddie Mac, p. 1

lending goals. HUD's recent increases in the goals for 2001-03 will encourage the GSEs to further step up their support for affordable lending."[411]

Or in 1995 when HUD announced its National Homeownership Strategy and acknowledged:

> "While members of the partnership have already made significant strides in reducing [low downpayments as a] barrier to home purchase, more must be done. In 1989 only 7 percent of home mortgages were made with less than 10 percent downpayment. By August 1994, low downpayment mortgage loans had increased to 29 percent."[412]

HUD went on to add in the National Homeownership Strategy:

- "[m]any low-income families do not have access to sufficient funds for a downpayment"[413],
- "many prospective homebuyers still cannot qualify for a conventional mortgage"[414],
- "Nevertheless, great strides have been made by the lending community in recent years to reduce downpayment requirements, particularly for low- and moderate-income homebuyers. This trend is encouraging and should be continued with support from the partnership" [415], and
- "Lending institutions, secondary market investors, mortgage insurers, and other members of the partnership should work collaboratively to reduce homebuyer downpayment requirements."[416]

The GSEs' losses were largely due to high risk loans acquired to meet AH goals (loans that were outside of the GSEs' guidelines in 1991), losses associated with goals rich subprime and Alt-A private MBS securities acquired the GSEs, and losses on low income tax credits acquired to meet AH goals.

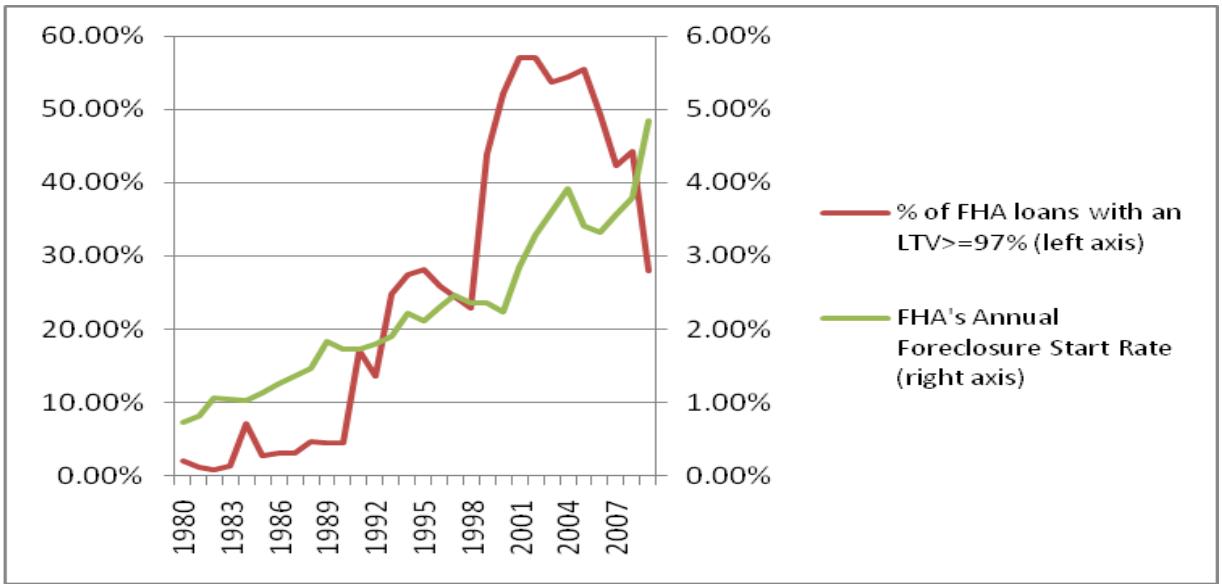
The results of the government's efforts to force loosened underwriting standards are graphically show in Charts 55, 56 and 57. These set out the growth in FHA lending and home purchase lending with an LTV or combined LTV (CLTV) >=97% since 1980:[417] The growth in home purchase loans with downpayments of <=3% coincides with the passage of the GSE Act of 1992.

---

[411] Id., p. 5
[412] HUD's "National Homeownership Strategy – Partners in the American Dream", http://web.archive.org/web/20010106203500/www.huduser.org/publications/affhsg/homeown/chap1.html
[413] Id.
[414] Id.
[415] Id.
[416] Id.
[417] Sources: FHA 2009 Actuarial Study, HUD reports on the GSEs' affordable housing goals, Fannie and Freddie 10-Qs, and the Federal Housing Finance Board. As LTV data is not available for VA loans, these are excluded from the totals. VA was a relatively minor contributor...

Charts 56 and 57 also show how the FHA and the all loan foreclosure start rates respectively have risen over the same period.

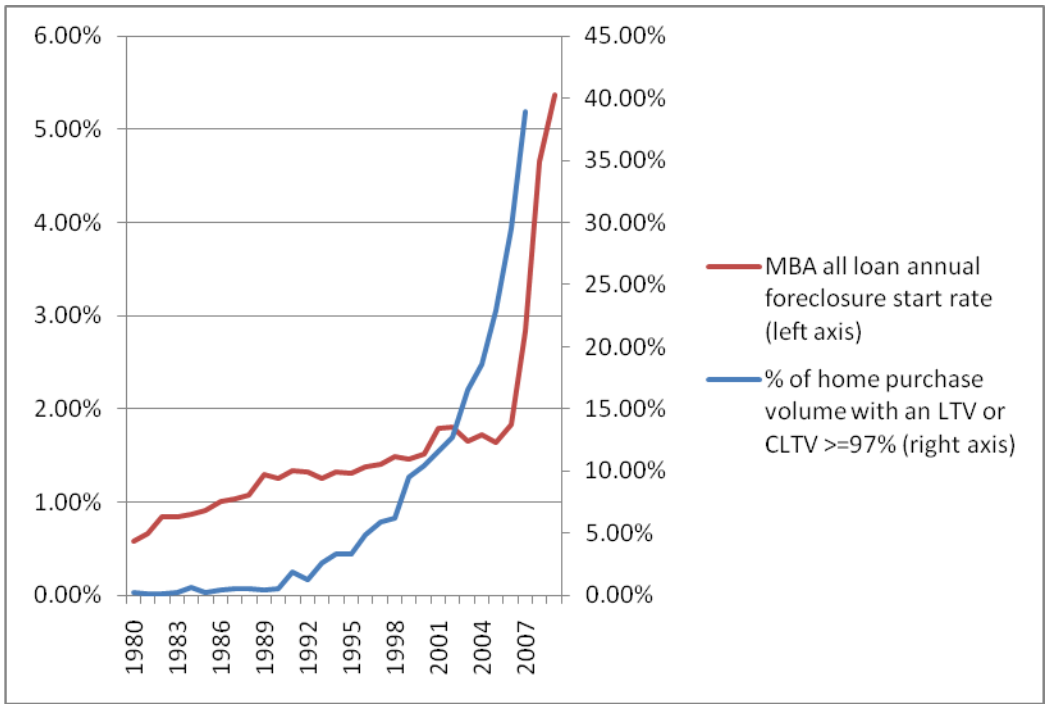
Chart 56: Percentage of FHA Volume with an LTV >=97% and FHA Foreclosure Start Rate



Sources: MBA National Delinquency Survey and FHA 2009 Actuarial Study and compiled by Edward Pinto

Chart 57 demonstrates the growth in the incidence of home purchase loans with a down payment of <=3% (an LTV or CLTV>=97%) from about 1 in 400 home purchases in 1980 to 1 in 7 in 2003 and 1 in 3 in 2007. Foreclosure start rates rose as down payments dropped.

