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Report to Congressional Committees

September 2009

FANNIE MAE AND FREDDIE MAC

Analysis of Options for Revising the Housing Enterprises' Long-term Structures

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Highlights

Highlights of GAO-09-782, a report to congressional committees

Why GAO Did This Study

Congress established Fannie Mae and Freddie Mac (the enterprises) with two key housing missions: (1) provide stability in the secondary market for residential mortgages (also in periods of economic stress) and (2) serve the mortgage credit needs of targeted groups such as low-income borrowers. To accomplish these goals, the enterprises issued debt and stock, purchased mortgages from lenders with the proceeds, and retained them in portfolio or pooled them into mortgage-backed securities (MBS) sold to investors. On September 6, 2008, the Federal Housing Finance Agency (FHFA) placed the enterprises into conservatorship out of concern that their deteriorating financial condition ($5.4 trillion in outstanding obligations) would destabilize the financial system. With estimates that the conservatorship will cost taxpayers nearly $400 billion, GAO initiated this report under the Comptroller General's authority to help inform the forthcoming congressional debate on the enterprises' future structures. It discusses the enterprises' performance in meeting mission requirements, identifies and analyzes options to revise their structures, and discusses key transition issues.

GAO reviewed studies and data, and interviewed housing finance experts and officials from the enterprises, FHFA, Departments of the Treasury (Treasury) and Housing and Urban Development (HUD), the Federal Reserve, lenders, and community groups.

View GAO-09-782 or key components.
For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

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What GAO Found

The enterprises have a mixed record in meeting their housing mission objectives, and both capital and risk management deficiencies have compromised their safety and soundness as follows:

- The enterprises' secondary market activities are credited with helping create a liquid national mortgage market, lowering mortgage rates somewhat, and standardizing mortgage underwriting processes. However, their capacity to support housing finance during periods of economic stress has not been established, and they only have been able to do so during the current recession with substantial financial assistance from Treasury and the Federal Reserve.
- There is limited evidence that a program established in 1992 that required the enterprises to meet annual goals for purchasing mortgages serving targeted groups materially benefited such groups.
- The enterprises' structures (for-profit corporations with government sponsorship) undermined market discipline and provided them with incentives to engage in potentially profitable business practices that were risky and not necessarily supportive of their public missions. For example, the enterprises' retained mortgage portfolios are complex to manage and expose them to losses resulting from changes in interest rates. Further, the enterprises' substantial investments in assets collateralized by subprime and other questionable mortgages in recent years generated losses that likely precipitated the conservatorship.

It will be necessary for Congress to reevaluate the roles, structures, and performance of the enterprises, and to consider options to facilitate mortgage finance while mitigating safety and soundness and systemic risk concerns. These options generally fall along a continuum with some overlap in key areas:

- *Reconstitute the enterprises as for-profit corporations with government sponsorship but place additional restrictions on them.* While restoring the enterprises to their previous status, this option would add controls to minimize risk. As examples, it would eliminate or reduce mortgage portfolios, establish executive compensation limits, or convert the enterprises from shareholder-owned corporations to associations owned by lenders.
- *Establish the enterprises as government corporations or agencies.* Under this option, the enterprises would focus on purchasing qualifying mortgages and issuing MBS but eliminate their mortgage portfolios. The Federal Housing Administration (FHA), which insures mortgages for low-income and first-time borrowers, could assume additional responsibilities for promoting homeownership for targeted groups.
- *Privatize or terminate them.* This option would abolish the enterprises in their current form and disperse mortgage lending and risk management throughout the private sector. Some proposals involve the establishment of a federal mortgage insurer to help protect mortgage lenders against catastrophic mortgage losses.

GAO provides a framework for identifying trade-offs associated with the options and identifies potential regulatory and oversight structures, principles, and actions that could help ensure their effective implementation (see table).

Summary of Implications of the Options to Revise the Enterprises' Structures

	Reestablish as government-sponsored enterprises (GSE)	Establish government corporation or agency	Privatize or terminate
Ability to provide liquidity and support to mortgage markets	Reconstituting the enterprises as GSEs may provide liquidity and other benefits to mortgage finance during normal economic times. However, as for-profit entities, their capacity to support housing finance during stressful economic periods is open to question.	A government entity, with access to Treasury-issued debt, may be positioned to provide mortgage liquidity during normal and stressful economic periods. But, without a portfolio to hold mortgages, its capacity to do the latter also may be limited. Treasury or the Federal Reserve may need to step in and purchase mortgage assets under such circumstances.	If other financial institutions assumed key enterprise activities such as mortgage purchases and MBS issuance, liquid mortgage markets could be reestablished in normal economic times. But, private mortgage lending has collapsed in the current recession. A federal mortgage insurer could help ensure that private lenders provide mortgage funding in stressful economic periods.
Support housing opportunities for targeted groups	For-profit status and elimination of mortgage portfolios could limit enterprises' capacity to fulfill this objective. But, permitting smaller mortgage portfolios, expanding FHA programs, or providing direct financial assistance to targeted borrowers could be alternatives.	Might be expected to perform this function as a public entity. But, may face challenges implementing a program to purchase mortgages for such groups if they cannot hold these mortgages in portfolio. FHA insurance programs could be expanded as an alternative.	Would eliminate traditional basis (government sponsorship) for previous programs that required enterprises to serve mortgage credit needs of targeted groups. But, a federal mortgage insurer could be required to establish such programs due to its government sponsorship.
Potential safety and soundness concerns	Although additional regulations could minimize risks, safety and soundness concerns may remain as this option would preserve the enterprises' previous status as for-profit corporations with government sponsorship.	May mitigate risk due to lack of profit motive and the elimination of existing mortgage portfolios. However, managing the enterprises' ongoing MBS business still would be complex and risky, and a government entity may lack the staffing and technology to do so effectively.	In one scenario, risks would decrease as mortgage lending would be dispersed among many institutions. But, large institutions that assumed functions such as MBS issuance may be viewed as too big to fail, which could increase risks. A federal mortgage insurer also may not charge premiums that reflect its risks.
Key elements for potential regulatory and oversight structure	Reduce or perhaps eliminate the enterprises' mortgage portfolios, increase capital standards and impose regulations, such as executive compensation limits, and establish new ownership structures, as appropriate. Require financial disclosures to help ensure transparency and provide congressional oversight of the enterprises' and FHFA's performance.	Provide entity with flexibility to hire staff and obtain necessary technology. Establish risk-sharing arrangements with the private sector, appropriate disclosures of risks and liabilities in the federal budget to help ensure transparency, and robust congressional oversight of operations.	Fragmented U.S. financial regulatory structure would need to be revised, as GAO has identified in previous reports, to help oversee risks of large institutions that may assume enterprise functions or acquire their assets. Oversight structure for a federal mortgage insurer also would need to be established.

Source: GAO analysis of structural reform options.

During the conservatorship, the federal government has tasked the enterprises to implement a variety of programs designed to help respond to the current housing crisis, such as helping borrowers forestall foreclosures. While these efforts may be necessary to help mitigate the effects of the housing crisis, they also might significantly affect the costs of the conservatorship and transition to a new structure. For example, investors might be unwilling to invest capital in reconstituted enterprises unless Treasury assumed responsibility for losses incurred during their conservatorship. Finally, any transition to a new structure would need to consider the enterprises' still-dominant position in housing finance and be implemented carefully (perhaps in phases) to ensure its success.

In written comments, FHFA stated that the report is timely and does a good job summarizing the dominant proposals for restructuring the enterprises and some of their strengths and weaknesses. FHFA also offered key questions and principles for guiding initial decisions that will have to be made about the future of the mortgage market.

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Abbreviations

CBO	Congressional Budget Office
CDBG	Community Development Block Grant
CRS	Congressional Research Service
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FHFB	Federal Housing Finance Board
FHLBank System	Federal Home Loan Bank System
Ginnie Mae	Government National Mortgage Association
GSE	government-sponsored enterprise
HAMP	Home Affordable Modification Plan
HARP	Home Affordable Refinance Program
HERA	Housing and Economic Recovery Act of 2008
HUD	Department of Housing and Urban Development
LIHTC	Low-Income Housing Tax Credit
MBS	mortgage-backed securities
OCC	Office of the Comptroller of the Currency
OFHEO	Office of Federal Housing Enterprise Oversight
OTS	Office of Thrift Supervision
PC	participation certificate
PIH	HUD's Office of Public and Indian Housing
SIFMA	Securities Industry and Financial Markets Association
USDA/RD	Department of Agriculture's Rural Development Housing and Community Facilities Programs
VA	Department of Veterans Affairs

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United States Government Accountability Office
Washington, DC 20548

September 10, 2009

Congressional Committees

On September 6, 2008, the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac into conservatorship out of concern that the deteriorating financial condition of the two government-sponsored enterprises (GSE or enterprise) threatened the stability of financial markets.[1] According to FHFA's former Director, James B. Lockhart III, at the time the conservatorships were established, Fannie Mae and Freddie Mac had worldwide debt and other financial obligations totaling $5.4 trillion, and their default on those obligations would have significantly disrupted the U.S. financial system.[2] The Department of the Treasury (Treasury) has agreed to provide substantial financial support to the enterprises so that they can continue to support mortgage finance during the current financial crisis.[3] As of June 30, 2009, Treasury had provided about $85 billion in funds to support the enterprises. The Congressional Budget Office (CBO) has estimated that the total cost of the conservatorships to taxpayers will be $389 billion.[4] The Board of Governors of the Federal Reserve System (Federal Reserve) also has committed to a variety of activities, including purchasing substantial amounts of the enterprises' debt and securities, to support housing finance, housing markets, and the financial markets more generally.[5] While

[1]The Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 (July 30, 2008), established FHFA, which is responsible for the safety and soundness and housing mission oversight of Fannie Mae, Freddie Mac, and the other housing government-sponsored enterprise, the Federal Home Loan Bank System.

[2]Lockhart announced his resignation on August 6, 2009, and left FHFA on August 28, 2009.

[3]On September 7, 2008, Treasury agreed to provide up to $100 billion in financial support to each enterprise through the purchase of their preferred stock so that the enterprises maintain a positive net worth. In February 2009, Treasury agreed to increase this commitment to $200 billion per enterprise. Treasury also agreed to purchase the enterprises' mortgage-backed securities and establish a lending facility to meet their borrowing requirements if needed.

[4]The CBO figure is based on its March 2009 estimate that the market value of the enterprises' liabilities exceeded their assets by about $290 billion in 2008–2009 (their existing business) and $99 billion in estimated federal subsidy costs for their activities between 2010–2019. This estimate can change from one reporting period to the next due to fluctuations in market values.

[5]These Federal Reserve activities are described in more detail later in this report.

the conservatorships can remain in place indefinitely as efforts are undertaken to stabilize the enterprises and restore confidence in financial markets, FHFA has said that the conservatorships were not intended to be permanent. Over the longer term, Congress and the Executive Branch will face difficult decisions on how to restructure the enterprises and promote housing opportunities while limiting risks to taxpayers and the stability of financial markets.

Congress originally established Fannie Mae and Freddie Mac as government entities in 1968 and 1989, respectively, chartering them as for-profit, shareholder-owned corporations.[6] They share a primary mission that has been to stabilize and assist the U.S. secondary mortgage market and facilitate the flow of mortgage credit. To accomplish this goal, the enterprises issued debt and stock and used the proceeds to purchase conventional mortgages that met their underwriting standards, known as conforming mortgages, from primary mortgage lenders such as banks or thrifts.[7] In turn, banks and thrifts used the proceeds to originate additional mortgages. The enterprises held some of the mortgages that they purchased in their portfolios. However, most of the mortgages were packaged into mortgage-backed securities (MBS), which were sold to investors in the secondary mortgage market.[8] In exchange for a fee (the guarantee fee) the enterprises guaranteed the timely payment of interest and principal on MBS that they issued. The charter requirements for providing assistance to the secondary mortgage markets specify that those markets are to include mortgages on residences for low- and moderate-income families. In 1992, Congress instituted authority for requiring the enterprises to meet numeric goals set by the Department of Housing and

[6]Congress initially chartered Fannie Mae in 1938 but did not establish it as a shareholder-owed corporation until 1968. Congress initially established Freddie Mac in 1970 as an entity within the FHLBank System and reestablished it as a shareholder-owned corporation in 1989.

