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An Overview of the Housing Finance System in the United States

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Summary

When making a decision about housing, a household must choose between renting and owning. Multiple factors, such as a household's financial status and expectations about the future, influence the decision. Few people who decide to purchase a home have the necessary savings or available financial resources to make the purchase on their own. Most need to take out a loan. A loan that uses real estate as collateral is typically referred to as a mortgage.

A potential borrower applies for a loan from a lender in what is called the primary market. The lender underwrites, or evaluates, the borrower and decides whether and under what terms to extend a loan. Different types of lenders, including banks, credit unions, and finance companies (institutions that lend money but do not accept deposits), make home loans. The lender requires some additional assurance that, in the event that the borrower does not repay the mortgage as promised, it will be able to sell the home for enough to recoup the amount it is owed. Typically, lenders receive such assurance through a down payment, mortgage insurance, or a combination of the two. Mortgage insurance can be provided privately or through a government guarantee. After a mortgage is made, the borrower sends the required payments to an entity known as a mortgage servicer, which then remits the payments to the mortgage holder (the mortgage holder can be the original lender or, if the mortgage is sold, an investor). If the borrower does not repay the mortgage as promised, the lender can repossess the property through a process known as foreclosure.

The secondary market is the market for buying and selling mortgages. If a mortgage originator sells the mortgage in the secondary market, the purchaser of the mortgage can choose to hold the mortgage itself or to securitize it. When a mortgage is securitized, it is pooled into a security with other mortgages, and the payment streams associated with the mortgages are sold to investors. Fannie Mae and Freddie Mac securitize mortgages that conform to their standards, known as *conforming mortgages*. Mortgages that do not conform to all of Fannie Mae's and Freddie Mac's standards are referred to as *nonconforming mortgages*. Ginnie Mae guarantees mortgage-backed securities (MBS) made up exclusively of mortgages insured or guaranteed by the federal government. Other financial institutions also issue MBS, known as private-label securities (PLS). The characteristics of the borrower and of the mortgage determine the classification of the loan. What happens to a mortgage in the secondary market is partially determined by whether the mortgage is government-insured, conforming, or nonconforming. Depending on the type of MBS or mortgage purchased, investors will face different types of risks.

Congress is interested in the condition of the housing finance system for multiple reasons. The mortgage market is very large and can impact the wider U.S. economy. The federal government supports homeownership both directly (through the Federal Housing Administration [FHA], Department of Veterans Affairs [VA], and U.S. Department of Agriculture [USDA]) and indirectly (through Fannie Mae and Freddie Mac). This support by the federal government means that the government is potentially liable for financial losses. Fannie Mae, Freddie Mac, and FHA experienced financial difficulty in the years following the housing and mortgage market turmoil that began around 2007, although they are more financially stable of late. Congress has shown an ongoing interest in exercising oversight and considering legislation to potentially reduce the government's risk in the mortgage market and reform the broader housing finance system.

For an abbreviated version of this report, see CRS In Focus IF10126, *Introduction to Financial Services: The Housing Finance System*, by Katie Jones and N. Eric Weiss.

Contents

Tables

Appendixes

Contacts

Introduction

One critical housing decision that households make is whether to rent or to own. Multiple factors influence the decision, such as a household's financial status and expectations about the future. Homeownership offers advantages such as tax deductions, the possibility of increasing wealth through price appreciation, and relatively stable housing costs. In contrast, purchasing a home has expenses, such as a real estate agent's commission, the time and effort involved in searching for a new home, the cost of a home inspection, and various state and local fees, which might deter homeownership. Furthermore, homeowners also face the risk that house prices could decrease. These costs can make homeowners less mobile than renters and less able to move elsewhere to take advantage of employment opportunities.

Few homebuyers have sufficient financial resources to make the purchase without borrowing money. Most need to take out a loan known as a mortgage. This report serves as a primer that explains how the system of housing finance works. It focuses on single-family, owner-occupied housing not on rental, commercial, or multi-family real estate.[1]

Historically, the government has played an important role in the housing finance system, both supporting the system and regulating it. As described in more detail in the "Lender Protection" section, the government provides explicit support to certain homeowners through government agencies such as the Federal Housing Administration (FHA) and implicit support to others, such as through the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. Advocates of government support for homeownership argue that homeownership strengthens ties to community and may allow households to accumulate wealth. The government's support attempts to balance two competing objectives: (1) expanding access to homeownership for qualified borrowers and (2) minimizing the risk and cost to the government.

The government's regulation of the housing finance system is divided across the different levels of government. Some issues, such as the *foreclosure* process, are primarily regulated by the states, while other issues, such as certain borrower protections when taking out a mortgage, are regulated at the federal level. This report largely focuses on the federal role in supporting housing finance, not on its role in the regulation of it.

The housing finance system has two major components: a *primary market* and a *secondary market*. Lenders make new loans in the primary market, and loans are bought and sold by financial institutions in the secondary market. The next section describes the primary market, explaining what a mortgage is and how a mortgage is made. The following section describes the secondary market. The **Appendix** provides a glossary of terms used in this report as well as other common mortgage terms.

The Primary Market

In the primary market, a lender extends a loan to a borrower to purchase a house.[2] Many different types of lenders, including banks, credit unions, and finance companies (institutions that lend

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[1] Condominiums and cooperatives are legal structures for homeownership that combine single family and other aspects. Manufactured housing is sometimes financed as personal property and other times financed with a mortgage. For more on commercial and multi-family real estate, see CRS Report R41046, *Multifamily and Commercial Mortgages: An Overview of Issues*, by N. Eric Weiss.

[2] Different types of single-family properties might require different types of mortgages or might influence the type of mortgage that a borrower takes out. For example, mortgages used to purchase condominiums or co-ops might have different requirements than mortgages used to purchase detached single-family homes.

money but do not necessarily accept deposits) make home loans. A loan that uses real estate as collateral is typically referred to as a *mortgage*. When a borrower applies for a mortgage, the lender will underwrite, or evaluate, the borrower.

The lender may consider multiple factors, such as the applicant's credit history, income, debts, assets, and the value of the house being purchased. The underwriting process usually takes several weeks or a month as the borrower assembles various financial documents, such as tax returns, that the lender requires.

