b. Economic Conditions, Market Estimates, and the Feasibility of the Low- and Moderate-Income Housing Goal

The public comments indicated a concern that the market share estimates and the housing goals failed to recognize the volatility of housing markets and the existence of macroeconomic cycles. There was particular concern that the market shares and housing goals were based on a period of record low interest rates and high affordability. This section discusses these issues, noting that the Secretary can consider shifts in economic conditions when evaluating the performance of the GSEs on the goals, and noting further that the market share estimates can be examined in terms of less favorable market conditions than existed during 1993 and

Volatility of Market. Industry forecasts of the 1996 mortgage market are the starting point for HUD's estimates of market share for each housing goal. HUD projected \$700 billion in singlefamily originations for 1996 based on forecasts of \$720 billion by the Mortgage Bankers Association and \$700 billion by Fannie Mae. These industry forecasts are based on certain underlying economic conditions. Unanticipated shifts in economic activity will obviously affect the degree to which these forecasts are borne out. Thus, changing economic conditions can affect the validity of HUD's market estimates as well as the feasibility of accomplishing the housing goals.

One only has to recall the volatile nature of the mortgage market in the past few years to appreciate the uncertainty around projections of that market. Large swings in refinancing, consumers switching between adjustable-rate mortgages and fixed-rate mortgages, increased first-time homebuyer activity due to record low interest rates, and shifts in FHA activity have all characterized the recent mortgage market. These conditions are beyond the control of the GSEs but they would affect their performance on the housing goals. A mortgage market dominated by heavy refinancing on the part of middle-income homeowners would reduce the GSEs' ability to reach a specific target on the low- and moderate-income goal, for example. A jump in interest rates would reduce the availability of very-low-income mortgages for the GSEs to purchase. But on the other hand, the next few years may be highly favorable to achieving the goals because of the high refinancing activity in 1993. A period of low interest rates would sustain affordability levels without causing the rush to refinance seen in 1993. A high percentage of potential refinancers have already done so, and are less likely to do so again. Year-to-date 1995 data support this argument.

Feasibility Determination. HUD is well aware of the volatility of mortgage markets and the possible impacts on the GSEs' ability to meet the housing goals. FHEFSSA allows for changing market conditions.62 If HUD has set a goal for a given year and market conditions change dramatically during or prior to the year, making it infeasible for the GSE to attain the goal, HUD must determine "whether (taking into consideration market and economic conditions and the financial condition of the enterprise) the achievement of the housing goal was or is feasible." This provision of FHEFSSA clearly allows for a finding by HUD that a goal was not feasible due to market conditions, and no subsequent actions would be taken.

Affordability and Market Estimates. The market share estimates rely on 1993 and 1994 HMDA data for the percentage of low- and moderate-income borrowers. As discussed earlier, record low interest rates and affordability initiatives of the private sector encouraged first-time buyers and low-income borrowers to enter the market during this period. A significant increase in interest rates over their 1993–94 levels would reduce the presence of low-income families in the mortgage market and the availability of low-income mortgages for purchase by the GSEs.

HUD simulated the effects of a twopercentage point increase in interest rates on the payment-to-income ratios of 1993 and 1994 GSE borrowers (see Appendix A). Lower-income borrowers started with higher payment ratios and were thus disproportionately affected by the simulated increase in interest rates. Dropping from the GSE data all lessthan-median income borrowers whose payment-to-income ratios increased to above 28 percent reduced the low- and moderate-income percentage of GSE business by 15 percent (about 5 percentage points) and the very-lowincome percentage by 17 percent (about 1.25 percentage points). While this is only a partial look at the effects of higher interest rates, it indicates that the effects will be concentrated at the lowerincome end of the market. A counterbalancing effect would be that a rise in interest rates reduces the refinance rate. In 1993, refinance borrowers had higher incomes than home purchase borrowers, but in 1994, purchase and refinance

As discussed in Appendix A, the effects of higher interest rates on affordability have to be considered in the context of other market changes. Rising employment, incomes, and consumer confidence, for example, can mitigate the effects of higher rates on the demand for mortgage credit. Unfortunately, it is difficult to quantify the impacts of these economic changes on the market estimates for the housing goals. What one can do, however, is examine the sensitivity of the market estimates to changes in the percentage of borrowers that have an income less than area median income. As noted earlier, reducing that percentage to 30 percent from its 1993–94 level of 37–40 percent drops the overall low- and moderate-income estimate to 46 percent under the baseline projections.

The market model was re-estimated assuming an even higher interest rate environment—lower origination volumes (\$535 billion for single-family and \$23 billion for multifamily) and an owner low- and moderate-income percentage (26) that was only two-thirds of the 1994 level. 63 In this case, the market estimate of 44 percent remains above HUD's goals of 40 percent for 1996 and 42 percent for 1997. Obviously, there are combinations of projections that would drive the lowand moderate-income market estimate even lower; however, setting the goals to ensure their feasibility under the most pessimistic of economic conditions is not appropriate, given that the Secretary can re-evaluate goal feasibility if market conditions change dramatically.

c. Conclusions About the Size of Lowand Moderate-Income Market

Based on the above findings as well as numerous sensitivity analyses, HUD concludes that 48–52 percent is a reasonable estimate of the mortgage market's low- and moderate-income share for 1996 and beyond. HUD recognizes that shifts in economic conditions could increase or decrease the size of the low- and moderate-income market during that period.

4. Further Considerations—Factors Not Taken Into Account in Developing the Market Estimates

The 48–52 percent low- and moderate-income market estimate does not take into account several factors which could enhance the GSEs' performance with regard to the goals.

mortgage borrowers had more similar incomes.

⁶² Section 1336(b)(3)(A).

 $^{^{63}\,\}mbox{The}\ \mbox{\$535}$ billion is a lower bound estimate provided by Freddie Mac.