

## Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market

**T**wo years ago, the federal government assumed control of the ailing Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac), two institutions that facilitate the flow of funding for home loans nationwide. The cost to taxpayers of that takeover, and the structural weaknesses that contributed to the institutions' financial problems, have prompted policymakers to consider various alternatives for the government's future role in the secondary (resale) market for residential mortgages.

This study looks at how Fannie Mae and Freddie Mac evolved into the institutions they are today. As context for discussing future options, the study also examines both the rationales that are often cited for federal involvement in the secondary mortgage market and the problems with Fannie Mae and Freddie Mac that existed before the recent financial crisis. The secondary market channels funds to borrowers by facilitating the resale of mortgages and mortgage-backed securities (MBSs). In that market, lenders such as banks, thrifts, and mortgage companies obtain funding for the loans they originate by selling the loans to purchasers such as Fannie Mae, Freddie Mac, and other financial institutions (including banks and insurance companies).

Alternative proposals for the secondary mortgage market involve different choices about whether the federal government should continue to guarantee payment on certain types of mortgages or MBSs and, if so, what the scope, structure, and pricing of those guarantees should be. The proposals also involve choices about support for affordable housing and the competitive structure and regulation of the secondary market. This study examines the

trade-offs involved in making those key design choices and evaluates the strengths and weaknesses of three broad approaches for the future of the secondary mortgage market:

- A hybrid public/private model in which the government would help to ensure a steady supply of mortgage financing by providing explicit guarantees on privately issued mortgages or MBSs that met certain qualifications;
- A fully public model in which a wholly federal entity would guarantee qualifying mortgages or MBSs; or
- A fully private model in which there would be no special federal backing for the secondary mortgage market.

This analysis focuses primarily on the long-term strengths and weaknesses of the alternative approaches, not on the transition from the status quo to a new model. Transitional issues—such as what to do with the existing portfolios and obligations of Fannie Mae and Freddie Mac—are important in their own right, but they are largely separate from the questions about the long-term future of the secondary mortgage market that are examined here. In particular, alternative ways of resolving the transitional issues probably would not substantially affect the relative long-term merits of different models for the secondary market, and the different models do not appear to require any particular resolution of the transitional issues—choices about each could be combined in various ways. If changes were made in the next few years, care would need to be taken not to disrupt the housing and mortgage

markets further. Those markets remain fragile: The sharp decline in housing prices since mid-2006 has left many homeowners owing more on their mortgages than their homes are worth, foreclosure rates are still high, and obtaining a mortgage continues to be difficult for many households.

## Fannie Mae, Freddie Mac, and the Secondary Mortgage Market

Four decades ago, Congressional charters set up Fannie Mae and Freddie Mac as government-sponsored enterprises (GSEs)—privately owned financial institutions established by the government to fulfill a public mission. The two GSEs were created to provide a stable source of funding for residential mortgages across the country, including loans on housing for low- and moderate-income families.<sup>1</sup> Fannie Mae and Freddie Mac carry out that mission through their operations in the secondary mortgage market. They purchase mortgages that meet certain standards from banks and other originators, pool those loans into mortgage-backed securities that they guarantee against losses from defaults on the underlying mortgages, and sell the securities to investors—a process referred to as securitization. In addition, they buy mortgages and MBSs (both each other's and those issued by private companies) to hold in their portfolios. They fund those portfolio holdings by issuing debt obligations, known as agency securities, which are sold to investors.

Until recently, the GSEs' debt securities and MBSs were not officially backed by the federal government. Nevertheless, most investors believed that the government would not allow Fannie Mae and Freddie Mac to default on their obligations. That perception of an implicit federal guarantee stemmed from the very prominent role the two entities played in the housing market and in the broader financial markets. It also stemmed from the specific benefits that the two entities received because of their status as GSEs, such as not having to register their securities with the Securities and Exchange Commission, being exempt from state and local corporate income taxes, and having a line of credit with the Treasury.

Because of their implicit federal guarantee, Fannie Mae and Freddie Mac could borrow to fund their portfolio holdings at much lower interest rates than those paid by fully private financial institutions that posed otherwise comparable risks, and investors valued the GSEs' credit guarantees more highly than those issued by fully private guarantors. Some of those benefits from federal support flowed to mortgage borrowers in the form of greater availability of credit and somewhat lower interest rates. The GSEs' other stakeholders (shareholders, managers, and employees) also reaped some of the gains. The advantages of implicit federal support allowed Fannie Mae and Freddie Mac to grow rapidly and dominate the secondary market for the types of mortgages they were permitted to buy (known as conforming mortgages). In turn, the perception that the GSEs had become "too big to fail" reinforced the idea that they were federally protected.

