

CRS Report for Congress

Fannie Mae and Freddie Mac: Changes to the Regulation of Their Mortgage Portfolios

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Summary

This report analyzes the costs and benefits of the Fannie Mae's and Freddie Mac's retained portfolios while they remain under conservatorship.

Increasing numbers of homeowners are threatened with foreclosure because of interest rate resets on subprime mortgages, combined with stagnant or falling home prices. Congress responded to this situation by passing the Housing and Economic Recovery Act of 2008 (H.R. 3221, P.L. 110-289), which uses the congressionally chartered, stockholder-owned government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, to lead the market in providing more affordable mortgages.

The GSEs have retained mortgage portfolios with a combined value of more than \$1.4 trillion. The size of the portfolios, past management problems, risks to the financial system, and potential cost to the taxpayer led, in part, to provisions of the Housing and Economic Recovery Act that changed the rules governing the activities and regulation of Fannie Mae and Freddie Mac. The bill created the Federal Housing Finance Agency (FHFA) and authorized it to regulate the size of the GSEs' retained mortgage portfolios; it also raised the conforming loan limit in certain high-cost areas, thereby allowing the GSEs to purchase larger mortgages in these areas.

Previous regulatory actions have affected the GSEs' portfolios. In 2006, following discovery of accounting and management problems, the GSEs agreed to restrictions on their retained portfolios. In 2007, the Office of Federal Housing Enterprise Oversight (OFHEO), now the Federal Housing Finance Agency (FHFA), denied requests from both Fannie and Freddie to raise or eliminate the caps, but these restrictions were relaxed shortly afterwards. On September 6, 2008, the GSEs were placed in conservatorship (government management). One condition of the conservatorship set the portfolio limit to \$850 billion as of December 2009, with a 10% yearly decline until the portfolios reach \$250 billion.

The GSEs' portfolios include mortgages and mortgage-backed securities (MBS) that are subject to financial risks. When these risks are not managed properly, or if market movements turn dramatically against the GSEs, the government faces two unsatisfactory alternatives: either let the GSEs go into default and work to control the financial repercussions, or step in and assume payments on the GSEs' debt at a significant cost to taxpayers. The GSEs and their supporters argue that the profits generated by the investment portfolios enhanced the GSEs' ability to support affordable housing programs and reduce mortgage interest rates.

This report will be updated as warranted by significant developments.

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Background

Increasing numbers of homeowners are threatened with foreclosure because of interest rate resets on mortgages in the subprime and Alt-A mortgage markets, and falling home prices in formerly rapidly appreciating markets. The Economic Stimulus Act of 2008 (P.L. 110-185) temporarily increased the conforming loan limit, which established the maximum size of a mortgage that Fannie Mae and Freddie Mac — two congressionally chartered, stockholder-owned businesses — can purchase.¹ The GSEs, which are prohibited by law from directly making mortgage loans to homeowners, purchase mortgages from the original lenders, who can then make more loans. Fannie Mae and Freddie Mac add their guarantee of timely payment of the mortgages and bundle them into mortgage-backed securities (MBS), which they either keep in their portfolios or sell to investors. The Housing and Economic Recovery Act of 2008 (P.L. 110-289) created a new regulator (the Federal Housing Finance Agency or FHFA), and gave it broad authority to regulate the GSEs' assets including their retained mortgage portfolios. The legislation could help homeowners by making affordable refinancing more available and by increasing the conforming loan limit.

On September 7, 2007, regulators placed Fannie Mae and Freddie Mac under conservatorship, which gives FHFA control over their operations. FHFA increased the limit for GSEs' portfolios to \$850 billion each until December 31, 2009, and then requires the GSE to reduce their portfolios by at least 10% annually until they reach \$250 billion each.