The mortgage application process can be relatively expensive for borrowers. The borrower pays a variety of upfront fees for items such as credit reports, an independent appraisal, a land survey, a title search, and lender fees. The borrower generally has to pay additional costs when the mortgage documents are signed at what is called a *closing*. Collectively, these are referred to as settlement costs or *closing costs*.[3] The borrower and the seller can negotiate who will pay which fees, but the borrower is generally responsible for at least some closing costs. By law, the lender is required to provide a standardized form to the borrower at closing that shows the itemized closing costs associated with the mortgage.[4]

Mortgage Characteristics

A mortgage has four basic characteristics:[5]

1. the amount of the loan (the principal),
2. the length (or term) of the loan,
3. the schedule for the loan's repayment (monthly installments or lump sum), and
4. the interest rate.

Different types of mortgages vary across these characteristics. A *fixed-rate mortgage* is a mortgage in which the interest rate does not change over the life of the loan. An *adjustable-rate mortgage* has an interest rate that is tied to an underlying index; at agreed-upon intervals, as the index adjusts, so does the interest rate and the monthly payments.[6] A *balloon mortgage* has a lump-sum amount, or a *balloon payment*, due at the end of the loan.

The most common type of mortgage in the United States is the 30-year, fixed-rate, *self-amortizing* mortgage, in which every payment is the same amount and pays some of the interest and some of the principal until the loan is paid off.[7] For example, if a borrower takes out a

[3] For more information on what closing costs can include, see Consumer Financial Protection Bureau, *Your Home Loan Toolkit: A Step-by-Step Guide*, http://portal.hud.gov/hudportal/documents/huddoc?id=HUD_SETTLE_COST.pdf.

[4] A closing disclosure documents must be provided to a borrower three days before closing. See, CRS Report R44217, *Integrated Mortgage Disclosure Forms and H.R. 3192 and S. 1484/S. 1910: In Brief*, by Sean M. Hoskins.

[5] Daniel J. McDonald and Daniel L. Thornton, "A Primer on the Mortgage Market and Mortgage Finance," Federal Reserve Bank of St. Louis, January/February 2008, http://research.stlouisfed.org/publications/review/08/01/McDonald.pdf. In addition to the four characteristics mentioned above, a mortgage may include other characteristics, such as whether there is a prepayment penalty (i.e., a fee that may have to be paid if a borrower attempts to fully repay the mortgage before the specified date). However, the four listed characteristics are generally the main focus.

[6] The interest rate is likely to have a ceiling and a floor and only be able to adjust by a fixed amount at a given time. The specifics may vary by individual mortgages. Some mortgages may have an interest rate that is fixed for a given time before becoming adjustable. For example, a 2/28 mortgage has a fixed interest rate for the first two years and an adjustable rate for the existing 28 years.

[7] The homebuyer usually makes one payment that covers the mortgage, property taxes, and hazard insurance. Changes in taxes or insurance can change the amount of this monthly payment.

$200,000 mortgage with a 6.5% fixed interest rate to be repaid over 30 years, the borrower's monthly payment is about $1,264.[8] After 360 months of making monthly payments of $1,264 (one payment per month for 30 years), the mortgage is completely paid off.

Although the typical mortgage contract may have a 30-year term, most mortgages are paid off early. Borrowers pay off a mortgage in several ways. First, a borrower can repay the loan in full over the prescribed time period or earlier if the borrower makes extra payments. Second, the borrower can *refinance* the mortgage. In a refinance, the borrower takes out a new mortgage (usually with better terms than the original, such as a lower interest rate), using the new mortgage to repay the original mortgage. [9] The borrower then makes payments on the new mortgage. Third, a borrower can sell the home and use the proceeds to repay the mortgage.

Lender Protection

When taking out a mortgage, the house that is being purchased is pledged as collateral. If the borrower is unable or unwilling to pay, the lender can seize the house and sell it to recoup what is owed.[10] To increase the probability that the sale of the house will be sufficient to recover the amount of the mortgage outstanding (and to reduce the advantage to the homeowner of defaulting), the lender will generally require a *down payment*. The down payment also serves as a buffer to protect the lender in the event that house prices fall. For example, if a borrower wants to purchase a $400,000 house, the borrower might make a $100,000 down payment (25%) in order to borrow the $300,000 needed.[11] As long as the house can be sold for more than the amount of the mortgage outstanding, the lender faces little risk of not being repaid. A larger down payment results in a lower *loan-to-value ratio* (i.e., the ratio of the amount of the mortgage to the value of the home).

Although lenders typically require a 20% down payment, a borrower could use mortgage insurance instead, if he or she does not have enough for a 20% down payment. Mortgage insurance, an insurance policy purchased by either the borrower or the lender (though usually by the borrower), compensates the lender in the event that the borrower defaults. It provides greater assurance to the lender of being repaid. Borrowers typically purchase mortgage insurance from private businesses (*private mortgage insurance* or PMI) or the federal government.

Government mortgage insurance coverage varies depending on the agency providing the insurance, but most programs have lower down payment requirements than other types of mortgages or may not require a down payment at all. The three main agencies that provide government mortgage insurance are

[8] The $1,264 payment would cover the monthly principal and interest payment on the mortgage. In addition, each month the borrower might also pay property taxes and insurance premiums into an escrow account as part of the monthly payment. An escrow account is a special account that a borrower pays into as part of the monthly mortgage payment to ensure that taxes and insurance payments are made on behalf of the borrower.

[9] A borrower could also refinance as a "cash out refinancing." In a cash out refinancing, the borrower refinances the home by taking out a mortgage with a larger principal amount than is needed to extinguish the existing mortgage. The borrower keeps the difference. For cash out refinancing to be approved, a borrower will typically need to have sufficient equity in the home.

[10] In some cases, it is possible that the borrower could still owe the lender the difference between the sales price of the house and the mortgage amount owed. This will depend on state law and, in states where the borrower can be held responsible for the difference, whether the lender chooses to forgive that difference.

[11] To determine the value of the house, the lender may require an appraisal, which is an independent valuation of the home. In addition to the down payment, the borrower would need to save enough to cover the closing costs of the mortgage. Closing costs are the fees associated with the mortgage settlement process.

