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FEDERAL HOUSING ENTERPRISES

HUD's Implementation of Its Mission Oversight Needs to Be Strengthened

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Federal Housing Enterprises: HUD's Implementation of Its Mission Oversight Needs to Be Strengthened

In a recently issued report, GAO assessed the Department of Housing and Urban Development's (HUD) implementation of its housing mission oversight responsibilities for Fannie Mae and Freddie Mac-(the enterprises)-the two largest government sponsored enterprises. GAO found that HUD had adopted a conservative approach to setting housing goals that require the enterprises to purchase mortgages serving low- and moderate-income borrowers and those who live in central cities and rural areas (targeted groups). GAO also identified several weaknesses in HUD's enterprise housing mission oversight activities that need to be addressed.

Among its other provisions, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 required HUD to develop numeric housing goals for the enterprises to promote housing opportunities for targeted groups. In 1995, HUD adopted a conservative approach to setting the final housing goals for 1996 through 1999 that placed a high priority on maintaining the enterprises' financial soundness. HUD's final housing goals represented a modest increase in the enterprises' existing commitment to targeted mortgage purchases and are not expected to generate significant financial losses, even during periods of severe economic stress. During 1996 and 1997, both enterprises complied with the housing goals.

GAO also recommended that HUD take the following actions to strengthen its housing mission oversight:

1. Develop and implement a program to assess the accuracy of the enterprises' reported housing goal compliance data.

2. Conduct further research to determine the extent to which the implementation of the housing goals is promoting housing opportunities. For example, determine whether the housing goals have provided mortgage lenders with incentives to lower mortgage interest rates for targeted groups.

3. Implement a process and obtain the necessary expertise to ensure that the enterprises' sophisticated financial activities are consistent with their housing mission.

Finally, GAO recommended that HUD estimate the costs of its mission oversight requirements and consider proposing to Congress that the enterprises bear these costs to help ensure effective oversight.

Statement

Federal Housing Enterprises: HUD's Implementation of Its Mission Oversight Needs to Be Strengthened

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the Department of Housing and Urban Development's (HUD) housing mission oversight of the two largest government-sponsored housing enterprises: the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (the enterprises). HUD has a basic oversight responsibility to ensure that the enterprises' mortgage purchase activities serve the credit needs of all Americans and that the enterprises' financial activities are consistent with their housing mission.

In 1992, Congress concluded that HUD's regulatory framework had not been effective in ensuring that the enterprises' activities benefit low- and moderate-income Americans and those who live in underserved areas, such as central cities and rural communities (targeted groups). Consequently, Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992[1] (the 1992 Act). The 1992 Act required HUD to develop, implement, and enforce a comprehensive housing mission regulatory framework established by Congress. Among other provisions, the 1992 Act directed HUD to set housing goals, which require the enterprises to meet specified criteria each year for the purchase of mortgages serving targeted groups.

At your request, we recently issued a report[2] on HUD's implementation of its enterprise housing mission oversight responsibilities under the 1992 Act. We concluded that (1) HUD adopted a generally conservative approach in 1995 to setting the final enterprise housing goals for 1996 through 1999 that placed a high priority on maintaining the enterprises' financial soundness, and (2) Fannie Mae and Freddie Mac were in compliance with the final housing goals in 1996 and 1997, according to data the enterprises submitted to HUD. We also concluded that there are several weaknesses in HUD's mission oversight that need to be addressed. Specifically,

- HUD has not implemented a program to assess the accuracy of the enterprises' housing goal-compliance data;
- HUD's research agenda does not address several issues necessary to fully understand the extent to which the housing goals promote housing opportunities; and

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

[2]Federal Housing Enterprises: HUD's Mission Oversight Needs to Be Strengthened (GAO/GGD-98-173, July 28, 1998).

- HUD has not yet fully implemented a process under its general regulatory and new mortgage program approval authorities to ensure that the enterprises' financial activities are consistent with their housing mission.