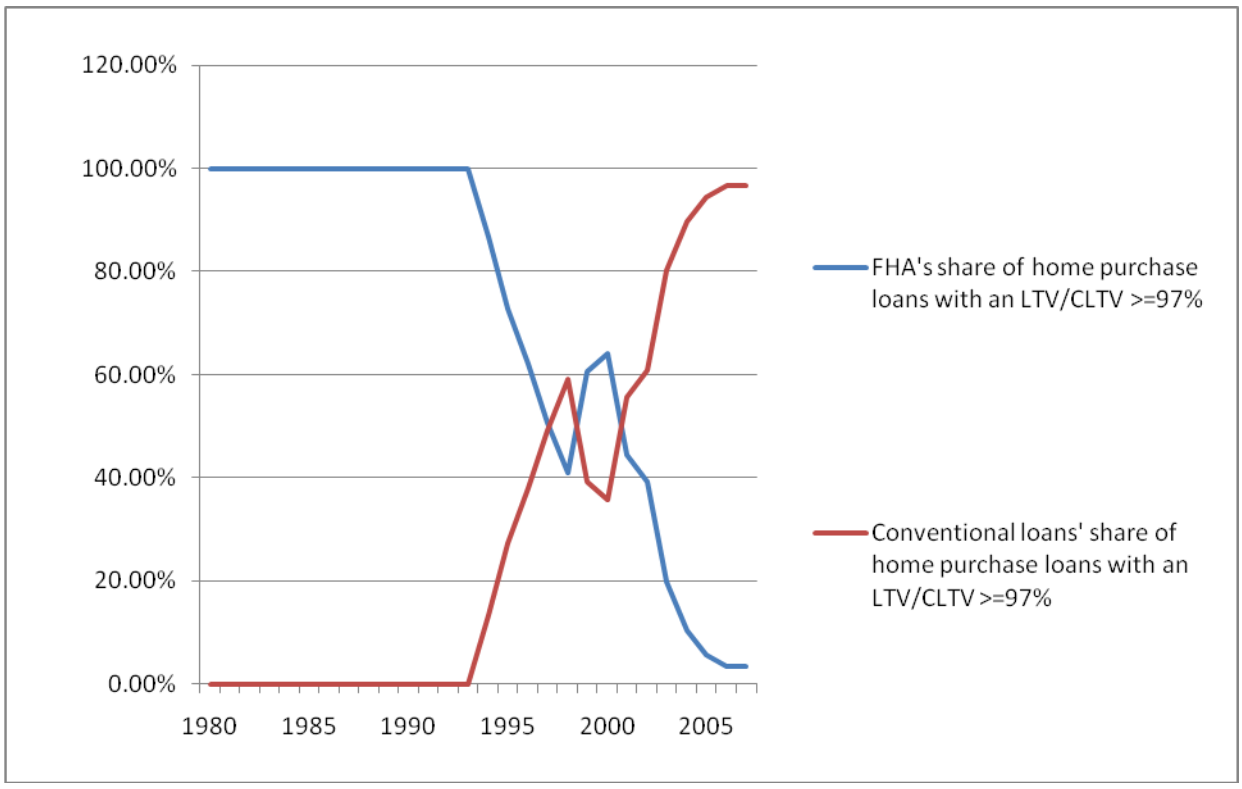
Chart 57: Estimated Percentage of Home Purchase Volume with an LTV or CLTV >=97% (Includes FHA and Conventional Loans*) and Combined Foreclosure Start Rate for Conventional and Government Loans:



Sources: MBA National Delinquency Survey, FHA 2009 Actuarial Study, and HUD"s Office of Policy Development and Research - Profiles of GSE Mortgage Purchases in 1999 and 2000, in 2001-2004, and in 2005-2007, SMR's "Piggyback Mortgage Lending," and Fannie's 2007 10-K. Compiled by Edward Pinto

*Fannie's percentage of home purchase loans with an LTV or CLTV >-97% used as the proxy for conventional loans.

Chart 58: Estimated FHA and Conventional (estimated for all Conventional Loans, not just the GSEs*) Loans Share of Home Purchase Loans with an LTV or CLTV>97%:



Sources: FHA 2009 Actuarial Study, and HUD"s Office of Policy Development and Research - Profiles of GSE Mortgage Purchases in 1999 and 2000, in 2001-2004, and in 2005-2007. Compiled by Edward Pinto

*Fannie's percentage of home purchase loans with an LTV or CLTV >-97% used as the proxy for conventional loans.

The trends shown by Charts 56 and 57 are indicative of the magnitude of the changes that took place with respect to all of the Three Cs of Mortgage Credit.

The above chronology demonstrates that:

1. *The impetus for passage of the GSE Act of 1992 and the affordable housing goals was a desire to invigorate the long dormant CRA.*
2. *To this end community groups convinced Congress and HUD to mandate loosened underwriting standards throughout virtually the entire conventional (non-FHA and VA) home finance market in an effort to have the GSEs and private market become the leading source for low- and moderate-income home financing.*
3. *At the behest of Congress, HUD and the GSEs played the central role in weakening lending standards and increasing leverage. The community groups responsible for drafting the affordable housing portion if the GSE Act of 1992 knew that unless and until the GSEs were forced to loosen their underwriting standards, the primary market would*

maintain their conservative standards. The GSEs started loosening their underwriting standards early in the 1990s. By the late 1990s their automated underwriting systems had become the industry standard, effectively replacing many proprietary ones. By the early 2000s much of the industry was using the GSEs' automated systems regardless of whether the loan was destined for purchase by the GSEs. Each time the GSEs loosened their guidelines, originating lenders both knew what new flexibilities were now "acceptable" to the GSEs and what flexibilities they would need to implement in order to maintain or grow their market share of loans sold away from the GSEs.

4. *The pressure exerted by the affordable housing goals (particularly the Special Affordable housing goal) on the GSEs (and the rest of the market) to loosen underwriting standards was immense and continually growing. While the moderate-income only portion of the goals increased from a baseline of 23% pre-GSE Act of 1992[418] to 29% in 2008[419], the Special Affordable goal increased from the 7% baseline pre-GSE Act to 27% in 2008. From 1992 to 2008 the GSEs were mandated to quadruple their acquisitions of loans to low- and very-low income borrowers. HUD used the goals setting process to force the GSEs to serve an ever larger percentage of low- and very low-income borrowers. As the GSEs were required to go deeper and deeper into this income segment, they had to offer higher and higher LTVs, numerous other underwriting flexibilities, and cross-subsidies provided by the GSEs' lower risk business.*

In 1995 HUD had asked:

> **"Lending institutions, secondary market investors, mortgage insurers, and other members of the partnership [to] work collaboratively to reduce homebuyer downpayment requirements."[420]**

It had reiterated this goal on numerous occasions.

By 2006 an estimated 30% of home buyers put no money down. Many more put as little as 1-3% down. HUD had accomplished its goal but at a terrible cost

*In 1994 Fannie's chief credit officer warned against Fannie's introduction of a 97% LTV mortgage based in part on the disastrous experience in Texas in the early1980s (1 in 4 loans with an LTV of 95% failed).[421] (See **1994-B**) In 1995 Fannie set a cumulative failure rate limit on any single community lending product line at 12 percent."[422] **(See 1995-B)** Texas' early 1980s cumulative default experience would be matched **nationwide***

[418] The 30% low- and moderate-baseline pre-GSE Act minus the 7% low- and very-low baseline pre-GSE Act.
[419] The 56% low- and moderate-baseline pre-GSE Act minus the 27% low- and very-low baseline pre-GSE Act.
[420] Supra. HUD's "National Homeownership Strategy – Partners in the American Dream".
[421] WSJ, "Why Calls Are Escalating to Clip Fannie Mae's, Freddie Mac's Wings", July 14, 2000, http://online.wsj.com/article/SB963527598420670221-search.html?KEYWORDS=Freddie+Mac&COLLECTION=wsjie/6month
[422] Supra. Fannie Mae Credit Policy memo, "Community Lending Review"

*by FHA for its 2007 book year of loans and **nationwide** by Fannie for its 2007 book year of loans with LTVs>=95% and/or a FICO<659.* [423]

