

# BACKGROUND

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## A Pathway to Shutting Down the Federal Housing Finance Enterprises

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### Abstract

*Since the New Deal–era federal housing policies of the 1930s, Congress has cobbled together a system of federal housing finance enterprises (FHFEs) that today cover more than \$6 trillion (60 percent) of the outstanding single-family residential mortgage debt in the U.S. The federal government has used the FHFEs to accomplish various policy goals—housing policies too often advanced under the notion of creating “affordable” homeownership opportunities. Over time, these policies have encouraged unsustainable levels of mortgage debt for millions of homeowners, and were central to several devastating downturns in the U.S. housing market. Overall, these policies have harmed American homeowners, cost federal taxpayers hundreds of billions of dollars in bailouts, and undermined the resilience of the housing finance system. It is time that Congress end these failed experiments of the federal government, and restore the conditions for a free enterprise in housing finance by shutting down these FHFEs.*

Over the past 80 years, Congress has assembled a system of federal housing finance enterprises (FHFEs), which have led to the long-term deterioration of credit underwriting standards, created moral hazard, and encouraged imprudent risk-taking in the housing finance system. Indeed, beginning with the New Deal–era housing policies of the 1930s, Congress has created an ever-growing apparatus of FHFEs that provides various forms of insurance and guarantees of residential home loans. The list of the FHFEs encompasses federal government agencies, the Federal Housing Administration (FHA), and the Rural Housing Service (RHS) authorized to provide mortgage insurance and guarantee coverage, as well as

### KEY POINTS

- Over the past 80 years, Congress has assembled a system of federal housing finance enterprises (FHFEs), which have led to the deterioration of credit underwriting standards and encouraged imprudent risk-taking in the housing finance system.
- FHFEs encompass the Federal Housing Administration, the Rural Housing Service, Ginnie Mae, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.
- FHFEs are antithetical to a free market in housing finance, and have led to less discipline by market participants. FHFEs create moral-hazard dilemmas for market participants that put homeowners, taxpayers, and private shareholders at greater risk of financial loss, while increasing home prices relative to what they would be otherwise.
- FHFEs have encouraged an explosion of mortgage debt over the past several decades, while national homeownership is at the lowest rate since the mid-1960s.
- It is time for Congress to end these failed experiments and shut down these FHFEs.

This paper, in its entirety, can be found at <http://report.heritage.org/bg3171>

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the Government National Mortgage Association (Ginnie Mae), which is authorized to guarantee the timely payment of pass-through income to investors of qualified mortgage-backed securities (MBS). In addition, the FHFES include three government-sponsored enterprises (GSEs)—the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Banks (FHLBs)—each chartered by Congress to facilitate operations in the secondary market for mortgages and MBS.

As wholly owned agencies of the federal government, the financial viability of Ginnie Mae, the FHA, and the RHS is directly subsidized by federal taxpayers. The GSEs, on the other hand, were chartered as private financial corporations, though they have benefitted from numerous federally financed subsidies not conferred to other corporations. Over the years, for example, these federal subsidies have included lines of credit with the U.S. Treasury, exemptions from regulatory filing requirements,<sup>1</sup> and various tax advantages. Because of the special privileges provided to these GSEs, financial market participants assumed, correctly, that these corporations have the implicit guarantee of the federal government. This implied guarantee became explicit when Fannie Mae and Freddie Mac, after suffering devastating financial losses during the 2007–2009 housing crisis, were placed into conservatorship under the Federal Housing Finance Agency (FHFA) and, combined, received several hundred billion dollars in direct bailout terms set by the U.S. Treasury. Overall, federal taxpayers currently cover more than \$6 trillion (60 percent) of single-family residential housing mortgage debt.<sup>2</sup>

As these institutions increase in size and influence over the housing finance system, their market activities, including the vast accumulation of debt, expose federal taxpayers to greater cost of bailouts during events of financial failure. Yet, Congress has repeatedly decided not to end the failed experiments, and has instead accomplished many reforms of the FHFES that have only further enmeshed federal taxpayers to the institutions. Nevertheless, there is a viable window for accomplishing federal policy reform that would shut down these institutions, thereby eliminating the distortions they create in the housing finance system. Congress can and should take the necessary steps to dissolve these FHFES, and allow the conditions for a vibrant free market in housing finance that can best provide individuals with durable and truly affordable homeownership opportunities over time.

## Origins of the Federal Housing Finance Enterprises

**The Federal National Mortgage Association.** Congress authorized the creation of national mortgage associations in the National Housing Act of 1934, and then in 1938, the government-owned Reconstruction Finance Corporation (RFC) used this authority to establish a subsidiary agency titled the National Mortgage Association of Washington, which soon became known as the Federal National Mortgage Association.<sup>3</sup> Over the first decade of its existence, Fannie Mae predominantly purchased mortgages insured by the Federal Housing Administration, although Fannie Mae’s purchases expanded in the 1940s to include mortgages insured through a program established for military

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1. The federal bailout terms with the U.S. Treasury require Fannie Mae and Freddie Mac to file financial disclosure forms with the U.S. Securities and Exchange Commission. These reporting requirements were established in terms of the respective Senior Preferred Stock Purchase Agreements (SPSPAs) with each corporation in September 2008. Federal Housing Finance Agency, “Senior Preferred Stock Purchase Agreements,” <http://www.fhfa.gov/Conservatorship/Pages/Senior-Preferred-Stock-Purchase-Agreements.aspx> (accessed September 6, 2016).
  2. By end of the second quarter of 2016, there was \$10 trillion in total outstanding mortgage debt for single-family residential housing and \$114 trillion in total outstanding mortgage debt for multi-family residential housing. Ginnie Mae guaranteed \$1.6 trillion in single-family residential housing mortgage debt, and \$96 billion in multi-family residential housing mortgage debt. Fannie Mae and Freddie Mac held \$2.81 trillion and \$1.7 trillion in single-family residential housing mortgage debt, and, respectively, \$210 billion and \$180 billion in multi-family residential housing mortgage debt. Federal Reserve Bank at St. Louis, “Board of Governors of the Federal Reserve System (US), Mortgage Debt Outstanding by Type of Holder,” <https://fred.stlouisfed.org/> (accessed October 4, 2016).
  3. Congress established the Federal Housing Administration in 1934, and gave the agency the power to insure home loans that met the requirements specified in the National Housing Act of 1934. The National Housing Act of 1934 also provided the statutory foundation for the creation of federally chartered National Mortgage Associations. The National Housing Act of 1934, P.L. 479-73D §§ 1-5, 201-209 and 301-308, [https://fraser.stlouisfed.org/scribd/?item\\_id=457156&filepath=/docs/historical/martin/54\\_01\\_19340627.pdf](https://fraser.stlouisfed.org/scribd/?item_id=457156&filepath=/docs/historical/martin/54_01_19340627.pdf) (accessed August 29, 2016).

veterans.<sup>4</sup> The federal government reorganized in 1950, which included the transfer of Fannie Mae from the RFC to the control of the newly formed Housing and Home Finance Agency (predecessor to the Department of Housing and Urban Development).<sup>5</sup> Then in 1954, Congress altered Fannie Mae's federal charter and provided it a means to raise private capital through the issuance of shares in common stock—although the federal government acquired shares of the preferred stock which established Fannie Mae's initial capitalization.

Indeed, Congress set a path toward privatization for Fannie Mae in the federal charter established by the Housing Act of 1954. This charter authorized Fannie Mae to remain a constituency division of the Housing and Home Finance Agency under the general control of the federal government.<sup>6</sup> The federal legislation also authorized the federal government to provide the initial capitalization and acquire shares of preferred stock in Fannie Mae, while including provisions for the drawdown (retirement) of the government-held shares of preferred stock. The 1954 charter enacted a method for Fannie Mae to raise private capital over time, largely from required (and

nonrefundable) contributions to a capital surplus account by mortgage lenders selling home loans to the corporation.<sup>7</sup> Fannie Mae determined the issuance and distribution structure of common shares to mortgage lenders largely based on these contributions. In the secondary market, Fannie Mae was authorized to conduct operations and create liquidity for residential mortgages eligible (and, as amended) under the National Housing Act, and thus this activity was focused on home loans insured by the FHA and through the home loan program established for military veterans.