- **Federal Housing Administration (FHA).**[12] FHA, an agency within the Department of Housing and Urban Development (HUD), provides mortgage insurance on loans that meet its requirements (including a minimum down payment requirement and an initial *principal balance* below a certain threshold) in exchange for fees, or premiums, paid by borrowers. If a borrower defaults on an FHA-insured mortgage, FHA will repay the lender the entire remaining principal amount it is owed. FHA is the largest provider of government mortgage insurance.
- **Department of Veterans Affairs (VA).**[13] VA provides a guaranty on certain mortgages made to veterans. If a borrower defaults on a VA-guaranteed mortgage, the VA will repay the lender a portion (but not all) of the remaining principal amount owed. Because it is limited to veterans, the VA loan guaranty program is smaller and more narrowly targeted than FHA.
- **U.S. Department of Agriculture (USDA).**[14] USDA administers a direct loan program for low-income borrowers in rural areas, and a loan guarantee program for low- and moderate-income borrowers in rural areas. If a borrower defaults on a USDA-guaranteed loan, USDA repays the lender a portion (but not all) of the remaining principal amount owed. The USDA program is more narrowly targeted than FHA in that it has income limits and is limited to rural areas.

Mortgage Servicing

After a loan is made, the borrower is responsible for making the required payments. In the housing finance system, a mortgage *servicer* is usually hired by the lender to function as the intermediary between the lender and the borrower. [15] The servicer receives a fee out of the monthly proceeds for its work. The role of the servicer may be performed by the same institution that made the loan to the borrower or by another institution.

When a borrower is current (making the required payments on time), a mortgage servicer collects payments from the borrower and forwards them to the lender.[16] If the borrower is behind on the payments (i.e., is *delinquent*), the servicer may offer the borrower a workout option to potentially allow the borrower to stay in his or her home. Examples of workout options include loan modifications, such as principal balance reductions and interest rate reductions, as well as repayments plans, which allow borrowers to repay the amounts they owe over a period of time to become current on their mortgage payments. If the borrower is in *default*, which can be defined in different ways but generally means that the borrower has missed a certain number of mortgage payments, the servicer may pursue a mortgage liquidation option. Mortgage liquidation options include a foreclosure or alternatively a *short sale*, a process in which the borrower sells the home

[12] For more information on FHA-insured mortgages, see CRS Report RS20530, *FHA-Insured Home Loans: An Overview*, by Katie Jones.

[13] For more information on VA-guaranteed mortgages, see CRS Report R42504, *VA Housing: Guaranteed Loans, Direct Loans, and Specially Adapted Housing Grants*, by Libby Perl.

[14] For more information on USDA-guaranteed mortgages, see CRS Report RL31837, *An Overview of USDA Rural Development Programs*, by Tadlock Cowan.

[15] The term lender is used here, but a servicer acts as an intermediary between the borrower and any entity that holds the mortgage. The mortgage holder might be an investor or another entity rather than the lender. The sale of mortgages to investors is described in more detail in "The Secondary Market" section of this report.

[16] If a servicer maintains an escrow account for the borrower, the insurance premiums and taxes are also sent to the appropriate entities by the servicer.

and uses the proceeds to satisfy the mortgage debt even if the sale proceeds are less than the amount owed on the mortgage.[17]

The process by which a mortgage holder forecloses on a delinquent borrower is governed by state law. Because the foreclosure process is largely governed at the state level, the foreclosed home is sold under different procedures in different states. For example, in some states, delinquent mortgages are auctioned off on the courthouse steps, while in other states, other bidding processes are used. Other aspects of the foreclosure process may depend on the type of mortgage involved. For example, FHA requires servicers to consider delinquent borrowers for specific types of loss mitigation options before initiating the foreclosure process. Other types of mortgages may have their own requirements for considering loss mitigation options prior to a foreclosure.

In theory, any funds received from a foreclosure that exceed the unpaid mortgage balance and allowed expenses are returned to the foreclosed borrower. In practice, the legal costs and property maintenance costs are so great that this very rarely happens.

Mortgage Classifications

Mortgages can be classified into several categories based on their characteristics. The broadest distinction is between *government-insured mortgages* and *conventional mortgages*. Government-insured mortgages have mortgage insurance from a government agency, such as FHA, VA, or USDA, whereas conventional mortgages do not have government insurance. As previously noted, this insurance pays the lender if the borrower defaults. Borrowers can also be classified into two broad groups based on their credit history: *prime* and *non-prime.* Although there is no single agreed-upon definition, prime borrowers generally have very good credit and are offered more attractive mortgage terms, such as better interest rates, than non-prime borrowers. Non-prime borrowers exhibit one or more factors that make them appear riskier to lenders, such as past credit problems or a lack of complete income and asset documentation.

Conventional mortgages can be broken down into two additional groups, *conforming* and *nonconforming* mortgages. Conforming loans are loans eligible to be purchased in the secondary market by Fannie Mae and Freddie Mac, two GSEs that are discussed later in this report. To be a conforming loan, the mortgage must meet certain creditworthiness thresholds (such as a minimum *credit score*) and be less than the "conforming loan limit," a legal cap on the principal balance of the mortgage that can vary based on the geographic area where the house is located.[18] Borrowers with conforming loans are usually prime borrowers.

Nonconforming loans can be broken down into three additional categories depending on the reason they are not conforming. First, nonconforming loans above the conforming loan limit are called *jumbo loans*.[19] Second, *Alt-A loans* are for near-prime borrowers who may have credit problems or who do not have complete documentation for income or assets. Third, *subprime loans* are generally for the riskiest borrowers; they either have low credit scores, documentation issues, or some other factor that makes them appear to be riskier to lenders. Subprime borrowers are likely to be charged a higher interest rate to compensate the lender for the additional risk.[20]

[17] As with foreclosure, in some states, it is possible that the borrower could still owe the lender the difference between the sales price of the house and the mortgage amount owed. See footnote 10.

[18] See CRS Report RS22172, *The Conforming Loan Limit*, by N. Eric Weiss and Sean M. Hoskins.

[19] Borrowers with jumbo loans can still be considered prime borrowers if they have a good credit history.

[20] One commonly used metric to determine a borrower's classification is the borrower's credit score at the time the loan is originated. There is no single commonly agreed-upon *subprime* definition, but under one typical definition,

Risks Associated with Holding Mortgages

When a lender originates a mortgage, it accepts certain risks. The three major risks are credit, prepayment, and funding risk.