Congress Has Established a Comprehensive Enterprise Housing Mission Regulatory Framework

Under their federal charters, the enterprises are responsible for serving the secondary mortgage market credit needs of targeted groups. The enterprises also receive benefits from their relationship with the federal government to assist in meeting their housing mission. The most important of these benefits allows the enterprises to borrow money at lower interest rates than comparable private corporations. Given their federal charters and financial benefits, Congress concluded in the 1992 Act that the enterprises had a responsibility to reach out and meet the credit needs of targeted groups. Thus, the act directed the HUD Secretary to develop numeric housing goals for each enterprise in the following three categories:

- housing for low- and moderate-income[3] families;
- housing located in central cities, rural areas, and other underserved areas; and
- special affordability goals that target mortgage purchases serving very-low-income and low-income families living in low-income areas.

The 1992 Act also defined HUD's general regulatory and new mortgage program[4] approval authorities. HUD has the general regulatory authority to ensure that the enterprises' activities are consistent with their housing mission. HUD also has the authority to review new mortgage programs proposed by the enterprises to ensure that the programs are consistent with the enterprises' charters and not contrary to the public interest.

[3]The government defines households whose incomes do not exceed an area's median family income as moderate income and households whose incomes do not exceed 80 percent of an area's median family income as low income. The government defines households whose income does not exceed 60 percent of an area's median family income as very-low income.

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

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

The 1992 Act provided the HUD Secretary with the authority to set the final housing goals. When setting the final housing goals for 1996 through 1999, the HUD Secretary adopted a conservative approach that emphasized protecting the enterprises' financial soundness. The enterprises are reportedly in compliance with the goals, but HUD has not taken sufficient steps to verify the reported data.

HUD Set Conservative Housing Goals

The 1992 Act established six general, but potentially competing, factors to guide the HUD Secretary's decisionmaking process in setting the final housing goals. In particular, the 1992 Act directed the HUD Secretary to balance (1) the ability of the enterprises to "lead the [mortgage finance] industry" in financing the mortgages of targeted groups and (2) the need to maintain the enterprises' financial soundness. These factors may be in competition with one another because requiring the enterprises to significantly increase their purchases of targeted mortgages could result in additional credit losses.[5]

During our work, we found that HUD had adopted a conservative approach to setting the final housing goal rule that placed a high priority on maintaining the enterprises' financial soundness. The following summarizes our findings:

- HUD defined the term "lead the industry" to mean that the enterprises should provide technical and financial assistance to mortgage lenders to encourage additional mortgage lending to targeted borrowers, rather than adopting alternative definitions that could have required the enterprises to substantially increase their targeted mortgage purchases; and
- HUD and the Office of Federal Housing Enterprise Oversight (OFHEO)—an independent HUD office responsible for ensuring the financial soundness of the enterprises—conducted research that found that the required targeted mortgage purchases under the final housing goals were modest and would not materially affect the enterprises' financial condition.

Table 1 provides HUD's housing goals for 1996 through 1999. We note that HUD set the goals below HUD's estimates of targeted mortgage lending that was already occurring in the primary mortgage market.

[5]Credit losses result from borrower defaults and associated foreclosure expenses.

Table 1: Enterprise Housing Goals for 1996-1999 and HUD's Estimates of Primary Market Shares.

Goal category	Percentage goal[a] 1996	Percentage goal[a] 1997-1999	Estimated originations in primary market[b]
Low- and moderate-income	40%	42%	48-52%
Underserved areas	21	24	25-28
Special affordability	12	14	20-23

[a]HUD's goals are based on the number of dwelling units financed by enterprise-targeted mortgage purchases as a percentage of the total dwelling units financed through mortgage purchases. Assuming an enterprise purchased mortgages containing 1 million dwelling units in a particular year, and that 400,000 of these units qualified under the low- and moderate-income goal, the enterprise's goal compliance would be 40 percent (400,000/1,000,000).

[b]In 1995, HUD estimated the percentage of dwelling units financed by targeted mortgages originated by banks, thrifts, and mortgage bankers in the primary mortgage market for each housing goal.

Source: HUD.

