

Federal Housing Finance Agency
Office of Inspector General



Subprime Mortgages: Enterprise and FHFA Reporting

White Paper • WPR-2019-001 • March 27, 2019



WPR-2019-001

March 27, 2019

Executive Summary

Much has been written about the causes of the 2008 financial crisis. One of the causes has been attributed to the rise in subprime mortgage originations. Generally speaking, subprime mortgages were extended to applicants considered to be the least creditworthy because of low credit scores or uncertain income prospects (both of which reflected higher default risk). According to the Federal Reserve Bank of Dallas, subprime and near-prime mortgages (defined as mortgages made to borrowers whose credit exceeded subprime borrowers but were unable to fully document their incomes or provide traditional down payments) rose from 9% of newly originated securitized mortgages in 2001 to 40% in 2006.

According to a Federal Reserve Bank of New York staff report, Fannie Mae and Freddie Mac (the Enterprises) were significant investors in private-label securities (PLS) because PLS were viewed as very profitable investments and helped the Enterprises meet their affordable housing goals. By the end of 2007, the Enterprises owned over \$300 billion of PLS and commercial mortgage securities, of which \$133 billion were PLS backed by subprime single-family loans. Fannie Mae reported publicly in a 2007 10-K investor summary that it also had \$8 billion in subprime exposure at the end of 2007 from subprime loans it had purchased and guaranteed. Freddie Mac has not publicly reported comparable information. It represented to us that it had never purchased subprime mortgages for its guarantee portfolio (other than guaranteeing a *de minimis* amount of structured securities backed by loans identified as subprime by the original issuer).

In the summer of 2007, as subprime mortgage defaults escalated, other financial markets dried up. This period is now widely considered to mark the beginning of the financial crisis. Serious concerns emerged as delinquencies and foreclosures of subprime mortgages also rose. Subprime lenders exited the market and subprime mortgage lending dried up. According to Federal Housing Finance Agency (FHFA or Agency) data, Fannie Mae and Freddie Mac last purchased subprime PLS for their own investment portfolios in 2008.

According to some commentators, subprime mortgages are re-emerging in the mortgage marketplace. FHFA and the Enterprises recognize that subprime mortgages present a greater risk of default than prime mortgages. Each has stated publicly and reiterated to us that there is no universally accepted definition of subprime. According to FHFA, it has not adopted a definition of subprime for use by the Enterprises. In light of the possible increase in subprime mortgage products and FHFA's lack of definition of subprime, we sought reporting requirements and available information to understand the risks to the Enterprises from subprime mortgages. According to FHFA and the



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Enterprises, neither Fannie Mae nor Freddie Mac are presently purchasing subprime loans.

In this white paper, we first summarize the Enterprises' historical exposure to subprime mortgages. Next, we describe annual reporting by the Enterprises on their acquisitions of subprime mortgages. Then, we explain the statutory obligations imposed on FHFA to collect and report data on the Enterprises' acquisitions of subprime mortgages. Last, we set forth the reports issued by FHFA in satisfaction of these requirements.

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ABBREVIATIONS

Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
HERA	Housing and Economic Recovery Act of 2008
OIG	Federal Housing Finance Agency Office of Inspector General
MBS	Mortgage-backed securities
NMDB	National Mortgage Database
PLS	Private-label securities

BACKGROUND.....

Much has been written about the causes of the 2008 financial crisis. One of the causes has been attributed to the rise in subprime mortgage originations. Historically, potential homebuyers had difficulty in obtaining mortgages if they had low credit scores, provided small down payments, and/or had high debt-to-income ratios. Beginning in the late 1990s, subprime mortgages became available from lenders. Generally speaking, subprime mortgages were extended to applicants considered to be the least creditworthy because of low credit scores or uncertain income prospects (both of which reflected higher default risk). According to the Federal Reserve Bank of Dallas, subprime and near-prime mortgages (defined as mortgages made to borrowers whose credit exceeded subprime borrowers but were unable to fully document their incomes or provide traditional down payments) rose from 9% of newly originated securitized mortgages in 2001 to 40% in 2006.

