Are the GSEs Leading, and If So Do They Have Any Followers? An Analysis of the GSEs' Impact on Home Purchase Lending to Underserved Markets During the 1990s

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Executive Summary

Chapter I: Conceptual Overview and Study Design

- The Government Sponsored Enterprises (Fannie Mae and Freddie Mac) are privately owned, for-profit corporations. But, because they receive significant government benefits, they are expected, indeed mandated, to "lead the mortgage finance industry in making credit available for low- and moderate-income families" (Lind, 1996a).

- Historically, most studies show that the GSEs have not led the market. Not surprisingly, the GSEs disagree. Recent empirical studies have provided mixed results.

- Conflicting claims and findings concerning the GSEs may reflect differing definitions of "leadership" and differing methodologies for assessing performance. The Government Accounting Office said in 1998 that 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. The GAO concluded that HUD's interpretation of the term "leading the industry" had not required the GSEs to substantially increase their targeted mortgage purchases.

- In 2000, HUD itself said that "Obviously, the GSEs are not leading the industry in financing units that qualify for the housing goals" and that "A wide variety of quantitative and qualitative indicators demonstrate that the GSEs have ample, indeed robust, financial strength to improve their affordable lending performance."

- Given the billions of dollars in federal benefits that Fannie Mae and Freddie Mac receive, given that current goals have been easy to meet, given that there is no evidence that higher standards would necessarily endanger the financial soundness of the GSEs, and given the benefits of promoting greater rates of homeownership in underserved markets, we think it is relevant to examine whether the GSEs are "leading the market" in another, and we think more intuitive sense: namely, are the GSEs doing relatively more of their business with underserved markets than are other types of financial institutions that do not enjoy the GSEs' special privileges and benefits?

- However, even this definition may not be totally adequate for capturing what should be meant by "leadership." Implicit in this definition – and for that matter, in the goals that HUD set in 1995, and the higher goals HUD adopted in 2000 – is that more GSE purchases of underserved market loans will result in more such loans being made. This assumption is certainly reasonable. A primary market lender may be unwilling or unable to make a loan unless some other entity is willing to buy it. *Nevertheless, the assumption is not necessarily correct*. The GSEs could increase their purchases of underserved market loans without causing more such loans to be made. GSE purchases could shift the ownership of underserved market loans around without necessarily increasing their number. Or, the types of purchases GSEs make may be ineffective in stimulating new lending.

- We therefore argue that leadership should also be assessed in a second way: Namely, does the GSEs' "leadership" encourage primary market activity that narrows the gaps in home mortgage lending that exist between served and underserved markets? Do they influence primary market lenders to make more loans to underserved markets than they would otherwise? Or, do the GSEs' activities simply cause the ownership of underserved market loans to get redistributed?

- Five types of underserved markets are examined in this study: Very low income families, low income families in low to moderate income areas, targeted (underserved) areas, Blacks, and Hispanics.

- The period 1993-2000 is studied. Home Mortgage Disclosure Act for metropolitan areas is examined. The Public Use Data Base that HUD compiles from GSE data (File B) is also employed for analyses of the entire nation. Separate analyses are done that include and exclude loans from subprime and manufactured housing lenders.

- Several factors affect the primary and secondary mortgage markets, many of which cannot be measured with the data used here. We therefore do not claim that any single piece of analysis can provide definitive proof one way or the other of GSE leadership. Rather, we employ a variety of analytic techniques. We ask, if the GSEs are leading, how is this manifested in the real world? While there may be alternative explanations for any single finding, the body of evidence as a whole should at least provide suggestive evidence.

- In Chapter II, we profile nationwide lending trends between 1993 and 2000. We compare the underserved market performance of the two GSEs with the primary market, other secondary market lenders, and with each other. In chapter III, we examine the factors that contributed to whatever progress the GSEs made. We look at the changing sources and characteristics of their loans, and we examine whether the determinants of their purchases changed in ways that were favorable or unfavorable to underserved markets. In chapter IV, we conduct multivariate analyses to see whether the GSEs appeared to encourage or discourage underserved market lending by the primary market lenders they did the most business with. In our fifth and final chapter, we offer our conclusions concerning what these analyses tell us about GSE leadership during the 1990s.

