

History of the Government Sponsored Enterprises

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The housing Government-Sponsored Enterprises (GSEs) have a long history. Understanding the role that these organizations played historically in the mortgage markets is important to understanding the financial crisis, its causes, and lessons for the future.

The housing GSEs are the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank System (FHLBank System), which currently consists of 12 Federal Home Loan Banks (FHLBanks).

Housing Finance Before Federal Involvement

Before the Great Depression of the 1930s, housing finance was exclusively the realm of the private sector. Housing finance generally consisted of short term renewable loans. The features of these loans, which included high down payments (approximately half the home's purchase price), short maturities (10 years or less), and large **balloon payments**, presented significant challenges to widespread home ownership.^[1] The primary source of mortgage funding came from life insurers, commercial banks, and **thrifts**.^[2] In the absence of a nationwide housing finance market, availability and pricing for mortgage loans varied widely across the country.^[3]

The Great Depression

The Great Depression proved as traumatic to the nation's housing market as it was to the U.S. economy. By 1932, the unemployment rate had risen to 23.6%.^[4] and by early 1933, the government estimated that 20% to 25% of the nation's home mortgage debt was in default.^[5]

Federal Response to the Depression Era Housing Crisis

The federal government began its response to the housing crisis in 1932, with the enactment of the Federal Home Loan Bank Act (the Bank Act). The Bank Act created the FHLBank System and the Federal Home Loan Bank Board (FHLBank Board) as its regulator.^[6] The federal government also created the Home Owners' Loan Corporation (HOLC), the Federal Housing Administration (FHA), and Fannie Mae.

Federal Home Loan Bank System

The FHLBank System was designed to serve as a reserve credit system to support housing finance and provide relief to troubled homeowners and lending institutions.^[7] Member institutions, including building and loan associations, cooperative banks, homestead associations, insurance companies, and savings banks, were required to purchase the stock of the regional FHLBanks.^[8] The Bank Act provided the FHLBanks with budgetary authority to borrow up to \$215 million from Treasury and issue tax-free bonds as a source of funds for the benefit of member institutions.^[9]

Creation of Home Owners' Loan Corporation

In June 1933, as part of the New Deal, President Roosevelt signed into law the Home Owners' Loan Act.^[10] This Act established the HOLC. The HOLC was managed by the FHLBank Board, and its key role was to refinance mortgages to slow down the rate of foreclosures.^[11] The HOLC established a precedent by introducing long-term, fixed-rate mortgage financing, specifically a **self-amortizing**, fixed-rate mortgage. The HOLC stopped making loans in 1936 and ultimately ceased operations in 1951.^[12]

Creation of Federal Housing Administration

Another New Deal measure, the National Housing Act, was enacted in 1934. It established FHA to offer federally backed insurance for home mortgages made by **FHA approved lenders**.^[13] FHA insurance protected approved lenders against losses on the mortgages they originated. FHA insurance gave lenders added security and expanded the pool of potential homebuyers for whom lenders were willing to underwrite loans.^[14] FHA financed its operations through insurance premiums charged to borrowers and interest earned on its reserves.^[15] Further, FHA expanded the use of fixed-rate, long-term mortgages.

Creation of Fannie Mae

A 1938 amendment to the National Housing Act established Fannie Mae.³ Originally, Fannie Mae was a federal government agency. Its mandate was to act as a secondary mortgage market facility that could purchase, hold, and sell FHA-insured loans. By purchasing FHA-insured loans from private lenders, Fannie Mae created liquidity in the mortgage market, providing lenders with cash to fund new home loans.

TIMELINE

1930s:

- 1932 Federal Home Loan Bank Act is passed, creating the FHLBank System
- 1933 Home Owners' Loan Act is passed, creating the Home Owners' Loan Corporation
- 1934 National Housing Act enacted, establishing the Federal Housing Administration
- 1938 Fannie Mae established

1940s:

- 1944 GI Bill authorizes VA mortgage loans and Fannie Mae's purchases of such mortgages

1950s:

- 1964 Charter Act reorganizes Fannie Mae

1960s:

- 1960 Fannie Mae reorganized as publicly-traded, shareholder-owned company
- 1960 Housing and Urban Development Act of 1960 created the Government National Mortgage Association ("Ginnie Mae")