¹ The nationwide conforming loan limit, the maximum size mortgage that Fannie Mae and Freddie Mac can purchase, was modified by the Economic Stimulus Act of 2008, P.L. 110-185, from \$417,000 to add a \$729,720 limit in high cost areas; this increase expires December 31, 2008. The Housing and Economic Recovery Act of 2008, P.L. 110-289, makes the high cost exception permanent, but revises downward the maximum mortgage size to \$625,500. These limits are revised annually based on house prices. Reform of the regulator of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks is contained in Title I of the Housing and Economic Recovery Act of 2008, signed by the president July 30, 2008. Unless stated otherwise, all bills in this report were introduced in the 110th Congress. Fannie Mae and Freddie Mac are known as government-sponsored enterprises (GSEs). This report will refer to them as GSEs. There is a third housing GSE, the Federal Home Loan Banks (FHLBanks) that have not created large portfolios and are owned by members, not the public. This report does not discuss the FHLBs; for additional information on them, see CRS Report RL32815, *Federal Home Loan Bank System: Policy Issues*, by Edward V. Murphy.

Absent conservatorship, the Housing and Economic Recovery Act could encourage the GSEs to purchase mortgages that refinance homeowners out of subprime and other troubled mortgages by adding new funds to support mortgages for distressed homeowners. The high cost exception to the conforming loan limit could allow certain homeowners in these high cost areas to benefit from the lower interest rate that conforming mortgages have compared to jumbo mortgages.²

The FHFA, with financial support from Treasury, established a conservatorship and, as part of the conservatorship agreement, temporarily raised portfolio limits to \$850 billion. Portfolio limits are then gradually reduced by at least 10% annually until each portfolio is less than \$250 billion. The temporary increase could allow the GSEs to provide more liquidity to mortgage markets during the current financial turmoil, but the gradual reduction could address concerns about systemic risk.³ Treasury's financial support allows the GSEs to buy more mortgages than they would otherwise be able to in turbulent financial markets. If the GSEs respond by acquiring more mortgages, then the GSEs would assume the risk of default by the homeowner.

At the time that the GSE conservatorship was announced, Treasury announced that it had signed contracts to provide financial support for Fannie Mae and Freddie Mac. Treasury agreed to

- make short-term, collateralized loans to the GSEs with interest rates set at the London Inter Bank Offer Rate (LIBOR) plus 50 basis points (0.5%),
- purchase new GSE MBS on the open market, and
- purchase senior preferred stock from the GSEs if their liabilities exceed their assets.

In return, Treasury received from each GSE \$1 billion in new senior preferred stock and warrants to purchase 80% of the common stock at a nominal price.

Prior to conservatorship, accounting and management problems at the GSEs led FHFA's predecessor, the Office of Federal Housing Enterprise Oversight (OFHEO), to restrict the GSEs' activities by limiting the size of their mortgage portfolios. These problems at both of the GSEs came to light after they agreed to register one class of stock with the Securities and Exchange Commission (SEC). By law, the GSEs were exempt from filing financial statements with the SEC. Nevertheless, both agreed to register one class of common stock.⁴ This irrevocable decision made them

² Jumbo mortgages traditionally have been defined as mortgages that are larger than the conforming loan limit. With the combination of a national conforming loan limit (currently \$417,000) and a high-cost area exception (\$729,750 until December 31, 2008), different people who use the term "jumbo" either refer to loans above \$417,000 or above \$729,750. In any case, mortgages not eligible for GSE purchase are typically more expensive than those that the GSEs can purchase.

³ Systemic risk is the risk that problems in one area (or one company) could spread throughout the system in potentially catastrophic ways.

⁴ 12 U.S.C. 1717(c)(1) exempted Fannie Mae from registering with the SEC, and 12 U.S.C. (continued...)

subject to requirements to file reports with the SEC on their finances and on changes in insider stock holdings.

While preparing to register its stock, Freddie Mac announced in January 2003 that it had understated its earnings, and it began to revise its financial statements and to install management controls to ensure accurate financial reporting in the future.⁵ In a restatement issued November 2003, Freddie Mac increased its net income for 2002 and earlier years by a total of \$5.0 billion. Freddie Mac paid \$125 million in civil fines, and \$50 million to settle SEC charges that it fraudulently misstated earnings. In addition, Freddie Mac has paid more than \$410 million to settle investor lawsuits. Unable to file required financial statements with the SEC until its accounting problems were resolved, Freddie Mac filed its first timely quarterly report (10-Q) with the SEC on July 18, 2008.

