Effect of the Conservatorship of Fannie Mae and Freddie Mac on Affordable Housing

Winston Sale

I. Introduction

On September 7, 2008, the Federal Housing Finance Agency (FHFA), under authority granted by the Housing and Economic Recovery Act of 2008 (HERA), placed the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively referred to as government-sponsored enterprises [GSEs]) into conservatorship.1 Conservatorship is “a statutory process designed to stabilize a troubled institution with the objective of returning the [GSEs] to normal business operations.”2 Under the conservatorship, FHFA is operating the GSEs and will continue to do so until they are stabilized.3 The GSEs’ placement in conservatorship was the result of spiraling losses and deteriorating economic conditions that threatened the GSEs’ solvency and their dual public missions of providing stability and liquidity to the housing finance

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system and promoting affordable housing. The GSEs' immense sizes, with over $5.4 trillion in guaranteed mortgage-backed securities (MBS) and debt outstanding between them, also presented a systemic risk to financial markets, which could have collapsed if the GSEs became insolvent.4

The events leading to the conservatorship will likely result in a major reorganization of the GSEs' structures, operations, and missions. This article addresses specifically the conservatorship's impact on the GSEs' affordable housing missions. To evaluate its effect, this article first examines how the GSEs arrived at the conservatorship, both from the context of their historical origins as well as the record of recent events leading to the current financial crisis. Second, the takeover itself is examined: the structure of the conservatorship, the GSEs' new leadership, and the effect that conservatorship has had on the GSEs' business activities. Finally, the conservatorship's impact on single-family and multifamily affordable housing activities, the Low Income Housing Tax Credit (LIHTC) market, and the recently enacted Housing Trust Fund will be examined.

The root of the GSEs' problems, and the current economic crisis generally, is the high rate of default among home mortgages over the last two years. Defaults, and the foreclosures that follow, have been especially prevalent among subprime loans, in which the GSEs invested heavily over the past four years. Increased demand for subprime loans during this period led to widespread degradation in loan underwriting standards, greatly increasing credit risk in the GSEs' investment and guaranteed mortgage portfolios. Although the GSEs were not directly responsible for the boom in subprime lending or the dereliction of loan underwriting practices that followed, their role in the housing finance system uniquely contributed to both phenomena, intensifying the types of problems against which they were designed to protect.

Though well-intentioned, the GSEs' affordable housing missions were a major contributing factor to their financial decline. The conflict of interest between the GSEs' profit motives and their obligations to meet demand for affordable housing goals set forth by the Department of Housing and Urban Development (HUD) led to business practices that undermined the GSEs' security and soundness and amplified the damage done by the subprime lending boom.5 In an effort to both reclaim lost market share and satisfy their affordable housing goals, the GSEs expanded their investments in subprime loans and MBS that qualified under their relaxed Alt-A underwriting standards but proved to be far less creditworthy than expected. Congress's unwillingness to overhaul GSE oversight allowed GSEs to continue expanding their investment portfolios with risky loans, increasing competition in the subprime mortgage market and setting the stage for a destabilizing wave of foreclosures.6

The GSEs thrived in an environment with minimal oversight, high leverage, and high-risk lending. However, their business activities substantially contributed to an industry-wide desertion of conservative lending practices, fostered the housing bubble, and set the stage for their conservatorship.
The GSEs' highly leveraged business models prevented them from providing any countercyclical benefit in a declining market and, moreover, led to the realization of the systemic risk feared by their critics. Furthermore, one of the consequences of the GSEs' business practices prior to the conservatorship may be a net decrease in the overall availability of affordable housing. Combined, widespread community disinvestment; tightening lending standards; and decreased demand for the LIHTC will have a detrimental effect on the availability of affordable housing for several years to come.

II. A Brief History of Fannie Mae and Freddie Mac

A. Origins of Government Intervention in Housing Finance

The modern fixed-rate, long-term, fully amortizing home mortgage is the financing vehicle of choice for homeownership in the United States. However, this borrower-friendly instrument represents a substantial evolution from the home loans available prior to the Great Depression. Through the 1930s, home loans in the United States were available only for short, five-to-ten-year terms. Typically, the full remaining principal was due at term. Most loans carried a variable interest rate and required refinancing if the borrower was unable to repay the principal due. During the Great Depression, property values in the United States declined by up to 50 percent relative to peak values, causing lenders to refuse refinancing for loans worth more than the homes securing the debt. A wave of foreclosures resulted as borrowers defaulted at a rate of approximately 250,000 per year between 1931 and 1935. During the worst period of the Depression, nearly one in ten homes was in foreclosure. Attempting to recoup losses, lenders sold repossessed real estate at volume, increasing downward pressure on the housing market and worsening the underlying problem.

The federal government responded to the crisis by creating the Home Owners' Loan Corporation (HOLC), the Federal Housing Administration (FHA), and the Federal National Mortgage Association (FNMA). Using funds from government-backed bonds, HOLC purchased mortgages in default from financial institutions and reinstated them. HOLC then converted variable-rate, short-term, nonamortizing mortgages into fixed-rate, long-term, fully amortizing mortgages. The federal government, seeking to avoid holding mortgages for the long term, established FHA to insure HOLC loans, thereby allowing investors to purchase federally insured mortgages with confidence. Having served its mission, HOLC was disbanded in 1936 and replaced by the predecessor of FNMA, a government agency created for the purpose of facilitating a secondary market in FHA-insured mortgages.

After the creation of FNMA, little changed in the mortgage and housing markets until the close of World War II and the passage of the G.I. Bill of Rights. The G.I. Bill both rewarded veterans and, in conjunction with substantial liberalization of FHA terms, stimulated housing construction. After World War II, strong economic conditions combined with the fixed-rate, self-amortizing mortgage to rapidly expand homeownership in America.
Despite its success, the home mortgage finance system was not without its weaknesses. In 1966, a rise in the Treasury yield caused deposits to flow out of savings and loans and into Treasury bonds, resulting in a shortage of funds for mortgage borrowers.\textsuperscript{21} Congress, in 1968, responded in part by splitting off part of FNMA into the Government National Mortgage Association (Ginnie Mae) and designating FNMA a “government-sponsored private corporation” (Fannie Mae).\textsuperscript{22} Ginnie Mae remained within the government to continue guaranteeing FHA mortgages and to package and securitize FHA loans.\textsuperscript{23} Fannie Mae was spun off as a congressionally chartered, privately held institution, traded on the New York Stock Exchange (NYSE).\textsuperscript{24} Fannie Mae was also granted the ability to buy and sell nongovernment-backed mortgages.\textsuperscript{25}

In 1970, Congress created Freddie Mac to securitize mortgages issued by then-ailing savings and loans.\textsuperscript{26} Freddie Mac’s equity shares were originally held solely by the twelve Federal Home Loan Banks and their member savings and loans.\textsuperscript{27} In 1989, Congress converted Freddie Mac into a publicly traded company, also listed on the NYSE.\textsuperscript{28} Although formed to serve different purposes, the GSEs, by the 1990s, featured structures and business strategies that had become quite similar. Their congressionally mandated missions are still to provide stability and liquidity in the secondary residential mortgage market, promote access to mortgage credit, and support the production and preservation of affordable housing.\textsuperscript{29}

\subsection*{B. GSEs’ Missions}

Home buyers generally prefer long-term, fixed-rate, self-amortizing mortgages. However, long-term, fixed-rate loans expose lenders to interest rate risk; when interest rates rise above a mortgage’s fixed rate, the lender loses money on the difference. Lenders eliminate risk by bundling mortgages together and selling them to the GSEs. Lender capital is then freed from long-term obligations and can be lent again via new mortgage originations that net fees to lenders for originating the loans.

The GSEs purchase bundles of loans from mortgage originators and pool them into MBS.\textsuperscript{30} MBS are then resold to individual investors and institutions better suited to holding long-term, fixed-rate assets.\textsuperscript{31} In exchange for an approximately 20 basis point (.20 percent) fee on the remaining principal, the GSEs guarantee MBS investors timely payments of interest and principal on the mortgages underlying the security.\textsuperscript{32} This mortgage credit guarantee insures the MBS investor against default risk on the underlying mortgages and is one of the GSEs’ core lines of business.

The GSEs also hold investment portfolios of their own, consisting mostly of MBS bought on the open market and from each other, as well as individual mortgages purchased from originators. Investment assets are funded by GSE debt.\textsuperscript{33} The GSEs are highly leveraged, with total equity of less than 4 percent of total assets.\textsuperscript{34} To appreciate the scale of this leveraging, consider that as of the end of the first quarter of 2008, Fannie Mae held
$843 billion in assets, about half of which was comprised of loans, and retained only $47 billion in total capital. Similarly, Freddie Mac held $802 billion in total assets and $16 billion in total capital. It is worthwhile noting that these leverage rates included a 30 percent capital increase above regulatory minimum core capital levels required through 2007 by the Office of Federal Housing Enterprise Oversight (OFHEO), the federal regulator of the GSEs until August 2008. In other words, the GSEs' capitalization rate during this period was 30 percent higher than typically required by their federal regulator.

Since being made private entities, the GSEs have seen their share of the mortgage finance market grow exponentially. In 1980, the residential mortgage market consisted of $1.1 trillion in obligations, of which the GSEs held approximately 7 percent. By 1995, the GSEs held approximately 35 percent of the $2.9 trillion mortgage market. In the first half of 2008, the GSEs held $5.3 trillion in MBS and debt outstanding, and approximately 76 percent of all new mortgages originated in that same period.