In 1968, Congress again reformed Fannie Mae, only this time chartering it as a government-sponsored private corporation, and partitioned a portion of its financial portfolio to the newly created Ginnie Mae.<sup>8</sup> This legislative maneuvering amounted to shifting the debt portfolio for Fannie Mae off the official books of the federal government—a main impetus behind the passage of this section of the Housing and Urban Development Act of 1968—and provided some semblance of protection for federal taxpayers from liability for covering its debt.<sup>9</sup> Indeed, the 1968 Housing Act gave Fannie Mae the ability to raise

4. The federal Veterans home loan program was authorized in the Serviceman's Readjustment Act of 1944. In 1946, the Reconstruction Finance Corporation, and its subsidiary, the Federal National Mortgage Association, received authorization to facilitate mortgage purchases that were guaranteed through the Serviceman's Readjustment Act, a function which lapsed in 1947. Then, in 1948, Congress re-authorized the Federal National Mortgage Association to purchase insured mortgages as provided under the 1944 Serviceman's Readjustment Act. Serviceman's Readjustment Act of 1944, P.L. 346, June 22, 1944, with amendments prior to August 11, 1948, pp. 16–23, 42–43, and 47–50, <https://babel.hathitrust.org/cgi/pt?id=umn.31951d03569283;view=1up;seq=1;size=150> (accessed September 26, 2016); and U.S. Department of the Treasury, *Final Report on the Reconstruction Finance Corporation: Pursuant to Section 6(c) Reorganization Plan No. 1 of 1957*, 1959, pp. 94–95, [https://fraser.stlouisfed.org/scribd/?title\\_id=134&filepath=/docs/publications/rfc/rfc\\_19590506\\_finalreport.pdf](https://fraser.stlouisfed.org/scribd/?title_id=134&filepath=/docs/publications/rfc/rfc_19590506_finalreport.pdf) (accessed September 22, 2016).
5. Fannie Mae was reorganized under the Housing and Home Finance Agency, a predecessor agency to the Department of Housing and Urban Development, in 1950. The Housing and Home Finance Agency was established in 1947 as part of a national reorganization plan. Reorganization Plan No. 3 of 1947, 12 *Federal Register* 4981, 61 Stat. 694, July 27, 1947, <http://uscode.house.gov/view.xhtml?req=granuleid:USC-prelim-title5a-node83-leaf95&num=0&edition=prelim> (accessed September 26, 2016); *Reorganization Plan No. 22 of 1950*, 15 *Federal Register* 3177, 64 Stat. 1269, May 24, 1950, <https://www.gpo.gov/fdsys/pkg/USCODE-2011-title5/html/USCODE-2011-title5-app-reorganiz-other-dup40.htm> (accessed September 15, 2016); and U.S. Department of the Treasury, *Final Report on the Reconstruction Finance Corporation*, pp. 93–96.
6. Housing Act of 1954, P.L. 560 § 201, <https://www.gpo.gov/fdsys/pkg/STATUTE-68/pdf/STATUTE-68-Pg590.pdf> (accessed September 12, 2016).
7. The National Housing Act of 1954 (also referred to as the Federal National Mortgage Association Charter Act of 1954) authorized that Fannie Mae could issue shares of common stock to mortgage lenders that sold home loans to the corporation and made required contributions to its retained capital account. Also, Fannie Mae could retire the shares in preferred stock that the federal government had acquired by using surplus funds it had accrued in the retained capital surplus account. There was no authorized schedule established for the retirement of the government-held stock. Housing Act of 1954, P.L. 560 § 201.
8. Housing and Urban Development Act of 1968, P.L. 90–448 § 801, <https://www.gpo.gov/fdsys/pkg/STATUTE-82/pdf/STATUTE-82-Pg476.pdf> (accessed August 29, 2016).
9. The federal government maintained a significant level of control over the quasi-private Fannie Mae. This included, for example, requirements that the U.S. President nominate one-third of the corporation's board of directors and that the U.S. Secretary of the Treasury approve the securities (mortgage-backed securities) facilitated by Fannie Mae, and that these securities carry the same exemptions as direct and guaranteed obligations of the U.S. government from the laws administered by the U.S. Securities and Exchange Commission. Housing Act of 1968, P.L. 90–448 §§ 802(y)(7) and 804(a).

capital through the issuances of common shares of publicly traded stock,<sup>10</sup> and for the corporation to continue to facilitate secondary mortgage market operations for mortgages authorized (and, as amended) under the National Housing Act.<sup>11</sup> Fannie Mae's secondary mortgage market operations therefore were concentrated to the government-insured home loan market until in 1970 Congress expanded Fannie Mae's authority to include operations in the secondary conventional (non-government-insured) mortgage market.<sup>12</sup>

Until the mid-1980s, Fannie Mae's business activity in the secondary mortgage market primarily consisted of the purchases of whole loans in the conventional and government-insured mortgage markets.<sup>13</sup> Fannie Mae's strategy of concentrating on the acquisition of whole mortgages resulted in negative interest rate margins (the difference between its income derived from interest payments and borrowing (interest) costs) that led to several years of severe financial losses during the 1980s.<sup>14</sup> The General Accounting Office (now, the Government Accountability Office) reported that Fannie Mae suffered "cumulative net losses of over \$350 million in 1981, 1982, 1984, and 1985."<sup>15</sup> Fannie Mae was extended

several privileges at federal taxpayers' expense that included "regulator forbearance" (in other words, the problem was ignored) and a special tax provision that effectively allowed the corporation to forgo paying federal income taxes for up to 10 years.<sup>16</sup> In the wake of these financial losses, Congress revised the degree of federal oversight required of the corporation (along with several other GSEs, including Freddie Mac), and in 1992, Fannie Mae was officially moved under the direct supervision of the Office of Federal Housing Enterprise Oversight, a division of the Department of Housing and Urban Development.<sup>17</sup>

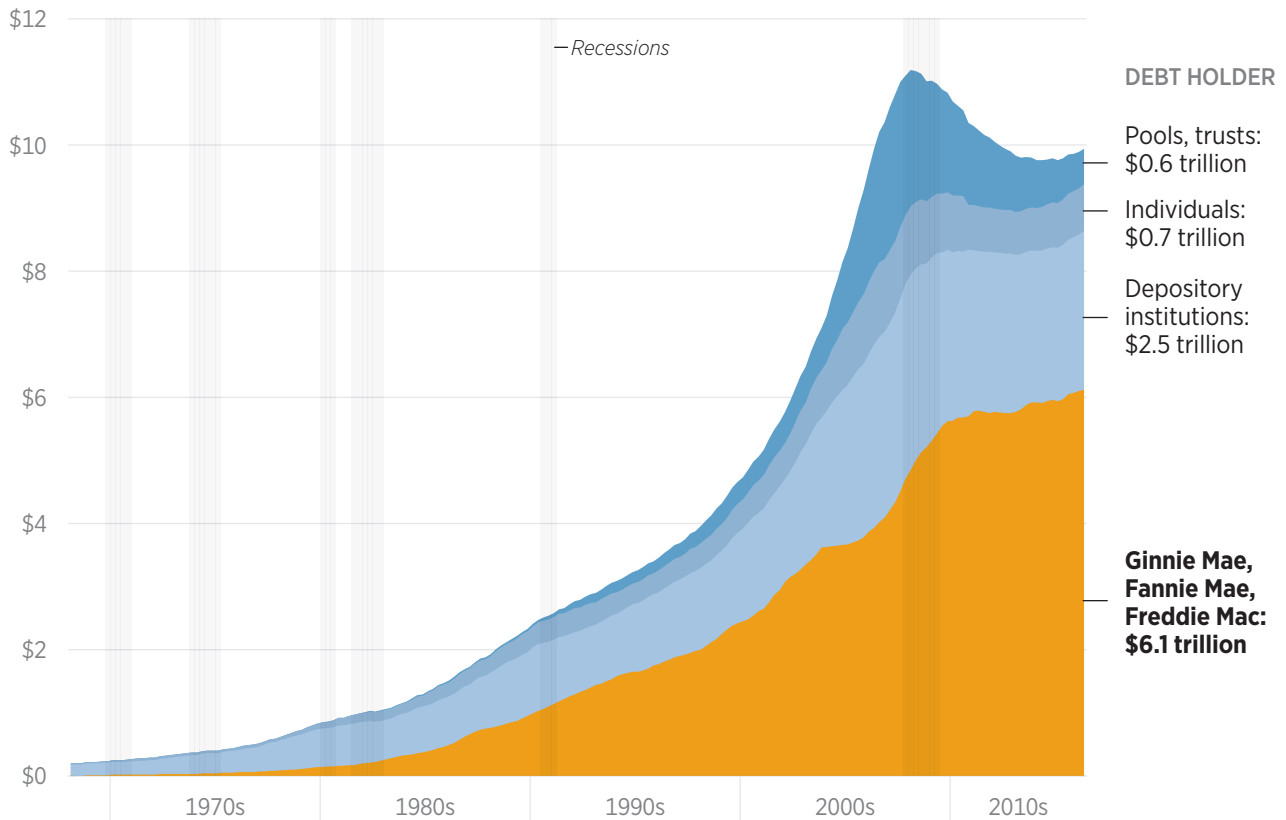
During the early 1990s, Congress also established requirements for Fannie Mae related to the advancement of "affordable" housing policies—federal policies that were primarily aimed at subsidizing homeownership and rental housing assistance for low-income and moderate-income households.<sup>18</sup> Over the next several decades, Fannie Mae committed an enormous amount of its overall business activity to its affordable-housing initiatives, including a pledge in 1994 that the corporation would purchase \$1 trillion in mortgage and mortgage-related securities associated with home loans to low and moder-