Credit risk refers to the risk that the lender bears if a borrower does not repay the mortgage on time.[21] *Prepayment risk* is the risk that a mortgage will be paid off sooner than expected, typically by a borrower refinancing the mortgage or selling the home. This is more likely to happen when interest rates fall, because borrowers are more likely to refinance their mortgages to take advantage of lower interest rates.[22] When a borrower refinances, the lender is paid in full the amount owed, but it now has to reinvest those funds at a time when its expected return on new investments is lower because interest rates have fallen.

Although prepayment risk is a risk associated with falling interest rates, there are also risks for lenders that come from rising interest rates. One of these risks, called *funding risk*, arises because some lenders borrow money in the short term to fund long-term investments, such as 30-year mortgages. Short-term interest rates are typically lower than long-term interest rates because of the additional risk associated with lending money for a longer period of time. Lenders, therefore, can profit from the difference, or spread, between the short-term and long-term rates. If interest rates rise, then the lender will have to borrow funds at a higher interest rate, while still earning the same interest rate on the mortgage. As long as the short-term rate stays below the long-term return, the lender would profit on the difference, although its profits would be lower than if the short-term interest rates had not increased. If short-term rates increase above the fixed return on the mortgage, then the investment would no longer be profitable.

Another lender's risk associated with rising interest rates is opportunity costs. If interest rates rise, but lender's money is tied up in long-term mortgages made at lower interest rates, then the lender is missing out on higher returns that it could be earning if it were able to originate mortgages or make other investments at the higher current interest rate.

The lender that originates a mortgage does not necessarily have to bear all of the associated risks. In some cases, the borrower could bear some of these risks. Adjustable-rate mortgages, for example, transfer the risk that interest rates might rise from the lender to the borrower. Lenders can also sell mortgages to investors, who then bear the risks associated with the mortgage. The market for buying and selling mortgages is called the secondary market, which is described below.

Primary Market Summary

A potential borrower applies for a loan from a lender in the primary market. The lender evaluates the borrower and decides whether to extend a loan and on what terms. The lender typically requires some additional assurance that the loan will be repaid either through a down payment or mortgage insurance (or a combination of the two). If the loan is made, the borrower sends the required scheduled payments to the servicer, which then remits the payments to the mortgage holder. The characteristics of the borrower and of the mortgage determine the classification of the loan. As is discussed next in "The Secondary Market" section, what happens to a mortgage in

borrowers with scores above 660 are considered prime; scores between 620 and 659 are Alt-A; scores below 620 are considered subprime. See Office of the Comptroller of the Currency, *OCC Mortgage Metrics Report*, at https://www.occ.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics/metrics-q2-2016.pdf.

[21] This discussion of risks describes risks to the lender that originates the mortgage, but the discussion is also applicable to any other entity that might purchase the mortgage from the original lender, such as an investor. "The Secondary Market" section of this report describes how mortgages are bought and sold.

[22] Borrowers also prepay the mortgage when they sell the house.

the secondary market is partially determined by whether the mortgage is government-insured, conforming, or nonconforming.

The Secondary Market

After a lender originates a mortgage loan, the lender has several options. The lender could choose to hold the mortgage in its *portfolio* or sell it to another entity. Mortgages are bought and sold in the secondary market to domestic and international investors. When a mortgage is sold, the mortgage servicer may change. In any case, the borrower continues to send monthly mortgage payments to the mortgage servicer.[23] The servicer remits the payments to the entity that purchased the mortgage.

The secondary market plays an important role in providing funding for loans made in the primary market. When a mortgage is sold in the secondary market, the lender can use the proceeds to fund additional new mortgages in the primary market. If the lender holds the mortgage in its portfolio, the lender has fewer available funds to make new mortgages. Furthermore, selling the loan to another entity allows the lender to transfer mortgage lending risks to the buyer.

Securitization

When a lender sells a mortgage in the secondary market, the new mortgage holder can hold the mortgage as a *whole loan*. When held as a whole loan, the mortgage is in the portfolio of the new mortgage holder, and the new mortgage holder bears the risks associated with the mortgage.

Alternatively, the new mortgage holder may choose to *securitize* the mortgage instead of holding it as a whole loan.[24] Mortgage securitization comes in many different forms, but generally speaking, the process involves a financial institution acquiring and combining (pooling together) many different mortgages and then issuing a *mortgage-backed security* (MBS). An MBS can be divided into different pieces, or *tranches*, that are sold to investors.[25] The investors do not own the underlying mortgages but are buying the right to receive the future stream of payments that come from those mortgages. A servicer collects the payments of all the borrowers whose mortgages are part of the security and remits the payments to the investors.

For investors, purchasing MBS offers several benefits compared with holding whole mortgages. Most notably, an MBS is generally more *liquid* than whole mortgages, meaning it is easier to quickly sell an MBS at the current price. Because the market for MBS is more liquid than the market for whole mortgages, MBS might be attractive to investors who would not otherwise choose to invest in mortgages. More investors in the mortgage market, in turn, can mean more funding is available for lenders to offer mortgages. More funding available in the primary market,

[23] Servicers are subject to contracts negotiated with investors that guide the servicers' actions, including actions servicers can take when borrowers are delinquent on their mortgages. These contracts are referred to as pooling and servicing agreements (PSAs). PSAs generally instruct the servicer to act in the best interest of the investors. See, Larry Cordell, Karen Dynan, and Andreas Lehnert, et al., *The Incentives of Mortgage Servicers: Myths and Realities*, Federal Reserve Board, 2008-46, at https://www.federalreserve.gov/pubs/feds/2008/200846/200846pap.pdf.

[24] A loan could be sold multiple times before it is eventually securitized, often from a smaller lender to a larger lender that pools the loans.

[25] Tranches can be structured in many different ways. For example, an MBS can be structured as a pass-through security, such that, if an investor purchases 10% of the security, then the investor is entitled to receive 10% of the payments made by borrowers. Alternatively, an MBS can have tiered tranches with the highest tranche entitled to the first stream of payments that borrowers make (and assuming the least amount of risk) and the lowest tranche entitled to the remaining payments (and assuming the most risk).

and the existence of a secondary market where lenders know they can easily sell the mortgages they make, can result in lower interest rates that lenders charge to borrowers.