[7]For example, the enterprises typically purchased mortgages with loan-to-value ratios of 80 percent or less (mortgages with down payments of at least 20 percent) and required private mortgage insurance on mortgages with higher loan-to-value ratios. The enterprises also had a limit, known as the conforming loan limit, on the size of mortgages purchased by the enterprises. Mortgages above this limit are called jumbo mortgages. The conforming conventional market differs from other markets, such as the subprime market, which generally have differing underwriting standards, or markets where mortgages are insured or guaranteed by the federal government, such as through programs that the Federal Housing Administration or the Department of Veterans Affairs administers.

[8]Each enterprise's portfolio also includes MBS that it issued.

Urban Development (HUD) on a yearly basis for the purchase of single- and multifamily conventional mortgages that serve targeted groups.[9]

While the enterprises operated profitably for many years, their structures long have been in question. For example, critics questioned the extent to which private for-profit corporations could be expected to serve a federally mandated housing mission. Furthermore, critics stated that the federal government's sponsorship conveyed certain financial and other advantages to the enterprises that encouraged them to engage in riskier activities than otherwise would be the case.[10] In particular, despite the federal government explicitly not guaranteeing the enterprises' debt and MBS or including them in the federal budget, there was an assumption in financial markets of an "implied" federal guarantee, which enabled the enterprises to borrow at lower rates than other for-profit corporations.[11] Critics argued that this implicit government guarantee and access to less costly credit created a moral hazard. That is, it encouraged the enterprises to assume greater risks and hold less capital than would have been the case in the absence of such a guarantee.

According to former Treasury Secretary Henry M. Paulson, Jr., the FHFA conservatorships provide an opportunity for Congress to reconsider the nature and structure of the enterprises and make revisions to better ensure their safety and soundness as they participate in efforts to stabilize the mortgage markets. Researchers and research institutes, financial commenters and market participants, and others have made a variety of proposals about the future structure of Fannie Mae and Freddie Mac, both before and after the establishment of the FHFA conservatorships. Some proposals call for converting the enterprises into government entities while others advocate privatization or termination. While there is no consensus on what the next steps should be, whatever actions Congress takes will have profound impacts on the structure of the U.S. housing finance system.

[9]Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub. L. No. 102-550, title XIII; see 12 U.S.C. §§ 4561-4564. HERA transferred HUD's authorities and responsibilities for the goals to FHFA (§§ 1122, 1128).

[10]The enterprises' charters convey certain other benefits, such as exemptions from state and local income taxes.

[11]Each enterprise's charter act specifies that its debt obligations and MBS are to clearly indicate that they are not guaranteed by the United States and do not constitute a debt or obligation of the United States or any U.S. agency or instrumentality other than the enterprise itself. 12 U.S.C. § 1719(b), (d) (Fannie Mae); 12 U.S.C. § 1455(h) (Freddie Mac).

We initiated this review under the Comptroller General's authority to provide Congress with information on the roles, benefits, and risks associated with the enterprises' activities in housing finance over the years and to help inform the forthcoming deliberation on their future structure. Specifically, this report (1) discusses how the enterprises' roles, structures, and activities have changed over time and their performance in achieving key housing mission objectives; (2) identifies various options for revising the enterprises' eventual structure; (3) analyzes these options in terms of their potential capacity to achieve key housing mission and safety and soundness objectives; and (4) discusses how the federal government's management of the conservatorships and response to the housing crisis could affect any transition.

To meet our objectives, we reviewed reports, studies, and data on the enterprises and their regulation, including our reports, as well as proposals to revise their structures. We also met with researchers who wrote relevant reports or were knowledgeable on enterprise-related issues and with representatives from FHFA, Treasury, the Federal Reserve, HUD, the Government National Mortgage Association (Ginnie Mae), CBO, the enterprises, banking and mortgage organizations, the National Association of Home Builders, and community groups. Through such research and interviews, we sought to identify (1) key housing mission, safety and soundness, and other objectives that have been associated with the enterprises over the years; (2) options to reform the enterprises' structures and how they would affect these objectives; and (3) principles associated with effective regulatory oversight structures. While it is not possible to conclusively determine the potential implications of the various proposals, we grounded our analysis of likely outcomes on previous research and evaluations. We also sought to include, where appropriate, assessments of how recent developments in financial markets, particularly actions by federal agencies to provide financial support to troubled banks and other institutions, could affect the operations of the various options. We recognize that a variety of factors could change over time, such as the condition of credit markets and the financial performance of the enterprises while in conservatorship, which could affect our analysis of the options. A more detailed analysis of our objectives, scope, and methodology is included in appendix I.

We conducted this performance audit from October 2008 to September 2009, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

The enterprises constitute one component of a range of federal initiatives that, since the 1930s, have facilitated the availability of mortgage credit and housing opportunities (see table 1). While these initiatives may involve differing missions, structures, and activities, they generally rely on federal support and subsidies to achieve their objectives. In some cases, these initiatives—such as the Federal Home Loan Bank System (FHLBank System), the enterprises' general mortgage support activities, federal tax deductions for mortgage interest, and exemptions for capital gains—apply broadly and are designed generally to facilitate mortgage lending and homeownership. In other cases, the initiatives have been designed to facilitate home ownership and housing opportunities for targeted populations and groups. For example, programs administered by the Federal Housing Administration (FHA), Department of Veterans Affairs (VA), Department of Agriculture's Rural Development Housing and Community Facilities Programs (USDA/RD), and HUD's Office of Public and Indian Housing (PIH) are designed to facilitate homeownership and housing opportunities for moderate- and low-income persons, as well as first-time buyers, veterans, residents of rural areas, and Native Americans, respectively. In some cases, these federal housing initiatives also target similar populations and borrowers. For example, through their general business activities and affordable housing goal requirements, the enterprises, like FHA, provide mortgage credit to low-income borrowers and other targeted groups.

Table 1: Federal Initiatives Designed to Facilitate the Availability of Home Mortgage Credit and Housing Opportunities

Entities that operate in the primary mortgage market	Purpose
FHLBank System (GSE)	Established in 1932 by Congress as a GSE to support mortgage lending and related community investment. The 12 FHLBanks borrow funds in debt markets and provide their members low-cost, long- and short-term advances (loans), which members use to fund mortgage loans and maintain liquidity for their operations. Advances are primarily collateralized by residential mortgage loans and government and agency securities. Advances are priced at a small spread over comparable Treasury obligations.
FHA (government agency in HUD)	Congress created FHA under the National Housing Act of 1934 to expand opportunities for homeownership. FHA provides mortgage insurance on loans made by private lenders. Located in HUD since 1965, FHA's loans generally are for low-income, first-time homebuyers and minorities. FHA is legislatively constrained by the dollar amount of loans it can insure.
VA (federal agency)	VA guarantees housing loans for veterans and their families. VA does not impose a maximum loan amount that may be guaranteed. However, for certain high-cost counties, county "limits" must be used to calculate VA's maximum guarantee amount. Unlike FHA, VA guarantees only a portion of the loan.
USDA/RD Housing and Community Facilities Programs—Loan Guarantee Program	USDA/RD guarantees loans for moderate-income individuals or households to purchase homes in rural areas.
Entities that operate in the secondary mortgage market	
Fannie Mae and Freddie Mac (GSEs)	The GSEs guarantee investors in their securities that they will receive their expected principal and interest payments. Fannie Mae and Freddie Mac have similar federal charters. The loans they purchase are required to be under the legislative conforming limit (currently at $417,000, except for high-cost areas that have a limit of $729,750). They also are required to meet affordable housing goals for both single- and multifamily housing.
Ginnie Mae (government corporation in HUD)	It guarantees securities backed by pools of FHA-, VA-, USDA/RD-, and PIH- insured or guaranteed mortgages. Specifically, Ginnie Mae guarantees that investors in MBS issued by lenders will receive timely principal and interest payments. Ginnie Mae guaranteed MBS have the full faith and credit of the federal government.
Direct outlays	
HUD programs, such as HOME, Community Development Block Grant (CDBG), Section 8 rental assistance, and HOPE VI assistance	HOME and CDBG provide grants to state or local governments with a flexible funding source to meet their diverse affordable housing needs. Section 8 subsidizes rents for low-income residents and HOPE VI is used to rebuild or rehabilitate public housing.
USDA/RD Housing and Community Facilities Programs	USDA/RD makes direct, low-interest loans with no down payments to help low- and moderate-income individuals or households purchase homes and also operates a rental assistance program.
Tax subsidies	
Mortgage interest tax deduction	Available to homeowners of all income levels, it allows homeowners who itemize deductions on their income tax returns to deduct the interest they pay on their mortgages.
Treatment of capital gains	Individual taxpayers are exempted from paying a capital gains tax on the first $250,000 of capital gains ($500,000 for joint filers) from the sale of their principal residence. A principal residence is defined as a property that was owned and used as a primary residence for a total of at least 2 years during the 5-year period that ended on the date of the sale.

Entities that operate in the primary mortgage market	Purpose
Mortgage revenue bonds	State or local agencies issue tax-exempt bonds, the proceeds of which are used to provide below market interest rate mortgages to first-time homebuyers who earn no more than the area median income. Most of the costs of the bonds are borne by the federal government in the form of lost tax revenue.
Low-Income Housing Tax Credit (LIHTC)	Created by the Tax Reform Act of 1986, LIHTC has become the primary vehicle for production of affordable rental housing in the country. States are authorized to allocate federal tax credits as an incentive to the private sector to develop rental housing for low-income households. Project investors can claim the tax credit award annually on their tax returns for 10 years.

Source: GAO.

Establishment and Management of the FHFA Conservatorships

During 2007 and the first half of 2008, Fannie Mae's and Freddie Mac's financial conditions deteriorated significantly, which FHFA officials said prompted the agency to establish the conservatorships. As later described in this report, the enterprises incurred substantial credit losses on their retained portfolios and their guarantees on MBS. These credit losses resulted from pervasive declines in housing prices, as well as specific enterprise actions such as their guarantees on MBS collateralized by questionable mortgages (mortgages with limited or no documentation of borrowers' incomes), and investments in private-label MBS collateralized by subprime mortgages. In July 2008, Fannie Mae's and Freddie Mac's financial condition deteriorated, which prompted congressional and Executive Branch efforts to stabilize the enterprises and minimize associated risks to the financial system. In particular, Congress passed and the President signed the Housing and Economic Recovery Act of 2008 (HERA) which, among other things, established FHFA. HERA sets forth FHFA's regulatory responsibilities and supervisory powers, which include expanded authority to place the enterprises in conservatorship or receivership, and provides Treasury with certain authorities to provide financial support to the enterprises, which are discussed below. While Treasury and other federal regulatory officials stated in July 2008 that the conservatorship or other major measures likely would not be necessary, the enterprises' financial conditions continued to deteriorate. According to FHFA and Treasury officials, their ongoing financial analysis of Fannie Mae and Freddie Mac in August and early September 2008, as well as continued investor concerns about the financial condition of each enterprise, resulted in FHFA's imposition of the conservatorships on September 6, 2008, to help ensure the enterprises' viability, fulfill their housing missions, and stabilize financial markets.

As conservator of the enterprises, FHFA has replaced their Chief Executive Officers, appointed new members of the boards of directors, assumed responsibility for overseeing key business decisions, and ceased the enterprises' lobbying activities. While FHFA oversees key enterprise business decisions, agency officials said that they expect enterprise managers to continue to run day-to-day business activities. FHFA officials also said that the agency's staff continues to oversee the enterprises' safety and soundness and housing mission achievement. For example, FHFA officials said that agency examiners are located on-site at each enterprise to assess their ongoing financial performance and risk management.

