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GSEs and the Government's Role in Housing Finance: Issues for the 113th Congress

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Summary

The federal government's role in the mortgage market dates to the Depression and is considered by many to be substantial: Fannie Mae, Freddie Mac, and Ginnie Mae (officially the Government National Mortgage Association, which is part of the Department of Housing and Urban Development) together guarantee virtually all new mortgage-backed securities (MBS). With slightly less than $10 trillion in mortgages outstanding, the residential mortgage market is of central importance both to households and to lenders.

As government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac have special privileges and obligations. Their congressional charters give them a close relationship to the federal government that is widely (but not universally) viewed as an implicit federal guarantee of their bonds and MBS. Broadly speaking, their role is to ensure appropriate availability of mortgages to creditworthy households. By law, the GSEs purchase mortgages from lenders, and either hold the mortgages as investments or pool the mortgages into mortgage-backed securities, which are sold to institutional investors. The GSEs guarantee that investors in these MBS will receive timely payment of principal and interest even if the borrower becomes delinquent.

In September 2008, the GSEs individually agreed with their regulator, the Federal Housing Finance Agency (FHFA), that unexpected mortgage delinquencies and resulting losses jeopardized their solvency. The GSEs agreed to direct government control, known as voluntary conservatorship, which is the equivalent of bankruptcy reorganization for a financial company. As part of the agreement to conservatorship, Treasury contracted to provide financial support to keep the GSEs solvent. Pursuant to this agreement, which has been amended three times, the federal government has purchased more than $187 billion in special stock from Fannie Mae and Freddie Mac. In addition, the government holds $821 billion in MBS issued by Fannie Mae and Freddie Mac. The agreement requires Treasury to provide up to $274 billion of additional funds, if necessary. In return for this support, Treasury receives special stock and other considerations.

The 113th Congress and the Administration are deliberating how and when to unwind the federal control of Fannie Mae and Freddie Mac, and what (if any) is the proper role of the federal government in the nation's mortgage markets. Some proposals have called for reducing the government's support of Fannie Mae and Freddie Mac, selling off their assets, and revoking their congressional charters. Other proposals have concentrated not so much on unwinding Fannie Mae and Freddie Mac, as on replacing them with new institutions.

It is not only Fannie Mae and Freddie Mac that have raised issues. At the end of FY2012, the Federal Housing Administration (FHA), which is part of the Department of Housing and Urban Development, reported the fund backing its insured mortgages had a negative net worth of -1.44%.

This report examines options concerning the future of the GSEs and the future government role in residential mortgage markets. Other CRS reports address related issues such as conservatorship, the GSEs' financial condition, residential mortgage markets in other nations, and affordable housing.

This report will be updated as warranted.

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Introduction

The federal government's role in the mortgage market dates to the Depression, when Fannie Mae (officially the Federal National Mortgage Association) and the Federal Housing Administration (FHA, which is part of the Department of Housing and Urban Development, HUD) were created. Many consider its role to be substantial: Fannie Mae, Freddie Mac (which Congress created as the Federal Home Loan Mortgage Corporation in 1970), and Ginnie Mae (officially, the Government National Mortgage Association and part of HUD)[1] guarantee virtually all of the mortgage-backed securities (MBS) newly issued. In recent years, Fannie Mae and Freddie Mac jointly have been responsible for approximately 45% of residential mortgages outstanding. With slightly less than $10 trillion in mortgages outstanding, the residential mortgage market is of central importance both to households and to lenders. In addition, FHA and Ginnie Mae, the Department of Veterans' Affairs, and the Department of Agriculture's Rural Housing make full faith and credit mortgage guarantees.[2]

As government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac have special privileges and obligations, though they are corporate entities with shareholders. Broadly speaking, the GSEs' role is to ensure appropriate availability of mortgages to creditworthy households. By law, the GSEs purchase mortgages from lenders, and either hold the mortgages as investments or pool the mortgages into MBS, which are sold to institutional investors. The GSEs guarantee that investors in these MBS will receive timely payment of principal and interest even if the borrower becomes delinquent. Their congressional charters give them a close relationship to the federal government that is widely (but not universally) viewed as providing an implicit federal guarantee of their bonds and MBS.

In September 2008, the GSEs individually agreed with their regulator, the Federal Housing Finance Agency (FHFA), that unexpected mortgage delinquencies and resulting losses jeopardized their solvency. The GSEs agreed to direct government control, known as conservatorship, which is the equivalent of bankruptcy reorganization for financial companies. As part of the agreement to conservatorship, Treasury agreed to provide financial support to keep the GSEs solvent. To date, Treasury has provided $116 billion to keep Fannie Mae solvent and $72 billion to keep Freddie Mac solvent.[3] The agreement has been amended three times.[4] It currently requires Treasury to provide, as needed, up to an additional $125 billion to Fannie Mae and an additional $149 billion to Freddie Mac. In return for this support, Treasury receives senior preferred stock valued at the amount of support provided. At the signing of the support agreements, each GSE gave Treasury $1 billion of senior preferred stock and warrants to purchase 79.9% of the common stock in each.

[1] Ginnie Mae insures mortgage-backed securities that are supported by government-insured mortgages.

[2] For more information on federal housing programs in general, see CRS Report RL34591, *Overview of Federal Housing Assistance Programs and Policy*, by Maggie McCarty et al. For information on FHA's financial status see CRS Report R42875, *The FHA Single-Family Mortgage Insurance Program: Financial Status and Related Current Issues*, by Katie Jones.

[3] FHFA, "Current Data on Treasury and Federal Reserve Purchase Programs for GSE and Mortgage-Related Securities," December 18, 2012, at http://www.fhfa.gov/webfiles/24847/TSYSupport%202012-12-18.pdf.

[4] The original agreements and the three amendments are available on the FHFA website at http://www.fhfa.gov/Default.aspx?Page=364.

The Treasury and the Federal Reserve together purchased $1.357 billion of MBS under a special program that ended in March of 2010. On December 12, 2012, the Federal Reserve announced a new program to purchase approximately $45 billion of MBS monthly.[5] Holdings of MBS are reduced by scheduled mortgage payments and by refinancing mortgages. At the end of 2012, the Federal Reserve and Treasury held $821 billion of Fannie Mae's and Freddie Mac's MBS.[6]

The 113th Congress continues deliberation started in earlier Congresses as to how and when to unwind the federal control of Fannie Mae and Freddie Mac, and what (if any) is the proper role of the federal government in the nation's mortgage markets. Some proposals called for reducing the government's support of Fannie Mae and Freddie Mac, selling off their assets, and revoking their congressional charters. Other proposals concentrated not so much on unwinding Fannie Mae and Freddie Mac, as on replacing them with new institutions.