Fannie Mae registered its common stock with the SEC on March 31, 2003, and thus became subject to SEC reporting requirements. In September 2004, OFHEO charged that Fannie Mae had failed to follow Generally Accepted Accounting Principles (GAAP).⁶ Fannie Mae responded that its disagreement with OFHEO involved differences in interpretation of very technical rules, rather than improprieties. After investigating, the SEC announced that Fannie Mae's financial reports and management were inadequate and directed the GSE to restate its earnings for the previous five years. Fannie Mae was unable to file required financial statements with the SEC until its accounting problems were resolved. In December 2006, Fannie Mae released restated financials for 2001-2005 that reduced its earnings by \$6.3 billion, and Fannie Mae subsequently paid \$400 million in civil penalties. Fannie Mae resumed timely SEC filings on November 9, 2007.

Because of concerns over the GSE's management and controls, OFHEO proposed in 2006 that Fannie Mae should not increase its retained mortgage-related portfolio to more than the amount held on December 31, 2005 (\$727 billion). Fannie Mae agreed. Separately, Freddie Mac agreed in a letter to OFHEO to limit its annual portfolio growth to 2%, or approximately \$28 billion. Without these agreements, the GSEs would have been able to increase their retained portfolios as desired.

On August 11, 2007, OFHEO denied requests from both GSEs to relax the limitations on their portfolios. OFHEO stated that sufficient progress had not been made to resume timely financial reporting (including annual 10-K and quarterly 10-Q filings with the SEC) and that management controls were not adequate for more growth.

Approximately one month later (on September 19, 2007), OFHEO announced that it was making several changes that would have the effect of allowing the GSEs

⁴ (...continued)

155(g) exempted Freddie Mac. Section 1112 of P.L. 110-289 ended that exemption.

⁵ CRS Report RS21567, *Accounting and Management Problems at Freddie Mac*, by Mark Jickling contains more details.

⁶ CRS Report RS21949, *Accounting Problems at Fannie Mae*, by Mark Jickling.

to increase their retained mortgage holdings to \$735 billion each and to grow beyond this.⁷ First, it gave each GSE the same portfolio cap as of July 1, 2007.⁸ Second, it agreed that Fannie Mae could increase its portfolio at the same rate as Freddie Mac — not more than 2% per year and not more than 0.5% per quarter. This would allow each GSE to increase its portfolio by \$14.7 billion annually, or \$3.7 billion quarterly. Third, for the fourth quarter of 2007 (October-December 2007), each GSE's portfolio could grow by up to 1%, but the 2% annual cap would still apply. This would allow each GSE to increase its portfolio size by \$7.4 billion in the last quarter of 2007. Fourth, OFHEO imposed additional reporting requirements on both GSEs.

The GSEs have lost money every quarter starting in the third quarter of 2007. FHFA placed the GSEs in conservatorship on September 7, 2008. In reaching its decision, the FHFA cited continuing troubles in the mortgage credit environment in general, and the inability of the GSEs to raise significant capital in particular.⁹ As part of the conservatorship, the GSEs agreed to new rules for their portfolios. Initially, the GSEs would be allowed to expand their retained portfolios without additional capital requirements to \$850 billion each until December 31, 2009. After that, the conservatorship agreements call for portfolios to decline 10% per year until they reach \$250 billion each.¹⁰ The GSEs can create and sell an unlimited amount of MBS without additional capital.