5. *The growing levels of CRA and special affordable housing acquisitions mainly targeted at borrowers with an income <80% of median created more stimulation than this market segment could reasonably absorb. The 1996 Fed study (see **1996-D**) demonstrated that the pool of low and moderate income borrowers had a much higher percentage of low FICO scores and the use of low down payment loans and other loosened credit standards with this group (regardless of FICO) would lead to disastrous default results.*
6. *The goal of greatly reducing the gap in homeownership rates based on income was promulgated and implemented without regard to the types and dollar volumes of loosened underwriting that would be needed to accomplish this goal or the impact on the housing market. There was no recognition of the boom/bust nature of real estate, a trait greatly magnified by the leverage extremes advanced by government policy. Each additional push down the demand curve increased the risks being introduced into the housing finance system. Policy makers generally and HUD in particular would accept no amount of progress as sufficient until the gap was eliminated in its entirety. In the resulting clash between an unproven theory that policies mandating loosened underwriting would lead to a beneficial increase in the homeownership rate and the practicalities of a real estate market prone to boom and bust cycles, the bust cycle won.*
7. *HUD played a central regulatory role in orchestrating a multi-faceted weakening of underwriting standards over many years. **It does not appear that any other country had ceded the role of underwriting standard setter to a non-prudential regulator.***
8. *If the GSEs' prudent lending standards of 1991 had largely remained in place, underwriting standards throughout the housing finance industry would have been much stronger. As a result the boom would have been lessened and the real estate correction that follows a boom would have been much less severe and would not have engulfed much of the housing market.*
9. *After 15 years of unrelenting efforts by government agencies and enterprises to replace traditional underwriting standards with ones that were flexible and innovative, the housing finance system (with the notable exception of FHA) has once again largely returned to traditional standards, thereby confirming the validity of these standards. This is further evidence that the government's efforts served to promote unsafe, unsound and unsustainable lending was a misguided policy and harmed the individuals it was intended to help along with large swaths of the homeowner population and did great harm to the economy generally. As noted earlier, the recently enacted Financial Reform Bill does not include size of downpayment or a borrower's credit history in the list of*

[423] Source: FHA 2009 Actuarial Study, p. F-3 and author's estimate for Fannie's 2007 national book of loans with LTVs >=95% and/or FICOs <660. This estimate is based on Fannie's Q.1.10 Credit Supplement, pp. 6-8, http://www.fanniemae.com/ir/pdf/sec/2010/q1credit_summary.pdf;jsessionid=N4QBC0GJYCHBJJ2FQSISFGI

"underwriting and product features that historical loan performance data indicate result in a lower risk of default."[424]

10. *The increases in leverage and the hollowing out of lending standards that took place over a 15 year period was the direct result of policies established by Congress and administrative agencies, in particular the GSE Act, CRA, and the National Housing Strategy.*
11. *Government policies mandating the loosening of underwriting standards were pro-cyclical. These policies were reinforced by both new and existing pro-cyclical policies also supportive of housing.*
12. *HUD's "revolution in affordable lending" had created a dangerously synchronized mortgage market with an unprecedented number of overleveraged loans made to an unprecedented number of overleveraged borrowers. HUD had fashioned a housing finance market ill-equipped to absorb the shock of declining prices.*
13. *The similarity between the role played by HUD's promotion low and no downpayment lending Fannie and Freddie's encouragement of cash out refinances in the financial crisis and the role margin lending played in the stock market run-up and crash in the late 1920s is striking. Homebuyers were encouraged to purchase homes with little or no down payment (akin to buying stock on margin) and encouraged to extraction the equity created by booming house prices (akin to borrowing against one's stock margin account to buy more stock.*[425]
14. *It was HUD's "revolution in affordable lending" with its attendant weakening of lending standards and increasing leverage that triggered the mortgage meltdown and ensuing financial crisis. The long period of unprecedented credit loosening accounts for the length and exceptional nature of the 12 trends noted at the beginning of this paper and explains why the United States suffered a mortgage meltdown worse than any other country.*

By 2004 the Urban Institute's findings presented to HUD in 1997[426] that "the GSEs' guidelines, designed to identify creditworthy applicants, are more likely to disqualify borrowers with low incomes, limited wealth, and poor credit histories; applicants with these characteristics are disproportionately minorities" was no longer true. From 2000-2007 trillions of dollars of mortgages were acquired by the GSEs and others that were made to borrowers with low incomes or poor credit histories or who made no downpayments.

---

[424] Section 941, p. 529, http://banking.senate.gov/public/_files/Rept111517DoddFrankWallStreetReformandConsumerProtectionAct.pdf

[425] Howard Bierman, Jr., Cornell University, Economic History Association, "My conclusion is that the margin buying was a likely factor in causing stock prices to go up, but there is no reason to conclude that margin buying triggered the October crash. Once the selling rush began, however, the calling of margin loans probably exacerbated the price declines. (A calling of margin loans requires the stock buyer to contribute more cash to the broker or the broker sells the stock to get the cash.)" http://eh.net/encyclopedia/article/Bierman.Crash

[426] http://www.urban.org/publications/1000205.html

V. Appendices:

See Appendix A for links to three memoranda that provide additional quantitative detail

See Appendix B for additional detail on the interrelated nature of CRA, the GSE Act of 1992, and HUD's Best Practices Initiative.

See Appendix C for additional detail on the performance of FHA loans.

See Appendix D for detail on the role of appraisals in the financial crisis.

See Appendix E for detail on Alt-A loans' contribution to affordable housing goals.

Appendix A:

Below are links to three memoranda that document the accumulation of subprime and Alt-A loans in the U.S. first mortgage market:

1. "Sizing Total Exposure to Subprime and Alt-A Loans in U.S. First Mortgage Market as of 6.30.08": http://www.aei.org/docLib/Pinto-Sizing-Total-Exposure.pdf

2. "Sizing Total Federal Government and Federal Agency Contributions to Subprime and Alt-A Loans in U.S. First Mortgage Market as of 6.30.08": http://www.aei.org/docLib/Pinto-Sizing-Total-Federal-Contributions.pdf

3. "High LTV, Subprime and Alt-A Originations Over the Period 1992-2007 and Fannie, Freddie, FHA and VA's Role": http://www.aei.org/docLib/Pinto-High-LTV-Subprime-Alt-A.pdf

Appendix B: Further detail on CRA's role in "too big to fail", the mortgage meltdown and the interrelated nature of CRA, the GSE Act of 1992, and HUD's Best Practices Initiative

Supporters of CRA ask how a statue passed in 1977 could play such a central role in the financial crisis: The answer is that government policy initiatives taken in 1992-1995 invigorated CRA and placed it at the center of the effort to force the housing finance industry to institute flexible and innovative underwriting standards. Affordable housing initiatives represented by CRA, the GSE Act of 1992, and HUD's Best Practices Initiative were intertwined in numerous ways. This is best exemplified by Countrywide. One of the main arguments made to support the position that CRA was not a significant contributor to the mortgage crisis is that large originators like Countrywide were not subject to the Act. This argument fails for a number of reasons. First and foremost, Countrywide originated $789 billion in loans over 2001-2007 to fulfill its $1 trillion HUD "Best Practices" commitment.[427] Countrywide's "Best Practices" originations comprised 31% of its total volume in dollars over the period 2001-2007[428] (the percentage based on units would be higher since "Best Practices" loans tended to be smaller in dollar size). Thus Countrywide played a leading role in originating low-income loans to fulfill what would ultimately become a $1 Trillion commitment under HUD's Best Practices Initiative.[429] Many of these loans were sold to Fannie and Freddie to help them meet their affordable housing goals. Finally, much of the remainder was assembled into whole-loan packages and securities of CRA-eligible loans for sale to banks to help meet their CRA goals.

[427] In a question and answer statement released by Countrywide in late-2007 it noted $789 billion in loan originations towards its $1 trillion goal. http://www.realtown.com/articles/view/questions-and-answers-from-countrywide-about-lending

[428] Inside Mortgage Finance

[429] "Countrywide Is First Mortgage Lender to Voluntarily Agree to Fair Lending Goals with HUD" PASADENA, Calif., Sept. 14, 1994, PRNewswire: "The nation's largest mortgage lender and servicer, Countrywide Funding Corp., signed a voluntary Declaration of Fair Lending Principles and Practices ("Declaration") with the U.S. Department of Housing and Urban Development (HUD) -- the first such document -- underscoring Countrywide's commitment to increase the number of home loans made to minority and low-income borrowers….Countrywide implemented its House America program in October 1992…. Countrywide has made a $5 billion commitment with Fannie Mae and Freddie Mac to make such loans in 1994/1995 under its House America program." Additional Countrywide commitments:

- In 2000 $80 billion in community development lending included as a provision in Countrywide's reaffirmation of its 1994 HUD agreement (noted in *Mortgage Banking*, May 1, 2000);
- In 2001 an expanded $100 billion in community development lending through 2005. This goal was exceeded by early 2003 (Countrywide press release dated May 14, 2001); and
- In 2003 an expanded $600 billion goal, extended to 2010 (noted in *Mortgage Banking*, Feb. 2005).
- In a question and answer statement released by Countrywide in late-2007 it noted $789 billion in loan originations towards its [recent] $1 trillion goal. (http://www.realtown.com/articles/view/questions-and-answers-from-countrywide-about-lending).