Historically, lenders originated fixed-rate, traditional mortgages funded with deposits from savers. By the 1970s and 1980s, mortgage lenders began to sell these mortgages to the Enterprises, which in turn, pooled large groups of mortgages into residential mortgage-backed securities (MBS) that were sold to investors. The Enterprises guaranteed that investors would receive payments on their securities even if defaults and losses occurred on the underlying loans. Because the Enterprises are federally chartered, investors perceived that these guarantees were government-backed, notwithstanding explicit language on these MBS securities stating that they were not government obligations. The Enterprises received a monthly “guarantee fee” on the mortgages pooled into the MBS that they issued.

Investment banks turned pools of subprime and prime mortgages into securities and these pools were called private-label securities (PLS). Neither the Enterprises nor Ginnie Mae originated these PLS pools. “By the end of 2006, the volume of outstanding mortgages financed by PLS had grown to over \$2.6 trillion, or more than 27% of all residential mortgage debt,” according to a draft report presented at a Federal Reserve Bank of St. Louis conference. Leading up to the 2008 financial crisis, subprime mortgage originations increased sharply. U.S. housing and mortgage markets became stressed during 2007 and 2008 as a result of significant house price declines and the weakening economy. The Enterprises were significant investors in PLS, which were viewed as very profitable investments and helped the Enterprises meet their affordable housing goals, according to a Federal Reserve Bank of New York staff report. By the end of 2007, the Enterprises owned over \$300 billion of PLS and

commercial mortgage securities, of which \$133 billion were PLS backed by single-family subprime loans.¹

Fannie Mae reported publicly in a 2007 10-K investor summary that it also had \$8 billion in subprime exposure at the end of 2007 from subprime loans it had purchased and guaranteed. Freddie Mac has not publicly reported comparable information. It represented to us that it had never purchased subprime mortgages for its guarantee portfolio (other than guaranteeing a *de minimis* amount of structured securities backed by loans identified as subprime by the original issuer).²

In summer 2007, as subprime mortgage defaults escalated, other financial markets dried up. This period is now widely considered to mark the beginning of the financial crisis. Serious concerns about the performance of subprime mortgages emerged as delinquencies and foreclosures of such also rose. In 2009, the first FHFA Director observed that the primary and secondary markets for subprime (and non-traditional) lending collapsed during the second half of 2007. Subprime lenders exited the market and subprime mortgage lending dried up.

As noted by some commentators, subprime mortgages are re-emerging in the mortgage marketplace. According to FHFA data, Fannie Mae and Freddie Mac last purchased subprime PLS for their own investment portfolios in 2008. The focus of this white paper is subprime mortgages, not securities.

FHFA and the Enterprises recognize that subprime mortgages present a greater risk of default than prime mortgages. Each has stated publicly and reiterated to us that there is no universally accepted definition of subprime. According to FHFA, it has not adopted a definition of subprime for use by the Enterprises. An FHFA official told us that a definition of subprime could be based on a number of different elements: a subprime borrower, a subprime loan, or a

¹ In their annual reports on Form 10-K, the Enterprises categorize these securities as subprime based on information provided to them at the time the securities were acquired. In addition to investing in PLS, the Enterprises added their guarantees to some PLS. Fannie Mae reported that, as of year-end 2007, it had subprime exposure from \$13.8 billion of wrapped PLS, of which \$9.4 billion was held in its portfolio. Freddie Mac estimated that it had approximately \$6 billion of subprime exposure from wrapped PLS as of year-end 2007. Fannie Mae disclosed in its 2018 Form 10-K that it had reduced its subprime and Alt-A PLS exposure (including both securities and wraps) to less than \$3.7 billion. Freddie Mac reported to FHFA that it had approximately \$2 billion of PLS remaining at year-end 2018.

