

# **The Future of the Government Sponsored Enterprises: The Role for Government in the U.S. Mortgage Market**

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## **Abstract**

This paper analyses options for reforming the U.S. housing finance system in view of the failure of Fannie Mae and Freddie Mac as government sponsored enterprises (GSEs). The options considered include GSE reform, a range of possible new governmental mortgage guarantee plans, and greater reliance on private mortgage markets. The analysis also considers the larger question of the proper role for government in the U.S. housing and mortgage markets. We start by reviewing the history of the GSEs and their contributions to the operation of U.S. housing and mortgage markets, including the actions that led to their failure in conjunction with the recent mortgage market crisis. The reform options we consider include those proposed in a 2011 U.S. Treasury White Paper, plans for new government mortgage guarantees from various researchers and organizations, and the evidence from Western European countries for the efficacy of private mortgages markets.

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## **I. Introduction**

The two large Government Sponsored Housing Enterprises (GSEs),<sup>1</sup> the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”), evolved over three quarters of a century from a single small government agency, to a large and powerful duopoly, and ultimately to insolvent institutions protected from bankruptcy only by the full faith and credit of the U.S. government. Between 2007 and 2010, the two GSEs had realized losses of \$232 billion, and they required draws of \$154 billion under the Treasured Preferred Stock Purchase Agreements to remain in operation. (See Federal Housing Finance Agency 2011). This paper traces the transformation of the GSEs from privately held institutions with powerful direction and political influence to vassals reporting to an administrative agency in the Department of Housing and Urban Development (the Federal Housing Finance Agency, FHFA).

Within the next few years, the agencies will have to be restructured. Proposals for reform include recapitalizing them in some form as Government Sponsored Enterprises (GSEs), reconstituting them as agencies of the federal government with more narrowly-specified missions, or privatizing the organizations. There are also proposals to replace the GSEs with some new government mortgage guarantee/insurance program. The GSE reform and mortgage guarantee proposals are both nested within the larger question of the proper role for government in the U.S. housing and mortgage markets. This paper is intended to help in the deliberations about “what to do” about these costly failures. We

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<sup>1</sup> A third, much smaller, Government Sponsored Housing Enterprise is the Federal Home Loan Bank System (FHLBS). The issues for reforming the FHLBS are similar to many of the issue raised in this paper for Fannie Mae and Freddie Mac, although we have not analyzed separately on the FHLBS or other non-housing government enterprises.

briefly review the history of the housing enterprises and their performance, including the recent housing crisis. We document the contributions of Freddie and Fannie to the operation of U.S. housing markets, and we analyze the role of the agencies in the recent housing crisis. We search for evidence on the importance of Freddie and Fannie in achieving other important housing goals. We compare U.S. policies with those adopted in other developed countries.

This is not the first time we have provided some analysis of the reform options in housing finance, either individually (Jaffee, 2010, 2011; Quigley 2006) or jointly (Jaffee and Quigley, 2010, 2011). However, it is our first attempt to consider all the history and all of the options.

In section II below we discuss the background and origin of the GSEs and of the federal role in supplying housing credit. Section III describes the broader objectives of these credit institutions and their goals. Section IV analyzes the most recent failures of the credit market and the secondary housing market. In this section, we link the current housing crisis to the insolvency of credit institutions. Section V presents a series of recommendations concerning the restructuring of these institutions and alternative mechanisms for government support of the U.S. mortgage market.

## **II. Background**

With the public sale of its stock and its conversion into a government sponsored enterprise in 1968, the Federal National Mortgage Association (FNMA) emerged from obscurity as an agent in the market for home mortgage credit. The FNMA had been established in 1938, based on provisions in the 1934 National Housing Act, after the collapse of the housing market during the Great Depression. The 1934 Act had

established the Federal Housing Administration (FHA) to oversee a program of home mortgage insurance against default. Insurance was funded by the proceeds of a fixed-premium charged on unpaid loan balances. These revenues were deposited in Treasury securities and managed as a mutual insurance fund. Significantly, default insurance was offered on “economically sound” self-amortizing mortgages with terms as long as twenty years and with loan-to-value ratios up to eighty percent.

Diffusion of the new FHA product across the country required national standardization of underwriting procedures. Appraisals were required, and borrowers’ credit histories and financial capacities were reported and evaluated systematically. The Mutual Mortgage Insurance Fund, established to manage the reserve of FHA premiums, was required to be actuarially sound. This was generally understood to allow very small redistributions from high income to low income FHA mortgagees. By its original design, the FHA was clearly intended to serve the vast majority of homeowners.

In the 1934 Act, Congress had also sought to encourage private establishment of National Mortgage Associations that would buy and sell the new and unfamiliar insured mortgages of the Federal Housing Administration (FHA). By creating a secondary market for these assets, the Associations sought to increase the willingness of primary lenders to make these loans. No private associations were formed, however. When further liberalization of the terms under which associations could be organized was still unsuccessful, the Federal National Mortgage Association was chartered in 1938 by the Federal Housing Administrator following the request of the President of the United States. Federal action was precipitated particularly by concern over the acceptability of new FHA ninety-percent twenty-five-year loans authorized that year.

At first, the Association operated on a small scale, but its willingness to buy FHA mortgages encouraged lenders to make them. A 1948 authorization to purchase mortgages guaranteed by the Veterans Administration led the Association to make purchases, commitments, loans, and investments that soon approached the congressionally authorized limit of \$2.5 billion. Since the maximum interest rate on VA mortgages was below the market rate, FNMA's advance commitments to buy VA-guaranteed mortgages at par assured windfall gains to private borrowers or lenders. The 1954 Housing Act reorganized Fannie Mae as a mixed-ownership corporation with eligible shareholders being the federal government and lenders that sold mortgages to Fannie Mae. FNMA was then able to finance its operations through sale of its preferred stock to the U.S. Treasury, through sale of its common stock to lenders whose mortgages it bought, and by the sale of bonds to the public.

The Housing and Urban Development Act of 1968 transferred FNMA's special assistance and the management and liquidation of part of its portfolio to the newly constituted Government National Mortgage Association. Its secondary market operations remained with FNMA, now owned entirely by private stockholders. Commercial banks were the primary beneficiaries of FNMA's secondary market activities in FHA and VA mortgages -- since the banks specialized in originating the government-guaranteed mortgages. In contrast, the mortgages originated by Savings and Loan Associations (S&Ls) and Mutual Savings Banks ("Thrift Institutions") were primarily "conventional" mortgages, meaning they received no government guarantee. The thrift institutions lobbied for equal treatment, and were rewarded in 1970 with the establishment of the Federal Home Loan Mortgage Corporation ("Freddie Mac") under the regulatory control

of the Federal Home Loan Bank System, the S&L regulator. Freddie Mac stock first became publicly available in 1989, although shares owned by Freddie Mac's financial partners had been traded on the New York Stock Exchange starting in 1984.

### **III. Homeownership and Government Policy**

According to de Tocqueville (1835), Americans have long been obsessed with owner-occupied housing. Richard Green (2011) sees this as a political issue, as societies are less disposed to make revolution when personal and real property is augmented and distributed among the population. Other recent work emphasizes the external benefits of owner-occupied housing, and a large social science literature has developed exploring the connection between higher levels of homeownership and the economic and social outcomes of households. Appendix Table A1 reports some of the findings linking homeownership to social outcomes. Two other papers (Dietz and Haurin, 2003; Haurin, Dietz and Weinberg, 2002) provide an exhaustive comparison of the economic and social consequences for those living in owner-occupied and rental housing.

Most of the research supports the conclusion that homeownership has some positive effects upon the social outcomes for individuals and households. But the research does not conclude that the effect is very large. But even if the effect were large, nothing supports the conclusion that homeownership should be supported by the institution of the GSEs or their policy choices. In particular, the primary impact of instruments that focus on lowering the cost or expanding the availability of mortgages will be larger mortgages, which makes those instruments ineffective and costly relative to direct subsidies for homeownership.

This is important -- for as noted below many of the popular arguments in support of subsidies for the GSEs are based upon the promotion of homeownership in the economy.

#### **IV. Policy Objectives for the GSEs**

##### **A. Primary Objectives**

The GSE charters are quite explicit in stating the goals and responsibilities of the enterprises, but they do not state homeownership goals directly. Instead, they seek to:

- 1) provide stability in the secondary market for residential mortgages;
- 2) respond appropriately to the private capital market;
- 3) provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;
- 4) promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and
- 5) manage and liquidate federally owned mortgage portfolios in an orderly manner, with a minimum of adverse effect upon the residential mortgage market and minimum loss to the Federal Government.

This section reviews the key activities of the GSEs with respect to providing stability, assistance, and liquidity to the secondary market for residential mortgages. The

specific objectives of the secondary market activities have varied over time, including operations to reinforce or offset fiscal and monetary policy, to increase residential construction, to make a market in federally underwritten mortgages, to reduce regional yield differentials, and to act as a mortgage lender of last resort. (See Guttentag, 1963, for an extensive discussion of these key activities.)

### **A.1 Quantitative Impact of the GSEs on the U.S. Home Mortgage Market**

Table 1 reviews the quantitative role of the GSEs in the US mortgage market over the recent past. It reports the outstanding amounts of whole home mortgages at the end of each decade from 1950 through 2010. The top panel shows the total outstanding. Through 1960, all whole home mortgages were directly held in portfolios, and even by 1970 the only exception was \$3 billion of mortgage-backed securities (MBS) issued by the newly established Government National Mortgage Association (GNMA). The largest portfolio investor has always been the set of depository institutions, commercial banks and thrift institutions (savings and loan associations, savings banks, and credit unions).<sup>2</sup> The market investor portfolios include capital market investors ranging from pension funds and mutual funds to insurance companies. Starting in 1980, increasing amounts of whole home mortgages have been held within MBS pools. The top panel of Table 1 separates the three main categories of MBS pools: pools issued by the GSEs, by GNMA, and by private label securitizers (PLS).

The middle panel of Table 1 shows each of the investor categories for whole home mortgage holdings as a percentage of the total amount outstanding. One major trend is apparent; portfolio holdings declined steadily from 100 percent of the total in

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<sup>2</sup> The GSE category covers the Fannie Mae on-balance-sheet portfolio through 1970 and the sum of the Fannie Mae and Freddie Mac portfolios thereafter.



1960 to 37 percent of the total by 2010. Among the portfolio investors, both depository institution and market investor holdings declined steadily starting in 1970. The GSE portfolio holdings of whole home mortgages, five percent of the total in 2010, remained a small percentage of the total throughout the history, with fluctuations within the narrow band of three percent to eight percent of the total.

The second major trend reported in Table 1 is the steady rise in mortgage pool holdings as a percentage of the total, starting at one percent in 1970 and reaching 63 percent of the total by 2010. GSE pools show the most rapid rise, reaching 41 percent of total outstanding home mortgages by 2010. The PLS pools also grew steadily, reaching twelve percent of the total by 2010. The GNMA pool share of total outstanding mortgages, ten percent at year-end 2010, fluctuated in a narrow range between ten percent and fifteen percent of the total from 1980 to the present.

The bottom panel of Table 1 shows the direct GSE share of the home mortgage market, computed as the sum of whole mortgages held in the GSE portfolios and their outstanding MBS. While this GSE share rose steadily from 1950, the primary increase started in 1990, with the share reaching 46 percent of all outstanding home mortgages in 2010. This direct share does not include MBS from other issuers that were held in the GSE portfolios, a topic to which we turn below.<sup>3</sup>

While Table 1 accounts for all outstanding home mortgages, it does not distinguish among the investor groups holding the MBS instruments created by the mortgage pools. This issue is addressed in Table 2, in which ownership of the MBS pools has been allocated among the various investor classes. These values are then combined

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<sup>3</sup> Quantitatively, including the GSE holdings of other MBS would raise the total GSE share to 47 percent and 48 percent for 2000 and 2010 respectively. This ratio actually peaked in 2003, reaching fifty percent.

with the portfolio holdings of whole mortgages to determine the ownership structure of all home mortgages, whether held as whole mortgages or as investment in MBS pools.<sup>4</sup> It is apparent from Table 2 that, starting in 1980, market investors were expanding relative to the depository institutions and the GSEs, and that by 2010 the market investors were the largest investor class for the sum of whole mortgages and mortgage securities.

Figure 1 reports the percentage of outstanding whole mortgages held directly in portfolios for each of the three investor classes. The depository institutions have always been the predominant holder of whole mortgages. At year-end 2010, the depository institutions held 76 percent of all whole mortgages that were directly held in portfolios, with the market investors and the GSEs each holding a twelve percent share.

Figure 2 reports the percentage of outstanding MBS for the three holder classes.<sup>5</sup> It is apparent that the market investors have always been dominant in holding MBS positions. At year-end 2010, market investors were holding 67 percent of the outstanding MBS, with depository institutions holding 21 percent and the GSEs twelve percent.

Figure 3 combines the results for Figures 1 and 2, reporting the share for each holder class of their combined positions in whole mortgages and MBS. By 2010, the market investors had the largest position, representing 47 percent of all home mortgages, with depository institutions in the second position, holding 41 percent of all home mortgages. At the same time, the GSEs were holding twelve percent of all home mortgages (as either whole mortgages or MBS) a share just below their average over the last three decades.

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<sup>4</sup> As far as we are aware, this integration of whole mortgage portfolio holdings and MBS pools by investor has not been available previously.

<sup>5</sup> The graphs start in 1970, since there were no outstanding MBS before that year.

Figure 3 indicates that the GSE combined holdings of whole mortgages and MBS has always represented a relatively small share of total U.S. home mortgages outstanding. In this sense, closing the GSEs now, in an orderly way, would have a minor impact on the U.S. mortgage market. That is, the twelve percent GSE share could be readily replaced by a combination of market investors and depository institutions (who are already holding the remaining 88 percent of U.S. home mortgages). There are, however, two other measures of potential GSE benefits with regard to outstanding whole mortgages and MBS: (1) the contribution of MBS issued by the GSEs, and (2) stabilization of the U.S. home mortgage market through countercyclical activities by the GSEs. We now consider each of these in turn.

## **A.2 The Role of GSE-Issued MBS**

Figure 4 shows the relative shares of outstanding home mortgage MBS by issuer class. The GSE share has been dominant since 1990, representing 65 percent of all outstanding MBS in 2010. The share of private label securitizers (PLS) has been steadily rising, but still represented only 19 percent of outstanding MBS at year-end 2010. The GNMA share has been steadily declining, reaching a 16 percent market share by year-end 2010.

The dominant historical position of GSE MBS in the current U.S. home mortgage market is sometimes used to justify a future role for the GSEs in the market. But, at its core, the GSE dominance of the MBS market for home mortgages has been largely derived from the assumption of market investors—reinforced by GSE marketing—that the GSE MBS had an implicit government guarantee (and which turned out to be correct, after imposition of the GSE Conservatorships in 2008). In this sense, the dominant GSE MBS

position is just an example of *crowding out*, whereby any asset with a low-cost government guarantee against loss will likely replace private activity in the same market. If the government guarantee were eliminated, there is every reason to expect that private market activity would simply replace the activity of the government entity.

A brief review of the history of U.S. MBS development is valuable for understanding the limited contribution of the GSEs to MBS innovations:<sup>6</sup>

- 1968: GNMA creates first modern MBS by securitizing FHA/VA mortgages;
- 1970s: GSEs expand MBS market based on their implicit government guarantee;<sup>7</sup>
- 1980s: Salomon Bros. securitizes multi-class, non-guaranteed, MBS instruments;<sup>8</sup>
- 1990s: Multi-class (structured finance) mechanism applied to wide range of asset-backed securities, including auto, credit card, and commercial mortgage loans;
- 2000s: Subprime lending becomes the most important application of MBS/ABS methods.

Credit for the modern innovation of single-class MBS belongs to the government itself with the creation of the GNMA MBS. GNMA was, and remains, an agency within the Department of Housing and Urban Development. Likewise, credit for the innovation

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<sup>6</sup> US mortgage securitization probably actually began soon after the founding of the Republic. Following the war of 1812, the US federal government was desperate for revenue and extended loans to homesteaders for property on the Western frontiers. Without the resources to make and hold these loans, the government pooled and sold these loans to investors. By the 1920s, securitization was already a well accepted format for selling loans to investors. These mortgage-backed securities failed during the real estate crisis of the 1930s, and it was decades before U.S. securitization was reactivated in 1968.

<sup>7</sup> The GSEs could point to their \$2.25 billion line of credit at the US Treasury as backing for their guarantee, a significant factor only in the early years when their scale of operations was relatively small. It also helped the GSE case that the US government never firmly and officially rejected the notion of an implicit guarantee.

<sup>8</sup> The colorful development of private-label MBS under Lewis Ranieri at Solomon Brothers is wonderfully chronicled in *Liars Poker* by Lewis (1990).

of the multi-class MBS belongs to the private sector with the development of structured MBS by Salomon Bros. in the 1980s. In fact, the GSEs have always been followers, not innovators, in the MBS market. The success of the GSEs in establishing the market for their own MBS depended entirely on the perception of capital market investors that they faced no credit risk as the result of the implicit federal guarantee. Absent this government guarantee, the single-class GSE MBS would have simply lost out in the marketplace to the multi-class, private-label, MBS.