GSE Risks

Although lenders had been informed that the GSEs' bonds were not backed by the U.S. government, many thought that there was an implied guarantee that the federal government would back the GSEs, if necessary. There was some basis for this belief, because tax laws were revised in 1982 to help Fannie Mae avoid becoming insolvent.¹¹ The conservatorships with their continued bond payments and Treasury financial support add to this justification, as does testimony by FHFA Director James B. Lockhart before the Senate Committee on Banking, Housing, and

⁷ Office of Federal Housing Enterprise Oversight, "OFHEO Provides Flexibility on Fannie Mae, Freddie Mac Mortgage Portfolios" September 19, 2007, available at [<http://www.ofheo.gov/newsroom.aspx?ID=388&q1=0&q2=0>].

⁸ Historically, Fannie Mae's retained mortgage portfolio has been larger than Freddie Mac's. The difference has narrowed since the agreements on portfolio size with OFHEO.

⁹ U.S. FHFA, "Statement of James Lockart," press release, September 7, 2008, p. 3-5, available at [http://www.treas.gov/press/releases/reports/fhfa_statement_090708hp1128.pdf]. The press release discusses financial markets troubles from February 2008 onward, especially a market indicator of lack of confidence in the GSEs, the spread between GSE debt yields and yields on U.S. Treasuries.

¹⁰ U.S. Treasury, *Fact Sheet: Treasury Senior Preferred Stock Purchase Agreement*, press release, September 7, 2008, p. 2, available at [http://www.treas.gov/press/releases/reports/pspa_factsheet_090708%20hp1128.pdf].

¹¹ P.L. 97-372, 96 Stat.1726 et seq., "The Miscellaneous Revenue Act of 1982." See Section 102, titled "Adjustment to Net Operating Loss Carryback and Carryforward Rules for Federal National Mortgage Association."

Urban Affairs on October 23, 2008.¹² This section discusses potential financial risks that the reorganized GSEs are likely to confront during and after the conservatorship. The conservatorship and the agreements with Treasury have placed an all but explicit guarantee behind the GSEs' bonds, although stockholders were not protected.

Under the agreements signed with Treasury, the GSEs' risks are effectively transferred to the federal government. Treasury has agreed to purchase \$100 billion of new preferred stock on an as needed basis from each GSE.¹³ In other words, if a GSE were to become insolvent, the government would invest up to \$100 billion in the GSE. The government will receive warrants to purchase common stock for a nominal cost if it purchases the preferred stock. Treasury can increase one or both ceilings with a new agreement with conservator(s).

If the GSEs are unable to sell new MBS, the Treasury has agreed to purchase them using the Federal Reserve Bank of New York as its fiscal agent. The only limit on the amount of MBS purchased is the debt ceiling. Treasury announced that it has begun to purchase MBS, but it has not announced the volume of these purchases.¹⁴ Treasury has attempted to minimize the risk by requiring collateral for loans and obtaining first claim on any funds available for dividends.

To conserve GSE funds, the conservators have suspended dividends on common and preferred stock. After this announcement, the price of the GSEs' common and preferred stocks declined. If conservatorship ends or dividend payments resume, the prices of the various types of stock are likely to increase.

Conservatorship may affect the GSEs' portfolios because it gives them access to a new source of funds, the Government-Sponsored Enterprise Credit Facility (GSECF), and allows Treasury to purchase new GSE mortgage-backed securities. This assures Fannie Mae and Freddie Mac access to relatively inexpensive funds to finance their portfolios and a ready market for MBS if they decide to sell them.

Following standard financial risk analysis, GSE risks are broken down into credit risk, prepayment risk, interest rate risk, and operational risk. These risks are discussed as they apply to the GSE. How various legislative options would affect these risks is discussed in the analysis section, which follows.

¹² Testimony of FHFA Director James B. Lockhart before U.S. Senate Committee on Banking, Housing and Urban Affairs, "Turmoil in the U.S. Credit Markets: Examining Recent Regulatory Responses," 110th Cong., 2nd sess., October 23, 2008, available at [http://banking.senate.gov/public/_files/LOCKHARTTestimony1023.pdf]. A clarification is available at [<http://www.ofheo.gov/newsroom.aspx?ID=478&q1=1&q2=None>].