The GSEs' growth can be attributed in part to several advantages that they enjoy over their competition as quasi-governmental enterprises. For example, the GSEs' securities are "government securities," which means they are eligible for use as collateral for public deposits, for purchase by the Federal Reserve in open market operations, and for unlimited investment by federally insured depository institutions. The GSEs also use the Federal Reserve as their fiscal agent, which means that their securities are issued using the same system as U.S. Treasury borrowings. However, the GSEs' borrowing advantages and sheer sizes are what have allowed them to minimize competition in the conforming mortgage market and grow their balance sheets to immense proportions over a short period of time.

GSE securities are required by law to include explicit language that they are not guaranteed by the federal government. However, the market has perceived the GSEs' federal charters and related special benefits to imply a federal guarantee, an assumption proven correct by their placement in conservatorship in September 2008. The market's perception that in the event of insolvency, the government would rescue the GSEs (and their creditors along with them) facilitated the GSEs' ability to borrow at interest rates more favorable than those available to AAA-rated corporations. This provided the GSEs with a 41 basis point (.41 percent) debt-funding advantage over their competition. By borrowing at a lower rate, the GSEs could pay originators more for mortgages and force competition out of the market, allowing them to occupy large portions of the residential mortgage market.

The GSEs' borrowing advantage was, in effect, a subsidy derived from the market's perception that the federal government would not allow the GSEs to fail. The government fostered this perception by permitting the GSEs to grow to such sizes that their failures could put the entire United States economy at risk. A portion of this subsidy does trickle down to mortgage borrowers. The impact of the subsidy is best exemplified by the
approximately 25 basis point (.25 percent) interest rate advantage for conforming loans (which the GSEs may purchase) over jumbo loans (which the GSEs cannot purchase). The 16 basis point difference (.41 − .25 = .16) between the GSEs’ borrowing advantage and the subsidized conforming loan rate is retained by their shareholders and other stakeholders.

Whether the benefits conveyed by the GSEs warrant their unique privileges is highly controversial. As discussed above, the GSEs pass on less than two-thirds of the subsidy they receive through reduced mortgage interest rates. Some contend that the GSEs enhance stability of the mortgage market by acting as a market maker in MBS. However, the GSEs’ congressional champions have long cited their affordable housing missions as the prime justification for their privileged roles in the mortgage finance market.

C. GSEs’ HUD-Designated Affordable Housing Goals

In 1992, Congress established the GSEs’ modern regulatory structure through the Federal Housing Enterprise Financial Safety and Soundness Act of 1992 (FHEFSSA). The GSEs’ affordable housing obligations were concomitantly formalized by the same act. Under the FHEFSSA, the GSEs were to meet three distinct housing goals: (1) the Low- and Moderate-Income Housing Goal (Low/Mod Goal); (2) the Central Cities, Rural Areas, and Other Underserved Areas Goal (Underserved Areas Goal); and (3) the Special Affordable Housing Goal (together, Housing Goals). Prior to HERA, the establishment and enforcement of these goals resided within the powers of the secretary of HUD. In July 2008, under HERA, GSE oversight was transferred from the HUD secretary to the director of FHFA, and the Housing Goals were repealed and replaced by a new regime of goals to be administered by the director of FHFA. Because the FHEFSSA goals were in effect prior to the conservatorship and will remain in effect through 2009, they will be referenced for purposes of comparison within this discussion.

The Low/Mod Goal provides for the HUD secretary to establish requirements for the “purchase by each enterprise of mortgages on housing for low- and moderate-income families[,]” for example, households with income less than or equal to area median income (AMI). The Underserved Areas Goal requires the HUD secretary to “establish an annual goal for the purchase by each enterprise of mortgages on housing located in central cities, rural areas, and other underserved areas[,]” as defined by certain census tract characteristics. The HUD secretary may also provide for separate, specific subgoals under the Low/Mod and Underserved Areas Goals. The Special Affordable Housing Goal requires the HUD secretary to establish a goal, in an amount not less than 1 percent of the amount of mortgages purchased by the GSEs in the preceding year, designed to increase the GSEs’ purchase of mortgages serving “[h]ouseholds with income (1) less than or equal to 60 percent of AMI or (2) less than or equal to 80 percent of AMI and located in low-income areas.”
Since HUD's establishment of the Housing Goals in 1993, the GSEs' affordable housing efforts have generally improved. However, in 2000, HUD recognized that the GSEs' performances lagged behind the primary market. That year, HUD promulgated higher goals for 2001 to 2003 that were designed to make the GSEs market leaders in the area. From 2001 to 2004, as a percentage of their total new business, 50 percent of the loans they purchased had to qualify for the Low/Mod Goal, 31 percent had to qualify for the Underserved Areas Goal, and 20 percent had to qualify for the Special Affordable Housing Goal. During that period, the GSEs successfully met the goals established in 2000, but their performances continued to lag behind the primary market. This prompted HUD, which wanted the GSEs to "lead the industry" in their commitment to affordable housing, to further increase the Housing Goals in 2004.

In 2004, HUD promulgated the GSEs' affordable housing goals for 2005–2008 (2004 Final Rule). The 2004 Final Rule substantially increased HUD's goals for the GSEs' affordable housing effort. Based on 2000 census data, HUD estimated that between 2004 and 2008, the size of the conventional, conforming market for loans that would qualify for each housing goal was 51 percent to 56 percent for the Low/Mod Goal, 23 percent to 27 percent for the Special Affordable Housing Goal, and 35 percent to 39 percent for the Underserved Areas Housing Goal. The 2004 Final Rule required that by 2008, 56 percent, 27 percent, and 39 percent of the GSEs' purchases of home purchase mortgages qualify for those goals, respectively. In other words, by 2008, HED expected the GSEs to purchase the maximum estimated market share of conventional, conforming mortgages qualifying for each of the housing goals. The 2004 Final Rule provided for a three-year phase-in period for the goals, shown in table 1 below.

Upon publishing the proposed 2005–2008 housing goals, HUD received comments from both GSEs and other industry participants regarding the

Table 1
GSE Affordable Housing Goals*

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<tr>
<td>Low/Mod Goal</td>
<td>50%</td>
<td>52%</td>
<td>53%</td>
<td>55%</td>
<td>56%</td>
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<tr>
<td>Underserved Areas Goal</td>
<td>31%</td>
<td>37%</td>
<td>38%</td>
<td>38%</td>
<td>39%</td>
</tr>
<tr>
<td>Special Affordable Goal</td>
<td>20%</td>
<td>22%</td>
<td>23%</td>
<td>25%</td>
<td>27%</td>
</tr>
<tr>
<td>Special Affordable Multifamily Subgoal</td>
<td>Fannie Mae - $5.49 BILLION</td>
<td>Freddie Mac - $3.92 BILLION</td>
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risk inherent in aggressively increasing the GSEs’ housing goals. “Both GSEs indicated that they would need to increase their purchase of subprime loans to meet the [increased housing] goals.” Freddie Mac voiced its concern that meeting the housing goals could affect its ability to conduct “responsible lending practices.” Further, Freddie Mac indicated that the increased goals would limit its ability to influence subprime lending practices. More specifically, Freddie Mac claimed that, to meet the higher housing goals, it might not have the option in the future of turning away subprime loans that have less desirable loan terms than the subprime business it currently purchases.

Commenters on the proposed goals also expressed concern that “unrealistically high goals could force the GSEs to jump into the market in a manner that negatively distorts underwriting and pricing.” In response to these concerns, HUD stated that, in its opinion, the GSEs’ automated underwriting systems were capable of effectively limiting risk and that millions of Americans would benefit from the increased stability and standardization that the GSEs would bring to the subprime market. In an eerily prescient forecast of events to come, commenters critical of the proposed goals highlighted the likelihood that the increased goals could lead to a widespread increase in default rates and potentially large-scale home abandonment and neighborhood disinvestment. In response, HUD again stated that the GSEs’ underwriting models could sufficiently calculate for risk and that increased competition in traditionally underserved areas would reduce predatory lending practices. HUD went forward with promulgating the 2004 Final Rule goals without change.

As shown in table 2, in 2005, the first year of the new phased-in goal increases, both GSEs surpassed each of the Housing Goals promulgated in the 2004 Final Rule. The GSEs were similarly successful in meeting their Housing Goals in 2006 and 2007.