Although securitization may have several advantages, it may also present several disadvantages. Securitization—and the secondary market in general—requires additional participants to facilitate the flow of credit than when a loan is held by the originator. Additional participants, with some acting on behalf of others, can increase costs and introduce competing incentives for the various participants and potential conflicts of interest. For example, more participants in the transaction may result in a principal-agent problem, a situation in which one entity (the agent) is supposed to work on behalf of another entity (the principal), but the agent may have an incentive to act in its own best interest rather than in the best interest of the principal. For example, mortgage servicers act on behalf of investors to evaluate a borrower for mortgage workout options or to begin the foreclosure process when a borrower falls behind on mortgage payments, as specified by a contract between the investor and the servicer. However, in some cases, a servicer may have an incentive to choose the option that is in its own best interest rather than in the best interest of the investor, and the investor might not be well positioned to police the servicer's actions.[26]

Types of MBS

The securitization process can take many different forms, but three broad categories are described below: Fannie Mae and Freddie Mac, Ginnie Mae, and *private-label securitization* (PLS). The underlying loans that comprise the MBS are related to the mortgage classifications described in "The Primary Market" section of this report: generally, conforming mortgages are included in Fannie Mae and Freddie Mac MBS, government-insured mortgages in Ginnie Mae MBS, and nonconforming mortgages in private-label MBS, although there are exceptions.[27]

When mortgages are securitized, investors generally take on the risks associated with the mortgage loan, such as credit risk and prepayment risk. However, in some cases, an entity other than the investor might guarantee the MBS, in which case the entity providing the guaranty takes on the credit risk while investors bear the risks associated with rising and falling interest rates. Investors in Fannie Mae, Freddie Mac, and Ginnie Mae MBS do not bear credit risk because of the guarantees those entities provide, but PLS investors and holders of non-guaranteed mortgages are exposed to credit risk.

Fannie Mae and Freddie Mac

During the Great Depression, Congress created Fannie Mae (officially, the Federal National Mortgage Association, or FNMA) as a government agency to encourage mortgage lending.[28] In 1968, Congress divided Fannie Mae into two parts: (1) a government corporation, the Government National Mortgage Association (or Ginnie Mae) and (2) a government-sponsored enterprise that retained the name Fannie Mae. In 1970, Congress established Freddie Mac

[26] For more information on servicers' business model and the role they play in mortgage modifications, see the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), *Quarterly Report to Congress,* October 26, 2010, Section 3, "The Economics of Loan Servicing," at https://www.sigtarp.gov/Quarterly%20Reports/October2010_Quarterly_Report_to_Congress.pdf.

[27] By law, Ginnie Mae MBS can only contain federally insured mortgages. By law, Fannie Mae and Freddie Mac can only purchase conforming mortgages, and they have generally not found it profitable to purchase and securitize government-insured mortgages. Because of their GSE status, Fannie Mae and Freddie Mac have been able to offer better prices in the secondary mortgage market for conforming mortgages. Private-label securitizers have not been able to compete with the GSEs in issuing MBS backed by conforming mortgages.

[28] Congress also established the Federal Home Loan Bank (FHLB) Board and the 12 (now 11) regional Federal Home Loan Banks in the 1930s. Savings and loans, which were devoted to mortgage lending, were the original members.

(officially, the Federal Home Loan Mortgage Corporation, or FHLMC) as part of the *Federal Home Loan Bank System*, owned by member banks.

Fannie Mae and Freddie Mac do not originate mortgages, a process that occurs in the primary market. Instead, the GSEs purchase conforming mortgages, which meet their eligibility criteria. The GSEs either hold the mortgages in their own portfolios or pool the mortgages into MBS, which are sold to investors or retained by the GSEs as investments. The GSEs guarantee that investors in these MBS will receive timely payment of principal and interest even if the borrower becomes delinquent on the underlying mortgage. The GSE guarantee transfers the credit risk (i.e., the risk that some borrowers might default and not repay their mortgages) from the investors to the GSEs. To compensate the GSEs for their guarantee, the GSEs receive a *guarantee fee*. The GSE guarantee makes their MBS more easily traded and worth more to investors, increasing investors' demand for GSEs' MBS. The support provided by GSEs in the secondary market can translate to lower rates for borrowers in the primary market.[29]

Both Fannie Mae and Freddie Mac are private companies, even though both have congressional charters that contain special privileges and certain special responsibilities to support affordable housing for low- and moderate-income households. As private companies, their employees are not government employees, and their debts are explicitly not backed by the federal government. Despite the explicit disclaimer, it was commonly believed that the federal government would, in fact, back the GSEs if necessary. In September 2008, Fannie Mae and Freddie Mac were in extreme financial difficulty and agreed to be placed in voluntary *conservatorship*, which allows the federal government to run them. The stated goals of the conservatorship are to run the GSEs in ways that meet their public policy goals, conserve the enterprises' assets, and return them to stockholder control or dissolve them via receivership.[30]

Ginnie Mae

Congress established Ginnie Mae in 1968 when it divided Fannie Mae into two separate entities. Ginnie Mae remains a government agency as part of the Department of Housing and Urban Development.

Ginnie Mae guarantees MBS made up exclusively of mortgages insured or guaranteed by the federal government, namely FHA, VA, USDA, or HUD's Office of Public and Indian Housing. Similar to the GSEs, Ginnie Mae guarantees investors in its MBS timely payment of principal and interest payments in exchange for a guarantee fee. By providing a secondary market for government-backed mortgages, Ginnie Mae increases the amount of capital available in the primary market for lenders to offer government-backed mortgages. Unlike Fannie Mae and Freddie Mac, Ginnie Mae does not purchase or securitize mortgages; rather, it guarantees the MBS issued by certain issuers (such as banks or credit unions) that have been approved by Ginnie Mae. Furthermore, Ginnie Mae's employees are government employees, and its guaranty is explicitly backed by the full faith and credit of the U.S. government. This means that, if Ginnie Mae were unable to fulfill its obligations, its MBS investors would be paid from the U.S. Treasury funds.

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[29] Wayne Passmore, Roger Sparks, and Jamie Ingpen, "GSEs, Mortgage Rates, and the Long-Run Effects of Mortgage Securitization," December 2001, http://www.federalreserve.gov/pubs/feds/2001/200126/200126pap.pdf found that although the GSEs may result in lower mortgage interest rates, some of the funding advantage of the GSEs goes to investors and company management.