Since FHFA became conservator, the enterprises have been tasked by the federal government to help respond to the current housing and financial crisis. For example, in November 2008, the enterprises suspended the initiation of foreclosure proceedings on mortgages that they held in their portfolios or on which they had guaranteed principal and interest payments for MBS investors, and this initiative subsequently was extended through March 31, 2009. Furthermore, under the administration's Homeowner Affordability and Stability Plan, which was announced on February 18, 2009, the enterprises are tasked to (1) provide access to low-cost refinancing for loans they own or guarantee to help homeowners avoid foreclosures and reduce monthly payments and (2) initiate a loan modification plan for at-risk homeowners that will lower their housing costs through a combination of interest rate reductions, maturity extensions, and principal forbearance or forgiveness.

Treasury Has Been Providing Financial Support to the Enterprises during Their Conservatorships

As authorized by HERA, the Secretary of the Treasury entered into agreements with Fannie Mae and Freddie Mac on September 7, 2008, to provide substantial financial support to the enterprises and thereby minimize potential systemic financial risks associated with their deteriorating financial condition.[12] Specifically, Treasury has entered into agreements and announced the following initiatives:

- Enhance the enterprises' financial solvency by purchasing their senior preferred stock and making funding available on a quarterly basis, to be

[12]Temporary authority for Treasury to provide financial support provided through the purchase of enterprise securities and debt obligations is set forth in section 1117 of HERA.

recovered by redemption of the stock or by other means.[13] While the initial funding commitment for each enterprise was capped at $100 billion, Treasury increased the cap to $200 billion per enterprise in February 2009 to maintain confidence in the enterprises. As of June 30, 2009, Treasury had purchased approximately $50.7 billion in Freddie Mac preferred stock and $34.2 billion in Fannie Mae preferred stock under the agreements. As part of the preferred stock purchase agreement, Treasury has received warrants to buy up to 79.9 percent of each enterprise's common stock for $0.00001 per share. The warrants are exercisable at any time and should the enterprises' financial conditions improve sufficiently, the warrants would help the government recover some of its investments in the enterprises. However, according to CBO, it is unlikely that the federal government will recover much of its massive financial investments in the enterprises.[14] Treasury also is to receive dividends on the enterprises' senior preferred stock at 10 percent per year and, beginning March 31, 2010, quarterly commitment fees from the enterprises.

- Purchase MBS until December 31, 2009, when the purchase authority expires. From September 2008 through July 2009, Treasury purchased $171.8 billion in the enterprises' MBS. While Treasury's authority under HERA to make such MBS purchases expires at the end of 2009, it may continue to hold previously purchased MBS in its portfolio beyond that date.

- Establish a temporary secured credit lending facility that allows the enterprises, as well as the FHLBank System, to borrow funds in the event they face difficulties issuing debt in financial markets. Under this Treasury program, the enterprises are to collateralize any borrowings with their MBS and the FHLBanks are to collateralize such borrowings with mortgage assets. To date, neither the enterprises nor any FHLBanks have used this borrowing authority, and Treasury's authority for this program expires at the end of 2009.

[13]After the end of any quarter in which either Fannie Mae's or Freddie Mac's balance sheet reflects that total liabilities exceed total assets, the enterprises have 15 business days to request funds under the terms of the agreement. Treasury then has 60 days to provide the funds, as necessary, up to the maximum amount of the guarantee.

[14]Comparing the amounts Fannie Mae and Freddie Mac have received to date, $34 billion and $51 billion respectively, to their income (adjusted to 2008 real dollars) earned during the 10-year period that included their highest profits reveals that Fannie Mae has received more than 70 percent of its 10-year earnings, and Freddie Mac has received more than 100 percent of its 10-year earnings.

The Federal Reserve's Steps to Improve Conditions in the Mortgage Markets

The Federal Reserve also has agreed to acquire substantial amounts of debt and MBS of the enterprises and other entities in order to reduce the cost and increase the availability of credit for the purchase of homes, and to foster improved conditions in financial markets. In November 2008, the Federal Reserve announced it would purchase up to $100 billion of debt issued by Fannie Mae, Freddie Mac, and the FHLBank System, and up to $500 billion in MBS guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae. On March 18, 2009, the Federal Reserve announced that during the current year it would purchase an additional $100 billion of the enterprises' debt up to a total of $200 billion and an additional $750 billion of enterprise MBS up to a total of $1.25 trillion. As of August 19, 2009, the Federal Reserve had purchased $111.8 billion in federal agency housing debt securities and $609.5 billion in guaranteed MBS.[15]

The Enterprises Had a Mixed Record on Achieving Housing Mission Objectives, and Risk-Management Deficiencies Compromised Their Safety and Soundness

To help inform the forthcoming congressional consideration of the enterprises' future purposes and structures, this section discusses key aspects of their histories and performance in achieving key housing mission and safety and soundness objectives. Specifically, in this section, we discuss (1) the enterprises' changing roles, structures, and activities over the years; (2) their performance in supporting mortgage finance consistent with charter obligations; (3) the extent to which the numeric housing goals may have materially benefited homeownership opportunities for targeted groups; and (4) the effect of the enterprises' risk-management practices on their safety and soundness.

Enterprises' Roles, Structures, Activities, and Regulatory Oversight Underwent Important Changes since the 1930s

As discussed below, the enterprises underwent important structural changes over the decades and accrued diverse missions and activities relating to the public and for-profit aspects of their structures and functions. Table 2 provides a time line that summarizes the key events in the federal housing finance system related to the enterprises over the past 77 years.

[15]Fannie Mae, Freddie Mac, and the FHLBanks issue securities for federal agency housing debt. The guaranteed MBS are those guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae.

Table 2: Time Line of Significant Events in Federal Housing Finance System

1930s: Government stabilized the flow of funds into housing, promoted stability by providing liquidity in housing finance through the secondary market, and standardized longer term, fixed-rate mortgages	
1932	FHLBank System was created.
1934	FHA was created; FHA was given authority to authorize the establishment of privately held national mortgage associations for the purchase and sale of mortgages.
1938	FHA, within its authority, established a national mortgage association, which became Fannie Mae, within FHA for the purpose of the purchase and sale of FHA-insured mortages.
1940s: In the postwar period, housing demand grew rapidly	
1946	Fannie Mae's predecessor began buying and selling loans guaranteed by VA.
1948	FHA given authority specifically to charter the Federal National Mortgage Association (Fannie Mae) which received statutory authority to buy and sell loans guaranteed by VA.
1950s: Fannie Mae's purchases of FHA-insured and VA-guaranteed mortgages increased substantially	
1954	Fannie Mae was chartered specifically to provide liquidity in the mortgage market, and support the mortgage market when there was a threat to the stability of the economy.
1954	The 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.
1960s: Federal housing agencies were restructured	
1965	FHA became part of HUD, within its Office of Housing.
1968	Fannie Mae was divided in two: Fannie Mae continued in the secondary market sector as a private, shareholder-owned entity with a federal charter overseen by HUD, while the newly created Ginnie Mae guaranteed FHA and VA mortgages from within HUD.
1970s: Freddie Mac was created and Fannie Mae moved into the conventional mortgage market	
1970	Federal Home Loan Mortgage Corporation (Freddie Mac) was created to develop a secondary market for conventional mortgage loans.
1970	Ginnie Mae first issued securities, backed by FHA and VA loans.
1971	Freddie Mac introduced the first conventional mortgage security, the mortgage participation certificate (PC).
1972	Fannie Mae bought its first conventional mortgages—those not backed by FHA or VA.
1980s: Fannie Mae faced challenges with interest-rate risk and Freddie Mac became publicly traded	
Early 1980s	Fannie Mae held mortgage assets in portfolio and experienced financial trouble because of high, short-term interest rates; the federal government provided financial support.
1981	Fannie Mae first issued MBS.
1989	Freddie Mac became a publicly traded, shareholder-owned corporation.
	FHLBank oversight transferred to the Federal Housing Finance Board (FHFB) from the Federal Home Loan Bank Board.
1990s: Unprecedented growth	
1992	Federal Housing Enterprises Safety and Soundness Act was enacted and established the Office of Federal Housing Enterprise Oversight (OFHEO) as an independent agency within HUD to monitor the safety and soundness of the enterprises.
	Numeric housing goals were established.
Mid 1990s	Rapid growth in enterprise mortgage portfolios begins.

2000s: Housing bubble bursts and the enterprises undertake activities that led to their conservatorships	
Early 2000s	Fannie Mae and Freddie Mac started buying Alt-A and subprime mortgage securities.
2003	Freddie Mac found by OFHEO to have used improper accounting methods.
2004	Fannie Mae found by OFHEO to have used improper accounting methods.
2008	HERA created FHFA to oversee Fannie Mae, Freddie Mac, and the FHLBank System, abolished OFHEO and FHFB as regulatory agencies, and transferred HUD's mission authority (including numeric housing goals) to FHFA.
	FHFA placed Fannie Mae and Freddie into conservatorship on September 6, 2008.

Source: GAO.

Created in the 1930s, Fannie Mae Initially Provided Additional Liquidity to the Mortgage Market by Buying and Holding FHA Mortgages

Prior to the 1930s, the federal government did not play a direct role in supporting housing finance. Typically lenders—mainly savings and loans (thrifts), but also banks—originated short-term mortgages (from 3 to 10 years). Since thrifts and banks primarily served local markets, regional differences in the demand for and supply of mortgage credit resulted in regional disparities in mortgage interest rates and credit availability. During the Great Depression, thousands of thrifts and banks failed due to their credit losses, and housing finance generally became unavailable.

In response, the federal government established institutions and initiatives to revive the housing finance market. In 1932, Congress established the FHLBank System—the first housing GSE—to provide short-term loans (called advances) to member savings and loans institutions that would use them to fund home mortgages.[16] Additionally, Congress established FHA in 1934 in part to promote and insure long-term housing mortgages (up to 20 years) that called for borrowers to pay off the principal and interest of loans over a specified number of years.[17] Fannie Mae was established by FHA under authority provided in 1938 as a government-held association to buy and hold mortgages insured by FHA, thereby providing additional liquidity to the mortgage market.[18] During the 1940s, Congress authorized Fannie Mae to purchase VA-guaranteed mortgages to facilitate the efforts of veterans to purchase homes.[19]

The Housing Act of 1954 instituted Fannie Mae as a mixed-ownership corporation and specified in its federal charter the entity's role and

[16]Federal Home Loan Bank Act, 47 Stat. 725 (July 22, 1932).

[17]National Housing Act, 48 Stat. 1246, 1252 (June 27, 1934).

[18]National Housing Act Amendments of 1938, 52 Stat. 8, 23 (Feb. 3, 1938).

[19]62 Stat. 1207 (July 1, 1948).

requirements that subsequently served as some of the enterprises' key housing mission objectives.[20] Among its provisions, the act required Fannie Mae to (1) provide liquidity for mortgage investments to improve the availability of capital for home mortgage financing and (2) support the mortgage market when there was a threat to the stability of the economy. The 1954 act also provided Fannie Mae with certain financial benefits thought necessary to carry out its objectives, such as exemptions from all local taxes except property taxes. Lenders that sold mortgages to Fannie Mae were required to purchase stock in it, but the federal government remained the enterprise's majority owner.

Throughout the late 1950s and 1960s, Fannie Mae's purchases of FHA-insured and VA-guaranteed mortgages increased substantially. During this period, limits on interest rates that banks and thrifts could offer for deposits and restrictions on their ability to branch across state lines contributed to liquidity constraints and continuing regional disparities in mortgage interest rates. By operating across the nation, Fannie Mae could help alleviate such scarcities and disparities.

Congress Established Fannie Mae and Freddie Mac as For-profit Corporations in 1968 and 1970, Respectively, to Carry Out Housing Missions

In 1968, the Housing and Urban Development Act (the 1968 act) reorganized Fannie Mae as a for-profit, shareholder-owned company with government sponsorship and established Ginnie Mae as an independent government corporation in HUD.[21] Ginnie Mae's primary function was to guarantee the timely payment of principal and interest from pools of FHA-, USDA/RD-, and PIH-insured and VA-guaranteed mortgages. Ginnie Mae has the full faith and credit backing of the federal government. Although now a for-profit, shareholder-owned company, Fannie Mae continued its activities, which were mainly purchasing FHA and VA mortgages. According to some financial analysts, Congress largely reorganized Fannie Mae as a private company for budgetary purposes (that is, to remove its financial obligations from the federal budget). The 1968 act also gave the HUD Secretary general regulatory authority over Fannie Mae, as well as authority to require that a reasonable portion of its mortgage purchases serve low- and moderate-income families. The Secretary subsequently established numeric housing goals for Fannie Mae that essentially required that at least 30 percent of its purchases serve low- and moderate-income families, and at least 30 percent serve families living in central cities.