The declining housing market in 2006 and 2007 made it increasingly difficult for the GSEs to meet the 2004 Final Rule goals for those years. In their 2007 reports to HUD on their affordable housing efforts, both GSEs discussed growing difficulty in meeting the increasing Housing Goals as a result of the credit crunch and the collapse of the subprime lending market. Fannie Mae reported that in 2007, it met each of its base housing goals but “did not fully attain its low- and moderate-income and special affordable home purchase subgoals.” Similarly, Freddie Mac reported that it had been unable to meet two of the 2007 income-based subgoals because “the subgoal targets exceeded market origination levels in 2007 to an insurmountable degree.” Similarly, Freddie Mac reported that it had been unable to meet two of the 2007 income-based subgoals because “the subgoal targets exceeded market origination levels in 2007 to an insurmountable degree.” HUD, recognizing that adverse market conditions and the precarious financial condition of the GSEs had made attaining the 2007 Housing Goals unrealistic, informed the GSEs in April 2008 that they would suffer no penalty for failing to meet their 2007 goals and would not be required to submit plans to come into compliance with the missed quotas.
### Table 2

**GSE Housing Goal Performance 2005–2006***

<table>
<thead>
<tr>
<th>Goal</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low/Mod Goal</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fannie Mae</td>
<td>55.1%</td>
<td>56.9%</td>
<td>55.3%</td>
</tr>
<tr>
<td>Freddie Mac</td>
<td>54%</td>
<td>55.9%</td>
<td>55.9%</td>
</tr>
<tr>
<td>Underserved Areas Goal</td>
<td>37%</td>
<td>38%</td>
<td>38%</td>
</tr>
<tr>
<td>Fannie Mae</td>
<td>41.4%</td>
<td>43.6%</td>
<td>43.4%</td>
</tr>
<tr>
<td>Freddie Mac</td>
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<td>42.7%</td>
<td>43.1%</td>
</tr>
<tr>
<td>Special Affordable Housing</td>
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<td>23%</td>
<td>25%</td>
</tr>
<tr>
<td>Goal</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fannie Mae</td>
<td>26.3%</td>
<td>27.8%</td>
<td>26.5%</td>
</tr>
<tr>
<td>Freddie Mac</td>
<td>24.3%</td>
<td>26.4%</td>
<td>25.6%</td>
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### III. Subprime Lending, the Housing Boom, and Conservatorship

#### A. Background

During the late 1990s and early 2000s, a number of factors led Americans to begin investing heavily in real estate. Residential real estate provided a safe, tangible alternative to volatile stocks; and, as money flowed into housing, home values soared. Low interest rates and relaxed mortgage lending standards made homeownership possible for populations previously unable to qualify for mortgages, further increasing the demand for housing. In financial markets, investors grew hungry for securities backed by residential mortgages that could provide handsome returns but appeared to carry little risk, which increased pressure on mortgage originators to satisfy demand. As market leaders, the GSEs helped establish and maintain mortgage underwriting practices considered to be industry standard. However, as competition for mortgages increased, the GSEs began loosening standards for mortgages that they would purchase. At the same time, Congress was encouraging the GSEs to further expand into the nonprime mortgage market, increasing competition for nonprime originations. The end result was a lending frenzy that fed the escalating housing boom but
also led to widespread degeneration of underwriting standards. Hundreds of thousands of mortgages were originated during this period, many of which were unlikely to be repaid.

The nonprime, or subprime, mortgage is a relatively new lending vehicle that expands the availability of credit to borrowers otherwise unable to qualify for conventional mortgages.\(^{84}\) A subprime loan is not necessarily different in structure compared to a prime loan; however, a subprime borrower pays a higher rate of interest than a prime borrower to compensate for the loan’s increased risk of default.\(^{85}\) High up-front fees and prepayment penalties are also typical among subprime mortgages.\(^{86}\) Subprime loans can be profitable for lenders due to reduced interest risk, high fees, and the above-market interest return.\(^{87}\) However, enhanced profitability is offset by increased credit risk, which is reflected in higher interest rates. Subprime loans are also especially lucrative for mortgage originators, who profit from increased fee structures and the advantages inherent in lending in underserved markets.\(^{88}\) For purposes of securitization, subprime loans are graded and bundled according to level of risk and then sold to the secondary market, where they are typically converted to MBS and sold to investors.\(^{89}\)

Prior to the housing boom, it was not uncommon for MBS to contain small amounts of subprime debt.\(^{90}\) However, during the boom, MBS investors’ appetites for lucrative, subprime-heavy securities increased exponentially.\(^{91}\) As demand for highly profitable MBS increased, the secondary mortgage market allowed underwriting standards to degrade, and originators began targeting historically underserved communities to exploit reduced documentation requirements.\(^{92}\) Between 2001 and 2004, the national subprime mortgage market grew from $180 billion to $608 billion.\(^{93}\) By 2005, nonprime loans accounted for 33 percent of all mortgage loan originations.\(^{94}\) Despite the high risk of default typical among subprime loans, rapidly increasing home values allowed distressed borrowers to refinance against new equity accrued in their homes, keeping default rates in check.\(^{95}\)

As long as the real estate market continued to rise, subprime mortgages and the securities they backed remained secure. However, as appreciation of home values stalled in the second quarter of 2006, borrowers became unable to refinance out of unaffordable loans, and default rates started to climb. Declining home prices, tightening credit, and an exodus of speculative investors all contributed to a downward spiral in the real estate market throughout 2007.\(^{96}\) In many areas, real estate price deflation has been compounded by the adverse effect that foreclosures have on surrounding properties, which drive down neighboring homes’ values and increase the likelihood of more foreclosures.\(^{97}\) As foreclosures spread, otherwise stable borrowers are finding themselves in “upside down” mortgages on homes worth less than the debt owed, a highly reliable predictor of default.\(^{98}\) The negative effect of foreclosures on neighboring properties has caused the problems affecting subprime loans to spread into the prime mortgage market, weakening the housing market as a whole.
B. Fannie and Freddie Bet Heavily on Subprime

As discussed above, the GSEs securitize and guarantee loans as well as hold portfolios of their own. Though highly profitable, these investment portfolios posed a significant risk to the security and soundness of the GSEs and have been a concern of GSE regulators for some time. In testimony given before the Senate Banking Committee in 2004, Federal Reserve Chairman Alan Greenspan expressed concern regarding the growing size of the GSEs’ investment portfolios, citing the danger of concentrated interest rate and prepayment risk. Chairman Greenspan expressed additional concern that rather than raising capital to hedge against risk as would a savings and loan, the GSEs were increasing leverage, further increasing risk but multiplying profitability in direct proportion to their leverage. Greenspan stated, “Without the expectation of government support in a crisis, such leverage would not be possible without a significantly higher cost of debt.” In other words, the GSEs were leveraging investment portfolio profits against an anticipated taxpayer bailout in the event that their portfolios collapsed. It was against this background of leveraged risk that the GSEs began purchasing increasing amounts of profitable, but potentially risky, subprime mortgages and private label securities saturated with subprime loans.

In 2006 and 2007, responding to pressure from originators selling subprime mortgages, investors seeking enhanced returns, and Congress eager to expand the GSEs’ affordable housing missions, the GSEs took aggressive measures to regain market share lost to Wall Street institutions investing heavily in subprime mortgages. In 2005, 14 percent of the GSEs’ new business (new mortgages purchased from originators) was subprime, Alt-A (loans with less than standard documentation), interest-only, or mortgages with multiple risk characteristics. During the first half of 2007, approximately one-third of the GSEs’ new business was in subprime loans and Alt-A loans. Like many mortgage investors, the GSEs’ assumptions regarding nonprime loan performance relied on historical mortgage finance data, which was based on the statistical performance of “plain vanilla,” conservatively underwritten, long-term, amortizing mortgages. However, the analytical models that the GSEs used to quantify investment risk proved unable to accurately measure risk posed by new “exotic” adjustable-rate loans originated by the hundreds of thousands. As a result, the GSEs failed to adequately price loans for risk and were insufficiently capitalized to survive a major increase in credit risk.

As the downturn in the real estate market worsened and mortgage defaults increased, it became increasingly clear to the GSEs and their regulators that the possibility of making good on guaranteeing billions in bad loans was going to become reality. Adding fuel to the fire, the impending crisis in the GSEs’ guarantee business was compounded by the rapid deterioration of their investment portfolios. The GSEs’ investments in private label securities had exploded between 2004 and 2007. From 2001 to 2003, less than 6 percent of Fannie Mae’s total mortgage-related securities...
purchases consisted of private label securities.\textsuperscript{109} From 2004 to 2007, no less than 51 percent of Fannie Mae's mortgage-related securities purchases were private label, totaling over $229 billion in purchases.\textsuperscript{110} Freddie Mac's investment purchases were similarly aggressive, with an average 15 percent investment in private label securities from 2001 to 2003 jumping to an average of 48 percent from 2004 to 2007.\textsuperscript{111} From 2004 to 2007, Freddie Mac purchased over $498 billion in private label securities.\textsuperscript{112}

To understand the level of risk associated with these purchases, however, it is necessary to examine the component makeup of the securities purchased. For example, of the securities that Fannie Mae purchased in 2004, 54 percent consisted of subprime and Alt-A mortgages, the overwhelming number being adjustable-rate loans.\textsuperscript{113} In other words, a full one-quarter of Fannie Mae's private label securities investments in 2004, $54 billion worth, consisted of either subprime or Alt-A mortgages.\textsuperscript{114} Freddie Mac pursued an even more aggressive investment strategy than Fannie Mae. In 2006, 84 percent of Freddie Mac's private label securities purchases were either subprime or Alt-A, for a total value of $103 billion.\textsuperscript{115} That same year, 78 percent of Freddie Mac's retained private label MBS portfolio consisted of nonprime securities, worth approximately $176 billion at the time.\textsuperscript{116} The GSEs' increasing affordable housing goals partly explain the jump in investment in nonprime-heavy private label securities, which count toward meeting the GSEs' Housing Goals. However, the opportunity for outsized returns on these securities, which were deemed relatively safe at the time, likely provided equal motivation.

