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Fannie Mae and Freddie Mac: A Legal and Policy Overview

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Summary

In the wake of accounting and management scandals involving Freddie Mac and Fannie Mae, Congress has expressed a heightened interest in the regulation of these two government-sponsored enterprises. Fannie Mae and Freddie Mac, whose stocks are traded on the New York Stock Exchange, are chartered by Congress to support the secondary home mortgage market. In return for fulfilling this public mission, they are given special privileges.

The Office of Federal Housing Enterprise Oversight (OFHEO), which regulates Fannie Mae and Freddie Mac for safety and soundness, imposed extra capital requirements and reached agreements with Fannie and Freddie to limit the growth of their holdings of mortgages. After Fannie Mae and Freddie Mac published timely financial statements in February 2008, OFHEO removed the growth caps effective March 1, 2008. The extra capital requirements remain in place, but could be removed in the future.

The Economic Stimulus Act of 2008 increased the maximum size of a mortgage that Fannie Mae and Freddie Mac can purchase during 2008 to $729,750 in high-cost areas. Supporters hope that this will reduce the cost of mortgages for more than the previous limit of $417,000.

The purpose of this report is to give a general legal and policy background on why the enterprises came into existence, what their missions are, and how they carry out those missions.

This report will be updated as events warrant.

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Fannie Mae and Freddie Mac: A Legal and Policy Overview

Introduction

Fannie Mae (Federal National Mortgage Association)[1] and Freddie Mac (Federal Home Loan Mortgage Corporation),[2] referred to in this report as "the enterprises," are privately owned, congressionally chartered financial institutions created to establish and maintain a secondary mortgage market.[3] They are two of three government-sponsored enterprises (GSEs) that provide capital to primary market mortgage originators in support of an overall federal policy to assure ready availability of financing for housing.[4] Fannie Mae and Freddie Mac support the residential mortgage market by purchasing mortgages from lenders that use the proceeds to make more loans available to home buyers. In exchange for carrying out their public policy missions, Congress has granted the enterprises statutory benefits not available to other private financial institutions, discussed below.

Even though Fannie Mae and Freddie Mac are congressionally chartered, both are private, shareholder-owned entities, and their shares are traded on the New York Stock Exchange. The enterprises are headed by 18-member Boards of Directors, 13 of whom are elected by their shareholders, and five of whom are appointed annually by the President. Of the five appointed by the President, at least one must come from the homebuilding industry, at least one from the mortgage lending industry, at least one from the real estate industry, and, in the case of Freddie Mac, at least one from an organization that has represented consumer or community interests for not less than two years or one person who has demonstrated a career commitment to providing housing for low-income households.[5] Although the board members owe a fiduciary responsibility to the shareholders of their respective enterprises, they are also obligated to assure that their enterprises are fulfilling their statutory missions.

Two of the largest financial institutions in the world, Fannie Mae and Freddie Mac have grown significantly over the past 15 years. Between 1990 and 2005, assets

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[1] 12 U.S.C. §§ 1716 et seq.

[2] 12 U.S.C. §§ 1451 et seq.

[3] See, e.g., 12 U.S.C. § 1716.

[4] The other GSE is the Federal Home Loan Bank System, 12 U.S.C. §§ 1421 et seq., which is comprised of 12 regional Federal Home Loan Banks (FHLBs) that lend funds to their member mortgage lenders based upon the security of those lenders' mortgages. 12 U.S.C. § 1431.

[5] 12 U.S.C. § 1723(b), 12 U.S.C. § 1452(a)(2)(A).

at the enterprises grew more than 944% to $1.64 trillion, while outstanding liabilities increased by 980% to $1.51 trillion. By comparison, the amount of publicly held federal debt at the end of 2005 was $4.6 trillion. In fact, the enterprises have become two of the largest private debt issuers in the world. In addition to enterprise debt, investors hold more than $2.5 trillion in mortgage-backed securities issued by the enterprises.[6] The enterprises are exempt under law from registering their stock with the Securities and Exchange Commission (SEC), but have agreed to voluntarily register. Registration makes the enterprises subject to the SEC's financial filing requirements.

In 2003, Freddie Mac announced that it would have to restate financial reports for the previous three years due to improper accounting methods.[7] In November 2003, Freddie Mac revised its earnings for 2002 and earlier years upward by $5.0 billion. Freddie Mac dismissed its three top executives as a result of these accounting discrepancies, Freddie Mac has not filed any earnings statements with the SEC and has been behind other publicly owned firms in announcing financial results; Freddie Mac released preliminary six-month 2006 results in October 2006 while other firms were getting ready to release third quarter results.

