



7 Things You Need to Know About Fannie Mae and Freddie Mac

By John Griffith | September 6, 2012

Exactly four years ago, during the early days of the financial crisis, the federal government took control of mortgage financiers Fannie Mae and Freddie Mac through a legal process called conservatorship. Since then, the two companies have required roughly \$150 billion in taxpayer support to stay solvent, while the government has kept the housing market afloat by backing more than 95 percent of all home loans made in the United States.¹

Fannie and Freddie remain two of the largest financial institutions in the world, responsible for a combined \$5 trillion in mortgage assets.² Still, few Americans understand what Fannie and Freddie actually do for homeowners, what part they played in the recent housing crisis, or what role they'll have in the mortgage market of the future. On the fourth anniversary of their conservatorship, here are seven things you need to know about the two mortgage giants.

1. What do Fannie Mae and Freddie Mac do?

The primary function of Fannie Mae and Freddie Mac is to provide liquidity to the nation's mortgage finance system. Fannie and Freddie purchase home loans made by private firms (provided the loans meet strict size, credit, and underwriting standards), package those loans into mortgage-backed securities, and guarantee the timely payment of principal and interest on those securities to outside investors. Fannie and Freddie also hold some home loans and mortgage securities in their own investment portfolios.

Since mortgage lenders don't have to hold these loans on their balance sheets, they have more capital available to make loans to other creditworthy borrowers. Lenders also have an added incentive to offer safe and sustainable products—namely long-term, fixed-rate mortgages—because they know Fannie and Freddie will likely purchase them. Since Fannie and Freddie guarantee payments in the event of a default—for a fee, of course—investors don't have to worry about credit risk, which makes mortgages a particularly attractive investment.

Under this system, mortgage credit was continuously available well into the late-1990s under terms and at prices that put sustainable homeownership within reach for most American families. By the end of that decade, however, Wall Street had figured out how to purchase and securitize mortgages without needing Fannie and Freddie as intermediaries, leading to a fundamental shift in the U.S. mortgage market.

2. What role did Fannie and Freddie play in inflating the housing bubble of the mid- to late-2000s?

Contrary to conservative talking points, the answer is very little. During the bubble, loan originators backed by Wall Street capital began operating beyond the Fannie and Freddie system that had been working for decades by peddling large quantities of high-risk subprime mortgages with terms and features that drastically increased the chance of default. Many of those loans were predatory products such as hybrid adjustable-rate mortgages with balloon payments that required serial refinancing, or negative amortization, mortgages that increased the unpaid balance over time.³

Wall Street firms such as Lehman Brothers and Bear Stearns packaged these high-risk loans into securities, got the credit-rating agencies to bless them, and then passed them along to investors, who were often unaware or misinformed of the underlying risks. It was the poor performance of the loans in these “private-label” securities—those not owned or guaranteed by Fannie and Freddie—that led to the financial meltdown, according to the bipartisan Financial Crisis Inquiry Commission,⁴ among other independent researchers.⁵

In fact, Fannie and Freddie lost market share as the bubble grew: The companies backed roughly half of all home-loan originations in 2002 but just 30 percent in 2005 and 2006.⁶ In an ill-fated effort to win back market share, Fannie and Freddie made a few tragic mistakes. Starting in 2006 and 2007—just as the housing bubble was reaching its peak—Fannie and Freddie increased their leverage and began investing in certain subprime securities that credit agencies incorrectly deemed low-risk. Fannie and Freddie also lowered the underwriting standards in their securitization business, purchasing and securitizing so-called Alt-A loans. While Alt-A loans typically went to borrowers with good credit and relatively high income, they required little or no income documentation, opening the door to fraud (which was often perpetrated by the mortgage broker rather than the homebuyer).⁷

These decisions eventually contributed to the companies’ massive losses, but all this happened far too late to be a primary cause of the housing crisis.⁸

3. Why did Fannie and Freddie require a taxpayer bailout?

Fannie and Freddie failed in large part because they made bad business decisions and held insufficient capital. Also, unlike most private investment firms, Fannie and Freddie had only one line of business—residential mortgage finance—and thus did not have other sources of income to compensate when home prices began to fall.

In 2008 Fannie and Freddie lost a combined \$47 billion in their single-family mortgage businesses, forcing the companies to dig deep into their capital reserves. Nearly half of those losses came from Alt-A loans, despite those loans accounting for just 11 percent of the companies' total business.⁹ But those losses were only the beginning: Between January 2008 and March 2012, Fannie and Freddie would lose a combined \$265 billion, more than 60 percent of which was attributable to risky products purchased in 2006 and 2007.¹⁰

By late summer in 2008—about a year after the start of the housing crisis—Wall Street firms had all but abandoned the U.S. mortgage market, while pension funds and other major investors throughout the world continued to hold large amounts of Fannie and Freddie securities. If Fannie and Freddie were allowed to fail, experts agreed that the housing market would collapse even further, paralyzing the entire financial system. The Bush administration in September 2008 responded by placing Fannie Mae and Freddie Mac into government conservatorship, where they remain today.

4. Did affordable housing goals for Fannie and Freddie play any role in the subprime crisis?

No.

In 1992 Congress established the “affordable housing goals,” which were numerical targets for the share of Fannie- and Freddie-backed lending that went to low-income and minority borrowers. For years conservative analysts have falsely pointed to these goals as a catalyst for the housing crisis, claiming they pushed Fannie and Freddie to take on unprecedented levels of risk, creating a bubble and a bust in the subprime housing market that sparked the financial catastrophe.