During the same period that Fannie Mae and Freddie Mac were investing heavily in subprime and Alt-A securities, underwriting and documentation standards for the loans backing those securities degenerated significantly.\textsuperscript{117} In its 2007 survey on credit underwriting practices, the Office of the Comptroller of the Currency (OCC) listed methods that mortgage originators reported using to ease lending standards for a fourth consecutive year:

- Easing standards for home equity lending, both conventional and high [loan-to-value ratio (LTV)], include an increase of the maximum loan amount, lower credit score cutoffs, and higher allowable debt-to-income (DTI) and combined LTV ratios. Easing in residential real estate lending was centered in the expanded use of stated income, increased interest only periods, higher allowable LTV and DTI ratios, and protracted amortization periods.\textsuperscript{118}

Anecdotal evidence suggests that originators' lending standards declined below even those reported to OCC; many loans were originated with essentially no documentation of the borrower's assets or ability to pay.\textsuperscript{119} As a result, subprime loans originated in 2006 and 2007 have proven to be far less creditworthy than expected.\textsuperscript{120} The increased credit risk of loans originated during this period, combined with the volume at which they were purchased, put the GSEs on a steep financial decline beginning in 2007.

\textbf{C. FHFA Takes Action}

In August 2007, the boom in subprime lending came to an abrupt end.\textsuperscript{121} Through the fall of 2007 and into early 2008, the real estate and mortgage
markets continued to struggle as home prices declined and delinquencies rose. Liquidity in private label securities backed by nonprime loans evaporated, and MBS prices declined over growing liquidity and credit concerns. In fiscal year 2007, Fannie Mae posted its first loss since 1985, and Freddie Mac posted its first loss ever—$2.1 and $3.1 billion, respectively. The GSEs took significant steps to protect against the growing credit risk that they faced, including tightening underwriting standards, increasing pricing, improving loss-control practices, and decreasing exposure to distressed servicers. However, as the market continued to deteriorate, it became clear that more aggressive measures would be required to preserve capital.

Despite the GSEs' efforts, the market began to recognize the effect that the deteriorating housing market was having on the GSEs, heightening credit concerns and rendering unavailable new capital of meaningful size. Without access to new capital, the GSEs would be required to cease new business and begin shedding assets to raise funds. Taking these steps would have resulted in increased mortgage rates, increasing the GSEs' interest risk while simultaneously reducing the value of their securities. These actions would have increased downward pressure on already distressed markets, further destabilizing the GSEs' positions. Upon consultation with the Federal Reserve and OCC, FHFA determined that government intervention was necessary before the market for GSE securities became too unstable to permit normal business activity. On September 7, 2008, with the consent of the boards of directors of both companies, FHFA placed Fannie Mae and Freddie Mac into conservatorship. Conservatorship is defined as "a statutory process designed to stabilize a troubled institution with the objective of maintaining normal business operations and restoring its safety and soundness."

On Monday, September 8, the GSEs opened for business as usual but with FHFA overseeing their operations as both management and board of directors. FHFA examiners were detailed on-site to the GSEs to ensure a smooth transition to the conservatorship, support the new chief executive officers (CEOs), and communicate any issues needing resolution back to the FHFA director. Other immediate changes included ceasing all lobbying and political activities, eliminating dividends on common and preferred stock, and entering into agreements with the U.S. Treasury to further promote liquidity and stability. The CEOs of both companies were replaced, with Herb Allison selected to be the new CEO of Fannie Mae and David Moffett the new CEO of Freddie Mac. Neither of the departing CEOs received a golden parachute. Herb Allison is a former vice chairman of Merrill Lynch and was, for eight years prior to the conservatorship, chairman of the financial services giant Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF). Prior to the conservatorship, David Moffett had been a senior advisor to the Carlyle Group following six years as the vice chairman and chief financial officer of U.S. Bancorp. On September 16, FHFA named Philip A. Laskawy, former chief executive of Ernst and Young, nonexecutive chairman of Fannie
Mae.\textsuperscript{137} John A. Koskinen, former chief executive of the Palmieri Co. consulting firm and deputy director of the Office of Management and Budget under President Clinton, was named nonexecutive chairman of Freddie Mac.\textsuperscript{138} However, the secretary of FHFA remains the final decision maker for all GSE activities.\textsuperscript{139}

In addition to FHFA's takeover, the Treasury Department announced that it also would be taking significant measures to help stabilize the GSEs and to protect the investors holding their securities. First, the Treasury and FHFA established preferred stock purchase agreements whereby the Treasury would ensure that each company maintains a positive net worth.\textsuperscript{140} In exchange for the Treasury eliminating any mandatory triggers for receivership and ensuring that the GSEs will fulfill their financial obligations, taxpayers receive senior preferred equity shares bearing losses only after existing common and preferred shareholders.\textsuperscript{141} Second, the Treasury established a new secured lending facility for the GSEs and the Federal Home Loan Banks (FHLBs), which serves as an ultimate liquidity backstop available, as provided by HERA, until December 2009.\textsuperscript{142} Finally, the Treasury initiated a temporary program to purchase GSE MBS in an effort to allow the GSEs to continue purchasing new mortgages and, in turn, reduce the costs of mortgage borrowing to home buyers.\textsuperscript{143} These temporary authorities will expire at the end of 2009.\textsuperscript{144} Until then, the GSEs' portfolios will be allowed to grow up to $850 billion before being required to gradually decline at a rate of 10 percent per year.\textsuperscript{145} Beginning in 2010, the GSEs will be required to pay a fee for the ongoing support provided by the preferred stock purchase agreements.\textsuperscript{146} Treasury Secretary Paulson expressed his view that Congress should perceive the Treasury's measures as temporary stopgaps designed to stabilize the GSEs while a new regulatory scheme is developed.\textsuperscript{147}

IV. Impact of the Conservatorship on Affordable Housing

Through their affordable housing activities, both congressionally mandated and otherwise, the GSEs play important roles in promoting the availability of affordable housing nationally. However, the GSEs' recent financial distress has significantly impeded their dual public missions of ensuring stability and liquidity in the mortgage market and preserving and expanding the nation's affordable housing stock. FHFA Director James Lockhart cited the severe compromise of the GSEs' public missions as central to FHFA's decision to place them in conservatorship.\textsuperscript{148} It is clear that the GSEs' financial troubles and the resulting conservatorship will have a substantial impact not only on their abilities to meet their existing statutorily required affordable housing goals but also potentially on new housing obligations set forth by HERA as well as on affordable housing activities engaged in by the GSEs on their own accounts.\textsuperscript{149} Furthermore, policymakers who once may have seen the GSEs as a viable alternative to the direct federal funding of affordable housing production now have good reason to reconsider this option.
As discussed above, in exchange for their privileged status and the corresponding benefits enjoyed by their shareholders, the GSEs are obligated to aid in the preservation and expansion of affordable housing in the United States.150 The GSEs meet this goal in the single-family market in part by facilitating homeownership in traditionally underserved communities and, more recently, by broadly rewriting loan terms to make mortgages affordable to distressed borrowers.151

In the multifamily market, the GSEs purchase large mortgages on multifamily properties and, in doing so, provide credit liquidity when other commercial lending sources run dry. Until recently, the GSEs also invested heavily in LIHTCs, the federal government's primary subsidy vehicle for the production of new affordable housing. The GSEs also invest indirectly in affordable housing through substantial contributions to nonprofit housing providers and housing-related organizations.

Finally, under HERA, the GSEs are obligated to divert an amount of funds equal to a small percentage of all new business to the newly created Housing Trust Fund (HTF).152 Once fully funded, the HTF will provide a new, nonappropriated federal funding source for the production of affordable housing. The following sections examine how the GSEs' affordable housing efforts have fared since being placed in conservatorship and will consider what long-term effects government intervention may have in the GSEs' affordable housing missions going forward.

The following analysis of the GSEs' affordable housing efforts relies primarily on the GSEs' financial filings with the Securities and Exchange Commission since the start of the conservatorship.

A. Affordable Single-Family Housing

The GSEs' 2007 affordable housing activity reports and FHFA Director Lockhart's statements have made clear that the GSEs' affordable housing efforts in the single-family mortgage market will be scaled back to adapt to ongoing market challenges. In a September 23, 2008, statement before the Senate Committee on Banking, Housing, and Urban Affairs, FHFA Director James Lockhart informed the committee that the GSEs' inability to meet their affordable housing goals would continue through 2008, with performance likely worse than in 2007.153 Director Lockhart assured the committee, however, that under the conservatorship, even if the Housing Goals proved to be unattainable, he would expect both GSEs to "develop and implement ambitious plans to support the borrowers and markets targeted by the goals."154

Consistent with statements made by Secretary Paulson and Director Lockhart, the GSEs have been instructed to increase their acquisition rates of mortgage loans and mortgage-related securities to provide additional liquidity to the mortgage market.155 However, both enterprises report difficulty in increasing portfolio size due to their reduced abilities to issue callable or long-term debt and due to the general prohibition under their senior preferred stock purchase agreements with the U.S. Treasury to
issue debt in excess of 110 percent of their aggregate indebtedness as of June 30, 2008. Since entering conservatorship in the third quarter of 2008, the GSEs have experienced mixed results from their efforts to increase purchases of single-family mortgages. During the second and third quarters of 2008, Fannie Mae’s single-family mortgage business decreased by $15 billion. However, during the same period, Freddie Mac’s new single-family mortgage business increased by $5 billion. With regard to the purchase of housing goal-qualifying loans, Freddie Mac stated in its third-quarter 2008 Form 10-Q filing that it estimates its “affordable mortgage purchases will substantially mirror the levels of goal-qualifying loans being originated in the market today.” Fannie Mae’s third-quarter 2008 Form 10-Q filing does not address the status of its efforts to meet its affordable housing goals.