10. In 1968, Congress provided Fannie Mae with the authority to issue shares in common stock for public ownership (any person, firm, corporation, or other entity), and these shares each carried a voting right (cumulative for each share held) in the election of directors to Fannie Mae. Financial institutions responsible for servicing mortgages held by Fannie Mae were required to hold a minimum amount of common stock at all times. Housing Act of 1968, P.L. 90-448 §§ 802(h)-(m).
11. The Housing and Urban Development Act of 1968 authorized Fannie Mae to lend on securities as amended under section 302(b), and to facilitate certain secondary market functions related to investment activities in mortgages and mortgage-related securities. Housing Act of 1968, P.L. 90-448 §§ 802(d) and 804(a).
12. Fannie Mae's authority in the secondary mortgage market was later expanded in 1970 to include conventional mortgages. Emergency Home Finance Act of 1970, P.L. 91-351 § 201, <https://www.gpo.gov/fdsys/pkg/STATUTE-84/pdf/STATUTE-84-Pg450.pdf> (accessed September 26, 2016).
13. Fannie Mae started to issue MBS in 1981, though it had been involved in the mortgage-backed bond market prior to these MBS issuances. Beginning in the mid-1980s, Fannie Mae began to shift its portfolio toward mortgage-backed securities, and its mortgage portfolio activity in these securities has steadily increased since then. Fannie Mae, *Prospectus for the Guaranteed Mortgage Pass-Through Certificates*, November 1, 1981, p. 4, [http://www.fanniemae.com/syndicated/documents/mbs/mbspros/November\\_1\\_1981.pdf](http://www.fanniemae.com/syndicated/documents/mbs/mbspros/November_1_1981.pdf) (accessed September 23, 2016).
14. Fannie Mae, *Prospectus for the Guaranteed Mortgage Pass-Through Certificates*, November 27, 1985, p. B2, [http://www.fanniemae.com/syndicated/documents/mbs/mbspros/November\\_27\\_1985.pdf](http://www.fanniemae.com/syndicated/documents/mbs/mbspros/November_27_1985.pdf) (accessed September 23, 2016).
15. U.S. General Accounting Office, "Government-Sponsored Enterprises: The Government's Exposure to Risks," August 1990, p. 9, <http://www.gao.gov/assets/150/149461.pdf> (accessed September 30, 2016).
16. In 1982, Congress passed a law that extended provisions for Fannie Mae to carry back (or carry forward) certain losses for federal tax purposes. U.S. General Accounting Office, "Government-Sponsored Enterprises: The Government's Exposure to Risks," p. 9, and Miscellaneous Revenue Act of 1982, P.L. 97-362 § 102, <https://www.gpo.gov/fdsys/pkg/STATUTE-96/pdf/STATUTE-96-Pg1726.pdf> (accessed September 30, 2016).
17. Housing and Community Development Act of 1992, P.L. 102-550 §§ 1321-1328, 1331-1338, 1341-1349, 1361-1369 and 1381-1383, [https://fraser.stlouisfed.org/scribd/?title\\_id=1106&filepath=/docs/historical/congressional/housing-community-development-1992.pdf](https://fraser.stlouisfed.org/scribd/?title_id=1106&filepath=/docs/historical/congressional/housing-community-development-1992.pdf) (accessed September 12, 2016).
18. Housing and Community Development Act of 1992, P.L. 102-550 §§ 1331-1338, and The National Affordable Housing Act of 1990, P.L. 101-625, <https://www.congress.gov/bill/101st-congress/senate-bill/566/text> (accessed September 15, 2016).

CHART 1

## Federal Enterprises Hold \$6 Trillion in Residential Mortgage Debt

TOTAL OUTSTANDING MORTGAGE DEBT OF SINGLE-FAMILY RESIDENCES



**SOURCE:** Data from the Board of Governors of the Federal Reserve System, retrieved via HaverAnalytics (accessed October 18, 2016).

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ate income households.<sup>19</sup> As has been documented by numerous housing policy experts, these federal affordable-housing policies beginning in the 1990s prompted a dramatic deterioration in underwriting standards for residential single-family homes, and represented some of the government policies that led to the 2007–2009 housing market collapse.<sup>20</sup> Fannie Mae, given its size and influence in the sec-

ondary mortgage market, was crucial to the systematic increase in mortgage credit (and high-risk mortgage lending) that contributed to the collapse in the housing market.

These so-called affordable-housing policies were central to the unraveling in the U.S. housing market between 2007 and 2009,<sup>21</sup> as well as the severe decline in financial solvency of Fannie Mae. Indeed,

19. James R. Hagerty, *The Fateful History of Fannie Mae: New Deal Birth to Mortgage Crisis Fall* (Mt. Pleasant, SC: The History Press, 2012), pp. 93–105, and Peter J. Wallison, *Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again* (New York: Encounter Books, 2015), pp. 161–163.

20. Fannie Mae worked to meet the federal “affordable” housing goals through purchases in whole loans as well as its activity in the MBS market, including purchases of private-label MBS that met the affordable-housing requirements. Norbert J. Michel and John L. Ligon, “Fannie and Freddie: What Record of Success?” Heritage Foundation *Backgrounder* No. 2854, November 7, 2013, <http://www.heritage.org/research/reports/2013/11/fannie-and-freddie-what-record-of-success>.

21. Wallison, *Hidden in Plain Sight*, pp. 125–233.



as a result of significant and sudden increases in loan defaults and home foreclosures,<sup>22</sup> Fannie Mae began to suffer devastating financial losses in 2008 and was placed into federal conservatorship. During the FHFA conservatorship, the federal government has effectively nationalized Fannie Mae, which includes bailout terms with the U.S. Treasury that have resulted in the federal government acquiring approximately \$140 billion worth of preferred and senior-preferred shares of stock in Fannie Mae and warrants to acquire 79.9 percent of the shares of common stock.<sup>23</sup> To make matters worse, Fannie Mae continues to hold significant influence in the housing finance system, covering more than \$3 trillion in outstanding single-family and multi-family housing residential mortgage debt. Federal taxpayers remain exposed to significant risk of covering any further financial losses given the scheduled depletion of Fannie Mae's capital reserve account by 2018, and should there be any significant increase in interest rates or downturn in general conditions in the housing market.

**The Government National Mortgage Association.** Congress created Ginnie Mae in 1968 to function as a wholly owned corporate instrumentality of the U.S. government, and provided that it finances the guarantee of the timely payment of

pass-through income to investors, to carry the full faith and credit of the U.S. government.<sup>24</sup> Ginnie Mae received authority to issue and guarantee pass-through income on MBS in 1968,<sup>25</sup> and this mortgage securities market officially took off in 1970.<sup>26</sup> There was a special emphasis between the Federal Home Loan Bank Board (FHLBB) and Ginnie Mae to coordinate the early issuances of the guaranteed MBS, and this market remained concentrated to those securities issued by Ginnie Mae and Freddie Mac until 1977 when Bank of America began to issue the first private-label MBS.<sup>27</sup> Over the next several decades, Ginnie Mae's total guarantee portfolio has steadily increased, and as of the end of the second quarter of 2016, it guaranteed approximately \$1.6 trillion (16 percent) in outstanding unpaid balances on single-family residential housing mortgages.