² However, the Office of Federal Housing Enterprise Oversight, a predecessor to FHFA, reported in its 2007 Performance and Accountability Report that, in addition to the large role Fannie Mae and Freddie Mac played in the subprime market through the purchase of PLS backed by subprime mortgages, “[t]o a smaller extent the Enterprises also buy and hold subprime mortgages directly.” OFHEO added that it had encouraged the Enterprises to purchase safe-and-sound loans that would enable qualified borrowers at risk of foreclosure to refinance their mortgages and that the Enterprises had committed to purchase refinances of loans made to subprime borrowers.

subprime lender. For example, subprime can refer to borrowers with lower credit scores, loans with higher interest rates, or loans originated by traditional subprime lenders.

ENTERPRISE REPORTING ON THEIR SUBPRIME MORTGAGE ACQUISITIONS

Fannie Mae

Fannie Mae reported in each of its annual Form 10-Ks from 2008 through 2017 that it was not currently acquiring new subprime mortgages, and explained the basis on which it made that disclosure each year.³ In its Form 10-K for 2017, Fannie Mae disclosed that it classified a mortgage as subprime if the mortgage did not meet its underwriting criteria, “which typically require compliance by the seller with [its] Selling Guide . . . and/or evaluation of the loans through [its automated underwriting] system,” **and** was originated by a lender specializing in subprime business or by a subprime division of a large lender. While Fannie Mae acknowledged in its 2017 Form 10-K that it had mortgages with one or more features similar to subprime mortgages, it explained that it did not consider those mortgages to be subprime because they did not meet all of these criteria. Starting in 2009, Fannie Mae established a general minimum 620 FICO score for loans delivered in accordance with its Selling Guide. In addition, Fannie Mae generally requires debt-to-income ratios not to exceed 50% and loan-to-value ratios not to exceed 97%, although there are exceptions.⁴

Fannie Mae reported to us that, prior to 2009, it had a separate channel for purchasing subprime mortgages. That channel was closed in 2008. Mortgages submitted through this now-closed subprime channel were originated according to the lender’s subprime underwriting guidelines. Fannie Mae explained that because it no longer has a subprime channel, and the channels through which it purchases mortgages do not allow subprime mortgages, Fannie Mae is comfortable with the statements in its 2008 to 2017 annual reports that it was not currently purchasing new subprime mortgages.

³ From 2012 to 2018, Fannie Mae added that it acquired refinancings of some existing Fannie Mae subprime loans in connection with its Refi Plus initiative. Refi Plus allowed refinancing of existing loans owned or securitized by Fannie Mae for borrowers who had an acceptable payment history but had been unable to refinance, for example, due to a decline in house prices. Unlike the loans being replaced, Fannie Mae did not count the refinancings as subprime.

⁴ See OIG, *Fannie Mae Purchased Single-Family Mortgages, Including those Purchased through Master Agreements, in Accordance with Selected Credit Terms Set Forth in its Selling Guide for 2015-2017* (Mar. 27, 2019) (AUD-2019-006) (online at www.fhfa.ig.gov/Content/Files/AUD-2019-006%20-%20Fannie%20Mae%20Master%20Agreements.pdf).

In a published supplement to its annual 10-K report for 2017, Fannie Mae represented that legacy subprime loans on its books totaled 0.1% of its single-family conventional business as of year-end 2017, and those loans produced 1.6% of its single-family credit losses for the year. Based on this information, we project that Fannie Mae held more than \$2.8 billion in legacy loans that met its definition of subprime as of year-end 2017, which produced \$47 million in credit losses for that year.

