Written in 2009, this document was intended to summarize the mechanisms and institutions involved in home buying in America. It was prompted by the recent crisis in the financial markets, especially as relates to home foreclosures.

There are several entities discussed here:

- FHA
- Fannie Mae
- Ginnie Mae
- Freddie Mac
- Farmer Mac

Context—A History of Home Ownership, or How We Got Here

From 1900, when the census first started gathering data on home ownership, through 1940, fewer than half of all Americans owned their own homes. Home ownership rates actually fell in three of the first four decades of the 20th century.

The expansion of home ownership is not the story of virtue and hard work, grit and determination. Instead it is a result of government, financial regulation, and taxation. We are a nation of homeowners and home-speculators because of Uncle Sam.

Until the early 1900s having a mortgage came with a stigma as debt was proscribed. Because of that middle-class Americans rented. Mortgage lenders typically required 50% or more of the purchase price as a down payment, interest rates were high, and terms were short, usually just three to five years. This was true in 1929.

The banking crisis of the 1930s forced all lenders to retrieve due mortgages. Refinancing was not available, and many borrowers, now unemployed, were unable to make mortgage payments. Consequently, half of all mortgages were in default and many homes were foreclosed, causing the housing market to plummet. Banks collected the loan collateral (foreclosed homes) but the low property values resulted in a relative lack of assets. Because there was little faith in the backing of the U.S. government, few loans were issued and few new homes were purchased.

Government studies in the 1920s concluded a single-family home with a yard and a room for each child was the optimal condition for raising children. This would not only make better Americans, but it would help quell the spread of communism. Home ownership was felt to be good for the economy, good for the family, and makes the owner a better citizen. However, most Americans still could not afford a home of their own.

By the end of World War II housing starts had dropped from one million a year to fewer than 100,000 per year. Shortly thereafter the Baby Boom was underway, ultimately increasing demand for homes. William Levitt, government-guaranteed loans, and eager would-be homeowners combined in such a way as to birth the suburbs while gutting the inner cities.

Home ownership in 1950 was 55%, in 1960 it was 62%, and in 2005 it was 69%.

Until after World War II mortgages were made by depository institutions (like banks and savings and loans). After the war the demand for mortgages exceeded the ability of the banks to provide funds based on deposits. Enter securitized mortgages.

Federal Housing Administration (FHA)

Created as part of the National Housing Act of 1934.

Ownership. A United States government agency. In 1965, the Federal Housing Administration became part of the Department of Housing and Urban Development (HUD).

Scope. The goals of this organization are: to improve housing standards and conditions; to provide an adequate home financing system through insurance of mortgage loans; and to stabilize the mortgage market. Its intent was to regulate the rate of interest and the terms of mortgages that it insured. Ostensibly it was intended to help lower-income and first-time buyers purchase homes.

The FHA insures only a limited range of mortgages provided by FHA-approved lenders.

Effect. FHA increased home ownership from 40% in the 1930s to nearly 70% in 2001.

Federal National Mortgage Association (FNMA), commonly known as Fannie Mae

Created in 1938 by an amendment to the National Housing Act.

Ownership. Private stockholder-owned corporation, a government-sponsored enterprise (GSE). Fannie Mae stock is traded on the NYSE.

Scope. To purchase and securitize mortgages in order to ensure that funds are consistently available to the institutions that lend money to home buyers.

Chartered to support liquidity and stability in the secondary mortgage market, where mortgage loans are purchased and sold. The Company participates in the secondary mortgage market by purchasing mortgage loans and mortgage-related securities for its mortgage portfolio. It also makes other investments that increase the supply of affordable housing. The Company is organized in three business segments: Single-Family Credit Guaranty, Housing and Community Development (HCD), and Capital Markets.

History. From 1938 to 1968, Fannie Mae was the sole institution that bought mortgages from depository institutions, principally savings and loan associations, which encouraged more mortgage lending and effectively insured the value of mortgages by the US government. In 1968, Fannie Mae split into a private corporation and a publicly financed institution. The private corporation was still called Fannie Mae, and its charter continued to support the purchase of mortgages from savings and loan associations and other depository institutions, but without an explicit insurance policy that guaranteed the value of the mortgages. The publicly financed institution was named the Government National Mortgage Association (Ginnie Mae) and it explicitly guaranteed the repayments of securities backed by mortgages made to government employees or veterans (the mortgages themselves were also guaranteed by other government organizations). To provide competition for the newly private Fannie Mae and to further increase the availability of funds to finance mortgages and home ownership, Congress then established the Federal Home Loan Mortgage Corporation (Freddie Mac) as a private corporation through the Emergency Home Finance Act of 1970. The charter of Freddie Mac was essentially the same as Fannie Mae's newly private charter: to expand the secondary market for mortgages and mortgage backed securities by buying mortgages made by savings and loan associations and other depository institutions.