[20] Housing Act of 1954, Pub. L. No. 68-560 (1954).

[21] Housing and Urban Development Act of 1968, Pub. L. No. 90-448 (1968).

However, HUD was not given authority to collect data that would be necessary to determine compliance with the goals.

In the Emergency Home Finance Act of 1970, Congress chartered Freddie Mac as a housing GSE to help mitigate business challenges facing the thrift industry.[22] Increasing interest rates had undermined thrifts' capacity to finance long-term mortgages held in their portfolios.[23] Freddie Mac was to purchase long-term mortgages from thrifts and thereby help stabilize the industry and enhance its capacity to fund additional mortgages. As a result, Freddie Mac was the first enterprise to develop products to facilitate securitization of mortgage loans. Freddie Mac was first owned by the Federal Home Loan Bank Board, which regulated the thrift industry. Freddie Mac did not become a shareholder-owned company like Fannie Mae until it was reorganized in 1989. While subject to HUD's general regulatory oversight under the 1989 legislation, Freddie Mac initially was not subject to the same mortgage purchase goals as Fannie Mae.

Although both Freddie Mac and Fannie Mae were to provide a secondary market for conventional mortgages, they pursued markedly different business strategies in the 1970s and 1980s. Freddie Mac focused its business activities on purchasing conforming, conventional mortgages from thrifts and issuing MBS rather than holding mortgages in its portfolio. According to a Freddie Mac official, this business strategy was intended to help the thrift industry manage interest-rate risk by passing such risk to the MBS investors. In contrast, Fannie Mae followed its traditional business strategy by purchasing mortgages and holding them in its portfolio. During the early 1980s, Fannie Mae experienced substantial losses, as did the thrift industry, due to sharply rising interest rates while Freddie Mac's financial performance generally was unaffected. During this period, the federal government provided certain financial benefits to Fannie Mae, such as regulatory forbearance and tax benefits, to help it recover. After Freddie Mac was turned into a for-profit, shareholder-

[22]Emergency Home Finance Act of 1970, Pub. L. No. 91-351, title III (1970).

[23]Thrifts generally funded long-term, fixed-rate mortgages that they held in their portfolios with deposits, which were regulated. When short-term interest rates rose above levels that thrifts were permitted to offer to depositors, depositors sought investment alternatives, such as money market funds, that offered higher yields. Thus, thrifts faced difficulties in funding their mortgage portfolios.

owned corporation in 1989, it began to hold more mortgages in its retained portfolio, similar to Fannie Mae.[24]

Congress Revised Enterprise Regulation in 1992 to Better Ensure Safety and Soundness and Help Manage the Potential Conflict between Their Profit Motives and Housing Missions

By 1992, Congress concluded that the enterprises posed potential safety and soundness risks, and regulations that had been in place since 1968 were inadequate to manage such risks. Over the years, the enterprises had become large and complex organizations, and Fannie Mae's financial difficulties in the early 1980s indicated that they posed risks to taxpayers and financial stability. Furthermore, HUD had not fulfilled its statutory responsibility to monitor the enterprises' financial operations and risks. For example, HUD did not routinely examine the enterprises' financial activities or promulgate regulations necessary to help ensure their safe and sound operations. There was also a concern that the enterprises were not adequately serving the mortgage credit needs of low- and moderate-income borrowers and other targeted groups due to their potentially higher default risks. In a 1996 report, we noted that, in 1992, there was a perception that the enterprises' distribution of conventional, conforming loan funding to low- and moderate-income borrowers was lagging behind the primary mortgage market, and a Federal Reserve study was consistent with this perception.[25] Moreover, HUD did not enforce the housing goals—which at that time applied only to Fannie Mae—or collect the data necessary to do so.

In enacting the Federal Housing Enterprises Safety and Soundness Act of 1992 (the 1992 Act), Congress fundamentally revised regulation of the enterprises and took steps to clarify Fannie Mae's and Freddie Mac's roles within the housing finance system and better define their public housing mission responsibilities. For example, the 1992 Act reiterated the enterprises' long-standing obligations to support mortgage finance through secondary market activities, including during stressful economic periods, and clarified and expanded the enterprises' charter obligations to facilitate the flow of mortgage credit serving targeted groups. Moreover, the 1992 Act set forth oversight authority and mechanisms to better manage

[24]Freddie Mac became a publicly held corporation under the charter set forth in the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73 § 731.

[25]GAO, *Housing Enterprises: Potential Impacts of Severing Government Sponsorship*, GAO/GGD-96-120 (Washington, D.C.: May 13, 1996) and Glenn B. Canner and Wayne Passmore, "Residential Lending to Low-Income and Minority Families: Evidence from the 1992 HMDA Data," *Federal Reserve Bulletin*, February 1994, 70-108.

potential conflicts between the enterprises' profit motivations and housing missions.

- First, it established OFHEO as an independent agency in HUD responsible for the enterprises' safety and soundness. Among other things, OFHEO was given supervisory authority to establish and monitor compliance with minimum and risk-based capital standards and conduct routine safety and soundness examinations. In so doing, Congress established a safety and soundness regulatory framework that resembled the supervisory framework for insured depository institutions such as banks and thrifts, although OFHEO's authority was less extensive.

- Second, the 1992 Act expanded the enterprises' previous housing mission responsibilities by requiring them to meet specific annual goals for the purchase of mortgages serving targeted groups. Specifically, it directed the HUD Secretary to promulgate regulations setting annual housing goals for both Fannie Mae and Freddie Mac for the purchase of mortgages serving low- and moderate-income families; special affordable housing for families (i.e., low-income families in low-income areas, and very low-income families); and housing located in central city, rural, and other underserved areas. The 1992 Act also provided HUD with the authority to collect data necessary to monitor the enterprises' compliance with the goals and to enforce such compliance. It should be noted that the enterprises' affordable housing goals required them to compete with other federal initiatives to support housing, particularly FHA's mortgage insurance programs that also primarily serve low- and moderate-income borrowers and first-time homeowners. This issue is discussed in more detail later in this report.

- Third, the 1992 Act set forth HUD's regulatory authority over the enterprises and specified procedures that HUD must follow when reviewing and approving new mortgage program proposals by the enterprises. That is, it directed the HUD Secretary to approve any new program that an enterprise proposed, unless the Secretary determined that the program violated the enterprise's charter or would not be in the public interest. Additionally, the 1992 Act required the HUD Secretary, for a specified transition period, to reject a new program proposal if the Director of OFHEO determined that the proposal would risk a significant financial deterioration of the enterprise.

Despite Improvements, Limitations in Oversight Continued to Affect The Enterprises' Safety and Soundness and Mission Compliance

While the 1992 Act enhanced the enterprises' regulatory structure in several important respects, it still had important limitations in its capacity to ensure the enterprises' safety and soundness and housing mission compliance. First, federal oversight of the enterprises and the FHLBank System was divided among OFHEO, HUD, and FHFB—which was the safety and soundness and housing mission regulator for the FHLBank System. However, OFHEO and FHFB were small agencies that lacked the resources necessary to monitor large and complex financial organizations from the standpoint of safety and soundness, as well as mission goals. Furthermore, as compared with federal bank regulators, both OFHEO and FHFB lacked key authorities—such as authority to take enforcement actions based on declining capital levels and unsound financial practices—that were available to federal bank regulators.[26]

Enterprise regulation also had limited capacity to address potential conflicts between the enterprises' profit motivations and their federally mandated housing missions. In particular, we noted that, due to the financial benefits derived from their federal charters and their dominant position within the mortgage finance system, the enterprises had financial incentives to engage in potentially profitable activities that were not fully consistent with their charter obligations and restrictions.[27] For example, Freddie Mac, during the mid-1990s, had invested in nonmortgage assets, such as long-term corporate bonds, that potentially allowed the enterprise to earn higher returns based on the enterprises' funding advantage.[28] Freddie Mac argued that its investments in nonmortgage assets were permissible and necessary to help manage the liquidity of its investment portfolio. Although HUD had general regulatory and new mortgage program authorities, it was not clear if HUD was well-positioned to assess such arguments or the extent to which the enterprises may have been straying from their charter obligations and restrictions. At that time, HUD officials said that they lacked staff with the expertise necessary to oversee large and complex financial institutions and determine if the enterprises'

[26]For a comparison of these authorities, see GAO, *Comparison of Financial Institution Regulators' Enforcement and Prompt Corrective Action Authorities*, GAO-01-322R (Washington, D.C.: Jan. 31, 2001).

[27]GAO, *Government-Sponsored Enterprises: A Framework for Strengthening GSE Governance and Oversight*, GAO-04-269T (Washington, D.C.: Feb. 10, 2004) and GAO, *Government-Sponsored Enterprises: Federal Oversight Needed for Nonmortgage Investments*, GAO/GGD-98-48 (Washington, D.C.: July 28, 1998).

[28]GAO/GGD-98-48.

activities were consistent with their charters and housing finance missions.

By retaining the enterprises' off-budget status as GSEs, the 1992 Act permitted a continuation of the lack of transparency about the enterprises' risks and potential costs to taxpayers. Under the Federal Credit Reform Act of 1990, the potential costs associated with many direct federal loan and loan guarantee programs have to be disclosed in the federal budget.[29] Congress and the Executive Branch can use such disclosures to assess the potential costs and future risks of such programs and take steps on a timely basis to potentially mitigate such costs and risks (for example, tightening eligibility criteria). Despite the implied federal guarantee of their obligations, the government's exposure in connection with the enterprises is not disclosed in the federal budget because GSE activities were excluded from the federal budget totals.[30] The 1992 Act did not change the status of the enterprises as off-budget entities. However, it should be noted that such financial disclosures could have involved an offsetting risk. Such treatment might have increased the perception that, despite the enterprises' statements to the contrary, the federal government would provide financial support to them in an emergency, which may have further reduced market discipline and enterprise actions to mitigate risks.

Congress substantially revised the enterprises' regulatory structure with the passage of HERA in 2008. In HERA, Congress abolished OFHEO and FHFB and established FHFA as the regulator of the enterprises and the FHLBank System. HERA charges FHFA with responsibility for housing GSE safety and soundness. In this regard, HERA augments the safety and soundness responsibilities and authorities administered by the predecessor agencies. Additionally, HERA transferred responsibility for the enterprises' mission oversight, including their satisfaction of numeric goals for purchases of mortgages to low- and moderate-income borrowers and the review and approval of enterprise new mortgage programs, from HUD to FHFA. FHFA's supervisory authority over safety and soundness

[29]Pub. L. No. 101-508, title XIII (1990). Under the act, the credit subsidy cost of direct loans and loan guarantees is the net present value of the estimated long-term cost to the government at the time the credit is provided of such programs, less administrative expenses. The act was intended to improve disclosures about the risks associated with government direct loans and guarantee programs and assist Congress in making budget decisions about such programs.

[30]GAO, *Budget Issues: Profiles of Government-Sponsored Enterprises*, GAO/AFMD-91-17 (Washington, D.C.: February 1991).

matters includes specific authority to place the housing GSEs into conservatorship or receivership based on grounds set forth in HERA. Since placing Fannie Mae and Freddie Mac into conservatorship in September 2008, FHFA has appointed new Chief Executive Officers and boards of directors at each enterprise and stands in lieu of shareholders in matters of corporate governance. In contrast, FHFA's role with respect to the FHLBank System has remained solely that of an independent regulator.

The Enterprises' Performance in Achieving Key Housing Finance Support Objectives Has Been Mixed

It is generally accepted that the enterprises have been successful in enhancing liquidity in the mortgage finance system as directed in their charters. We have reported that the enterprises established a viable secondary mortgage market for conventional loans that enabled capital to flow to areas with the greatest demand for mortgage credit.[31] This free flow of capital tended to equalize interest rates across regions for mortgages with similar risk characteristics. However, the removal of restrictions on the ability of banks and thrifts to pay market rates for deposits and to operate across state lines also have contributed to mortgage liquidity and the establishment of an integrated national mortgage finance system.