This report concentrates on the GSEs' and the government's roles in supporting home mortgages. Other reports examine the causes of the GSEs' financial problems,[7] the nature of the GSEs' conservatorship,[8] federal housing programs,[9] and the maximum loan amount on mortgages purchased by the GSEs.[10]

GSE Background

As is discussed in more detail below, the GSEs purchase mortgages from lenders, package the mortgages into MBS, and either keep the MBS "in portfolio" or sell them to institutional investors. To finance the MBS that they keep, the GSEs sell bonds to investors. Because of their close connection with the federal government and the implicit government guarantee, the GSEs' bonds have traditionally been considered safer than what is implied by their finances. Because of this perception of safety, the bonds pay interest rates that usually are only slightly more than the federal government pays. This ability to borrow relatively inexpensively allows the GSEs to be more profitable.

After years of profitability, the financial turmoil of 2008 caused the market to question the GSEs' financial strength. In September 2008, during extreme financial turmoil and growing concern over financial losses, Fannie Mae and Freddie Mac individually agreed to be placed under voluntary conservatorship with FHFA.[11] For the GSEs, as is the case for most financial companies, conservatorship is roughly the equivalent of bankruptcy reorganization. Under

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[5] Federal Reserve Bank of New York, "Statement Regarding Purchases of Treasury Securities and Agency Mortgage-Backed Securities," December 12, 2012, at http://www.newyorkfed.org/markets/opolicy/operating_policy_121212.html.

[6] Federal Reserve, "H.4.1 Factors Affecting Reserve Balances," December 27, 2012, at http://www.federalreserve.gov/releases/h41/20121227/ and Treasury, "Monthly Treasury Statement of Receipts and Outlays of the United States Government," December 2012, at http://fms.treas.gov/mts/mts1212.pdf.

[7] CRS Report RL34661, *Fannie Mae's and Freddie Mac's Financial Problems*, by N. Eric Weiss.

[8] CRS Report RL34657, *Financial Institution Insolvency: Federal Authority over Fannie Mae, Freddie Mac, and Depository Institutions*, by David H. Carpenter and M. Maureen Murphy.

[9] CRS Report R42145, *Housing Issues in the 112th Congress*, coordinated by Katie Jones.

[10] CRS Report RS22172, *The Conforming Loan Limit*, by N. Eric Weiss and Sean M. Hoskins.

[11] Gretchen Morgenson and Charles Duhigg, "Mortgage Giants Overstated Size of Capital Base," *The New York Times*, September 7, 2008, p. 1.

conservatorship, senior executives are replaced and stockholders have no input on management of the company. This happened to the GSEs. By law, the goal of conservatorship is to put the company on a sound financial footing, after which the company is returned to stockholder control. If this cannot be accomplished, the firm is placed in receivership, which is roughly the equivalent of dissolving a bankrupt company. In certain situations their receivership is mandatory and in others receivership is voluntary.

From their start, the GSEs have been controversial because of the perceived conflicts between their public purpose and their responsibility to maximize stockholder value. As is discussed in more detail later, the advantages of GSE status has made it difficult for other companies to compete against the GSEs. Congress debated GSE regulatory reform in the 108th, 109th, and 110th Congresses,[12] eventually passing the Housing and Economic Recovery Act of 2008 (P.L. 110-289).

The GSEs' mission has changed over time. Fannie Mae's and Freddie Mac's current charters contain five purposes:

1. To stabilize the secondary mortgage market for residential mortgages;
2. To respond "appropriately" to the capital market;
3. To increase the liquidity of mortgages (including mortgages for low- and moderate-income families);
4. To promote access to mortgage credit in all areas of the nation (including underserved areas); and
5. To "manage and liquidate federally owned mortgage portfolios in an orderly manner, with a minimum of adverse effect upon the residential mortgage market and minimum loss to the Federal Government."[13]

It could be argued that between the time Fannie Mae and Freddie Mac became GSEs and the time that they were placed in conservatorship, they accomplished these goals except, perhaps, for operating with minimum loss to the federal government. Even under conservatorship, they continued (with assistance from the federal government) to fulfill their mission, although it can again be contested that they have operated with minimal loss to the federal government.

HERA temporarily authorized greater standby government support for the GSEs, including the Federal Home Loan Banks (FHLBanks), by allowing the Secretary of the Treasury to purchase stock from the GSEs. In addition, HERA created a new, stronger GSE regulator, the Federal Housing Finance Agency (FHFA), to replace the Office of Federal Housing Enterprise Oversight (OFHEO).

As mentioned earlier, FHFA and the GSEs agreed to voluntary conservatorship, in which FHFA assumed control of Fannie Mae and Freddie Mac. Each GSE sold to Treasury $1 billion of senior preferred stock and gave Treasury warrants to purchase 79.9% of its common stock.[14] Treasury

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[12] These bills were S. 1508 in the 108th Congress, S. 190 and H.R. 1461 in the 109th, and H.R. 1427 in the 110th.

[13] 12 U.S.C. 1716 (Fannie Mae), and 12 U.S.C. 1451 Note (Freddie Mac).

[14] Holders of a company's preferred stock do not elect the board of directors or otherwise exercise control over the firm, but payment of their specified dividend has a priority over the payment of dividends to common stockholders. A warrant is a type of option issued by a company to purchase stock at a specified price.

agreed to purchase a maximum of $100 billion (later raised to $200 billion) additional senior preferred stock to maintain a positive net worth of each GSE. The first amendments to the agreements raised the support to a maximum of $200 billion each. The second amendments provided unlimited support from 2010 to 2012. This support does not count against the $200 billion maximums. The third amendments changed the 10% cash dividend paid to Treasury to have the GSEs pay all of their quarterly profits to Treasury. In the event that there are no profits in a quarter, no dividend is owed.

