Congressional Research Service
Informing the legislative debate since 1914

IN FOCUS

February 5, 2015

Introduction to Financial Services: The Housing Finance System

This *In Focus* provides a summary of the U.S. single-family housing finance system and several related policy issues of importance to Congress.

The Mortgage Market

A loan that uses real estate as collateral is typically referred to as a *mortgage*. The U.S. mortgage market is one of the largest markets in the world with approximately $10 trillion in debt outstanding. The mortgage market can be thought of as having two major components—the *primary market* in which mortgages are originated and the *secondary market* in which existing mortgages are bought and sold.

Primary Market. A potential borrower applies for a mortgage from a lender (a *mortgage originator*) in 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 make home loans, including banks, credit unions, and finance companies (institutions that lend money but do not accept deposits).

The lender usually requires some additional assurance that, in the event the borrower does not repay the mortgage, 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 agency, such as the Federal Housing Administration (FHA). FHA provides mortgage insurance on loans that meet its requirements (including a minimum down payment and a maximum mortgage amount) in exchange for fees, or premiums, paid by borrowers. If a borrower defaults on an FHA-insured mortgage, FHA repays the lender the remaining principal amount it is owed. FHA is the largest provider of government mortgage insurance, but the government also provides access to the mortgage market through programs offered by the Department of Veterans Affairs (VA) and the U.S. Department of Agriculture (USDA).

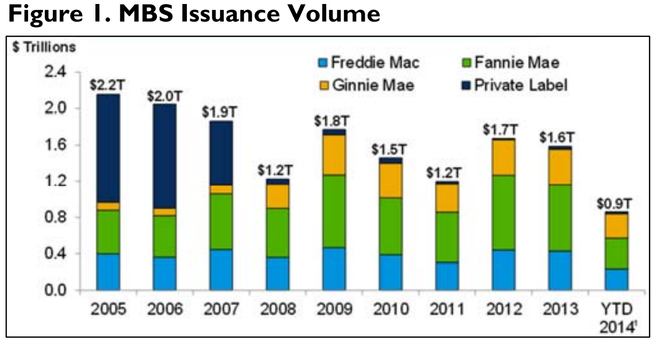
If a mortgage is made, the borrower sends the required scheduled payments to a *mortgage servicer*, which then remits the payments to the *mortgage holder* (which could be the original lender or, if the mortgage is sold, an investor). If the borrower does not repay the mortgage as promised, the servicer can attempt to keep the borrower in the home through a *work out option* (such as reducing the mortgage interest rate) or can repossess the property through a process known as *foreclosure*.

Secondary Market. 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 could choose to hold the mortgage itself or to *securitize* it. When a mortgage is securitized, it is pooled with other mortgages to create a *mortgage-backed security* (MBS), and the payment streams associated with the mortgages are sold to investors.

Mortgages can be securitized through different channels:

- *Fannie Mae* and *Freddie Mac*, two government-sponsored enterprises (GSEs), securitize mortgages that conform to their standards (*conforming mortgages*). To be a conforming mortgage, the mortgage must meet certain creditworthiness thresholds (such as a minimum credit score) and be below the *conforming loan limit*, a cap on the principal balance of the mortgage. The GSEs guarantee that the investors in their MBS will receive timely payment of principal and interest even if the borrower becomes delinquent.
- *Ginnie Mae*, a government agency in the Department of Housing and Urban Development, guarantees MBS issued by private entities but made up exclusively of mortgages guaranteed by the federal government (such as by FHA). Ginnie Mae's guarantee is backed by the full faith and credit of the U.S. government.
- Private financial institutions also issue MBS, known as *private-label securities* (PLS). PLS can be composed of any type of mortgage but often contain non-conforming mortgages that either exceed the conforming loan limit (*jumbo mortgages*) or do not meet Fannie Mae's or Freddie Mac's creditworthiness standards (*non-prime or subprime mortgages*). PLS do not have an implicit or explicit government guarantee.

Figure 1. MBS Issuance Volume



Source: Freddie Mac, *Freddie Mac Update*, December 2014, p. 10, http://www.freddiemac.com/investors/pdffiles/investor-presentation.pdf.

