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Introduction to Financial Services: The Housing Finance System

Background

Prior to the Great Depression, U.S. residential mortgage markets operated at local levels and were highly sensitive to local conditions. Lenders funded mortgages by relying on local deposits, which were concentrated in heavily populated areas, such as Chicago and New York, rather than less populated areas in need of loans. Interstate banking restrictions made it difficult to move funds from geographical areas with large concentrations of deposits to areas with comparatively smaller amounts. The immobility of funds contributed to differences in mortgage rates and underwriting (loan qualifying) criteria across the nation.

During economic downturns, frequent deposit withdrawals led to cash flow (liquidity) shortages that stymied lending. At the time, *savings and loan associations (S&Ls)*—nonprofit, member-owned cooperative financial institutions that relied on members' savings deposits to fund mortgages—were the primary sources of home financing during liquidity shortages. S&Ls were unable to borrow temporary funds from the Federal Reserve System because they were not eligible members. For this reason, the lending terms of residential mortgages were structured to reduce liquidity risks borne by S&Ls. For example, borrowers were required to make large down payments (e.g., 50%-60%) to mitigate default risks and to reduce mortgage sizes, thereby reducing the amount of funds small lenders needed to collect to make loans. Mortgages typically had variable interest rates and 10- to 12-year maturities, thus mitigating cash flow disruptions due to frequent changes in local mortgage rates.

Government Interventions to Facilitate Mortgage Market Liquidity

Over the years, Congress has addressed market liquidity issues, particularly for single-family mortgages (i.e., loans secured by residential dwellings having one to four separate units), by establishing federal agencies and government-sponsored enterprises (GSEs). Some of the key ones are listed below.

- **Federal Home Loan Bank (FHLB) System.** Created in 1932 (P.L. 72-304), the FHLB System is a GSE that currently consists of 11 regional FHLBs. Each FHLB provides liquidity to member lending institutions in its district in the form of *advances*, which are temporary cash loans that must be collateralized (secured) by members' eligible assets that promote housing finance and community development (e.g., mortgages, mortgage-related assets, and certain small business loans). The FHLBs initially served as lenders of last resort for S&Ls. Congress expanded their membership in 1989 to serve in that role for banks and credit unions. The Federal Housing Finance Agency (FHFA) is the primary regulator of the FHLB System.

- **Federal Housing Administration (FHA).** The National Housing Act of 1934 (P.L. 73-479) created FHA, now a Department of Housing and Urban Development (HUD) agency. FHA insures private lenders against the default risks on mortgages meeting certain criteria. FHA introduced fixed-rate mortgages with maturities of 20 years or more, evolving into the 30-year fixed rate mortgages commonly used today.

- **Department of Veterans Affairs (VA).** Congress created the VA home loan program in 1944 (P.L. 78-346). Similarly to FHA, the VA loan guaranty program insures private lenders against the default risks on mortgages made to veterans who meet certain criteria. Unlike FHA, VA does not insure 100% of a loan's default risk; a percentage of the default risk is guaranteed based on the loan's principal balance.

- **Fannie Mae (Federal National Mortgage Association).** Title III of the National Housing Act of 1934 initially established Fannie Mae as a federal agency to purchase federally insured mortgages from lenders. By holding residential mortgages on its balance sheet, Fannie Mae extended the risk-bearing capacity of the mortgage market when small lenders lacked capacity and access to funds. In 1968, Congress split Fannie Mae into two distinct organizations (P.L. 90-448). The private-sector organization retained the Fannie Mae name and operated like an interstate lender, purchasing mortgages and funding them by issuing debt securities.

- **Ginnie Mae (Government National Mortgage Association).** Congress created the federal agency Ginnie Mae in 1968 after splitting Fannie Mae. Ginnie Mae sells to private investors the interest rate risks linked to mortgages that are federally insured against default risk by FHA or VA.

- **Freddie Mac (Federal Home Loan Mortgage Corporation).** Congress created Freddie Mac in 1970 (P.L. 91-351) as a GSE and subsidiary of the FHLB System. Freddie Mac was authorized to buy conventional mortgages, which are mortgages without insurance provided by a federal government agency. Freddie Mac largely purchased mortgages from S&Ls and funded them by issuing debt securities.

Following passage of P.L. 101-73 in 1989, the business models and missions of Fannie Mae and Freddie Mac (F&F) were harmonized, allowing them to purchase mortgages and sell mortgage-backed securities (MBS) linked to the underlying mortgages. (MBS investors are typically large institutional investors, such as pension funds, domestic banks, foreign banks, and hedge funds.) F&F must also fulfill required affordable housing goals regularly set by their primary regulator, FHFA.