In addition, the Federal Reserve has extended financial assistance to the GSEs by purchasing MBS and bonds.[15] By law, conservatorship will end with their return to stockholder control if the GSEs become safe and solvent or with receivership if they are unable to pay their debts.[16]

Provisions in HERA require that a GSE be placed in mandatory receivership and its assets liquidated if (1) the GSE's assets have been less than its liabilities for 60 consecutive days, or (2) the GSE has not been paying its bills (except for debts subject to bona fide dispute) for the past 60 days.[17] Thus far, mandatory receivership has been avoided because of the assistance from Treasury.

The remainder of this report discusses alternatives available to Congress for restructuring or replacing Fannie Mae and Freddie Mac. The list is not exhaustive—it probably is impossible to develop a complete list. The options take as a starting point that Fannie Mae and Freddie Mac return to financial health and are able to leave their current conservatorship. Unless modified by Congress or Treasury, the profit-sweep dividend on the senior preferred stock will prevent the GSEs from accumulating additional funds that could be used to return to stockholder control.

In debating alternatives for the futures of Fannie Mae and Freddie Mac, Congress might wish to consider whether the five goals are still germane. For example, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (P.L. 103-328) may have made the fourth point in the GSEs' charters (promoting mortgage credit throughout the nation) unnecessary because the act allowed interstate banking and led to more equal access to credit throughout the nation.

Fannie Mae's and Freddie Mac's Business Models

This section uses Fannie Mae's and Freddie Mac's business models to provide a basis for understanding their roles in the housing finance system and their problems. Fannie Mae's and Freddie Mac's business models have evolved similarly. They both

- sell bonds to purchase mortgages;
- purchase single-family mortgages that other companies have originated;[18]

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[15] Federal Reserve Bank of New York, "FAQs: MBS Purchase Program," press release, March 24, 2009, http://www.newyorkfed.org/markets/mbs_faq_090324.html and Federal Reserve Bank of New York, "FAQs: Purchasing Direct Obligations of Housing-Related GSEs," press release, April 21, 2009, http://www.newyorkfed.org/markets/gses_faq_090421.html.

[16] Federal Housing Finance Agency, "Questions and Answers on Conservatorship," press release, September 7, 2008, http://www.fhfa.gov/webfiles/35/FHFACONSERVQA.pdf.

[17] P.L. 110-289, Sec. 1145. Actual dissolution of a GSE would require Congressional action.

[18] In addition, the GSEs purchase multifamily mortgages. These multifamily mortgages are a relatively small portion of (continued...)

- guarantee investors that the mortgages will be paid and pool the mortgages to create MBS;
- charge sellers a fee to guarantee these mortgages;
- sell the MBS to institutional investors, or keep them in their own investment portfolios. If the GSE decides to keep the MBS, it uses the money raised by selling the bonds to finance these MBS. Otherwise it uses the proceeds from selling the MBS to purchase more mortgages.

For many years, the GSEs were very profitable using this business model because they were widely viewed as having a close relationship to the federal government.[19] Some called it an implicit federal guarantee of their bonds and MBS. This allowed the GSEs to guarantee their MBS and to finance their investment portfolios at lower cost than competitors, which had neither GSE charters nor a special relationship with the federal government. GSE profitability was increased by their charter provisions such as those exempting them from state and local income taxes, and by lower capital requirements than their non-GSE competitors.[20] To enhance profits, the GSEs use a variety of techniques, some of which increased the riskiness of the GSEs' finances:

- Because short-term interest rates are normally lower than longer-term interest rates, the GSEs finance their investment portfolios of MBS by borrowing for short periods of time. This strategy could result in losses if interest rates were higher when this debt was refinanced.[21] The GSEs reduced their vulnerability to increased interest rates by the use of financial derivatives.
- Having nationwide geographic diversification reduced the GSEs' credit or default risk. Regional declines in home prices—such as the home price decline of approximately 25% between 1985 and 1990 in the "Oil Patch"—were balanced by stable prices in other areas. The GSEs further reduced their risk by purchasing insurance from financial guaranty companies.
- The GSEs found profitable ways to satisfy the requirement in their charters that mortgages for more than 80% of the value of a house have credit enhancements such as mortgage insurance. For example, one GSE would purchase the first mortgage for 80% of a home's value, and the other GSE would purchase a second mortgage for 5% or even 15% of the same home's value. This resulted in larger mortgages and more fees for the GSEs, but increased the severity of losses when defaults occurred.

(...continued)

the GSEs' purchases.

[19] The precise value of the GSE charter has not been estimated. According to Daniel Mudd, who was at the time chief executive officer of Fannie Mae, in 2005 Fannie Mae considered turning in its charter, but could not find a more attractive business opportunity. See Daniel H. Mudd, "Memorandum for the Record," Financial Crisis Inquiry Commission, March 26, 2010, http://c0181567.cdn1.cloudfiles.rackspacecloud.com/2010-03-26%20FCIC%20memo%20of%20staff%20interview%20with%20Dan%20Mudd,%20Fannie%20Mae.pdf.

[20] Capital is defined by law and regulation, and is similar to cash or government bonds in that it is very liquid and pays little or no interest.

[21] Most 30-year mortgages are paid off in 7 to 10 years because of refinancing or moving. On average, the GSEs need to finance a 30-year mortgage (or MBS) held in portfolio for this 7 to 10 year time period.

- Tax planning techniques, including purchasing tax-exempt bonds and low-income housing tax credits (LIHTCs), reduced the GSEs' tax liabilities. The risk of these strategies was that if the GSEs' earnings did not meet expectations, the benefits of tax planning expenditures may not be fully realized and could increase losses.
- Compared with many other types of financial institutions, the GSEs were required to keep less capital as a reserve against possible losses. This increased leverage made possible higher profits, but increased the risk of larger losses or financial failure compared to holding more capital.

Liquidation and Alternatives

If FHFA's conservatorship is not able to return the GSEs to financial health, there are at least two approaches that could avoid complete liquidation of the GSEs.

"Bad Bank" Option

First, the "bad bank" approach would mirror one technique used by the Federal Deposit Insurance Corporation (FDIC) to resolve insolvent banks.[22] The FDIC creates a "bad bank" to hold the problem assets, leaving the good assets with the original bank. Without the problem assets, the original bank is financially viable and possibly able to attract new capital. In the case of the GSEs, delinquent mortgages and MBS, with related guarantees, would be transferred to the new entity. The bad bank would need capital to purchase the nonperforming assets from the GSEs. Because the private sector would be unlikely to invest in the bad bank, the capital to purchase the assets would probably come from the federal government.