Freddie Mac

Freddie Mac reported in each of its annual Form 10-Ks from 2008 through 2017 that it had not historically characterized its mortgages as prime or subprime, but it does “monitor the amount of loans [it has] guaranteed with characteristics that indicate a higher degree of credit risk.” Freddie Mac told us that it “does not purchase, and never has purchased, subprime mortgages for its guarantee portfolio.” According to Freddie Mac, “[I]oans that originating lenders classify and label as ‘subprime’ loans upon their origination, marketing, and sale are ‘subprime’ loans. . . . Freddie Mac did not buy and hold in its guarantee portfolio loans classified by the originating lender as ‘subprime’ loans upon their issuance.” It explained that subprime mortgages typically were originated by specialized lenders, and “Freddie Mac did not, during the relevant period, purchase or hold in its guarantee portfolio loans sold through ‘traditional subprime channels’ of loan origination.” Freddie Mac also told us that, in the event it changed its practice, it would disclose its subprime purchases.⁵

FHFA’S STATUTORY REPORTING AND DATA COLLECTION REQUIREMENTS ON SUBPRIME MORTGAGES

Annual Reporting

The Housing and Economic Recovery Act (HERA), which established FHFA, requires the FHFA Director to produce an annual housing report that shall (among other requirements):

- “[I]dentify the extent to which each [E]nterprise is involved in mortgage purchases and secondary market activities involving subprime . . . loans” and
- “[C]ompare the characteristics of subprime . . . loans both purchased and securitized by each [E]nterprise to other loans purchased and securitized by each [E]nterprise.”

⁵ Freddie Mac told us currently it does not guarantee loans with a FICO score below 600, but that limit does not apply to Relief Refi mortgages, for example. Freddie Mac generally requires debt-to-income ratios not to exceed 50% and loan-to-value ratios not to exceed 97%, although there are exceptions.

FHFA has issued Annual Housing Reports since 2009. Beginning in 2010, these reports have included a section titled “Enterprise Purchase of Subprime and Nontraditional Loans” or “Subprime and Nontraditional Loans.” Through 2017, FHFA reported the total dollar amount and percentage of mortgages acquired by both Enterprises combined with credit scores less than 620, and less than 660. Our review of FHFA’s Annual Housing Reports through 2017 found that none explicitly “identif[ied] the extent to which each [E]nterprise is involved in mortgage purchases and secondary market activities involving subprime . . . loans” or “compare[d] the characteristics of subprime . . . loans both purchased and securitized by each [E]nterprise to other loans purchased and securitized by each [E]nterprise.” FHFA acknowledged to us that it had not “resolve[d] the difficult question of exactly how to define ‘subprime,’” but maintained that it provided “[m]eaningful” information in its annual reports. An FHFA official told us that a possible “shorthand” industry definition for subprime was mortgages with FICO scores less than 620.⁶

On October 30, 2018, FHFA published its 2018 Annual Housing Report. For the first time in these reports, FHFA reported that “the Enterprises are not involved in mortgage purchases and secondary market activities involving subprime . . . loans.” However, this report does not define subprime mortgages or the criteria used by FHFA to reach that conclusion. We reviewed the materials used to clear the report for publication and found that those materials did not contain a definition of subprime or the criteria used by FHFA to make this determination.

We asked FHFA to explain the basis for this statement in its 2018 Annual Report. FHFA responded that the statement “reflects the fact that the Enterprises purchase very few mortgages that could plausibly be characterized as subprime . . .”

Monthly Data Collection

HERA also requires the FHFA Director to conduct each month a survey of mortgage markets to collect data relating to specific loan characteristics, including (but not limited to):⁷

⁶ According to FHFA’s 2018 Annual Housing Report, in 2017, the two Enterprises acquired a total of \$4.9 billion in single-family mortgages with FICO scores less than 620 and \$45.8 billion with FICO scores less than 660. Fannie Mae has reported that loans it acquired after 2009 with FICO scores at origination below 620 consisted primarily of refinances of existing loans under its Refi Plus initiative. Citing the 2011 findings of the Financial Crisis Inquiry Commission, Freddie Mac told us that mortgages with a 620 FICO score originated by mainstream mortgage lenders performed very differently from mortgages with a 620 FICO score sold through subprime channels.

⁷ HERA also allows the FHFA Director to anonymize the data collected in the monthly surveys and requires the Director to make the data available to the public in a timely manner.