There are additional reasons why CRA is intertwined with mortgage bankers such as Countrywide:

1. Countrywide was indirectly subject to the affordable housing goals of Fannie and Freddie, an initiative designed to spur CRA and CRA-like lending. Throughout the 13-year period 1995-2007, Countrywide was Fannie and Freddie's (on a combined basis) largest or second largest customer. In 2007 Countrywide accounted for 29% of Fannie's and 16% of Freddie's business.[430] Given Fannie and Freddie's escalating AH goals, much of Countrywide's "Best Practices" originations would have gone towards fulfilling these goals. Being in a preferred position as one of Fannie and Freddie's most significant customers had many perks, including highly advantageous pricing and underwriting flexibilities. Countrywide needed to originate growing amounts of "Best Practices" loans in order to maintain its #1 position and attendant perks;

2. Countrywide was able to package up and sell many of its remaining "Best Practices"/CRA-type loans to banks to meet their CRA requirements. Countrywide is reported to have had the following on its website: "The result of these efforts is an enormous pipeline of mortgages to low- and moderate-income buyers. With this pipeline, Countrywide Securities Corporation (CSC) can potentially help you meet your Community Reinvestment Act (CRA) goals by offering both whole loan and mortgage-backed securities that are eligible for CRA credit."[431] Just like with affordable housing loans, the qualifying requirements for CRA were easily determined, making targeted marketing to prospective banks relatively easy. Given the demand that CRA created for these loans combined with Countrywide's volume and geographic reach, these originations sold at a premium and became a substantial profit center; and

3. Fannie and Freddie had special CRA-Targeted MBS programs that helped institutions seeking to purchase a CRA-qualified investment. Up to 100 percent of the loans backing this geographically-customized MBS was to borrowers with incomes below 80 percent of the area median income. It is entirely possible that CRA-eligible loans sold by Countrywide to Fannie or Freddie were repackaged into CRA-Targeted MBS and sold to banks to meet their CRA requirements.[432]

Given that these programs overlapped and constituted mandated credit allocation, qualifying loans tended to be worth more than similar loans that did not meet one or more goals. This gave rise to a lively after-market where these loans could be sold at premium prices.

[430] Inside Mortgage Finance
[431] http://www.businessinsider.com/three-ways-the-cra-pushed-countrywide-to-lower-lending-standards-2009-6#ixzz0qM528sIc
[432] For example see https://www.efanniemae.com/sf/ip/cra/mbs.jsp

CRA became the regulatory path to the creation of "too big to fail" banking institutions:

CRA helped promote "too big to fail institutions" by rewarding banks that loosened their underwriting standards with the ability to consummate mergers. Ninety-three percent of the $4.5 trillion in post-1995 CRA commitments reported by the National Community Reinvestment Coalition[433] related to just 4 banks and banks they merged with. This demonstrates that bankers chose loosened underwriting in order to facilitate mergers. The four banks were Bank of America, Citibank, JP Morgan Chase, and Wells Fargo. This resulted in a cycle whereby the expansion of risky lending under CRA (and other affordable lending initiatives) placed other lenders in a situation where they had to offer similar products in order to compete. Additionally, the ideal merger candidates would be other banks that had similar announced and implemented "innovative and flexible" underwriting standards for CRA lending. Announcement of a CRA commitment was a signal that its loosened credit culture would be compatible with that of an acquiring bank. It may also be that banks with management intent on growth through mergers rather than a more conservative path of internally generated growth were a natural fit with CRA's loosened lending standards and weak credit culture. These mergers greatly advanced the goal of invigorating CRA by achieving loosened underwriting standards among the largest banks (see Chart 59):

Chart 59:

Announced CRA Commitments by Wells Fargo, JPMorgan Chase, Bank of America, and Citibank and banks they acquired:

Final bank	Acquired banks/entity with an announced CRA commitment(s)	CRA commitment (year announced and dollar amount)
Wells Fargo	Norwest	1985 (no $ amt.) 1986 ($41 m.)
	First Fidelity	1987 ($2 m.) 1987 ($28 m.)
	Meridian	1989 ($3 m.) 1989 ($18 m.)
	Corestates	1989 ($33.8m) 1989 ($48 m.)
	First Interstate	1990 ($18 m.) 1991 ($25 m.)
	First Union	1991 ($10 m.) 1992 ($20 m.)
	SouthTrust	1993 ($24 m.) 1993 ($59 m.)
	Wachovia	1993 ($200 m.) 1993 ($2 b.) 1993 ($13.5m) 1994 ($2 b.) 1994 ($272 m.)

[433] NCRC 2007 Annual Report, P. 6, http://www.community-wealth.org/_pdfs/articles-publications/cdfis/report-silver-brown.pdf

Wells Fargo (continued)		1994 ($32 m) 1995 ($40 m.) 1995 ($319.4 m.) 1996 ($500 m.) 1994 ($15 m.) 1994 ($124 m.) 1996 ($45 b.) 1997 ($3 b.) 1998 ($13 b.) 1998 ($45 m.) 1998 ($15 b.) 1999 ($1 b.) 2001 ($35 b.) 2004 ($75 b.) 2006 ($150 b.) 2006 ($8 b.)
JPMorgan Chase	Chemical Bank One Texas Commerce Manufacturers Hanover First Chicago NBD Home Savings Dime Washington Mutual	1984 (120 m.) 1986 ($7.5 m.) 1986 ($2 m.) 1987 ($5 m.) 1987($6 m.) 1987 ($26 m.) 1987 ($25 m.) 1989 ($1 m.) 1989 ($200m) 1989 ($1.5 b.) 1990 ($2 m.) 1991 ($72.5 m.) 1991 ($250 m.) 1993 ($66 m.) 1993 ($1 b.) 1994 ($20 m.) 1995 $36.2 m.) 1995 ($18 b.) 1995 ($2 b.) 1995 ($2 b.) 1995 ($656 m.) 1996 ($3 b.) 1997 ($75 b.) 1998 ($2 b.) 1998 ($35 b.) 1998 ($120 b.) 1998 ($3 b.) 1998 ($6.7 b.) 1998 ($350 m.) 1999 ($2.5 b.) 2001 ($375 b.) 2001 ($350 m.) 2003 ($3.1 b.) 2003 ($500 b.) 2004 ($800 b.)

Bank of America	Continental	1983 (no $ amount)
		1983 ($1 m.)
	Seafirst	1984 (no $ amount)
		1985 (no $ amount)
	Barnett	1985 ($2 m.)
		1985 ($8.6 m.)
	Fleet	1985 ($50 m.)
		1986 ($50 m.)
	Bank of New England	1986 ($20 m.)
		1986 ($50 m.)
	Bank of America	1986 ($80 m.)
	(acquired by	1988 ($43 m.)
	NationsBank, which	1990 ($4 m.)
	kept the Bank of	1990 ($2 m.)
	America name).	1990 ($12 m.)
		1990 ($17 m.)
	Citizens & Southern	1990 ($2 m.)
		1991 ($1.5 b.)
	Shawmut	1992 ($100 m.)
		1992 ($316 m.)
	Bank of Boston	1992 $2 b.)
		1992 ($10 b.)
	Bay Bank	1992 ($8 b.)
		1993 ($50 m.)
	Summit	1993 ($200 m.)
		1993 ($400 m.)
	Sovran	1993 ($5 m.)
		1994 ($15 m.)
	MNC	1994 ($1 m.)
		1994 (29.8 m.)
	Boatmen's	1994 ($15 m.)
		1994 ($25 m.)
	U.S. Trust	1994 ($1 b.)
		1996 ($502 m.)
	LaSalle	1996 ($237.3 m.)
		1997 ($140 b.)
		1998 ($350 b.)
		1999 ($14.6 b.)
		1999 ($70 b.)
		2000 ($1.2 b.)
		2004 ($750 b.)
		2008 $1.5 t.)
Citibank	Cal Fed	1997 ($430m)
		1998 ($25.1 b.)
	Travelers	1998 ($115 b.)
		1998 ($115 b.)
		2002 ($120 b.)
		2003 ($200 b.)
		2003 ($3 b.)