One significant change to the GSEs’ single-family mortgage business practices likely to affect low- and moderate-income families is the GSEs’ tightening loan eligibility standards. In its 2007 Annual Housing Activities Report, Fannie Mae reported that credit market volatility and deteriorating loan performance required curtailment of eligibility for high-risk loans. Particularly affected are loans with high LTV ratios and borrowers with poor credit histories and/or layered risk characteristics. In addition to tightening credit terms, effective January 1, 2009, Fannie Mae is discontinuing the purchase of newly originated Alt-A loans. Similarly, Freddie Mac tightened its credit terms in 2007, reducing risk layering on high-risk mortgages such as interest-only and stated-income mortgages. Although tightening credit standards reduces credit risk borne by the enterprises, it also reduces the number of low- and moderate-income borrowers eligible for conforming loans. Reduced eligibility means that fewer borrowers will be able to refinance out of mortgages they may no longer be able to afford because of payment shock due to interest rate reset or other financial difficulties.

Recognizing the urgent need to proactively manage their growing credit losses, the GSEs initiated loan-modification programs designed to assist single-family borrowers in distress. Fannie Mae increased its foreclosure prevention workout efforts from approximately 7,000 per month during the first half of 2008 to approximately 14,000 per month during the third quarter of 2008. Fannie Mae also increased its outreach for distressed loans through targeted mailings to high-risk borrowers and through a “Second Look” review of owner-occupied properties headed toward foreclosure.

Following the example of the Federal Deposit Insurance Corporation’s success in reducing IndyMac’s credit losses through loan modification, on November 11, 2008, FHFA announced the implementation of a new, streamlined loan-modification program targeting borrowers at high risk of foreclosure. To be eligible for the program, borrowers must have missed three payments or more, own and occupy the property as a primary residence, and not have filed for bankruptcy. The program modifies the borrower’s mortgage to make the monthly payment affordable for the borrower.
purposes of the program, an “affordable” monthly payment is defined as “a first mortgage payment, including homeowner association dues, of no more than 38 percent of the household’s monthly gross income.”\footnote{169} In an effort to provide distressed borrowers time necessary to apply for the streamlined modification program, the FHFA announced on November 20, 2008, a temporary suspension of foreclosure actions from November 26, 2008, to January 9, 2009.\footnote{170}

Working in concert, the GSEs’ foreclosure-mitigation programs represent important steps toward providing relief for millions of distressed borrowers caught in loans that they cannot afford. However, tightening credit standards, reduced purchasing of nonprime loans, and the reduction in the net volume of new mortgage purchases generally mean that fewer low- and moderate-income borrowers will be eligible for conforming mortgages. Many otherwise creditworthy borrowers will thus be forced to borrow from subprime lenders of last resort because they no longer satisfy the GSEs’ more stringent underwriting criteria. Many other potential borrowers will be unable to secure credit at all. Although FHFA, as conservator of the GSEs, must reestablish the safety and soundness of the enterprises, it is likewise imperative to GSEs’ missions and the health of the housing market generally that potential low- and moderate-income borrowers have continued access to conforming loans. The availability of mortgage credit and the health of the housing market are inexorably related. Thus, it is essential that the conservator ensure that credit remains available not only to prime borrowers but also to nonprime borrowers able to objectively demonstrate the ability to repay their loans. The conservator would be failing to uphold the GSEs’ affordable housing missions if by zealously reinforcing the GSEs’ protection against credit risk, otherwise creditworthy low- and moderate-income borrowers are relegated to costly, nonconforming subprime loans. Although this potential trend has not yet materially manifested itself, the foundation has been set for the re-erection of substantial barriers to borrowing for low- and moderate-income families.

\section*{B. Affordable Multifamily Housing}

In the multifamily market, the GSEs provide credit liquidity by purchasing, guaranteeing, and securitizing mortgages on multifamily properties,\footnote{171} the continued production and preservation of which are key to meeting the country’s projected housing needs in the next decade.\footnote{172} As with the GSEs’ affordable housing obligations, Director Lockhart stated his determination to ensure that “in conservatorship, both Enterprises remain dedicated to, and actively involved in, multifamily lending.”\footnote{173} In conservatorship, the GSEs have advertised a business-as-usual approach to their multifamily lending businesses.\footnote{174} Both GSEs have increased the sizes of their multifamily mortgage portfolios between the second and third quarters of 2008 as well as over their total multifamily portfolios in the third quarter of 2007.\footnote{175}

Fannie Mae’s total multifamily loan purchases during the third quarter of 2008, at approximately $7 billion, increased its total multifamily portfolio
investment to approximately $112 billion. This represented a 6 percent increase in its total multifamily portfolio over the second quarter of 2008 and a 15 percent increase over the total portfolio at the end of the third quarter 2007. Fannie Mae’s multifamily credit guarantee business has increased by approximately 10 percent since the third quarter of 2007, and its average LTV ratio of guaranteed multifamily loans has remained at 67 percent. Fannie’s increase in multifamily credit exposure has been made possible by the still-positive performance of multifamily assets despite the housing crisis. As of the close of the third quarter of 2008, only .16 percent of multifamily loans guaranteed by Fannie Mae were seriously delinquent. To compare, of single-family mortgages guaranteed by Fannie Mae for the same period, 1.72 percent were seriously delinquent. Stability in the average LTV ratio of multifamily loans between 2007 and 2008 also reflects the relative health of the multifamily market. Stable LTV ratios mean that multifamily borrowers are not forced to put up significantly more equity to close deals similar to those closed prior to the crisis, which helps promote liquidity in the multifamily market.

Freddie Mac’s multifamily segment proved to be its only profitable segment during the third quarter of 2008, earning $135 million. Freddie Mac’s multifamily mortgage purchases for the third quarter of 2008, at $5.2 billion, increased by 23 percent compared to its purchases during the second quarter of 2008 and 56 percent compared to its purchases for the third quarter of 2007. Freddie Mac’s retained multifamily portfolio has also proven to be relatively stable despite the economic downturn, with only .07 percent of its retained multifamily portfolio up to ninety days past due and none of its portfolio reported as seriously delinquent. Freddie Mac’s multifamily guarantee portfolio has increased substantially over the last year, with the average balance of its guarantee portfolio doubling from $7 billion at the end of the third quarter in 2007 to $14 billion at the end of the third quarter in 2008. In the third quarter of 2008, Freddie Mac guaranteed over $845 million worth of multifamily loans, down from approximately $1 billion during the second quarter but up from $194 million during the third quarter of 2007.

Although the GSEs’ multifamily business lines have generally increased since entering conservatorship, their financials do not necessarily reflect the on-the-ground realities facing multifamily market participants. Specifically, anecdotal evidence suggests that Fannie Mae has generally extended the amount of time required to close on financing for multifamily transactions. Extended due diligence periods are due in part to the difficulty lenders are having in accurately valuating multifamily assets in an unstable market. Specifically, lenders and borrowers are having difficulty agreeing on accurate capitalization rates, which are essential to determining property value and, thus, the level of leverage (or LTV ratio) in a multifamily transaction. However, the consensus among industry participants is that balance sheet lenders (lenders that retain mortgages on their balance sheet rather than sell them to the secondary market) are generally likely
to close on multifamily loans more quickly than the GSEs and without a sacrifice in cost.\textsuperscript{189} Thus, it appears that since entering conservatorship, the GSEs’ increased investments in multifamily loans have coincided with increased hesitancy to complete individual transactions. However, given the conservator’s role in preserving the security and soundness of the GSEs, this comes as little surprise.

C. GSEs’ Tax Credit Investments

Through 2006, the GSEs contributed substantially to the production of affordable multifamily housing by investing heavily in the LIHTC.\textsuperscript{190} However, the GSEs’ poor financial health resulted in a pullback in LIHTC investment beginning in mid-2007.\textsuperscript{191} The withdrawal of the GSEs, which occupied almost 40 percent of the LIHTC equity trading market, had a substantial effect on LIHTC equity pricing.\textsuperscript{192} Following the GSE pullback, LIHTC trading values declined 10 percent from the mid-ninety-cent range down to the mid- and lower-eighty-cent range, with some projects unable to find equity investors at all.\textsuperscript{193} It remains unclear how conservatorship will affect the GSEs’ long-term tax credit investment strategy. However, to the relief of many LIHTC industry participants, the GSEs do not appear to be planning to liquidate their LIHTC investments, which would further depress LIHTC equity pricing.\textsuperscript{194}

Citing uncertainty in its future business model and the rapid deterioration of market conditions, Fannie Mae concluded that it was more likely than not that it would be unable to realize all of its deferred tax assets, which include LIHTC investments.\textsuperscript{195} As a result, during the third quarter of 2008, Fannie Mae recognized $21.4 billion noncash charge as a valuation allowance for the future tax benefit likely not to be utilized.\textsuperscript{196} When this is considered in conjunction with Fannie Mae’s already declining investment in LIHTC partnerships, it appears nearly certain that Fannie Mae will not be returning to the LIHTC market at any point in the near future.\textsuperscript{197} Furthermore, given the conservator’s stated objective of reducing the GSEs’ portfolio sizes 10 percent annually over the next several years, it appears unlikely that Fannie Mae will participate again in the LIHTC market as it had prior to 2007.