¹³ U.S. Treasury, *Fact Sheet: Government Sponsored Enterprise Credit Facility*, press release, September 7, 2008, available at [http://www.treas.gov/press/releases/reports/gsecf_factsheet_090708.pdf].

¹⁴ "US Treasury began buying Fannie, Freddie MBS in September," *Reuters*, available at [<http://www.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUSN0334078720081003>].

Credit Risk. Credit risk is the risk that the borrowers (mortgagors) will not repay their loans on time. When Fannie and Freddie buy mortgages and combine them into MBS, they guarantee that the loans will be repaid on time. In 2005, according to media reports, Standard & Poor's and most other major observers concluded that because of the different maturity dates, loan-to-value ratios, private mortgage insurance, and geographic diversification, credit risk was not a serious problem.¹⁵ In hindsight, default rates on loans increased in many places in the country at the same time, for many classes of mortgages, so geographic diversification proved to be less of a protection for the GSEs than many assumed it would be.¹⁶

Prepayment Risk. Prepayment risk is the risk to an investor that a mortgage will be paid before its full term is concluded, leaving the investor to find another investment — perhaps when interest rates have decreased. Prior to the current housing cycle, prepayment risk was considered more likely to be serious than credit risk. Homeowners prepay for two major reasons: moving and to obtain more favorable terms. Many subprime borrowers took out their mortgages anticipating prepaying. Prepayment risk falls on the ultimate holder of a mortgage or MBS. Since 1986, the GSEs have offered multiclass MBS, which divide prepayment risk among the different classes. They are customized for investors to match their tolerance and preference for prepayment risk versus anticipated yield. When GSEs keep the MBS, they also keep this risk.

Interest Rate Risk. Interest rate risk comes from financing the MBS portfolios by borrowing money (issuing bonds), and is related to prepayment risk. The GSEs face much higher interest rate risk for mortgages held in portfolio than for mortgages that they issue as MBS. To finance the long-term loans held in their portfolios, the GSEs use short-term bonds and financial derivatives. When interest rates increase, the GSEs must roll over their bonds with higher-rate ones. When interest rates decrease, homeowners prepay their mortgages, and the GSEs buy new ones at lower rates. Between July 2007 and July 2008, Fannie Mae's gross mortgage portfolio rose from \$730 billion to \$758 billion. Fannie Mae's mortgage guarantee business through MBS was much larger, rising from \$2.2 trillion to \$2.6 trillion during the same period.¹⁷

Interest rate risk can be very serious. Many savings and loan associations became insolvent in the early 1980s because of it. During that time, Fannie Mae's portfolio was poorly hedged. While he was Treasury Secretary, John W. Snow testified that "Fannie Mae became insolvent on a mark-to-market basis. Only a combination of legislative tax relief, regulatory forbearance, and a decline in interest

¹⁵ James R. Haggerty, "Mortgage-Securities Drop Will Depend on Economy," *Wall Street Journal*, September 17, 2005, p. B7. For a typical Standard and Poor's analysis see Victoria Wagner, "Freddie Mac," *Standard & Poor's Raging Direct*, November 30, 2005. Available at [<http://www.freddiemac.com/investors/pdf/s-and-p2005.pdf>].

¹⁶ See U.S. FHFA, "Statement of James Lockart," press release, September 7, 2008, p. 4, citing the "alarming levels" of mortgage delinquency rates as a contributing factor to placing the GSEs in conservatorship.

¹⁷ Fannie Mae, *Monthly Summary Highlights: July 2008*, July 2008, available at [<http://www.fanniemae.com/ir/pdf/monthly/2008/073108.pdf>].

rates allowed Fannie Mae to grow out of its problem.”¹⁸ Despite state-of-the-art hedging with financial derivatives, some believe that the GSEs’ portfolios continue to have significant interest rate risk.