Enterprise Targeted Mortgage Purchase Activity Increased Between 1993 and 1997

According to annual data that Fannie Mae and Freddie Mac provide to HUD, the enterprises have increased their share of targeted mortgage purchases since 1993 and were in compliance with the final housing goals in 1996 and 1997 (see table 2). Fannie Mae's performance under the housing goals has generally exceeded that of Freddie Mac.

Table 2: Enterprise Mortgage Purchases Under the Affordable Mortgage Housing Goals, 1993-1997

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

Source: HUD.

HUD's housing goals may have contributed to the enterprises' reported increases in targeted mortgage purchases. However, other factors, such as a generally growing U.S. economy, favorable mortgage interest rates, and a strong housing market also likely played a role.

HUD Has Not Verified the Enterprises' Goal Compliance Data

HUD has implemented some limited procedures to verify the accuracy of the enterprises' reported goal compliance data. However, HUD has not implemented a program to assess the overall data collection and reporting process. Given the decentralized nature of the housing goal data and the resulting potential for error, it may therefore not be possible for HUD at this time to independently draw conclusions about the accuracy of the data. In our report,[6] we recommend that HUD—consistent with available resources—develop and implement a program to assess the accuracy of the goal compliance data.

HUD's Research Agenda Does Not Address Several Issues That Are Essential to Understanding the Goals' Effects

HUD has a basic oversight responsibility to try to determine the extent to which the housing goals are meeting the intent of the 1992 Act (i.e., promoting housing affordability and opportunities for targeted groups). Such research is essential for HUD to determine the appropriate levels at which to set the housing goals in the future. HUD has ongoing research to assess the goals' effects, but the research agenda does not fully address several essential issues, such as the goals' effects on mortgage terms for targeted groups and the multifamily mortgage finance market.

HUD Research Does Not Assess Goals' Effects on Mortgage Loan Terms

HUD's reported data on the enterprises' compliance with the housing goals are input measures that show the annual volumes of the enterprises' targeted loan purchases. The reported data do not provide information on the extent to which the enterprises' increased purchases are resulting in increased home ownership and housing opportunities for targeted groups.

Currently, HUD has a variety of research projects—in-house, contract, and grant—to assess a range of issues that address the impacts of the goals. For example, in September 1997, HUD awarded 11 research grants totaling about $400,000 to study the mortgage purchase activities of the enterprises.

However, HUD's research agenda does not address the extent to which the housing goals provide lenders with incentives to make mortgage credit more affordable to targeted groups. For example, in theory, the additional liquidity associated with increased enterprise purchases to meet the housing goals should lower lenders' costs on qualifying loans, which then can be passed on in the form of lower mortgage interest rates. We recommend in our July 28 report that HUD include in its research agenda

[6] GAO/GGD-98-173, July 28, 1998.

the effect of the housing goals on mortgage interest rates and other loan terms for targeted groups.

HUD Has Not Adequately Analyzed Multifamily Purchase Activities

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

However, there is also available information that suggests that the enterprises' risk-management strategies involve offsetting trade-offs that may serve to limit lenders' incentives to originate affordable multifamily mortgages. For example, by requiring lenders to retain most or all of the expected credit risks, the enterprise risk management strategies could limit the lenders' willingness to extend mortgage credit. By contrast, when the enterprises purchase single-family mortgages, they generally relieve the lenders of the associated credit risks, which has encouraged the development of a liquid, secondary market for single-family mortgages. We recommend in our report that HUD conduct further research on enterprise risk-management strategies and their effects on multifamily mortgage finance and housing opportunities.

HUD Lacks Focus and Expertise as a Financial Regulator

Although HUD's staff have significant expertise in housing and related issues, we have identified weaknesses in HUD's capacity and focus as a regulator of financial institutions. We note that Congress reached similar conclusions when it passed the 1992 Act. The fact that HUD's enterprise oversight budget is financed through congressional appropriations of taxpayer dollars rather than assessments on the enterprises may be one reason for HUD's lack of focus on financial regulatory issues.