As of the close of the third quarter of 2008, Freddie Mac had investments in 189 LIHTC partnerships, worth $10.5 billion as measured in total assets.\textsuperscript{198} For its part, Freddie Mac made no new investments in LIHTC partnerships in 2008.\textsuperscript{199} Freddie Mac also anticipates that it will be unable to use all of the tax benefits generated by existing and future LIHTC partnerships to reduce future income tax.\textsuperscript{200} Given the status of Freddie Mac’s current LIHTC investment strategy, it appears that Freddie Mac will also be absent from the LIHTC market for some time to come. If Fannie Mae’s noncash charge against the value of its remaining tax credits is any indication of the conservator’s plans for the GSEs, it is possible that Freddie Mac will not participate again in the LIHTC market as it had prior to the conservatorship.
Although a broad analysis of the LIHTC's future without the GSEs is beyond the scope of this article, it is clear that the recent decline in LIHTC equity trading values will continue into the foreseeable future unless Congress devises a means to supplant the GSEs' former share of market demand with new, alternative participants. Flagging LIHTC investment demand has continued despite Congress's efforts to shore up the tax credit's appeal via HERA, due in part to rapidly deteriorating economic conditions and trauma throughout the financial sector. One somewhat unfortunate benefit of the current LIHTC situation is that it illustrates the inherent weakness of an affordable housing subsidy that not only provides no countercyclical benefit but is also heavily reliant on the health of the GSEs and, vicariously through them, on the housing sector itself for efficient subsidy distribution. These events will likely cause policy makers to carefully reconsider relying on a tax credit–based subsidy as the primary federal vehicle for affordable housing production going into what may prove to be a prolonged recession.

D. GSEs' Charitable Giving

In addition to their participation in the single-family and multifamily housing markets, the GSEs play an indirect role in supporting affordable housing by contributing to affordable housing associations and nonprofits. For example, in 2007, the GSEs contributed $47 million to over 400 Washington, D.C.–area nonprofits alone, almost 10 percent of the nonprofits working in communities in the region.201 Under the conservatorship, the director of FHFA retains discretion over and has temporarily halted contributions to charitable organizations, a circumstance that has not escaped Congress's attention.202 Although the suspension in charitable giving will likely affect nonprofits in the Washington, D.C., region far more than it will national housing efforts, a trickle-down effect is possible as many affordable housing research and advocacy groups receive donations from the GSEs to fund their efforts. At the time of this writing, the GSEs have announced no plans to restart their charitable-giving programs.

E. Housing Trust Fund

In addition to reforming GSE oversight, Congress created, through HERA, the federal Housing Trust Fund designed "to increase and preserve the supply of rental housing for extremely low- and very low-income families, including homeless families," and to increase homeownership for the same.203 The GSEs are required to set aside in each fiscal year an amount equal to 4.2 basis points for each dollar of the unpaid principal balance of total new business purchases.204 Of that aggregate amount, 25 percent will be deposited into the HOPE Reserve Fund established by the Treasury.205 Of the remaining amount, 65 percent will be transferred to HUD to fund the Housing Trust Fund, and 25 percent will be transferred to the Treasury for the new Capital Magnet Fund.206 Amounts transferred to the Housing Trust Fund will be used to provide grants to states to increase and preserve housing available for extremely low- and very low-income families.
The Congressional Budget Office estimates that when fully funded in 2010, the Housing Trust Fund and the Capital Magnet Fund together will command approximately $283 million in budget authority, $446 million in 2011, and $624 million in 2012. However, the director of FHFA has the authority to suspend allocations to the funds if the director finds that the allocations are or would contribute to the instability or undercapitalization of one of the GSEs. Director Lockhart has announced that FHFA will be suspending Fannie Mae’s contribution to the Housing Trust Fund until further notice. However, this is currently inconsequential to the Housing Trust Fund because during 2009, 100 percent of the allocation is to be used to reimburse the HOPE for Homeowners Program, also established by HERA. The Housing Trust Fund could be affected, however, if FHFA chooses to continue the suspension of contributions to the fund for several years into the future. Given Director Lockhart’s continuing reaffirmations of the conservatorship’s commitment to the GSEs’ affordable housing goals, an ongoing suspension of contributions appears to be an unlikely scenario.

Contributions to the Housing Trust Fund are derived from the GSEs’ new business purchases. Thus, anticipated contribution levels should not be affected by the conservatorship’s strategy of slowly reducing the GSEs’ portfolios. The conservator’s current strategy of increasing the GSEs’ new business activities, combined with disorganization and reduced competition in the housing finance market, suggests that once the GSEs begin contributing to the Housing Trust Fund in 2010, the contributions may actually be higher than anticipated.

V. Conclusion

The conservatorship will have a lasting effect on the organization and roles of the GSEs and on the means by which they promote affordable housing. The GSEs’ current business models are flawed because they attempt to serve the interests of profit-minded shareholders while simultaneously expanding the availability of affordable housing. Although the GSEs’ dual obligations do not necessarily inherently conflict, the practical result of counting theoretically profitable subprime loans toward their affordable housing obligations led to an improvident business strategy that did not sufficiently hedge for risk. In the process of advancing a well-intentioned homeownership-focused housing policy, the GSEs helped foster a market environment that exploited inadequate regulatory oversight and led to an economy-crippling real estate bust. The conflicting interests of good housing policy and profit maximization must be resolved to ensure that the GSEs may continue to safely provide liquidity and stability to the secondary mortgage market while concomitantly advancing the cause of affordable housing.

The conservator’s efforts to stabilize the GSEs and reinforce their safety and soundness have already had some negative effects on affordable housing. Tightening credit standards will decrease the number of conforming
single-family mortgages available to low- and moderate-income borrowers, inevitably leading to increased barriers to homeownership in underserved communities. However, the GSEs’ efforts to mitigate losses by modifying troubled loans will have a positive effect on communities hit hard by spreading foreclosures. Multifamily lending does not appear to have been adversely affected by the conservatorship and may increase as the GSEs refocus their efforts on profitable multifamily segments. However, the GSEs’ suspension of new LIHTC investments will continue to have major repercussions on affordable multifamily housing production for the foreseeable future. The GSEs’ halt of charitable giving will have a large impact for non-profits in the Washington, D.C., region but likely will not affect affordable housing efforts nationally. Contributions to the Housing Trust Fund, though temporarily suspended, should not be affected over the long term.

Despite the GSEs’ financial turmoil and resulting conservatorship, their future roles in affordable housing appear to be secure. However, many important questions remain. Previous efforts to balance the GSEs’ financial success with their affordable housing missions materially contributed to the current economic crisis, proving that the GSEs cannot return to their established business models without major reform. Permanent nationalization of major portions of the GSEs’ businesses cannot be ruled out. However, the potential for increased market stability must be considered against effects on efficiency and the operation of a free secondary mortgage market.

An alternative solution to nationalization could be a reorganization of the GSEs whereby their affordable housing missions were spun off to an associated entity created to serve those missions alone. The creation of a nonprofit National Affordable Housing Mortgage Association, “Addie Mae,” funded in part by the still-private GSEs and expressly backed by the federal government, could assume the GSEs’ affordable housing obligations and reduce the danger of profit motivation conflicting with housing-related best practices. Under this model, the GSEs would remain private for-profit entities and would continue to provide liquidity and stability to the secondary mortgage market. They would operate under strict regulatory guidelines regarding the size and composition of their retained portfolios to reduce systemic risk but would no longer be directly responsible for government-mandated affordable housing activities. Addie Mae would fulfill that role as a government-backed, privately run nonprofit association capitalized in part by GSE profits. Addie Mae, however, would focus its efforts solely on purchasing and guaranteeing affordable single-family and multifamily loans and promoting responsible lending practices in underserved communities. As an entity financially related to the GSEs, but distinct in governance and mission, Addie Mae could more effectively perform the GSEs’ affordable housing duties while reducing the risk inherent in their current organizations.

Finally, a major issue that remains to be solved is how to best ameliorate the ongoing LIHTC problem. Since the GSEs left the LIHTC market, equity
trading values have plummeted. Recession has exacerbated the problem by further depressing demand. Industry experts estimate that in 2009 there will be sufficient demand for only 30 percent of the total LIHTCs available.\textsuperscript{215} Delay inherent in the production pipeline for affordable multifamily projects means that the drop in affordable multifamily housing starts during 2008 and 2009 will affect the affordable rental housing supply for several years to come. Considering the anticipated growth in demand for rental housing over the next several years, the end result will likely be rising rents for low- and moderate-income families. Congress must examine whether it is possible to reform the LIHTC so as to find substitute market participants to absorb demand formerly generated by the GSEs. However, the issue remains that as a profit-dependent tax credit, the LIHTC’s design inherently fails to provide a countercyclical subsidy for affordable housing production.