The bad bank could require continuing funds from the government, but might continue in operation in the hope that as housing and financial markets recover, the value of the problem mortgages and MBS would increase to exceed the value of the guarantees.

Reducing Senior Preferred Stock Dividends

Second, the GSEs' senior preferred stock could be restructured so that dividend payments to Treasury become less of a financial burden to the GSEs. Currently, the GSEs pay all of their profits at the end of each quarter as the required dividend. If there is no profit, no dividend is owed. (Previously, the dividends were payable regardless of whether there was a profit or not. A 12% annual stock dividend could be paid instead of a 10% cash dividend.)

The advantage of restructuring the senior preferred stock is that it would allow the GSEs to return to stockholder control, which is discussed in detail below. The disadvantage is that the GSEs and their stockholders would have received significant financial benefits without fully having paid for those benefits. This could lead to the expectation of future government support and encourage the GSEs to assume more risk than they would without this expectation.

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[22] CRS Report RS22963, *Financial Market Intervention*, by Edward V. Murphy and Baird Webel.

Receivership

HERA provides for voluntary and involuntary receivership. As mentioned above, FHFA is required to place a GSE in involuntary receivership if either the GSE's liabilities exceed its assets for 60 days, or if a GSE fails to pay its bills (except for those being disputed) for 60 days. FHFA is authorized by HERA to create a temporary successor.

Restructuring Options

Assuming that one way or another both GSEs return to financial solvency, some of the options to restructure government support for homeownership that Congress might consider are

- return Fannie Mae and Freddie Mac to their stockholders with little or no change to their congressional charters;
- eliminate their GSE status and convert Fannie Mae and Freddie Mac into private corporations;
- eliminate their GSE status and convert Fannie Mae and Freddie Mac into one or more government agencies; or
- make supplementary changes to support the secondary mortgage market, such as providing government reinsurance of MBS or encouraging the use of covered bonds.

Table 1 summarizes these options.

Table 1. Summary of GSE Restructuring Options

Category	Option	Summary
Maintaining GSE status	Return control to stockholders	Return GSEs to status prior to being placed in conservatorship with no changes to oversight
	Retain GSE status with additional regulation	Return GSEs to status prior to being placed in conservatorship with additional oversight
Maintaining GSE status	Explicit guarantee	Return the GSEs to status prior to being placed in conservatorship, but the federal government would replace the so-called implicit on bonds and MBS with an explicit guarantee for MBS. (The explicit guarantee probably would eliminate the GSE status of Fannie Mae and Freddie Mac. See 2 U.S.C. 622(8))
	Utility model	Return GSEs to status prior to being placed in conservatorship, but regulate their profits
	Split GSEs	Return GSEs to status prior to being placed in conservatorship, but divide the two GSEs into many GSEs
	Combine with FHLBanks	Fannie Mae and Freddie Mac would be merged with the FHLBanks, which is the third housing GSE

Category	Option	Summary
Eliminate GSE status	Government agency	Merge the GSEs with FHA and Ginnie Mae, which are parts of HUD, or convert the GSEs into a new government agency
	Privatization	Remove all of the GSEs' special obligations and privileges by revoking their Congressional charters
	Privatization with Co-Op Insurance	Remove all of the GSEs' special obligations and privileges by revoking their Congressional charters, and organize a co-operative to provide first line insurance for MBS.
Supplementary	Reinsurance	Provide explicit federal backup insurance for MBS
	Covered bonds	Encourage the issuance of overcollateralized MBS

Source: CRS. See remainder of report for proponents of specific options.

This report continues by discussing the advantages and disadvantages of these options and by adding more detail to the options.

Options Maintaining GSE Status

By law, the GSEs' conservatorship will end if they meet their minimum capital requirements, or when the FHFA director determines that ending conservatorship would be in the public interest. If this occurs, there are a number of options that could be considered that would include maintaining Fannie Mae and Freddie Mac as GSEs. These are returning control to the stockholders with no additional modification, imposing additional regulations on the GSEs, explicitly guaranteeing the GSEs' MBS, imposing utility-type profitability limits on the GSEs, merging Fannie Mae and Freddie Mac into the Federal Home Loan Bank System, and issuing additional GSE charters.

Option: Return Control to Stockholders

Congress could decide to make little or no change to the GSEs' charters. The GSEs would continue to be stockholder-owned companies with special charters and special obligations to support the housing market.

If this option were adopted, common stockholders would regain their right to elect the boards of directors, which in turn would appoint senior management. Dividends to preferred stockholders could resume. Dividends on the senior preferred stock owned by the federal government would continue. The GSEs would decide whether to retire the senior preferred stock held by the federal government. The boards of directors could resume common dividends. Bond payments would continue. As required by the contract with Treasury, the GSEs would shrink their portfolios by 15% annually until their portfolios were less than $250 billion.

Return to stockholder control implicitly assumes that the GSEs would return to profitability. Since all quarterly profits are paid to Treasury as dividends, the GSEs cannot accumulate funds necessary to leave conservatorship. In agreeing to conservatorship, the GSEs each gave the federal government warrants to purchase 79.9% of their common stock for $0.00001 per share.

Before effective control could be returned to common stockholders, the GSEs probably would need to reach some agreement with the federal government over the disposition of these warrants and the senior preferred stock. Based on similar past government intervention such as Chrysler in 1979, Continental Illinois in 1985, and more recently the troubled asset relief program (TARP), alternative dispositions of these warrants include federal government exercise, sale of the warrants through a federal government open market auction (which the GSEs could win), and federal government cancellation of the warrants.[23] In the third quarter of 2013, with its stock trading at approximately $1.20,[24] Fannie Mae had a market capitalization of approximately $2 billion. This would make 80% of the enterprise worth $160 billion. In the third quarter of 2013, Freddie Mac's stock price was $1.10[25] and its market capitalization was approximately $702 million, making 80% of Freddie Mac worth $561 million. Because the GSEs "have succession until dissolved by Act of Congress," it is not clear what limits there might be on an outside company purchasing the warrants.