That's simply not true. A recent study from the Federal Reserve Bank of St. Louis found that the affordable housing goals had no observable impact on the volume, price, or default rates of subprime loans during the crisis, even after controlling for the loan size, loan type, borrower characteristics, and other factors.¹¹ Federal Reserve Economist Neil Bhutta reached a similar conclusion in 2009, finding that the affordable housing goals had a negligible effect on Fannie and Freddie lending during the housing bubble.¹²

That shouldn't come as a surprise. Fannie and Freddie did not securitize any loans that met the industry definition of "subprime," and the loans in their riskier securities—commonly identified as "subprime-like" or "subprime equivalent"—experienced delinquency rates that mirrored the prime market.¹³ The Alt-A loans that drove their losses were typically made to higher-income households and thus did not qualify for the affordable housing goals.¹⁴ While Fannie and Freddie did hold some subprime mortgage-backed securities in their investment portfolios—many of which qualified for the affordable housing goals—these investments lagged behind the rest of the market and made up only a tiny fraction of total subprime lending during the housing bubble.¹⁵

5. How are Fannie and Freddie doing today?

Much better, but both companies still have a very long way to go. Thanks in part to rising home prices, Fannie Mae in August posted its largest quarterly profit since the crisis began, marking its second consecutive profitable quarter.¹⁶ Meanwhile, Freddie Mac reported a quarterly profit for the fifth time since the crisis began.¹⁷

The improved finances at both companies led the U.S. Treasury Department in August to rework the terms of the government bailout. Under the previous agreement, Fannie and Freddie drew money from the Treasury Department as needed to bolster its capital reserves. In exchange, the companies issued preferred stock to the government on which they paid a mandatory 10 percent dividend. Under the new rules, Treasury will simply claim all of Fannie and Freddie's profits at the end of each quarter and provide capital when necessary in the event of a quarterly loss.¹⁸

While the worst of the crisis appears to be over, Fannie and Freddie are a long way from repaying their debt. According to Moody's Analytics, it could take the companies 15 years to pay back taxpayers in full.¹⁹ Meanwhile, as the government continues to play a central role in the day-to-day operations of Fannie and Freddie, the continued uncertainty has led many key staff to leave and has caused an underinvestment in necessary infrastructure and systems.²⁰

6. What should we do with Fannie and Freddie?

With the federal government backing nearly every home loan made in the country today, almost everyone agrees that the current level of support is unsustainable in the long run, and private capital will eventually have to assume more risk in the mortgage market. That leaves two critical questions before policymakers today: What sort of presence should the federal government have in the future housing market, and how do we transition responsibly to this new system of housing finance?

Since the conservatorship of Fannie and Freddie began, dozens of advocacy groups, academics, and industry stakeholders have offered possible answers to these questions.²¹ The overwhelming majority of these suggested plans agree that some form of government support is necessary to ensure a stable housing market and to maintain the 30-year fixed-rate mortgage.

In January 2011 the Mortgage Finance Working Group—a progressive group of housing finance experts, affordable housing advocates, and leading academics sponsored by the Center for American Progress—released its plan for responsibly winding down Fannie Mae and Freddie Mac and bringing private capital back into the U.S. mortgage market.²² Our proposal includes an explicit government backstop on certain mortgage products, requirements that private firms serve the whole market, and an empowered regulator to ensure the sustainability and affordability of mortgage products. The plan also lays out five guiding principles for any reform effort:

- Broad and consistent access to mortgage credit across all communities
- Stability in mortgage finance during all kinds of economic conditions
- Transparency and standardization of products that can be understood
- Access to affordable mortgage finance for both homeownership and rental housing
- Consumer protections to ensure that mortgage products and practices operate in the long-term best interests of borrowers

7. What would happen if we fully privatized the U.S. mortgage market?

Many conservative analysts and politicians—resorting to heated rhetoric and mistruths about the origins of the crisis—argue that we need a fully private mortgage market run by Wall Street. It was the fully private segment of the market, however, that caused millions of foreclosures and brought down the entire financial system. If we draw the wrong lesson from the financial crisis and abruptly withdraw the government from mortgage finance, it will lead to a sharp reduction in the availability of home loans, cutting off access to mortgage finance for the middle class.

History is a helpful guide here. Prior to the introduction of the government guarantee on residential mortgages in the 1930s, mortgages typically had 50 percent down-payment requirements, short durations, and high interest rates—putting homeownership out of reach for many middle-class families.²³ The housing finance system was subject to frequent panics during which depositors demanded cash from their banks, leaving lenders insolvent.²⁴ That volatility is one reason why every other developed economy in the world has deep levels of government support for residential mortgage finance.²⁵

In addition, abruptly removing government support would almost certainly mean the end of the 30-year fixed-rate mortgage, now a pillar of the U.S. housing market. Middle-

class families for decades have depended on the security and affordability of this product, which allows borrowers to fix their housing costs and better plan for their futures in an ever more volatile economy.²⁶ Most experts agree that this highly beneficial product would largely disappear without a government guarantee.²⁷

Conclusion

To be sure, Fannie Mae and Freddie Mac were flawed companies that made several bad business decisions, and taxpayers should never again have to foot the bill for any financial institution's greed. But as policymakers look to the future of U.S. housing finance, they must seek smart reforms that focus on what was broken in the previous system, while maintaining what worked for decades. The federal government must continue to play a key role in the housing market, regardless of whether it works through Fannie and Freddie, a new agency, or purely private firms.

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Endnotes

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