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CRS Report for Congress

GSE Reform: A New Affordable Housing Fund

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Summary

One key feature of the government-sponsored enterprise (GSE) reform bill that the House passed in the 109th Congress (H.R. 1461) was the requirement that Fannie Mae and Freddie Mac give part of their profits to create new affordable housing funds. Based on the GSE's average profits from 2000 to 2003, the amount would have been about $390 million annually during the first two years and $580 million in subsequent years. The requirement would have expired after five years.

The chairmen of the House Financial Services Committee and the Senate Banking Committee have said that GSE reform, including an affordable housing fund, will be a priority in the 110th Congress.

The affordable housing fund would have helped lower-income homeowners and renters and given priority to the victims of natural disasters such as Hurricanes Katrina and Rita. Funds from Fannie Mae and Freddie Mac would have gone to affordable housing organizations, which would have then worked directly with the beneficiaries. Nonprofits would have faced controversial restrictions on election and political activities. The bill also would have modified existing GSE housing goals to concentrate on lower-income families. It would have set the housing goal targets in the law, replacing the existing targets set by regulation.

This report will be updated as legislative events warrant.

Background on Housing GSE Mission

Fannie Mae and Freddie Mac purchase mortgages from lenders and package them into mortgage-backed securities that they either hold in their portfolio or sell to investors. Congress chartered Fannie Mae and Freddie Mac as stockholder-owned, government-sponsored enterprises (GSEs) with the mission of supporting home ownership by enhancing mortgage market liquidity and providing assistance to lower-income families and underserved areas.[1] In exchange, the GSEs receive several advantages, such as the right to borrow $2.25 billion each from the U.S. Treasury, exemption from state and local taxes, and exemption from the requirement to register securities offerings with the Securities and Exchange Commission.

The Office of Federal Housing Enterprise Oversight (OFHEO) regulates the GSEs for safety and soundness, whereas the Department of Housing and Urban Development (HUD) monitors adherence to their mission goals. H.R. 1461 would have combined OFHEO and HUD's regulatory division into a new, independent regulatory agency called the Federal Housing Finance Agency (FHFA).

The Federal Housing Enterprise Financial Safety and Soundness Act of 1992 (GSE Act)[2] gives HUD the authority to set specific goals for serving low-income families and underserved markets. The 2005 to 2008 goals establish a minimum percentage of mortgages in three income and geographic categories of homes for the GSEs to purchase based on the origination of similar mortgages. A fourth goal sets a minimum dollar volume of purchases.[3] H.R. 1461 would have repealed the 2005-2008 goals and replaced them with three new sets: (1) housing goals, which were similar to the repealed goals but set in law instead of regulation; (2) a duty to serve underserved markets; (3) and an affordable housing fund.[4] The new goals would have targeted slightly lower-income families than the current goals and raised the percentage goals.

Housing Goals. The new housing goals would have required the GSEs to purchase on a percentage basis at least as many mortgages for very low- and extremely low-income families as are generated by the primary market.[5] The GSEs could have requested a reduction in the percentage. The affordable housing funds could not have been used to meet the housing goals.

Duty to Serve Underserved Markets. The duty to serve underserved markets set no specific guidelines, goals, or targets, but the new FHFA would have been required to evaluate the GSEs annually and report to Congress. The GSEs would have been required to lead the industry in creating new mortgage products for manufactured housing and in preserving affordable housing developed under various HUD rental programs.

Affordable Housing Fund. The new affordable housing fund provisions would have required each of the GSEs to contribute 3.5% of profits in the first two years and 5%

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[1] In this report, Fannie Mae and Freddie Mac are referred to by name, as GSEs, and as the enterprises. The Federal Home Loan Banks are also GSEs and covered by these bills, but because they are covered in a different section, they are excluded from discussion here.

[2] 12 U.S.C. 11.

[3] U.S. Department of Housing and Urban Development, "HUD's Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005 — 2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac," 69 *Federal Register* 63587, Nov. 2, 2004.

[4] H.R. 1461, Sections 125, 126, and 128.

[5] Very low-income families have incomes at or below 50% of area median family income; extremely low-income families have incomes at or below 30% of area median family income.

in the next three years. After five years, the fund would have expired. Based on the GSEs' average profits from 2000 to 2003, the affordable housing funds could have received $390 million annually during the first two years and $580 million annually during the next three years. The House bill did not indicate how the funds would have been managed.

The fund would have had five general goals: (1) to increase home ownership by families at or below 50% of area median income; (2) to increase mortgage funds in designated low-income areas; (3) to increase the supply of rental and owner-occupied housing for families at or below 50% of area median income; (4) to increase investment in public infrastructure in connection with related affordable housing goals; and (5) to leverage funding from other sources.[6]

H.R. 1461 would have earmarked the affordable housing fund. Twenty-five percent (initially about $98 million) would have gone to the Federal Home Loan Banks' REFCORP.[7] At least 10% (initially about $39 million) would have gone toward home ownership activities. No more than 12.5% (initially about $48 million) would have gone toward public infrastructure associated with financed affordable housing projects. The bill set no minimum for rental housing support.