If the GSEs have to make large adjustments to their portfolios, only very large financial institutions will be able to handle the other side of the financial transactions. If these financial institutions are unwilling or unable to take the other side of the financial transaction, the GSEs could be unable to refinance or adjust their retained mortgage portfolios.¹⁹

Operational Risk. Operational risk is the risk of loss due to inadequate or failed internal procedures and systems. Fannie Mae’s and Freddie Mac’s accounting and management problems have raised questions about internal controls. Accounting systems provide the basis for portfolio adjustment decisions. If the accounting system is providing inaccurate information, the resulting portfolio adjustment decisions are likely to be incorrect.

The Role of Portfolios Under Conservatorship

FHFA’s conservatorship announcement cited five reasons for the action:

- Safety and soundness issues including capitalization,
- Current market conditions,
- Financial performance and condition of each company,
- Funding difficulties, and
- The critical importance each company has in supporting the residential mortgage market in this country.²⁰

The issues of current capitalization, financial performance and condition, and the inability of each GSE to fund itself directly arguably relate to problems created by financing long-term mortgages with short-term borrowing. Arguably with smaller portfolios, their need to raise capital would have been less and their capitalization

¹⁸ U.S. Department of Treasury, Testimony of Secretary John W. Snow Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, “Proposals for Housing GSE Reform,” press release, April 7, 2005, p. 4, available at [<http://www.treas.gov/press/releases/js2362.htm>].

¹⁹ In a letter from Alan Greenspan, then-Chairman of the Federal Reserve, to the Honorable Robert F. Bennett, U.S. Senate, September 2, 2005, p. 1, available at [<http://online.wsj.com/public/resources/documents/Greenspan091505.pdf>]. Greenspan wrote: “Moreover, the success of interest-rate-risk management, especially the exceptionally rapid timing necessitated by dynamic risk adjustments, requires that the ultimate counterparties to the GSEs’ transactions provide sufficient liquidity to finance an interest-rate-risk transfer that counters the risk. Otherwise, large and destabilizing adjustments will result in sharp changes in the interest rates required to rebalance and hedge a portfolio.”

²⁰ U.S. FHFA, “Statement of FHFA Director James B. Lockhart,” press release, September 7, 2008, p. 5, available at [http://www.treas.gov/press/releases/reports/fhfa_statement_090708hp1128.pdf].

would have been stronger. With smaller portfolios, the need to enter debt markets on an almost weekly basis most likely would have been reduced. On the other hand, without their portfolios, the GSEs over a period of time arguably would have been less profitable and might have experienced financial difficulty sooner.

Fannie Mae reports that as of the end of August 2008, approximately one week before being placed under conservatorship, it had a portfolio of \$760 billion, and Freddie Mac reports that its portfolio at the end of August 2008 was \$761 billion.²¹ Fannie Mae's portfolio grew at a relatively slow 4.4% annualized rate in the month of August, but Freddie Mac's portfolio decreased at an annualized 56.2% rate. Both GSEs appear to have been slowing their portfolio growth rates since February 2008, but this has not been a smooth month-to-month decline. Delinquency rates on mortgages steadily increased between July 2007 and August 2008. Some might conclude from this that, in response to financial market conditions, the GSEs were both trying to limit or reduce their portfolio sizes. One advantage of reducing portfolio size is that it both raises capital and reduces the need for capital as a cushion against delinquency and losses. The government's financial support and the elimination of capital requirements allow each of the GSEs to increase its mortgage portfolio by approximately \$90 billion very inexpensively. It can also sell new MBS without any reserve against losses. This could increase profitability.

GSE Mortgage Portfolios

This section analyzes the benefits and costs of proposals to alter the limits on the GSEs' portfolios.

As discussed above, the conservatorship agreements with GSE have temporarily increased GSE portfolio limits to \$850 billion each, with this amount declining gradually to \$250 billion each. Furthermore, the terms of the conservatorship do not require the GSE to hold capital against increases in their portfolios or new MBS sold. Absent the conservatorship, the recently enacted GSE reform bill delegated authority to the FHFA to regulate the GSEs' portfolios. This section discusses the issues involved in either increasing or decreasing those limits.