The enterprises' activities also have been credited with achieving other benefits consistent with their charter obligations to support mortgage finance, which include the following:

- Lowering mortgage interest rates on qualifying mortgages below what they otherwise would be. GAO and others have stated that the advantageous borrowing rates that the enterprises derived from the implied federal guarantee on their financial obligations were passed on to borrowers to

[31] GAO/GGD-96-120.

some degree, although estimates vary.[32] However, we also have noted that these benefits were not entirely passed along to homebuyers. Rather, the enterprises' shareholders and senior management also benefited for many years from the relatively higher profits that the companies achieved due to cost savings associated with the implied guarantee.

- Establishing standard underwriting practices and forms for conventional mortgages. Due to the enterprises' large purchases of conventional mortgages each year, their underwriting guidelines and forms became the industry standard. GAO and others have found that standardization facilitated the efficiency of the mortgage underwriting process and resulted in cost savings for lenders and borrowers. The enterprises' efforts to standardize mortgage underwriting likely also helped develop the MBS market, as consistent standards are viewed as critical for helping investors evaluate risks.

However, 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.[33] 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.

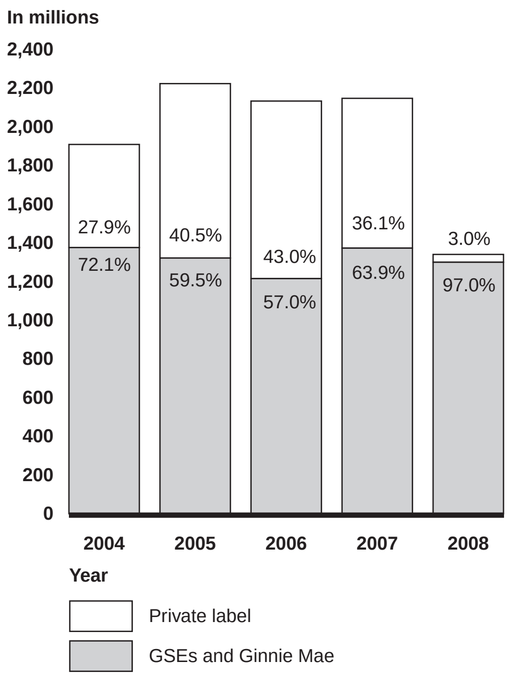
[32]In 1996, we reported on our participation in research with CBO, HUD, and Treasury that, among other things, included analysis on the degree the advantageous borrowing rates the enterprises derived from their government sponsorship was passed on to borrowers. We estimated that the benefit to homebuyers on interest rates on fixed rate single family mortgages below the conforming loan limits ranged from 15–35 basis points (a basis point is equal to one one-hundredth of a percent). This amounted to a savings of about $10–25 on the monthly payments on a $100,000 mortgage balance. See GAO-96-120. More recent research conducted by Federal Reserve staff suggests that the savings to borrowers from the enterprises' activities range from 0–7 basis points. See Passmore, Wayne, Shane M. Sherlund, and Gilliam Burgess, "The Effect of Housing Government-Sponsored Enterprises on Mortgage Rates," *Real Estate Economics*, Vol. 33, Fall 2005, pp. 427-463; and Passmore, Wayne, Diana Hancock, Andreas Lehnert, and Shane Sherlund, "Federal Reserve Research on Government-Sponsored Enterprises," Proceedings from the 42th Annual Conference on Bank Structure and Competition, May 2006.

[33]GAO/GGD-96-120.

During the current financial crisis, the enterprises have provided critical support to mortgage finance, but only with the benefit of substantial financial assistance provided by Treasury and the Federal Reserve during the conservatorships. As shown in figure 1, the enterprises and Ginnie Mae accounted for nearly 60 percent of MBS issuances in 2006, while private-label issuances, such as MBS collateralized by pools of subprime and jumbo mortgages, accounted for nearly 40 percent. By the end of 2008, the enterprises and Ginnie Mae accounted for about 97 percent of MBS issuances, while private-label issuances stood at about 3 percent due to the collapse of many subprime lenders and the associated reduction in nonconforming mortgage origination and precipitous downturn in securitization markets. According to FHFA's former Director, one of the reasons that the agency established the conservatorships in September 2008 is that the financial challenges the enterprises were facing as independent entities compromised their capacity to support mortgage finance. For example, the enterprises' mortgage purchases slowed in 2008, and they planned to raise certain fees to help offset their losses. While the enterprises are now a critical component of the federal government's response to the housing crisis, such support would not be possible without Treasury's financial support and the Federal Reserve's plans to purchase almost $1.45 trillion of their MBS and debt obligations as well as those of other entities.[34]

[34]In addition to the enterprises' MBS and debt obligations, the Federal Reserve's purchases include FHLBank debt obligations and Ginnie Mae guaranteed MBS.

Figure 1: Enterprises and Private-Label MBS Issuances, 2004–2008



Source: GAO analysis of data from Securities Industry and Financial Markets Association.

Evidence to Support Effectiveness of Enterprises' Program to Increase Purchases of Mortgages Serving Targeted Groups Is Limited

While the enterprises' numeric housing goal mortgage purchase program has been in place for more than 10 years, its effectiveness in supporting homeownership opportunities for targeted groups and areas is not clear. Pursuant to the 1992 Act, HUD established interim goals for 1993 and 1994, which were extended through 1995, and final goals for the period from 1996 through 1999. In 1998, we found these were conservative goals, which placed a high priority on maintaining the enterprises' financial soundness.[35] For example, according to research conducted by HUD and OFHEO, the additional mortgage purchases required under the goals were modest and would not materially affect the enterprises' financial condition. HUD also established housing goals in 2000 (covering 2001–2004) and in 2004 (covering 2005–2008). According to a speech by the FHA Commissioner in 2005, the 2004 goals established significantly higher requirements than the 2000 goals.

[35]GAO, *Federal Housing Enterprises: HUD's Mission Oversight Needs to Be Strengthened*, GAO/GGD-98-173 (Washington, D.C.: July 28, 1998).

According to HUD data, the enterprises generally have met the numeric housing goals since the beginning of the program. For example, table 3 shows that Fannie Mae and Freddie Mac met the low- and moderate-income housing goals in place from 2002 through 2007. However, the enterprises failed to meet this goal in 2008, and, according to HUD, did not meet certain subgoals in 2007.

Table 3: Enterprise Compliance with Low- and Moderate-Income Numeric Mortgage Purchase Goals, 2002–2008

	Percentage of low- and moderate-income purchases						
	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Goal	50.0	50.0	50.0	52.0	53.0	55.0	56.0
Fannie Mae performance	51.8	52.3	53.4	55.1	56.9	55.5	53.6
Freddie Mac performance	50.3	51.2	51.6	54.0	55.9	56.1	51.5

Source: GAO.

Note: Under the goals, in 2002 for example, half of each enterprise's total mortgage purchases were to serve borrowers who qualified as being low- and moderate-income under HUD's definition. (See GAO/GGD-98-173).

Although the enterprises generally satisfied the numeric purchase goals through 2007, HUD and independent researchers have had difficulty identifying tangible benefits for targeted groups associated with the enterprises' purchase program. In setting higher housing goals beginning in 2005, HUD stated that the intent was to encourage the enterprises to facilitate greater financing and homeownership opportunities for the groups targeted by the goals. HUD concluded that, although the enterprises had complied with previous goals, they continued to serve less of the affordable housing market than was served by conventional conforming primary market lenders during those years. Furthermore, recent research indicates that, although the enterprises have enhanced their product offerings to meet the housing goals, the effects of the housing goals on affordability and opportunities for target groups have been limited. For example, a 2003 study that modeled the impacts of the housing goals found that the enterprises likely increased credit in specified areas in only 1 of the 5 years included in the model.[36] A 2006 study concluded that the enterprises' purchases of mortgages in certain targeted low- and moderate-income areas (census tracts in California

[36]Brent Ambrose and Thomas Thibodeau, "Have the GSE Affordable Housing Goals Increased the Supply of Mortgage Credit?" *Regional Science and Urban Economics* 34 (2004).

during the 1990s with depressed housing markets) generally did not increase homeownership rates as compared with other low- and moderate-income areas that were not specifically targeted by the numeric housing goals. The research found only one low-income target area (in San Francisco) that showed improvements in homeownership rates as a result of the enterprises' activities.[37]

Another study suggested that enterprise-FHA interactions in the same areas may help explain why the program's benefits were limited.[38] While the enterprises' numeric mortgage purchase program and FHA's mortgage insurance were intended to benefit similar targeted groups, such as low-income and minority borrowers, the study suggested that the programs may have offset each other. That is, as the enterprises increased their mortgage purchases in areas with concentrations of targeted groups, FHA activity declined in those areas. According to the study, while the relatively lower costs of conventional loans compared with FHA-insured loans provided benefits for those households able to switch to a conventional loan, this cost differential also permitted the enterprises to attract an increasing share of the most creditworthy targeted borrowers in these areas, which FHA had served before. In response to losing its more creditworthy borrowers, FHA could have retained market share by reaching for borrowers that represented greater credit risks and either (1) accepted the riskier portfolio wholesale or (2) increased premiums to insure itself against expected losses. However, the study concluded that FHA applied stricter underwriting standards and reduced its loan volume. Therefore, the overall impact of the two programs on promoting homeownership opportunities in these areas was limited. After 2002, both the enterprises' and FHA's market share declined in areas with concentrations of low-income and minority groups as subprime lending grew in size, which may have limited the impact of both the enterprises' housing goal program and FHA's mortgage insurance activities.[39]

[37]Raphael Bostic and Stuart Gabriel, "Do the GSEs Matter to Low-income Housing Markets? An Assessment of the Effects of GSE Loan Purchase Goals on California Housing Outcomes," *Journal of Urban Economics* 59 (2006).

[38]Xudong An and Raphael Bostic, "GSE Activity, FHA Feedback, and Implications for the Efficacy of the Affordable Housing Goals," *Journal of Real Estate Finance and Economics* 36 (2008).

[39]See, GAO, *Federal Housing Administration: Decline in the Agency's Market Share Was Associated with Product and Process Developments of Other Mortgage Market Participants*, GAO-07-645 (Washington, D.C.: June 29, 2007).

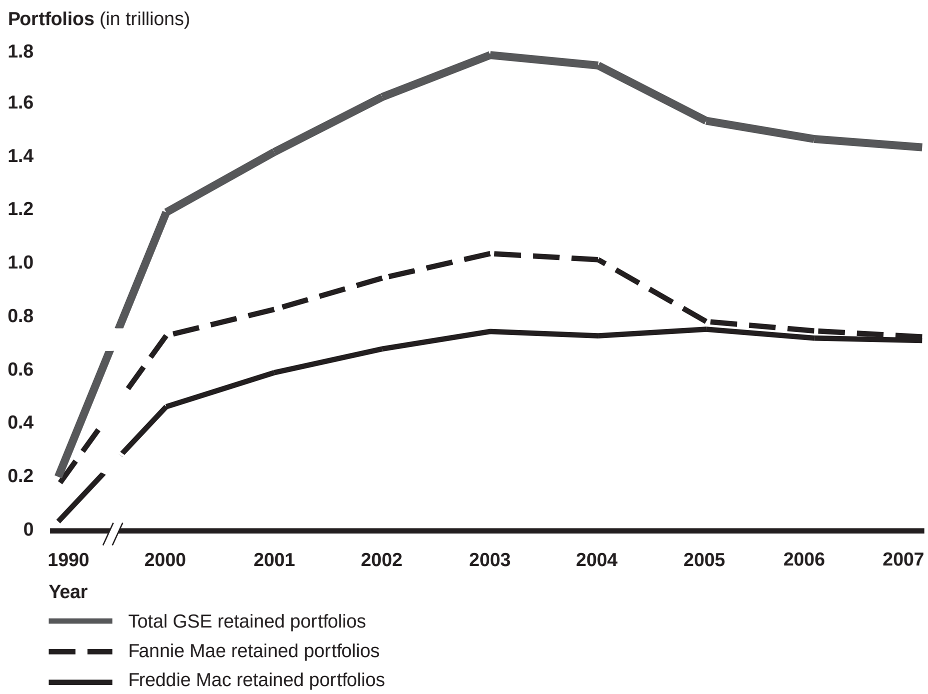
Earlier research sponsored by HUD in 2001 largely discounted the alleged benefits for affordable multifamily finance resulting from the enterprises' numeric mortgage goals.[40] According to the research, the enterprises generally did not play a leading role in affordable multifamily mortgage finance because their underwriting standards were considered conservative and fairly inflexible, compared with other multifamily mortgage providers. In contrast, representatives from mortgage finance, housing construction, and consumer groups we contacted said that the benefits from the enterprises' purchases of affordable multifamily mortgages pursuant to their goals have been significant. The representatives said that the enterprises' involvement and, in some cases, guarantees on the financing of affordable multifamily projects, which may be complex and involve a variety of government and private-sector entities, were crucial to their successful completion. In addition, the representatives said that the enterprises were the only source of funding for multifamily projects because many other traditional providers, such as banks and insurance companies, largely have withdrawn from the market during the current financial crisis.