GSE proponents often argue that the GSEs reduced securitization costs and mortgage interest rates. Here, too, the reality is that the GSEs provide no benefit other than the implicit guarantee. A case in point is the TBA (“to be announced”) forward market for GSE and GNMA MBS. While this market arguably expands the liquidity of the traded MBS, the benefit depends completely on the market’s perception that the guarantees—explicit for GNMA and implicit for the GSE MBS—make credit risk irrelevant in the pricing and trading of the securities. It is equally noteworthy that the markets for *asset-backed securitization*, for the securitization of credit card, auto, and commercial mortgage loans, and other loan classes as well, expanded rapidly starting in the early 1990s without any contribution from the GSEs. Indeed, as with the original GNMA MBS, the GSEs benefited from the innovation by others, creating their own structured finance offerings once the market demand for such securities had been expanded through private market innovation.<sup>9</sup>

Finally, the claim is sometimes made that the GSE MBS activity is critical for the survival of the thirty-year, fixed-rate, residential mortgage. This claim is unwarranted. In

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<sup>9</sup> See Downing, Jaffee, and Wallace (2009) for a discussion of how the GSEs profited by restructuring their simple passthrough MBS into more complex multi-tranche securitizations.

fact, two features of the GSE MBS instrument were clearly detriments to the expansion of the long-term, fixed-rate, mortgage:

First, the GSE MBS transferred the entire interest rate risk imbedded in the fixed-rate mortgages to the market investors who purchased the instruments. The GSEs took no action to mitigate this risk;

Second, the GSE MBS generally disallowed prepayment penalties on all the mortgages they securitized. While borrowers may have felt they benefitted from this “free” call option, it greatly magnified the interest rate risk imposed on investors in the GSE MBS, and led to higher interest rates on the fixed-rate mortgages.

Finally, a number of Western European countries successfully use long-term, fixed rate, mortgages, but have no entity comparable to the GSEs, Denmark is the most conspicuous example. We discuss the experience of Western European countries in Section A5 below.

### **A.3 The Limited GSE Contributions to Mortgage Market Stability**

The GSEs also claim credit for taking actions to stabilize the U.S. mortgage markets. The U.S. Government Accountability Office (2009), however, finds little evidence of such benefits:

“... the extent to which the enterprises have been able to support a stable and liquid secondary mortgage market during periods of economic stress, which are key charter and statutory obligations, is not clear. In 1996, we attempted to determine the extent to which the enterprises’ activities would support mortgage finance during stressful economic periods by analyzing Fannie Mae’s mortgage activities in some states, including oil producing states such as Texas and Louisiana, beginning in the 1980s. Specifically, we analyzed state-level data on Fannie Mae’s market shares and housing price indexes for the years 1980–1994. We did not find sufficient evidence that Fannie Mae provided an economic cushion to mortgage markets in those states during the period analyzed.”

Reports by the Congressional Budget Office (1996, 2010) come to similar conclusions. The academic literature also generally concludes that the GSE contribution to U.S. mortgage market stability has been modest at best. This view is stated in early studies by Jaffee and Rosen (1978, 1979) and more recent studies by Frame and White (2005) and Lehnert, Passmore, and Sherlund (2008). In contrast, Naranjo and Toevs (2002), a study funded by Fannie Mae, found evidence of effective stabilization by the GSEs, as did other studies carried out internally by the GSEs. Unlike the previous studies, Peek and Wilcox (2003) focused on the flow of mortgage funds, and not on mortgage interest rates, and found the GSE contribution to be countercyclical. Of course, this research was all conducted before the subprime housing bubble and its collapse. In this event, as we now document, the GSE participation was decidedly destabilizing.

#### **A.4 The GSE Role in the Subprime Mortgage Boom and Crash**

The losses reported by the GSEs starting in 2008 leave no doubt that the GSEs acquired a significant volume of risky mortgages during the subprime boom. However, the extent, timing, and significance of these acquisitions is debated. For example, Jaffee (2010) describes the GSE role as “expanding” the subprime boom, especially in 2007, whereas Wallison (2011, p.2) concludes that GSE activity, based on their housing goals, was a primary “source” of the crisis. In this section, we evaluate the role played by the GSEs in the subprime mortgage boom and crash.

A quantitative evaluation of the GSE role in the subprime crisis faces a number of significant data issues:

- 1) Definitions for *subprime* and *Alt A* mortgages differ across data sets, and certain high-risk mortgages are not included under either label.

- 2) Defining *high-risk mortgages* (including subprime and Alt A instruments) is necessarily complex because mortgage default risk arises from numerous factors including borrower and property attributes (FICO scores, loan-to-value ratios, etc.), special amortization options (interest only, negative amortization, etc.), and fixed-rate versus adjustable-rate loans.
- 3) The GSEs could not acquire any mortgages with an initial loan amount above the conforming loan limit (so-called jumbo mortgages).

Our analysis starts by reviewing a newly compiled mortgage origination dataset from the GSE regulator, the Federal Housing Finance Agency (2010a). These data compare the risk characteristics of all mortgages acquired by the GSEs (whether securitized or held in retained portfolios) with the risk characteristics of all conforming, conventional, mortgages that were included in private label securitizations (PLS), tabulated by year of mortgage origination. Because the dataset has nearly complete coverage and is restricted to conforming mortgages, it provides the best available direct -- “apples to apples” -- comparison of the GSE acquired mortgages relative to the comparable market. Nevertheless, there are two limitations. First, while the FHFA data include all the conforming mortgages that collateralized PLS MBS instruments, the GSE holdings of PLS tranches are not so identified. We do not expect a significant bias in any comparisons from this source, however, because the GSE PLS holdings were almost entirely AAA tranches with little *ex ante* credit risk.<sup>10</sup> Second, the FHFA data exclude conforming mortgages that were not securitized (*i.e.*, they were retained in lender portfolios). To the extent that lenders did retain conforming mortgages with high-risk

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<sup>10</sup> See Thomas and Van Order (2011) for further discussion. PLS tranches as a share of total GSE acquisitions reached its high point at 22.9 percent in 2005, but had fallen to 7.4 percent by 2007. Furthermore, actual cash flow losses on GSE PLS positions have been modest to date, although the GSEs have recognized significant mark to market valuation losses on these positions.



attributes, the FHFA dataset will undercount the high-risk dimensions of the overall conforming origination pools, and will therefore overstate the GSE share of all high-risk originations. Here too, we do not expect a significant bias in our comparisons, because most subprime and Alt-A mortgages were securitized, and the securitization rate was even higher among those high-risk loans that were also conforming mortgages.<sup>11</sup>

Panel A of Table 3 shows the dollar amount of the conforming mortgages by origination year and various risk attributes. Rows (1) to (3) report on loans with one of the identified high-risk factors: high loan-to-value (LTV) ratios, low FICO scores, and adjustable rate mortgages (ARMs) respectively. However, there is some double counting since some loans have more than one of these attributes. The aggregate high-risk originations shown in row (4) net out all double counting.<sup>12</sup> Row (6) shows the percentage of high-risk mortgages as a share of total conforming mortgages (in row 5). This high-risk share of total conforming originations rose steadily through 2004 and then declined steadily thereafter.

Panel B of Table 3 computes the share of the conforming mortgages acquired by the GSEs—whether as backing for guaranteed MBS or to hold on their balance sheets—for each risk attribute. For example, in 2001, the GSEs acquired about 92.2 percent of all

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<sup>11</sup> For example, 2007 data from *Inside Mortgage Finance* indicate that only \$33 billion (or 7%) of the subprime/Alt A mortgages originated that year were not securitized. Even if these were all conforming mortgages, their share of total conforming originations that year would be less than 3 percent. Furthermore, *Inside Mortgage Finance* indicates that over 31% of subprime MBS and 9 percent of Alt A MBS in 2007 were “GSE eligible”—i.e. conforming mortgages eligible for GSE purchase—further reducing the incentive of portfolio lenders to hold these mortgages in unsecuritized form. It is also noteworthy that while there is no consensus conclusion from the expanding literature on whether securitization created lax underwriting standards—see for example the contrast between Bubb and Kaufman (2009) and Keys et al. (2010)—there is no finding that portfolio lenders were systematically retaining high-risk mortgages.

<sup>12</sup> For example, for the fixed-rate mortgage originations in 2007, 2.2 percent had LTV > 90 percent and FICO score < 620. For adjustable rate mortgages in 2007, 19.2 percent had either LTV > 90 percent or FICO score < 620. Overall, in 2007 4.7 percent of the originated mortgages had more than one of the high-risk attributes.

conforming mortgages with LTV ratios above 90 percent. For all 3 of the risk attributes, the GSE share fell steadily through 2005 and then expanded rapidly through 2007. By 2007, the GSEs were acquiring 79.9 percent of the high-risk, conforming, mortgage originations. In interpreting these numbers, however, it must be recognized that, as shown in row (11), the GSEs represent a large share of the overall conforming mortgage market; as their overall market share approaches 100 percent, their share of each risk attribute would necessarily do the same.

Panel C corrects for the large GSE share of the conforming market by computing a “relative intensity,” dividing the GSE market share for each risk attribute in Panel B by the overall GSE market share in Row (11). A coefficient of one indicates the GSEs are holding the “market portfolio,” whereas coefficients below one indicate they are avoiding risky mortgages and coefficients above one indicate the GSEs are actively acquiring risky mortgages. The pattern for each of the three risk attributes shows the relative intensity rising steadily starting in 2005. In each case, the high point of the seven-year history was reached in 2007. Since the relative intensities over the full time span are generally less than one, it would appear the GSEs were not leading the market for high-risk lending as the subprime boom took off.<sup>13</sup> But the jumps in the relative intensities in 2007 for most of the indicators suggests that the GSEs then rapidly expanded their participation in the subprime boom. This is one key basis for our conclusion that the GSEs were a destabilizing influence on the conforming mortgage market as the subprime boom headed to its peak in 2007.

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<sup>13</sup> Thomas and Van Order (2011), although using different datasets, come to the same conclusion.

The analysis has so far focused on the GSE acquisition of high-risk mortgages as a share of the overall conforming mortgage market. We now consider the GSE acquisition of high risk mortgages as a share of their total acquisitions. Table 4 reports the first three attributes high LTV ratios; low FICO scores; and ARMs; as reported in Table 3. The time pattern is again distinctive, with the share of the GSEs new business dedicated to mortgages with these high-risk attributes generally rising starting in 2004, the only exception being the declining share of ARM acquisitions by Fannie Mae. The companies also reported their acquisitions of interest-only, condo/coop, and investor mortgages; and here too the pattern is generally rising from 2004. 2007 represents the year of maximum share for each high-risk mortgage attribute with the exception of Fannie Mae ARMs and Freddie Mac interest-only mortgages. These data thus present a second independent basis for our conclusion that the GSEs were a decidedly destabilizing influence on the conforming mortgage market as the subprime boom headed to its peak in 2007.

### **A.5 Mortgage Markets Without GSEs**

The analysis above leaves little doubt that the GSEs destabilized the U.S. mortgage market during the later stages of the subprime boom, but there is a further question how the U.S. mortgage markets would function without the GSEs. To help answer this, in this section we develop evidence based on the performance of the mortgage markets in Western European countries. The European economies and housing markets are sufficiently similar to the U.S. to provide a potentially interesting comparison, while they have the key distinction that government intervention in these housing and mortgage markets is far less than for the U.S.; in particular, none of these

countries has entities with any significant resemblance to the U.S. GSEs.<sup>14</sup> This conclusion is stated very clearly by Coles and Hardt (2000, p. 778):<sup>15</sup>

“There is no national or European government agency to help lenders fund their loans. Mortgage loans have to be funded on the basis of the financial strength of banks or the intrinsic quality of the securities. EU Law (Article 87 and 88 of the EC treaty) outlaws state aid in the form of guarantees as there may be an element of competitive distortion.”

Table 5 compares the U.S. and Western European mortgage markets for a range of quantitative attributes from 1998 to 2009 based on a comprehensive data base of housing and mortgage data for fifteen European countries from the European Mortgage Federation (2009). Column 1 compares the 2009 owner occupancy rates for the U.S. and European countries. The U.S. value is 67.2 percent, which is just below its peak subprime boom value. It is frequently suggested that the high rate of homeownership is the result of the large U.S. government support of the mortgage market, including the GSEs. It is thus highly revealing that the U.S. rate is just at the median— eighth out of the 16 developed countries—and precisely equals the average value for the European countries. Furthermore, the lower owner occupancy rates in some of the countries, Germany for example, appear to be the result of cultural preferences rather than government inaction. A full analysis of the determinants of owner occupancy rates across countries should also control for the age distribution of the population, since younger households, and possibly the oldest households, may have lower ownership rates in all countries. Chirui and Jappelli (2003) provide a start in this direction, showing that lower downpayment rates are a significant factor encouraging owner occupancy after controlling for the population

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<sup>14</sup> See European Central Bank (2009) for an extensive review of housing finance in the European Union countries.

<sup>15</sup> Hardt was the Secretary General of the European Mortgage Federation at the time.

age structure in a sample of fourteen OCED countries. The U.S. has also generally benefitted from very low downpayment rates, but it still has an average ownership rate, reinforcing the conclusion that the government interventions have been largely ineffective in raising the U.S. home ownership rate relative to its peers.

Column 2 measures the volatility of housing construction activity from 1998 to 2009 based on the coefficient of variation of housing starts as a measure of relative volatility. The U.S. relative volatility is fifth highest out of the 16 countries, implying that the government interventions have failed to reduce U.S. housing cycles relative to those in Western Europe. Column 3 measures the volatility of house price changes based on the standard deviation of the annual house price appreciation from 1998 through 2009. Here the U.S. stands fourth, meaning the country has faced a relatively high rate of house price volatility. This negative result is all the more significant because the U.S. is far larger than any of the individual European countries, and thus the benefits of regional diversification should have lowered the observed U.S. volatility.

Column 4 compares the level of mortgage interest rates in Western Europe and the U.S., using “representative variable mortgage rates” for Europe and the Freddie Mac one-year ARM commitment rate for the U.S. The column shows that the U.S. has the sixth highest average mortgage interest rate from 1998 to 2009, and exceeds the Western European average by 20 basis points. Since overall interest rates also vary across countries, as a further test, column 5 shows the average spread between the mortgage rate and the Treasury bill rate for each country. The U.S. ranks third highest based on the spread and exceeds the Western European average by 57 basis points. Of course, numerous factors determine these mortgage rates and spreads, including the precise terms

of the variable rate mortgages, other contract features such as downpayment requirements, and the generally greater credit risk of U.S. mortgages. Nevertheless, the fact remains that despite the government subsidies and other interventions in the U.S. residential mortgage markets, U.S. mortgage rates have remained among the highest levels compared with the countries of Western Europe. Finally, Column 6 shows the 2009 ratio of home mortgages outstanding to each country's annual GDP, a standard measure of the depth of a country's mortgage market. The U.S. ratio is 81.4 percent which puts it fifth within this group of sixteen developed economies. A relatively high U.S. result is not surprising, given the large mortgage subsidies provided through the GSEs and other channels. It is noteworthy, moreover, that four Western European countries achieved even higher ratios without substantial government interventions in their mortgage markets

The overall conclusion has to be that Western European mortgage and housing markets have outperformed the U.S. markets over the full range of available measures. Although data are not provided here, a similar conclusion would hold for the Australian and Canadian mortgage markets; see Lea (2010). There are, of course, a wide range of possible explanations for the superior performance of the European mortgage markets. The key point for present purposes is simply that the superior performance of the European mortgage markets is *not* explained by greater government intervention. In the absence of GSEs, almost all Western European mortgage lending is carried out privately by banks, primarily funded by bank deposits or covered bonds. Other indirect forms of government support, such as the tax deductibility of mortgage interest and property taxes are notably absent in most European countries.

## **B. Other Justifications for GSE Subsidies**

The activities of the GSEs are justified by the particular benefits accruing to specific classes of borrowers, or more specifically, to all home purchasers and homeowners from the activities supported by these institutions. As noted above, benefits have been claimed for the stabilization of the mortgage supply and corresponding reductions in the volatility of housing construction and home sales. But there are at least three other classes of potential benefits arising from the GSE:

Increases in the extent of mortgage credit accruing to deserving income and demographic groups -- credit which augments that supplied by the private marketplace;

Increases in the lending support provided to builders, owners, or residents of specific types of housing, *e.g.*, multifamily rental housing, which would otherwise not be provided in the market;

Subsidies accruing more broadly to housing market participants, for example, to all home purchasers in the form of lower interest costs arising from the increased liquidity afforded by the GSEs and the implicit guarantee of repayment provided by those institutions;

This section reviews the evidence on the extent and distribution of these benefits.

### **1. Increased Credit to Targeted Groups and Geographical Areas**

The original charter establishing Fannie Mae as a GSE in 1968 recognized a “national goal of providing adequate housing for low and moderate income households,” and it authorized the Secretary of the Department of Housing and Urban Development (HUD) to require that a reasonable portion of Fannie Mae’s purchases of home mortgages be related to this goal. Although regulations requiring the GSEs to allocate a

fixed percentage of mortgage purchases to lower-income households were advanced in the 1970s, mandatory rules were not proposed in Congress until after the passage of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989. Ultimately, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 modified and made more explicit the “housing goals” to be promoted by the GSEs. The Act directed the HUD Secretary to establish quantitative goals for mortgages to “low- and moderate-income” households and for mortgages originated in “underserved areas.” It also imposed a “special affordable housing goal” for mortgages for low-income housing in low-income areas. The 1992 legislation stipulated two-year transition goals, but after that period, the HUD Secretary was empowered to promulgate more detailed regulations.