[30] CRS Report R44525, *Fannie Mae and Freddie Mac in Conservatorship: Frequently Asked Questions*, by N. Eric Weiss.

Private-Label Securitization

PLS is a form of securitization that typically uses nonconforming mortgages, meaning mortgages that do not conform to the GSE standards either because they are too large (jumbo loans) or they do not meet the necessary credit standards (typically these loans will be Alt-A and subprime). PLS is similar to GSE and Ginnie Mae securitization—all involve the pooling of mortgages and the issuing of securities—but private-label securities do not have an explicit or implicit government guarantee.

Unlike with PLS, GSE and Ginnie Mae securities provide a guarantee that minimizes the credit risk to the investor. PLS MBS instead often rely on alternative forms of "credit enhancement" to minimize the credit risk to investors. For example, a private-label MBS may purchase insurance from a private insurer to guarantee the investor's payment. [31] Alternatively, the credit risk could be minimized for some investors by structuring the MBS so that there are multiple tranches, with the most senior tranche entitled to the first stream of payments that borrowers make (and assuming the least amount of risk) and the lowest tranche entitled to the remaining payments (and assuming the most risk).

In addition to MBS, there are other types of products that private-label securitizers create that are derived from mortgages. For example, instead of pooling together mortgages to issue an MBS, a securitizer could pool together different tranches of MBS as a *collateralized-debt obligation* (CDO).[32] Securitizers can also pool together CDOs to create even more types of products.

Table 1 summarizes the relationship between the different types of MBS and the different classifications of mortgages.

[31] See CRS Report RL34364, *Bond Insurers: Issues for the 110th Congress*, by Baird Webel and Darryl E. Getter.

[32] Larry Cordell, Yilin Huang, and Meredith Williams, "Collateral Damage: Sizing and Assessing the Subprime CDO Crisis," May 2012, at http://www.philadelphiafed.org/research-and-data/publications/working-papers/2011/wp11-30.pdf.

Table 1. Mortgage-Backed Securities Classification

Type of MBS	Type of Underlying Mortgage
Fannie Mae and Freddie Mac	Conforming mortgages
Ginnie Mae	Government-guaranteed mortgages
Private Label	Conventional (not government-guaranteed), nonconforming (jumbo, Alt-A, and subprime) mortgages

Source: Created by the Congressional Research Service (CRS).

Notes: The table shows the types of underlying mortgages that typically comprise the different types of MBS. By law, Ginnie Mae MBS can only contain federally insured mortgages. By law, Fannie Mae and Freddie Mac can only purchase conforming mortgages, and they have generally not found it profitable to purchase and securitize government-insured mortgages. Because of their GSE status, Fannie Mae and Freddie Mac have been able to offer better prices in the secondary mortgage market for conforming mortgages. Private-label securitizers have not been able to compete with the GSEs in issuing MBS backed by conforming mortgages.

Investors

Investors that purchase mortgages and MBS are an important source of funding for mortgages originated in the primary market. Investors in MBS are typically large *institutional investors*, such as pension funds, domestic banks, foreign banks, and hedge funds. Investors choose which of the types of MBS to purchase based on the type and amount of risk the investor wishes to bear and on the expected return from their investment.

GSE, Ginnie Mae, and PLS MBS are generally divided into two broad categories: *agency MBS*, which includes GSE and Ginnie Mae MBS, and *non-agency MBS*, which is only PLS. Investors purchase agency and non-agency MBS in different ways.

To-Be-Announced Market

Agency MBS are typically purchased by investors through the *to-be-announced (TBA) market*. The TBA market is a forward market: the specific mortgages in the MBS that are being purchased are unknown on the date the trade is agreed to. Instead, the buyer and seller agree on six basic criteria.[33] These criteria are

1. issuer (Fannie Mae, Freddie Mac, or Ginnie Mae as guarantor),
2. coupon (the annual MBS interest rate),
3. maturity (when the MBS will be paid off in full),
4. price (the price being paid for the MBS),
5. par amount (the total amount borrowed by the homeowners), and
6. settlement date (the date the buyer will pay for the MBS and receive it).

The trade may not be settled (or completed) for several weeks. Two days before the trade is settled, the seller informs the buyer about the specifics of the mortgages in the pool being sold. The pool being sold must satisfy the original criteria agreed to in accordance with the settlement

[33] James Vickery and Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market,* Federal Reserve Bank of New York, at http://www.newyorkfed.org/research/epr/2013/1212vick.pdf.

guidelines established by the Securities Industry and Financial Markets Association (SIFMA), an industry trade group.[34]

The TBA market provides several different benefits to the housing finance system. The establishment of a large and liquid secondary market can boost the demand for MBS by investors, which in turn can lower the interest rate charged to borrowers in the primary market.[35] In addition, by providing several weeks between when a trade is agreed to and eventually settled, the TBA market allows sellers of MBS to know the price and amount of MBS that they will sell at a future date. This can reduce the uncertainty sellers face in determining how many new mortgages to purchase or originate in the primary market and at what price. The time between when a trade is agreed to and when it is settled also helps borrowers to lock in interest rates a month or more before their loan is finalized.

Specified-Pool Market

Non-agency MBS are issued and sold by private companies to investors. They are ineligible for the TBA market and instead sell through a *specified-pool market* in which the details of the specific bonds are known when a trade is made.[36] Some agency MBS also sell in a specified-pool market, although most agency MBS trade through the TBA market. Non-agency MBS tend to be less liquid than agency MBS, meaning it is more difficult to sell non-agency MBS without reducing the price. The relative illiquidity of specified-pool markets compared with the TBA market may be due to the structure of the market, the absence of a large forward market for non-agency MBS, or the type of securities being traded (i.e., securities that do not have a perceived or explicit government guarantee).