1970s:

- 1970 Freddie Mac created
- 1971 Freddie Mac offers its first conventional Mortgage-Backed Security
- 1970s and early 1980s: Fannie Mae and Freddie Mac pursue differing business strategies: Fannie Mae holds mortgages in portfolio, while Freddie Mac securitizes them

1980s:

- Early 1980s: Fannie Mae suffers financial deterioration due to rising interest rates, while Freddie Mac's losses are limited due to securitization strategy
- 1980 Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) is passed to address the savings and loan crisis
- 1980 Freddie Mac becomes a publicly traded, shareholder-owned company

1990s:

- 1992 Federal Housing Enterprises Financial Safety and Soundness Act enacted, creating the Office of Federal Housing Enterprise Oversight
- 1995 HUD establishes new goals for Fannie Mae and Freddie Mac, requiring them to meet an "affirmative obligation to facilitate the financing of affordable housing for low-income and moderate-income families"

2000s:

- 2000s: Fannie Mae and Freddie Mac begin purchasing Alt-A and subprime mortgages
- 2006 Housing prices begin to fall nationwide for the first time since the 1930's
- 2008 Housing and Economic Recovery Act enacted, creating FHFA and FHFA-CE
- 2008 Fannie Mae and Freddie Mac enter FHFA-supervised conservatorships

Balloon Payment:
A payment the borrower must make to the lender at the mortgage term's end. This final payment is comparatively much larger than the payments that preceded it.

Thrift:
An organization that primarily accepts savings account deposits and invests most of the proceeds in mortgages. Savings banks and savings and loan associations are examples of thrift institutions.

Self-Amortizing Loans:
Loans in which periodic payments of principal and interest are scheduled over the life of the loan. Self-amortizing loans provide more opportunity for homeownership by allowing these scheduled payments, as opposed to large balloon payments at maturity (the end of the loan term).

FHA Approved Lenders:
Financial institutions that have been approved by FHA for the origination and servicing of FHA-insured mortgages.

Creation of Veterans Administration Mortgages

The mortgage market remained relatively unchanged following the establishment of Fannie Mae until 1944, when the Servicemen's Readjustment Act (commonly known as the GI Bill) created the Veterans Administration (VA) mortgage insurance program.[16] The program offered veterans long-term, low-cost mortgages. Fannie Mae began to purchase VA-insured loans in 1948, and its business grew rapidly.[17]

Reorganizations of Fannie Mae

The Federal National Mortgage Association Charter Act of 1954 (Charter Act) transformed Fannie Mae from a government agency into a public-private, mixed ownership corporation.[18] b The Charter Act also exempted Fannie Mae from all state and local taxes, except real property taxes.[19]

The Housing and Urban Development Act of 1968 (the 1968 HUD Act) reorganized Fannie Mae from a mixed ownership corporation to a for-profit, shareholder-owned company.[20] This reorganization removed Fannie Mae from the federal budget,[21] and Fannie Mae began funding its operations through the stock and bond markets.

The 1968 HUD Act also gave HUD regulatory authority over Fannie Mae, including authority to require that it devote a reasonable portion of mortgage purchases to low- and moderate-income housing.[22]

Creation of Ginnie Mae

The 1968 HUD Act also created a new housing finance organization, the Government National Mortgage Association (Ginnie Mae).[23] Unlike Fannie Mae, Ginnie Mae was established as a government owned corporation within HUD.[24] a structure it retains to this day. For a fee, Ginnie Mae guarantees timely payment of principal and interest on privately issued mortgage-backed securities (MBS) collateralized by FHA, VA, or other government insured or guaranteed mortgages.[25] In contrast, Fannie Mae and Freddie Mac (the Enterprises) typically purchase conventional conforming mortgage loans. They also issue and guarantee MBS collateralized by these mortgage loans or hold mortgage loans and MBS in their portfolios.

Creation of Freddie Mac

In 1970, the secondary mortgage market was expanded when Congress passed the Emergency Home Finance Act, which established Freddie Mac.[26] to help thrifts manage the challenges associated with **interest rate risk**.

Interest Rate Risk:
 The exposure of an institution's financial condition to adverse movements in interest rates.