The Ginnie Mae MBS are almost entirely structured from government-insured mortgages, and the guarantee provides investors with the assurance of the timely payment on pass-through income. The pass-through income paid to investors is generally derived from a portion of the principal and interest payments in the mortgage pools that comprise the MBS. Ginnie Mae has typically relied on financial institutions to both issue the MBS for purchase by investors and then to service the pass-through

22. As of June 2008, Fannie Mae and Freddie Mac combined balance sheets retained almost 11 million mortgages that had default rates between 13.8 percent and 17.3 percent. *Ibid.*, pp. 201-202.

23. The U.S. Treasury has acquired \$117.1 billion in senior preferred stock and \$19.1 billion in preferred stock of Fannie Mae, and it retains warrants to purchase up to 79.9 percent of the common stock of the corporation. Moreover, under the senior preferred stock purchase agreements, Fannie Mae is required to disburse dividend payments on the senior preferred shares held by the Treasury. The disbursements of dividends do not, however, represent any notion of repayment on the capital infusions financed by the Treasury. Federal Housing Finance Agency, "Senior Preferred Stock Purchase Agreements," Federal Housing Finance Agency, *2015 Annual Report to Congress*, June 2016, pp. 84 and 101, [http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA\\_2015\\_Report-to-Congress.pdf](http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_2015_Report-to-Congress.pdf) (accessed October 4, 2016); and Fannie Mae, "Form 10-Q: Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934," pp. 9-10 and 69-73, <http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2016/q22016.pdf> (accessed September 9, 2016).

24. Ginnie Mae is required to operate under the requirements codified in federal law for government corporations, and the guarantee provided on the timely payment of pass-through income on qualified mortgage-backed securities holds the full faith and credit of the U.S. government. U.S. Code Title 31, Subtitle VI, Sections 9101-9110, <https://www.gpo.gov/fdsys/pkg/USCODE-2009-title31/html/USCODE-2009-title31-subtitleVI.htm> (accessed September 27, 2016).

25. Ginnie Mae, *Government National Mortgage Association Statutory Authority*, pp. 3, 6, and 11, [http://www.ginniemae.gov/about\\_us/what\\_we\\_do/Documents/statutes.pdf](http://www.ginniemae.gov/about_us/what_we_do/Documents/statutes.pdf) (accessed September 28, 2016).

26. Soon after Ginnie Mae's first issuances of MBS in 1970, Freddie Mac started to issue and sell MBS in addition to the mortgage-backed bonds it was already selling to investors.

27. U.S. Securities and Exchange Commission, *A Staff Report of the Task Force on Mortgage-Backed Securities Disclosure: Enhancing Disclosure in the Mortgage-Backed Securities Market*, January 2003, p. 7, <https://www.treasury.gov/resource-center/fin-mkts/Documents/disclosure.pdf> (accessed September 23, 2016); "Clarke Discusses Secondary Mortgage Markets," *The Journal of the Federal Home Loan Bank Board*, Vol. 3, Nos. 1 & 2 (January/February 1970), p. 4, <https://babel.hathitrust.org/cgi/pt?id=uc1.c3427024;view=1up;seq=1> (accessed October 3, 2016); and "Board Actions on Friend Study Recommendations," *The Journal of the Federal Home Loan Bank Board*, Vol. 3, No. 9 (September 1970), p. 7, <https://babel.hathitrust.org/cgi/pt?id=uc1.c3427024;view=1up;seq=37> (accessed September 27, 2016).

income on the securities, although in recent years it has implemented an option for these financial institutions to issue the securities and transfer the servicing rights to Ginnie Mae.<sup>28</sup> Ginnie Mae charges fees in return for the guarantee on the pass-through income, which shields investors from certain risks, primarily credit (default) risk, in these investment securities. Ginnie Mae is protected by the guarantee fees in addition to the viability of the financial institutions issuing and servicing the MBS.

Overall, Ginnie Mae provides liquidity for government-insured home loans in the housing finance system, which occurs as mortgage lenders sell home loans to financial institutions used in the structuring of the MBS. Ginnie Mae requires insurance coverage on the mortgages in the pools used for the MBS, and the mortgage insurance is almost entirely covered by direct federal government agencies.<sup>29</sup> The Ginnie Mae-guaranteed MBS almost entirely derive from pools of home loans insured by the FHA, and to a lesser extent those home loans covered by the U.S. Department of Agriculture's Rural Housing Service, the Department of Housing and Urban Development's Office of Public Indian Housing, and the single-family home loan guarantee program of the Department of Veterans Affairs. In fact, FHA-insured mortgages alone make up roughly 86 percent of the insured loans in the MBS pools, while only 5 percent of loans are covered in the conventional (non-government-insured) mortgage mar-

ket.<sup>30</sup> These government insurance programs, particularly those of the FHA and the RHS, operate with comparatively high rates of default.<sup>31</sup> Therefore, the overall liquidity created by the Ginnie Mae guarantee structure increases the level of government-subsidized mortgage credit and expands the federal government's influence in the housing finance system.

**The Federal Home Loan Mortgage Corporation.** Congress chartered the Federal Home Loan Mortgage Corporation in July 1970 with the general authority to purchase home loans that were originated in the government-insured and conventional markets in addition to the facilitation of MBS guaranteed by Ginnie Mae. The 1970 federal charter of Freddie Mac restricted ownership of shares in its common stock to the Federal Home Loan Banks. Throughout the 1970s, Freddie Mac and Ginnie Mae remained influential in the U.S. secondary-mortgage market, particularly the MBS market, which remained concentrated to these two institutions. In 1977, the private-label MBS market emerged with the first issuances structured by Bank of America.<sup>32</sup>

Freddie Mac survived the interest rate volatility (spikes) during the 1980s largely because it did not concentrate its financial portfolio in the holding of long-term (debt) notes. Other financial institutions, such as the savings and loan institutions (S&Ls) and Fannie Mae assumed enormous interest rate risk and incurred financial losses because of the negative

28. In recent years, Ginnie Mae has started a program that allows the immediate transfer of the servicing rights on the pools from financial institutions to Ginnie Mae itself. Participation in the program, the Pools Issued for Immediate Transfer (PIIT) program, has increased in recent years, which exposes Ginnie Mae to different risks than it would be otherwise. Ginnie Mae, *2015 Annual Report*, p. 13, [http://www.ginniemae.gov/about\\_us/who\\_we\\_are/budget\\_performance/Annual\\_Reports/annual\\_report15.pdf](http://www.ginniemae.gov/about_us/who_we_are/budget_performance/Annual_Reports/annual_report15.pdf) (accessed October 4, 2016).

29. The 1968 Housing and Community Development Act provided that mortgages insured by the Farmers Home Administration as authorized under Title V of the 1949 Housing Act were included in the initial guarantee authority for Ginnie Mae. Ginnie Mae's secondary market functions later expanded to include certain public health service loans (1970), and then again to qualified loans to Indian families and Indian housing authorities (1996). Ginnie Mae, "Government National Mortgage Association Statutory Authority," pp. 3 and 10.

30. Ginnie Mae, *2015 Annual Report*, pp. 66–67.

31. The FHA and the RHS crowd out private (non-government-insured) mortgages by subsidizing lower-cost mortgage insurance options for comparatively high-risk borrowers. Both federal agencies can accomplish these objectives by relaxing underwriting standards required for take-up in their respective insurance and guarantee programs. In the FHA's single-family housing mortgage insurance program, there has indeed been a long-term degradation of credit underwriting standards in the single-family home loans insured by the FHA. Since 1990, for example, the share of FHA-insured single-family mortgage loans with down payments of 5 percent or less has increased from 34 percent to 75 percent of the agency's portfolio. The RHS tends to insure even higher risk single-family home loans than the FHA, the majority of which are assumed by borrowers that do not even reside in a rural area. For more information on the history of these two federal housing agencies, see John L. Ligon and Norbert J. Michel, "Federal Housing Administration: What Record of Success?" Heritage Foundation *Background* No. 3006, May 11, 2015, <http://www.heritage.org/research/reports/2015/05/the-federal-housing-administration-what-record-of-success>, and John L. Ligon, "Time to Shut Down the Rural Housing Service," Heritage Foundation *Background* No. 3097, March 23, 2016, <http://www.heritage.org/research/reports/2016/03/time-to-shut-down-the-usdas-rural-housing-service>.

