NEED TO KNOW

AMERICANS FOR PROSPERITY FOUNDATION

GOVERNMENT SPONSORED ENTERPRISES: FANNIE MAE AND FREDDIE MAC

A Government Sponsored Enterprise (GSE) is a private company created by congressional charter. Although they are technically considered "private," they enjoy numerous implied and legal privileges that give them advantages against the rest of the market. The two most well- known (and infamous) GSEs are the Federal National Mortgage Association, known as Fannie Mae, and the Federal Home Loan Mortgage Corporation, known as Freddie Mac. A less well-known GSE is the Government National Mortgage Association, known as Ginnie Mae.

THE GSES AND THE HOUSING MARKET

In a free market, when a bank makes a home loan to an individual, the bank takes a calculated risk that the individual will pay back the loan with interest. Under these conditions, banks have an incentive to balance the risk of their investment against their desire for profits.

However, Fannie Mae and Freddie Mac fundamentally alter these traditional market-based conditions and incentives. The two mortgage giants purchase mortgages from banks, bundle those loans into large packages or mortgages called mortgage backed securities (MBS), and then sell the MBS off to investors, other banks, and even governments. This process allows the banks to free up their resources to engage in even more mortgage lending, increasing the overall supply of credit for housing.

To help Fannie Mae and Freddie Mac fulfill their business model, Congress also grants them special legal and regulatory privileges. One example is the requirement to hold only a 2.5% capital buffer while the rest of the market has to hold a 4% capital buffer. Prior to 2008, Fannie Mar and Freddie Mac also held an implicit guarantee against failure from Congress: should they face losses that were too high, the market generally understood that the federal government would use taxpayer money to bail them out. That implied guarantee became an actual guarantee when the federal government took them over in 2008.

HOW THE GSES CONTRIBUTED TO THE FINANCIAL CRISIS

From 1995 to 2006, housing prices rose every single month, seemingly assuring investors that housing was a safe bet (2). But behind at least some of that remarkable rise in prices were Fannie Mae and Freddie Mac. By buying up and guaranteeing home loans with implicit subsidies from American taxpayers, they helped make housing an over-heated investment.

In 2001, the GSEs (including Ginnie Mae) issued 75% of all MBS. By 2007, Fannie Mae and Freddie Mac held or guaranteed over $5 trillion in home loans (3). When it became clear that the housing market was an artificial bubble propped up by risky loans ("subprime lending") and government subsidies—largely because of the government's interventions through Fannie Mae and Freddie Mac—in 2008 the housing bubble burst. Homeowners across the country defaulted on their home loans at much higher rates than expected. Banks that invested heavily in housing faced huge losses, spurring the financial crisis of 2008.

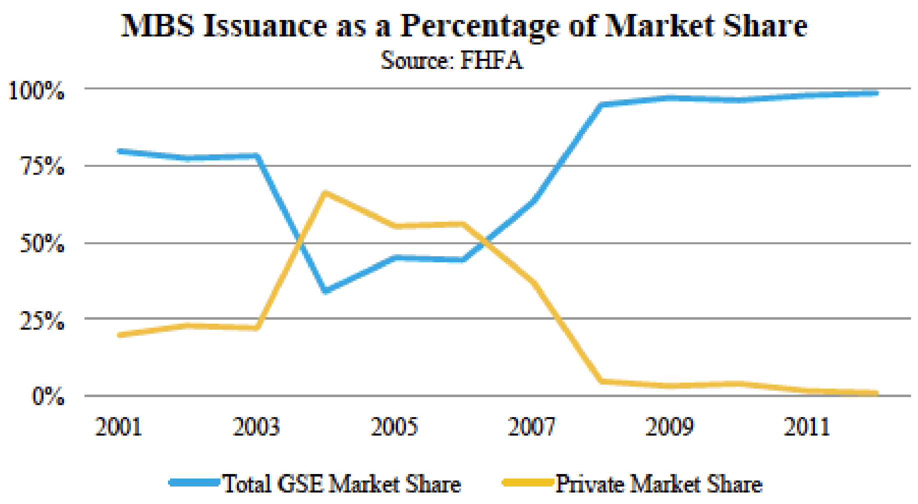
QUICK FACTS

- Fannie Mae and Freddie Mac were instrumental in causing the 2008 financial bubble, due to their distorting effects on the housing market.

NOTABLE & QUOTABLE

"Fannie and Freddie's increases in loan purchases, especially loans to low-income borrowers, helped inflate the housing bubble. That bubble in turn made the subprime market more attractive and profitable to lenders. It also set the stage for the collapse."

- **Russ Roberts** (1)



In September of 2008, President George W. Bush enacted a bailout package for Fannie and Freddie under the justification that they were "too big to fail." The GSE's new regulator, the Federal Housing Finance Agency (FHFA), placed them into conservatorship, effectively nationalizing them. Since 2008, Fannie Mae and Freddie Mac have received $187 billion in bailout funds from the Treasury Department, all at taxpayer expense (4).

Under government conservatorship, Fannie Mae and Freddie Mac continue to utilize their legal and regulatory advantages to crowd out private sector participation in the housing market. The federal government has, in fact, relied on the two mortgage giants in hopes that they could help the housing market recover. By the first quarter of 2012, 99% of all MBS were issued by the three GSEs combined (5).

CONCLUSION

The GSEs are just another form of government intervention in the housing market that distorts the economy more than it helps. Under a charter from Congress, Fannie Mae and Freddie Mac created an artificial supply for mortgage lending, bundled those mortgages into securities, and then spread the risky pools of loans they represented throughout the investment market. In the end, taxpayers have been left to pay the bill.

Endnotes:
1. Russ Roberts, Gambling with Other People's Money, Mercatus Center (May 2010) (online at http://mercatus.org/sites/default/files/publication/RUSS-final.pdf)
2. Viral Acharya, Matthew Richardson, Stijn Van Nieuwerburgh, and Lawrence White, Guaranteed to Fail: Fannie Mae, Freddie Mac and the Debacle of Mortgage Finance, at 33 (Princeton University Press, 2011)
3. James R. Barth et al., The Rise and Fall of the U.S. Mortgage and Credit Markets, Milken Institute (January 2009) (online at http://www.milkeninstitute.org/pdf/Riseandfallexcerpt.pdf)
4. Federal Housing Finance Agency, Conservator's Report on the Enterprises' Financial Performance: First Quarter 2012 (online at http://eee.fhfa.gov/webfiles/24016/Conservator'sReport1Q2012061512_FINAL.pdf).
5. Ibid.

Americans for Prosperity Foundation's "Need to Know" informational series explores current events and recent scholarship on public policy isues from a free-market economics perspective. A full list of "Need to Know" briefings is available at www.AmericansForProsperityFoundation.org/NeetToKnow.