Under the HUD regulations, finalized in December 1995, the first goal (“low- and moderate-income housing”) directs that a specified fraction of new loans purchased each year by the GSEs be originated by households with incomes below the area median. The second goal (“underserved areas”) requires that a specified fraction of mortgages be originated in census tracts with median incomes less than 90 percent of the area median, or else in census tracts with a minority population of at least 30 percent and with a tract median income of less than 120 percent of area median income. The third goal (“special affordable housing”) targets mortgages originated in tracts with family incomes less than 60 percent of the area median; or else mortgages in tracts with incomes less than 80 percent of area median and also located in specific low-income areas. Any single mortgage can “count” towards more than one of these goals. (For example, any loan that



meets the “special affordable housing” goal also counts towards the “low- and moderate-income” goal.)

The numerical goals originally set by HUD for 1996 were modest – requiring, for example, that 40 percent of the GSEs’ mortgage purchases be loans made to households with incomes below the area median. Over time, the goals for new business set by HUD have been increased.<sup>16</sup> The goal for mortgages to low- and moderate-income households has been increased from 40 percent in 1996 to 56 percent by 2008. Until 2007, mortgage originations by both Fannie Mae and Freddie Mac had reached their primary goals every year. The HUD goal for “underserved areas” was increased from 21 percent in 1996 to 39 percent in 2008. Originations by the larger GSE, Fannie Mae, exceeded this goal in every year; originations by Freddie Mac exceeded the goal in each year until 2008. The “special affordable” housing goal was increased by HUD from 12 percent in 1996 to 27 percent in 2008. Both GSEs surpassed this goal in loan originations each year until 2008.

Figures 6, 7, and 8 report the HUD goals and GSE progress in achieving those goals from their publication in 1995 to the federal takeover of the GSEs in 2008.

Figures 9, 10, and 11 provide another perspective on the magnitude of the goals set by HUD for the GSEs. They report each of the three goals as well as an estimate of the share of all newly-issued mortgages in each of the categories. For example, in 2000 the HUD-specified “low- and moderate-income goal” was to reach 42 percent of new purchases for the GSEs. However, in 2000 low- and moderate-income mortgages, according to the same definition, constituted about 59 percent of all new mortgages. At

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<sup>16</sup> Note, however, that at the time that the 1992 act was debated in Congress, only 36 percent of Fannie Mae’s single-family deliveries were for housing whose value was below the area median. (See FHFA Mortgage Market Note, *The Housing Goals of Fannie Mae and Freddie Mac*, February 1, 2010.)

that time, the “underserved areas” goal was 21 percent of GSE mortgages, while these mortgages constituted more than a 30 percent market share of new mortgages. In virtually all cases, the goals imposed were a good bit lower than the share of mortgage loans of that type originated in the economy. There is no evidence that the goals were set so that the GSEs would “lead the market” in servicing these groups of households.

## **2. Increased Credit to Targeted Housing Types: Multifamily**

Numerical goals for purchases of multifamily mortgages are not mentioned in the Financial Safety and Soundness Act of 1992, but there was considerable concern at the time that the GSEs were not financing their “fair share” of multifamily housing, especially small multifamily properties. For example, in 1991, small multifamily units accounted for less than five percent of Freddie Mac’s multifamily unit purchases. At that time, small multifamily units constituted 39 percent of all recently-financed multifamily units. (See Hebert, 2001.) Thus, the first rules for implementing the 1992 Act put forward by HUD also included explicit goals for multifamily housing.

These goals have been in the form of dollar-based targets. Goals in 1996-2000 were approximately 0.8 percent of the mortgage purchases of Fannie Mae and Freddie Mac recorded in 1994; goals in 2001-2004 (2005-2007) were 1.0 percent of each GSE’s estimated mortgage purchases in 1997-1999 (2000-2002). Beyond the achievement of these numerical goals, multifamily mortgage purchases also qualified for “bonus points” towards the achievement of the three goals specified in the 1992 law. It has been argued that these “bonus points” (discontinued in 2004) were a major inducement leading to an increase in participation by the GSEs in the multifamily housing market, particularly in their financing of small multifamily properties. (See Manchester, 2006.)

Figure 11 reports the dollar goals for multifamily dwellings specified by HUD regulations and the performance of each of the GSEs. As noted in the figure, until quite recently purchases of multifamily dwellings exceeded the HUD goal by a substantial amount. (In 2005, however, it was anticipated that achievement of the GSE multifamily goals was infeasible, and they were suspended.)

## **V. Broad Benefits to Homeowners and Purchasers**

### **a. The Effectiveness of the GSE Goals in Directing Mortgage Credit**

Of course, the finding that the GSEs have achieved the annual goals specified in regulations need not imply that Freddie and Fannie have been very effective in increasing mortgage credit to targeted groups. For example, many suggest that the numerical goals set for the Government Sponsored Enterprises have been far too low (*e.g.*, Weicher, 2010), and that, as a result the GSEs have simply followed the market with a lag of a few years. Indeed, the data in Figures 5, 6 and 7, provide no evidence that Freddie Mac or Fannie Mae purchased more than their “fair share” of mortgages in any of these areas of congressional concern. GSE purchases of mortgages that satisfied any of these congressional goals – as a fraction of all new purchases – were consistently smaller than their “market share” in all newly-issued mortgages.

Similarly, Figure 10 indicates that the GSEs’ new purchases of “special multifamily” mortgages greatly exceeded the dollar goals mandated by HUD in every year.

Finally, Figure 11 demonstrates that the GSEs’ multifamily housing business was only a small fraction of the mortgage purchases of the GSEs in any year. It never

amounted to more than about seven percent of Fannie Mae's purchases, nor more than six percent of Freddie Mac's new business in any year.

Figure 12 reports the aggregate amount of commercial mortgage backed security (CMBS) and multifamily originations between 2003 and 2009 as reported by the Mortgage Bankers of America. Mortgage originations by Freddie Mac and Fannie Mae were small – less than \$9 billion in any year. Until 2008, GSE originations were less than twenty percent of all such mortgage banker mortgage originations. Note, however that in 2008-2009, CMBS and commercial banks left the market entirely; originations by life insurers declined as well. Since the conservatorship in 2008, virtually all multifamily mortgages have been originated by the GSEs.

These simple comparisons suggest that any causal effect of the GSEs on lending to deserving income classes, neighborhoods, and property types is not likely to be large – at least before 2008. Economic analysis of the potential impacts of the GSEs is also complicated by other public programs in effect. For example, in 1977, the Community Reinvestment Act (CRA) was passed to encourage banks to exert further efforts to meet the credit needs of their local communities, including lower-income areas. In identifying neighborhoods of special concern in administering the CRA, neighborhoods (census tracts) with median incomes below 80 percent of the area median income are targeted. As noted above, “underserved areas” of concern in GSE regulation are census tracts with median incomes below 90 percent of the area median income. In addition, many borrowers targeted under GSE criteria are also eligible for Federal Housing Administration (FHA) loans or Veterans' Administration (subsidized) loans.

The existence of parallel government programs under the CRA, FHA, and VA raises the possibility that the GSE purchases of qualifying mortgages simply displaced lenders who would have made the same mortgage under one of the other programs. To the extent that this has been the case, the GSE purchases would have had no noticeable impact on the mortgage market for the qualifying borrowers. Of course, it is a subtle empirical problem to determine whether the GSE purchases were simply displacing loans from the other programs. Nevertheless, a number of academic papers have sought to identify and quantify the effects of the GSE goals on local and neighborhood housing markets and on classes of borrowers.

Table 6 summarizes much of this research.

An early paper by Canner, Passmore and Surette (1996) examined loans eligible for insurance under the FHA. The authors evaluated how the risk associated with these loans is distributed among government mortgage institutions, private mortgage insurers, the GSEs, and banks' in-house portfolios. The results indicated that FHA bears the largest risk share associated with lending to lower-income and minority populations, with the GSEs lagging far behind. Bostic and Gabriel (2006) analyzed the effects of the GSE mortgage purchase goals upon homeownership and housing conditions in California. A careful comparison of neighborhoods just above the GSE cutoff for "low-moderate-income" and "special affordable" designation with nearby neighborhoods just below the cutoff found essentially no differences in the levels and differences in home-ownership rates and housing conditions during the decade of the 1990s.

In a more sophisticated analysis using a similar comparison of neighborhoods "just above" and "just below" the GSE cutoff, An, *et al*, 2007 focused on three indicators

of local housing markets: the home ownership rate, the vacancy rate, and the median home value. The authors related (an instrument for) the intensity of GSE activity in a census tract to these outcomes, using a variety of control variables. The results indicated that increases in GSE purchase intensity were associated with significant but very small declines in neighborhood vacancy rates and increases in median house values. The authors conclude that the “results do not indicate much efficacy of the GSE affordable housing loan-purchase targets in improving housing market conditions (2007, p. 235).”

Two papers by Bhutta (2009, 2010) adopted a regression discontinuity design to test the effects of the “underserved areas” goal upon the supply of credit to those areas. Rather than attempt to match similar neighborhoods for statistical analysis, Bhutta exploited the facts that census tracts qualified for CRA scrutiny if their median incomes were 80 percent of the local area, and they qualified for scrutiny under the HUD GSE goals if their median incomes were 90 percent of the area median design. Bhutta merged tract-level data on mortgages (from the Home Mortgage Disclosure Act) with neighborhood (census) data. Bhutta’s results do find a significant effect of the “underserved area” goal on GSE purchasing activity – but the effect is very small (2-3 percent during the 1997-2002 period).

A more recent paper by Moulton (2010), also using a regression discontinuity approach, finds no effect of the GSEs -- on individual loans rather than aggregate credit allocations. Moulton uses micro data on mortgage loan applications to examine whether the GSE’s affordable housing goals altered the probability that a loan application was originated by a mortgage lending institution or that a loan was purchased by one of the

GSEs. The analysis led to the conclusion that the GSE affordable housing goal had no effect at all on mortgage lending or on GSE purchases.

The consistent finding of little or no effect of the GSE goals on housing outcomes, mortgage applications, or mortgage finance could suggest that there is little effect of the GSE rules upon FHA lending as well. But several papers have reported that an increased market share of GSE mortgages in a census tract is associated with a decline in the FHA share of mortgages (An and Bostic, 2008; Gabriel and Rosenthal, 2010). These results may explain why the increases in lending mandated by the HUD regulations to achieve the congressional goals of the 1992 Act have had very little net impact on housing and neighborhood outcomes. Small increases in GSE activity have been offset by roughly comparable declines in FHA activity.

The extent to which an expansion of GSE activity simply crowds out private mortgage purchases remains an open research question. For example, Gabriel and Rosenthal (2010) argue that increased GSE activity in the mortgage market involved little or no crowd-out until about 2005. After that, GSE activity crowded out private activity until the crash in mortgage markets in 2007.

But even if there were a complete crowd-out of private mortgage activity arising from rapacious behavior by the GSEs, it is hard to attribute any of this to the goals set by the 1992 Act – especially since the goals were substantially less than the share of these new mortgages in the market.

To summarize: the academic and scientific literature has generally found the GSE goals to be ineffective. The goals were low. Despite appearances, they provided no

incentive for the GSEs to “lead the market” in providing credit to potentially riskier housing investments. They accomplished nothing in increasing credit for riskier loans.

But there is a view that the housing goals were actively harmful in facilitating the subprime housing crisis.

This position has been put most forcefully by Peter Wallison (2011) in his rebuttal statement to the Financial Crisis Inquiry Commission. He argues that the requirement to meet the housing goals “forced” the GSEs to make substandard loans, which is why they ultimately acquired such large positions in subprime mortgages and subprime mortgage securities. Indeed, Wallison claims that the HUD goals actually “caused” the subprime crisis. There is no question that the GSEs ultimately acquired large portfolios of subprime mortgages and securities -- see our discussion in Section IV,A,4 above -- but Wallison provides no evidence at all that these subprime portfolios had anything to do with the GSE goals.

Recently, an impressive journalistic account of recent history in the mortgage market argues forcefully that the housing goals in the 1992 act led directly to the subprime mortgage debacle of 2008 (Morgenson and Rossner, 2011). Our analysis of the academic literature supports no such claim. It is certainly possible that the passionate rhetoric from the GSEs provided a convenient “cover” for the trend towards lower quality, even toxic, mortgages by 2004-2005. However, there is no evidence that this rhetoric increased *GSE lending to* targeted groups during the 1990s. Ironically (or perhaps diabolically), the rhetoric about “affordable housing” from the GSEs had little effect upon *their own mortgage purchases* until the subprime crisis was well underway.



As noted above, the empirical evidence simply fails to support a claim that the GSE housing goals were a primary source of the subprime crisis. First, there are simple questions of timing. The GSE goals were enunciated in a law passed in 1992; it is implausible that their effect was not felt until a quarter century had elapsed. Further, as noted below, the GSE accumulation of subprime mortgages accelerated only in 2007, too late to have “caused” the subprime bubble (but certainly early enough to have accelerated its appearance).

Second, as noted above, it appears that the GSE mortgage purchases in support of the housing goals were principally loans that would otherwise have been made by other lenders.

Most importantly, the subprime crisis has a long list proximate causes, including U.S. monetary policy, a global savings glut, the error of assuming a national housing pricing collapse was highly unlikely, etc. (see Jaffee, 2009, 2010, for further discussion.)

**b. Benefits to all housing market participants**

There has been active research seeking to establish the value of the enhanced liquidity and subsidy to homeowners. In principle, the subsidy provided by the implicit guarantee can be calculated. Freddie Mac and Fannie Mae issue debt in the same market in which other participants in the banking and finance industry participate. The yield difference (“spread”) between the debt of the GSEs and that of other firms can be applied to the newly issued GSE debt to compute the funding advantage in any year arising from the GSE status. Of course, it is not quite straightforward to apply this principle and to produce credible estimates. The relevant benchmark estimate (*i.e.*, the appropriate sector and bond rating) is not without controversy, and a comparison with broad aggregate

indices combines bonds containing a variety of embedded options. Pearce and Miller (2001), among others, reported comparisons of GSE and AA-rated financial firms, suggesting that the agencies enjoyed a 37 basis point (bps) spread. More sophisticated comparisons by Nothaft, *et al*, (2002) suggest that the relative spreads are about 27 bps (vis-à-vis AA-minus firms). Table 7 summarizes available comparisons. A careful analysis of yields at issue for GSE debt and the option-free debt issued by a selection of finance industry corporations (Ambrose and Warga, 2002) concludes that the GSEs enjoy a spread of 25-29 bps over AA bank bonds and 37-46 over AA financials. Quigley (2006) provides a terse summary of available estimates.<sup>17</sup>

The substantial subsidies arising from the funding advantage of the GSEs means that mortgage rates for all homeowners can be lower than they otherwise would be, that is, the subsidy can improve the well-being of homeowners and home purchasers.

But of course, in the first instance the subsidy is provided directly to private profit-making firms with fiduciary duties to their shareholders. It is thus not obvious that all, or even most, of the funding advantage provided by the public subsidy is passed through to homeowners. As documented by Hermalin and Jaffee (1996), the secondary market for mortgage securities (at least for those securities composed of loans comparable to the rules under which Fannie and Freddie operate) is hardly a textbook model of atomistic competition. The two GSEs are large, and each has a large market share of the conforming segment of the market. There are high barriers to entry, and the MBS product is more-or-less homogeneous. Moreover, mortgage originators have an

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<sup>17</sup> These estimates are in the range of the spreads which have been assumed (41 bps) by the Congressional Budget Office (CBO, 2001) in estimating the annual federal subsidy to the GSEs. They are similar to the estimates of spreads (40 bps) used by Passmore, (2005) in a more recent exercise.

inherent first-mover advantage in deciding which newly-issued mortgages to sell to Fannie and Freddie. This may force the GSEs to pay a premium for the mortgages they purchase in the market. These factors, duopoly and adverse selection, may mean that much of the subsidy accrues to the shareholders of the GSEs or to the owners of other financial institutions, not to homeowners or home purchasers.

The effects of the GSEs upon mortgage rates can be calculated by estimating the spread between the interest rates on mortgages which conform to the loan limits and underwriting guidelines of the GSEs and the rates on otherwise comparable mortgages. As in the analysis of funding advantages, it is not quite straightforward to apply this principle and to produce credible estimates. (For example, most research compares the rates paid by borrowers with loans one dollar below the conforming limit with rates paid by borrowers with loans one dollar above the limit. But the latter group of borrowers differs from the former group, or else they surely would have made an additional cash payment and taken a conforming loan.)<sup>18</sup>

Early analyses, *e.g.* by Hendershott and Shilling (1989) comparing interest rates on jumbo and conforming mortgages, indicated that this spread was 24-39 bps. More recent studies, *e.g.*, by Passmore, *et al* (2002), by McKenzie (2002), and by the CBO (2001), conclude that the spread is 18-23 bps. These more recent studies differ mostly in their application of more complex screens to insure comparable data for conforming and

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<sup>18</sup> Of course, other reasons besides the greater liquidity provided by the GSEs could explain some of an observed spread between jumbo and conforming mortgages. Jumbo mortgages are generally prepaid more aggressively -- borrowers have more at stake, if nothing else. This means that investors will require higher rates on jumbos merely to compensate for the increased prepayment risk. On the other hand, borrowers with jumbo mortgages have better credit, and they make larger down payments, which should create lower rates on jumbo mortgages. See, also, Ambrose, *et al* (2001), Heuson, *et al* (2001), or Woodward (2004b).

nonconforming loans. Table 8 summarizes these comparisons. More recent work by Passmore, *et al* (2005) suggests that this spread may be as low as 16 bps.

In summary, it appears that the GSEs' funding advantage is about 30-40 bps, and the effect of this is to reduce mortgage rates by 16-25 bps. Stated another way, on the order of half of the subsidy rate to the GSEs is transmitted to homeowners in the form of reduced mortgage interest rates. Presumably, the remainder is transmitted to the managers of the GSEs, the shareholders of the enterprises or to the owners of other financial institutions.<sup>19</sup>

## **VI. Where Do We Go From Here?**

As noted in the introduction, all agree that the current structure of the housing finance system must be reformed in the very near term. The fundamental question is then to determine the proper role for government in support of the U.S. housing and mortgage markets, whether as a modification or replacement of the GSEs.