Arguments in Favor

The main point in favor of the no change option is that by some measures the GSEs have been successes; some argue that since the GSEs became stockholder owned (1968 in the case of Fannie Mae, and 1989 in the case of Freddie Mac), only the recent exceptional housing markets have required government intervention.[26] Arguably, the GSEs have led to many changes in the nation's mortgage markets that have improved efficiency and consumer choice including

- standardizing mortgages, which has contributed to economies of scale and lower interest rates for homeowners;
- automating and standardizing underwriting, which has reduced the cost of obtaining a home mortgage;
- making widespread certain features such as assumable mortgages and mortgages without prepayment penalties, both of which facilitate refinancing;
- tapping new sources of funding including pension funds, trusts, and international investors, which has led to lower mortgage interest rates;

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[23] CRS Report RL34423, *Government Interventions in Financial Markets: Economic and Historic Analysis of Subprime Mortgage Options*, by N. Eric Weiss, and CRS Report RS22956, *The Cost of Government Financial Interventions, Past and Present*, by Baird Webel, Marc Labonte, and N. Eric Weiss analyze selected past government actions. Copies of Fannie Mae's and Freddie Mac's warrants is available at U.S. Treasury, "Federal National Mortgage Association: Warrant to Purchase Common Stock," September 7, 2008, http://www.treasury.gov/press-center/press-releases/Documents/warrantfnm3.pdf and U.S. Treasury, "Federal Home Loan Mortgage Corporation: Warrant to Purchase Common Stock," September 7, 2008, http://www.treasury.gov/press-center/press-releases/Documents/warrantfrec.pdf. See also, CRS Report R40005, *Chrysler Corporation Loan Guarantee Act of 1979: Background, Provisions, and Cost*, by James M. Bickley.

[24] For the current stock price and market capitalization of Fannie Mae, see https://www.google.com/finance?q=OTCBB%3AFNMA.

[25] For the current stock price and market capitalization of Freddie Mac, see https://www.google.com/finance?q=OTCBB%3AFMCC

[26] Fannie Mae became stockholder owned in 1968 by *Housing and Urban Development Act of 1968*, P.L. 90-448, 82 Stat. 536, and Freddie Mac in 1989 by *Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, P.L. 101-73, 103 Stat. 429.

- eliminating state and local mortgage interest rate differentials, which has lowered mortgage rates in some parts of the nation, but possibly increased them in others;
- innovating in affordable housing and equal housing opportunity, and
- creating a liquid secondary mortgage market, which has lowered mortgage interest rates.

Some might debate whether these innovations have been improvements, and others might claim to have invented them before the GSEs.

Arguments Against

There are at least three broad arguments against returning the GSEs to their former status. First, the GSEs' history includes previous financial and management problems. In 1982, Fannie Mae was in financial distress, and the government intervened after Congress passed the Miscellaneous Revenue Act of 1982, which provided some tax benefits for Fannie Mae.[27] In the early 2000s, Fannie Mae and Freddie Mac both had serious accounting and management issues that led to consent agreements with the Office of Federal Housing Enterprise Oversight (OFHEO), which then regulated them, and the Securities and Exchange Commission (SEC); and the GSEs' leaderships were replaced. Fannie Mae paid about $400 million in fines, and Freddie Mac paid $125 million in fines.

Second, many, if not all, of the changes used as points in favor of returning the GSEs to stockholder control arguably would have occurred without Fannie Mae and Freddie Mac, although possibly not as early. Other large mortgage market participants, such as banks and mortgage insurance companies, could have standardized and automated the lending process. Ginnie Mae, a government agency, issued the first MBS. These changes probably would have been sustained without the GSEs.

Prior to the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (P.L. 103-328), banks were not allowed to operate in more than one state. Banks in one state might have many deposits relative to the demand for loans, and reduce interest rates, including those on home mortgages, to encourage borrowing. At the same time, banks in another state might have relatively few deposits compared to loan demand and would increase interest rates. Because of the ban on interstate banking, money could not easily flow between states to equalize interest rates. One of the GSEs' roles was to move funds to where demand for home mortgages was greatest. After Riegle-Neal permitted interstate banking, it was arguably inevitable that interest rates and mortgage interest rates would become uniform across the nation.

Third, the conservatorship of the GSEs has changed the future financial environment of the GSEs such that returning to the previous system could be impossible.

- Having previously intervened, the federal government may be perceived as likely to provide any necessary future financial support to the GSEs to pay bonds, despite charter provisions that state that GSE debts are not guaranteed by the federal government.

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[27] *Miscellaneous Revenue Act of 1982*, P.L. 97-362, 96 Stat. 1726 et seq. Fannie Mae

- Attracting new common stockholders to recapitalize the GSEs could be difficult because of the federal government's taking control and stopping dividend payments to common stockholders. The burden of the senior preferred dividends and the warrants could make it very difficult to raise additional capital by selling new stock.
- Attracting new preferred stockholders to recapitalize the GSEs could be difficult since the federal government stopped dividend payments to preferred stockholders.

Option: Retain GSE Status with Additional Regulation

In returning the GSEs to stockholder control, additional statutory and regulatory oversight could reduce risk to the taxpayer. This could include increased minimum capital requirements to provide more of a buffer against future insolvency, limits to executive compensation could reduce the incentive to take excessive risks, changed accounting procedures could provide a clearer picture of the GSEs' financial status, or portfolio size limits could reduce some risks. Regulations arguably could help prevent future financial problems with the GSEs. An argument can be made that if the government were to give the GSEs more explicit or implicit assistance, the GSEs might have to broaden their support of affordable housing.[28]

On the one hand, an advantage of returning the GSEs to their stockholders while imposing additional regulation is that it is a return to a familiar model. The GSE support for affordable housing could continue.

On the other hand, making changes to GSE regulation has been a very contentious issue whenever Congress debated it in the past; previous regulation failed to prevent the GSEs from going into conservatorship; and the federal government has expended large amounts of money to maintain the GSEs' financial viability.

Option: Retain GSE Status with Explicit Guarantee

It can be argued that prior to 1992, the implicit guarantee in the GSEs' charters was provided at no cost to the GSEs. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA, P.L. 102-550) authorized HUD to set explicit affordable housing goals for the GSEs. The GSEs were not expected to lose money on mortgages purchased to meet the housing goals, but they were not guaranteed that the housing goals mortgages would be as profitable as other mortgages. Thus the implicit guarantee was provided at an implicit cost. One problem with implicit guarantees and implicit costs is that since their terms are not clearly defined, they are hard to value and hard to limit.