Linking Limits to Subprime Refinances

During the legislative debate on GSE regulation, some proposals to increase the GSEs' mortgage portfolios contained a requirement that a large percentage (which varied depending on the proposal) would be devoted to providing subprime borrowers with a way to refinance out of their high interest rate mortgages into more affordable ones.²² The homeowners would benefit because they would keep their

²¹ Fannie Mae, *Monthly Summary*, August 2008, available at [<http://www.fanniemae.com/ir/pdf/monthly/2008/083108.pdf>]. Freddie Mac, *Monthly Volume Summary*, August 2008, available at [<http://www.freddiemac.com/investors/volsum/pdf/0808mvs.pdf>].

²² CRS reports on subprime mortgages include CRS Report RL33930, *Subprime Mortgages*: (continued...)

homes and refinance into a mortgage with lower monthly payments. Some investors holding the subprime mortgages could benefit as they get out of subprime mortgages that have a higher probability of defaulting and causing losses. Other investors, such as those expecting interest payments in later years, would suffer losses because of the prepayments. The GSEs could benefit because the new mortgages might be profitable, and the increase in their mortgage portfolios could provide additional profit.

A subprime mortgage can have a fixed rate or an adjustable rate. A fixed rate subprime can have an introductory reduced payment before becoming fully amortizing at the agreed upon fixed rate. An adjustable-rate subprime mortgage also can have an introductory “teaser” period (typically two or three years), before becoming fully amortizing and adjusting based on some interest rate on a stated schedule. A news story highlighted the case of a subprime borrower whose mortgage interest rate will increase in 2008 from 8.2% to 14%; the monthly payment will increase from \$3,700 to \$8,000.²³ The idea is that many subprime homeowners who cannot afford the subprime mortgage after the reset could afford the monthly payments of a traditional 30-year mortgage.

For calendar year 2007, even before changes to OFHEO’s policy, the GSEs could purchase and retain in portfolio approximately \$320 billion in mortgages to replace those being paid off by borrowers. Fannie Mae could purchase and retain in portfolio \$124 billion in mortgages and MBS.²⁴ Likewise, for calendar year 2007, Freddie Mac could purchase and retain in portfolio \$196 billion of mortgages and MBS; \$168 billion would replace those being paid off by borrowers, and \$28 billion would be allowed by the 2% growth.²⁵ In addition, Fannie Mae and Freddie Mac can purchase without limit mortgages that they assemble in mortgage-backed securities (MBS), add their guarantees of timely payment of principal and interest, and sell to investors.

Loans Related to a Public Policy Goal

The portfolio limits could be tied to purchases of loans that are related to the GSEs’ public mission. Examples of other policy goals might include mortgages for

²² (...continued)

Primer on Current Lending and Foreclosure Issues, by Edward Vincent Murphy; and CRS Report RL33775, *Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets*, by Edward Vincent Murphy.

²³ Rick Brooks and Constance Mitchell Ford, “The United States of Subprime,” *Wall Street Journal*, October 11, 2007, p. A1, A16.

²⁴ In the first half of 2007, Fannie Mae’s retained mortgage portfolio experienced nearly \$62 billion in liquidations. Fannie Mae’s annualized liquidation rate was 17%. See Fannie Mae, *Monthly Summary*, July 28, 2007, available at [<http://www.fanniemae.com/ir/pdf/monthly/2007/063007.pdf>].

²⁵ Freddie Mac experienced almost \$84 million in liquidations and its annualized liquidation rate was 24% in the first half of 2007. See Freddie Mac, *Monthly Volume Summary: June 2007*, available at [<http://www.freddiemac.com/investors/volsum/pdf/0607mvs.pdf>].

higher-risk, low-income borrowers, jumbo mortgages, energy efficient mortgages, elderly reverse mortgages, or mortgages targeted to other populations. Often, these policy goals involve a mortgage instrument without a long track record or with which the GSEs, or the investors who buy the GSEs' MBS, have little experience. The GSEs historically have kept some types of nontraditional loans in their portfolios because they apparently are hard to package and to sell in MBS at a price that the GSEs find attractive. The GSEs, with their experience, have found them more profitable to retain than to sell. Allowing the GSEs to retain loans related to another policy goal in their portfolios would then result in lower interest rates to borrowers who meet the policy's criteria.²⁶

