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United States House of Representatives
Committee on Financial Services
Washington, D.C. 20515

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M E M O R A N D U M

To: Members of the Committee on Financial Services

From: FSC Majority Committee Staff

Date: March 14, 2013

Subject: March 19, 2013 Full Committee Hearing on "Sustainable Housing Finance: An Update from the Federal Housing Finance Agency on the GSE Conservatorships"

On Tuesday, March 19, 2013, at 10:00 a.m. in Room 2128 of the Rayburn House Office Building, the Committee on Financial Services will hold a hearing on "Sustainable Housing Finance: An Update from the Federal Housing Finance Agency on the GSE Conservatorships." Mr. Edward J. DeMarco, Acting Director, Federal Housing Finance Agency (FHFA), will be the only witness.

The Federal Housing Finance Agency (FHFA)

The Housing and Economic Recovery Act of 2008 ("HERA") (P.L. 110–289) created the Federal Housing Finance Agency (FHFA). FHFA is an independent regulatory agency responsible for the oversight of the housing government sponsored enterprises (GSEs). The housing GSEs include Fannie Mae, Freddie Mac (known as the Enterprises) and the Federal Home Loan Banks. FHFA's mission is to ensure the housing GSEs are safe and sound and that they serve as a reliable source of liquidity and funding for housing finance and community investment. HERA combined the staffs of the Office of Federal Housing Enterprise Oversight (OFHEO), the Federal Housing Finance Board (FHFB), and the GSE mission office at the Department of Housing and Urban Development (HUD).

The FHFA Strategic Plan for Fiscal Years 2013-2017 sets four strategic goals for FHFA: (1) Safe and sound housing GSEs; (2) Stability, liquidity, and access in housing finance; (3) Preserving and conserving Enterprise assets, and (4) Preparing for the future of housing finance in the United States.[1]

On March 4, 2013, the FHFA released its 2013 Conservatorship Scorecard ("Scorecard") for Fannie Mae and Freddie Mac. The Scorecard details specific priorities for Fannie Mae and Freddie Mac in 2013 that builds upon the three strategic goals announced in FHFA's Strategic Plan for Enterprise Conservatorships released in 2012:

- Build a new securitization infrastructure, including a common securitization platform;
- Contract Fannie Mae and Freddie Mac's dominant presence in the marketplace while simplifying and shrinking certain operations; and

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[1] http://www.fhfa.gov/webfiles/24790/Final%20FHFA%20Strategic%20Plan-10-9-12.pdf

- Maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.[2]

The Government Sponsored Enterprises

The Federal National Mortgage Association, popularly known as Fannie Mae, and the Federal Home Loan Mortgage Corporation, popularly known as Freddie Mac, are government-sponsored enterprises (GSEs). GSEs are corporations chartered by the federal government for the purpose of fulfilling a public policy goal. Although GSEs are chartered by the federal government, they are owned by private shareholders. This public-private hybrid status confers a significant advantage on GSEs over purely private companies: even though the GSEs are privately owned, their government charters create the impression that they are agencies of the federal government, leading market participants to believe that their debt is backed by the federal government. This implicit federal guarantee allows the GSEs to borrow money more cheaply than their competitors, which gives the GSEs a significant advantage in competing for market share.

Congress chartered Fannie Mae during the New Deal to make homeownership more affordable for lower- and middle-income Americans, and Congress chartered Freddie Mac in 1970 with a similar purpose. Fannie Mae and Freddie Mac were chartered as GSEs to provide liquidity in the mortgage market and to promote homeownership for underserved groups and locations.

Although the GSEs' mission is to promote homeownership, the GSEs are not mortgage lenders: they do not lend directly to individual borrowers. Instead, they purchase mortgages from lenders, guarantee them, and package them into mortgage-backed securities, which they either keep as investments or sell to institutional investors. By purchasing mortgages from lenders, the GSEs allow lenders to move these mortgages off their balance sheets in exchange for cash, thereby increasing liquidity in the mortgage market. For example, if a bank held $1 million in cash to lend for mortgages, it could make four $250,000 30-year loans and hold those loans for 30 years, until the borrowers paid off those loans. But the bank could not make other loans until it collected enough interest and principal to make new loans. By selling these loans to a GSE, however, the bank can make more loans to new borrowers. Increasing liquidity in the mortgage market is the statutory purpose of the GSEs.