The Enterprises' Risk-management and Operational Practices Have Been Deficient

While housing finance may have derived some benefits from the enterprises' activities over the years, GAO, federal regulators, researchers, and others long have argued that the enterprises had financial incentives to engage in risky business practices to strengthen their profitability partly because of the financial benefits derived from the implied federal guarantee on their financial obligations. For example, during the late 1990s and early 2000s, we raised concerns about the rapid growth of the enterprises' retained mortgage portfolios, which reached about $1.6 trillion by 2005 (see fig. 2). Although increasing the size of their mortgage portfolios may have been more profitable than issuing MBS, it also exposed the enterprises to significant interest-rate risk. We reported that the rapid increase in the enterprises' mortgage portfolios and the associated interest-rate risk did not result in a corresponding benefit to the achievement of their housing missions. For example, the rapid growth in the enterprises' retained mortgage portfolios in the late 1990s, and in 2003 through 2004, occurred during periods of strong economic growth when mortgage markets did not necessarily require the enterprises to be robust portfolio lenders.

[40] Abt Associates, "Study of the Multifamily Underwriting and the GSEs' Role in the Multifamily Market: Final Report," prepared for HUD (August 2001).

Figure 2: Growth in Enterprises' Retained Mortgage Portfolios, 1990–2008

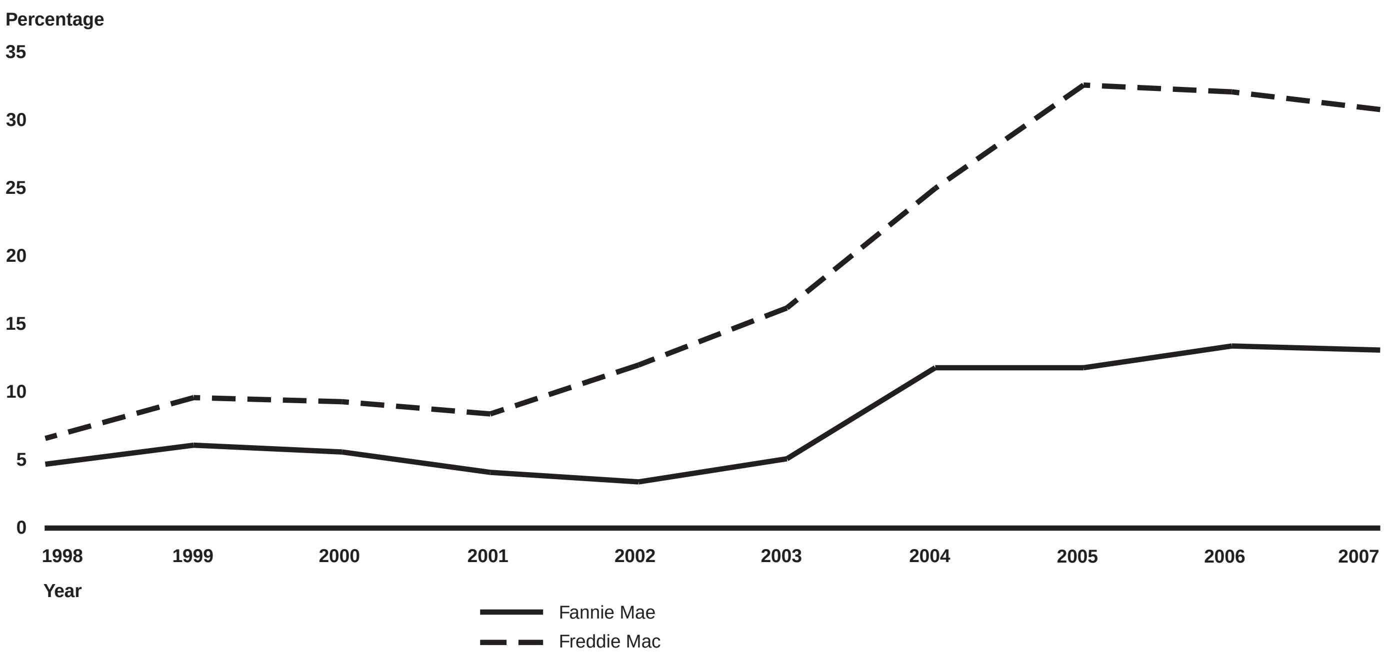


Source: OFHEO *Report to Congress*, April 15, 2008.

In 2003 and 2004, OFHEO found that Freddie Mac and Fannie Mae manipulated accounting rules so that their public financial statements would show steadily increasing profits over many years and thereby increase their attractiveness to potential investors. The misapplication of accounting rules generally involved standards for reporting on derivatives, which the enterprises used to help manage the interest-rate risks associated with their large retained mortgage portfolios. According to investigative reports, the enterprises also may have manipulated their financial reports to show consistently increasing profits to help ensure senior executives would receive bonuses. OFHEO also found that the enterprises lacked key operational capacities, such as information systems and personnel, necessary to manage large mortgage portfolios and account for them correctly. The enterprises were required to restate their financial statements and adjust their earnings reports by billions of dollars.

While the enterprises were subject to increased OFHEO scrutiny because of these accounting and operational deficiencies in 2004 and 2005, they still embarked on aggressive strategies to purchase mortgages and mortgage assets with questionable underwriting standards. For example, they purchased a large volume of what are known as Alt-A mortgages, which typically did not have documentation of borrowers' incomes and had higher loan-to-value ratio or debt-to-income ratios. Furthermore, as shown in figure 3, enterprise purchases of private-label MBS increased rapidly as a percentage of retained mortgage portfolios from 2003 through 2006. By the end of 2007, the enterprises collectively held more than $313 billion in private-label MBS, of which $94.8 billion was held by Fannie Mae and $218.9 billion held by Freddie Mac. According to some commenters, the 2004 increase in housing goals provided the enterprises with incentives to purchase mortgage assets, such as Alt-A mortgages and private-label MBS collateralized by subprime and Alt-A mortgages,that in large degree served targeted groups. However, former FHFA Director Lockhart stated that the enterprises' primary motivation in purchasing such assets was to restore their share of the mortgage market, which declined substantially from 2004 through 2007 as the "nontraditional" (for example, subprime) mortgage market rapidly increased in size. FHFA further stated that the enterprises viewed such mortgage assets as offering attractive risk-adjusted returns.

Figure 3: Total Private-Label Mortgage Backed Securities as Percentage of the Enterprises Retained Mortgage Portfolios, 1998–2007



Source: OFHEO *Report to Congress*, April 15, 2008.

According to FHFA, while these questionable mortgage assets accounted for less than 20 percent of the enterprises' total assets, they represented a disproportionate share of credit-related losses in 2007 and 2008. For example, by the end of 2008, Fannie Mae held approximately $295 billion in Alt-A loans, which accounted for about 10 percent of the total single-family mortgage book of business (mortgage assets held in portfolio and mortgages that served as collateral for MBS held by investors). Similarly, Alt-A mortgages accounted for nearly half of Fannie Mae's $27.1 billion in credit losses of its single-family guarantee book of business in 2008. At a June 2009 congressional hearing, Lockhart said that 60 percent of the AAA-rated, private-label MBS purchased by the enterprises have since been downgraded to below investment grade.[41] He also stated that investor concerns about the extent of the enterprises' holdings of such assets and the potential associated losses compromised their capacity to raise needed capital and issue debt at acceptable rates.

Options to Revise the Enterprises' Structures Aim to Help Ensure Housing Mission Achievement, While Mitigating Safety and Soundness Risks

The enterprises' mixed records in achieving their housing mission objectives and the losses and weaknesses that resulted in the conservatorships reinforce the need for Congress and the Executive Branch to fundamentally reevaluate the enterprises' roles, structures, and business activities in mortgage finance. Researchers and others believe that there is a range of options available to better achieve housing mission objectives (in some cases through other federal entities such as FHA), help ensure safe and sound operations, and minimize risks to financial stability. These options generally fall along a continuum with some overlap among key features and advocate (1) establishing a government corporation or agency, (2) reconstituting the enterprises as for-profit GSEs in some form, or (3) privatizing or terminating them (see table 4). This section discusses some of the key principles associated with each option and provides details on how each could be designed to support housing objectives.

[41] House Committee on Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, testimony of James B. Lockhart III, "The Present Condition and Future Status of Fannie Mae and Freddie Mac," 111th Cong., 2nd sess., June 3, 2009.

Table 4: Summary of Options to Revise the Enterprises' Structures

Potential structure	Proposed function
Government corporation or agency	Focus on purchasing qualifying mortgages and issuing MBS but eliminate mortgage portfolios, which are complex to manage and can result in losses due to fluctuations in interest rates. Responsibilities for promoting homeownership for targeted groups could be transferred to the FHA, which insures mortgages for low-income and first-time borrowers.
Reestablish for-profit enterprises with government sponsorship	Restore the enterprises to their preconservatorship status but add controls to minimize risk. These controls might include eliminating or reducing the enterprises' mortgage portfolios or subjecting the enterprises to public utility-type regulation, which involves business activity restrictions and profitability limits, and establishing executive compensation limits. Convert enterprises from publicly-traded, shareholder-owned corporations to cooperative associations owned by mortgage lenders.
Privatization or termination	Abolish the enterprises in their present form and disperse mortgage lending and risk management throughout the private sector. Some proposals involve the establishment of a federal mortgage insurer to help protect mortgage lenders against catastrophic mortgage losses.

Source: GAO.

Government Corporation or Agency

Some proposals advocate that, after the FHFA conservatorships are terminated, consideration should be given to establishing a government corporation or agency to assume responsibility for key enterprise business activities.[42] Supporters of these proposals maintain that the combination of the implied federal guarantee on the enterprises' financial obligations, and their need to respond to shareholder demands to maximize profitability, encouraged excessive risk-taking and ultimately resulted in their failures. Accordingly, they also believe that a government corporation or agency, which would not be concerned about maximizing shareholder value, would be the best way to ensure the availability of mortgage credit for primary lenders, while minimizing the risks associated with a for-profit structure with government sponsorship. Establishing a government corporation or agency also would help ensure transparency in the federal government's efforts through appropriate disclosures of risks and costs in the federal budget.

Under one proposal, a government corporation would assume responsibility for purchasing conventional mortgages from primary

[42]See, for example, Dwight M. Jaffee, "Reforming Fannie and Freddie," *Regulation*, Winter 2008-2009, 52-57, and Thomas H. Stanton, "Lessons from Public Administration: Recommendations for the Future of Fannie Mae and Freddie Mae," presented to the 45th Annual Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 7, 2009.

lenders and issuing MBS.[43] However, under this proposal, the enterprises' retained mortgage portfolios would be eliminated over time because of their interest-rate risk and associated safety and soundness concerns. Taxpayer protections would come from sound underwriting standards and risk-sharing arrangements with the private sector. The government corporation also would be required to establish financial and accountability requirements for lenders and institute consumer protection standards for borrowers as appropriate.