32. U.S. Securities and Exchange Commission, *A Staff Report of the Task Force on Mortgage-Backed Securities Disclosure*, p. 7.

interest rate yields in their debt portfolios. Freddie Mac was able to get through this period by its focus on MBS that primarily allowed it to pass interest rate risk to investors in capital markets. In the late 1980s, Congress altered Freddie Mac's charter to allow the corporation to raise capital by issuing publicly traded shares of (voting) common stock, in addition to the shares of (non-voting) common stock restricted to ownership by the Federal Home Loan Banks.<sup>33</sup>

Then, in the early 1990s, Freddie Mac was placed under general regulatory oversight of the federal government within the domain of the Office of Federal Housing Enterprise Oversight, a division within the Department of Housing and Urban Development. For nearly the next two decades, Freddie Mac (as was Fannie Mae) was used as an instrument to accomplish federal housing policies in the advancement of "affordable" housing, particularly geared toward single-family homeownership. Indeed, in the early 1990s, Congress took legislative steps that exposed Freddie Mac to the political whims of affordable-housing advocates by instituting requirements for the corporation to meet specified goals relating to the advancement of affordable-housing opportunities for underserved groups, particularly geared toward low-income and moderate-income households.<sup>34</sup> These federal affordable-housing policies, as discussed already, were indeed central to the deterioration of underwriting standards, the increase in high-risk mortgage lending, and the eventual mortgage credit bubble that resulted in the 2007–2009 housing market collapse.

Freddie Mac, given its exposure to the large number of poor-quality (high-credit-risk) mortgages,

suffered significant losses during the downturn in the housing market between 2007 and 2009. In response, Congress authorized the transfer of the financially insolvent Freddie Mac in 2008, along with Fannie Mae, under the conservatorship oversight of the FHFA. During the FHFA conservatorship, the federal government has effectively nationalized Freddie Mac, which has included specific ownership terms accompanying the federal bailout by the U.S. Treasury. In the bailout process, the U.S. Treasury has acquired shares of senior preferred and preferred stock totaling nearly \$90 billion, and retains warrants to purchase up to 79.9 percent of the shares of common stock.<sup>35</sup> Overall, federal taxpayers remain in a vulnerable position to cover further financial losses incurred by Freddie Mac, which could likely occur given the scheduled depletion of the corporation's capital reserves, ongoing uncertainty in the housing market, and potential volatility (increases) in interest rates.

**The Federal Home Loan Bank System.** Congress passed legislation in 1932 that established 12 Federal Home Loan Banks, which were created with the intent to increase liquidity in the mortgage finance system by purchasing home loans from specialized mortgage lending institutions and life insurance companies. These purchases by the FHLBs afforded the specialized lenders additional capacity in their respective portfolios to originate new home loans. To meet that goal, the 12 FHLBs funded these purchases by taking on debt, known as advances, so that they could provide loans to member financial institutions.<sup>36</sup> Until the late 1980s, membership in the FHLB system was

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33. The 1970 federal charter for the Federal Home Loan Mortgage Corporation restricted shareholder ownership of the corporation to the 12 federal home loan banks. Later, in 1989, Congress amended the charter such that the corporation could raise capital through non-voting common stock and voting common stock. Ownership of the non-voting common stock was required for the federal home loan banks, and the voting common stock was tradable and publicly owned. Emergency Home Finance Act of 1970, P.L. 91-351 §§ 301-310, July 24, 1970, <https://www.gpo.gov/fdsys/pkg/STATUTE-84/pdf/STATUTE-84-Pg450.pdf> (accessed September 23, 2016), and Financial Institutions Reform, Recovery, and Enforcement Act of 1989, P.L. 101-73 § 731(d), August 9, 1989, [https://fraser.stlouisfed.org/scribd/?title\\_id=1046&filepath=/docs/historical/congressional/financial-institutions-reform-1989.pdf](https://fraser.stlouisfed.org/scribd/?title_id=1046&filepath=/docs/historical/congressional/financial-institutions-reform-1989.pdf) (accessed September 23, 2016).

34. Wallison, *Hidden in Plain Sight*, pp. 125–233.

35. The U.S. Treasury holds \$72.4 billion worth of senior-preferred shares and \$14.1 billion in preferred shares of stock in Freddie Mac, and the corporation is required under the stock purchase agreement to disburse dividends on the senior-preferred shares held by the U.S. Treasury. Freddie Mac, "Form 10-Q: Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934," pp. 3 and 71, [http://www.freddie.com/investors/er/pdf/10q\\_2q16.pdf](http://www.freddie.com/investors/er/pdf/10q_2q16.pdf) (accessed October 5, 2016), and Federal Housing Finance Agency, "Senior Preferred Stock Purchase Agreements."

36. David C. Wheelock, "The Federal Response to the Home Mortgage Distress: Lessons from the Great Depression," *Federal Reserve Bank of St. Louis Review* (May/June PART 1 2008), pp. 139–141, <https://research.stlouisfed.org/publications/review/08/05/Wheelock.pdf> (accessed October 27, 2016).



predominantly restricted to the specialized thrift lending institutions (mostly S&Ls).

The FHLB system has evolved considerably over its more than 80 years of operation, with a significant pivot in 1990 when Congress expanded FHLB membership to include federally insured depository institutions in addition to the S&Ls.<sup>37</sup> When Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, it authorized a bailout for the S&Ls, as well as new federal housing slush funds to advance so-called community and affordable-housing development. FIRREA required that 10 percent of the earnings retained by member institutions be used to pay the interest cost on bonds issued to finance the S&L bailout,<sup>38</sup> and that 10 percent of the FHLBs' retained earnings be used to finance affordable-housing and community-development initiatives. At present, FHLB membership is open to most financial institutions provided that residential home loans comprise at least 10 percent of their balance sheets.<sup>39</sup>

The FHLB system currently consists of 11 regional FHLBs with commercial banks representing more than half of the member institutions in the consor-

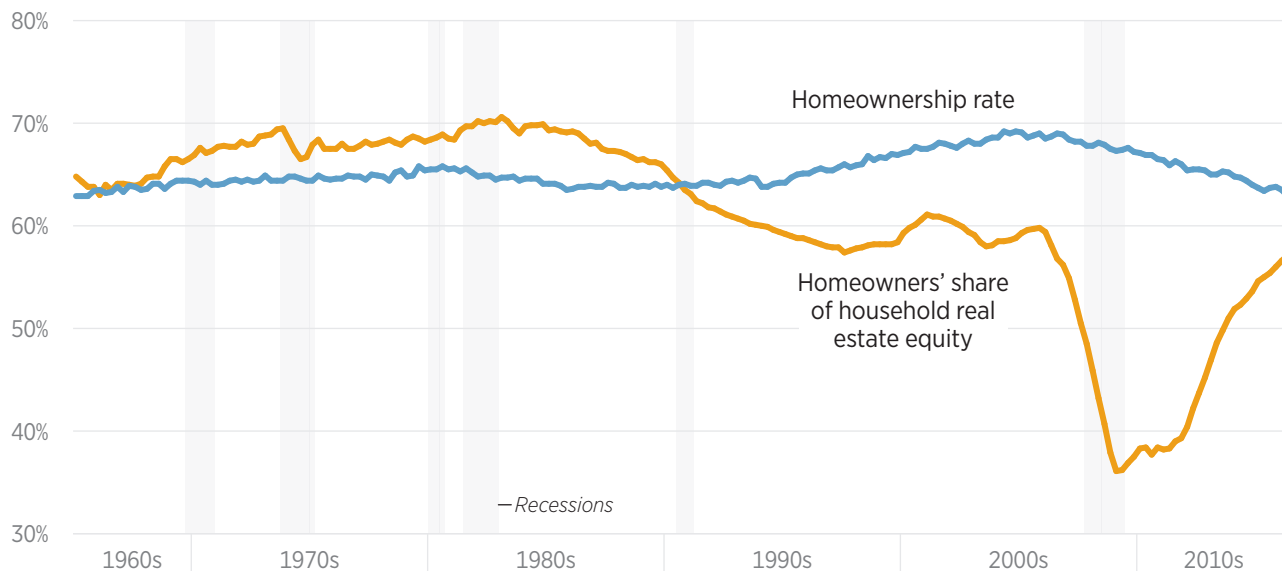
tium, and the Office of Finance serves as the FHLB system's fiscal agent, including the issuance of the advances.<sup>40</sup> Each of the regional FHLBs is a separate, government-chartered, mutual organization owned by its member financial institutions and, as such, can be required to cover the financial obligations of the other FHLBs.<sup>41</sup> The FHLBs effectively function as wholesale purchasers of home loans issued by their member financial institutions. As of the end of 2015, the FHLBs combined had assets totaling \$969.6 billion (almost two-thirds in the form of loans called advances),<sup>42</sup> and there were 7,235 member institutions (4,669 commercial banks) in the FHLB system.<sup>43</sup>