- “[T]he characteristics of individual subprime . . . mortgages that are eligible for purchase by the [E]nterprises” and
- “[T]he characteristics of borrowers under such mortgages, including the creditworthiness of such borrowers and determination of whether such borrowers would qualify for prime lending.”

FHFA has been working to develop the National Mortgage Database[®] (NMDB), a joint project of FHFA and the Consumer Financial Protection Bureau. FHFA’s recent Annual Reports to Congress (which differ from FHFA’s Annual Housing Reports) represented that the NMDB “will enable FHFA to meet the statutory requirements of HERA to conduct a monthly mortgage market survey,” noting survey requirements related to subprime mortgages as well as others. Additionally, FHFA reported, “FHFA must collect information on the creditworthiness of borrowers, including a determination of whether subprime . . . borrowers would have qualified for prime lending.” FHFA subsequently told us that the NMDB, as currently designed, “does not enable FHFA to make that determination, because of the difficulties of defining ‘subprime’ and the paucity of information on such mortgages, and their borrowers, under current market conditions.” In FHFA’s view, “the deeper analysis contemplated by this element appears to be beyond the scope of currently available data.” An FHFA official told us that the Agency spent about a year thinking about how to meet this requirement and decided not to pursue it. FHFA told us it “will evaluate the appropriate statement to make on this subject at the time of the next [A]nnual Report to Congress.”

CONCLUSION.....

Fannie Mae reported in annual reports for 2008 to 2017 that it was not currently acquiring new subprime mortgages, and Freddie Mac told us it had never acquired subprime mortgages for its guarantee portfolio.

HERA requires FHFA to issue annual reports that include data on Enterprise involvement in purchases of subprime mortgages and to compare the characteristics of subprime mortgages acquired or securitized by the Enterprises to other loans that they acquired or securitized. Our review of FHFA’s Annual Housing Reports through 2017 found that none explicitly “identif[ied] the extent to which each [E]nterprise is involved in mortgage purchases and secondary market activities involving subprime . . . loans” or “compare[d] the characteristics of subprime . . . loans both purchased and securitized by each [E]nterprise to other loans purchased and securitized by each [E]nterprise.” FHFA acknowledged to us that it had not “resolve[d] the difficult question of exactly how to define ‘subprime,’” but maintained that it provided “[m]eaningful” information in its annual reports. In October 2018, FHFA reported that the Enterprises are not involved in mortgage purchases and secondary market activities involving subprime loans. However, FHFA told us that it had not defined subprime for this purpose. According to the Agency, the statement reflects the fact that the Enterprises purchase very few mortgages that could plausibly be characterized as subprime.

HERA also requires FHFA to conduct a monthly survey of mortgage markets to collect data relating to specific loan characteristics, including characteristics of individual subprime mortgages that are eligible for purchase by the Enterprises and the characteristics of borrowers using subprime mortgages. FHFA has been working to develop the NMDB, and it represented in recent Annual Reports to Congress that the NMDB will enable FHFA to meet subprime data requirements in HERA. However, FHFA subsequently told us that the NMDB, as currently designed, does not enable FHFA to make the determination of whether subprime borrowers would have qualified for prime lending, “because of the difficulties of defining ‘subprime’ and the paucity of information on such mortgages, and their borrowers, under current market conditions.” In FHFA’s view, “the deeper analysis contemplated by this element appears to be beyond the scope of currently available data.” An FHFA official told us that the Agency spent about a year thinking about how to meet this requirement and decided not to pursue it.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this white paper was to provide an overview of the Enterprises' disclosures regarding their involvement in subprime mortgage acquisitions, FHFA's data collection and reporting requirements regarding subprime mortgages under HERA, and FHFA's actions related to those requirements. The focus was subprime mortgages, not mortgage securities backed by subprime loans. To achieve this objective, we reviewed internal FHFA and Enterprise documents as well as publicly available documents. We also interviewed FHFA and Enterprise officials and reviewed written information they provided.

We provided FHFA with the opportunity to respond to a draft of this white paper. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this white paper.

ADDITIONAL INFORMATION AND COPIES.....

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