Fannie Mae and Freddie Mac were profitable in most years until recently, when the United States experienced its most severe financial crisis since the Great Depression of the 1930s. As housing prices dropped nationwide and foreclosures increased, the two GSEs suffered large losses on various investments in their portfolios, such as subprime mortgages (loans made to borrowers with poorer-than-average credit) and "private-label" MBSs (securities issued and insured by private companies without government backing). The GSEs also faced heightened uncertainty about the magnitude of the ultimate decline in housing prices and increase in unemployment and thus about the size of credit losses on their outstanding guarantees (which in September 2008 totaled \$3.8 trillion). Those factors impaired the GSEs' ability to issue low-cost debt to fund their mortgage purchases, and doubts arose about whether they had enough capital to cover potential losses.

The enactment of the Housing and Economic Recovery Act of 2008 (Public Law 110-289) established the Federal Housing Finance Agency and gave it the authority to place Fannie Mae and Freddie Mac in conservatorship—a step it took in September 2008. The Treasury was granted the authority to provide the GSEs with unlimited capital (by purchasing their stock) in order to maintain their solvency through 2012. Those actions gave the government control over the two institutions and effectively made the government's backing of their debt securities and MBS guarantees explicit.

1. The Federal Home Loan Bank System, which is also a GSE, once played a significant role in mortgage finance. But because its focus has broadened beyond housing, and because options for changing that system involve different considerations than options for the future of the secondary mortgage market, this study focuses on Fannie Mae and Freddie Mac.

As a result of that aid and the explicit federal guarantee, Fannie Mae and Freddie Mac were able to continue channeling funds to the mortgage market, even as private financial institutions were faltering. Consequently, in 2009, the two GSEs owned or guaranteed roughly half of all outstanding mortgages in the United States (including a significant share of subprime mortgages), and they financed three-quarters of new mortgages originated that year. Including the 20 percent of home loans insured by federal agencies, such as the Federal Housing Administration (FHA), more than 90 percent of new mortgages made in 2009 carried a federal guarantee.

## Possible Rationales for a Federal Role in the Secondary Market

In assessing future options for Fannie Mae and Freddie Mac, a fundamental issue is what role, if any, the federal government should play in the secondary mortgage market. Historically, support for that market has been part of a broader federal housing policy aimed at encouraging home ownership and, to a lesser extent, at making housing more affordable for low- and moderate-income families. The activities of Fannie Mae and Freddie Mac have been an important aspect of that policy, although the largest federal subsidies for home ownership have generally come from favorable tax treatment for housing.<sup>2</sup>

Federal policies that affect the secondary market are mainly intended to achieve two public purposes:

- Helping to ensure a steady supply of financing for residential mortgages, and
- Providing subsidized assistance for mortgages on housing for low- and moderate-income families.

The government has pursued those goals largely through policies that increase the liquidity of mortgages and mortgage-backed securities. In a liquid market, investors can quickly buy or sell large quantities of an asset without

affecting its price. The government can enhance the liquidity of the secondary mortgage market by providing credit guarantees, which make MBSs safer and thus easier for investors to value, and by standing ready to buy and sell MBSs. Such government support has the greatest impact on the availability and price of mortgage funding during disruptions in the financial markets. At such times, interruptions in the supply of mortgage credit can spill over to the market for new-home construction and weaken the broader economy. Such interruptions can also impede labor mobility by making it more difficult for people to buy and sell homes when they want to move.

Supporting liquidity in the secondary mortgage market through federal credit guarantees tends to lower interest rates only slightly for most mortgage borrowers under normal market conditions. When mortgages are unsubsidized, the cost of providing a credit guarantee is offset by the fees charged to investors, and those guarantee fees are passed on to borrowers. Nevertheless, borrowers may benefit because investors are willing to pay somewhat higher prices (or, equivalently, accept lower interest rates) for MBSs that are more liquid. In a competitive marketplace, that advantage tends to reduce the rates paid by borrowers relative to what rates would be in the absence of federal guarantees. (To the extent that Fannie Mae and Freddie Mac are able to dominate the market for MBSs, the value of greater liquidity may accrue largely to them rather than to borrowers.)

The benefits of the government's actions to increase liquidity in the secondary market by providing credit guarantees and purchasing mortgages must be weighed against the costs. Those actions expose taxpayers to the risk of potentially large losses when the cost of honoring guarantees exceeds the value of guarantee fees collected—or when mortgages held by the government lose value because of changes in interest rates or prepayment rates (that is, the extent to which borrowers pay mortgages off early). Federal guarantees also reduce the incentive for mortgage originators to avoid making risky loans in the first place.