The bill would have included major additional provisions:

- Any profit from affordable housing fund activities would have reduced the allocation in the following year.
- The FHFA director would have issued regulations to prevent Fannie Mae and Freddie Mac from making the return on the funds for nongrants (which could have reduced their liability to provide funding in future years) the primary consideration in awarding funds.
- Funds could not have been used by the GSEs or recipients for administrative or outreach purposes, except as allowed by the FHFA.

Other restrictions would have applied to home ownership. First, only first-time home buyer families with incomes at or below 50% of the area median income would have been eligible.[8] Second, the price of the home purchased could not have exceeded 95% of the area median for comparable dwellings. Third, the homeowners could have resold the house only to low-income families, and resale profits would have been subject to recapture for 10 years under certain conditions.[9] Any recaptured profits would have been divided equally between the entity that sold the home to the family and HUD, not the GSE that provided the funds used to purchase the home.

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[6] H.R. 1461, Section 128(a).

[7] CRS Report RS20197, *Community Reinvestment Act: Regulation and Legislation*, by Walter W. Eubanks, explains REFCORP.

[8] First-time home buyers are home buyers who have not owned a home in the past three years. Exceptions to this criteria exist for certain groups that have owned a home more recently.

[9] H.R. 1461, Section 128, refers to section 215(b)(3) of the Cranston Gonzalez National Affordable Housing Act (42 U.S.C. 12745[b][2]). The 10-year time limit and other resale provisions are in 42 U.S.C. 12745(b)(3).

There would have been no restrictions on the funding mechanism: grants, market rate loans, interest rate buy-downs, downpayment assistance, closing cost aid, and equity investments were allowed, but the funding would have gone to for-profit and nonprofit developers of affordable housing. Funding could have gone only to an organization, agency, or other entity with experience in similar affordable housing activities. An organization with experience running affordable rental housing might not have been eligible to build owner-occupied units. Funding could not have gone directly to a family.

Restrictions on Sponsors. The primary business activity of those directly funded would have to have been the provision of affordable housing. The funds could not have been used for political activities, advocacy, lobbying (directly or indirectly), counseling services, travel expenses, preparing or providing advice on tax returns, administrative costs, or outreach. If the entity was a nonprofit, it would have further restrictions on political and election activities:

- The nonprofit could not have engaged in federal election activities or lobbying for a period starting 12 months before submitting an application for funding.
- The nonprofit could not have been affiliated with any organization, agency, or entity that did not comply with these electioneering and lobbying limitations. Affiliation was defined in terms of overlapping boards of directors, executives, staffs, shared resources, and funding.
- If the recipient was a national nonprofit, the funds could not have been distributed to another nonprofit.
- The funds could not have replaced or freed up other funding.

The restrictions on election-related activities would prevent many groups, such as the Association of Community Organizations for Reform Now (ACORN), and the National Council of La Raza, from receiving funding as they are currently constituted.[10] More than 100 nonprofits — including three local chapters of Habitat for Humanity, the League of Women Voters, United Way of America, labor organizations, and religious groups — sent House members a letter objecting to what they term the "gag" provision.

The restriction preventing national nonprofits from redistributing funding would have prevented the GSEs from using a related organization, such as the Fannie Mae Foundation, as an intermediary in distributing affordable housing fund monies. It also would have prevented Habitat for Humanity from passing affordable housing funds on to local affiliates. (In FY2004 Habitat gave local affiliates nearly $64 million.[11]) The bill would not, however, have prevented funds from going directly to local affiliates, as already occurs in a similar program run by the Federal Home Loan banks.

Advisory Affordable Housing Board. The funds would have been monitored by an advisory Affordable Housing Board that would have been appointed by, and

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[10] Republican Study Committee, *Legislative Bulletin*, Oct. 26, 2005, p. 7. See [http://johnshadegg.house.gov/rsc/GSE%20Legislative%20Bulletin.pdf]. Viewed Jan. 5, 2007.

[11] Habitat for Humanity International, Inc., *Audited Consolidated Financial Statements, Years Ended June 30, 2004 and 2003 with Report of Independent Auditors*, page 5. See [http://www.habitat.org/giving/report/2004/FINANCIALS.pdf]. Viewed Jan. 5, 2007.

reported to, the FHFA director. The board would have determined extremely low- and very low-income housing needs. It would have advised the director on establishing selection criteria and changes to the program. It would have reviewed the quarterly reports from the enterprises and informed the director if the funding activities complied with the regulations setting funding priorities. The board would have been considered a federal advisory board, meaning that meetings must have been publicly announced and open. Committee records, including minutes, would have been available for public inspection and subject to the Freedom of Information Act (FOIA).