After initially denying that it had a similar problem, Fannie Mae was found to have manipulated reported earnings.[8] In December 2006, Fannie Mae issued a restatement, which reduced reported earnings for 2001-2004 by $6.3 billion. Fannie Mae's chief executive officer and its chief financial officer resigned as a result of the misstatement. Fannie Mae filed its 2004 financial report with the SEC on December 6, 2006. On December 12, 2006, Fannie Mae sued its former auditor, KPMG, for $2 billion in damages related to the accounting problems.

The purpose of this report is to give a general legal and policy background on why the enterprises came into existence, what their missions are, and how they carry out those missions.

Operations

Fannie Mae and Freddie Mac support the U.S. housing finance system by purchasing mortgages from primary lenders that use the proceeds to make new home loans, thereby stabilizing the availability of mortgage credit over the business cycle. The enterprises are permitted to buy mortgage loans on single-family or multi-unit

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[6] For more information on these figures, see Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2007, Analytical Perspectives*, p. 223 at [http://www.whitehouse.gov/omb/budget/fy2007/pdf/spec.pdf]. Also, see Office of Federal Housing Enterprise Oversight, *Mortgage Markets and the Enterprises in 2006*, June 2007 at [http://www.ofheo.gov/media/research/MortgageMarkets2006.pdf].

[7] See CRS Report RS21567, *Accounting and Management Problems at Freddie Mac*, by Mark Jickling, for more details.

[8] See CRS Report RS21949, *Accounting Problems at Fannie Mae*, by Mark Jickling, for more details.

property; they may be fixed or adjustable rate (or a hybrid), a first or second lien, and may be conventional, insured by the Federal Housing Administration (FHA), or guaranteed by the Department of Veterans Affairs (VA). Single-family mortgage purchases are subject to the "conforming loan limit," which is $417,000 in most states for 2007 for single-unit houses and is adjusted annually.[9] The enterprises have limited authority to undertake other activities.

The Economic Stimulus Act of 2008 temporarily increased the conforming loan limit in high cost areas to a maximum of $729,750.[10] The limit for any area would be the greater of (1) the 2008 conforming loan limit ($417,000); or (2) 125% of the area median house price, but no more than 175% of the 2008 conforming loan limit ($729,750, which is 175% of $417,000). The act gave the Department of Housing and Urban Development (HUD) 30 days to calculate the new limits. The increase expires December 31, 2008.

The enterprises finance the purchase of mortgages in two ways. First, they may be held "in portfolio" and financed by the sale of ordinary bonds and other debt. This strategy generally earns high profits because of the spread between the rates earned on long-term mortgages and the relatively low cost of shorter-term borrowing. Financing in this manner creates risk, however, because if market interest rates rise significantly, borrowing costs can rise enough to reduce yields from the mortgages whose rates generally do not rise (or are adjusted more slowly).

The second way the enterprises finance the purchase of mortgages is securitization. This is done by pooling similar mortgages together with and reselling them as securities backed by the entire pool to investors. Mortgage-backed securitization earns a smaller but more constant profit from the differential between the yield on mortgages in the pool and the payout to investors in the securities.

Historical Development

Prior to the development of the secondary mortgage market, mortgage markets were local, and there were significant differences across the nation in mortgage rates and serious fluctuations in lending activity. Primary lenders had to balance their lending practices with their deposits received, which led to severe credit shortages during economic downturns, when savings accounts were depleted by withdrawals.[11] This shortage was exacerbated due to the concentration of major money centers in

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[9] Office of Federal Housing Enterprise Oversight, "2007 Conforming Loan Limit to Remain at $417,000," November 28, 2006, at [http://www.ofheo.gov/media/pdf/PRConfLoan07.pdf]. It remained at $417,000 in 2008. For a discussion of the conforming loan limit see CRS Report RL34236, *Fannie Mae and Freddie Mac: Proposals to Regulate Their Mortgage Portfolio Size in the 110th Congress*, by N. Eric Weiss and CRS Report RS22172, *The Conforming Loan Limit*, by N. Eric Weiss and Mark Jickling.

[10] P.L. 110-185 was signed into law on February 13, 2008. See CRS Report RS22799, *The Recovery Rebates and Economic Stimulus for the American People Act of 2008 and Jumbo Mortgages*, by N. Eric Weiss for more information.

[11] Michael P. Malloy, The Regulation of Banking 381 (1992).

areas like Chicago and New York, far from many who needed home loans. There was no way to move funds from these areas where mortgage money was available to other areas such as California where it was in relatively short supply. In effect, this amounted to a geographic barrier that prevented the law of supply and demand from operating on a national level in the home loan market.[12] The secondary mortgage market combined these many regional mortgage markets into a single national market that draws financing from around the world.