Besides encouraging a stable supply of financing, another objective of federal involvement in the secondary mortgage market is to increase the availability of credit and subsidize its costs for people with low or moderate income. Broadening access to home ownership could be beneficial because owning a home may give people a greater stake in their community and thus make

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2. Congressional Budget Office, *An Overview of Federal Support for Housing*, Issue Brief (November 2009). Some analysts argue that federal housing policy has encouraged unsustainable rates of home ownership and overinvestment in housing while reducing investment in sectors of the economy that may be more productive—a view reinforced by the disruptions in the housing market that triggered the recent economic crisis. Those broader issues are beyond the scope of this analysis, which focuses on federal support for the secondary mortgage market.

communities more stable. Moreover, certain types of housing assistance may be provided more effectively through support for the secondary market than through grants or tax preferences. For example, some borrowers may have the financial means to own a home but have trouble obtaining private credit—a problem known as “credit rationing.” That problem can occur when it is difficult for lenders to assess the riskiness of certain borrowers, such as those with short credit histories. Lenders cannot address that greater risk by charging higher interest rates, because such terms tend to attract borrowers who are more likely to default. However, the government may decide that the value to society from subsidizing certain loans is greater than the cost of doing so.

Currently, several federal agencies—including the FHA, the Department of Veterans Affairs (VA), and the Government National Mortgage Association (Ginnie Mae)—provide assistance to low- and moderate-income borrowers through the secondary market, as (to a more limited extent) do Fannie Mae and Freddie Mac. The FHA and VA increase the flow of credit to such borrowers by explicitly insuring mortgages against losses from default, and Ginnie Mae guarantees the payment of interest and principal on MBSs backed by pools of those mortgages. Fannie Mae and Freddie Mac are required to provide support for affordable housing by meeting certain goals set by regulators. Those goals specify the percentage of the GSEs’ mortgage guarantees and purchases that must involve loans used to finance rental housing for, or home purchases by, people with low or moderate income.

## Weaknesses of the Precrisis Model

Despite the potential beneficial effects of federal involvement in the secondary mortgage market, the rules and market structure under which Fannie Mae and Freddie Mac operated before conservatorship—referred to in this study as the precrisis model—had numerous weaknesses. Those weaknesses included the following:

- Adverse effects from the implicit federal guarantee of the two GSEs (such as a concentration of market power, risks to the stability of the larger financial system, incentives for excessive risk taking, and a lack of transparency about costs and risks to the government);
- Limited effects on affordable housing;
- Lax regulation; and

- Tensions in trying to balance competing public and private goals.

The implicit federal guarantee concentrated market power in Fannie Mae and Freddie Mac by giving them lower funding costs than potential competitors in the secondary market. As a consequence, the GSEs grew to dominate the segments of the market in which they were allowed to operate. Because of their size and interconnectedness with other financial institutions, they posed substantial systemic risk—the risk that their failure could impose very high costs on the financial system and the economy. The GSEs’ market power also allowed them to use their profits partly to benefit their other stakeholders rather than exclusively to benefit mortgage borrowers.

The implicit guarantee created an incentive for the GSEs to take excessive risks: Stakeholders would benefit when gambles paid off, but taxpayers would absorb the losses when they did not. (Financial institutions that lack the benefit of a federal guarantee have less incentive to take risks because doing so can increase their financing costs, although some still act imprudently at times.) One way that Fannie Mae and Freddie Mac increased risk was by expanding the volume of mortgages and MBSs held in their portfolios, which exposed them to the risk of losses from changes in interest or prepayment rates. Over the past decade, the two GSEs also increased their exposure to default losses by investing in lower-quality mortgages, such as subprime and Alt-A loans.<sup>3</sup>

Because the federal guarantee was implicit rather than explicit, the costs and risks to taxpayers did not appear in the federal budget. That lack of transparency made it more difficult for policymakers to assess and control the GSEs’ costs and risks. Lack of transparency also made it difficult for policymakers to evaluate whether the GSEs were effectively and efficiently meeting their affordable-housing goals; several studies have questioned the effectiveness of the GSEs’ affordable-housing activities.

Weak regulation was a further shortcoming of the precrisis model. For instance, until 2008, the GSEs’ regulators lacked the power to increase capital requirements for

3. Subprime and Alt-A mortgages are offered to some borrowers who do not meet the qualifications for a prime mortgage (one extended to the least risky borrowers) because of such risk factors as a low credit rating, insufficient documentation of income, or the ability to make only a small down payment.