Similar to the other two housing GSEs, Fannie Mae and Freddie Mac, the FHLBs benefit from the implied guarantee of the federal government that is assumed by market participants given the various special privileges, including the exemption of certain taxes and regulatory requirements, as well as lines of credit to the federal government. The FHLBs fund the majority of their market activity through the issuance of debt, which in the event of significant financial failure could result in taxpayer

37. In 1998, Congress eliminated the requirement that S&Ls hold membership in the FHLB system. The FHFA has more recently authorized membership to certain non-depository institutions provided that they are "certified by the Treasury Department's [Community Development Financial Institutions] Fund, such as community development loan funds." Federal Housing Finance Agency, *2015 Annual Report to Congress*, p. 52.
38. Mark J. Flannery and W. Scott Frame, "The Federal Home Loan Bank System: The 'Other' Housing GSE," *Federal Reserve Bank at Atlanta Economic Review*, Third Quarter 2006, pp. 33-34, [https://www.frbatlanta.org/-/media/Documents/research/publications/economic-review/2006/vol91no3\\_flannery-frame.pdf?la=en](https://www.frbatlanta.org/-/media/Documents/research/publications/economic-review/2006/vol91no3_flannery-frame.pdf?la=en) (accessed September 1, 2016).
39. Federal Housing Finance Agency, "Members of the Federal Home Loan Banks; Proposed Rule," *Federal Register*, Vol. 79, No. 177, September 12, 2014, <https://www.gpo.gov/fdsys/pkg/FR-2014-09-12/pdf/2014-21114.pdf> (accessed September 01, 2016).
40. Since the late 1990s, FHLBs have been permitted to expand business activity to include not only the purchase of residential home loans but also investment securities backed by home loans, including mortgages in the conventional mortgage market. Consequently, some of the FHLBs suffered financial losses in recent years and were not immune to financial setbacks during the recent housing crisis as their MBS portfolios suffered severe declines in valuation. Federal Housing Finance Agency, *2014 Annual Report to Congress*, p. 39, [http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA\\_2014\\_Report\\_to\\_Congress.pdf](http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_2014_Report_to_Congress.pdf) (accessed September 8, 2016), and Federal Housing Finance Agency, *2015 Annual Report to Congress*, pp. 20-42.
41. The federal home loan banks operate within a cooperative (joint and several) ownership structure—each bank has an independent business portfolio with distinct operational management structure and shareholder (ownership) guidance. Each FHLB is liable, though, for financial losses incurred by the other FHLBs. The shares of capital stock are structured generally in the following way: There are two classes of capital stock issued within the FHLB system, and member financial institutions outside of the 11 FHLBs can purchase. Class B shares are redeemable at par value after a five-year holding period, and class A shares are redeemable after a six-month holding period. The shares between the different classes (and subclasses) of Class A and Class B stock carry different voting (activity) rights and dividend payment rates. When a bank is deemed undercapitalized by the FHFA, there are certain restrictions on how shares held may be redeemed, and FHLBs are restricted from disbursing dividend payments. The FHLBs must each hold a minimum level of *risk capital*, *regulatory capital*, and *leverage capital* in order to meet the capitalization requirements. Office of Finance, *2015 Annual Report for the Federal Home Loan Bank System*, pp. 8-11, [http://www.fhfb-of.com/ofweb\\_userWeb/resources/2015Q4CFR.PDF](http://www.fhfb-of.com/ofweb_userWeb/resources/2015Q4CFR.PDF) (accessed September 8, 2016), and Flannery and Frame, "The Federal Home Loan Bank System: The 'Other' Housing GSE," pp. 38-43.
42. The FHLB Office of Finance issues advances (debt) to the respective federal home loan banks, which is the primary means that the banks use to fund their overall market activity related to the purchasing of residential loans from member financial institutions.
43. Federal Housing Finance Agency, *2015 Annual Report to Congress*, pp. 20-22.

CHART 2

## U.S. Homeownership and Real Estate Equity



**SOURCES:** Board of Governors of the Federal Reserve System, "Households; Owners' Equity in Real Estate as a Percentage of Household Real Estate, Level," <https://fred.stlouisfed.org/series/HOEREPHRE> (accessed October 12, 2016), and U.S. Census Bureau, "Homeownership Rate for the United States," <https://fred.stlouisfed.org/series/RHORUSQ156N> (accessed October 11, 2016).

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bailouts, similar to the federal government's intervention during the aftermath of the S&L crisis of the 1980s,<sup>44</sup> or the bailouts that occurred during the 2008 financial crisis with Fannie Mae and Freddie Mac. Thus, while the exact incentives may differ from other GSEs, the federal subsidies have led to higher levels of debt liability at the FHLBs, and increases the risks to federal taxpayers of covering the cost of bailouts should the banks begin to experience severe financial losses.

### The Influence of the FHFES in the U.S. Housing Finance System

The presence of the federal housing finance enterprises is antithetical to a free market in housing finance, and the FHFES' interference in the housing finance system has led to less discipline by market participants. These FHFES create moral-hazard

