



Did affordable housing mandates cause the subprime mortgage crisis?



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ABSTRACT

The 1992 Federal Housing Enterprises Financial Safety and Soundness Act (GSE Act) mandated that a specified percentage of Fannie Mae and Freddie Mac purchases come from underserved populations. A number of prominent observers have pointed to the GSE Act as a root cause of the recent housing crisis. This paper evaluates the link between the GSE Act and relaxed mortgage market standards. Using loan application-level data from the Home Mortgage Disclosure Act, I analyze whether the GSE Act's single-family affordable housing goals altered mortgage lending or purchasing decisions. To identify this effect, I use a regression discontinuity design that exploits arbitrary cutoffs used to determine whether a loan satisfies the GSE Act goals. I find that the GSE Act's single-family affordable housing goals increased GSE purchases from very low-income borrowers by 4.4% but had no effect on mortgage lending. These results stand up to a number of specification and robustness checks.

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1. Introduction

Fannie Mae and Freddie Mac are government sponsored enterprises (GSE) whose mission is to provide liquidity, stability and affordability to the U.S. housing and mortgage market. Throughout most of their existence, these entities accomplished this goal solely by purchasing mortgages from lenders and thereby increasing the flow of funds available to mortgage borrowers. In 1992, Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act (GSE Act) which for the first time established that a proportion of each GSE's annual loan purchases come from low-income households and low-income and minority neighborhoods.

The recent collapse of the real estate market and escalating foreclosure rates has led some to suggest that the GSE Act's affordable housing goals contributed to the

subprime mortgage crisis.¹ Edward Pinto, the chief credit officer at Fannie Mae from 1987 to 1989, notes in the Wall Street Journal that loosened credit standards and a mandate by the GSE Act to facilitate affordable-housing loans resulted in "a tsunami of high risk lending that sank the GSEs, overwhelmed the housing finance system, and caused an expected \$1 trillion in mortgage loan losses by the GSEs, banks, and other investors and guarantors, and most tragically an expected 10 million or more home foreclosures." Similar sentiments are expressed by others. Howard Husock of the Manhattan Institute notes in the New York Times that "One cannot say with any certainty whether the more important cause of the current housing crisis was affordable-housing mandates or the actions of investment banks and ratings agencies. There can be no doubt, however, that both contributed."

¹ The S&P/Case-Shiller National Seasonally Adjusted Home Price Indices indicate that housing prices fell by 31% from a peak in the first quarter of 2006 to a trough in the first quarter of 2009. According to data from RealtyTrac, foreclosure filings were reported on 2.3 million properties in 2008, an 81% increase from 2007 and 225% increase from 2006.

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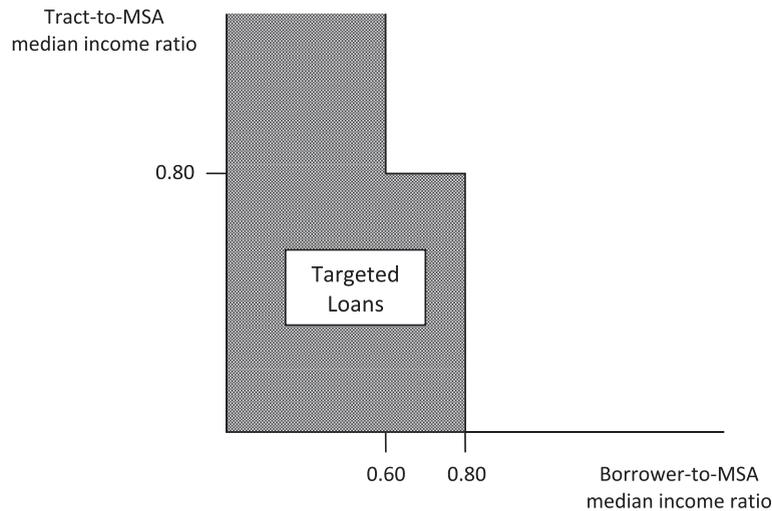


Fig. 1. loans targeted by the special affordable goal.

Despite these rather definitive statements about the GSE Act's contribution to the recent housing collapse, there is little econometric evidence linking the GSE Act to relaxed GSE or lender standards. Further, as I outline below, the GSE Act's loan purchase requirements have consistently been set below the levels at which the GSEs are purchasing targeted loans. If the GSE Act's affordable housing goal requirements are not binding, the goals may have little impact on GSE loan purchase decisions. Finally, not everyone is so quick to blame the GSE Act for the recent crisis. Stiglitz (2009) makes the claim that these accusations against affordable housing mandates are "clearly just an attempt to shift blame" as "the problems in America's mortgage markets began with the subprime market, while Fannie Mae and Freddie Mac primarily financed "conforming" (prime) mortgages.

In hopes of preventing future housing crises it is important to understand how, if at all, the GSE Act has contributed to the current housing crisis. Additionally, falsely accusing the GSE Act could lead policy makers to ignore other, more important determinants of the GSEs' failure and the mortgage market collapse. Further, the original objective of the GSE Act was to increase credit access and homeownership among underserved populations. Policy makers should be interested in whether the GSE Act or related housing policies can alter the housing market in a way that achieves public policy ends.²

In this paper, I use mortgage loan application-level data from mortgage lending institutions across the U.S. collected under the Home Mortgage Disclosure Act (HMDA) to examine whether the GSE Act's single-family affordable housing goals altered the probability that (1) a loan application is originated by a mortgage lending institution, (2) an originated loan is purchased by Fannie Mae or Freddie

Mac, or (3) an originated loan is a subprime or "high-price" loan.³ This paper focuses on loans originated in 2006–2007, as loans originated in 2006 and 2007 have had the highest cumulative default rates of any recent vintage of mortgages (Jaffee, 2010).⁴

The GSE Act established three single-family affordable housing goals for the GSEs. A specified percentage of GSE loan purchases must be from (1) very low-income borrowers and low-income borrowers living in low-income areas, (2) lower-income borrowers, and (3) low-income and minority neighborhoods. I refer to these three goals as the Special Affordable Goal (SAG), the Low- and Moderate-Income Goal (LMIG), and the Underserved Areas Goal (UAG), respectively.

Whether a loan satisfies an affordable housing goal is determined by arbitrary cutoffs in an "assignment" variable. For example, a borrower is targeted by the Low and Moderate Income Goal if the borrower's income is less than or equal to the median family income of their respective metropolitan statistical area. These cutoff rules provide the foundation for use of a regression discontinuity (RD) design where the fundamental idea is that loan applications from individuals just above and below a relevant cutoff are similar except for goal satisfaction status. Therefore, if a significant difference in application or housing outcomes is observed for loans just above and below the cutoff, it can be attributed to the GSE Act's housing goals.

This paper finds that the SAG increased GSE purchases from very low-income borrowers by 4.4% but had no effect on mortgage lending. Additionally, this paper finds no evidence that the LMIG or UAG altered GSE purchase or mortgage lending decisions. These results stand up to a number of specification and robustness checks.

² For instance, the Department of Housing and Urban Development (HUD) is responsible for setting GSE Act affordable housing goal requirements. If HUD is swayed by political pressure from the GSEs or other sources, they may set nonbinding affordable housing goals, hindering congress's ability to manipulate the housing market through this channel.

³ The HMDA High-price loan variable generally considered a proxy for subprime (Mayer and Pence, 2008).

⁴ Jaffee (2010) computes cumulative default rates through the third quarter of 2010 for loans originated in calendar years 2000–2008.

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