Secondary Market Summary

The secondary market is the market for buying and selling mortgages that have been originated. Lenders might choose to keep the mortgages that they originate in their own portfolios, or they might sell them to the secondary market. If a mortgage originator sells the mortgage in the secondary mortgage, the purchaser of the mortgage could choose to hold the mortgage itself or to securitize it in a pool of mortgages. Fannie Mae and Freddie Mac securitize mortgages that conform to their criteria and guarantee investors payments on those MBS. Historically, Fannie Mae and Freddie Mac securities have not had an explicit government guarantee, although they were thought to have an implicit government guarantee. Ginnie Mae provides an explicit government guarantee on MBS made up exclusively of mortgages insured or guaranteed by the federal government. Other financial institutions issue PLS that do not have an implicit or explicit government guarantee. Depending on the type of MBS or mortgage purchased, investors will face different types of risks, including credit risk and prepayment risk.

[34] The Securities Industry and Financial Markets Association (SIFMA) guidelines are called the Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities and are available at http://www.sifma.org/tba/#up.

[35] James Vickery and Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market,* Federal Reserve Bank of New York, at http://www.newyorkfed.org/research/epr/2013/1212vick.pdf.

[36] SIFMA, "TBA Market Fact Sheet," at http://www.sifma.org/issues/item.aspx?id=23775.

Appendix. Glossary

Term	Definition
Adjustable-rate mortgage	A mortgage whose interest rate can change at agreed-upon intervals (frequently annual) based on changes in a specified index.
Agency MBS	A term used to refer to mortgage-backed securities that are guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae.
Alt-A mortgage	A mortgage made to a borrower who is considered slightly less creditworthy than a prime borrower; perhaps, because of the borrower's credit rating or the lack of standard documentation.
Amortization or amortization schedule	The repayment of principal (as opposed to interest) on a loan. This determines how much of the original amount borrowed is owed at any time.
Balloon payment	A special payment, usually larger than a standard monthly payment, which is due at the end of a mortgage.
Basis point	One-hundredth of one percentage point (0.01%). Basis point is sometimes shortened to *point*.
Closing	The final step in a real estate transaction in which loan documents are signed and the borrower is given the funds. Documents transferring and registering the new ownership of a home are also signed at closing.
Closing costs	Costs charged at the time loan documents are signed at closing. Closing costs can include title searches, appraisals, land surveys, legal fees, and various taxes, among other things. In addition, borrowers are usually required to prepay certain costs, such as accrued property taxes, at closing.
Closing points	A fee charged to the borrower at the closing of a mortgage. The fee is stated in basis points and goes to the lender.
Collateralized debt obligation (CDO)	A security created by mortgage securitizers that pools together different tranches of MBS.
Condominium	An individually owned unit in a multiunit structure.
Conforming loan limit	The maximum original principal balance of a mortgage that can be purchased by Fannie Mae or Freddie Mac.
Conforming mortgage	A mortgage that meets the credit and loan limit standards for mortgages that Fannie Mae and Freddie Mac can purchase.
Conservatorship	When management of a financial institution that is in financial trouble is legally taken over by an outside conservator. The goal of conservatorship is to keep the entity in operation and to either return it to stockholder control or to dissolve it in receivership, if necessary.
Conventional mortgage	A mortgage that is not insured or guaranteed by a government agency, such as FHA, VA, or USDA.
Cooperative	A legal structure for ownership of a multiunit structure. The residents' ownership of stock in the cooperative gives them the right to a specific unit.
Correspondent lenders	Lenders with a contractual relationship to sell loans, including mortgages, to another, usually larger, financial institution.
Credit risk	The risk to the mortgage holder that a borrower will default on the mortgage and not repay the loan as promised. This is sometimes also referred to as default risk.
Credit score	A numerical evaluation of a borrower's credit history.
Department of Housing and Urban Development (HUD)	A Cabinet-level agency that includes both the FHA and Ginnie Mae.

Term	Definition
Default	The failure to meet contracted loan obligations, such as failing to make monthly payments on time. Different entities may define default differently. Some use default to mean a borrower has missed three or more monthly loan payments. Others use default to mean a borrower has missed one monthly loan payment or other required action.
Delinquent	Failure to meet contractual loan obligations, such as to make timely monthly payments, but the failure to meet contractual obligations has not gone on long enough for the borrower to be considered to be in default. A borrower is generally considered to be delinquent as soon as he or she misses a mortgage payment.
Down payment	Money that the borrower puts towards the purchase of the home so that the entire cost of the home is not financed by the mortgage. Lenders generally require down payments to increase the probability that, if the borrower does not repay the mortgage as promised, the home can be sold for an amount high enough to cover the mortgage amount outstanding.
Federal Home Loan Bank (FHLB) System	A government-sponsored enterprise owned by member lenders and chartered by Congress to provide liquidity to the mortgage market by lending funds using mortgages as collateral.
Federal Housing Administration (FHA)	A government agency within the Department of Housing and Urban Development that provides mortgage insurance on certain mortgages that meet its criteria and are made by private lenders.
Federal Home Loan Mortgage Corporation (Freddie Mac)	A stockholder-owned company with a congressional charter that purchases already made mortgages. Its formal name is the Federal Home Loan Mortgage Corporation.
Federal Housing Finance Agency (FHFA)	An independent federal agency that is Fannie Mae's and Freddie Mac's regulator and conservator. FHFA also regulates the FHLB System.
Federal National Mortgage Association (Fannie Mae)	A stockholder-owned company with a congressional charter that purchases already made mortgages. Its formal name is the Federal National Mortgage Association.
FICO	A credit score developed and calculated by a company of the same name.
Fixed-rate mortgage	A mortgage whose the interest rate cannot change over the life of the mortgage. This is in contrast to an adjustable-rate mortgage.
Foreclosure	The process by which a mortgage holder repossesses a home after a borrower defaults on the mortgage, or the outcome of that process. Laws governing foreclosure vary by state.
Funding risk	The risk to mortgage holders that rising interest rates will decrease their profits. This could happen if mortgage holders borrow money in the short term and invest it in long-term investments, such as mortgages, to profit from the spread between short-term and long-term interest rates. If interest rates rise, the mortgage holder's borrowing costs go up, but the interest rate that it earns on its investments remains the same, reducing its profits.
Guarantee fee (G fee)	A fee that Fannie Mae and Freddie Mac charge the seller when they purchase a mortgage. The G fee is mandatory and is used to guarantee timely payment of principal and interest to purchasers of Fannie Mae or Freddie Mac mortgages. Ginnie Mae also charges guarantee fees. G fees are passed onto the borrower in the interest rate paid.
Ginnie Mae	A government agency that guarantees mortgage-backed securities that are made up of government-insured mortgages. The Ginnie Mae guarantee has the full faith and credit of the United States government behind it. Ginnie Mae, officially the Government National Mortgage Association, is part of the Department of Housing and Urban Development.