While this proposal advocates the establishment of a government corporation to replace Fannie Mae and Freddie Mac, it states that there are risks associated with doing so. For example, a government corporation might face challenges retaining capable staff or become overly bureaucratic and unreceptive to market developments. Accordingly, the proposal includes a provision that the government corporation should be carefully reevaluated to ensure that it does not "ossify" over time. The proposal also concludes that the new government corporation either "sunset" (terminate) after 5 years if the market has stabilized or be allowed to continue under a renewable charter that would require periodic reviews.

Under a second proposal, a government corporation or agency also would focus on issuing MBS rather than maintaining a retained mortgage portfolio.[44] Borrowers would be charged actuarially based premiums to help offset the risks associated with the government corporation's or agency's activities. For example, mortgages with a 10 percent or lower down payment would be subject to a higher premium than mortgages with a 20 percent down payment. The government corporation or agency also would focus its activities on middle-income borrowers, and the mortgage credit needs of targeted groups would be served by an expansion of FHA's mortgage insurance programs. The proposal suggests that specific appropriations to FHA represent a more efficient means to assist low-income borrowers than seeking to assist such borrowers through the enterprises' activities. A third proposal advocates that the government provide funding directly to targeted borrowers though down-payment

[43]Stanton, "Lessons from Public Administration."

[44]Jaffee, "Reforming Fannie and Freddie."

assistance rather than relying on the enterprises' mortgage purchase program.[45]

For purposes of comparison, we note that Ginnie Mae is an existing government corporation that performs important functions in the secondary markets for government guaranteed and insured mortgage loans. Specifically, Ginnie Mae guarantees the timely payment of principal and interest on MBS that are collateralized by pools of mortgages that are insured or guaranteed by FHA, VA, PIH, and USDA/RD. However, Ginnie Mae does not perform functions that are envisioned for a government corporation or agency that might replace Fannie Mae and Freddie Mac. In particular, Ginnie Mae does not issue MBS, as do Fannie Mae and Freddie Mac. Moreover, Ginnie Mae is not responsible for monitoring the underwriting or the credit risk associated with the mortgages that collateralize the MBS pools but instead relies on FHA, VA, PIH, and USDA/RD to do so.

Reconstituted GSEs

While many of the enterprises' critics view the for-profit GSE structure as precipitating the enterprises' financial crises that led to conservatorship, market participants and commenters, trade groups representing the banking and home construction industries, as well as community and housing advocates we contacted, believe that the for-profit GSE structure generally remains superior to the alternatives. They assert that continuing the enterprises as for-profit GSEs would help ensure that they would remain responsive to market developments, continue to produce innovations in mortgage finance, and be less bureaucratic than a government agency or corporation. But, they also generally advocate additional regulations and ownership structures to help offset the financial risks inherent in the for-profit GSE structure.

While this option generally envisions that the enterprises would focus on issuing MBS, as is the case with proposals to establish government corporations or agencies, several proponents believe they should be permitted to maintain a mortgage portfolio to meet certain key responsibilities. For example, home construction, small bank, and community and housing advocates noted that the enterprises may need to maintain portfolios to support multifamily and rural housing finance.

[45]Robert E. Litan and Martin N. Baily, "Fixing Finance: A Roadmap for Reform," *Initiative on Business and Public Policy*, Brookings Institution, Washington, D.C., February 17, 2009.

Representatives from the home building industry said that the enterprises generally have held the majority of their affordable multifamily mortgage assets in their portfolios. Fannie Mae officials also said that issuing MBS collateralized by multifamily mortgages can be difficult compared with issuing MBS collateralized by single-family properties for several reasons.[46]

A variation of this option involves breaking up the enterprises into multiple GSEs. For example, the Congressional Research Service (CRS) has stated that the enterprises could be converted into 10 or so GSEs, which could mitigate safety and soundness risks.[47] That is, rather than having the failure of two large GSEs threaten financial stability, the failure of a smaller GSE likely would have a more limited impact on the financial system. CRS also has stated that creating multiple GSEs could enhance competition and benefit homebuyers.

A potential regulatory action to limit the risks associated with reconstituting the enterprises as GSEs would be to establish executive compensation limits as deemed appropriate. As discussed previously, OFHEO investigative reports in 2003 and 2004 concluded that the enterprises manipulated their financial statements in part to help ensure that senior executives would receive bonuses. In June 2009, FHFA

[46]The financing of multifamily projects may not be as amenable to securitization, or the issuance of MBS, than single-family mortgages for several reasons, according to Fannie Mae. For example, Fannie Mae said that many multifamily loans are securitized into single-pool loans providing less diversification for investors. Moreover, repayment of loans secured by multifamily loans typically depends upon the successful operation of the related properties rather than the existence of independent income and assets of the borrowers. Multifamily loans are typically underwritten and structured individually and may have flexible features that give the borrower the ability to add, release, or substitute the property securing the loan under certain conditions. The underlying property types vary and may include conventional market-rate apartments, affordable housing, seniors housing, student housing, manufactured housing communities, and cooperative housing. Further, Fannie Mae said multifamily loans are typically structured with 10-year loan terms, but may be of varying lengths, some of which appeal to investors more than others. Most multifamily loans have prepayment provisions that require the borrower to pay a fee if the loan is voluntarily repaid prior to maturity. Prepayment provisions appeal to investors; however, loans with variances from the standard provisions are not as liquid because they provide less predictability and are more difficult for MBS investors to model.

[47]CRS, *Fannie Mae's and Freddie Mac's Financial Problems*, RL-34661 (Washington, D.C.:, May 20, 2009).

published proposed rules to implement sections of HERA that give FHFA authority over executive compensation at the enterprises.[48]

It has also been suggested that the enterprises be converted from publicly traded companies into cooperatives owned by lenders similar to the FHLBank structure. For example, one commenter suggested that, by having lenders assume some of the risks associated with the enterprises' activities, mortgage underwriting standards could be enhanced. A mortgage lending group stated in a recent analysis of options to revise the secondary mortgage markets that, under a cooperative structure for enterprises, lenders would need to post as collateral a portion of their loan-sale proceeds to cover some initial level of potential losses.[49] This collateral would be refundable to the lenders as loans age and that rights to the collateral could be sold to third parties. The trade group also noted that while the cooperatives would determine pricing, credit standards, and eligibility requirements, they still would need to be subject to safety and soundness oversight by the federal government. However, representatives from a trade group that represents smaller banks said that it might be difficult to convince such banks to participate in a cooperative. They said that many smaller banks suffered substantial losses on the preferred stock they held in Fannie Mae and Freddie Mac before their conservatorships and would be very reluctant to make such investments in the future.

It also has been suggested that the reconstituted enterprises be subject to public utility-type regulation.[50] Traditionally, such regulation has been used at the federal and state level to oversee and control the financial performance of monopolies or near monopolies, such as electric, telephone, and gas companies. To help prevent disadvantages to ratepayers, federal and state governments traditionally have imposed limits on such public utilities' rate of return and required that their rate structures be fair and equitable. It has been suggested that the enterprises' historically dominant positions in the mortgage markets, and their cost

[48]74 *Fed. Reg.* 26989 (June 5, 2009). The proposed rules would provide for FHFA's imposition of limits on executive compensation and prior approval of termination benefits. They would supersede the OFHEO compensation regulation, which currently applies.

[49]Mortgage Bankers Association, "Key Considerations for the Future of the Secondary Mortgage Market and the Government Sponsored Enterprises," Washington, D.C., January 2009.

[50]This discussion is based on issues raised in the following: Robert S. Seiler, Jr., "Fannie Mae and Freddie Mac as Investor-owned Public Utilities," *Journal of Public Budgeting, Accounting & Financial Management* II, no. 1 (1999).

advantages associated with the implied guarantee, among other advantages, potentially make them candidates for public utility-type regulation.

Former Treasury Secretary Paulson advocated keeping the enterprises as corporations, because of the private sector's capacity to assess credit risk compared with government entities, with substantial government support but with a variety of controls on their activities. First, Paulson suggested that the corporations purchase mortgages with a credit guarantee backed by the federal government and not retain mortgage portfolios. Second, Paulson recommended that the corporations be subject to public utility-type regulation.[51] Specifically, he recommended that a public utility-type commission be established with the authority to set appropriate targets for the enterprises' rate of return and review and approve underwriting decisions and new mortgage products. Paulson also recommended that the enterprises pay a fee to help offset the value of their federal support and thereby also provide incentives for depository institutions to fund mortgages, either as competitors to a newly established government structure or as a substitute for government funding.

Privatization or Termination

Some analysts and financial commenters contend that privatizing, significantly reducing, or eliminating the enterprises' presence in the mortgage markets represents the best public policy option.[52] Advocates of this proposal believe that it would result in mortgage decisions more closely aligned with market factors and reduce safety and soundness risks. That is, sources of mortgage credit and risk would not be concentrated in two large and complex organizations that might take excessive risks because of the implied federal guarantee on their financial obligations. Instead, mortgage credit and risk would be diversified throughout the financial system. Federal Reserve Chairman Ben S. Bernanke has suggested that privatized entities may be more innovative and efficient than government entities, and operate with less interference from political interests.[53]

[51]Former Treasury Secretary Henry M. Paulson, Jr., speech before the Economic Club of Washington, January 8, 2009.

[52]Because privatization of the enterprises in effect would terminate their GSE status, we are treating termination and privatization of the enterprises as equivalent in this report.

[53]Federal Reserve Chairman Ben S. Bernanke, "The Mortgage Meltdown, the Economy, and Public Policy" (presented at the University of California at Berkeley/University of California at Los Angeles Symposium, Berkeley, California, October 31, 2008).

Proposals to privatize, minimize, or eliminate the enterprises' presence in the mortgage markets may involve a transition period to mitigate any potential market disruptions and facilitate the development of a new mortgage finance system. For example, one proposal would freeze the enterprises' mortgage purchase activities, which would permit banks and other lenders to assume a greater role in the financial system.[54] Some researchers and financial commenters also have suggested that private-sector entities, such as consortiums or cooperatives of large banks, would have a financial incentive to assume responsibility for key enterprise activities, such as purchasing mortgages and issuing MBS.

Given the substantial financial assistance that Treasury and the Federal Reserve have provided to the enterprises during their conservatorships, it may be very difficult to credibly privatize them as largely intact entities. That is, the financial markets likely would continue to perceive that the federal government would provide substantial financial support to the enterprises, if privatized as largely intact entities, in a financial emergency. Consequently, such privatized entities may continue to derive financial benefits, such as lowered borrowing costs, resulting from the markets' perceptions. In exploring various options for restructuring the enterprises, Bernanke has noted that some privatization proposals involve breaking the enterprises into smaller units to eliminate the perception of federal guarantees.

Bernanke also has questioned whether fully privatized enterprises would be able to issue MBS during highly stressful economic conditions. He pointed out that, during the current financial crisis, private-sector mortgage lending largely stopped functioning. Bernanke cited a study by Federal Reserve economists that advocated the creation of an insurer, similar to the Federal Deposit Insurance Corporation, to support mortgage finance under the privatization proposal.[55] The new agency would offer

[54]Arnold Kling, "Freddie Mac and Fannie Mae: An Exit Strategy for the Taxpayer," Cato Institute Briefing Papers, no. 106 (Washington, D.C.: Sept. 8, 2008). For additional information on privatization and transition issues, see Peter Wallison, Thomas H. Stanton, and Bert Ely, *Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: Why and How*, The AEI Press (Washington, D.C.: 2004); and HUD/Policy Development and Research, *Studies on Privatizing Fannie Mae and Freddie Mac* (Washington, D.C.: 1996).

[55]Diana Hancock and Wayne Passmore, "Three Mortgage Innovations for Enhancing the American Mortgage Market and Promoting Financial Stability" (The University of California at Berkeley/University of California Los Angeles Symposium, Berkeley, California, October 31, 2008).

premium-supported, government-backed insurance for any form of bond financing used to provide funding to mortgage markets.