Fannie Mae and Freddie Mac or to place them in receivership—powers that regulators have long had over banks.

Finally, as private companies with a public mission and implicit public backing, Fannie Mae and Freddie Mac faced an intrinsic tension in balancing the objectives of maximizing profits for their shareholders, maintaining safety and soundness to minimize potential costs to taxpayers, and supporting affordable housing. For example, efforts to help low-income households tend to involve targeting loans toward borrowers who generally pose more risk than borrowers of traditional conforming mortgages do, thereby putting taxpayers at greater risk of loss. The affordable-housing goals and the pursuit of profit may have encouraged Fannie Mae and Freddie Mac to purchase subprime MBSs that were expected to generate high returns but that involved excessive risk for borrowers and taxpayers alike.

## Alternative Approaches for the Future of the Secondary Mortgage Market

The weaknesses inherent in the precrisis model may argue against returning to that model after the GSEs' conservatorship ends. A broad array of alternatives are possible for the federal government's future role in the secondary mortgage market. Any new approach would need to confront major design issues, such as whether to have federal guarantees and, if so, how to structure and price them; whether to support affordable housing and, if so, by what means; and how to structure and regulate the secondary market.

The Congressional Budget Office (CBO) analyzed three broad alternatives for structuring the secondary mortgage market (see Summary Table 1):

- Adopting a hybrid public/private approach that would involve explicit federal guarantees of some privately issued mortgage-backed securities;
- Establishing a fully federal agency that would purchase and guarantee qualifying mortgages; or
- Promoting a fully private secondary market with no federal guarantees.

In examining those broad approaches, CBO looked at a number of criteria, including whether a given alternative

would ensure a stable supply of financing for mortgages, how affordable-housing goals would be met, how well taxpayers would be protected from risk, whether federal guarantees would be priced fairly, and to what extent an approach would provide incentives to control risk taking. (For a synopsis of the trade-offs between the alternative approaches, see Summary Table 2 on page 8).

### Managing the Transition to a New Approach

Moving from the current operations of Fannie Mae and Freddie Mac under conservatorship to any new model would involve several transitional issues, including how to manage the GSEs' existing portfolios and guarantee obligations and what to do with their operating assets. The government faces two basic choices: either retain the GSEs' portfolios and the responsibility for their outstanding guarantees and allow both to run out as mortgages are paid off, or pay a private entity to assume the guarantee obligations and sell off the portfolios. Whatever model for the secondary market is ultimately adopted, the expected losses on the GSEs' existing business will largely be borne by taxpayers, because private investors would not assume those obligations without compensation. The GSEs' operating assets are valuable; they could be auctioned off to investors (with the proceeds helping to offset some of the losses to taxpayers) or kept for use by a federal agency.

This study does not address those transitional issues in depth. Handling them efficiently and without disruption to the secondary mortgage market—especially given current conditions in housing and mortgage markets—is both important and difficult. However, in CBO's judgment, those issues have little impact on the relative merits of various approaches for the long-term organization of the secondary market, which is the focus of this study.

### Major Design Issues

Many different models for the secondary mortgage market involve common design issues, such as how to structure and price any federal credit guarantees, whether and how to support affordable housing, and how to structure and regulate the secondary market.

**Structuring Federal Guarantees.** The design of federal guarantees is an important issue for both a hybrid public/private approach and a fully federal approach. A key choice involves which mortgages would be considered eligible for federal guarantees. Mortgage products that qualify for federal backing tend to be popular, and hence

**Summary Table 1.****Key Features of Alternatives for the Secondary Mortgage Market**

	Hybrid Public/Private Model	Fully Federal Agency	Fully Private Market
Existing operating assets of Fannie Mae and Freddie Mac	Handed over to specialized issuers of federally backed MBSs (could be non-profit, cooperative, or private firms), sold to private-label issuers, or liquidated	Used for operations of agency, sold to private-label issuers, or liquidated	Sold to private-label issuers or liquidated
Licenses to issue federally guaranteed MBSs	Under “public-utility model,” only a few; under “competitive market-maker model,” available to any firm meeting specified criteria	None; operations undertaken by agency	None
Federal guarantees for loans or MBSs	Explicit, possibly covering only catastrophic risks	Explicit	None (Phased out)
Private capital’s role in secondary market	Absorbs most or all losses, except in cases of unusually large shocks	None on federally guaranteed securities; absorbs all losses on private-label securities	Absorbs all losses
Allowable activities for federally guaranteed securitizers	Under “public-utility model,” restricted to issuing MBSs and holding very limited portfolios; under “competitive market-maker model,” restricted only enough to limit spillover of risk to government	Issuing guarantees and possibly holding portfolios of mortgages and MBSs	Not applicable
Support for affordable housing	Could occur through terms on federal guarantees, fees on issuers of federally backed MBSs, or government agencies	Could occur through agency	No special role; could occur through government agencies
Role of issuers of private-label MBSs	Serve borrowers whose mortgages do not qualify for federal guarantees	Serve borrowers whose mortgages do not qualify for federal guarantees	Dominant players in secondary market, along with other private financial institutions

Congressional Budget Office.