Compiled by Edward Pinto from NCRC data and public merger data

Supporters of CRA state that CRA loans perform well: Detailed performance data for single-family CRA lending is rarely published. A search of the top 25 banks by single family mortgage holdings yields only two lenders providing performance data on its CRA loans– –Third Federal Savings and Loan of Ohio and Bank of America (BofA). A third view is provided by data on The Shorebank (Chicago), the nation's first community development bank, which specializes in CRA lending. These three banks hold in portfolio a total of over $15 billion in CRA loans (BofA accounts for $14.8 billion of this total). BofA originated a much larger amount of community lending than what remains on its balance sheet. From 2001-2007 it originated $213 billion in single-family community lending loans. Most of this volume was presumably sold to Fannie or Freddie to help meet the GSEs' affordable housing goals:

1. Third Federal reports its "Home Today" affordable housing program, targeted to benefit low- and moderate-income home buyers, constituted just 3.1% or $286 million of its owned first mortgage loan portfolio totaling $6 billion, yet Home Today loans represented 31.9% of its 90+ delinquencies. At March 31.2010 its Home Today total of 90+ days delinquent and non-accrual loans was 33% vs. 2.0% on its non-Home Today first mortgage portfolio. It is worth noting that both portions of Third Fed's portfolio consist almost entirely of properties in Ohio and Florida; two of the states hardest hit by the mortgage meltdown. Yet Third Fed's traditionally underwritten loans are performing well.[434] [435]

---

[434] Third Fed's Q.2:10 10-Q, pp. 24 and 28, http://www.snl.com/irweblinkx/docs.aspx?iid=4041914

[435] Third Fed's involvement with CRA presents a case study as to how CRA was used to weaken credit standards. Third Fed started its "Home Today" program in 2000 and used it to make loans as those "customers who, generally because of poor credit scores, would not otherwise qualify for our loan products." In 2002-2003 Third Fed was targeted by the East Side Organizing Project (ESOP) "for ignoring Cleveland's low-income and minority neighborhoods." ESOP's president, Inez Killingsworth, noted that Third Federal's "2001 Home Mortgage Disclosure Act (HMDA) numbers show that while Third Federal is 'Ohio's leading mortgage lender,' they are redlining a whole section of Cleveland's east side neighborhoods.". ESOP leader Emma Adams went on to add: 'We tried to negotiate in good faith….' Killingsworth added: 'We are calling on y'all to take action. We will bring Third Federal to the table and show them how to become a CRA partner, reinvesting in our communities.'" (found at: http://www.disclosure-us.org/disc-feb2003/esopsummit.html)

Third Fed got the message as its Home Today program started growing rapidly, more than doubling to $195 million by September 2004 and reaching $299 million by March 2009. In 2007 Third Fed received fulsome praise from Killingsworth when she testified before a House subcommittee:

> "(w)e also have a very good relationship with Third Federal Savings & Loan…." (found at: http://oversight.house.gov/documents/20070322180426-24212.pdf)

What Killingworth neglected to mention was that Third Fed's Home Today program had a delinquency rate at about the time of her testimony (September 2006) of 24%. By June 2009, it had risen to 35% and remains at this level as of March 31, 2010. (Found at: http://www.snl.com/irweblinkx/doc.aspx?IID=4041914&DID=11149534) This is on par with the self-denominated subprime delinquency levels.

This result is consistent with a 2009 analysis published by the Federal Reserve Bank of Minneapolis which "indicates that subprime loans in ZIP Codes that are the focus of the CRA (those just below the [income] threshold) have performed virtually the same as loans in the areas right above the threshold." (found at: http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4136)

2. BofA reports at March 31, 2010, its CRA portfolio comprised seven percent of the residential mortgage loan balances but accounted for 18 percent of nonperforming residential mortgage loans (defined as loans designated as non-accrual). The CRA portfolio also comprised 26 percent of residential mortgage net charge-offs during the three months ended March 31, 2010.[436] An analysis of BofA's 10-Q allows one to calculate that its nonperforming loan rate was 22% on its $15 billion CRA loans. This is almost triple the nonperforming loan rate of 8.4% on BofA's entire 1st mortgage portfolio. An unknown percentage of BofA's CRA loans were 90+ days delinquent but not designated as nonperforming.

3. Shorebank, the nation's first community development bank, reports at March 31, 2010 its single-family first mortgage loan portfolio had a total of 90+ days delinquent and non-accrual loan rate of 22%. It also had total of 90+ days delinquent and non-accrual loan rates of 31% on its multi-family lending, 11% on its commercial real estate, 12% on its commercial and industrial lending, and 53% on its construction and development lending. These loan categories account for 98% of its total lending portfolio.[437] Shorebank has recently been attempting to negotiate a bailout. As of June 22, 2010, it was reported that "[P]eople with knowledge of the analysis say the Fed believes in order to remain solvent, ShoreBank would need much more money — at least $300 million and probably more because of the toxic nature of ShoreBank's balance sheet."[438]

On a more general note, a recent Fed study of CRA loans, as reported by then Fed Governor Kroszner[439], identified CRA loans as a type of subprime loan and noted that "CRA-related subprime loans performed in a comparable manner to other subprime loans."

Unfortunately, there is not a centralized database that tracks CRA loan performance. CRA loan data get mixed into the delinquency data reported for FHA, bank holdings, private mortgage backed securities, and the GSEs. Yet CRA loan performance must be known by these institutions. However there are two large loan groupings that allow us to get a further glimpse at the unsustainable nature of CRA loans:

Based on Special Affordable goals and a Fannie press release from 2003,[440] it is estimated that the GSEs purchased about 50% of CRA-qualified originations since 2003. CRA loans had a high percentage of low and ultra-low down payments (LTV>90%) and FICOs below 660. In 2007, 72% and 74% respectively of Fannie and Freddie's home purchase loans with an LTV>90% met one or more of their AH goals.[441] A somewhat smaller but still substantial percentage would have met CRA's <80% of median area income standards. Both GSEs report loan performance for

[436] Sources: http://investor.bankofamerica.com/phoenix.zhtml?c=71595&p=irol-sec, p. 134 and http://www.bankregdata.com/main.asp (BofA listing)
[437] http://www.bankregdata.com/main.asp (ShoreBank listing)
[438] http://www.foxbusiness.com/story/markets/wall-street-officials-bailout-shorebank-looks-doubtful/
[439] http://www.federalreserve.gov/newsevents/speech/kroszner20081203a.htm
[440] "Fannie Mae Passes Halfway Point in $2 Trillion American Dream Commitment; Leads Market in Bringing Housing Boom to Underserved Families, Communities" http://findarticles.com/p/articles/mi_m0EIN/is_2003_March_18/ai_98885990/pg_3/?tag=content;col1
[441] Source: HUD Office of Policy Development and Research

loans that had either low down payments (LTV>90%) or FICOs below 660. Loans with these characteristics were affordable housing goals rich. These groups of loans constitute a conservative proxy for the performance for CRA loans

Fannie's serious delinquency rate[442] on its $525 billion in high LTV and/or low FICO loans was about 13% at 3.31.10. This is 5.7 times the 2.38% serious delinquency rate on Fannie's traditionally underwritten loans. In terms of specific categories, Fannie's loans with a:

- Down payment equal to or less than 5% had a 12.93% serious delinquency rate;
- FICO < 620 had 17.86% serious delinquency rate; and
- FICO >= 620 and < 660 had 13.20% serious delinquency rate.[443]

At 3.31.10 Freddie also had about $320 billion in loans in the same high risk categories as Fannie. At 3.31.10 the serious delinquency rate on these loans was about 10.5%.[444]

To sum up what we know quantitatively about the performance of CRA and CRA-like loans:

1. The non accruing loan rate averages 22% (and likely higher if 90+ days delinquent loans were known for BofA) on the $15 billion of known CRA loans held by banks noted earlier;

2. The GSEs' nonperforming loan rate averages 13% on over $1 trillion of loans that are affordable housing goals rich, a substantial percentage of which are similar to CRA loans in terms of both income and credit risk characteristics;

3. FHA expects a 20% claims (foreclosure) rate on loans from approximately $230 billion in insured loans from book years 2005-2008. A substantial portion of these loans are similar to CRA loans in terms of both income and credit risk characteristics; and

4. Virtually all of the above loans[445] had "prime term" characteristics, that is they were fixed rate, owner occupied, fully documented, generally lacked prepayment penalties, and made at normal "prime" rates or in many cases at subsidized rates.[446] [447] Many had homebuyer counseling. The high default rates noted above indicate that the presence of these characteristics does not make the loans sustainable or non-predatory. The assertion that CRA and affordable housing loans could be safely made with low or no

[442] The terms "serious delinquency" and "nonperforming loans" are basically synonymous.
[443] Fannie's Credit Supplement, p. 6, http://www.fanniemae.com/ir/pdf/sec/2010/q1credit_summary.pdf;jsessionid=RTX4N3TMQJEBBJ2FQSISFGA
[444] http://www.freddiemac.com/investors/er/pdf/supplement_1q10.pdf, pp. 18 and 19
[445] The $845 billion in Fannie and Freddie loans noted above (FICO below 660 and/or LTV/CLTV >90%) are only a portion of the high risk loans acquired by the GSEs. The GSEs had another $800 billion consisting generally of Alt-A (mostly low doc/no doc), ARMS, and investor loans.
[446] As has been noted banks frequently reduced the interest rate by ¼% or ½ %, waived mortgage insurance, points and some closing costs and the GSEs routinely subsidized high risk lending that helped achieve affordable housing goals)
[447] In many cases the lower interest rate merely allowed the borrower to purchase a larger home.

> downpayments, with high debt ratios, or to borrowers with impaired credit so long as they also had so called "prime term" characteristics would perform like traditionally underwritten prime loans was wishful thinking with virtually no evidence to support it.

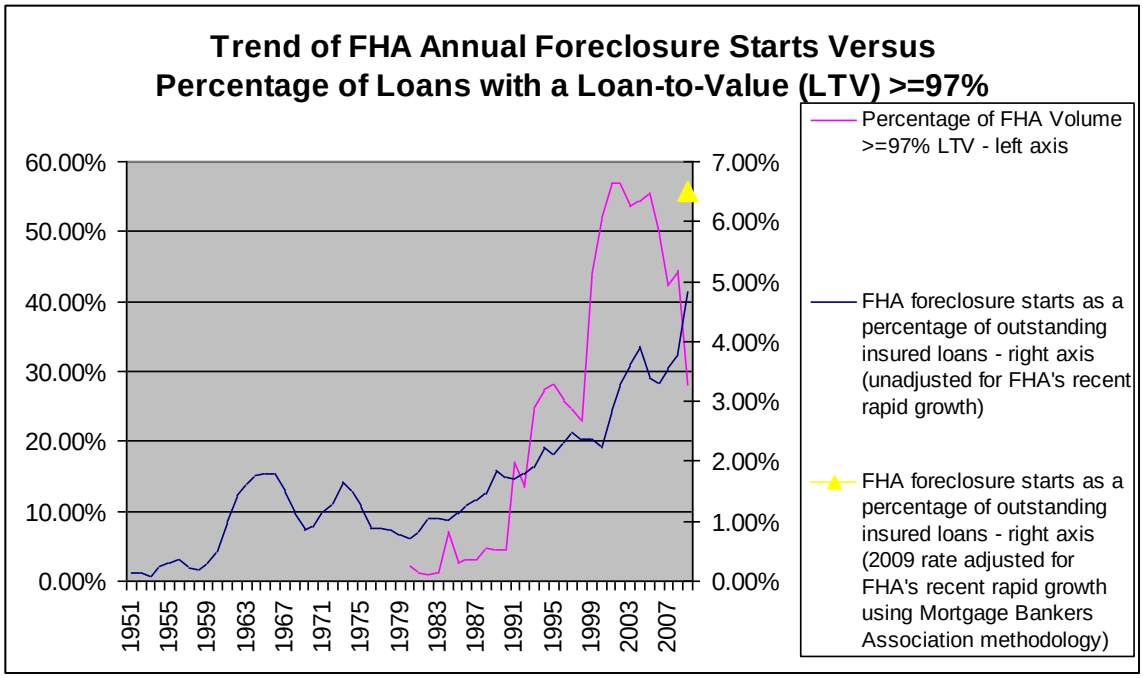
The actual performance of CRA loans was a low priority to regulators. In the Office of Thrift Supervision's "Directors' Guide to Management Reports" 18 warning signs or red-flags are noted regarding CRA and Fair Lending. Not one of the 18 warning signs or red flags mention CRA loan performance, foreclosure rates, delinquency statistics or the reporting of same.[448]

[448] OTS, Directors' Guide to Management Reports, pp. 39-40, http://files.ots.treas.gov/48091.pdf

Appendix C: Additional detail of FHA's loan experience

As FHA's percentage of loans with high LTVs increased, its foreclosure start rate moved up in lock step. More ominously, the foreclosure start rate is increasing throughout the housing boom.

Chart 60 (same as Chart 18):



Sources: FDIC, MBA, FHA, and compiled by Edward Pinto

FHA loans generally experience a high default rate, particularly when they come under stress. This is notwithstanding the fact that they are almost all fixed rate and fully documented. FHA's 2009 actuarial study projects a 20% average Cumulative Claim Rate[449] for its 2005-2008 books of loans, with its 2007 book projected to have 1 in 4 loans go to claim.[450] The same study reports that FHA is currently experiencing a 57% severity rate[451]. At these loss and severity rates one would expect a projected total loss rate of 11.4% (20% x 57%).

[449] FHA insures loans. When an insured loan is foreclosed upon it results in a claim.
[450] FHA's 2009 Actuarial Study
[451] FHA insurance covers 100% of the loss. A 57% severity rate means that it loses 57 cents on every dollar going to claim.

Appendix D: The role of appraisals in the financial crisis

Joan Trice of the Collateral Risk Network pointed out the key role of omission played by appraisers in "Reengineering the Appraisal Process":[452]

> "What role did appraisers play in the housing crisis? Appraisers didn't directly cause values to decline. They weren't the catalyst for homeowners to cease paying their mortgage. But they did help create fictitious equity and were complicit in facilitating trillions of dollars of loans that never should have been made. There are varying degrees of valuation inflation performed by appraisers....And then, somewhere in the mix, was the failure to recognize an overheated market and report trends and risk to their clients....If we had credibly valued the underlying collateral, I would submit that there would be an active MBS market."

Shortcomings of the current valuation process:

The methodologies utilized in valuing single-family residential properties rely almost entirely on comparable sales, to the exclusion of other valuation principles. This was not always the case. When the Federal Housing Administration (FHA) and the Veteran's Administration (VA) led the development of modern appraisal practice back in the 1930s and 1940s, determining a property's value required the reconciliation of four valuation principles:[453]

1. "**The principle of replacement:** The estimated cost of replacement fixes an upper limit of valuation.
2. **The principle of substitution:** the cost of acquiring an equivalent substitute [or comparable] property fixes the upper limit of valuation whether accomplished by (1) constructing identical or equivalent improvements on an equivalent site or (2) purchasing an already completed equivalent property at a price at which an effective supply of equivalent properties is available on terms assumed in the valuation [today this is called comparable value].
3. **The principle of income capitalization:** A properly made capitalization of expected income [rents] fixes an upper limit of valuation.
4. **The principle of suitability or appropriateness:** Unless proposed new building improvements will be appropriate to the site and neighborhood, valuation cannot be as high as replacement cost."

