affordable loan purchases. In that case, small-sized owner households can qualify as below 60 percent of median income simply because the dollar threshold is effectively defined for a three-person household.[59]

• Under the special affordable housing goal, the GSEs will increase their purchases of very low-income loans. Historically, these loan purchases have primarily had loan-to-value ratios below 80 percent, so that credit risk is minimal. In 1993, about 75 percent of the very low-income loans purchases by the GSEs had downpayments in excess of 20 percent.

• Under an economic downturn, such as the 1980s-type economics scenario in the RIA, additional goals-oriented loan purchases only have projected losses on Freddie Mac single family special affordable loans. These would be more than offset by remaining profits on other loans. Because of its much heavier use of a retained portfolio, Fannie Mae would have a much larger cushion against losses in an economic downturn.

• The GSEs have the ability to purchase loans with higher default risk without commensurately higher credit risk. They can do this through combinations of requiring deeper mortgage insurance coverage and charging higher guarantee fees.[60] Resulting price increases to lower-income borrowers could be more than offset by other innovations which are now driving down the cost of mortgage originations for all borrowers.

• As a group, multifamily loans have a higher default potential than do single-family loans. Appropriately underwritten multifamily loans also earn higher guarantee fees for the GSEs, offsetting their higher credit risk. Yet the analysis developed in the RIA shows a discernable risk-return tradeoff with respect to multifamily lending: Higher profit margins under stable economic conditions, but larger potential losses in economic downturns. Fannie Mae has virtually eliminated this loss potential by holding a much larger percentage of multifamily loan purchases in retained portfolio. Freddie Mac could follow much the same strategy as it increases its multifamily business. The housing goals are structured such that the GSEs can meet the goals without significantly increasing their credit risk from multifamily purchases much beyond that imbedded in current baseline multifamily purchase targets for 1995 and 1996.

• Guarantee fee income from securitized loans is sufficient to cover the expected credit costs of any additional goals-oriented purchases under baseline consensus economics. The much larger profit margins on their retained portfolios allow the GSEs to compete on guarantee fee prices, and still provide financial cushions against potential economic downturns.

• Increased retention in portfolio of additional, targeted loans purchased to help satisfy the housing goals is one possible way to hedge any increased credit risk. HUD's analysis finds that guarantee fees alone are insufficient to provide the earnings necessary to prevent losses on these loans in the event of a severe economic downturn. Portfolio earnings are five-to-eight times as large as guarantee fee income, as a percent of dollar loan volumes. The increase in total portfolio holdings required to fully protect against credit risk in the economic downturn scenario developed by HUD is so small as to not raise concerns about exposing the GSEs to any greater interest-rate risk.

• Lenders, the GSEs, and private mortgage insurers are implementing changes in mortgage marketing and underwriting that extend homeownership opportunities to below-median-income households without measurably increasing credit risk. These changes are increasing the pool of potential loan purchases that are both sound investments and qualify under the regulatory goals.

• These same risk-mitigation measures and alternative underwriting criteria should increase loan originations in minority and low-income neighborhoods and directly increase the GSEs' abilities to meet the central cities, rural areas, and other underserved areas goal. In addition, about 60 percent of underserved area home buyers have incomes above median income, which strengthens the credit quality of targeted purchases in these areas.

D. Determination of the 1995 and 1996 Low- and Moderate-Income Housing Goals

The annual goal for 1995 for each GSE's purchases of mortgages financing housing for low- and moderate-income families is established at 38 percent of the total number of dwelling units financed by each GSE's mortgage purchases. The 1996 goal is established at 40 percent. These goals represent an increase over the 1994 goal of 30 percent. Several considerations, many of which have been reviewed in earlier sections of this Appendix, led to the choice of these goals.

1. Housing Need

Almost three-fifths of American households qualify as low- and moderate-income under the Act's definitions—half of owners and 70 percent of renters. Data from the Census and from the American Housing Surveys demonstrate that housing problems and needs for affordable housing are indeed substantial among low- and moderate-income families. These households, particularly those with very low incomes, are burdened by high rent payments and will likely continue to face serious housing problems, given the dim prospects for earnings growth in entry-level occupations.

With respect to homeownership, many younger, minority, and lower income families did not realize their goal of homeownership during the 1980s due to the slow growth of earnings, high real interest rates, and continued house price increases. Recently, low interest rates and low inflation have improved affordability conditions and first-time homeowners have become a major driving force in the home purchase market. A large pent-up demand for homeownership exists on the part of low-income families closed out of the market during the 1980s, particularly families with children in need of larger units and better neighborhoods.

Several demographic changes will put strains on the housing finance system during the 1990s. The continued increase in immigrants will increase demand for both rental and owner-occupied housing. Non-traditional households have become more important as overall household formation rates have slowed. With later marriages, divorce, and other non-traditional living arrangements, the fastest growing household groups are single-parent and single-person households.

2. GSE Performance Shows Mixed Results

The Charter Acts require that the GSEs provide ongoing assistance to the secondary market including mortgages for low- and moderate-income families. The GSEs certainly have been assisting the overall secondary market, increasing their share of purchases of conventional conforming single family mortgage origination from 42 percent in 1989 to 70 percent in 1993. In fact, most industry observers would agree that the recent growth in the secondary market was the reason the decline of the thrift industry had only minor effects on the nation's housing finance system.

However, the Secretary is concerned about the GSEs' assistance to the lower income end of the market. Figure A.1 presents the distribution of the GSEs' single-family mortgage purchases by income category. In 1993, homeowners with incomes less than 60 percent of median represented only 5 percent of GSE purchases, and those with incomes less than 80 percent of median represented only 15 percent of GSE purchases. Families with incomes over 120 percent of median, on the other hand, accounted for over 55 percent of single-family mortgages purchased by the GSEs.

The market is originating many more loans for lower income homebuyers than the GSEs are purchasing. (See Figure A.2, which compares GSE performance with the market). The GSEs, based on 1993 HMDA data, purchased a much smaller proportion of conforming mortgages originated for very low-income homebuyers than of mortgages originated for high-income homebuyers (41 percent versus 55 percent). The HMDA data suggest that there is room in the lower income end of the homebuyer market for the GSEs to improve their performance.

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[59] Based on national income distributions, there are 4.2 million one- and two-person households who qualify as below median income according to the housing goals, but whose real income is above median when adjustments for size are factored in. Likewise, there are 2.85 million four-to-six person households who do not qualify as having below median income for goals purposes, but whose incomes are below median when adjusted for household size. On net, then, using an overall family median income has the potential for increasing the pool of potentially goals-qualifying mortgage loans for GSE purchase.

[60] The limits to this in the competitive mortgage originations market are not yet known, but both GSEs recently increased the depth of mortgage insurance required on low downpayment loans.