MBSs = mortgage-backed securities.

such backing can be used to encourage best practices by lenders. Including a wide range of products in the definition of qualifying mortgages—and setting high dollar limits for those loans—would provide benefits to more borrowers and could increase the stability of the secondary market. At the same time, a large-scale guarantee program would expose the government to greater risk, reduce the incentives for prudent risk taking, and tend to crowd out private participation in the market.

The government could charge guarantee fees that partly or fully offset the total expense of its guarantee program, including administrative costs, expected losses, and the cost of risk. (If fees and other collections were insufficient to cover those costs, the government would have to subsidize the program.) Basing guarantee fees on the riskiness of a mortgage would weaken the incentive for excessive risk taking and reduce the extent to which safer borrowers cross-subsidized riskier ones.

Some proposals envision providing federal guarantees but limiting the government's exposure to risk by sharing risk with the private sector. Under such proposals, private capital—along with homeowners' down payments and any capital provided by private mortgage insurance—would be the first line of defense against losses from defaults. Transferring risk to the private sector would not only lower the government's exposure directly but also give private entities greater incentives to control risk and thereby reduce the government's exposure further.

One risk-sharing option that could limit federal losses would be for the government to sell catastrophic risk protection on qualifying MBSs. With catastrophic guarantees, payouts to investors might be triggered, for instance, only when nationwide default rates exceeded some threshold. Smaller losses would be absorbed by private capital or insured by private mortgage insurance. Relying heavily on the private sector for credit protection would have drawbacks, however. Investors would probably perceive securities with very limited federal backing as being riskier and less uniform than those currently issued by Fannie Mae and Freddie Mac, which would make them less liquid. The availability of private capital and private mortgage insurance is also susceptible to disruptions in the financial markets.

**Supporting Affordable Housing.** The main design issue related to affordable housing is whether to transfer the GSEs' responsibilities in this area to fully federal entities (such as the FHA) that are funded with broad-based taxes or to pursue affordable-housing goals through taxes or mandates on private institutions operating in the secondary mortgage market. Supporting affordable housing generally involves providing subsidies, which are most easily controlled and monitored when administered by a federal agency. Some observers, however, question whether a federal agency could provide support as effectively or flexibly as private entities; in their view, it would be better to have such support remain the responsibility of private financial institutions.

In the precrisis model, the GSEs' affordable-housing activities were effectively funded through the financial advantage generated by the government's implicit guarantee. Under alternative approaches with an explicit federal guarantee, the fees charged to investors would probably either just cover or not entirely cover the government's cost for the guarantee program and so would not generate a surplus that could be used to support affordable hous-

ing.<sup>4</sup> Thus, the alternatives to fund affordable-housing activities would be either to use general revenues or to use special taxes or mandates on financial institutions. Broad-based taxes tend to be less distorting and hence preferable in terms of economic efficiency, although special assessments on financial institutions might be justified as compensation for benefits that those institutions receive from the government.

**Structuring and Regulating the Secondary Market.** Key issues related to the structure of the market include what role private-label securitizers would play, how much they would be regulated, and whether any of the GSEs' advantages would be extended to other market participants or abolished. For a hybrid public/private approach, another critical design issue is how the market would be structured—specifically, the number and types of intermediaries that would exist and the activities they would be permitted to engage in. Proposals range from licensing a small number of highly regulated private entities to package and sell federally guaranteed MBSs (the “public-utility model”) to allowing any private financial institution that met certain regulatory criteria to package and sell federally guaranteed MBSs (the “competitive market-maker model”).

An argument in favor of the public-utility model is that it could create a more level playing field for mortgage originators than a less regulated approach would; the public utilities would be required to serve all originators, thereby facilitating broad access to the secondary market. In addition, having a small number of intermediaries could increase the liquidity of the secondary market by ensuring that investors viewed different federally backed MBSs as interchangeable. If the intermediaries were structured as nonprofit entities, they might also have less incentive to take risk than for-profit firms do.