The GSEs were able to make a profit from purchasing mortgages from lenders because of the size and volume of their transactions, and because of the borrowing discount they enjoyed through their implicit government guarantee. After they purchased these loans, the GSEs had two options: they either securitized the loans for sale to third-party investors or they retained the loans as investments on their own books. To securitize these loans, the GSEs bundled loans into pools and structured these pools into mortgage-backed securities. The GSEs guaranteed that the principal and interest on these securities would be timely repaid, and sold these securities to

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[2] http://www.fhfa.gov/webfiles/25025/Scorecard2013.pdf

investors. For loans bought for their own portfolios, the GSEs profited from the difference between the interest earned on these mortgages and the below-market cost of funds they paid to borrow on the capital markets.

In theory, Fannie and Freddie were supposed to compete for a share of the housing finance market, which would increase the supply of mortgage credit and lower its cost for consumers. In practice, they operated as a duopoly that used their government charters and the government guarantee those charters implied to dominate the mortgage finance market. And while Fannie and Freddie were chartered to help make mortgage credit more affordable for lower- and middle-income Americans, many economists dispute the claim that the GSEs lowered the cost of credit for home buyers. For example, in 2005, a Federal Reserve study found that the GSEs had lowered mortgage rates for borrowers by only seven basis points, or .07 percent.

Over time, the GSEs grew large as they used the benefits of their charters to buy mortgages by borrowing at below-market rates because their creditors assumed—correctly, as it turned out—that the federal government would stand behind their debts to prevent a catastrophic economic collapse. Even today, in the wake of their failure and the financial crisis and recession of 2008-09, Fannie and Freddie continue to dominate the secondary mortgage market. Fannie and Freddie currently have more than $5.6 trillion in obligations outstanding, an amount nearly 40 percent the size of the entire U.S. economy. Over the last four quarters (2011Q3 – 2012Q3), the GSEs either owned or guaranteed about 61 percent of all new residential mortgage loans made in the United States. And the private-label securitization market for residential mortgages remains moribund: Fitch reports that since 2008, there has been only $5.2 billion in residential mortgage-backed securities issued without government support.

Fannie, Freddie, and the Fall

In the years leading up to the financial crisis and the collapse of the GSEs, many policymakers, economists, and observers of the housing markets warned that the size of the GSEs and their dominance of the market for housing finance posed a systemic risk to the U.S. economy. These critics pointed out that if the housing market declined substantially and large numbers of borrowers defaulted on their mortgages, the GSEs' implicit government guarantee would expose taxpayers to enormous liabilities and destabilize the economy. For instance, the *New York Times* reported in 1999 that with Fannie Mae's move into the subprime market, the GSE was "taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan industry in the 1980s."

Those warnings proved prophetic. On September 7, 2008—nearly a year after Treasury Secretary Henry Paulson called the bursting housing bubble "the most significant risk to our economy"—Fannie Mae and Freddie Mac were placed into conservatorship by the Treasury, the Federal Reserve, and the Federal Housing Finance Agency (FHFA). Under the conservatorship agreements, Treasury purchased $1 billion of senior preferred stock in each GSE and was granted the option to purchase 79.9 percent of each of the GSEs' common stock. The conservatorship agreements also established a $200 billion facility to purchase senior preferred stock in the GSEs to backstop their losses.

In February 2009, the Obama Administration raised this commitment to $400 billion. On Christmas Eve 2009, the Obama Administration removed any limits on the use of federal funds to cover losses at the GSEs. In removing these limits, the Obama Administration explained that it wanted to "leave no uncertainty about the Treasury's commitment to support these firms as they continue to play a vital role in the housing market during this current crisis." To date, in addition to the initial $2 billion commitment, Fannie Mae has drawn more than $116 billion and Freddie Mac has drawn $71 billion in taxpayer funds, for a total of approximately $187 billion ($137 billion, net of dividends paid), although the GSEs have also paid the Treasury approximately $50 billion in dividends, making the conservatorship of the GSEs the costliest of all the taxpayer bail-outs carried out over the past three years. After Fannie Mae and Freddie Mac were placed in conservatorship, the Congressional Budget Office concluded that they should be included in the federal budget to reflect their cost to the taxpayer. But the President's FY 2013 budget continued to treat Fannie Mae and Freddie Mac as off-budget private entities rather than government agencies whose activities are paid for by taxpayers.

Although estimates for the total cost of the conservatorship vary, the FHFA's Quarterly Conservator's Report for October 2012 estimated that "cumulative Treasury draws (including draws required to pay dividends) at the end of 2015 range from $191 billion to $209 billion."

On March 6, 2013, the Subcommittee on Capital Markets and Government Sponsored Enterprises held a hearing with four witnesses and examined how Fannie Mae, Freddie Mac, government housing policy and poorly underwritten mortgages led to the financial crisis of 2008.

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