A possible solution to this concern would be for the government to make the guarantee explicit and to charge an explicit guarantee fee. The exact terms of the guarantee could be stated. Homebuyers might directly pay this guarantee fee as they now pay the FHA's guarantee fee, or the GSEs could be charged the guarantee fee. In the latter case, the GSEs could decide how much

28 Current GSE affordable housing goals were published in Federal Housing Finance Agency, "2010–2011 Enterprise Affordable Housing Goals; Enterprise Book-Entry Procedures; Proposed Rule," 75 *Federal Register* 9034-9072, February 26, 2010.

of the fee to pass on to borrowers. By changing the guarantee fee to reflect changes in GSE risk, the federal government could provide an incentive to maintain prudent lending.

Instead of guaranteeing the GSEs, the federal government could make the explicit guarantee available on all mortgages that met certain standards. This would be similar in effect to enlarging the FHA's guarantee program to cover more of the mortgage market. The federally guaranteed mortgages could be bundled and securitized. Since they would have a federal guarantee, Ginnie Mae could securitize these mortgages.

One issue with this option would be deciding what types of mortgages could be guaranteed and how new types of mortgages could be added to the program. Guarantees for mortgages that would be originated anyway would be an expense to the GSEs and a contingent liability for the government that would not increase homeownership. If a lender were to develop an extremely risky new type of mortgage, should the government guarantee it? Should the government charge an actuarially sound guarantee fee? If so, would not the private sector offer the same guarantee?

Option: Retain GSE Status with Utility Model

In what is frequently called the utility model, the federal government could explicitly regulate the GSEs' profit margins much as state utility regulators control utility profits. If a GSE were to earn unusually high profits one year, the government could lower the profit margins—and profit—the next year. Similarly, lower profits in one year could result in higher allowed profit margins the next. The goal of this option is to eliminate the incentive to increase profits with risky actions by eliminating or reducing the ability to gain from the risky actions. The federal government could either explicitly approve new GSE products, or new GSE products could be implicitly regulated by setting guarantee rates.[29]

One (or more) federally chartered companies could be eligible for the guarantee. Public utilities' regulation has been justified on the basis that there are economies of scale that can be captured if there is only one utility. By restricting competition, only one water main, telephone line, natural gas pipe, or electrical line needs to be constructed to connect each home and business with the utility. The regulator is charged with balancing the economic interests of consumers against those of the monopoly provider. For example, while Fannie Mae and Freddie Mac have found their retained portfolios of MBS to be profitable, the net value to homeowners is subject to much debate. In the utility model, the retained portfolios might be restricted to simplify regulatory oversight and to reduce risks.

Option: Split the GSEs

Arguably, one of the sources of the GSEs' problems has been that there are only two of them. Economic analysis generally favors competition with many firms. Over time, Fannie Mae and Freddie Mac became virtual twins and essentially divided the conforming U.S. mortgage market between them.[30] The result was, it could be argued, not much different from having a monopolist

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[29] FHFA currently has authority to approve new products (HERA, Section 1123).

[30] Conforming mortgages are those that conform to Fannie Mae's and Freddie Mac's purchase standards including the conforming loan limit, downpayment, and credit history. The phrase "conforming loan" is sometimes used to mean all loans at or below the conforming loan limit, regardless of any other factors that might make them ineligible for GSE purchase. For more on the conforming loan limit, see CRS Report RS22172, *The Conforming Loan Limit*, by N. Eric (continued...)

GSE that could charge high prices and make persistently large profits in the absence of competition. Prior to the financial turmoil that started in 2007, there were dozens of non-GSEs in the relatively small private label MBS market. With many GSEs competing and innovating in different ways, the losses caused by Fannie Mae and Freddie Mac would have been more manageable and perhaps would not have required government intervention.

One option to increase competition would be to split the GSEs into many more. If each GSE were split into, say, 10 equal parts (for a total of 20 housing GSEs), each of the 20 resulting GSEs would have mortgage portfolios of one-tenth its parent and have one-tenth of its parent's mortgage guarantees outstanding.[31] Based on recent monthly volume reports, the baby Fannie Maes would each have a retained mortgage portfolio and outstanding guarantees of $320 billion; the baby Freddie Macs would each have a retained mortgage portfolio and outstanding guarantees of $196 billion.

It might be that 20 identical GSEs would be under financial stress at the same time. One way to reduce the probability of this would be to split the GSEs in such a way that they were not all the same. To promote diversity among the new GSEs, they could be created with different geographic coverage, or to specialize in certain types of housing such as condominiums or multifamily rental housing. Existing stockholders would receive shares in the new GSEs. On the other hand, this specialization could leave new GSEs more vulnerable to declines affecting only certain types of housing.

The GSEs would continue to be regulated. One argument for creating many GSEs is that competition among the GSEs could supplement formal regulatory oversight.

Option: Incorporate Fannie Mae and Freddie Mac into Federal Home Loan Bank System

A slightly different option would be to incorporate the GSEs into the Federal Home Loan Bank (FHLBank) system. Currently, each regional FHLBank is owned by its member banks; shares of the FHLBanks are not traded on a stock exchange. The 12 regional banks form a collective GSE that raises funds for loans (called advances) to the members, who pledge mortgages and MBS as collateral. The debt is the joint and several liabilities of the individual FHLBanks; if one bank were to become insolvent, the other banks would remain responsible for its debts. Freddie Mac was created as part of the FHLBank system to sell its mortgages on the secondary market and became a publicly traded, stockholder owned company in 1989.

The FHLBank system could purchase Fannie Mae and Freddie Mac, which could become a mortgage securitization facility (or facilities) within the FHLBank system. The lenders that are members of the FHLBank system would own the GSEs.

Alternatively, Fannie Mae's and Freddie Mac's mortgage portfolios and other assets could be divided among the 12 FHLBanks. Some resources, such as mortgage securitization, could be

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Weiss and Sean M. Hoskins.

31 According to this reasoning, the precise number of GSEs is of little importance as long as there are enough GSEs to provide meaningful competition, and no one GSE is "too big to fail."

merged into the FHLBanks' Office of Finance, which provides centralized financial services for the regional banks.