If the public utilities' business was limited to creating federally backed MBSs, however, they would be more exposed to mortgage credit risk than would financial institutions with a more diverse set of investments.

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4. Whether the fees would appear to exceed the costs of the guarantees would depend on the accounting approach used to determine their budgetary cost. From an economic perspective (which presumes that the government has no intrinsic advantage over large private financial institutions because it takes on the same risks), the fees collected would be unlikely to exceed the cost of the guarantees. If they did, borrowers could find better guarantee prices in the private sector.

**Summary Table 2.**  
**Key Factors for Assessing Alternatives for the Secondary Mortgage Market**

	Hybrid Public/Private Model	Fully Federal Agency	Fully Private Market
Supply of financing for mortgages	Under normal market conditions, the supply of funding for federally backed mortgages would be fairly stable. During periods of market stress, financing could become less available, especially under versions with narrower federal guarantees and more reliance on private capital.	The supply of funding for federally backed mortgages would be fairly stable—both in normal times and during periods of market stress—because uncertainty about the strength of the federal guarantee would be minimized.	The market would be more susceptible to fluctuations in the supply of funding. During periods of acute market stress, funding could become extremely scarce without federal intervention.
Support for affordable housing	Mortgages that satisfied affordable-housing goals could be subsidized through lower federal guarantee fees, with the subsidy cost shown in the budget. Or responsibility could be transferred to a fully federal agency, such as the Federal Housing Administration.	Subsidies could be delivered by the agency and would be shown in the federal budget.	Responsibility would be transferred to a fully federal agency, such as the Federal Housing Administration, or subsidies would be discontinued.
Taxpayers' exposure to risk	Intermediaries in the secondary market would bear all credit losses until their capital was exhausted, limiting the credit risk that taxpayers would face.  If only a few specialized firms participated in the market, they might receive government support if their solvency was threatened.	Taxpayers would bear the entire credit risk on guaranteed mortgages.  Private-label issuers seen as critical to the functioning of the mortgage market might receive government support during periods of acute market stress.	Taxpayers' exposure to credit risk would be very small under normal market conditions. Taxpayers could be exposed to greater risk through federal deposit insurance if banks bore more credit risk.  Firms seen as critical to the functioning of the mortgage market might receive government support during periods of acute market stress.
Pricing of federal guarantees	The government could have trouble fully pricing catastrophic risk or setting risk-sensitive prices, which would probably shift some cost to taxpayers.	The government probably has weaker incentives than private guarantors do to charge fees that would fully compensate for the risks associated with guarantees, suggesting that taxpayers would probably bear a cost.	No explicit federal guarantees; however, any implicit federal guarantees that arose would be free to the private issuers of MBSs and hence would entail a cost to taxpayers.

Continued



**Summary Table 2.** **Continued**  
**Key Factors for Assessing Alternatives for the Secondary Mortgage Market**

	Hybrid Public/Private Model	Fully Federal Agency	Fully Private Market
Incentives to control risk taking	The presence of federal guarantees would create an incentive for excessive risk taking. Limiting government guarantees and charging risk-based prices for them would reduce that incentive. In addition, private intermediaries would have an incentive to set risk-based prices and monitor risk taking.	Having the government absorb all credit losses would create a strong incentive for excessive risk taking by originators. The government could counter that incentive by setting risk-based prices for guarantees and by restricting eligibility for guarantees to safer mortgages. Incentives to limit risk taking would probably be weaker than if private capital was in the position to absorb some losses.	Financial intermediaries would have a relatively strong incentive to manage risk, but it would be weakened if their obligations were seen as implicitly guaranteed by the government.
Other considerations	<p>Depending on the model implemented, government control over the secondary mortgage market could be greater or less than under the precrisis model.</p> <p>Tensions between public and private purposes might remain, particularly under models with a small number of highly regulated intermediaries.</p> <p>Subsidies could tilt the allocation of capital in the economy too far toward housing and away from other uses.</p>	<p>The government would control a large segment of the capital market.</p> <p>The market would probably be less dynamic, and there would be less incentive for product innovation.</p> <p>Tensions between public and private purposes would be minimized.</p> <p>Subsidies could tilt the allocation of capital in the economy too far toward housing and away from other uses.</p>	<p>The government would regulate the secondary mortgage market but otherwise not intervene.</p> <p>The market would not rely on the viability of any one firm or business model.</p> <p>Tensions between public and private purposes would be minimized.</p>

Congressional Budget Office.