To encourage improvement in housing standards and conditions and to provide a system of mutual mortgage insurance, Congress enacted the National Housing Act in 1934.[13] Title III of the National Housing Act established national mortgage associations, giving rise to the creation of Fannie Mae. In its original form, Fannie Mae was a federal government agency that was chartered to support government-backed mortgages and carry out some government subsidy functions. In 1954, Congress re-chartered Fannie Mae as a mixed government and private sector entity, with a clearly delineated separation between its market-oriented (i.e., secondary mortgage trading) and governmental (i.e., special assistance and managing and liquidating government-held mortgages) functions.[14] In 1968, Congress split the firm into two distinct organizations, with the secondary market arm retaining the Fannie Mae name and the government functions arm taking the name Ginnie Mae, short for the Government National Mortgage Association.[15] The partitioning legislation re-chartered Fannie Mae as a GSE to become completely privately owned with no federal funding. Fannie Mae completed this transition in 1970.

In 1970, Congress enacted the Emergency Home Finance Act,[16] which authorized Fannie Mae to buy conventional mortgages. Fannie Mae bought most of the mortgages from mortgage bankers. Savings and loans, the other major source of mortgage money, were restricted to holding mortgages and were generally unable to work with Fannie Mae. To facilitate secondary market trading of conventional mortgages for savings and loan associations, the act created Freddie Mac as a wholly-owned subsidiary of the Federal Home Loan Bank System (FHLBS). In 1989, Congress re-chartered Freddie Mac so that its shares could trade on the New York Stock Exchange, in the same manner as Fannie Mae's.[17] The 1989 act also did away with the separate missions of Fannie Mae and Freddie Mac, with the result that today the two enterprises have similar characteristics.

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[12] See Carrie Stradley Lavargna, *Government Sponsored Enterprises are "Too Big to Fail:" Balancing Public and Private Interests*, 44 Hastings L.J. 991, 998 (1993).

[13] 48 Stat. 1246.

[14] P.L. 83-560, Title II.

[15] Housing and Urban Development Act of 1968 (P.L. 90-448).

[16] P.L. 91-351.

[17] P.L. 101-73.

GSE Privileges

To help Fannie Mae and Freddie Mac accomplish their public policy missions, Congress granted each of the enterprises certain benefits not available to other private financial institutions. For example, the limitations and restrictions concerning dealing in, underwriting, and purchasing investment securities for its own account by a national banking association do not apply to the enterprises.[18] Perhaps the biggest advantage that Fannie Mae and Freddie Mac enjoy over other private companies is the presumption on the part of investors that, were the enterprises to fall into dire financial straits, the government would bail them out.[19] This presumption of an implied federal guarantee allows many market advantages, including the ability to obtain capital for their operations at near governmental interest rates. Critics argue that this implied guarantee lends to the enterprises such an advantage that it effectively squeezes out serious competition in the housing market.[20]

Regulation

Given the ambiguous relationship that exists between the enterprises and the federal government, Congress has long been concerned about the adequacy of GSE regulation so that Fannie Mae and Freddie Mac can meet their public policy missions and not pose risks to taxpayers. In this regard, Congress enacted the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.[21] The act splits the oversight functions of mission from safety and soundness between two primary regulators: (1) the Department of Housing and Urban Development (HUD) and (2) the Office of Federal Housing Enterprise Oversight (OFHEO), an independent entity within HUD.[22]

HUD is responsible for mission regulation and general policy oversight of Fannie Mae and Freddie Mac. In particular, the regulator's authority includes the establishment and enforcement of the affordable housing goals, ensuring compliance with fair lending practices, and having prior approval authority over new programs. In terms of the affordable housing goals, the HUD Secretary is required to set three specific targets: (1) the low-and-moderate income goal, which is the percentage of annual business that must be for families with incomes below the area median

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[18] 12 U.S.C. § 24. For other examples of specific benefits afforded GSEs, see Note, Bradley K. Krehely, *Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac*, 6 N.C. Banking Inst. 519 (2002).

[19] This is despite the fact that the enterprises include in circulars for their debt and mortgage-backed securities the statement that those securities are not guaranteed by the federal government.

[20] See Note, Bradley K. Krehely, *Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac*, 6 N.C. Banking Inst. 519, 533 (2002).

[21] P.L. 102-550, Title XIII; 106 Stat. 3941; 12 U.S.C. §§ 4501 et seq.

[22] For why Congress separated these two functions, see CRS Report RS21724, *GSE Regulatory Reform: Frequently Asked Questions*, by N. Eric Weiss.

income; (2) the special affordable housing goal, which is the percentage of housing units financed that must be for families with low or very low incomes; and (3) the geographically targeted goal, which is the percentage of business targeted to disadvantaged localities. HUD must evaluate their success in achieving these affordable housing goals.[23]

HUD also must approve new programs that the enterprises wish to undertake to ensure that the new programs support the enterprises' missions.[24]

OFHEO's mission is to oversee the financial safety and soundness of the enterprises. To fulfill its mission, OFHEO is authorized to establish and ensure compliance with capital standards for the enterprises, conduct annual risk-based examinations to assess the management practices and financial condition of the enterprises, and take enforcement actions as specified by statute. OFHEO must classify the enterprises into one of four capital categories: adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized. The Director of OFHEO determines the classification category of each enterprise based on the minimum, critical, and risk-based capital requirements. If an enterprise should fall into any of the three classifications other than adequately capitalized, the Director is authorized to impose a variety of sanctions.[25]

Other Current Issues and Recent Developments

Two key legislative issues before Congress concerning the GSEs that have not been discussed are (1) the affordable housing mission and (2) the adequacy of the GSE regulatory system.