President Obama and Congress must determine the future of the GSEs. Under conservatorship and with the Treasury’s assistance, the GSEs appear to be stable financially; and their continued loss-mitigation strategies should help turn the housing market around. It is clear that the GSEs’ business models contributed to the current financial crisis and that the GSEs must be reformed. Within any crisis lies opportunity, and the affordable housing community must work to ensure that GSE reform maximizes the benefit to affordable housing. Through thoughtful advocacy, we may help build a new future for the GSEs that advances the cause of affordable housing but prevents the recurrence of activities that led to the conservatorship.

\begin{enumerate}
\item Id. Hous. Fin. Agency, supra note 1, at 5–6.
\item Id. at 6–7.
\item In 2005, then–Treasury Secretary John Snow explained to Congress, “[The GSEs’] rapid growth has created a new dimension of risk, one that not only involves our national system of housing finance, but the potential for systemic risk to financial markets in general. The potential for systemic risk is associated with Fannie Mae’s and Freddie Mac’s large portfolios of mortgages and mortgage-backed securities and other non-related assets, funded at extremely high rates of leverage.” Proposals for Housing GSE Reform: Hearing Before the H. Fin. Seres. Comm., 109th Cong. 4 (2005) (testimony of John W. Snow, Secretary, U.S. Dep’t of the Treasury). In 2004, Federal Reserve Chairman Alan Greenspan noted the potential for systemic risk is associated with Fannie Mae’s and Freddie Mac’s large portfolios of mortgages and mortgage-backed securities and other non-related assets, funded at extremely high rates of leverage.” Proposals for Improving the Regulations of the Housing Government Sponsored Enterprises: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 108th Cong. 7–10 (2004) (testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System). However, Chairman Greenspan felt that without strengthened GSE regulation, “the possibility of an actual crisis or insolvency is increased.” Id. at 9.
\end{enumerate}
5. The GSEs recognized this conflict and predicted with disturbing accuracy the potential damage that could result. See HUD’s Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005–2008 and Amendments to HUD’s Regulation of Fannie Mae and Freddie Mac, 69 Fed. Reg. 63,601 (Nov. 2, 2004).


8. Id.

9. Id.


11. Green & Wachter, supra note 7, at 95.

12. Id.

13. HOLC was instated by the Homeowners’ Loan Act of 1933, 48 Stat. 128 (terminated by order of Home Loan Bank Board Secretary, effective February 3, 1954, pursuant to an act of June 30, 1953 (67 Stat. 121)); FHA was instated by the National Housing Act of 1934, 48 Stat. 1246, 12 U.S.C. § 1707 (2008); and FNMA was established as a wholly owned subsidiary of the Reconstruction Finance Corporation, by redesignation of the National Mortgage Association of Washington, on April 5, 1938.

14. Green & Wachter, supra note 7, at 94.

15. Id. HOLC acquired and refinanced over one million troubled mortgage loans, i.e., about 20 percent of all mortgage loans in the country. Press Release, Congressman Mark Steven Kirk, Reestablish the Home Owner’s Loan Corporation (Jan. 23, 2008), available at www.house.gov/list/press/ill0_kirk/HOLC_release.html. The success of the HOLC program has not been lost on legislators. In January 2008, Congressman Kirk of Illinois called for the reinstatement of HOLC, dubbing it HOLC21, and funding it with a $25 billion stimulus package to help stem the growing tide of foreclosures. Id.


17. At the request of President Roosevelt, the National Mortgage Association of Washington, a wholly owned subsidiary of the Reconstruction Finance Corporation, was redesignated as FNMA on April 5, 1938. See also FANNIE MAE, AN INTRODUCTION TO FANNIE MAE 4 (Fannie Mae 2008).


19. In 1948, the maximum mortgage loan term was increased from twenty to thirty years; and in 1956, FHA raised the maximum loan-to-value (LTV) ratio
from 80 percent to 95 percent for new construction. Green & Wachter, supra note 7, at 97.

20. In 1940, the American homeownership rate was 43.6 percent. U.S. Census Bureau, General Characteristics of Housing 8 t.2 (1940). By 1980, homeownership had climbed to 65 percent, an almost 50 percent increase. U.S. Census Bureau, Housing Vacancies and Homeownership, Historical Table 14 (2008), www.census.gov/hhes/www/housing/hvs/historic/files/histtab14.xls.


28. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, 12 U.S.C. § 1455 (2007), amended by HERA §§ 1161(c)(2), 1117(b), 122 Stat. at 2653, 2780, 2684. Freddie Mac’s conversion was due in part to the belief that wider shareholding would raise the price of shares held by the then-ailing savings and loan industry. Frame & White, supra note 27.


30. Green & Wachter, supra note 7, at 99. The GSEs buy both bundles of loans and loans already securitized into MBS. The GSEs also retain some loans on their balance sheet.

31. Id.

32. Frame & White, supra note 27, at 160. For the nine months ending on September 30, 2008, Fannie Mae’s average effective guarantee fee rate was 26.4 basis points; Freddie Mac’s average was 17.4 basis points. Fed. Nat’l Mortgage Ass’n, Quarterly Report (Form 10-Q) 17 (Nov. 10, 2008); Fed. Home Loan Mortgage Corp., Quarterly Report (Form 10-Q) 28 (Nov. 10, 2008).

33. See Proposals for Housing, supra note 4.

35. Fed. Nat'l Mortgage Ass'n, supra note 34.
37. Office of Fed. Hous. Enter. Oversight, 2008 Report to Congress 13 (2008) [hereinafter OFHEO]. OFHEO cited operational risks as justification for the increased minimum capital requirements, including continuing deterioration of asset credit quality, increased interest rate risk, and over $5 billion in losses between the enterprises in 2007. Id. at 11–13. However, OFHEO classified the GSEs as “adequately capitalized for all quarters in 2007.” Id. at 13.
38. Frame & White, supra note 27, at 162 tbl. 1.
39. Id.
42. Frame & White, supra note 27, at 163.
44. See Turmoil in US Credit Markets, supra note 40.
45. Frame & White, supra note 27, at 164. The power of the implied guaran-
tee is exemplified by the fact that the GSEs on their own would likely receive an AA- credit rating or less. Cong. Budget Office, Fed. Subsidies and the Housing GSEs 15 (2001).
47. Id. at 2. GSEs are restricted to securitizing only conforming loans in order to limit their secondary market activity to moderate-cost homes. Prior to the passage of HERA, Fannie Mae’s conforming loan limit for 2008 was $417,000. Notice of Final Examination Guidance—Conforming Loan Limit Calculations; Response to Comments, 73 Fed. Reg. 16,898 (Mar. 31, 2008); see also Fannie Mae Historical Conventional Loan Limits (2008), available at www.fanniemae.com/aboutfm/pdf/historicalloanlimits.pdf;jsessionid=515GGX2C380HVJ2FQSHSFGA.
49. See generally Cong. Budget Office, supra note 46.
50. Frame & White, supra note 27, at 165. However, the counterargument that this benefit is outweighed by the systemic risk posed has been given par-
ticular credence by recent events.
51. In a 2003 House Financial Services Committee hearing, Rep. Barney Frank, who is now the chair of that committee, stated, “Fannie Mae and Freddie Mac have played a very useful role in helping make housing more affordable, both in general through leveraging the mortgage market, and in particular, they have a mission that this Congress has given them in return for some of the arrange-
ments which are of some benefit to them to focus on affordable housing...” Hearing on the Treasury Department’s Views on the Regulation of Government Sponsored Enterprises Before the H. Comm. on Financial Services, 108th Cong. 3 (2003).
57. HERA, Pub. L. 110-289, § 1128(b), 122 Stat. at 2653, 2696 (transition section to be codified at 12 U.S.C. §§ 4561(c)). The director of FHFA is required to establish regulations implementing two new goals enacted by HERA. First, the single-family housing goal requires the director to set forth GSE targets for purchasing purchase money originated to low-income families, families living in low-income areas, and very low-income families and refinancing mortgages for low-income families. Id. § 1128 (to be codified at 12 U.S.C. § 4562). The single-family housing goal also requires the GSEs to “report the number of rental housing units affordable to low-income families each year which are contained in mortgages purchased by the enterprise financing 2- to 4-unit single-family, owner-occupied properties and may, by regulation, establish additional requirements relating to such units.” Id. Second, the multifamily special affordable housing goal requires the director to “establish a single annual goal, by either unit or dollar volume, of purchases by each enterprise of mortgages on multifamily housing that finance dwelling units affordable to low-income families.” Id. § 1128 (to be codified at 12 U.S.C. § 1463).
59. 12 U.S.C. § 4564(a). Underserved areas are defined as “metropolitan census tracts with (1) tract median family income less than or equal to 90 percent of AMI or (2) minority concentration of at least 30 percent and tract median family income less than or equal to 120 percent of AMI; dwelling units in “nonmetropolitan counties with (1) median family income less than or equal to 95 percent of the greater of state or national nonmetropolitan median income or (2) minority concentration of at least 30 percent and county median family income less than or equal to 120 percent of the greater of state or national nonmetropolitan median income.” Dep’t of Hous. & Urban Dev., supra note 58.
63. Id.
66. Id. at 11–13; see supra note 62; see also 69 Fed. Reg. 63,590, at tbl.1 (Nov. 2, 2004).
68. Id. at 63,581.
69. Id.
70. Id. at 63,588.
71. Manchester, supra note 65.
72. HUD’s Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005–2008 and Amendments to HUD’s Regulation of Fannie Mae and Freddie Mac, 69 Fed. Reg. 63,600.
73. Id.
74. Id. at 63,601.
75. Id.
76. Id.
77. Id.
78. Manchester, supra note 65, at 4.
81. Id. at 4–5. Freddie Mac attributed the gap to “three factors: the escalation in income-based subgoals levels, the unforeseen precipitous drop in housing affordability beginning in 2005, and the unanticipated collapse of the subprime sector and consequent liquidity crisis beginning in mid-2007.” Id.
83. Factors included the $250,000 long-term capital gains exclusion on primary residences; high volatility in the stock market after the burst of the tech bubble and the events of September 11, 2001; low short-term lending rates, which led to low introductory-rate adjustable-rate mortgages; the widespread easing of mortgage-lending standards; and the national phenomenon of speculative house flipping, which became so popular that several television networks began producing shows spotlighting the practice, including The Real Deal on Learning Channel, Flip That House on Discovery Home Channel, and Flip This House on A&E.
85. “Preliminary evidence indicates that the probability of default is at least six times higher for nonprime loans (loans with high interest rates) than prime loans.” Id at 32.
86. Id.
87. Id.
88. See id.
89. See id. at 35 tbl.2 (showing Countrywide Financial’s 2005 B&C lending matrix).
90. MBS are divided into tranches of risk, with a typical MBS including slices of loans from a wide spectrum of risk-and-return thresholds. Prior to the boom, MBS contained only a small fraction of subprime loans, protecting the value of the securities from even widespread default within the subprime tranche.