A concluded property value equaled the least amount found by applying such principles. If this resulted in a value lower than the sales price, sellers either had to adjust the sales price downward or buyers had to increase the downpayment. This was consistent with the appraiser's role as set out by FHA in 1947 -- "a price at which a purchaser is warranted in paying for a property, rather than the price at which the property may be sold…."[454] It was the job of the

[452] Supra., Joan N. Trice,
[453] "McMichael's Appraising Manual", p. 148, 4th edition, 1951
[454] ***May, "The Valuation of Residential Real Estate" p. 17, 1953***

appraiser to determine the amount of debt that could be safely lent against a property without impairing the property's ability to earn its way out of the debt.

These steps were necessary because low downpayment lending and lengthy loan terms could raise demand and drive house prices higher. While this potential impact was recognized in appraisal practice over a half century ago, it now seems to have been forgotten:

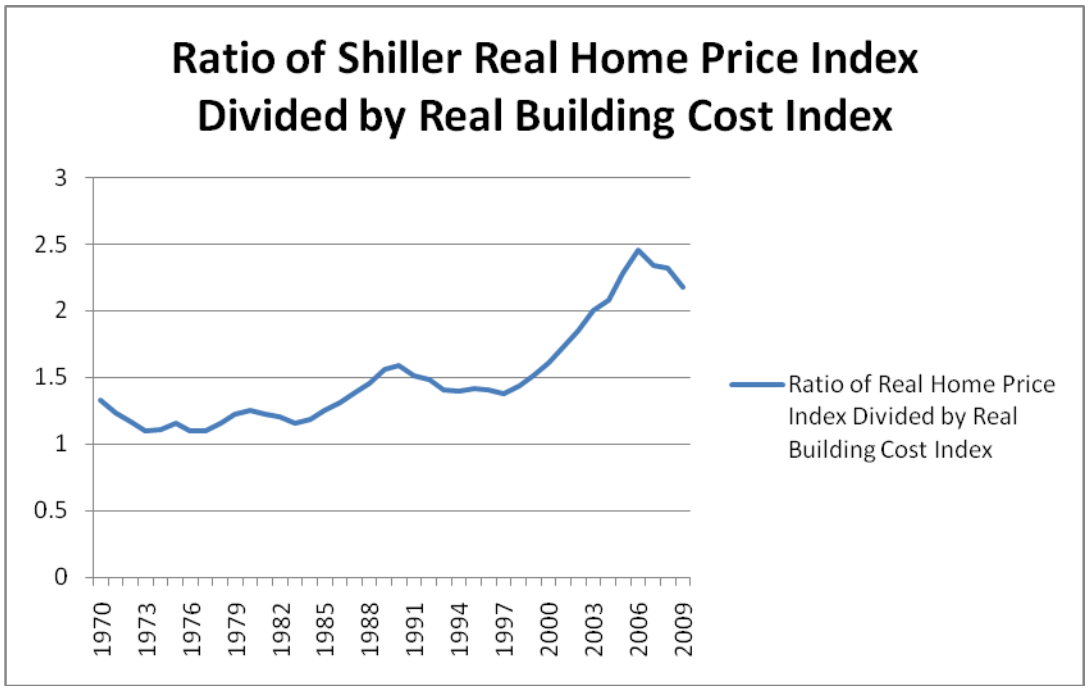
> "Assume that we are dealing with two residential properties in two different cities, which we shall call City *A* and City *B*. Both of these ***cities, we shall assume, have the same population history and trend, the same social and economic background, and the same supply and demand ratio. In each city, we have a residential property to appraise. Each of these properties is similarly environed, of the same size, quality, utilitarian capacity, and cost. The only factor of difference in the problem is the local custom concerning terms of sale, which we may assume are 25 per cent down and 5 years to pay the balance in the case of City A, and 10 per cent down and 15 years to pay the balance in City B. Does it now follow that, because of this difference in the terms of sale, the property located in City A may conceivably be valued at $10,000, and the property in City B at $12,500?, The answer is no; the value is the same in each case, but the price differs because the price as finally fixed in each case stems from the terms agreed upon."***[455]

1. Over time the principles of replacement and income capitalization came to be relied on less and less until they were made optional and eventually ignored, leaving comparable sales as the sole determinant. At the same time, the use of low or no downpayments and longer loan terms became increasingly widespread. Down payments of three percent or less started becoming more prevalent in the mid-1990s as a result of government policies. By 2006 the National Association of Realtors would report that 46% and 19% of first-time buyers and repeat buyers respectively nationwide put down no money. **As a result, an estimated 30% of home buyers put no money down.** Many more put as little as 1-3% down.

[455] Id. p. 18-19

Without the rigor of the principle of replacement, sales prices became seriously out of line with replacement costs:[456]

Chart 61:



Compiled by Edward Pinto

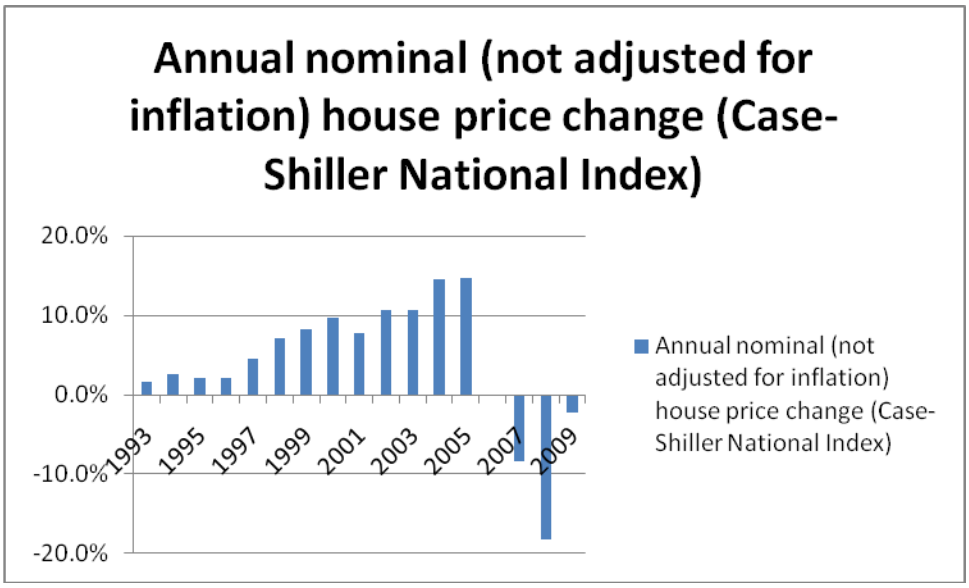
[456] Robert Shiller, http://www.econ.yale.edu/~shiller/data.htm

Without the rigor of the principle of income capitalization, sales prices became seriously out of line with rents:

Chart 62:

These shortcomings also help explain the recent wide swings in properties values as noted in Chart 63:

Chart 63:



Compiled by Edward Pinto

The additional demand created by large numbers of highly leveraged buyers serves to increase spot home prices. We are seeing this happen in 2010 in California. In June DataQuick reported:

> "[t]he federal government has kept the spigot wide open [in Southern California] for loans used to buy low- to mid-priced abodes. Government-insured FHA loans, popular among first-time buyers, accounted for 37.1 percent of all mortgages used to purchase homes in May, down from 38.4 percent in April and 40.3 percent in May 2009."

The S&P/Case-Shiller Index reports that home prices in major areas of California are up by 10% or more over the last year.

The problem faced by those bearing the risk on the loans financing these purchases is that new highly leveraged purchases become not only comparables used to value future sales (whether highly leveraged or not), but they also become comparables for the appraisals supporting cash out refinance loans. Can and should this represent the sole determinant of market value for all homeowners and for all valuation uses? An appraisal approach that relies solely on comparable sales is pro-cyclical[457] and denies appraisers the tools necessary to determine value and protect lenders and borrowers. Under current appraisal methodologies as commonly practiced, an

[457] Home prices are pro-cyclical as they tend to increase during times of economic growth and decline or increase more slowly during periods of economic contraction. If the cost and income capitalization approaches are used to identify and moderate supply and demand imbalances reflected by unsustainable market prices, the valuation and lending process can act in a counter-cyclical manner on a growing boom.

appraiser is left with determining "the price at which a property may be sold", not its value or more importantly, its value for lending purposes.