Also, the GSEs might be willing to purchase nontraditional mortgages related to another policy goal if there were other provisions that would make the overall change profitable after adjusting for risk and increased goodwill. For example, a statistical analysis of combined enterprise profitability reveals that between 1983 and 2001, each \$1 million of MBS outstanding added \$2,200 to net income (profit), but each \$1 million in retained mortgages or MBS added \$5,300 to net income.²⁷ In other words, a dollar in their retained portfolios generated more than twice as much profit as a dollar of MBS sold to other investors. Arguably, this increased profit from retaining a mortgage in portfolio might be sufficient to induce the GSEs to buy nontraditional mortgages, but only if the nontraditional mortgages could be retained in portfolio.

Allowing the GSEs to retain these mortgages would benefit nontraditional borrowers. The GSEs would either expand existing lending programs, such as nontraditional mortgages targeted to fulfil their housing goals, or create new programs. The interest rates on these loans would be higher than on prime mortgages — the higher rate would compensate for the higher risk of default — but the rates would be less than on mortgages financed outside the GSEs' structure. Even so, not every nontraditional borrower would qualify under the GSEs' underwriting standards.

In light of FHFA's statements detailing the reasons for placing Fannie Mae and Freddie Mac under conservatorship, the future of the GSEs' policy oriented mortgage purchases — housing goals, and contributions to the housing trust fund and capital magnet fund — is unclear. With the need to conserve capital to survive, one could argue that these programs should be suspended. One could also argue, however, that with the federal government's backing the need for capital is reduced and that the amount of capital that would be expended for these programs is relatively insignificant.

²⁶ In the secondary market, investors bid on mortgages taking the contracted interest rates as given. If investors want a higher yield, they offer a lower price for mortgages. Investors might demand a higher yield because the interest rates on alternative investments have increased, or because risk has increased.

²⁷ This relationship breaks down after 2001. The reason appears to be in part due to the restatement of earnings by the GSEs, and in part to net interest income almost doubling between 2001 and 2002. Data source: Office of Federal Housing Enterprise Oversight, *Mortgage Markets and The Enterprises in 2006*.

Risk Elements

Prior to conservatorship, the costs of increasing the GSE portfolio caps were mainly the costs of increased risk to the financial system.²⁸ It is difficult to compare potential costs against concrete benefits of increasing portfolio caps. The GSEs manage many risks common to many businesses in the financial sector. These risks can affect the companies, stockholders, employees, bondholders, and business partners, and because of their size, the GSEs' risks can also affect the nation's financial system and the economy. These risks can be analyzed using the four categories discussed previously.

Under conservatorship, any losses in excess of the GSEs' capital will be a direct cost to the Treasury. While Treasury states that it anticipates that the short-term GSE credit facility loans and MBS purchases will be profitable, there is no way to guarantee this. Suspension of dividends has saved funds for the GSEs at the cost of the stockholders who would have received them.

Conclusion

The GSEs' portfolios include mortgages and mortgage-backed securities that are subject to credit risk, prepayment risk, interest rate risk, and operational risk. If these risks are mismanaged, or if market movements turn unexpectedly against the GSEs, the government faces two unsatisfactory alternatives: either let the GSEs go into default and try to control the financial repercussions, or step in and assume payments on the GSEs' debt at taxpayer expense. On September 7, 2008, the government chose to assume GSE obligations at taxpayer expense. The issue of portfolio size will likely continue to be debated as policymakers consider what form the GSEs should take when they emerge from conservatorship.

²⁸ CRS Report RS22307, *Limiting Fannie Mae's and Freddie Mac's Portfolio Size*, by N. Eric Weiss covers the risks from the GSEs' portfolios in more detail.