The research results reported in this paper make it clear, we think, that the public benefits arising from the GSEs have been quite small. The establishment of Fannie Mae, a half century ago, and the establishment of Freddie Mac, forty years ago, did stimulate a more stable national market for housing finance and did substantially improve the liquidity and access of the market. As reported above, however, the specific benefits arising from the GSE structure have been minor. In any event, these benefits -- with some contributions from the GSEs -- were achieved by the 1980s. There now exists a national

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<sup>19</sup> Of course, the net effects of the GSEs upon public welfare and the economy has greatly exceed the three effects upon housing market participants discussed here. Indeed, the evidence suggests that the macro economic effects of the structure and operation of the GSEs during the past half decade has been much more important for the economy than the direct housing-market effects of the institutions.

market for home mortgages. The GSEs have followed reform in the secondary market and have benefited from private innovation.

There have been surprisingly few benefits to deserving households or neighborhoods which can be attributed to the GSEs. There has been more political or partisan attention to the cause of homeownership among lower-income households as a result of powerful advocacy by the interests of GSEs, but there is little evidence that lower-income homeownership was stimulated at all, at least not until the run up to the housing bubble.

It is true that the GSE structure has reduced interest rates on home mortgages, by about a quarter percent or so. But this benefit to homeowners has arisen from the federal guarantee for GSE debt. And the public cost of the subsidy has been far more than the benefits of lower interest rates to homeowners. About half of the overall subsidy has accrued to GSE employees, shareholders, and other market intermediaries. These large losses are directly attributable to the GSE structure which was imposed in the 1960's.

As noted below, we also conclude that the structure of the GSEs themselves has made regulation of the housing market far less transparent and has extended some of the consequences of the housing bubble of the past half decade.

#### **A. The Appropriate Role for Government in the U.S. Residential Mortgage Market**

If the GSEs in current form are to be closed, the fundamental policy question is to decide which government interventions, if any, should replace GSE functions and which should be performed by the private sector? Once that is decided, there is also the delicate issue of how to manage the transition from the current GSE conservatorship. Fortunately,

there are two quite flexible instruments available to close down the GSEs in a systematic, safe and dependable manner: (i) steadily reduce the conforming loan limit until it reaches zero; and (ii) steadily raise the fee charged by the GSEs for guaranteeing MBS. Although we will return to questions of the dynamic transition below, the key question is to determine the appropriate role of government in the U.S. mortgage market.

A large number of proposals have been offered for the reform of the U.S. mortgage market, ranging from a mortgage market managed primarily by private sector entities to recreation of the GSEs as public/private hybrids (albeit with new controls). Summaries and analyses of the general approaches are available in General Accountability Office (2009), Congressional Budget Office (2010), and Bernanke (2009). The following is an annotated list of the three primary proposals scrutinized:

- Reestablish GSEs with tighter controls and explicit guarantees. The entities would continue their organization as public/private hybrids, but with tight government controls, sometimes described as a “public utility” model. In most plans, the government guarantees would apply to the underlying mortgages, not the newly created entities. A cooperative structure such as that of the current Federal Home Loan Banks is an alternative version. The number of entities to be chartered varies by proposal.
- Restructure GSE functions explicitly within a government agency. A simple version would create a government agency that would explicitly insure mortgages up to some conforming limit and then securitize pools of these mortgages, very much as the current FHA and GNMA agencies operate. The support for underserved borrowers

and areas, including multi-family housing, currently covered under the GSE housing goals, would then continue in a revised form as explicit government programs.

- Privatization of the U.S. mortgage market. This proposal would create a fully privatized mortgage market, with no special federal backing for the secondary mortgage market, although this could include spinning out the GSEs as new private entities.

More recently, in February 2011, the U.S. Treasury and Housing and Urban Development agency, U.S. Treasury/HUD 2011), issued a white paper that offered an alternative list of three policy options. The policy options were based on three principles (White paper, p. 11):

1. Pave the way for a robust private mortgage market by reducing government support for housing finance and closing down Fannie Mae and Freddie Mac on a responsible timeline;
2. Address fundamental flaws in the mortgage market to protect borrowers, to help ensure transparency for investors, and to increase the role of private capital;
3. Target the government's vital support for affordable housing in a “more effective and transparent manner.”

In effect, these principles rule out the reestablishment of the GSEs as private/public hybrids.

The White paper then offers three options for long-term mortgage market reform:  
Option 1: A privatized system of housing finance with the government insurance role limited to FHA, USDA and Department of Veterans' Affairs' assistance for narrowly targeted groups of borrowers.

Option 2: A privatized system of housing finance with assistance from FHA, USDA and the VA for narrowly targeted groups of borrowers and a guarantee mechanism to scale up during times of crisis.

Option 3: A privatized system of housing finance with FHA, USDA and the VA assistance for low- and moderate-income borrowers and catastrophic reinsurance behind significant private capital.

Since the White paper's publication, most discussions of specific proposals among academics, public interest groups, and market participants have centered on versions of the White paper's Option 3. The alternative views expressed in these discussions mainly concern the extent and form in which the government's mortgage guarantees would be provided. Of course, if the government guarantee is sufficiently limited, option 3 is no different from option 2. While these discussions have focused on the form of the government mortgage guarantee, there is widespread agreement that the abusive mortgage market practices that evolved during the subprime boom must be ended through regulation; see U.S. Treasury/HUD (2011, pp.15-18). In fact, Federal Reserve actions to modify the Truth in Lending Act and a wide range of requirements in the Dodd-Frank Act have already gone a long way to eliminating any possible replay of such abusive practices in the U.S. mortgage market. There is also widespread agreement that the GSE housing goals should be replaced with an explicit and transparent system of targeted support for access and affordability. An obvious solution, and one endorsed by the White Paper, is to strengthen and expand the FHA for this purpose. The White Paper also proposes a public commitment to affordable rental housing.



## **B. Government Insurance of U.S. Mortgages**

We now review the major issues and differences among the plans that are proposed as the mechanism to replace the GSEs with a program of federal government mortgage insurance. Specific versions are available from Acharya, Richardson Van Nieuwerburgh, and White (2011), the Center for American Progress (2010), Ellen, Tye, and Willis (2010), and Hancock and Passmore (2010). While the plans differ in details and specificity, a composite can be summarized:

- 1) The plans anticipate government regulations will set the underwriting standards to be met by all mortgages that underlie the qualifying MBS, roughly comparable to the standards historically applied by the GSEs. The plans also generally anticipate a size limit roughly equivalent to the conforming loan limit historically applied to the GSEs;
- 2) Investors in the qualifying MBS will be protected from all default risk by a combination of private capital and government guarantee. The government guarantee component is considered essential. The various plans differ primarily in the split between private capital and government guarantee;
- 3) Risk-based insurance premia will be paid to the private capital and the government as compensation for the risks they bear.

For simplicity, we refer to this structure as the “government insurance proposal.” The insurance proposal is clearly preferable to any plan that would recreate the GSEs, since the government would set the underwriting standards and be compensated for the risk it bears.

The immediate question is whether the government can be effective and efficient in carrying out such a mortgage insurance program. Evidence is available from a variety

of existing government insurance programs. Perhaps the most positive evidence is the FHA program itself. As noted earlier, this program has existed since 1934, sets its premiums on an actuarial basis, and has never required a government subsidy or bailout for its self-supporting programs. Most interestingly, as documented in Jaffee and Quigley (2010), the FHA effectively sat out the subprime boom, allowing its overall market share to fall from a peak share of twenty-five percent in 1970 to under two percent by 2006. Even more dramatically, its market share of loans to minority borrowers, which had been close to fifty percent of this market as recently as 2000, fell to well below ten percent by 2006. In effect, the FHA took no action to deter its traditional clients from switching to private market lenders and the GSEs as the source of their mortgage loans. While this inaction could not protect the FHA from the rising loss rate that is now affecting most segments of the U.S. mortgage market, it has certainly minimized the dollar amount of the losses that the FHA could still potentially impose on U.S. taxpayers.

The FHA thus provides a model, or even a precise mechanism, for a broad government guarantee program, possibly covering the same market share—at times fifty percent of the overall market—that was traditionally served by the GSEs. Indeed, operating within its traditional programs, the FHA market share of total mortgage originations has already jumped dramatically from under two percent in 2006 to over twenty percent in 2009. The issue is whether the FHA mechanism, which has worked well serving a well-defined set of lower-income clients, can scale efficiently to serve what could be as much as three quarters of the entire U.S. mortgage market (summing a 50 percent GSE share with a traditional 25 percent FHA share). The major concern is whether the FHA -- or any comparable government insurance plan -- can resist the

*political* pressures to reduce its underwriting standards and to subsidize its risk-based insurance premiums. The evidence here is not encouraging.

An interesting and comparable case is the National Flood Insurance Program (NFIP). The NFIP was created in 1968, following a series of disastrous mid-western floods that caused a large part of the private insurance industry to stop offering flood coverage. The NFIP legislation required premiums to be set on an actuarial basis, including risk-based premiums, to discourage the construction of new homes in flood zones. This noble goal floundered, however, when the owners of existing properties in dangerous flood plains successfully lobbied to obtain special “grandfathered” premium reductions. This all became evident when there were insufficient reserves to pay the losses created by Hurricane Katrina, thus requiring taxpayer bailout of the NFIP on the order of \$22 billion. Further discussion of failed government insurance programs is provided in Jaffee and Russell (2006).

The Terrorism Risk Insurance Act (TRIA) provides an alternative approach to government insurance and may provide a useful structure for a government mortgage insurance program. TRIA was first passed by Congress in 2002, following the terrorism attack of September 2001. The issue was that, as a result of their World Trade Center losses, virtually all property insurers were refusing to renew policies on large commercial buildings unless there was a substantial government reinsurance program to cap their potential losses. TRIA accomplished this goal with a structure in which the government provides the insurers protection against possible catastrophic losses while placing the insurers in the first-loss position with a series of deductibles and coinsurance requirements. Roughly speaking, TRIA 2002 required the industry itself to cover most of

the losses that would have resulted from another event comparable to the sabotage of 2011, but provided quite complete government protection against any losses above that level. TRIA has now been renewed two times, and both times the deductible and coinsurance requirements have been raised, so a taxpayer loss would now occur only with truly extreme events.<sup>20</sup>

The specific proposals offered by Acharya, Richardson, Van Nieuwerburgh, and White (2011) and Hancock and Passmore (2010) both reference “catastrophe insurance” as the coverage to be provided under their plans. A particular concern, however, is that MBS investors might not consider government catastrophe coverage to be a sufficient inducement for them to take the first-loss positions on portfolios of U.S. mortgages. For example, while the property insurers may have been most concerned with the last twenty percent of the tail risk from terrorist attacks, investors in residential mortgage pools may be primarily concerned with the first twenty percent of the risk distribution. In that case, for a government mortgage insurance program to be effective, it may have to mimic the NFIP more than TRIA. In other words, even if the starting point were the principle of a backstop to catastrophe, the political process may create a plan that covers high-risk mortgages at subsidized rates, i.e., GSEs with a different “cover.”

This appears to be the conundrum for creating a feasible and acceptable program for government insurance of U.S. mortgages. While a true catastrophe government insurance plan appears feasible, investors and other market participants will, of course, have incentives to push as much of the first-loss risk as possible under the government’s coverage. If the political process can stand firm on the issue, then it is quite possible that

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<sup>20</sup> On the other hand, the government’s TRIA coverage is provided without charge.

private incentives will create an efficient market for U.S. mortgages. After all, it is hard to believe that only the countries of Western Europe have the ability to create effective mortgage markets while maintaining a low level of government intervention.

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**Table 1**  
**Outstanding Home Mortgages**

	Year						
	1950	1960	1970	1980	1990	2000	2010
<b>A. Billions of Dollars</b>							
Portfolio Holdings	\$45	\$141	\$289	\$851	\$1,496	\$2,297	\$3,918
Depository Institutions	27	95	207	642	1,066	1,669	2,959
Market Investors	17	40	65	146	316	441	478
GSE Portfolios	1	6	17	62	114	187	481
Mortgage Pools	0	0	3	107	1,111	2,811	6,614
GSE Pools	0	0	0	13	652	1814	4,311
GNMA Pools	0	0	3	94	404	612	1,038
PLS Pools	0	0	0	0	55	386	1,265
Total	\$45	\$141	\$292	\$958	\$2,606	\$5,108	\$10,531
<b>B. Percentage of Total</b>							
Portfolio Holdings	100%	100%	99%	89%	57%	45%	37%
Depository Institutions	60	67	71	67	41	33	28
Market Investors	38	29	22	15	12	5	5
GSE Portfolios	2	4	6	7	4	8	5
Mortgage Pools	0	0	1	11	43	55	63
GSE Pools	0	0	0	1	25	36	41
GNMA Pools	0	0	1	10	15	12	10
PLS Pools	0	0	0	0	2	8	12
Total	100%	100%	100%	100%	100%	100%	100%
<b>C. GSE Whole Loans Held + MBS Issued</b>	3%	4%	6%	8%	29%	44%	46%

Source: see data appendix

**Table 2**  
**Holdings of Whole Home Mortgages and MBS by Investor Class**

<b>Billions of Dollars</b>	<b>1950</b>	<b>1960</b>	<b>1970</b>	<b>1980</b>	<b>1990</b>	<b>2000</b>	<b>2010</b>
<b>Depository Institutions</b>							
Whole Mortgages	\$27	\$95	\$207	\$642	\$1,066	\$1,669	\$2,959
MBS	0	0	0	41	385	604	1,368
Total	27	95	207	683	1,450	2,272	4,326
<b>Market Investors</b>							
Whole Mortgages	17	40	65	146	316	195	478
MBS	0	0	3	66	714	1,446	4,444
Total	17	40	68	212	1,030	1,641	4,923
<b>GSEs</b>							
Whole Mortgages	1	6	17	62	114	433	481
MBS	0	0	0	0	12	762	802
Total	1	6	17	62	126	1,195	1,283
<b>Total Home Mortgages</b>	<b>\$45</b>	<b>\$141</b>	<b>\$292</b>	<b>\$958</b>	<b>\$2,606</b>	<b>\$5,107</b>	<b>\$10,531</b>

**Table 3**  
**Conforming Mortgage Originations by Origination Year,**  
**Characteristics, and GSE Market Share**

<b>A. Conforming Originations,<sup>21</sup> Billions of Dollars</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
(1) Loan to Value Ratio > 90%	108	121	154	130	112	115	169
(2) FICO Score < 620	94	126	164	194	211	162	92
(3) ARMs	83	200	332	516	579	447	165
(4) High Risk Originations <sup>22</sup>	241	367	536	664	719	597	374
(5) Total Conforming Originations	1,064	1,451	2,074	1,331	1,454	1,307	1,117
(6) High Risk as % of Total Conforming	22.6%	25.3%	25.9%	49.9%	49.5%	45.7%	33.5%
<b>B. GSE Share of Risk Attributes</b>							
(7) Loan to Value Ratio > 90%	92.2%	86.4%	76.0%	59.6%	58.4%	66.8%	93.1%
(8) FICO Score < 620	63.9	56.7	47.0	25.1	22.4	32.5	76.8
(9) ARMs	50.7	60.5	56.5	36.8	29.0	33.1	62.6
(10) High Risk Originations	77.2	72.7	65.3	43.5	36.3	42.5	79.9
(11) GSE Share Total Conforming Loans	93.7	91.6	88.7	67.5	61.9	67.1	90.7
<b>C. Relative Intensity (1.0 = “Market Portfolio”)<sup>23</sup></b>							
(12) Loan to Value Ratio > 90%	0.98	0.94	0.86	0.88	0.94	1.00	1.03
(13) FICO Score < 620	0.68	0.62	0.53	0.37	0.36	0.49	0.85
(14) ARMs	0.54	0.66	0.64	0.55	0.47	0.49	0.69
(15) High Risk Originations	0.82	0.79	0.74	0.64	0.59	0.63	0.88
(16) GSE Total Conforming Loans	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Sources: all data are from Federal Housing Administration (2010a).

<sup>21</sup> Conforming mortgage originations exclude originations retained in lender portfolios.

<sup>22</sup> Line (4) = (1) + (2) + (3) - adjustment for mortgages with multiple factors.

<sup>23</sup> Relative intensity = GSE Share of Risk Attribute/GSE Share Conforming Loans (row 11).

**Table 4**  
**Conventional Single-Family Business Volume by Attribute and Year**

<b>Fannie Mae</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
LTV > 90%	11%	8%	7%	10%	9%	10%	16%
FICO < 620	6	6	4	6	5	6	6
ARMs	6	9	10	22%	21	17	10
Interest Only	NA	1	1	5	10	15	16
Condo/Coop	NA	7	7	9	10	11	11
Investor	4	5	6	4	5	6	5
<b>Freddie Mac</b>							
LTV > 90%	11%	7%	5%	7%	6%	6%	11%
FICO < 620	4	3	3	4	4	5	6
ARMs	8	12	13	17	18	16	20
Interest Only	NA	NA	NA	3	1	0	0
Condo/Coop	NA	NA	NA	NA	NA	NA	NA
Investor	2	2	4	4	4	5	6

Source: Fannie Mae and Freddie Mac Annual Reports.

Loans may have more than one of the characteristics.