The advantage of this approach is that the FHLBank system has never—not even in the Depression—lost money on an advance. The counter argument is that history may not predict the future: FHLBank members are insured by the FDIC. In the event of a member failure, the FHLBank has the mortgages that the member pledged as collateral on its advances. If these are insufficient to meet the member's obligations to the FHLBank, the FHLBank can use its "super lien," which gives it a priority claim over other unsecured creditors. FDIC research suggests that the FHLBanks have no incentive to risk-adjust the interest rate on advances.[32] The FDIC argues that this encourages the FHLBanks to take excessive risks because the bank keeps the profit, but the FDIC gets the risk. In addition, in the event of a member failure, the FHLBank has priority ahead of the FDIC on assets.

Option: Issue Additional GSE Charters

In addition to modifying the GSEs' charters as discussed previously, another option would be to issue additional, possibly modified GSE charters. Congress could establish the requirements for obtaining these new charters and limit the activities that the new GSEs could undertake. The GSEs could, if Congress so desires, contribute to an insurance fund similar to the FDIC for banks. Either the existing GSE regulator, the FHFA, or a new regulator would oversee the GSEs. Since Fannie Mae and Freddie Mac would retain all of their current assets and liabilities, there arguably would be no need to compensate existing stockholders of Fannie Mae and Freddie Mac, but the stockholders might object to the new competition. The government could charge a fee for the GSE charters. Market competition among the many GSEs could supplement regulatory oversight.

Options Eliminating GSE Status

Fannie Mae and Freddie Mac are GSEs because of their charters, which were created by enactment of legislation, and legislative action could repeal the charters. In some circumstances, repeal might raise legal and other concerns about financial compensation for current common and preferred stockholders, assumption of responsibility for paying off existing bondholders, guarantees of timely payment of mortgages, and other liabilities. On the other hand, Treasury has warrants to purchase nearly 80% of each GSE's common stock at nominal cost making stockholder approval of a government proposal a certainty.

The GSEs could continue with state charters like other financial intermediaries including commercial banks. In the early 1990s, the Student Loan Marketing Association (Sallie Mae) sought to relinquish its GSE status because of the financial burdens that came with its being a GSE and to make loans that it could not as a GSE.[33] In 1996, Congress agreed to allow Sallie Mae

[32] Rosalind L. Bennett, Mark D. Vaughan, and Timothy J. Yeager, "Should the FDIC Worry About the FHLB? The Impact of Federal Home Loan Bank Advances on the Bank Insurance Fund," FDIC Center for Financial Research, Working Paper 2005-10, August 18, 2006, http://www.fdic.gov/bank/analytical/cfr/2005/wp2005/CFRWP_2005_10_Bennett_Vaughan_Yeager.pdf.

[33] Olaf de Senerpont Domis, "Sallie Mae Shifting Gears for Move to Private Sector Series: 10," *American Banker*, November 13, 1996, p. 4, and Jaret Seiberg, "House Data Have Economists Gazing at a Murky Crystal Ball Series: 3," *American Banker*, September 26, 1996, p. 1.

to relinquish its congressional charter and give up its GSE status.[34] Sallie Mae became a stockholder-owned company with no special privileges in 2004.

If the GSE charters were repealed, Congress might wish to consider whether the GSEs' securitization of mortgages should be continued by a government agency. The GSEs have been able to compete against the government programs (FHA's mortgage insurance, the Veterans' Affairs mortgage guarantees, and the Department of Agriculture's rural housing programs) by creating a broader product than some government programs, and by competing on price.

Some research has suggested that the GSEs' biggest competitive advantage against other private sector mortgage lenders derived from the close relationship with the federal government which allowed the GSEs to borrow funds at lower rates compared to other mortgage lenders.[35] Without GSEs and their funding advantage, investment bankers might securitize conforming mortgages that were formerly securitized by the GSEs. While there is little debate over the ability of the private mortgage market to operate in normal times, it is not clear that the private market would supply mortgage funding in times of stress. Since the GSEs entered conservatorship, there has been one private sector issue of MBS backed by mortgages that were too large for the GSEs to purchase. It could be argued, however, that at certain times a sharp reduction in the volume of new mortgages is an appropriate response to conditions.

The impact of the GSEs on mortgage interest rates is much debated. The current spread between conforming and jumbo mortgages is greater than the historical average. A 2006 Federal Reserve study found that the GSEs did not reduce interest rates, but cites other studies that found interest rate reductions of 4 to 35 basis points with older studies finding greater reductions.[36] (One basis point is 0.01 %.) This research suggests that there could be a small increase in mortgage interest rates if the GSEs were to cease securitizing mortgages. On the other hand, this research uses the difference between mortgages that the GSEs can purchase and jumbo mortgages that the GSEs cannot buy.

Without GSEs, institutional investors might shift some of their money to other securities or other countries. If this were to happen, mortgage interest rates could rise more than this research suggests.

Option: Government Agency

Another option would be to make the GSEs a government agency. Ginnie Mae, officially the Government National Mortgage Association, an office within the Department of Housing and Urban Development, purchases and securitizes government-insured and government-guaranteed mortgages in much the same way that the GSEs purchase and securitize conforming mortgages. Ginnie Mae contracts with investment banks on Wall Street to do the actual securitization of their mortgage purchases. This allows Ginnie Mae to function with approximately 60 employees yet be responsible more than $1.3 trillion in Ginnie Mae MBS.[37]

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[34] *Student Loan Marketing Association Reorganization Act of 1996*, P.L. 104-208.

[35] Andreas Lehnert, Wayne Passmore, and Shane Sherlund, *GSEs, Mortgage rates, and Secondary Market Activity*, Federal Reserve Board, 2006-30, Washington, DC, 2006, http://www.federalreserve.gov/pubs/feds/2006/200630/200630pap.pdf.

[36] Ibid.

[37] Ginnie Mae, "Ginnie Mae Releases Fiscal Year 2012 Results," press release, November 15, 2012,
(continued...)

Ginnie Mae's contractor purchases government-insured and guaranteed mortgages and pools them into MBS. Ginnie Mae adds the federal government's guarantee that the MBS purchasers will be paid, and the contractor sells the MBS to institutional investors. Until it became stockholder owned in 1968, Fannie Mae was part of Ginnie Mae.