Many parts of Europe are considering following Germany's example and tasking their appraisers with determining a "mortgage lending value":[458]

> "The value of a property as determined by a prudent assessment of future marketability of a property taking into account long term sustainable aspects of a property, the normal and local market conditions, and the current use and alternative appropriate uses of a property. Speculative elements shall not be taken into account in the assessment of the mortgage lending value."

Joan Trice of the Collateral Risk Network[459] noted the use of a mortgage lending or stabilized value in Europe.

> "This approach requires the use of all three approaches and places limits on how large the disparity can be between the approaches, before appraisers are required to report a lower value in frothy markets. Our markets have not recognized, until now, that residential appraisers are not just house appraisers. One by one, mortgages are collectively added to a pool. It is assumed that the risk of a single loan would not infect a pool of loans. It is much worse. The systemic disease of valuation inflation has infected the entire housing market and beyond."

She goes on to add:

> "In this scenario, any value that is above the stabilized three years value is considered unsecured. This would also lead to a different set of underwriting criteria that lenders could use to partition risk."

The concept of stabilized value is not new to the United States. The chief appraiser of The Security First National Bank of Los Angeles advised in the 1951 edition of "McMichael's Appraising Manual":[460]

> "It should be remembered that the mortgage lender's position is such that he is unable to participate in any enhancement of value that may accrue to his security….The lender, therefore, frequently adheres to policy that loans made on a boom market should be for a lesser percentage of current value than the law permits. In such cases, a further decision must be made as to the means of effectuating this policy. Should maximum loan percentages be *progressively reduced* as the market rises, or should the appraisal be *stabilized?"*

[458] International Valuation Standards Committee, "Exposure Draft of Proposed Revised International Valuation Application 2 – Valuation for Lending Purposes", June 2006
[459] Supra., Joan Trice
[460] Supra., McMichael's Appraising Manual", p. 115

The comparable property selection process is itself flawed and a major point of failure for the appraisal process. The current process starts with the sales price and uses this "answer" to narrow the selection of appropriate comparables – generally ending up with 3 properties. Under the best of circumstances, this process may eliminate some or even many of the most appropriate comparables.[461] In unscrupulous hands, this process results in the selection of clearly inappropriate comparables to support an inflated value.

Joan Trice of the Collateral Risk Network[462] also addressed this issue:

> "The process of three comparable sales on a grid is entirely outmoded…. [A]ppraisal practice needs interactive valuation models for the appraiser to define the appropriate market, be able to review large datasets, remove the outliers, and run regression tools…. An examination of historical sales going back at least 24 months would allow for trending and a more thorough reporting of market conditions."

All lending, including home lending, is by definition leveraged, naturally pro-cyclical, and prone to alternating periods of boom and bust. The current real estate bust is the worst in over 75 years largely due to the substantial elimination of downpayments and other loose lending practices that were in place for many years. A return to real estate valuations based on traditional appraisal principles would help prevent a recurrence. This starts with an acknowledgement that market conditions and loan terms can drive up a property's sales price faster than its fundamental or stabilized value, a value determined by trending comparable sales prices, replacement costs and rental value.

[461] In 1991 I conducted a study of industry appraisal practice relating to whether selected comparable properties were appropriate. In a review of 14 appraisals, a total of 48 comparables were selected and used by the appraisers. We did a thorough database search and developed a list of 65 potential appropriate comparables (there was an overlap of 25 properties between the two groups). Each appraisal was desk and field reviewed to determine the appropriateness of the 48 appraiser selected comparables. Twenty-three of the 48 were found to be clearly inappropriate (if there was any doubt it was rated appropriate). This information was shared with Fannie Mae's credit policy department. They had just conducted a similar review and also found a high degree of inappropriate comparables used.

[462] Supra., Joan Trice

Appendix E: Alt-A loans contribution to affordable housing goals

Quantitative analysis of data relating to non-owner occupied (NOO) single family rental units and Alt-A's NOO units' relationship to affordable housing goals. NOO loans are investor loans.

First, some background. In the early 1980s Fannie incurred substantial losses on NOO single family rental units. Fannie concluded in 1985 that it was ill suited to manage this potentially speculative and high risk loan product and implemented tighter underwriting provisions designed to limit its exposure to this as well as other loan categories which it had found presented unacceptable risks. As a result, loans Fannie (and Freddie) would not buy included investor loans, riskier types of low down payment loans, loans with high debt ratios, higher LTV cash out refinances, combination loans, and riskier types of ARMs. These non-agency eligible products came to comprise much of the "alternate to agency" or Alt-A market that developed during the 1990s. By 1991 Fannie and Freddie also exited the low doc/no doc arena (this product had developed post-1985). The addition of low doc/no doc lending completed the "alternate to agency" or Alt-A product line.

Alt-A volume as a percent of the overall market was quite small (averaging less than 2%) during the 1990s. While anecdotal evidence indicates that Fannie and Freddie's re-involvement in the Alt-A market began in the late 1990s, documented evidence begins in 2002. In 2002 the GSEs were the dominant purchasers of Alt-A loans (acquiring an estimated $84 billion in whole loans and private MBS). As will be demonstrated below, in 2006 about one-third of Fannie's NOO acquisitions came from Alt-A loans.

Relative to the relationship between the housing goals and NOO units:

1. Fannie's 2006 acquisitions are used as a representative year. While 12% of Fannie's total units in 2006 were NOO (377,661 NOO units), these units played a disproportionately large role in meeting goals. 22% of the low-mod, 20% of the underserved areas, and 33% of the special affordable goals were met with NOO units. Put another way, while 42% of single family owner units qualified as low– and moderate-units, 86% of single-family (1-4 unit) rental units so qualified. Additionally, while only 16% of single family owner units qualified as special affordable units, 54% of single-family (1-4 unit) rental units so qualified. [463]

2. A significant factor in the GSEs' purchases of Alt-A loans was due to their being goals rich. They had a very high percentage of non-owner occupied (NOO) 1, 2, 3, and 4 unit properties (16.7% for Fannie's Alt-A acquisitions in 2006).

3. The next step involves estimating the number of NOO loans included in Fannie's Alt-A

[463] Table 4 – 2006, http://www.huduser.org/Datasets/GSE/profiles_05-07.pdf

purchases in 2006. For this purpose a 2, 3 or 4 unit NOO counts only once since the data represents the number of loans, not the number of units. As a result this somewhat understates the NOO unit count derived for Alt-A loans.

4. In 2006 Fannie purchased Alt-A private MBS totaling $12 billion.[464]

In 2006 Fannie purchased Alt-A whole loans totaling $112 billion.[465]

5. To determine how many Alt-A loans this represented, divide $124 billion ($12 billion + $112 billion) by $173,643 (average loans size of Fannie's Alt-A purchases) which yields 714,000 Alt-A loans.[466]

6. To determine how many NOO loans this represented, multiply the 714,000 Alt-A loans by the Alt-A NOO percentage of 16.7% yielding an estimated 119,000 Alt-A NOO loans for 2006.[467] -

7. These 119,000 Alt-A NOO loans appear to represent at least 32% of the 377,661 single-family rental (NOO) units acquired by Fannie in 2006.

8. All but 49,000 of the 377,661 single-family rental (NOO) units counted towards the low-mod goal. Mathematically it appears that at least about 70,000 Alt-A NOO loans would have to have counted towards this goal.

9. While one can't make similar definitive statements about Alt-A's NOO contribution to the underserved area and special affordable goals, it would appear that it would have been substantial. This is because of Alt-A's one-third share of all single-family rental (NOO) units acquired by Fannie.

While this analysis is believed to be accurate, it is subject to the noted data limitations and stated assumptions due to lack of access to all the data.

[464] Table 1 b, Part 2, http://www.fhfa.gov/webfiles/2331/FHFAReportToCongress2008final.pdf
[465] See p. 5, http://www.fanniemae.com/media/pdf/newsreleases/2009_10K_credit_summary.pdf;jsessionid=A2BIVWR03124JJ2FECISFGA
[466] See p. 24, http://www.fanniemae.com/media/pdf/newsreleases/2008_Q1_10Q_Investor_Summary.pdf
[467] See p. 30. http://www.fanniemae.com/media/pdf/newsreleases/2008_Q1_10Q_Investor_Summary.pdf