**Table 5**  
**The Performance of European Mortgage Markets in Comparison with the US\***  
**Statistical Measures Computed with annual data by country for the years 1998 to 2009**

	<b>Rate of Owner Occupancy 2009</b>	<b>Coefficient of Covariation of Housing Starts</b>	<b>Standard Deviation of House Price Inflation</b>	<b>Mortgage Adjustable Rate Average Level</b>	<b>Mortgage Interest Rate Average Spread</b>	<b>Mortgage To GDP Ratio 2009</b>
<b>Western Europe</b>						
Austria	56.2%	6.8%	2.5%	5.0%	1.8%	26.2%
Belgium	78.0	15.9	4.1	5.8	2.5	43.3
Denmark	54.0	57.4	8.7	5.9	2.5	103.8
Finland	59.0	14.4	4.0	4.3	1.1	58.0
France	57.4	18.2	6.4	4.9	1.7	38.0
Germany	43.2	29.5	1.7	5.2	2.0	47.6
Ireland	74.5	84.2	13.8	4.4	1.1	90.3
Italy	80.0	25.7	3.1	5.0	1.6	21.7
Luxembourg	75.0	19.2	4.8	4.3	1.0	42.0
Netherlands	57.2	12.3	6.6	5.1	1.9	105.6
Norway	76.7	24.3	5.2	6.3	1.4	70.8
Portugal	76.0	27.2	4.1	4.9	1.6	67.5
Spain	85.0	60.5	7.7	4.3	1.0	64.6
Sweden	66.3	61.7	3.4	3.8	0.8	82.0
United Kingdom	69.5	13.9	7.1	5.2	0.8	87.6
<b>EU Average</b>	67.2%	31.4%	5.6%	5.0%	1.5%	63.3%
<b>US</b>	67.2%	40.0%	7.5%	5.2%	2.1%	81.4%
<b>US Rank</b>	8 <sup>th</sup> of 16	5 <sup>th</sup> of 16	4 <sup>th</sup> of 16	6 <sup>th</sup> of 16	3 <sup>rd</sup> of 16	5 <sup>th</sup> of 16

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\* Unless noted otherwise, the data are all from European Mortgage Federation (2009), an annual fact book that contains comprehensive mortgage and housing market data for the years 1998 to 2009 for 15 Western European countries and the United States.

**Table 6**  
**Effects of GSE Goals on Housing Market Outcomes**

<b>Author</b>	<b>Time Period</b>	<b>Data</b>	<b>Effect of Outcomes on GSE Goals</b>	<b>Effect on Other Housing Outcomes</b>	<b>Remarks</b>
Wyly and Holloway (2002)	1997-2000	Loan applications from HMDA		1% increase in subprime market share leads to a rise in nondisclosure (of race-ethnicity) of 0.6% in the refinance market. Nonreporting rates are the highest in the subprime refinance markets, especially in inner city and low-income areas.	An increasing number of HMDA loan applications contain no information on the applicant's race or ethnic identity. They also conducted a case study in Atlanta on the disappearance of race data.
Ambrose and Thibodeau (2004)	1995-1999	Dollar volume of purchase and refinance loans from HMDA, by MSA.	Lenders increased the supply of mortgage credit in areas with higher proportions of underserved borrowers. Increases in GSE purchases of seasoned loans in an MSA lead to increases in total mortgage origination volume in the MSA.	Volume of mortgages increased steadily between 1995 and 1998, declining slightly in 1999. 27% increase in volume of purchase mortgages by 1998, and mortgage refinances increased 211%. In 1999, mortgage refinance volume fell 42% and purchase mortgage volume increased another 12%.	1998 appears to be an unusual year and significance of the coefficients might arise from the sudden increase in mortgage purchase and refinance volume that year.
Friedman and Squires (2005)	2000	Loan application and purchase data from 2000 HMDA, by MSA. Restricted to conventional loans originated to purchase 1-4 family homes.		Blacks and Latinos are more likely to purchase homes in predominantly white neighborhoods in MSAs where more loans are made by CRA lenders.	Based on census tract racial composition grouped into three descriptive categories: predominantly white, racially integrated; and predominantly minority.

**Table 6**  
**Effects of GSE Goals on Housing Market Outcomes (continued)**

<b>Author</b>	<b>Time Period</b>	<b>Data</b>	<b>Effect of Outcomes on GSE Goals</b>	<b>Effect on Other Housing Outcomes</b>	<b>Remarks</b>
Avery, Bostic, and Canner (2005)	2000	Total lending and lending experiences of institutions from the <i>Survey of the Performance and Profitability of CRA-Related Lending, 2000</i>		Almost 60% of institutions explicitly responded to CRA obligations; half engaged in community development activities, and 30% had home mortgage purchases and refinance activities.	Survey conducted by the Board of Governors of the Federal Reserve to measure responses of lending institutions to CRA.
Bostic and Gabriel (2006)	1994, 1999	GSE loan purchase volume in California census tracts analyzed by MSA.	San Francisco MSA had a greater increase in homeownership rates in designated tracts. No significant differences observed elsewhere in California.	No significant differences in housing market performance between GSE-targeted census tracts and those just above and below the GSE target.	Model relates breaks from 80-90% and 90-100% of median income census tract effects to changes in housing market outcomes
An and Bostic (2006)	1995-2001	Shares of HMDA loans sold on secondary market, by purchasing institution and census tract.	1% increase in GSE market share leads to 0.27% reduction in sub market share.	Increases in GSE purchase activity are associated with declines in subprime mortgage activity, especially in neighborhoods with high minority populations.	Effect of FHA growth on sub market share is smaller.
An, Bostic, Deng, Gabriel, Green, and Tracy (2007)	1995-2000	Annual GSE home loan-purchase, from HMDA, by census tract.	Increases in the percent of GSE purchases by tract are associated with declines in neighborhood vacancy rates and increases in median home values.	Significant deterioration in the credit quality of FHA-insured borrowers after 1996; GSEs may have given FHA borrowers in targeted tracts better access to less expensive, conventional, conforming loans	Possible endogeneity: GSE percent of purchase may be function of other housing market trends; GSE loan-purchase may be a function of housing market trends; GSEs might simply shift their purchase activity among neighborhoods.

**Table 6**  
**Effects of GSE Goals on Housing Market Outcomes (continued)**

<b>Author</b>	<b>Time Period</b>	<b>Data</b>	<b>Effect of Outcomes on GSE Goals</b>	<b>Effect on Other Housing Outcomes</b>	<b>Remarks</b>
Laderman and Reid (2008)	2004-2006	Loan application and origination information from HMDA, and loan performance data from Applied Analytics (LPS). Analysis is restricted to conventional, first-lien, owner-occupied loans originated in MSAs in California.		Loans made by a CRA lender within its assessment area in low-income neighborhoods were less likely (odds ratio .73) to be foreclosed than loans made by IMCs in the same neighborhoods. In moderate-income neighborhoods, CRA lenders were 1.7 times less likely to be foreclosed.	Analyzed CRA mortgage lending activities to measure effect on current crisis, but did not examine the impact that CRA investment or service components may have had on the current financial crisis.
An and Bostic (2008)	1996 – 2002	HMDA loan level application and origination information, matched to census tracts. Analysis is restricted to owner-occupied home purchase loans.	GSE market shares are lower in central city tracts and in tracts with high minority populations and high vacancy rates. GSE market shares are higher in more affluent census tracts (with higher home values and/or higher incomes).	Negative and significant correlation between GSE and FHA market share, by census tract.	FHA and GSE loan purchases represent a small share of the market of loans. Other factors (like subprime mortgages) could dominate the relationship the authors found. The first stage regression is problematic; it showed no relationship between targeted census tracts and GSE market shares.
An and Bostic (2009)	1995-2001	Shares of HMDA loans sold on secondary market, by purchasing institution and census tract.	Tracts with fewer total loans have less GSE penetration.	Negative relationship between annual GSE purchase growth and annual growth in subprime loan originations. A 1 percentage point increase in GSE share is associated with a 0.45 percentage point decline in subprime market share.	GSEs do not purchase subprime loans; this study is based on TSLS regression.

**Table 6**  
**Effects of GSE Goals on Housing Market Outcomes (continued)**

<b>Author</b>	<b>Time Period</b>	<b>Data</b>	<b>Effect of Outcomes on GSE Goals</b>	<b>Effect on Other Housing Outcomes</b>	<b>Remarks</b>
Bhutta (2009)	1997-2004	Loan amounts, originations, and loans sold on secondary market, by purchasing institution and census tract, from HMDA. Analysis is restricted to census tracts in MSAs.	Goals increased GSE purchasing activity by 3-4% in targeted tracts and increased GSE-eligible originations by 2-3% on average.	No evidence that UAG-induced increases in GSE credit supply crowded out FHA and subprime lending.	Regression discontinuity design. In contrast to the An and Bostic 2008 paper, Bhutta estimates the impact of the GSE Act separately on the number of GSE purchases, the total number of GSE-eligible originations, and the number of GSE-ineligible loans in targeted tracts.
Bhutta (2010a)	1994-2002, 1998-2005	Loan information by lender type, application status, loan purpose, secondary purchaser (if any) from HMDA, by census tract of the property and borrower income.	On lending, CRA had little impact, even during the 2000s when lending to lower income areas soared. Small increase in nonbank lending in CRA-targeted neighborhoods of large MSAs, particularly in areas with historically low home sales.	Increased bank lending does not crowd out lending by mortgage bank subsidiaries and independent mortgage companies.	Regression discontinuity design. Limitation of RD design is that it only measures the CRA's impact at the cutoff (80 percent of median income), so if there were a larger impact for borrowers and neighborhoods further below the cutoff, the RD would understate the CRA's true impact.

**Table 6**  
**Effects of GSE Goals on Housing Market Outcomes (continued)**

<b>Author</b>	<b>Time Period</b>	<b>Data</b>	<b>Effect of Outcomes on GSE Goals</b>	<b>Effect on Other Housing Outcomes</b>	<b>Remarks</b>
Bhutta (2010b)	1997-2002	Mortgage originations and applications from HMDA, by census tracts in MSAs.	Small UAG effect on GSE purchases and mortgage originations. GSEs purchase about 3.4% fewer loans in tracts below the eligibility cutoff.	No crowd out of FHA and subprime lending.	Regression discontinuity design. Analysis might understate UAG's effect because RD can only identify the goal's impact for tracts near the eligibility thresholds. Bhutta notes that the UAG mostly affects relatively stable tracts, indicating that GSEs respond where it is least costly.
Gabriel and Rosenthal (2010)	1994-2008	Loan purchases and originations from HMDA, by census tracts located within MSAs. Census tracts were adjusted to match the 2000 census.	The disappearance of GSE crowd out, with the 2007 financial crisis, suggests loans purchased by GSEs added substantively to the flow of mortgage credit.	From 1994-2003, GSE crowd out of private secondary market purchases was small. From 2004-2006, private loan purchases expanded and GSE crowd out estimates jumped to 50%. After 2007, GSE crowd out was small again.	Addressed GSE purchase endogeneity of instrumenting for applications using lagged tract homeownership rates. Increased local secondary market activity may result in some easing in local underwriting standards, causing local applications to increase. Thus OLS estimates would be biased upwards. With or without IVs, the trends were similar.

**Table 6**  
**Effects of GSE Goals on Housing Market Outcomes (continued)**

<b>Author</b>	<b>Time Period</b>	<b>Data</b>	<b>Effect of Outcomes on GSE Goals</b>	<b>Effect on Other Housing Outcomes</b>	<b>Remarks</b>
Avery and Brevoort (2010)	2001, 2004-2006	Loan origination and purchases from HMDA, by census tract, with 3 outcome variables: 1) Percentage of mortgage borrowers who were 90 or more days past due on at least 1 mortgage obligation, from Equifax. 2) Percentage of first-lien mortgage loans originated in a tract during 2004-2006 with estimated front-end debt-to-income ratios exceeding 30 percent, as a proxy for high-risk or subprime lending activity from HMDA. 3) House price changes between 2001-2006 and 2006-2008 calculated from HMDA.	No statistically significant relationship between loan sales to the GSEs and delinquency.	Found no evidence that CRA and GSE goals contributed to house price increases during the 2001-2006 buildup. CRA targeted census tracts show fewer loan delinquencies in 2008.	Regression discontinuity design. Believes loan quality and performance is important to measure for GSE and CRA goal success, in addition to loan volume. Loan performance data are missing; they measured loan quality by post-buildup delinquency rates and risk characteristics. Also, aggregation of analysis obscure the fact that subprime boom took on different forms in different geographic regions.

**Table 6**  
**Effects of GSE Goals on Housing Market Outcomes (continued)**

<b>Author</b>	<b>Time Period</b>	<b>Data</b>	<b>Effect of Outcomes on GSE Goals</b>	<b>Effect on Other Housing Outcomes</b>	<b>Remarks</b>
Moulton (2010)	1996-1997, 2006-2007	Loan originations and purchases, foreclosures, vacancies, high-priced loans, and other housing outcomes from HUD and HMDA by census tract and also by loan applicant.	Special Affordable Goal increased GSE purchases from very low-income borrowers by four percent but had no effect on mortgage lending. No evidence that LMIG or UAG altered GSE purchase or mortgage lending decisions.	No relationship between GSE Act's affordable housing goals and increased foreclosures, vacancies, or other housing outcomes.	Regression discontinuity design. Diverges from Bhutta 2009 paper in a few ways. Bhutta uses data aggregated to the census tract-level, while Moulton uses variation in loan applicant-level data to examine individual loan outcomes, allowing Moulton to examine the individual-level goals outlined in the LMIG and SAG.



**Table 7**  
**Estimates of GSE Funding Advantage**

<b>Author</b>	<b>Data</b>	<b>Comparison</b>	<b>Spread in Basis Points</b>
US Treasury (1996)	Bloomberg	Agency vs A Financials	53-55
Ambrose and Varga (1996)	Fixed Income Research Program	Fannie Mae vs AA Financials AA Corporate A Financials A Corporate	37-46 38-39 56-72 55-65
Freddie Mac (1996)	Lehman Relative Value	Freddie vs AA & A AAA	39 23
Toevs (2000)	Lehman Bond Indexes	Fannie Mae vs AA-Indexes	37
Pearce and Miller (2001)	Bloomberg	Agency vs AA Financials	37
Ambrose and Varga (2002)	Fixed Investment Securities Database	Freddie and Fannie vs AA Banks	25-29
Nothaft, et al (2002)	Fixed Investment Securities Database	Freddie and Fannie vs AA Debentures A Debentures AA MTNs A MTNs	30 45 27 34
Passmore, et al (2005)	Bloomberg Lehman	Freddie and Fannie vs AAA & AA Financials: 68 Firms 44 Firms 15 Firms	41 38 38

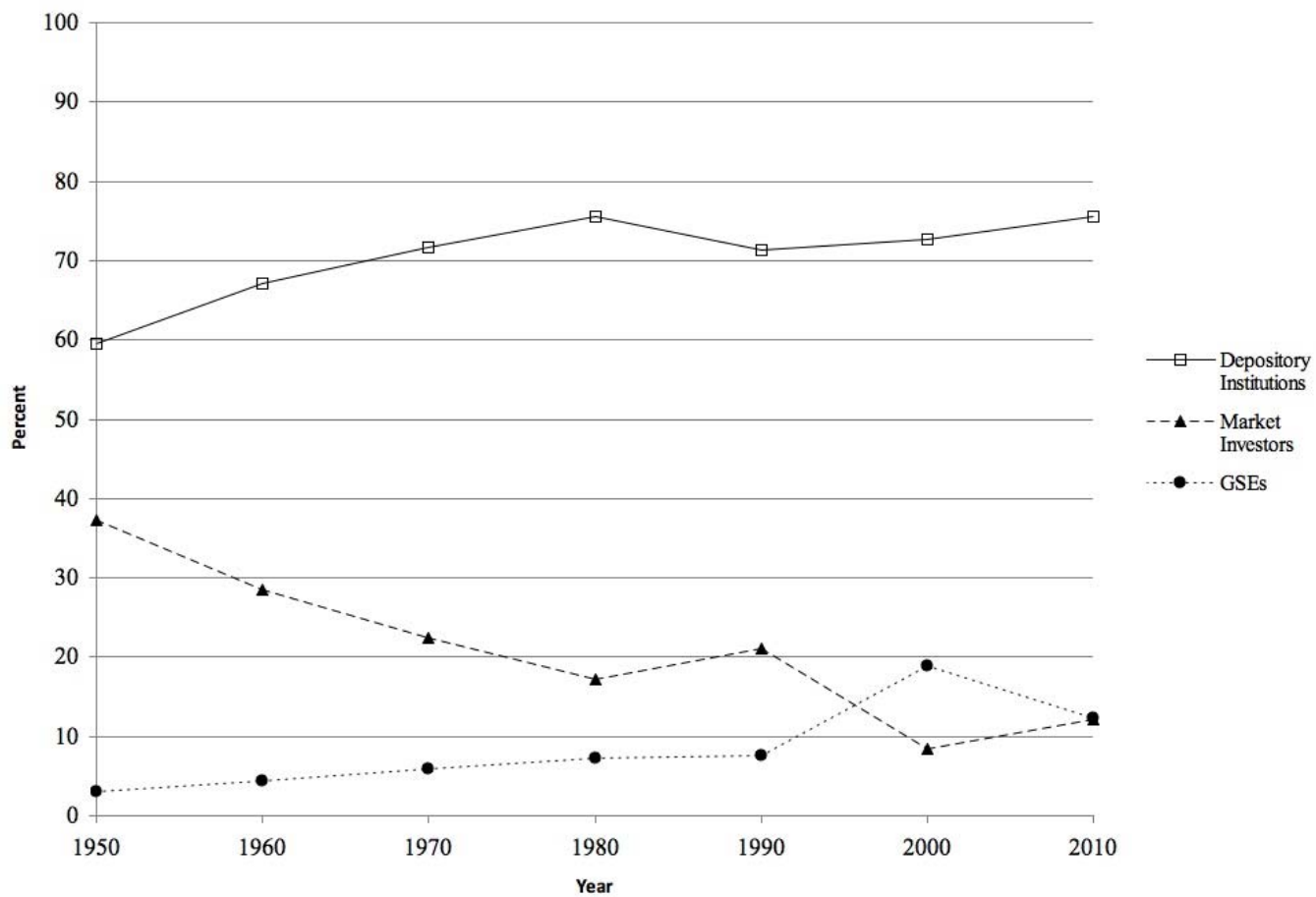
Source: Nothaft, *et al* (2002), Ambrose and Varga (2002), Passmore, *et al*, (2005). See Quigley (2006) for additional details.