Chapter II: Nationwide Trends in Underserved Market Lending, 1993-2000

- Underserved markets received more loans from traditional lenders in 2000 than in 1993. But, between 1993 and 2000, most borrowers from underserved markets did not experience any consistent gains or declines in terms of their share of primary market loans from traditional lenders or GSE purchases.

- Similarly, between 1993 and 1998 there was no consistent pattern of the GSEs either gaining ground or losing ground relative to the primary market. However, the trends for the two most recent years, 1999 and 2000, were positive, with underserved markets making gains among traditional primary market lenders and even greater gains in GSE purchases.

- The mixed record with traditional lenders, however, disguises the gains that underserved markets made thanks to subprime and manufactured housing lenders, whom the GSEs do very little business with. Once these lenders are considered, underserved markets made steady and clear gains.

- Very low-income borrowers constitute the one group that has made consistent progress during the 1990s, among both traditional primary market lenders and the GSEs. Their share of all traditional primary market loans increased from 10.93% in 1993-1996 to 11.99% in 1997-2000. Their share of GSE purchases improved even more, rising from 8.15% of all purchases in 1993-1996 to 10.32% in 1997-2000.

- Most measures from both HMDA and the GSEs' own data indicate that the GSEs have never been "leading the market." The percentage of loans they purchase from underserved markets has almost always been lower than the percentage of such loans that were made in the primary market. Indeed, the gap between the GSEs and the primary market has actually increased when subprime and manufactured housing loans are considered.

- The GSEs have also consistently trailed behind their secondary market competitors. Underserved market loans that others were willing to buy or hold in portfolio included types of loans that the GSEs were either unwilling or unable to purchase.

- There are, however, indications that GSE performance has recently improved, and that it may have even occasionally matched or surpassed the performance of traditional primary market lenders. The GSEs made greater gains in 1999-2000 than did traditional primary market lenders. The Public Use GSE data suggests that their nationwide Final Rule underserved market performance was much stronger in 1998 than it had been in earlier years (although the data also indicates that this was an atypical year for them). The GSEs also made gains against their secondary market competitors between 1998 and 2000, and in 2000 they actually had a very slight lead with very low income borrowers.

- A factor contributing to GSE gains has been the improvement in Freddie Mac's underserved market performance. For much of the decade, Freddie Mac trailed Fannie Mae in most underserved markets. However, by 2000, Freddie was close to parity with Fannie Mae in most categories and actually had slight leads in a few others. The fact that Freddie Mac disproportionately contributed to GSE overall gains does not, of course, mean that Freddie Mac has outperformed Fannie Mae; rather, it just means that Freddie has narrowed or eliminated the gaps that existed in the past.

Chapter III: Secrets of Success

- Part of the GSEs' improvements in underserved market lending during the 1990s was due to their turning to different types of sources for their loans. Loans from Other Sellers were historically more likely to come from underserved markets. But, since the GSEs purchased so few of these (about 2% of the GSEs' overall total) they had little impact on the GSEs' overall performance.

- This changed dramatically in 1998, when Other Sellers accounted for more than 10% of the GSEs' overall business and as much as a fourth of their underserved market loans. However, the impact was short-lived. By 2000 the GSEs were purchasing substantially fewer loans from Other Sellers, and the loans they did purchase were much less likely to come from underserved markets than they had been in the past.

- As reported in the Public Use GSE data, seasoned loans have been a less dramatic but more consistent source of the GSEs' progress since the Final Rule was adopted. Before 1997, seasoned loans were sometimes more likely to come from underserved markets, and sometimes not. Since 1997, seasoned loans have had a modest but fairly consistent positive impact on the GSEs' gains in underserved markets. The trends show that an increasing proportion of the GSEs' underserved market loans were made in years other than when they were purchased. This has helped to raise the overall percentage of underserved market loans held by the GSEs.

- Besides turning to new sources of loans and seasoned loans, another way the GSEs could have achieved success would have been by purchasing more underserved market loans from existing sources. But, for most underserved markets, there was little change between 1993-1998 and 1999-2000 in the likelihood that the GSEs would purchase a loan from that market.

- However, underserved markets did make clear gains in one key area. Having a very low income went from being the greatest obstacle to the GSEs purchasing a loan in 1993-1998 to being almost no obstacle at all in 1999-2000. Unmeasured variables unrelated to anything the GSEs did, such as improved credit scores, might account for this. However, more flexible GSE underwriting guidelines and the implementation of programs aimed at very low income borrowers are also plausible explanations for the improvements that occurred.