The board would have included the director of the FHFA, the Secretaries of HUD and Agriculture, two persons from for-profit affordable housing companies, and two persons from nonprofit affordable housing organizations. The first three members could have designated others to have been on the board in their places. The director could have appointed up to four other persons to the board.

The GSEs would have had some enforcement and compliance responsibilities. If Fannie Mae or Freddie Mac were to have determined that a recipient had misused affordable housing funds, the recipient would have had to repay the funds and would have been permanently barred from program participation. There would have been no lesser penalty. This debarment authority would not be shared with FHFA.

Priorities. The director would have issued regulations with specific criteria for selecting projects. The bill would have established a series of priorities. During the first two years, the top priority would have gone to the areas and persons affected by Hurricanes Katrina and Rita. The next levels of priority would have been (1) other presidential disaster areas, (2) the greatest impact, (3) geographic diversity, and (4) the ability to obligate the funds and undertake the activities quickly. "Greatest impact" and "geographic diversity" were not defined in the bill. For rental projects, additional priorities would have been (1) affordability for families with incomes below 30% of area median income and (2) the duration that rental projects would have remained affordable to extremely low-income families. In rental housing projects, only families with incomes at or below 50% of the area median income could have benefitted from the funds. These criteria differed from the housing goals, which would have counted units that would have been affordable to families of the target income regardless of actual tenant incomes. Historically, housing goals have used the latter approach because it is difficult for the GSEs to determine the income of rental tenants. In addition, Fannie Mae and Freddie Mac would have been prohibited from making affordable housing fund assistance preferential or conditional on obtaining financing or underwriting from the enterprise.

Policy Analysis. H.R. 1461 raised a number of policy issues. First was the question of incentives and unintended consequences. Connecting the size of the affordable housing fund to GSE profits may result in unintended incentives. The connection between profits and fund size would have given affordable housing developers a stake in the GSEs' profitability. The GSEs have two major profit centers: packaging individual mortgages into mortgage-backed securities and holding large portfolios that consist mainly of mortgage-backed securities. Both profit centers present risks that would have been regulated by FHFA (or OFHEO under current law). Large portfolios are more profitable for the companies but mainly benefit the GSEs, their stockholders, and senior management whose compensation is tied in part to corporate profitability rather than supporting the mortgage market. Large portfolios also represent systemic risk to the financial system as a whole.[12] Nevertheless, because increasing the size of the portfolios would have increased profits and thus the affordable housing funds, recipients and potential recipients would have had reasons to support portfolio growth, which may or may not have been what Congress intended.

A related issue was the potential for the GSEs to use their affordable housing funds in ways that further their corporate goals. The director would have been mandated to issue regulations to prevent the GSEs from making the return of funds the primary consideration in awarding funds, which would have reduced their future contributions. The bill would have prohibited them from tying the funds to other transactions with the enterprise, but nonpecuniary and nonfinancial returns to the GSEs were not addressed.

H.R. 1461 did not address the question of the legal, accounting, and tax relationships between the GSEs and their affordable housing funds. Were the funds separate, independent legal entities? Who would have controlled the money in the funds before it was released to the recipients? What type of investments would have been allowed for the $400 million to $600 million or more added each year? Who was responsible if the funds incurred losses? What were the tax liabilities of the funds? If a fund made a loan, what happened if the borrower defaults? Profits were returned to the fund and reduced the funding required the following year, but what about losses? Were recaptured profits of first-time homeowners returned to the GSEs, and if so, did this reduce the amount that they must contribute? H.R. 1461 stated that the GSEs do not need to hold risk-based capital against the affordable housing funds, but what about minimum capital requirements?

In addition to the persons named in H.R. 1461, up to four others could have been named to the Affordable Housing Board. Could these have been from the GSEs? The Fannie Mae Foundation (but not the Freddie Mac Foundation) promotes affordable housing for extremely low- and very low-income families. Could someone from the Fannie Mae Foundation have been appointed to the board? The board was charged with overseeing the distribution of funds. Would there have been a conflict of interest if an organization with an employee or officer on the board applied for funding? Would there have been a conflict of interest if a fund applicant had an existing business relationship with the GSE?

Legislative Developments

- H.R. 1461 was reported by the Committee on Financial Services to the House with an Affordable Housing Fund provision on July 14, 2005.
- H.R. 1461 was passed by House by a vote of 331 to 90 and sent to the Senate on October 30, 2005.
- S. 190 was reported by the Committee on Banking, Housing, and Urban Affairs to the Senate without an Affordable Housing Fund provision on July 28, 2005.

[12] CRS Report RS22307, *Limiting Fannie Mae's and Freddie Mac's Portfolio Size*, by Eric Weiss, summarizes some of the concerns that many analysts have about the size of the GSEs' portfolios.