**Table 8**  
**Estimates of Reduction in Mortgage**  
**Interest Rates Attributable**  
**to GSEs**

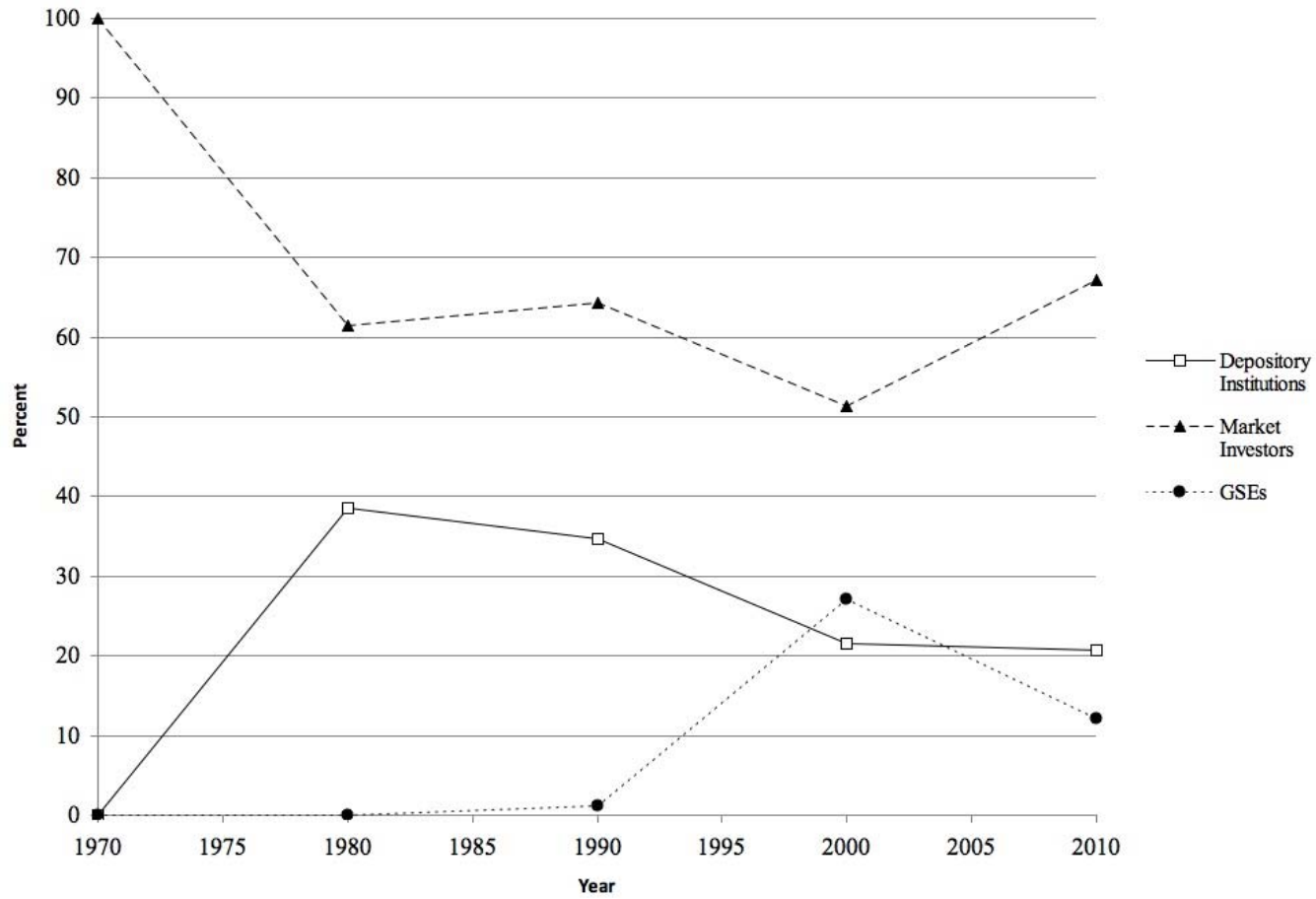
Author	Time Period	Region	Reduction in Basis Points
Hendershott and Shilling (1989)	1986	California	24-39
ICF (1990)	1987	California	26
		7 States	23
Cotterman and Pearce (1996)	1989-1993	California	25-50
		11 States	24-60
Pearce (2000)	1992-1999	California	27
		11 States	24
Ambrose, Buttimer and Thibodeau (2001)	1990-1999	Dallas	16-24
Naranjo and Toevs (2002)	1986-1998	US	8-43
Passmore, Sparks and Ingpen (2002)	1992-1999	California	18-23
CBO (2001)	1995-2000	US	23
McKenzie (2002)	1986-2000	US	22
	1996-2000	US	19
Ambrose, La Cour-Little and Saunders (2004)	1995-1997	US	6
Woodward 1996-2001 (2004b)	1996-2001	US	35-52
Passmore, Sherlan and Burgess (2005)	1997-2003	US	15-18
Blinder, Flannery and Lockhart (2006)	1997-2003	US	23-29

Source: McKenzie (2002); Ambrose (2004), Blinder, et al, (2006); Passmore, et al, (2005); Woodward (2004b). See Quigley (2006) for details.

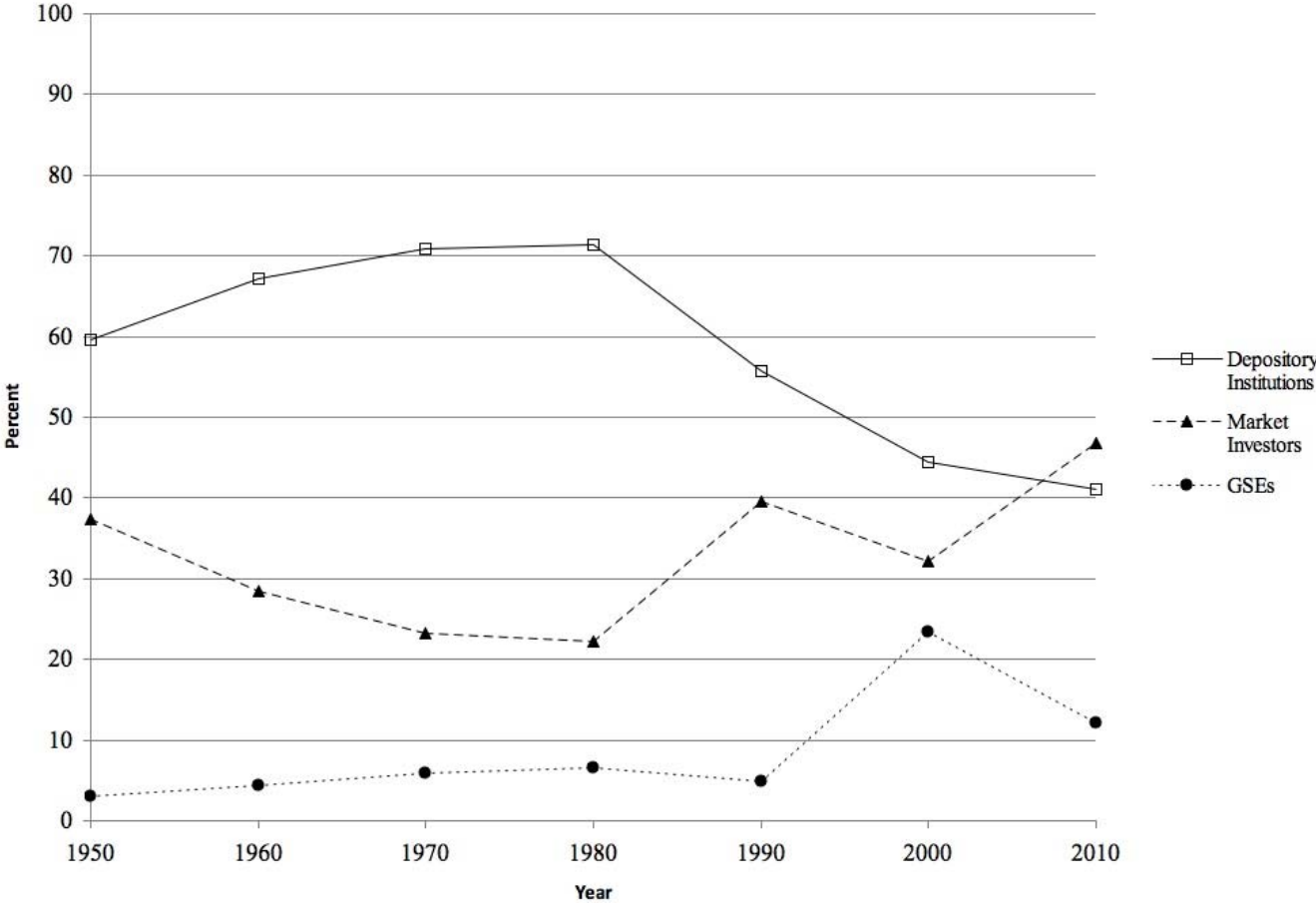
**Figure 1**  
**Share of Whole Mortgages Held Directly, by Holder Class**



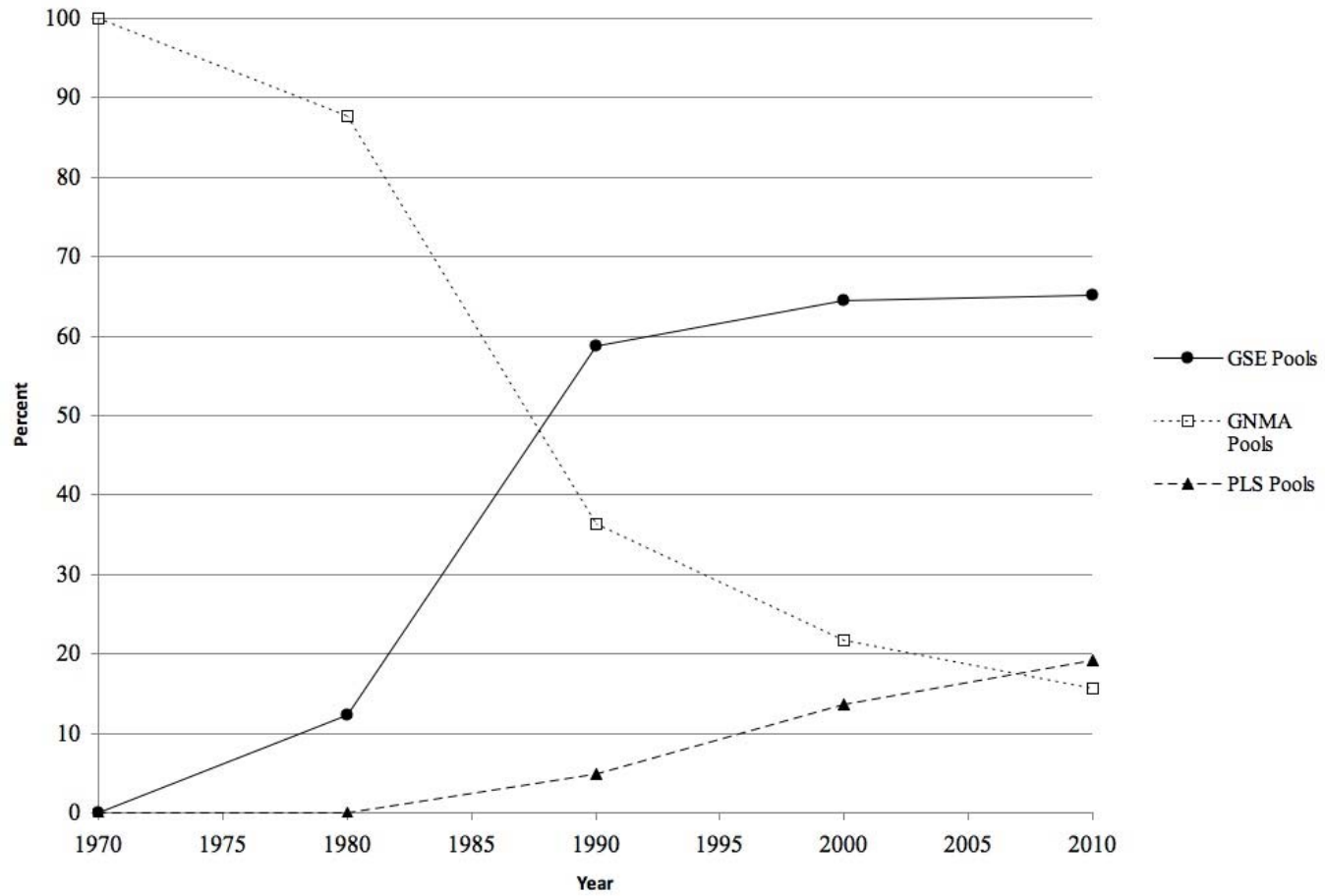
**Figure 2**  
**Share of MBS Outstanding, by Holder Class**



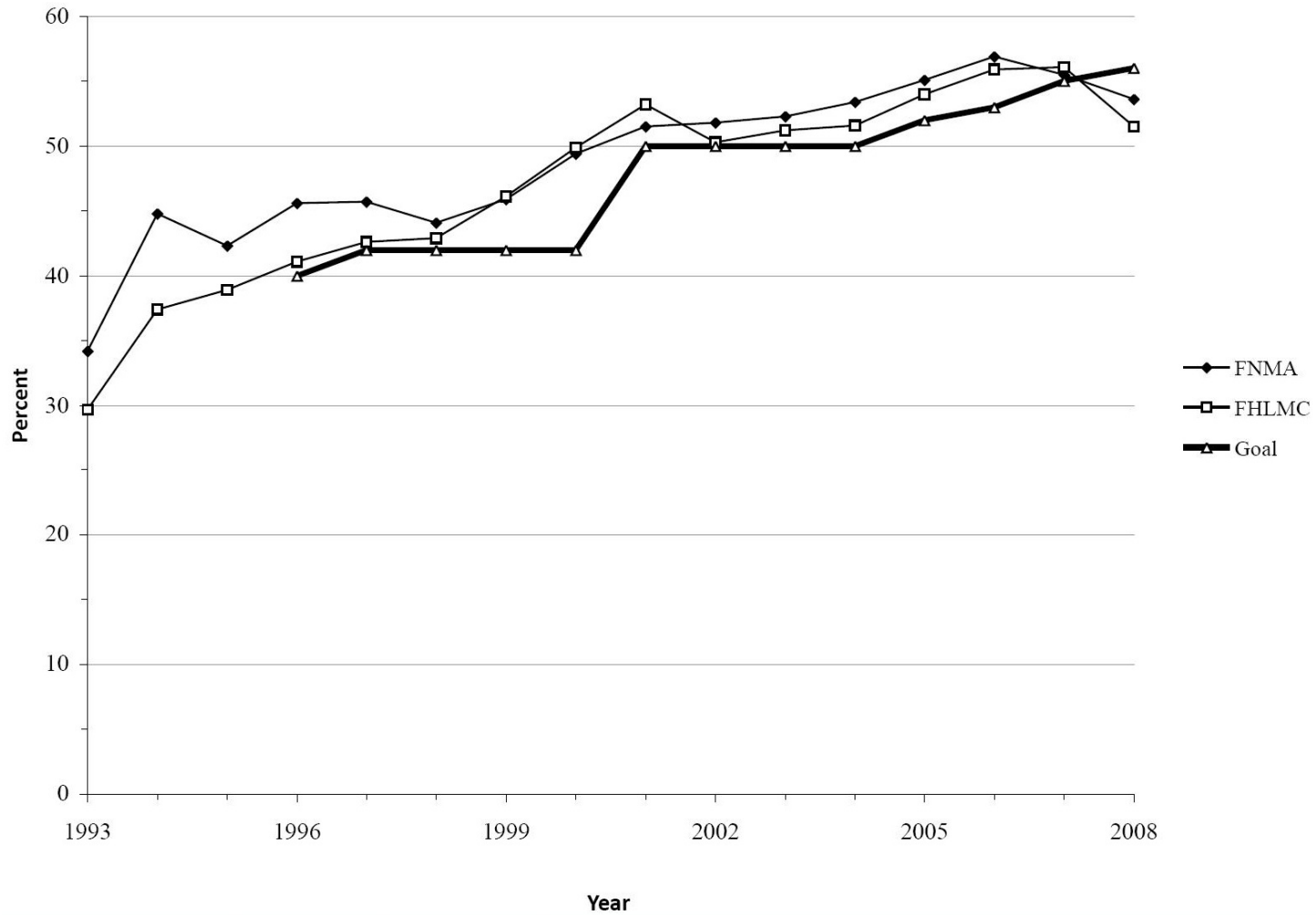
**Figure 3**  
**Share of Whole Mortgages and MBS, by Holder Class**