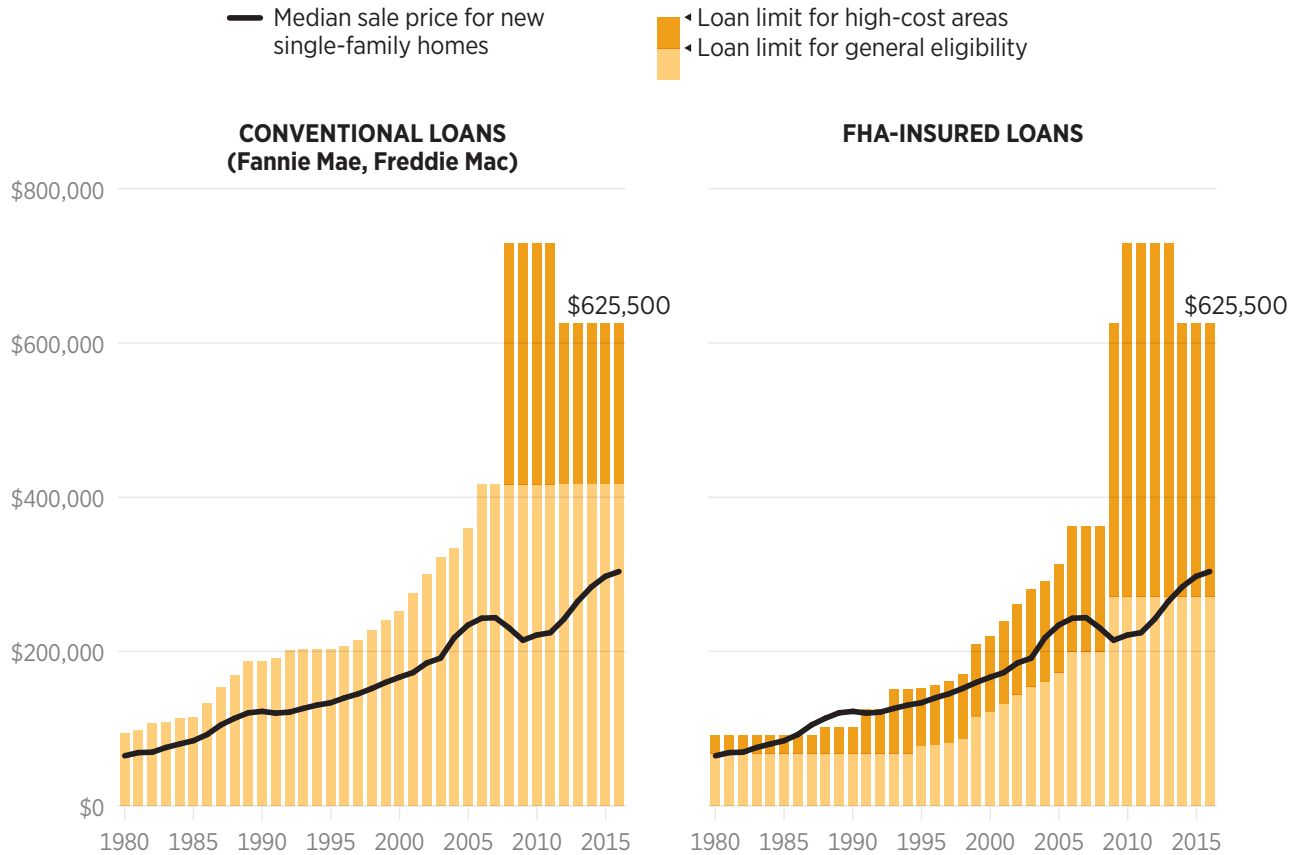
dilemmas for market participants that ultimately put homeowners, taxpayers, and private shareholders at greater risk of financial loss, all while increasing home prices relative to what they would be otherwise. Moreover, the FHFES have encouraged an explosion of mortgage debt over the past several decades, while national homeownership is at the lowest rate since the mid-1960s. Homeownership can provide certain benefits to individual households, but this certainly does not mean that the federal government should interfere with the housing choices of individuals. The federal government would better serve citizens by getting out of the way of the market's ability to guide individuals toward affordable and sustainable levels of mortgage debt when purchasing homes.

There are real costs associated with the federal government's intervention in the housing finance

44. As of 2004, the direct cost to federal taxpayers in the resolution of the savings and loan crisis of the later 1980s was \$124 billion, an estimate that excludes the tens of billions of dollars taxed to financially solvent member FHLB lending and bank institutions during the federal resolution. Bert Ely, "Savings and Loan Crisis," *The Concise Encyclopedia of Economics*, 2008, <http://www.econlib.org/library/Enc/SavingsandLoanCrisis.html> (accessed September 16, 2016).

CHART 3

## Mortgage Limits Remain Far Above Median Home Prices



**SOURCES:** Fannie Mae, “Historical Conventional Loan Limits,” [https://www.fanniemae.com/content/fact\\_sheet/historical-loan-limits.pdf](https://www.fanniemae.com/content/fact_sheet/historical-loan-limits.pdf) (accessed September 23, 2016); Fannie Mae, “Loan Limits for Conventional Mortgages,” <https://www.fanniemae.com/singlefamily/loan-limits> (accessed October 07, 2016); U.S. Department of Housing and Urban Development, “FHA Mortgage Limits,” <https://entp.hud.gov/idapp/html/hicostlook.cfm> (accessed October 13, 2016); and U.S. Census Bureau, “Median Sales Price for New Houses Sold in the United States,” <https://fred.stlouisfed.org/series/MSPNHSUS> (accessed October 7, 2016).

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system, which include the market-distorting subsidies that federal taxpayers grant the FHFES. The federal subsidies have the effect of masking the risks involved with the financial management and governance of the FHFES, and alter incentives among market participants to reliably and prudently align with the interests of individuals looking to take on home mortgages. Too often there is tremendous motivation for politicians to use the FHFES as instrumentalities to advance federal housing policy, which has certainly included the “affordable” housing policies over the past several decades. Of course, when the errors lead to periods of financial insolv-

ency at the FHFES, federal taxpayers too often step in to cover the cost burden of these failures. The subsidies extended to the FHFES thus cost federal taxpayers during normal market periods, and certainly during episodes of federal bailouts as the FHFES have suffered financial insolvency.

As for any benefits, the FHFES appear to have done little more than provide borrowers with minimally lower interest rates on home loans. Economic research suggests that the benefit to borrowers is likely only on the order of 10 basis points (0.10 percentage points) in lower interest rates on mortgage loans, and that shareholders and management of

the FHFES are likely to retain the majority of the benefits conferred by the taxpayer-financed subsidies.<sup>45</sup> To be sure, these estimates relate to the pass-through of the interest rate subsidy to borrowers of mortgages guaranteed by Fannie Mae and Freddie Mac. Separate academic research has also posited that removing this subsidy would enhance overall welfare and would likely improve economic outcomes in the housing market, especially for low-income and low-asset households.<sup>46</sup> Removing the interest rate subsidy would alter incentives for lower-income and lower-asset households in deciding when and how much mortgage debt to take up, and would likely encourage lower (more efficient) levels of home loan debt for these households.

Moreover, shutting down the FHFES would by no means leave individuals without financing options for purchasing homes. Indeed, winding down the FHFES would only prevent private financial corporations from issuing and purchasing government-insured mortgages, while removing government guarantees and insurance that currently crowd out private companies from providing such solutions. Private lending institutions already issue non-government-guaranteed home loans in the jumbo mortgage market (mortgages that exceed the loan limits in the conventional mortgage market), and to a lesser degree in the non-jumbo mortgage market (mortgages that would otherwise qualify for purchase by Fannie Mae or Freddie Mac). Nevertheless, if Congress were to shut down the FHFES, any

increase in interest rates due to the removal of the insurance and guarantee subsidies in the mortgage market would occur during a period of historically low interest rates.

### **Time to Shut Down the Federal Housing Finance Enterprises**

Congress can create truly affordable and sustainable homeownership opportunities for Americans by establishing the conditions for a free enterprise housing finance system. To achieve this vision of a free market in housing finance, Congress should shut down the FHFES and relinquish the system of market-distorting housing subsidies it has constructed over more than 80 years.<sup>47</sup> To this end, Congress should initiate the dissolution of the FHFES, and in so doing, preclude the transfer of the FHFES' authority to another GSE or the federal government except for the limited powers essential for the disposition of the respective mortgage and financial portfolios.

Until the FHFES are shut down, Congress should implement policies that gradually reduce the market operations carried out by the FHFES, and thus encourage private capital to return to the housing finance system.

**Initiate a Five-Year Wind Down of Fannie Mae and Freddie Mac.** By the end of the five-year period, Congress should repeal the respective charters to both Fannie Mae and Freddie Mac,<sup>48</sup> and instruct the FHFA director to act as receiver in the

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45. Wayne Passmore, Shane M. Sherlund, and Gillian Burgess, "The Effect of Housing Government-Sponsored Enterprises on Mortgage Rates," *Real Estate Economics*, Vol. 33, No. 3 (September 2005), pp. 427-463, and Alex Kaufman, "The Influence of Fannie and Freddie on Mortgage Loan Terms," *Real Estate Economics*, Vol. 42, No. 2 (2014), pp. 472-496.

46. Karsten Jeske, Dirk Krueger, and Kurt Mitman, "Housing, Mortgage Bailout Guarantees, and the Macro Economy," Preprint submitted to *Journal of Monetary Economics*, September 6, 2013, <http://economics.sas.upenn.edu/~dkrueger/research/JKMSub.pdf> (accessed September 1, 2016).

47. These reforms assume that there are no qualified mortgage (QM) requirements, and no qualified residential mortgage (QRM) requirements, or any other federal regulations relating to requirements for mortgages in the (current) conventional mortgage finance system. In other words, should these federal reforms be implemented, one should assume that Congress will also accomplish similar free-market reforms in housing finance that would repeal broad elements of the 2010 Dodd-Frank Act. Norbert J. Michel ed., *The Case Against Dodd-Frank: How the "Consumer Protection" Law Endangers Americans* (Washington, DC: The Heritage Foundation, 2016.)