Chapter IV: GSE Influence on Lenders

- Williams and Nesiba examined how characteristics of lenders were related to their underserved market performance. We expand their models to consider another type of lender characteristic: the amount of business a lender does with the GSEs.

- We hypothesize that, after controlling for other characteristics of lenders that may also affect their performance, those lenders who do the most business with the GSEs should also be the lenders that are most influenced by GSE policies and programs. If GSE policies and programs are beneficial to underserved markets, then the lenders who do the most business with the GSEs should be the lenders who make the most loans to underserved markets.

- We find that, between 1993-2000, just the opposite is almost always true: the more of its conventional home purchase loans a lender sells to the GSEs, the fewer of its loans go to underserved markets.

- But, for every underserved market, this negative effect of the GSEs is significantly smaller in 1999-2000 than it was in 1993-1998. Further, for very low income borrowers, the GSE effect is actually slightly positive in 1999-2000: the more of its loans a lender sells to the GSEs, the more likely it is to make loans to very low income borrowers.

- The exclusion of other relevant variables that can affect lenders means that these results must be treated with caution. Factors unrelated to anything the GSEs did could account for these findings. Nonetheless, one possible explanation for the improved performance of lenders across time is that GSE policies and programs became more beneficial (or at least less harmful) to underserved markets than they had been in the past.

Chapter V: Are the GSEs Leading?

- This report asks the question, "Are the GSEs Leading the Market?" Based on the evidence, we conclude, no, they are not – but they aren't as far behind as they have been.

- The GSEs clearly fail to meet our first criterion for leadership. They do not purchase relatively more underserved market loans than the primary market makes. They do not even purchase as many of these loans as do their secondary market competitors. The disparities between the GSEs and the primary market are even greater once the growing role of subprime and manufactured housing is considered.

- In addition, it is important to keep in mind how the GSEs have achieved their gains. As reported in their own data, some of their success has come from the purchases of loans from sellers other than lenders, e.g. investment funds. We do not know what these Other Sellers do with the proceeds from their sales, but it seems reasonable to assume that they will be less likely to reinvest in the home mortgage market than will lenders. In any event, whatever the effect of buying loans from Other Sellers is, it appears to have been short-lived and largely limited to 1998.

- GSEs have also made gains by purchasing seasoned loans from underserved markets. This helps to provide new resources for primary market lending. But again, it seems reasonable to question whether these purchases will be as beneficial to underserved markets as the purchase of same-year loans. By buying seasoned loans, the GSEs are buying the least risky loans from underserved markets. Before making a loan, primary market lenders must consider whether they are willing to assume risk until a loan eventually meets GSE standards for purchase.

- Other studies also suggest that the GSEs are purchasing the least risky and least underserved loans from underserved markets. For example, Bunce (2002) notes that low-income borrower loans purchased by the GSEs are dominated by loans with high down payments.

- But, there have been signs of progress, particularly in 1999 and 2000. In those years, primary market lending to underserved markets increased and GSE purchases of underserved market loans increased even faster. A very low income went from being the greatest barrier to GSE purchase in 1993-1998 to being almost no barrier at all in 1999-2000. The lenders who do the most business with the GSEs made relatively more loans to underserved markets in 1999-2000 than they had been earlier. There are many possible explanations for these changes, such as improved credit scores and other variables not measured in these data. But, greater GSE flexibility in underwriting guidelines and the implementation of GSE programs targeted at underserved markets are also plausible explanations.

- The fact that the GSEs have made gains, however, should not cause us to lose sight of the fact that there continue to be significant racial, economic, and geographic disparities in the way that the benefits of GSE activities are distributed. The fact that this may be less true than it was in the past does not mean that the GSEs have done everything that should be expected of them. By 2000, underserved market loans that other secondary market lenders were willing to purchase and that primary market lenders were willing to hold in portfolio included types of loans that the GSEs were unwilling or unable to purchase. Hence, the benefits of GSE activities still go disproportionately to members of served rather than underserved markets. Policy makers should monitor whether GSE progress continues. More critically, they should continue to ask the following: Given the significant benefits the GSEs receive, are they doing enough for underserved markets?