The federal government does not facilitate all of the activities that would generate liquidity for mortgage markets. Private financial institutions may issue MBSs, known as private-label securities (PLSs). Although PLSs can be linked to any type of mortgage, they are often linked to pools of nonconforming mortgages, which either exceed the conforming loan limit (jumbo mortgages) or do not meet F&F's creditworthiness standards.

Selected Policy Issues

The U.S. mortgage market attracts funding from global investors. Consequently, rather than reflect more of the costs borne by regional lenders to acquire funds, modern mortgage rates better reflect the payment and default risk behaviors of borrowers. Along with assuming various financial risks, the federal government agencies (FHA, VA, Ginnie Mae) and the GSEs (the FHLB System, F&F) have facilitated greater standardization of mortgage products and borrower underwriting criteria. Greater liquidity in the modern mortgage market has made it possible to offer products with less liquid features (e.g., fixed rates, 30-year maturities, larger amounts) than those offered in the early 1900s. These developments have arguably contributed to lowering borrowers' costs to finance homeownership, possibly contributing to rising homeownership rates.

Along with liquidity benefits, government intervention in the mortgage market brings about costs. For example, the financial markets might perceive the GSEs as being too important for the government to allow any of them to fail. In this case, the GSEs may have an incentive to take on greater financial risks, including competing for lending opportunities that the private sector would willingly take. As a result, taxpayers could ultimately bear the costs of risk-taking by the GSEs. The benefits to borrowers have also been debated. F&F, for example, purchase mortgages primarily offered to prime (creditworthy) borrowers and loan refinances for existing homeowners (rather than focusing solely on first-time buyers). Hence, the liquidity benefit may accrue to borrowers who would already have access to favorable mortgage rates. In addition, the benefits received by reducing the costs to finance homeownership may be offset if the overall demand for housing increases, prompting increases in house prices.

On September 6, 2008, FHFA placed F&F in conservatorship (i.e., took control of F&F from their stockholders and management) following financial loss from extreme turmoil in the housing and mortgage markets. Treasury received preferred shares in F&F in exchange for financial support in the form of funding commitments. As of June 15, 2020, Treasury has extended a combined total of $191.4 billion to F&F and received $301 billion in dividend payments, which are not applied to repayment of the $191.4 billion in funding. These developments have led to policy issues for Congress, including the following:

- Recent Congresses have debated the optimal post-crisis structure of F&F. Some plans have suggested eliminating or shrinking F&F. Some plans would rely predominantly on the private sector to replace them, and others would have an explicit government guarantee to supplement private capital under certain circumstances.
- In response to relaxed pre-crisis mortgage underwriting standards, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203). Among other things, the act provides legal protections to lenders if their loans satisfy the requirements for qualified mortgage (QM) status. Because all loans guaranteed by the federal agencies or purchased by F&F receive QM status, these entities have increased in importance. Many originators have limited themselves to making only QM loans to avoid exposure to potential liability and litigation risks. A loan's ability to receive QM status after F&F purchases it, however, expires either when F&F exit conservatorship or after an October 1, 2022, deadline extension—whichever comes first. Afterward, F&F could limit their purchases to QMs or charge higher fees for non-QM loans to offset potential legal and compliance risks. Either response would likely affect mortgage credit availability and liquidity.
- The federal government also facilitates the liquidity of *multifamily mortgages* (i.e., loans secured by residential dwellings, such as apartment buildings, with at least five or more separate units) to promote the construction of affordable rental units. Providing liquidity to this market does not mitigate the impacts linked to rising construction costs and rents, which have risen at faster rates compared with household incomes.

Additional CRS Resources

CRS Report R46855, *Housing Issues in the 117th Congress*, coordinated by Katie Jones

CRS Report R46499, *The Federal Home Loan Bank (FHLB) System and Selected Policy Issues*, by Darryl E. Getter

CRS Report RS20530, *FHA-Insured Home Loans: An Overview*, by Katie Jones

CRS Report R42504, *VA Housing: Guaranteed Loans, Direct Loans, and Specially Adapted Housing Grants*, by Libby Perl

CRS Report R45828, *Overview of Recent Administrative Reforms of Fannie Mae and Freddie Mac*, by Darryl E. Getter

CRS Report R44525, *Fannie Mae and Freddie Mac in Conservatorship: Frequently Asked Questions*, by Darryl E. Getter

CRS In Focus IF11413, *The Qualified Mortgage (QM) Rule and the QM Patch*, by Darryl E. Getter

CRS Report R46480, *Multifamily Housing Finance and Selected Policy Issues*, by Darryl E. Getter

Darryl E. Getter, Specialist in Financial Economics

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