**Figure 4**  
**Share of MBS Outstanding, by MBS Issuer**

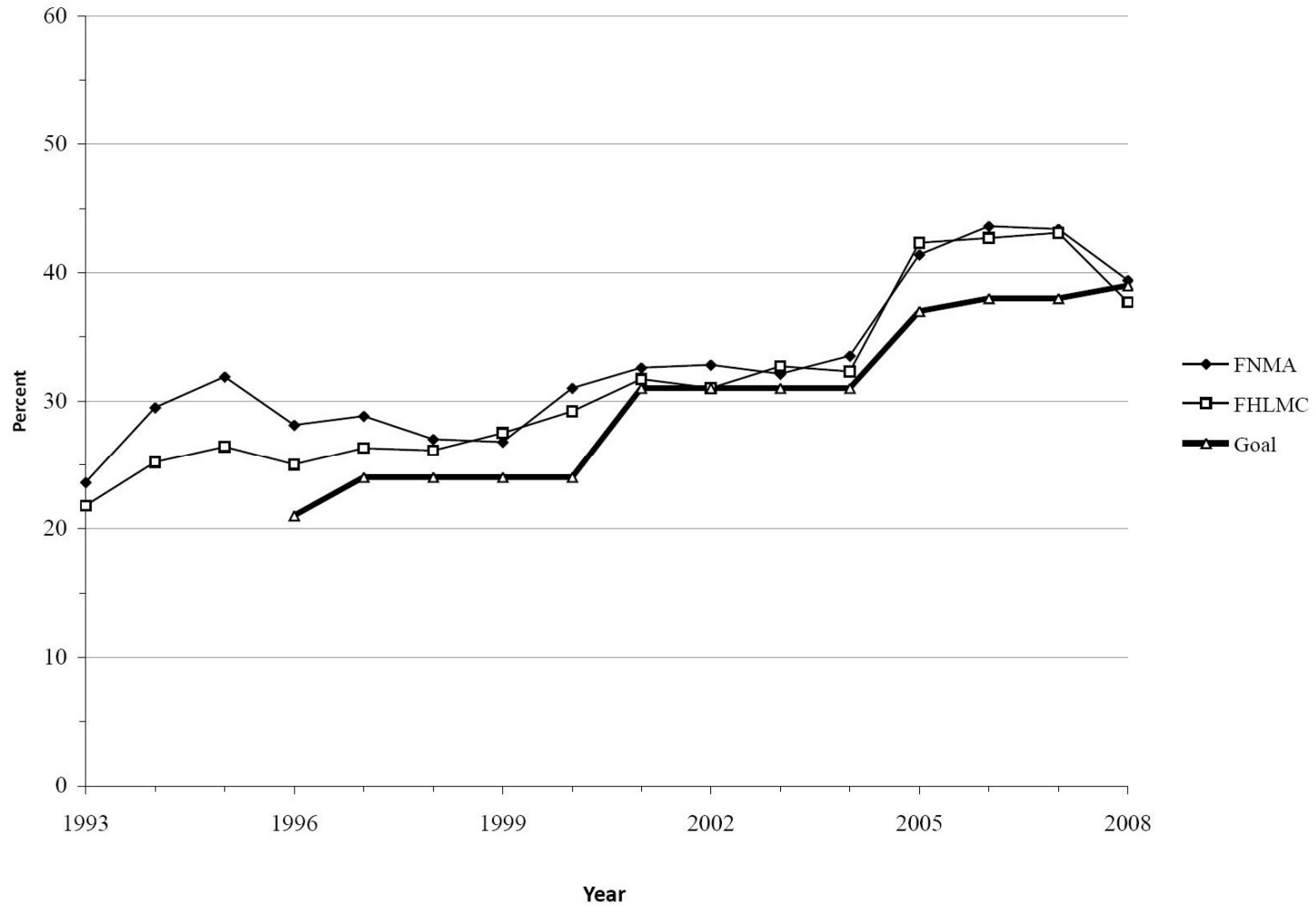


**Figure 5**  
**GSE "Low-Moderate Income" Housing Goal, 1993-2008**  
**(Percent of New Loans to Households With Incomes Below Area Median Income)**



Source: U.S. Department of Housing and Urban Development, Office of Policy Development and Research. "Overview of the GSEs' Housing Goal Performance, 1993-2001", "Overview of the GSEs' Housing Goal Performance, 2000-2007,"

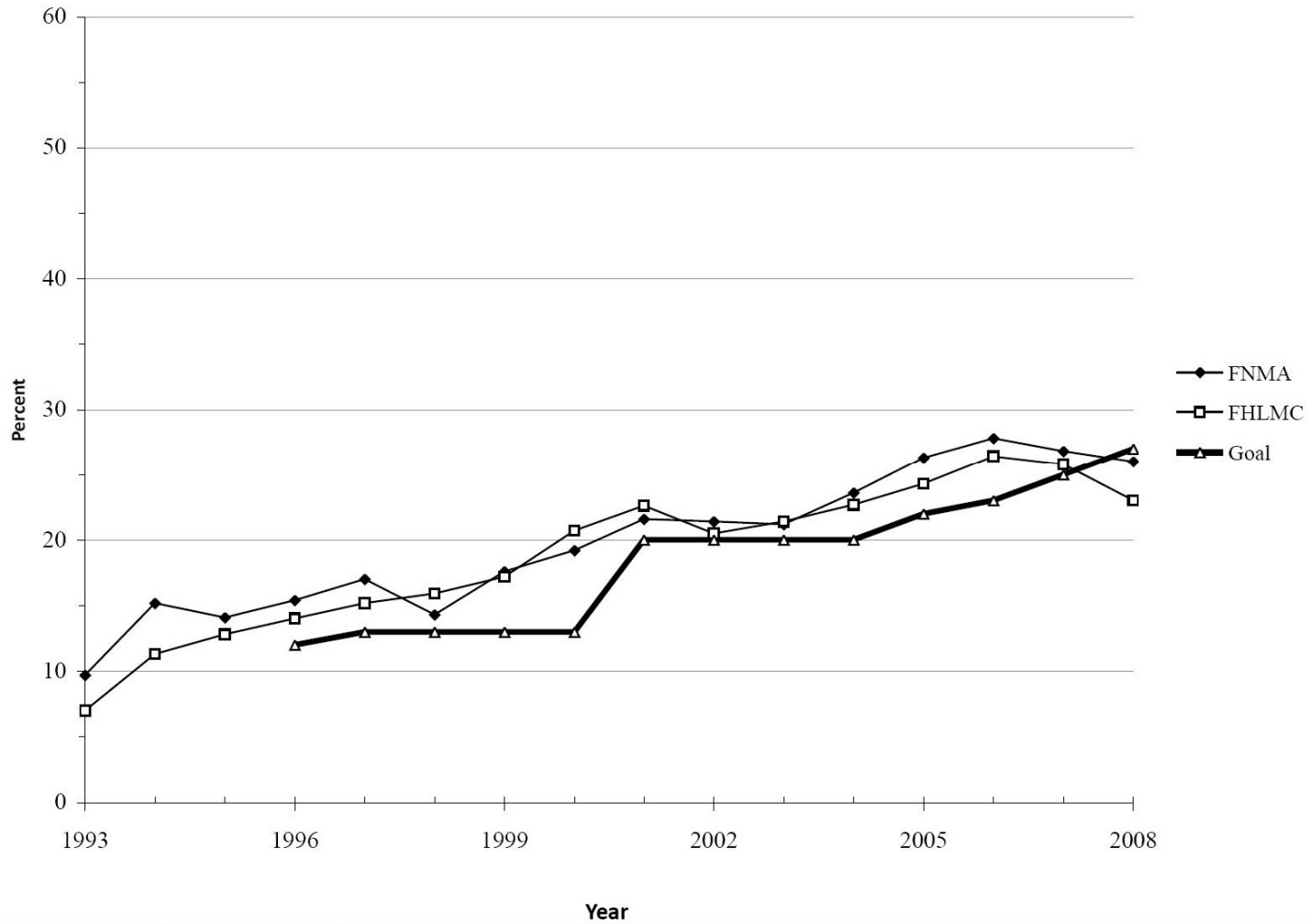
**Figure 6**  
**GSE "Underserved Area" Housing Goal, 1993-2008**  
**(Percent of New Loans Credited Towards Goal)**



Source: U.S. Department of Housing and Urban Development, Office of Policy Development and Research. "Overview of the GSEs' Housing Goal Performance, 1993-2001", "Overview of the GSEs' Housing Goal Performance, 2000-2007."

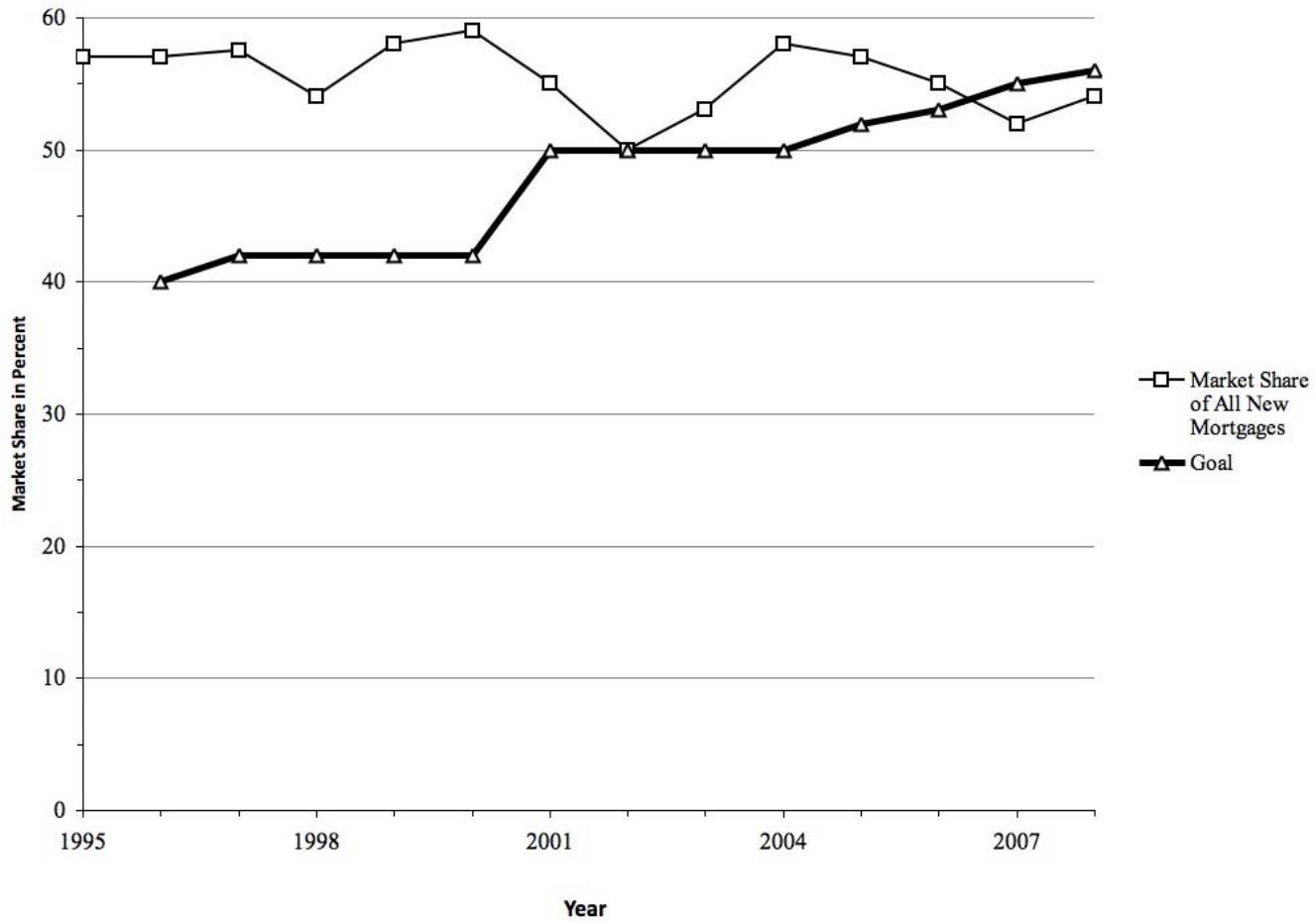


**Figure 7**  
**GSE "Special Affordable" Housing Goal, 1993-2008**  
**(Percent of New Loans Credited Towards Goal)**



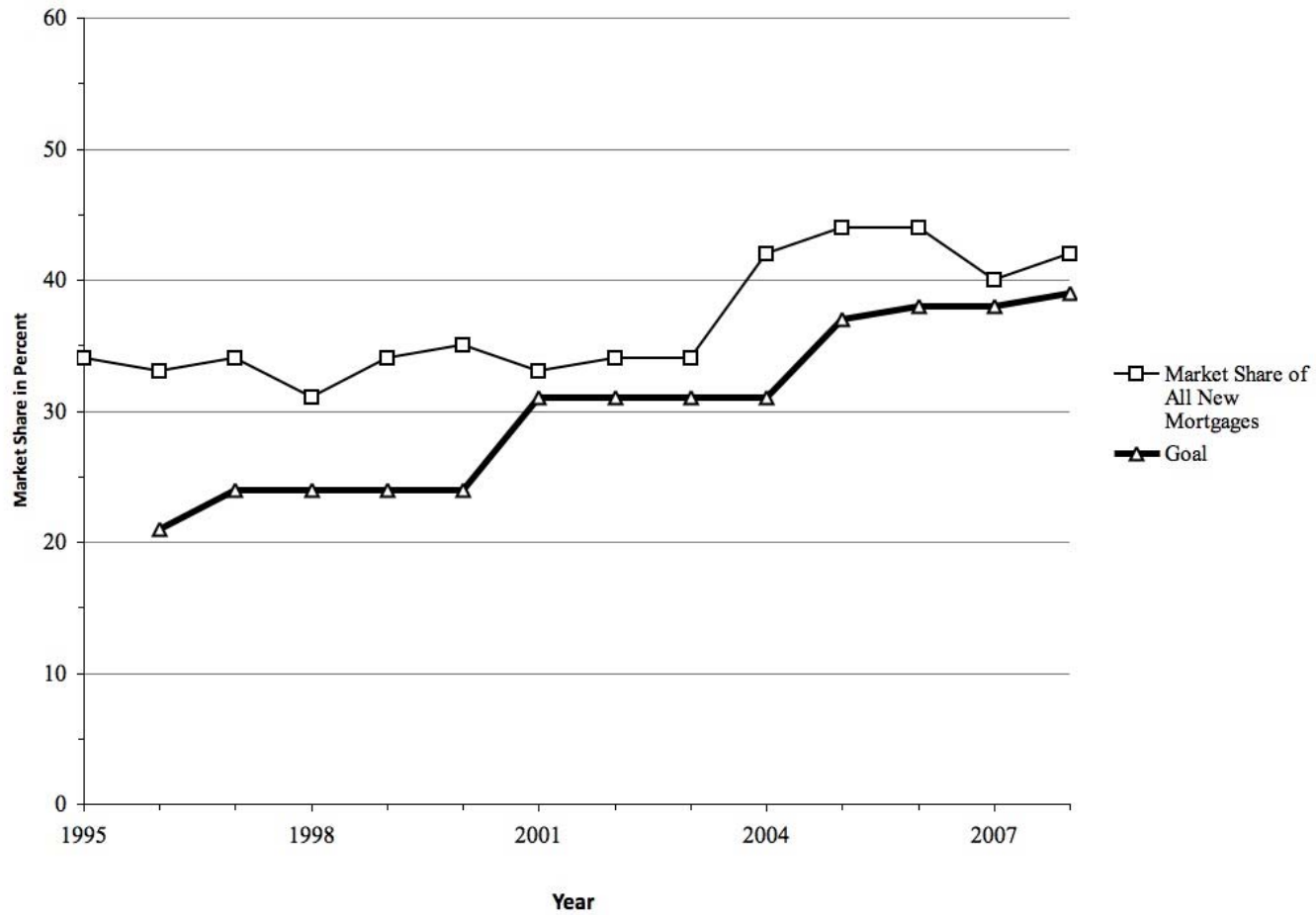
Source: U.S. Department of Housing and Urban Development, Office of Policy Development and Research. "Overview of the GSEs' Housing Goal Performance, 1993-2001", "Overview of the GSEs' Housing Goal Performance, 2000-2007."