48. Fannie Mae and Freddie Mac have respectively acknowledged the possibility that they each would be placed into receivership, particularly under the circumstance that the corporations could face a negative net financial worth in future years. The likely occurrence of this event will certainly increase in the coming years as Fannie Mae is required under current policy in the Senior Preferred Stock Purchase Agreements to deplete its capital reserves by January 2018. Fannie Mae, "Single-Family MBS Prospectus: Guaranteed Mortgage Pass-Through Certificates," June 1, 2016, pp. 33-35, [http://www.fanniemae.com/syndicated/documents/mbs/mbspros/SF\\_June\\_1\\_2016.pdf](http://www.fanniemae.com/syndicated/documents/mbs/mbspros/SF_June_1_2016.pdf) (accessed September 23, 2016); Freddie Mac, "Mortgage Participation Certificates," July 19, 2016, pp. 3-7, [http://www.freddie.com/mbs/docs/pcoc\\_071916.pdf](http://www.freddie.com/mbs/docs/pcoc_071916.pdf) (accessed September 23, 2016); and James L. Gattuso, "Taking Stock: Shareholder Lawsuits No Barrier to GSE Dissolution," Heritage Foundation *Issue Brief* No. 4225, May 19, 2014, <http://www.heritage.org/research/reports/2014/05/taking-stock-shareholder-lawsuits-no-barrier-to-gse-dissolution>.

dissolution of Fannie Mae and Freddie Mac,<sup>49</sup> which should include shutting down the common securitization platform and any subsidiary (joint) ventures formed by the corporations. In the interim period, Congress should decrease the conventional (conforming) loan limits for mortgages that are generally eligible for purchase by Fannie Mae and Freddie Mac.<sup>50</sup> Congress should also authorize increases in the guarantee fees Fannie Mae and Freddie Mac both charge on their respective operations in the secondary mortgage market.<sup>51</sup> These intermediate reforms should occur irrespective to those scheduled changes for both Fannie Mae and Freddie Mac in current policy, which include the reductions in the allowable limits for the mortgage investment portfolios and the requirements for the effective dissolution of the capital reserve accounts by January 2018.<sup>52</sup>

**Initiate a Five-Year Wind Down of Ginnie Mae, the FHA, and the RHS.** Congress should shut down Ginnie Mae, the FHA, and the RHS, thereby eliminating their direct provision of taxpayer-financed insurance coverage and guarantees on mortgages and mortgage-related securities. Winding down the FHA and RHS in particular would also eliminate the various rental housing assistance subsidies and subsidized loans guaranteed in the con-

struction of health care facilities subsidized by the agencies. During the process of shutting down the FHA and the RHS, Congress should increase the collateral requirements for insured loans, the guarantee premiums these institutions charge for risk adjustment, as well as the loan limits for mortgages eligible for insurance coverage. Moreover, during the process of shutting down all three federal entities, Congress should ensure that the respective dissolution processes preclude any new guarantee and investment portfolio activity.

**Repeal Federal Affordable Housing Goals and Duty-to-Serve Rules.** The federal government has pursued “affordable” housing policies by requiring that Fannie Mae, Freddie Mac, and the FHLB system meet specific goals—explicit quotas on the types of mortgages they finance—for low-income and moderate-income households. These so-called affordable-housing goals were fundamental to the collapse of the housing finance system between 2007 and 2009, and they have served mainly to increase consumer debt and inflate home prices. In addition to these affordable-housing goals, the FHFA has instituted an even broader and more nebulous regulatory apparatus that burdens the GSEs with a “duty to serve” specified markets deemed by the agency to lack sufficient access to mortgage credit.<sup>53</sup> Congress

49. The 2013 Protecting American Taxpayers and Homeowners Act of 2013 took a similar approach and can be used as a guide to formulate new legislation. Protecting American Homeowners and Taxpayers Act of 2013, H.R. 2767, July 22, 2013, <https://www.congress.gov/bill/113th-congress/house-bill/2767> (accessed September 16, 2016), and New Fair Deal Banking and Housing Stability Act of 2013, H.R. 3550, November 20, 2013, <https://www.govtrack.us/congress/bills/113/hr3550/text/ih> (accessed September 8, 2016).

50. Housing and Economic Recovery Act of 2008, P.L. 110–89 § 1124, <https://www.gpo.gov/fdsys/pkg/PLAW-110publ289/html/PLAW-110publ289.htm> (accessed October 11, 2016), and news release, “FHFA Announces 2015 Conforming Loan Limits: Unchanged in Most of the U.S.,” Federal Housing Finance Agency, November 24, 2016, <http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-2015-Conforming-Loan-Limits-Unchanged-in-Most-of-the-U-S.aspx> (accessed October 11, 2016).

51. Congress authorized the FHFA to conduct an “on-going study” of the fees charged by Fannie Mae and Freddie Mac for the guarantees that the corporations respectively provide on mortgages. The FHFA is required to submit an annual report to Congress related to its “on-going study” of the likely impacts of these guarantee fees. The FHFA director has the discretion to determine the adjustment to the guarantee fees. Housing and Economic Recovery Act of 2008, P.L. 110–80 § 1601, <https://www.gpo.gov/fdsys/pkg/PLAW-110publ289/html/PLAW-110publ289.htm> (accessed October 11, 2016), and Federal Housing Finance Agency, “Fannie Mae and Freddie Mac Single-Family Guarantee Fees in 2015,” <http://www.fhfa.gov/AboutUs/Reports/Pages/Single-Family-Guarantee-Fees-in-2015.aspx> (accessed October 11, 2016).

52. As amended, the respective Senior Preferred Stock Purchase Agreements (section 5.7) between the U.S. Treasury and the GSEs Fannie Mae and Freddie Mac require the reduction in the allowable mortgage investment portfolio for the corporation. These amendments to the GSEs’ respective SPSPAs cap the decreases in the allowable mortgage investment portfolio for the corporation at no less than \$250 billion.

53. Congress authorized in the Housing and Economic Recovery Act (HERA) of 2008 for Fannie Mae and Freddie Mac to carry out duty-to-serve requirements that function as a redistributive credit system. The proposed rule by the FHFA specifically targets very low-income, low-income, and moderate-income families in the manufactured housing market, the affordable-housing preservation market, and the rural housing market. Housing and Economic Recovery Act of 2008, P.L. 110–80 § 1129, <https://www.gpo.gov/fdsys/pkg/PLAW-110publ289/html/PLAW-110publ289.htm> (accessed October 11, 2016), and Federal Housing Finance Agency, “Update on FHFA’s Proposed Rule on Duty to Serve Underserved Markets,” July 21, 2016, <http://www.fhfa.gov/Media/Blog/Pages/Update-on-FHFAs-Proposed-Rule-on-Duty-to-Serve-Underserved-Markets.aspx> (accessed October 25, 2016).



should repeal the mandatory affordable-housing goals for the GSEs, including any affordable-housing trust funds, and eliminate the duty-to-serve regulatory rules required of Fannie Mae and Freddie Mac. In so doing, Congress should preclude the transfer of these regulatory systems to any other GSE or direct federal government agency.

**Remove the Special Privileges for the FHLBs.**

The fact that the Federal Home Loan Banks did not require a taxpayer bailout on the scale of the one provided to Fannie Mae and Freddie Mac does not justify continuing the FHLB system as a GSE. The FHLB system could be legally allowed to continue operating as a mutual organization, owned by its member financial institutions, and without a line of credit from the U.S. Treasury. Any other special privileges given to GSEs, such as the exemption of certain taxes and regulatory requirements, should also be eliminated.

**Conclusion**

Since the New Deal–era federal housing policies of the 1930s, Congress has cobbled together a system of federal housing finance enterprises that today cover more than \$6 trillion (60 percent) of the outstanding single-family residential mortgage debt in the U.S. The federal government has used the federal housing finance enterprises to accomplish various policy goals—housing policies too often advanced under the notion of creating “affordable” homeownership opportunities for individuals. Over time, these policies have led to unsustainable levels of mortgage debt for millions of homeowners, and were central to several devastating downturns in the U.S. housing market. Overall, these policies have harmed American homeowners, cost federal taxpayers hundreds of billions of dollars in bailouts, and undermined the resilience of the housing finance system. It is time that Congress end these failed experiments of the federal government, and restore the conditions for a free market in housing finance by shutting down these federal housing finance enterprises.

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