The FHLBanks originally capitalized Freddie Mac with a \$100 million contribution.[27] Freddie Mac began to purchase long-term mortgages from thrifts, increasing their capacity to fund additional mortgages and reducing their interest rate risk. The Act also authorized Fannie Mae and Freddie Mac to buy and sell mortgages not insured or guaranteed by the federal government.[28] In 1971, Freddie Mac issued the first conventional loan MBS.

Fannie Mae's and Freddie Mac's Business Practices in the 1970s and 1980s

Although both Fannie Mae and Freddie Mac provided lenders a secondary market for conventional mortgages, they pursued different business strategies during the 1970s and 1980s. Freddie Mac focused its business activities on purchasing conventional conforming mortgages from thrifts and issuing MBS rather than holding these mortgages in its portfolio. In doing so, Freddie Mac transferred the interest rate risks associated with the mortgages that it purchased to investors in its MBS. **By contrast, Fannie Mae followed its traditional business strategy of purchasing mortgage loans and holding them in its portfolio, which increased its interest rate risk.**[29]

The inflation and recessions of the late 1970s and early 1980s and the sharp rises in interest rates that accompanied them put tremendous financial strain on Fannie Mae and many thrifts, which funded their mortgage holdings principally with short term obligations such as deposits. By contrast, Freddie Mac's financial performance was relatively unaffected because of its emphasis on issuing MBS.[30]

During this period, the federal government provided financial benefits to Fannie Mae, such as regulatory forbearance and tax benefits, to help Fannie Mae recover from its financial losses.[31] Additionally, the Garn-St. Germain Depository Institutions Act of 1982 permitted thrifts to diversify their investments into potentially more profitable, but riskier, investment and loan activities. Due to the associated risks, many thrifts experienced substantial losses because of risky loans and investments, a condition that was aggravated by the recession of the early 1980s.[32]

Freddie Mac Reorganized

The savings and loan crisis of the 1980s resulted in billions of dollars of losses throughout the housing market. By 1989, the **Federal Savings and Loan Insurance Corporation (FSLIC)**, which provided deposit insurance for thrift customers, was insolvent. In response, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) in 1989. Among its provisions, FIRREA abolished the FSLIC, transferred its assets, liabilities, and operations to the newly created FSLIC Resolution Fund, and created a new insurance fund for thrift depositors known as the Savings Association Insurance Fund. FIRREA also created the Resolution Trust Corporation to resolve all troubled financial institutions placed into conservatorship or receivership.[33] Ultimately, the savings and loan crisis cost taxpayers about \$125 billion and the thrift industry \$29 billion.[34]

Federal Savings and Loan Insurance Corporation (FSLIC):
 Created by the National Housing Act of 1934, the FSLIC, which was administered by the FHLBank Board, insured savings and loan deposits until 1989.

FIRREA also reorganized Freddie Mac's corporate structure to one similar to Fannie Mae's: a for-profit corporation owned by private shareholders rather than by the FHLBanks.

FIRREA also restructured the regulatory framework for FHLBanks by abolishing the FHLBank Board. FIRREA assigned oversight responsibilities of the FHLBanks to the newly created Federal Housing Finance Board and opened membership in the FHLBank System to depository institutions (including eligible commercial banks and credit unions) that had more than 10% of their loan portfolios in residential mortgage-related assets.[35] As a result of this change, despite the closing of troubled thrifts, FHLBank System membership increased between 1989 and 2005 from 3,200 to more than 8,000, and total assets grew from approximately \$175 billion to \$1 trillion.[36]

1992 GSE Reforms

Given ongoing concerns about regulatory oversight of Fannie Mae and Freddie Mac, Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, which created the Office of Federal Housing Enterprise Oversight (OFHEO) as an independent regulator within HUD. OFHEO had the authority to conduct routine safety and soundness examinations of Fannie Mae and Freddie Mac and to take enforcement actions.[37]

Further, the measure amended Fannie Mae's and Freddie Mac's charters, requiring them to meet an "affirmative obligation to facilitate the financing of affordable housing for low-income and moderate-income families." [38] In 1995, HUD began to require Fannie Mae and Freddie Mac to meet certain mortgage purchase goals each year.[39]

Fannie Mae and Freddie Mac: 2000-2008

In 2003 and 2004, controversy arose concerning the Enterprises' accounting practices. Additionally, from about 2004 through 2007, Fannie Mae and Freddie Mac embarked on aggressive strategies to purchase mortgages and mortgage assets originated under questionable underwriting standards. For example, the Enterprises purchased large volumes of **Alt-A mortgages**, which typically lacked full documentation of borrowers' incomes and had higher loan-to-value or debt-to-income ratios. They also purchased private-label MBS collateralized by **subprime mortgages**.