Website. http://www.fanniemae.com/

Federal Home Loan Mortgage Corporation (FHLMC), known as Freddie Mac

Created by the Emergency Home Finance Act of 1970.

Ownership. Private stockholder-owned corporation, a government-sponsored enterprise (GSE). Freddie Mac stock is traded on the NYSE.

Scope. To expand the secondary market for mortgages in the US. Along with other GSEs, Freddie Mac buys mortgages on the secondary market, pools them, and sells them as mortgage-backed securities to investors on the open market.

Freddie Mac is engaged in purchasing residential mortgages and mortgage-related securities in the secondary mortgage market and securitizing them into mortgage-related securities that can be sold to investors. The Company purchases single-family and multifamily mortgage-related securities for its mortgage-related investments portfolio. It also purchases multifamily residential mortgages in the secondary mortgage market and hold those loans either for investment or sale. Freddie Mac finances purchases of its mortgage-related securities and mortgage loans, and manages its interest-rate and other market risks, primarily by issuing a variety of debt instruments and entering into derivative contracts in the capital markets. The Company operates in three segments: Investments, Single-family Guarantee and Multifamily.

History. The Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") of 1991 revised and standardized the regulation of both Fannie Mae and Freddie Mac. Prior to this act, Freddie Mac was owned by the Federal Home Loan Bank System and governed by the Federal Home Loan Bank Board, which was reorganized into the Office of Thrift Supervision by the Act. The Act severed Freddie Mac's ties to the Federal Home Loan Bank System, created an 18-member board of directors, and subjected it to HUD oversight.

Website. http://www.freddiemac.com/

Government National Mortgage Association, aka Ginnie Mae

Created. Formed in 1968 as the public arm of Fannie Mae. The statutory authority of Ginnie Mae is derived from Title III of the National Housing Act, 12 U.S.C. 1716 et seq.

Ownership. It is a U.S. government-owned corporation within the Department of Housing and Urban Development (HUD).

Scope. It was created to explicitly guarantee the repayments of securities backed by mortgages made to government employees or veterans (the mortgages themselves were also guaranteed by other government organizations.

Ginnie Mae provides guarantees on mortgage-backed securities (MBS) backed by federally insured or guaranteed loans, mainly loans issued by the Federal Housing Administration, Department of Veterans Affairs, Rural Housing Service, and Office of Public and Indian Housing. Ginnie Mae securities are the only MBS that are guaranteed by the United States government.

GNMA securities provide a connection between the capital markets and mortgage borrowers; investors purchase mortgage-backed securities (MBS also called RMBS), and borrowers gain access to investor funds. Capital market funding through MBS is much more efficient and provides a much larger funding base than traditional deposit-funding (such as by banks and savings and loans). But there is a dark side, which became visible in 2008.

Website. http://www.ginniemae.gov/

Federal Agricultural Mortgage Corporation, also known as Farmer Mac

Created by the Agricultural Credit Act of 1987.

Ownership. Federally chartered, private stockholder-owned corporation. Its stock is traded on the NYSE.

Scope. As a secondary market in agricultural loans such as mortgages for agricultural real estate and rural housing. The company purchases loans from agricultural lenders, and sells instruments backed by those loans. The company also works with the United States Department of Agriculture.

Responsible for guaranteeing the timely repayment of principal and interest to investors in a new agricultural secondary market. The secondary market allows a lending institution to sell a qualified farm real estate loan to an agricultural mortgage marketing facility, or pooler, which packages these loans, and sells to investors securities that are backed by, or represent interests in, the pooled loans. Farmer Mac guarantees the timely repayment of principal and interest on these securities and, under authorities granted in 1995, can also serve as a loan pooler.

Website. http://www.farmermac.com/

Financing Schemes

Secondary Market

The secondary market, also known as the aftermarket, is the financial market where previously issued securities and financial instruments such as stock, bonds, options, and futures are bought and sold. The term “secondary market” is also used to refer to the market for any used goods or assets, or an alternative use for an existing product or asset where the customer base is the second market (for example, corn has been traditionally used primarily for food production and feedstock, but a second- or third- market has developed for use in ethanol production). Another commonly referred to usage of the secondary market term is to refer to loans which are sold by a mortgage bank to investors such as Fannie Mae and Freddie Mac.