Note: Year-To-Date 2014 includes data as of November 30, 2014.

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 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 type of MBS to purchase based on the type and amount of risk they wish to bear and on the expected return from their investment.

Another key supplier of financing for mortgages is the Federal Home Loan Bank (FHLB) System, another GSE. The FHLB System is composed of 12 regional banks that are owned by their members, which include banks and other financial institutions involved in housing finance. These regional banks extend credit to their members, primarily to support mortgage lending.

Government Regulation of the Mortgage Market

A full description of the government's role in regulating the housing finance system is beyond the scope of this *In Focus*, but several important functions performed by the government are described below.

The Federal Housing Finance Agency (FHFA) is the regulator and conservator of Fannie Mae and Freddie Mac and the regulator of the FHLB System.

The federal banking regulators—the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA)—influence the mortgage market through their oversight of banks. For example, regulators influence the underwriting standards that banks use and set capital standards that apply to mortgages and MBS held by banks.

The Securities and Exchange Commission (SEC) oversees, among other things, the selling of securities to the public. The SEC has disclosure and registration standards that, in some cases, apply to MBS.

The Consumer Financial Protection Bureau (CFPB) was directed by the Dodd-Frank Act (P.L. 111-203) to regulate certain bank and nonbank participants in the mortgage market and to issue specific rules to protect consumers. Those rules include requirements that lenders verify a borrower's ability to repay the mortgage prior to offering the mortgage and standards that reform mortgage servicing. The CFPB also has authority under additional federal consumer laws to regulate parts of the mortgage market.

The states play an important role in the regulation of the housing and mortgage markets. For example, the foreclosure process is governed by state law.

Policy Issues

The bursting of the housing bubble in 2007 and the multi-year downturn in the housing and mortgage markets have raised several issues for Congress, some of which are discussed below.

Financial Status of the GSEs and FHA. Fannie Mae and Freddie Mac experienced significant financial losses and were placed in voluntary conservatorship in September 2008 by their regulator, FHFA. Fannie Mae and Freddie Mac, both of which remain in conservatorship, have received approximately $187 billion in assistance from the government and have made dividend payments to the government in excess of the assistance received since entering conservatorship. FHA has also been under financial stress in recent years and received $1.7 billion from Treasury at the end of FY2013 to ensure that it had enough funds on hand to pay for all of its expected future costs. Although additional financial support for FHA and the GSEs are not currently anticipated, Congress may continue to conduct oversight of the GSEs and FHA.

Housing Finance Reform. Some have questioned whether the pre-crisis structure of the housing finance system is appropriate for the future. Congressional interest has also concentrated on determining the future role of the federal government in housing finance. Many of the proposals in recent Congresses have suggested eliminating Fannie Mae and Freddie Mac. Some plans would rely predominantly on the private sector to replace the GSEs, whereas others would have an explicit government guarantee to supplement private capital under certain circumstances.

Mortgage Market Rulemakings. Financial regulators are continuing to implement several mortgage-related rulemakings that were required by the Dodd-Frank Act. While each of the rules is different, several policy issues are common across the rules, including concerns about the compliance costs for financial institutions, questions about how the rules affect credit availability for creditworthy borrowers, and whether revisiting the new mortgage market rules could lead to changes that may harm consumers.

Access to Credit. In recent years, many lenders tightened their underwriting standards, making it more difficult for some borrowers to receive mortgages. In addition, some claim that recent rulemakings and other factors, including higher costs for FHA and GSE loans, have led to a contraction in the credit available to potential homeowners and increased the cost of credit. Congress may consider proposals to ensure that creditworthy borrowers have access to affordable financing.

CRS Resources

CRS Report R42995, *An Overview of the Housing Finance System in the United States*, by Sean M. Hoskins, Katie Jones, and N. Eric Weiss

Issues Before Congress: Housing Finance Reform

Issues Before Congress: Homeownership Assistance

Sean M. Hoskins, shoskins@crs.loc.gov, 7-8958
Katie Jones, kmjones@crs.loc.gov, 7-4162
N. Eric Weiss, eweiss@crs.loc.gov, 7-6209

IF10126