How HUD Mortgage Policy Fed The Crisis

Subprime Loans Labeled 'Affordable'

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In 2004, as regulators warned that subprime lenders were saddling borrowers with mortgages they could not afford, the U.S. Department of Housing and Urban Development helped fuel more of that risky lending.

Eager to put more low-income and minority families into their own homes, the agency required that two government-chartered mortgage finance firms purchase far more "affordable" loans made to these borrowers. HUD stuck with an outdated policy that allowed Freddie Mac and Fannie Mae to count billions of dollars they invested in subprime loans as a public good that would foster affordable housing.

Housing experts and some congressional leaders now view those decisions as mistakes that contributed to an escalation of subprime lending that is roiling the U.S. economy.

The agency neglected to examine whether borrowers could make the payments on the loans that Freddie and Fannie classified as affordable. From 2004 to 2006, the two purchased $434 billion in securities backed by subprime loans, creating a market for more such lending. Subprime loans are targeted toward borrowers with poor credit, and they generally carry higher interest rates than conventional loans.

Today, 3 million to 4 million families are expected to lose their homes to foreclosure because they cannot afford their high-interest subprime loans. Lower-income and minority home buyers -- those who were supposed to benefit from HUD's actions -- are falling into default at a rate at least three times that of other borrowers.

"For HUD to be indifferent as to whether these loans were hurting people or helping them is really an abject failure to regulate," said Michael Barr, a University of Michigan law professor who is advising Congress. "It was just irresponsible."

Congress is expected to vote before its Fourth of July recess on legislation that would strip HUD of its regulatory authority over Fannie and Freddie and give it to a stronger regulator.

Fannie and Freddie finance about 40 percent of all U.S. mortgages, with $5.3 trillion in outstanding debt. Owned by private shareholders but chartered by Congress, they are exempt from state and local taxes and receive an estimated $6.5 billion-a-year federal subsidy because they can borrow money more cheaply than other investors. In return, they are expected to serve "public purposes," including helping to make home buying more affordable.

HUD officials dispute allegations that the agency encouraged abusive lending and sloppy underwriting standards that became the hallmark of the subprime industry. Spokesman Brian Sullivan said the agency and Congress wanted to increase homeownership among underserved families and could not have predicted that subprime lending would dominate the market so quickly.

"Congress and HUD policy folks were trying to do a good thing," he said, "and it worked."

Since HUD became their regulator in 1992, Fannie and Freddie each year are supposed to buy a portion of "affordable" mortgages made to underserved borrowers. Every four years, HUD reviews the goals to adapt to market changes.

In 1995, President Bill Clinton's HUD agreed to let Fannie and Freddie get affordable-housing credit for buying subprime securities that included loans to low-income borrowers. The idea was that subprime lending benefited many borrowers who did not qualify for conventional loans. HUD expected that Freddie and Fannie would impose their high lending standards on subprime lenders.

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