Concentrating risk exposure would replicate one of the major weaknesses of Fannie Mae and Freddie Mac and make the new public utilities more susceptible to shocks in the housing market than more-diversified institutions would be. In addition, having only a few large intermediaries that were essential to the functioning of the secondary market could recreate the “too big to fail” problem, even if federal guarantees were limited by law. And nonprofits might have weaker incentives than private-sector institutions do to control costs and risks and to innovate. Another concern with the public-utility model is “regulatory capture”—that over time, regulators might become more responsive to the goals of the regulated entities than to the interests of the general public.

The competitive market-maker model also has strengths and weaknesses. On the one hand, spreading mortgage credit risk more widely among more-diversified institutions would reduce risks to the overall financial system and the economy, compared with both the precrisis model and the public-utility model. Having a greater number of institutions issue federally backed MBSs would also encourage innovation and foster competition—which could help ensure that the benefits of federal support went to mortgage borrowers rather than to stakeholders of the financial intermediaries.

On the other hand, even with a federal guarantee, MBSs issued by different institutions might not be viewed as completely interchangeable. In that case, the liquidity of

MBSs would be reduced, and borrowing costs would increase. It is also possible that smaller mortgage originators might have trouble gaining access to the secondary market if large private institutions were unwilling to buy loans from them, although competition among market makers would make that outcome unlikely. Another concern with allowing broad participation by diversified firms is that the government could be exposed to greater risk because losses from firms' other lines of business could spill over to their activities in the secondary mortgage market.

### **A Hybrid Public/Private Model**

Many proposals for the future of the secondary market involve providing federal guarantees of certain mortgages or MBSs that would qualify for government backing. That approach would preserve many features of how the secondary market for conforming mortgages operated before Fannie Mae and Freddie Mac were placed in conservatorship. However, a hybrid approach would depart from the precrisis model in three main ways: A potentially different set of private intermediaries would be established to securitize federally backed mortgages, the federal guarantees on those mortgages would be explicit rather than implicit, and their subsidy cost would be recorded in the federal budget.

As the preceding discussions about structuring federal guarantees and regulating the secondary mortgage market illustrate, a hybrid approach could be implemented in ways that involved broader or narrower federal guarantees and more or less regulation of participants in the market. Under a hybrid approach, private capital and possibly private mortgage insurance would absorb credit losses before the federal guarantee would be called upon. Fannie Mae and Freddie Mac could be privatized and allowed to compete in the secondary market; they could be used to form a nonprofit organization that would issue federal guarantees; or they could be liquidated. The government could provide additional housing assistance to low- and moderate-income families by subsidizing guarantee fees for qualifying borrowers or by funding programs of the FHA or other federal agencies that target those groups.

Compared with the approach of establishing a fully federal agency, a hybrid public/private approach would lessen concerns about putting a large portion of the capital market under government control. It would also limit costs and risks to taxpayers by having intermediaries in the secondary market bear all credit losses until their

capital was exhausted. In addition, putting private capital at risk would provide incentives for prudent underwriting and pricing of risk. Compared with a fully private secondary market, a hybrid approach would probably improve the liquidity of the market, especially during times of financial stress. Moreover, providing an explicit federal guarantee would avoid the problems of lack of transparency and control that an implicit guarantee involves.

Relying on explicit government guarantees of qualifying mortgages would also have some disadvantages, the importance of which would depend partly on the design chosen. If competition remained muted, with only a few specialized firms participating in the secondary market, limiting risk to the overall financial system and avoiding regulatory capture could be difficult. Moreover, federal guarantees would reduce creditors' incentive to monitor risk. Experience with other federal insurance and credit programs suggests that the government would have trouble setting risk-sensitive prices and would most likely end up imposing some cost and risk on taxpayers. In addition, a hybrid approach might not eliminate the frictions that arise between private and public missions.

### **A Fully Federal Agency**

An alternative would be to create a government-run program that would provide explicit federal guarantees promising timely payment of interest and principal on qualifying mortgages or MBSs. (Such a program could share many features with the current activities of the FHA and Ginnie Mae.) The net cost of the federal program would appear in the budget and could be covered wholly or partly by charging guarantee fees. Policymakers could use the design of the fees to determine the size of subsidies to low-income borrowers or providers of low-income rental housing. Under that fully federal approach, some of the existing operations of Fannie Mae and Freddie Mac could become part of a new or existing federal agency.

A federally run program could have some advantages over alternatives that relied on the private sector. For example, such a program would be more likely to ensure a fairly steady flow of funds to the secondary mortgage market—both in normal times and during periods of financial stress—by minimizing uncertainty about the strength of the federal guarantee. Compared with the precrisis model, this approach would increase transparency by replacing an implicit guarantee with an explicit one.