Term	Definition
Government-insured mortgage	A mortgage insured or guaranteed by a government agency, such as FHA, VA, or the USDA.
Government-sponsored enterprise (GSE)	A private company with a congressional charter, such as Fannie Mae, Freddie Mac, and the FHLB System.
Institutional investor	An organization such as a commercial bank, sovereign wealth fund, college endowment, pension fund, or private equity fund that has large amounts of money to invest.
Insured depository	An institution that takes deposits that are insured by the federal government. Commercial banks (insured by the Federal Deposit Insurance Corporation) and credit unions (insured by the National Credit Union Administration) are two types of insured depositories.
Interest rate risk	The risk that a mortgage holder could lose money on a mortgage due to changes in interest rates.
Jumbo loan	A loan in which the original principal balance exceeds the maximum amount of a loan that Fannie Mae or Freddie Mac can purchase.
Liquid	A term used to refer to markets where a commodity, such as mortgages, can be sold easily and quickly.
Loan-to-value ratio (LTV)	The ratio of the principal balance of a mortgage to the value of the home that is used as collateral. A higher LTV means that a borrower has less equity in the home, and a lower LTV means that a borrower has more equity in the home. LTVs are expressed as a percentage, such as 80% (the unpaid principal balance is 80% of the value of the home).
Mortgage	A loan with specific real estate as collateral.
Mortgage banker	A banker who works for a mortgage bank that specializes in originating mortgages using funds that it borrows. A mortgage bank has a state license and does not accept deposits.
Mortgage broker	An intermediary who brokers mortgage loans on behalf of individuals or businesses; brings a mortgage lender and a borrower together although the lender and the borrower might not actually meet.
Mortgage-backed security (MBS)	A bond that is collateralized by mortgages.
Non-agency MBS	A term used to refer to private-label securities, that is, mortgage-backed securities that are issued by private companies and are not guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae.
Nonconforming mortgage	A mortgage that does not meet the required criteria to be eligible to be purchased by Fannie Mae or Freddie Mac in the secondary market.
Non-prime mortgage	A mortgage that does not qualify for the best mortgage terms, such as the lowest available interest rate, because the borrower has one or more factors that appear riskier to lenders. Alt-A mortgages and subprime mortgages are examples of non-prime mortgages.
Portfolio	The financial assets (bonds, stocks, mortgage-backed securities, mutual funds, etc.) that an investor owns.
Portfolio lender	A lender that makes mortgages that it intends to keep in its portfolio as investments.
Prepayment risk	The risk to a mortgage holder that a borrower will pay the mortgage earlier than anticipated, usually through refinancing. Since borrowers tend to refinance when interest rates decline, prepayments mean that a mortgage holder is unlikely to be able to reinvest the funds for as high of an interest rate as it was earning previously.

Term	Definition
Primary mortgage market	The market where lenders make mortgage loans to borrowers. It is not a physical location.
Prime mortgage	A mortgage made to a borrower with very good credit. The specific definition of what constitutes a prime mortgage varies depending on context and has changed over time.
Principal balance	The amount owed on a loan such as a mortgage.
Private-label securities (PLS)	Securities that are issued by private companies and are not guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae. PLS are usually made up of nonconforming conventional mortgages, and do not provide a guarantee of timely payment of principal and interest payments for the investor in the case of a borrower defaulting on the mortgage. PLS are sometimes referred to as non-agency MBS.
Private mortgage insurance (PMI)	Insurance typically required by lenders when a borrower does not make a 20% down payment or use a government mortgage insurance program. In the event of foreclosure, PMI covers part of the lender's loss.
Receivership	When a court or government regulator orders a financial company in severe distress dissolved to pay its creditors.
Refinance	A transaction in which a borrower with an existing mortgage takes out a new mortgage (usually with better terms than the original, such as a lower interest rate) and uses the proceeds from the new mortgage to repay the original mortgage. The borrower then makes payments on the new mortgage.
Secondary mortgage market	The market where lenders and investors buy and sell mortgage loans. It is not a physical location.
Securitization	The practice of pooling together many loans, such as mortgages, and selling the rights to receive the future stream of payments made on those loans to investors.
Self-amortizing mortgage	A mortgage in which each payment made by the borrower pays off some of the principal mortgage amount and some of the interest until the mortgage is fully paid off.
Servicer	The company that collects payments from the borrower and distributes the proceeds to the lender(s) and others (such as local property tax offices) entitled to payments.
Short sale	An alternative to foreclosure in which a borrower sells the home for less than the outstanding amount owed on the mortgage, and the lender accepts the sales proceeds as payment on the mortgage. Often, the lender will forgive the amount owed on the mortgage that exceeds the sales price, but it is possible for the borrower to still owe that amount in some cases. A lender agrees to a short sale because it is likely to receive more than in foreclosure.
Specified-pool market	A market for selling MBS in which the details of the specific mortgages that will be included in the security are known when the sale is made. PLS are most likely to trade in a specified-pool market.
Subprime mortgage	A mortgage to a borrower with less than a prime credit history. Alt-A mortgages come between prime and subprime mortgages. The term is also sometimes used to mean a mortgage with consumer unfriendly terms made to anyone.
To-be-announced (TBA) market	A market for selling MBS in which the details of the specific mortgages that will be included in the security are not specified when the sale is made, but rather the buyer and seller agree to certain basic characteristics of the mortgages that will be included. Only Fannie Mae, Freddie Mac, and Ginnie Mae mortgage-backed securities trade in the to-be-announced market.

Term	Definition
Tranche	A piece or slice of a MBS. Investors in different tranches of an MBS have different claims on the payment streams from the underlying mortgages.
U.S. Department of Agriculture (USDA)	The A Cabinet-level agency that provides guarantees on certain mortgage loans made by private lenders to borrowers in rural areas.
Department of Veterans Affairs (VA)	A Cabinet-level agency that provides guarantees on certain mortgage loans made by private lenders to borrowers who are veterans.
Whole loan	A mortgage that is held as-is in the portfolio of a lender or another entity, rather than being pooled into a MBS.

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