92. Id.


95. This equity appreciation was often captured through fees by unscrupulous originators, who then provided borrowers with a new mortgage no more affordable than the one out of which the borrowers were being refinanced.

96. See S&P/CASE-SCHILLER HOME PRICE INDICES, AUGUST 2008, available at www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_cs_mahp/0,0,0,0,0,0,0,0,1,1,0,0,0,0,0.html (last visited Apr. 1, 2009).

97. See Chomsisengphet & Pennington-Cross, supra note 84, at 32.


99. Proposals for Improving, supra note 4, at 6.

100. Id.

101. Id.

102. Private label securities are MBS sold by private firms rather than the GSEs. The GSEs were especially attracted to goal-rich private label securities, the purchase of which counted toward satisfying their HUD-mandated affordable housing goals. See 12 U.S.C. § 4566 (2007), amended by scattered sections of Housing and Economic Recovery Act of 2008, 122 Stat. 2653.


104. Turmoil in US Credit Markets, supra note 40, at 3.

105. Id.

106. See Duhigg, supra note 103.

107. Id.


109. OFHEO, supra note 37, at tbl. 1b, pt. 1.

110. Id.

111. OFHEO, supra note 37, at tbl. 1b, pt. 1.

112. Id.

113. OFHEO, supra note 37, at tbl. 1b, pt. 2.

114. Id.

115. OFHEO, supra note 37, at tbl. 10b, pt. 2. Detailed breakdowns of Freddie Mac's private label securities investments are not available prior to 2006. However, OFHEO reports that Freddie Mac's private label investments in 2004
and 2005, totaling over $300 billion, were "principally backed by subprime or Alt-A loans." Id at n.3.

116. OFHEO, supra note 37, at tbl.14b, pt.2.

117. See OFF. OF THE COMPTROLLER OF THE CURRENCY, SURVEY OF CREDIT UNDERWRITING PRACTICES 2006, at 6. "For the second consecutive year, examiners noted easing of retail credit standards in more than a quarter of the banks surveyed. At the product level, easing was most notable in home equity lending and indirect consumer lending. Easing standards for home equity lending, both conventional and high loan-to-value, include longer interest-only periods, the offering of 'piggy back' loans to avoid mortgage insurance requirements, lower scorecard cutoffs, and higher allowable debt-to-income and loan-to-value ratios." Id.

118. Id. at 7.

119. For example, some lenders offered No Income No Asset (NINA) loans, which required only a credit score to underwrite home equity loans of up to $500,000. This American Life, supra note 91.

120. Turmoil in US Credit Markets, supra note 40, at 5.

121. Id. at 6.

122. Id.

123. OFHEO, supra note 37, at 10.

124. Id. at 20, 41.

125. In its 2008 second-quarter report, Freddie Mac announced its expectation of a substantial dividend cut and a highly dilutive capital raise in order to raise capital. FED. HOME LOAN MORTGAGE CORP., QUARTERLY REPORT (FORM 10-Q) 1 (Aug. 6, 2008).


127. Id. at 11.


130. Press Release, supra note 128.


132. Id at 19–20.

133. Press Release, supra note 128, at 8.

134. Turmoil in US Credit Markets, supra note 40, at 18.

135. Id.


138. Id.

142. Id. at 3; see also Press Release, U.S. Treasury Dep’t Office of Pub. Affairs, Fact Sheet: Government Sponsored Enterprises Credit Facility (Sept. 7, 2008).
144. Press Release, supra note 141, at 3.
147. Id.
149. Id. at 24.
154. Id.
155. FED. HOME LOAN MORTGAGE CORP., supra note 32, at 5; FED. NAT’L MORTGAGE ASS’N, supra note 32, at 7.
156. FED. HOME LOAN MORTGAGE CORP., supra note 32, at 5; FED. NAT’L MORTGAGE ASS’N, supra note 32, at 7. Fannie Mae cited several factors contributing to the reduced demand for its debt securities, including continued market disruptions, market concerns about Fannie Mae’s capital position and future of its business, and the extent of U.S. government support for its business. FED. NAT’L MORTGAGE ASS’N, supra note 32, at 10.
157. Fannie Mae’s single-family mortgage portfolio acquisitions in the third quarter of 2008 totaled $46 billion. FED. NAT’L MORTGAGE ASS’N, supra note 32, at 16. This was down from $61 billion in the second quarter. FED. NAT’L MORTGAGE ASS’N, QUARTERLY REPORT (FORM 10-Q) 2 (Aug. 8, 2008).
158. Freddie Mac’s mortgage portfolio acquisitions for the third quarter of 2008 totaled $32 billion. FED. HOME LOAN MORTGAGE CORP., supra note 32, at 99. This was up from $27 billion during the second quarter. FED. HOME LOAN MORTGAGE CORP., supra note 125, at 77.
159. FED. HOME LOAN MORTGAGE CORP., supra note 32, at 24.
161. Id.
165. Id. at 13.
167. Id. at 2.
168. Id.
169. Id.
171. Freddie Mac does not typically securitize multifamily mortgages. Fed. HOME LOAN MORTGAGE CORP., supra note 32, at 43.
179. Id. at 117. Fannie Mae considers serious delinquency a leading indicator of potential foreclosure.
180. Id.
181. Fed. Home Loan Mortgage Corp., supra note 32, at 12. Freddie Mac’s multifamily segment’s success did little, however, to offset the approximately $4.6 billion loss suffered by its single-family and investments segments.
182. Id. at 13; Fed. Home Loan Mortgage Corp., supra note 125, at 7.
183. Fed. Home Loan Mortgage Corp., supra note 32, at 85. Seriously delinquent loans are loans more than ninety days past due. Id. at n.4.
184. Id. at 44.
185. Id.; Fed. Home Loan Mortgage Corp., supra note 125, at 32.
186. See Telephone Interview with Alexander Gross, supra note 174.
187. Id.
188. Id.
189. See id.
190. The LIHTC is found in § 42 of the Internal Revenue Code. See generally I.R.C. § 42 (2008).
194. During 2008, Fannie Mae did sell some investments in LIHTC partnerships for cash: “During the nine months ended September 30, 2008, we sold for cash a portfolio of investments in LIHTC partnerships reflecting approxi-
mately $858 million in future LIHTC tax credits and the release of future capital obligations relating to these investments." Fed. Nat’l Mortgage Ass’n, supra note 32, at 154. Fannie Mae’s LIHTC investments had an estimated fair value of $7.2 billion as of the close of the third quarter. Id. at 190 n.7.

195. Id. at 169.

196. Id. at 170.

197. Fannie Mae “had a recorded investment in LIHTC partnerships of $6.7 billion as of September 30, 2008, compared with $8.1 billion as of December 31, 2007.” Id. at 110.


199. Id. at 45.

200. Id. at 144.


204. § 1131, 122 Stat. at 2711.

205. § 1131, 122 Stat. at 2712. The Home Ownership Preservation Entity Fund is designed to fund the mortgage insurance provision of the HOPE for Homeowners program, which insures refinanced loans for distressed borrowers. § 1131, 122 Stat. at 2806.

206. § 1131, 122 Stat. at 2806. The Capital Magnet Fund is a program designed to attract private capital for and increase investment in affordable housing for extremely low- and very low-income families and economic development activities in low-income and underserved areas. § 1131, 122 Stat. at 2723–27.


208. HERA § 1131, 122 Stat. at 2653, 2654, 2712.


211. § 1131, 122 Stat. at 2711.

212. See Turmoil in US Credit Markets, supra note 40, at 17.


214. For example, utilizing the GSEs to promote conscientious affordable housing activities rather than encouraging the expansion of subprime lending.

215. Statement of Bob Moss, Senior Vice President of Boston Capital, American Bar Association “State of the Affordable Housing Industry” Teleconference (Dec. 2, 2008) (notes on file with the author). Mr. Moss anticipated that only three in eight projects awarded tax credits would begin construction in 2009.