**Figure 8**  
**GSE “Low-Moderate Income” Housing Goals and Market Shares, 1993-2008**



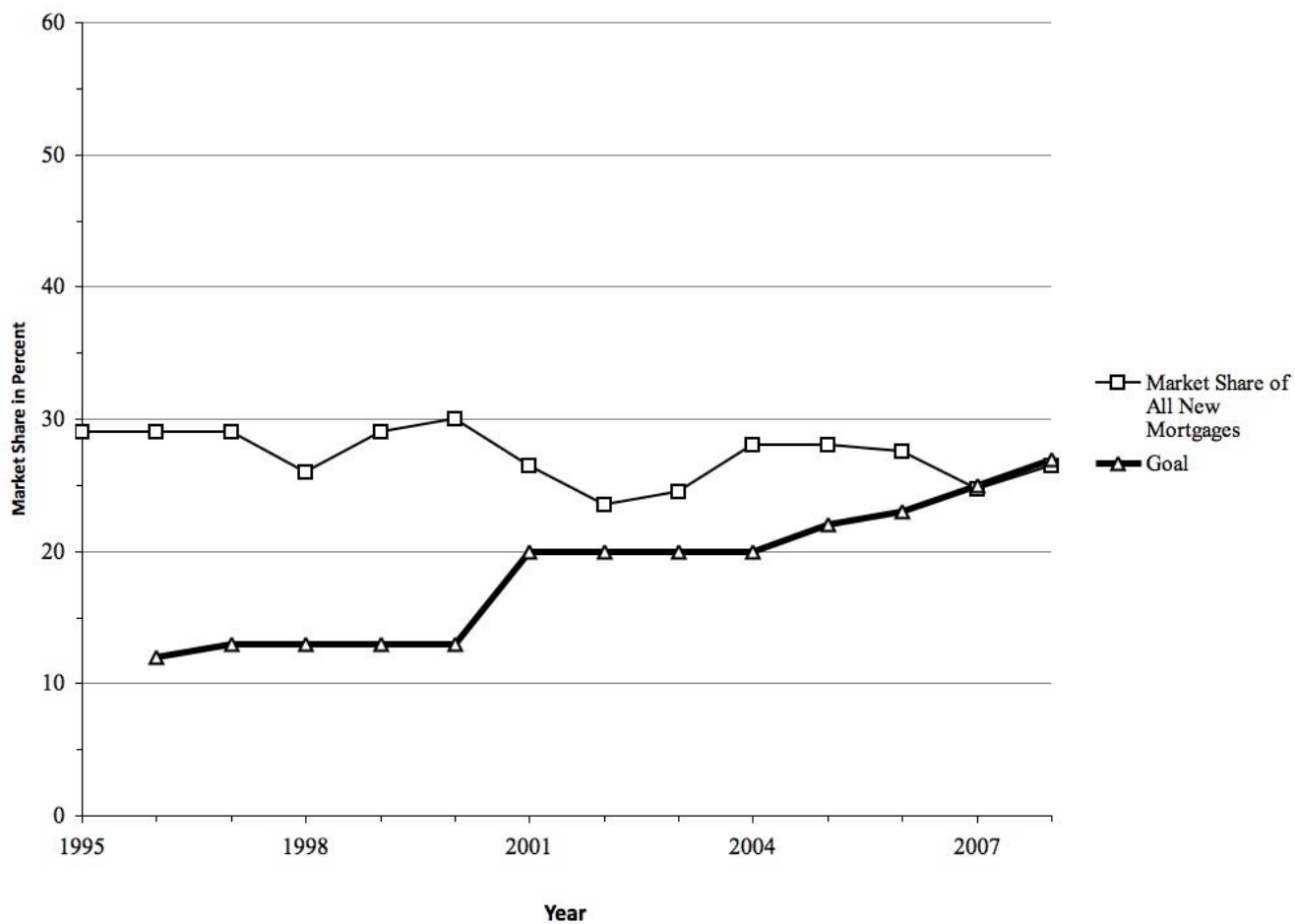
Source: Weicher, John C. "The Affordable Housing Goals, Homeownership and Risk: Some Lessons from Past Efforts to Regulate the GSEs", Conference on "The Past, Present, and Future of the Government-Sponsored Enterprises", Federal Bank of St. Louis.

**Figure 9**  
**GSE “Underserved Area” Housing Goals and Market Shares, 1993-2008**



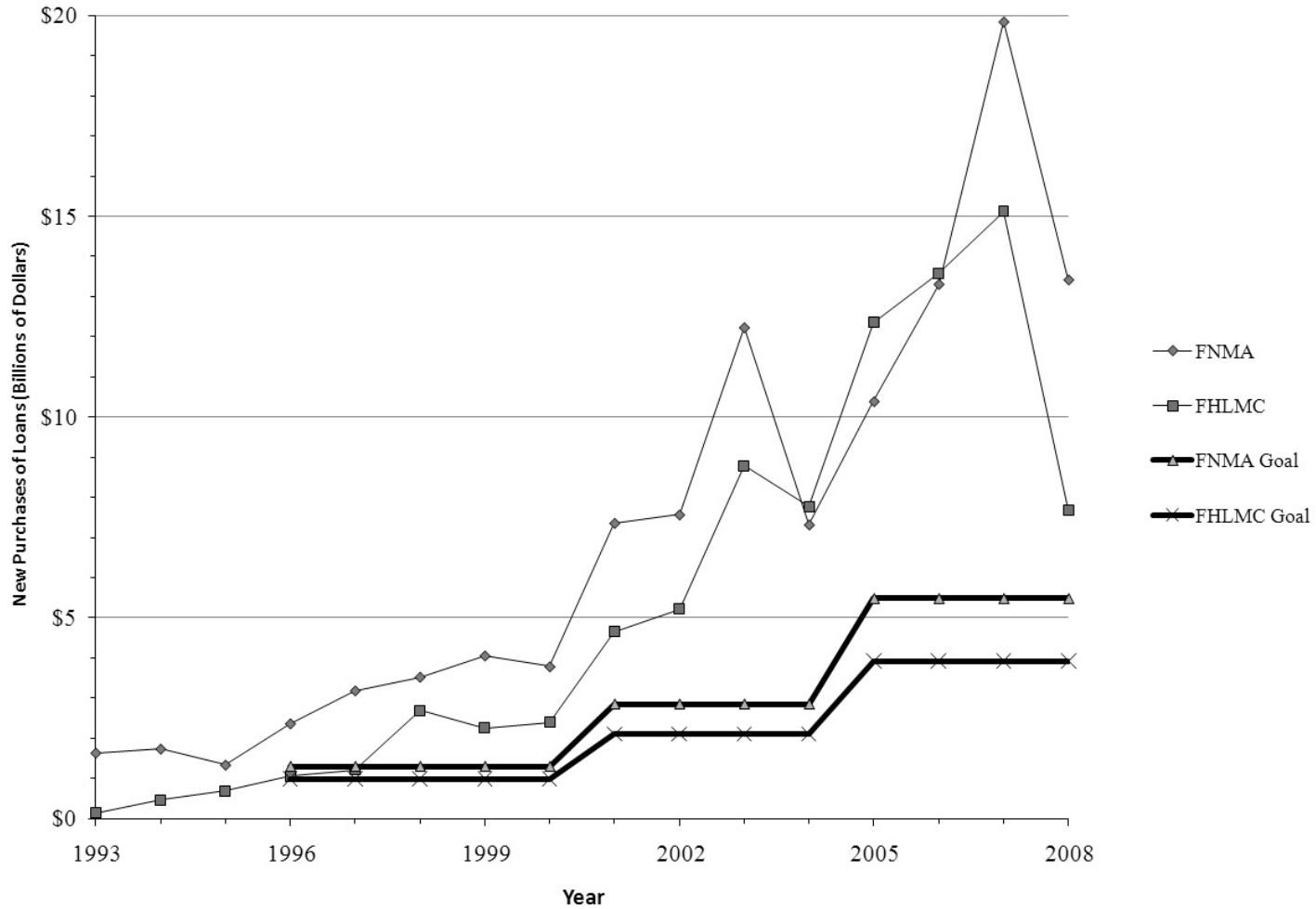
Source: Weicher, John C. "The Affordable Housing Goals, Homeownership and Risk: Some Lessons from Past Efforts to Regulate the GSEs", Conference on "The Past, Present, and Future of the Government-Sponsored Enterprises", Federal Bank of St. Louis.

**Figure 10**  
**GSE “Special Affordable” Housing Goals and Market Shares, 1993-2008**



Source: Weicher, John C. "The Affordable Housing Goals, Homeownership and Risk: Some Lessons from Past Efforts to Regulate the GSEs", Conference on "The Past, Present, and Future of the Government-Sponsored Enterprises", Federal Bank of St. Louis.

**Figure 11**  
**GSE “Special Affordable Multifamily” Housing Goals and GSE Purchases, 1993-2008\***



Source: U.S. Department of Housing and Urban Development, Office of Policy Development and Research. "Overview of the GSEs' Housing Goal Performance, 1993-2001", "Overview of the GSEs' Housing Goal Performance, 2000-2007."

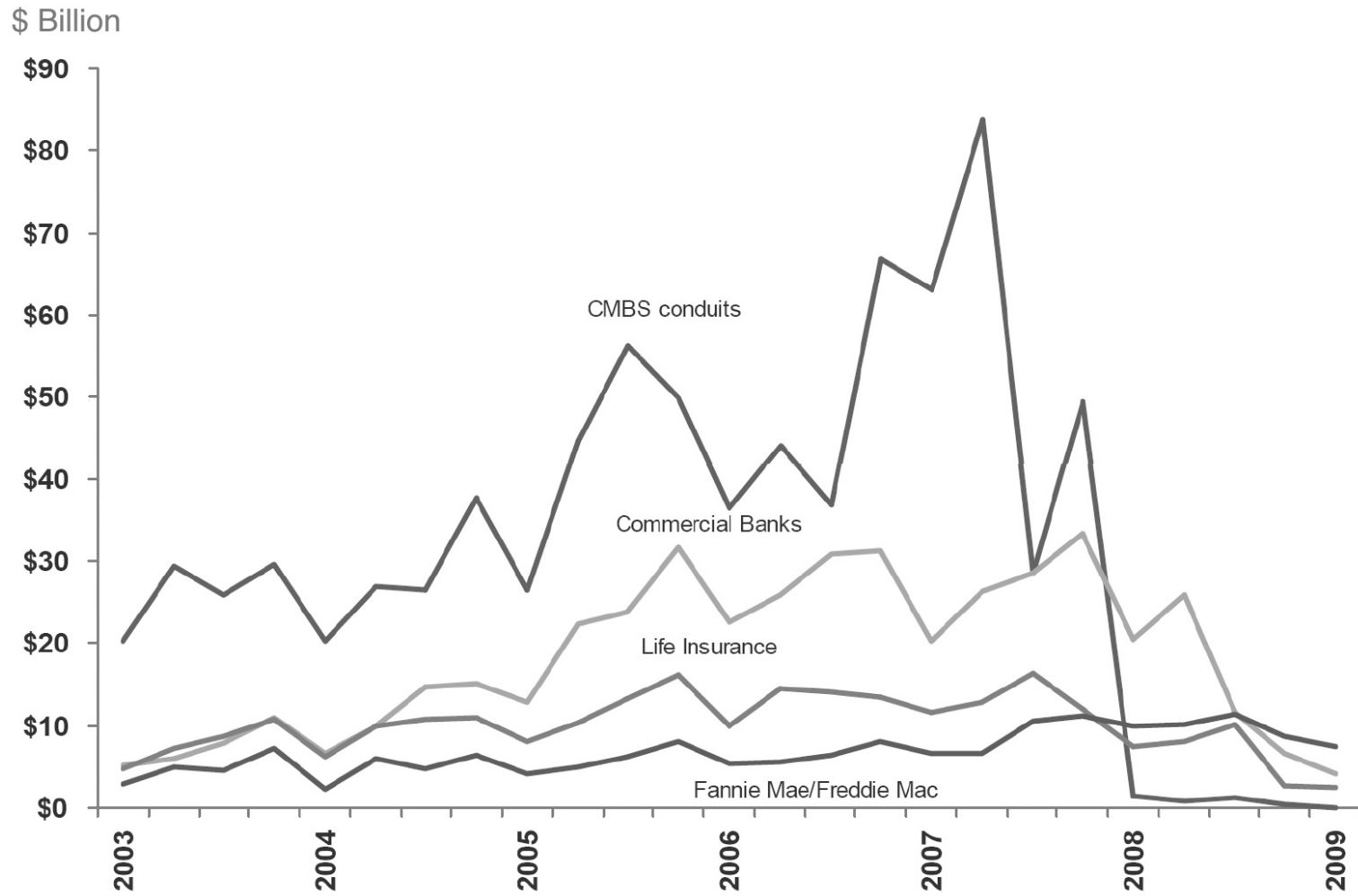
\* New loans to households residing in census tracts with incomes below the area median, in billions of dollars.

**Figure 12**  
**GSE Purchases of Multifamily Mortgages, 1985-2009**  
**(as a percent of all mortgages)**



Source: Federal Housing Finance Agency, Report to Congress 2009, Historical Data Tables; pp 125, 142.

**Figure 13**  
**Commercial and Multifamily Mortgage Bankers' Originations**  
**2004-2009**



Source: Mortgage Bankers Association, September 2009

**Appendix Table A1  
Homeownership and Social Outcomes**

<b>Author</b>	<b>Time Period</b>	<b>Data</b>	<b>Housing Outcome Observed</b>	<b>Comments</b>
Rossi and Weber (1996)	1988-1995	General Social Survey and the National Survey of Families and Households, supplemented by data from the American National Election Studies, by individual	Homeowners have slightly higher self-esteem, life satisfaction, and are more involved with community groups.	The effects of homeownership are not large and sometimes inconsistent. It is difficult to determine endogeneity.
Oswald (1996)	1960s - 1990	Statistical Abstract and Eurostat, by country	Homeownership reduces workers' mobility, thus causing them to stay unemployed longer. A ten percent increase in homeownership is associated with approximately a two percent increase in unemployment.	Small sample sizes makes the results unreliable.
Green and White (1997)	1980-1987	Panel Study of Income Dynamics (PSID), the Public Use Microsample of the 1980 Census of Population and Housing (PUMS), and High School and Beyond (HSB), by child	Adjusting for income and parental differences in the PSID data, children of owner-occupied homes have a predicted probability of completing high school of .91, compared to .82 for renters. The differential falls as income rises. In the PUMS, homeowner children had a .9 probability of being in school, compared to .83 for children of renters at the same age.	The HSB data comes from parents who completed high school. Probit models are used to account for selection bias due to differences between parents who own and rent. Also, using the lifetime earnings differential between a high school dropout and a high school graduate, the benefit of a government policy to encourage low income renters to own homes is estimated to be about \$31,000.



**Appendix Table A1  
Homeownership and Social Outcomes (continued)**

<b>Author</b>	<b>Time Period</b>	<b>Data</b>	<b>Housing Outcome Observed</b>	<b>Comments</b>
DiPasquale and Glaeser (1999)	1972-1994	General Social Survey, German Socio-Economic Panel, by individual	Controlling for age, race, sex, marital status, children, income, education, residential structure type, and city size, homeowners are roughly 10% more likely to know their US representative, 9% more likely to know the identity of their school board head, 15% more likely to vote in local elections, 6% more likely to work to solve local problems, than renters. Homeowners invest more in social capital and local amenities. Homeowners are better citizens.	Authors use the average homeownership rate of the individual's income quartile as an instrument for homeownership. They could not measure the extent of the positive externalities. They also found homeowners are less likely to move than renters. The cost of immobility is not calculated.
Aaronson (2000)	1975-1993	Panel Study of Income Dynamics, children aged 7 to 16	For the base case, where the child is white, male, lives in a household with married parents, two siblings, average income, and the head of household is a high school graduate, the probability of graduating from high school for children who live in owner occupied housing is 1.5% higher than renters. Latent family stability factors explain as least 20% of the homeownership effect.	Response to the Green and White paper. Argues that a child's school graduation does not depend on homeownership as much as it depends on the stability homeownership offers the child.
Green and Hendershott (2001)	1986-1992	Panel Survey of Income Dynamics, by individual	A ten-percentage point increase in homeownership increases unemployment by months. four percent increase	Response to Oswald paper. There are seasonal effects of unemployment and how quickly unemployed individuals find work. For example, in 1988, heads of households who became unemployed were reemployed significantly quicker in December than in other months.

**Appendix Table A1**  
**Homeownership and Social Outcomes (continued)**

<b>Author</b>	<b>Time Period</b>	<b>Data</b>	<b>Housing Outcome Observed</b>	<b>Comments</b>
Boyle (2002)	1983	Ontario Child Health Study, the National Longitudinal Study of Children and Youth, by child	The correlation between home ownership and child problem behavior was -0.18. The correlation between neighborhood homeownership rates and the incidence of child problems was not significant.	The study controlled for socioeconomic differences between owners and renters, but not for other parental characteristics like the physical, mental, and social health of the parents, which might have also affected the association between home ownership and child problem behavior.
Haurin, Parcel, and Haurin (2002)	1988, 1990, 1992, 1994	National Longitudinal Survey of Youth, children aged five to eight	The longer a parent owns a home, the greater the child's cognition skills and the fewer the child's behavior problems. The correlation between homeownership with "Behavior Problems Index" is -0.07.	The explanatory variables included both contemporaneous home ownership and duration of home ownership. (Controlling also for the mother's and father's characteristics separately education, wage, and race, as well as socioeconomic variables, for community factors like neighborhood characteristics.)
Conley and Gifford (2006)	1981-1994	Luxembourg Income Study, Comparative Welfare States Data Set, by country	Compared different countries and found that more widespread home ownership is positively associated with higher income inequality and negatively associated with welfare spending. A one percentage point increase in social insurance spending by the government results in 0.75 percentage point decrease in homeownership.	This study does not measure the causal directionality of homeownership, social insurance, and welfare.
Munch, Rosholm, and Svarer (2007)	1993-2001	Statistics Denmark administrative registers, by individual	Homeowners have a 29% lower unemployment risk than renters. Homeowners have a wage premium 5.37% higher than renters and owners set higher reservation wages for jobs outside the local labor market relative to renters.	Crude estimates.

**Appendix Table A1**  
**Homeownership and Social Outcomes (continued)**

<b>Author</b>	<b>Time Period</b>	<b>Data</b>	<b>Housing Outcome Observed</b>	<b>Comments</b>
Coulson and Li (2010)	1989, 1993	American Housing Survey, by cluster	Income increases with higher ownership rates, but the results are small and sometimes insignificant. The transition of a home from rental to ownership in a typical neighborhood creates \$1000-3000 per year in positive externality value.	Measured the units of observation by neighborhood cluster, which typically had 11 houses.