If Fannie Mae and Freddie Mac were to become a government agency, it is possible that many of the current staff and directors of the GSEs would find other employment. Potential reasons include duplication of functions, or because the salaries of current GSE employees would be reduced to fit the government pay schedule currently used at FHA and Ginnie Mae.

Option: Privatization

Fully privatized GSEs would no longer have special status from the federal government. They would be owned by investors. GSE stockholders would receive stock in the new companies. The stock of the new companies could trade on one or more stock exchanges. The new companies would assume the assets (retained portfolios) and liabilities (bonds, MBS and guarantees) of the existing GSEs.

The combined Ginnie Mae, Fannie Mae, and Freddie Mac market share was 100% in the third quarter of 2012 compared to 98% at the end of 2011.[38] Some might consider this to be too dominant, and Congress might consider dividing the GSEs into many companies as part of a privatization process. Congress might wish to consider if each of the new non-GSEs should be similar, or if some might specialize in geography or some other factor. This could reduce the probability that multiple mortgage lenders would simultaneously encounter financial difficulty, but would eliminate some of the risk reduction that comes from diversification.

Option: Privatization with Co-op Insurance

As mentioned earlier, the GSEs (but not their private sector competitors) guarantee that investors will receive timely payment of principal and interest even when a homeowner becomes delinquent. Another way to provide this sort of guarantee without GSEs would be to create a co-op to insure MBS. This would be similar to a private Federal Home Loan Bank System and share some features with Lloyd's of London, which also uses a co-op insurance business model. The co-op would create MBS from mortgages purchased from members. Members would be required to buy stock in the co-op proportional to the volume of mortgages sold to the co-op, and part of the proceeds from the mortgage sales would be posted as collateral against losses. The collateral could be released as the mortgages age.

The co-op members' stock could be sold if collateral were insufficient to cover losses. Beyond this, members would have no liability. The result would be that individual co-op members would keep their profits and share their losses.

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http://www.ginniemae.gov/media_center/Pages/PressReleaseDispPage.aspx?ParamID=57. In 2012, Fannie Mae reported that it had 7,000 employees, and Freddie Mac reported 4,900 employees.

[38] FHFA, *2012 Performance and Accountability Report,* November 15, 2012, at http://www.fhfa.gov/webfiles/24632/2012FHFAPARF.pdf.

The co-op would decide pricing, eligibility requirements, and credit requirements. The government would supervise the co-op for safety and soundness, and it would explicitly bear the risk of catastrophic disaster. In return, the government could charge the co-op a fee for supervision and risk.

If the co-op's rules allowed for wide membership, this option could encourage competition in mortgage securitization. Members would have a stake up to the amount of equity in the co-op, in the behavior of other members. A member who used the co-op to insure excessively risky mortgages would be risking all of the members' equity and increasing the probability that the federal government's catastrophic insurance might have to be used.

Supplementary Options

There are at least two supplementary options that could operate independent of any GSE restructuring: government reinsurance and covered bonds.

Reinsurance

The government could provide catastrophic reinsurance to the secondary mortgage market. This would be similar to the reinsurance provided under the Terrorism Risk Insurance Act of 2002 (TRIA, P.L. 107-297). GSEs and others selling MBS in the secondary market would provide primary insurance to purchasers. If the GSEs or others creating MBS experienced losses exceeding a certain limit, the federal government would provide compensation. This would allow many financial institutions to compete in the secondary mortgage market.

The terms of this insurance could be determined by statute or by regulation. Some of the factors to be considered would be: how large of a loss (dollars or percentage) would primary insurance incur before the reinsurance became effective? Who should be eligible for the reinsurance program? Would the reinsurance be 100%, or would these losses be shared? How should premiums be determined?

Covered Bonds

Covered bonds are a method of raising funds for mortgages that provides more security to purchasers than non-GSE MBS provide currently.[39] While the GSEs guarantee that the purchasers of their MBS will receive timely payment of principal and interest, the issuers of private-label MBS do not include any such guarantee. If a mortgage borrower defaults, the losses flow to the private label MBS holder as specified in the MBS prospectus.

Covered bonds seek to reduce the risk of financial loss to the bond purchaser. Regular bonds are backed by the income of the issuer and have no specific collateral. Covered bonds have collateral and a claim on the income and assets of the issuer. Typically, covered bonds have more collateral than the value of the bonds. If the value of the collateral declines (due to prepayment, default, foreclosure, etc.), the issuer must add additional collateral. In a best practices paper, Treasury said that there should be at least an extra 5% collateral coverage, that only 30-year fixed-rate

[39] CRS Report R41322, *Covered Bonds: Background and Policy Issues*, by Edward V. Murphy.

mortgages should be included, and that the maximum loan-to-value ratio on mortgages included should be 80%.[40]

Because covered bonds have a priority claim on the assets of the issuer, the remaining claimants are likely to receive less in the event of bankruptcy or receivership. In the case of an insured depository institution such as a bank or thrift, covered bonds would increase the FDIC's losses. Presently, covered bonds may not exceed 4% of an FDIC-insured institution's liabilities.[41] This limits the ability of insured depository institutions to issue covered bonds. Some have suggested that covered mortgage bonds could be issued using MBS from the GSEs or their successors.

Covered bonds are popular in Europe, where the covered bond issuer typically originates the mortgage. Some analysts believe this aligns the interests of originators and bond holders. In Germany, which issued the first covered bonds in 1899, covered bonds reportedly have never defaulted.[42]

Covered bonds are attractive to some because they could reduce the risks to purchasers of private label MBS, and increase competition in the secondary mortgage market.

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[40] U.S. Treasury, "Best Practices for Residential Covered Bonds," June 28, 2008, http://www.treasury.gov/about/organizational-structure/offices/General-Counsel/Documents/USCoveredBondBestPractices.pdf.

[41] Federal Deposit Insurance Corporation, "Covered Bond Policy Statement," 73 *Federal Register* 21951, April 23, 2008.

[42] Association of German Pfandbrief Banks, *The Pfandbrief 2012-2013 Facts and Figures about Europe's Covered Bond Benchmark*, p. 54, at http://www.pfandbrief.de/cms/bcenter.nsf/0/893C7DF93564AAB5C1257A7800329933/$File/EN_PBFB_2012.pdf and Orazio Mastroeni, European Central Bank, "Pfandbrief-style products in Europe," p. 63 at http://www.bis.org/publ/bppdf/bispap05b.pdf.