Moreover, most of the federal subsidies would probably flow to mortgage borrowers rather than to private financial institutions.

At the same time, however, a new federal program would permanently increase government control of a large segment of the capital market. Depending on the size of the subsidies, that greater federal presence could tilt the allocation of capital in the economy further toward housing and away from other activities. In addition, a federally operated secondary market would probably be less dynamic and result in fewer innovations than a market in which competing private institutions played a larger role. Furthermore, taxpayers, rather than private financial institutions, would bear much of the credit risk on guaranteed mortgages. That shift in risk bearing might give mortgage originators and other financial intermediaries less incentive to control risk—a situation (known as moral hazard) that commonly arises with guarantees and insurance.

Depending on the specific budgetary treatment of the program, the government could have weaker incentives than private parties do to charge guarantee fees that would fully compensate for the risks associated with the guarantees. Currently, the budgetary treatment of most federal credit guarantees follows the guidelines of the Federal Credit Reform Act of 1990, which do not include a charge for market risk in estimates of federal subsidies.<sup>5</sup> As a result, such estimates tend to understate a guarantee's economic cost to taxpayers.

### **A Fully Private Secondary Mortgage Market**

Another approach would be to move to a fully private secondary mortgage market and either wind down the operations of Fannie Mae and Freddie Mac or sell the federal stake in their assets to private investors. Responsibility for carrying out the GSEs' affordable-housing mission, to the extent it was continued, could be transferred to a government housing agency, such as the FHA. Private firms would then form the secondary market—just as they did for private-label MBSs before the recent financial crisis and as they continue to do for securities backed by other types of assets (such as automobile, student, commercial real estate, and credit card loans). In

times of severe distress, the government could still step in to promote liquidity. For instance, it could make FHA guarantees available to more borrowers, or it could buy MBSs (as the Treasury and the Federal Reserve did during the financial crisis). Expanding the activities of federal agencies, however, generally requires Congressional action.

Privatization might provide the strongest incentive for prudent behavior on the part of financial intermediaries by removing the moral hazard that federal guarantees create. (The enormous losses that have occurred in recent years on private-label subprime mortgages, however, offer a painful reminder that private markets are not immune to aggressive risk taking.) By increasing competition in the secondary market, the privatization approach would reduce the market's reliance on the viability of any one firm. Private markets may also be best positioned to allocate the credit risk and interest rate risk of mortgages efficiently, and they would probably be more innovative than a secondary market dominated by a fully federal agency. Further, privatization would eliminate the tension between public and private purposes inherent in the traditional GSE model.

Full privatization could have several drawbacks, however, including the risk that it might not prove credible. If the private firms operating in the secondary market were seen as critical to the functioning of the mortgage market, investors might again treat them as implicitly guaranteed by the government, weakening market discipline, reducing transparency, and creating moral hazard. In addition, without some predictable federal response, the liquidity of the private secondary market might dry up during periods of acute financial stress. Moreover, privatization might not significantly reduce taxpayers' overall exposure to risk if it shifted credit risk on mortgages to banks that were covered by federal deposit insurance and if that additional risk was not recognized in regulators' actions and in the fees charged for deposit insurance.

### **Other Mortgage-Financing Approaches**

As an alternative to mortgage-backed securities, the federal government could offer support for other funding mechanisms for home loans. One possibility would be to encourage greater reliance on covered bonds—bonds collateralized by residential mortgages—which many large European banks use to fund the mortgages they hold. With covered bonds, banks bear most of the risks of mortgage lending: When a mortgage is paid off or goes

5. Market risk is the risk that investors cannot avoid by holding a well-diversified portfolio and that they require compensation to bear. Mortgages involve market risk because defaults occur most frequently in times of economic stress, when losses are most costly.

into default, the issuer is contractually obligated to replace the collateral with a new mortgage. That allocation of risk has both advantages and disadvantages compared with MBSs, which spread risk more widely among financial institutions, investors, and the government.

Other developed countries with high rates of home ownership rely less on government-backed MBSs to fund mortgages than the United States does. Some observers have pointed to Europe's housing finance systems as

potential models for this country; those systems have supported rates of home ownership comparable with that in the United States while relying less on MBSs. Although covered bonds are common in Europe, there is considerable variation in how mortgages are funded and what types of mortgages are available. Nevertheless, all developed countries with high rates of home ownership depend on some degree of government support to maintain the flow of credit to the mortgage market during periods of financial stress.