HUD Did Not Act in a Timely Manner to Monitor Enterprise Nonmortgage Investments

In our March 1998 report,[7] we found that HUD had not used its general regulatory authority provided under the 1992 Act until 1997 to ensure that the enterprises' nonmortgage investment practices were consistent with their housing mission. We pointed out that such oversight by HUD is important because the enterprises have incentives to use the funding advantage associated with their federal sponsorship to make nonmortgage investments that may result in arbitrage profits.[8]

HUD did not act on its general regulatory authority until 1997 when a public controversy erupted over the fact that Freddie Mac had invested in long-term Phillip Morris corporate bonds. In 1997, HUD initiated a process to oversee the enterprises' nonmortgage investments, which has the potential to ensure more effective oversight. However, HUD has not yet fully implemented this process, and we believe it should continue to do so as expeditiously as possible.

HUD Lacks Expertise in Financial Products

Since the passage of the 1992 Act, HUD has approved the four enterprise new mortgage programs that have been proposed. As required by the act, HUD approved each of these programs within a 45-day deadline. However, in our March 1998 report, we noted that in 1997 HUD staff who reviewed Fannie Mae's Mortgage Protection Plan (MPP) proposal did not have expertise in the intricacies of the cash value life insurance industry. Such expertise was important because, under the MPP, Fannie Mae proposed that it would purchase a cash-value life insurance policy on a first-time homebuyer after the selected borrower's residential mortgage was purchased by Fannie Mae. We recommended that HUD ensure that it has sufficient expertise—either inhouse or contract—to monitor the enterprises' financial activities.

HUD May Lack Adequate Resources for Effective Oversight

Unlike other federal regulators that have housing enterprise oversight responsibilities,[9] such as OFHEO, HUD's mission oversight expenditures are funded through congressional appropriations of taxpayer dollars rather than assessments on the regulated entities. As a result, HUD's mission

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

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

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

oversight responsibilities necessarily compete with and are constrained by other HUD priorities in a budget environment of declining resources.

In previous reports,[10] we have commented that regulatory costs should be borne by the respective federal housing enterprises to ensure safety and soundness as well as effective housing mission oversight. For example, HUD's capacity to obtain the expertise to monitor the enterprises' financial activities may be limited, particularly since HUD's traditional housing research focus may continue to command a significant share of the Department's available resources. We recommended in our most recent report[11] that HUD collect data on the costs necessary to effectively oversee the enterprises and propose to Congress that the enterprises be assessed these costs.

Conclusions

The 1992 Act established a comprehensive regulatory framework for HUD to ensure that the enterprises complied with their housing mission. In 1995, HUD set conservative housing goals that were intended to ensure the enterprises' financial soundness, and the enterprises have reportedly complied with these goals. However, there is little information currently available on the extent to which the housing goals promote housing opportunities. We made several recommendations in our recent report to strengthen HUD's mission oversight, enhance its resources, and determine the effects of the housing goals.

Over the years, we have recommended the creation of a single regulator to be in charge of mission and safety and soundness oversight for the enterprises and the Federal Home Loan Bank System. Last year, we completed a report[12] on OFHEO's financial soundness oversight efforts, and we have just issued a report[13] addressing OFHEO's progress in meeting our recommendations. Our work on HUD's mission oversight highlights the challenges the Department faces in becoming an effective regulator of financial institutions. OFHEO and HUD are two agencies that generally operate independently of one another. We believe that this separation

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

[11]GAO/GGD-98-173, July 28, 1998.

[12]Federal Housing Enterprises: OFHEO Faces Challenges in Implementing a Comprehensive Oversight Program (GAO/GGD-98-6, Oct. 22, 1997).

[13]OFHEO's Progress in Implementing a Comprehensive Oversight Program for Fannie Mae and Freddie Mac (GAO/GGD-98-182R, July 29, 1998).

results in a fragmented approach to regulation that does not adequately consider the relationships between housing mission and financial soundness objectives, including the potential trade-offs. We also continue to support the creation of a single regulator for federal housing enterprises to ensure coherent and effective regulation.

Mr. Chairman, this concludes my statement. My colleagues and I would be pleased to respond to any comments that you may have.

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