In 2007 and 2008, housing prices plummeted and loan delinquencies and defaults significantly increased. Fannie Mae and Freddie Mac lost billions of dollars on their investment portfolios and MBS guarantees, including MBS collateralized by Alt-A loans.^[40] As foreclosures and losses increased, investor confidence in the Enterprises deteriorated. This led to a sharp increase in the Enterprises' borrowing costs and drastic declines in shareholder equity, triggering concerns about their potential failure and its broader implications.

During the mid-2000s, several FHLBanks also purchased large volumes of private-label MBS for their mortgage investment portfolios. Subsequently, many FHLBanks suffered financial deterioration due to their investments in private-label MBS collateralized by subprime mortgages. For example, FHFA's Acting Director stated that 6 of the 12 FHLBanks experienced financial challenges in 2009 primarily as a result of deterioration in the value of their private-label securities. Four of these six FHLBanks recorded cumulative net losses in the first three quarters of 2009: Boston, Chicago, Pittsburgh, and Seattle.^[41]

Accounting Problems of Fannie Mae and Freddie Mac

In 2003, Freddie Mac disclosed it had used improper accounting. OFHEO found that Freddie Mac had misstated earnings by \$5 billion between 2000 and 2003 and fined Freddie Mac \$175 million.

OFHEO also investigated Fannie Mae accounting problems and reported:

- "during the period ... 1998 to mid-2004, Fannie Mae reported extremely smooth profit growth ... those achievements were illusions deliberately and systematically created by the Enterprise's senior management with the aid of inappropriate accounting and improper earnings management."
- "... the Enterprise also had serious problems of internal control, financial reporting, and corporate governance."
- Fannie Mae engaged in excessive risk-taking, which included increased holdings of subprime and Alt-A private-label MBS and the use of derivatives to manage the interest-rate risk of GSE investment portfolios.
- Those errors resulted in Fannie Mae overstating reported income and capital by an estimated \$10.6 billion.

Fannie Mae paid a \$400 million civil penalty.

The misapplication of accounting rules served to smooth out variations in the Enterprises' reported earnings over time, masking their volatility and giving the Enterprises the appearance of low-risk companies. Among the accounting rule violations was their improper booking of derivatives, which the companies used to hedge against the effects of movements in interest rates on their investment portfolio of mortgages. These improper accounting practices ultimately led to the Securities and Exchange Commission directing Fannie Mae to restate its financial results for 2002 through mid-2004; the departure of the CEO, Franklin Raines, and the CFO, Timothy Howard; and losses of tens of billions of dollars in market capitalization for Fannie Mae shareholders. OFHEO estimated that expenses for the restatement process, regulatory examinations, investigations, and litigation would exceed \$1.3 billion in 2005 and 2006.

Congress enacted HERA in July 2008. Less than six weeks later, FHFA placed Fannie Mae and Freddie Mac into conservatorships, where they remain today. The FHFA Office of Inspector General, an independent oversight and law enforcement arm of FHFA, has begun an array of audits and evaluations examining FHFA's regulation of the housing GSEs and its conservatorships of Fannie Mae and Freddie Mac.

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Prime Mortgages:

A classification of mortgages that are considered to be of high quality.

Alt-A Mortgages:

A classification of mortgages in which the risk profile falls between prime and subprime. Alt-A mortgages are generally considered higher risk than prime due to factors that may include higher loan-to-value and debt-to-income ratios or limited documentation of the borrower's income.

Subprime Mortgages:

A classification of mortgages with a higher perceived risk of default than prime and Alt-A loans. Interest rates on subprime mortgage loans are often higher, reflecting the greater risk.

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