Affordable Housing Mission

HUD has consistently held that the enterprises "lag the market" in the sense that neither dedicates as high a proportion of its business to low- and moderate-income populations as the rest of the market, particularly for first-time home buyers.[26] Thus, in 2004 HUD significantly raised the affordable housing goals over the next four years. For example, low- and moderate-income borrowers must account for 56% of

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[23] 12 U.S.C. §§ 4541-4567.

[24] 12 U.S.C. § 4542.

[25] 12 U.S.C. §§ 4511-4526. For more information on the capital standards and range of enforcement actions available to OFHEO, see CRS Report RL33940, *H.R. 1427 and S. 1100: Reforming the Regulation of Government-Sponsored Enterprises*, by Mark Jickling, Edward Vincent Murphy, and N. Eric Weiss.

[26] See prepared testimony of Alphonso Jackson, Secretary, U.S. Department of Housing and Urban Development, in U.S. Congress, House Committee on Financial Services, *Hearing on oversight of the Department of Housing and Urban Development, including the Department's budget request for fiscal year 2005*, hearings, 108th Cong., 2nd sess., May 20, 2004, at [http://financialservices.house.gov/media/pdf/052004aj.pdf].

the mortgages purchased by the enterprises by 2008.[27] Previously, the lending requirement for this segment of the population was only 50%. In addition, HUD established home purchase subgoals for each of the three goal categories. By raising the goal targets and introducing home purchase subgoals, HUD intended to encourage the GSEs to increase their purchases of affordable housing loans and move them into a leadership position in the single-family conventional conforming loan market.

GSE Regulatory Reform Legislation

The House Committee on Financial Services on May 9, 2007, reported H.R. 1427, as amended. The full House passed the bill on May 22, 2007, by a vote of 313 to 104. It would make changes in GSE regulation and create an affordable housing fund tied to the value of mortgages securitized and held in portfolio by the enterprises. S. 1100 has been introduced in the Senate; this bill does not have an affordable housing fund.[28] S. 2391, the Government-Sponsored Enterprise Mission Improvement Act, would create an affordable housing fund. Both S. 1100 and S. 2391 were referred to the Senate Committee on Banking, Housing and Urban Affairs.

Another bill, H.R. 2895, the National Affordable Housing Trust Fund Act of 2007, would create a national affordable housing trust fund that would combine the GSE affordable housing fund with one created by the Federal Housing Administration. The House passed H.R. 2895 by a vote of 264-148 on October 10, 2007. The Senate referred it to the Committee on Banking, Housing, and Urban Affairs.

In the absence of legislative reform, financial regulators and the Administration have taken steps to reduce the importance of some of the government ties with the GSEs that, in the past, have helped propagate the notion of an implied government guarantee. The most recent developments on this front include the following:

- Beginning July 2006, the Federal Reserve required the GSEs to pay up front for cash payments that the Fed makes on their behalf, rather than allowing them to take advantage of intraday overdrafts.[29]

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[27] For more details, links to the five parts of the final rule are available on the HUD website at [http://www.hud.gov/offices/hsg/gse/gse.cfm].

[28] See CRS Report RL33940, *H.R. 1427 and S. 1100: Reforming the Regulation of Government-Sponsored Enterprises*, by Mark Jickling, Edward Vincent Murphy, and N. Eric Weiss for more information on these bills.

[29] Federal Reserve, "Changes to Policy Statement on Payments System Risk," press release, February 5, 2004, at [http://www.federalreserve.gov/boarddocs/press/other/2004/20040205/default.htm].

- The President has declined, since 2004, to exercise his authority to appoint five directors to the boards of Freddie Mac and Fannie Mae.[30]

- Since 2004, the Department of the Treasury has been considering a plan to limit the debt issuances of Fannie Mae and Freddie Mac.[31]

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[30] See the proxy statements of Fannie Mae and Freddie Mac, available at [http://www.fanniemae.com/ir/pdf/sec/2004/proxy04232004.pdf] and [http://www.freddiemac.com/investors/pdffiles/2003proxy.pdf].

[31] Rob Blackwell, "A Treasury View on GSE Debt, And Unintended Consequences," *American Banker*, May 14, 2004.