With primary issuances of securities or financial instruments, or the primary market, investors purchase these securities directly from issuers such as corporations issuing shares in an IPO or private placement, or directly from the federal government in the case of treasuries. After the initial issuance, investors can purchase from other investors in the secondary market.

The secondary market for a variety of assets can vary from loans to stocks, from fragmented to centralized, and from illiquid to very liquid. The major stock exchanges are the most visible example of liquid secondary markets - in this case, for stocks of publicly traded companies. Exchanges such as the New York Stock Exchange, Nasdaq and the American Stock Exchange provide a centralized, liquid secondary market for the investors who own stocks that trade on those exchanges. Most bonds and structured products trade “over the counter,” or by phoning the bond desk of one’s broker-dealer. Loans sometimes trade online using a Loan Exchange.

Securitized Mortgages, aka Mortgage-Backed Securities

Securitization is a structured finance process that distributes risk by aggregating debt instruments in a pool, then issues new securities backed by the pool. The term “securitization” is derived from the fact that the form of financial instruments used to obtain funds from the investors are securities. As a portfolio risk backed by amortizing cash flows—and unlike general corporate debt—the credit quality of securitized debt is non-stationary due to changes in volatility that are time- and structure-dependent. If the transaction is properly structured and the pool performs as expected, the credit risk of all tranches of structured debt improves; if improperly structured, the affected tranches will experience dramatic credit deterioration and loss. All assets can be securitized so long as they are associated with cash flow. Hence, the securities which are the outcome of securitization processes are termed asset-backed securities (ABS). From this perspective, securitization could also be defined as a financial process leading to an issue of an ABS.

Securitization, in its most basic form, is a method of financing assets. Rather than selling those assets “whole,” the assets are combined into a pool, and then that pool is split into shares. Those shares are sold to investors who share the risk and reward of the performance of those assets. It can be viewed as being similar to a corporation selling, or “spinning off,” a profitable business unit into a separate entity. They trade their ownership of that unit, and all the profit and loss that might come in the future, for cash right now. A very basic example would be as follows. XYZ Bank loans 10 people $100,000 a piece, which they will use to buy homes. XYZ has invested in the success and/or failure of those 10 home buyers—if the buyers make their payments and pay off the loans, XYZ makes a profit. Looking at it another way, XYZ has taken the risk that some borrowers won't repay the loan. In exchange for taking that risk, the borrowers pay XYZ a premium in addition to the interest on the money they borrow.

Asset securitization began with the structured financing of mortgage pools in the 1970s. For decades before that, banks were essentially portfolio lenders; they held loans until they matured or were paid off. These loans were funded principally by deposits, and sometimes by debt, which was a direct obligation of the bank (rather than a claim on specific assets). But after World War II, depository institutions simply could not keep pace with the rising demand for housing credit.

In February 1970, the U.S. Department of Housing and Urban Development created the transaction (?) using a mortgage-backed security. The Government National Mortgage Association (GNMA or Ginnie Mae) sold securities backed by a portfolio of mortgage loans.

More Information

"The New American Dream: Renting" by Thomas J. Sugrue, published in the Wall Street Journal on August 14, 2009.
http://online.wsj.com/article/SB10001424052970204409904574350432677038184.html?mod=rss_Today%27s_Most_Popular

De-regulation

Glass-Steagall Act

The Glass-Steagall Act of 1933 established the Federal Deposit Insurance Corporation (FDIC) in the United States and included banking reforms, some of which were designed to control speculation and prohibit a bank from owning other financial institutions which would create a conflict of interest, such as investment banks and insurance companies.

The reason banks were giving out such risky loans is that they were able to securitize them and sell them as mortgage-backed securities and other collateralized debt obligations to investors. With the ability to both create loans and then underwrite, securitize and sell mortgage backed instruments under one roof, it is easy for banks to create a ponzi-like scheme

Some provisions such as Regulation Q, which allowed the Federal Reserve to regulate interest rates in savings accounts, were repealed by the Depository Institutions Deregulation and Monetary Control Act of 1980. Provisions that prohibit a bank holding company from owning other financial companies were repealed on November 12, 1999, by the Gramm-Leach-Bliley Act (signed by Bill Clinton).