Bernanke and Paulson also have discussed using covered bonds as a potential means to enhance private-sector mortgage finance in the United States. According to Bernanke, covered bonds are debt obligations issued by financial institutions and secured by a pool of high-quality mortgages or other assets. Bernanke stated that covered bonds are the primary source of mortgage funding for European banks, with about $3 trillion outstanding. However, Bernanke concluded that there are a number of challenges to implementing a viable covered bond market in the United States. For example, as a source of financing, he said covered bonds generally are not competitive with financing provided by the FHLBanks or the enterprises, which have lower financing costs due to their association with the federal government.

A Framework for Identifying and Analyzing the Trade-offs Associated with Options to Revise the Enterprises' Structures, and Oversight Structures That Might Help Ensure Their Effective Implementation

Each of the options to revise the enterprises' structures involves important trade-offs in terms of their capacity to achieve key housing mission and safety and soundness objectives (see table 5). This section examines the three options in terms of their ability to (1) provide ongoing liquidity and support to mortgage markets, (2) support housing opportunities for targeted groups, and (3) ensure safe and sound operations. Furthermore, it identifies potential regulatory and oversight structures that might help ensure that the implementation of any of the options achieves their intended housing mission and safety and soundness objectives.

Table 5: Trade-offs Associated with Enterprise Reform Options as They Relate to Long-Established Enterprise Objectives and Potential Oversight Structures

Proposed Reform Option	Provide liquidity and support to mortgage markets including in bad economic times	Support housing opportunities for targeted groups	Ensure safe and sound operations	Possible elements of regulatory and oversight structure
Government corporation or agency	A government entity, with access to Treasury-issued debt to fund its operations, may be in a better position to provide liquidity to the mortgage market during normal economic periods and when capital markets are impaired. However, because in some cases investor demand for its MBS may be limited in times of financial stress a government entity that does not have a retained portfolio may face challenges supporting mortgage markets during such periods. Treasury or the Federal Reserve may have to purchase mortgage assets under such circumstances as has been the case during the current disruption in mortgage credit markets.	A government entity most likely would be expected to pursue housing opportunity programs for targeted groups due to its public status. However, if the government entity does not have a retained mortgage portfolio, it may face certain challenges in managing a housing goal program since some types of affordable loans, like multifamily loans, often are held in portfolio. As alternatives, fees could be assessed on the government entity's activities to support housing opportunities for targeted groups or FHA's mortgage insurance programs could be expanded.	This model may represent less risk than traditionally has been the case with the enterprises' GSE structure and because MBS issuance is less complicated and risky than managing a retained mortgage portfolio. However, this business activity still would be more complicated than Ginnie Mae's activities and could result in substantial taxpayer losses if mismanaged. Furthermore, a government corporation could face greater challenges than private-sector entities in obtaining the human and technological resources necessary to manage complex processes or lack the operational flexibility to do so.	Key elements for consideration include: (1) certain operational flexibilities to obtain appropriate staff and information technology to carry out responsibilities, (2) risk-sharing agreements with private lenders or mortgage insurers, (3) appropriate disclosures in the federal budget of risks and liabilities to ensure financial transparency, and (4) robust congressional oversight of operations.

Proposed Reform Option	Provide liquidity and support to mortgage markets including in bad economic times	Support housing opportunities for targeted groups	Ensure safe and sound operations	Possible elements of regulatory and oversight structure
Reconstituted GSEs	The enterprises as reconstituted GSEs may provide liquidity and other benefits to mortgage finance during normal economic times as they did for many years. However, their ability to provide such support during stressful economic periods is questionable given current experience. Furthermore, with significantly reduced or eliminated retained mortgage portfolios, reconstituted GSEs' capacity to provide support to mortgage markets during periods of economic distress may also be limited.	Reconstituted GSEs, with their responsibility to maximize profits for their shareholders, might find it difficult to support some public policy housing initiatives. Moreover, without a retained mortgage portfolio, the reconstituted GSEs may face challenges in implementing a numeric housing goal purchase program. This challenge could be addressed by permitting a reconstituted GSE to maintain a relatively small portfolio or by supporting housing opportunities for targeted groups through assessments on its activities.	The current financial crisis highlights some of the problems with the traditional GSE structure, including the incentive for the enterprises to increase leverage and maximize the size of their portfolios, creating risks to financial stability. Reconstituting the GSEs would combine private ownership with an explicit government guarantee, reestablish and perhaps strengthen these incentive problems, which again could lead to even greater moral hazard and safety and soundness concerns, as well as potentially increased systemic risks. Proposals to regulate GSEs like public utilities could, in principle, constrain excessive risk-taking, but the applicability of the public utility model of regulation to the enterprises has not been established. Moreover, FHFA has not been tested as an independent safety and soundness and housing mission regulator as the agency generally has acted as a conservator since its establishment in July 2008.	Key elements for consideration include: (1) reducing or perhaps eliminating retained mortgage portfolios as deemed appropriate depending on prioritization of numeric housing and safety and soundness objectives, (2) establishing capital standards that are commensurate with relevant risks, (3) developing additional regulations such as executive compensation limits or perhaps including public utility regulation, (4) requiring appropriate financial disclosures in the federal budget to enhance transparency, and (5) ensuring strong congressional oversight of the enterprises' and FHFA's performance.

Proposed Reform Option	Provide liquidity and support to mortgage markets including in bad economic times	Support housing opportunities for targeted groups	Ensure safe and sound operations	Possible elements of regulatory and oversight structure
Privatization or termination	Privatizing or terminating the enterprises would eliminate many problems with the current GSE model, including the conflict between public policy and private shareholders. If key enterprise activities such as mortgage purchases and MBS issuances are provided by other financial institutions, liquid mortgage markets could be reestablished in normal economic times. There is significant reason to question the capacity of private banks to support mortgage markets in times of financial distress without government support, given the failure or near failure of key financial institutions and the absence of private-label securitization during the current financial crisis. A federal mortgage insurer could help such lenders to provide liquidity and other benefits in times of financial stress.	Privatization or termination would remove the traditional legislative basis, government sponsorship, for the enterprises to implement programs to serve the mortgage credit needs of targeted groups. However, the basis for such programs may remain if a government insurer for mortgage debt is established and the federal government guarantees its financial obligations. Furthermore, programs might be justified by Congress on the grounds that large lenders that assume responsibility for key enterprise activities or purchase their assets are viewed as “too big to fail” and/or benefit from implied federal guarantees on their financial obligations.	The termination of the enterprises as GSEs and reliance on private-sector firms would leave market discipline and regulators of financial institutions with responsibility for promoting safety and soundness. However, moral hazard concerns would still remain if some mortgage lenders were deemed “too big to fail.” These concerns may be heightened because the current fragmented financial regulatory system already faces challenges in overseeing such organizations. Additionally, safety and soundness concerns may remain if a federal entity is established to insure mortgage debt and does not charge appropriate premiums to offset the risks that it incurs. FHA and the FHLBank System may become more prominent if the enterprises were privatized or terminated.	The need for a new financial regulatory system, due to concerns about the current fragmented system, may be heightened to the extent that terminating or privatizing the enterprises results in larger and more complex financial institutions. In considering a new system, Congress should consider establishing clear regulatory goals, a systemwide risk focus, and the need to mitigate taxpayer risks. If a new federal mortgage insurer is established, there should be an appropriate oversight structure for such an entity. This structure might include appropriate regulations and capital standards, the disclosure of risks and liabilities in the federal budget, and congregational oversight.

Source: GAO analysis of structural reform options.

Potential Trade-offs Associated with Establishing a Government Corporation or Agency

With many of its activities funded directly through Treasury debt issuances, a government corporation or agency (a government entity) could help provide liquidity to mortgage markets during good economic times through the purchase of large volumes of mortgages that meet specified underwriting criteria and issue MBS collateralized by such mortgages. In the process, a government entity also could help ensure standardization in the mortgage underwriting process. Additionally, a government entity might have a structural advantage over private entities—such as reconstituted GSEs, banks, or other private lenders—in providing liquidity to mortgage markets during periods of economic stress. That is, a government entity may be able to continue to fund its activities through government debt issuances. In contrast, for-profit entities face potential conflicts in supporting mortgage finance during stressful economic periods because they also must be concerned about maintaining shareholder value, which may mean substantially reducing their activities or withdrawing from markets entirely as has occurred during the recent economic downturn. However, to the extent that a retained mortgage portfolio may be necessary to help respond to a financial crisis, a government entity without such a portfolio may face challenges in supporting mortgage finance, particularly if investor demand for its MBS were to become limited. Other federal entities, such as Treasury and the Federal Reserve, may have to step in to purchase and hold mortgage assets on their balance sheets (as has been the case during the current financial crisis) if such a situation existed.

The absence of a retained mortgage portfolio for a government entity also could affect the traditional conventional, conforming mortgage market. Over the past 10 years, the enterprises, as discussed earlier, have maintained large mortgage portfolios. If this option is no longer available, lenders may find it more challenging to find buyers for these mortgages in the secondary market. It is not clear the extent to which a government entity could maintain the same general level of mortgage purchases as the enterprises if it were confined to assembling all such mortgages into MBS.

Potential Capacity to Facilitate the Flow of Mortgage Credit to Targeted Groups

A government entity most likely would be expected to support homeownership opportunities for targeted groups given its status as a public organization. This option also would resolve any structural conflicts that the enterprises faced over the years as for-profit, publicly-traded, shareholder-owned corporations in supporting homeownership opportunities for targeted groups. A government corporation or agency would be a public entity without the responsibility to maximize shareholder value. However, if a government entity were not permitted to have a retained mortgage portfolio, as some researchers have proposed, it likely would face challenges in implementing a numeric mortgage purchase program similar to that of the enterprises. As discussed previously, the enterprises tended to hold a significant portion of multifamily mortgages that were purchased pursuant to the numeric mortgage purchase programs in their retained portfolios. That is because it may be difficult to convert multifamily mortgage assets into MBS compared with single-family mortgages. There might be several different ways to address this challenge. For example, fees or assessments could be imposed on the activities of the government entity, and such revenues could be used to directly support the construction of affordable housing or provide down payment assistance to targeted homebuyers. Under HERA, the enterprises were to pay assessments to fund a Housing Trust Fund for the purposes of providing grants to states to increase and preserve the supply of rental housing and increase homeownership for extremely low- and very low-income families, but FHFA has suspended this program due to the enterprises' financial difficulties.[56] Alternatively, FHA could be expanded to assume responsibility for the enterprises' ongoing efforts to support homeownership opportunities as one researcher has suggested. However, as is discussed later, FHA's current operational capacity to manage a large increase in its business may be limited, which could increase taxpayer risks.

Potential Safety and Soundness Concerns

In some respects, a government entity that focused its activities on purchasing mortgages and issuing MBS might pose lower safety and soundness risks than has been the case with the enterprises. For example, a government entity would not be motivated by an implied federal guarantee to engage in risky business practices to achieve profitability targets and thereby maintain shareholder value as was the case with the enterprises. Furthermore, if a government entity were not to retain a mortgage portfolio, as has been proposed, then it would be less complex and potentially less risky than the enterprises' current structure. As already discussed, the enterprises' large retained portfolios exposed them to significant interest-rate risk, and they misapplied accounting rules that governed the hedging techniques necessary to manage such risks.

Nevertheless, successfully managing a large conventional mortgage purchase and MBS issuance business still may be a complex and challenging activity for a government entity, and the failure to adequately manage the associated risks could result in significant losses that could be the direct responsibility of taxpayers. For example, the enterprises' substantial losses in recent years have been credit-related (due to mortgage defaults), including substantial losses in their MBS guarantee business. This risk may be heightened if a government entity were expected to continue purchasing mortgages and issuing MBS during stressful economic periods when the potential for losses may be greater

[56]HERA amended the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 to require Fannie Mae and Freddie Mac to set aside an amount each fiscal year equal to 4.2 basis points for each dollar of unpaid principal balance of its total new business purchases and transfer 65 percent of the amount to HUD to fund the Housing Trust Fund and 35 percent of the amount to the Capital Magnet Fund, a trust fund in Treasury's Community Development Financial Institutions Fund. (Pub. L. No. 110-289 § 1131). On June 3, 2009, the FHFA Director stated that FHFA suspended enterprise contributions to the Housing Trust Fund in light of enterprise losses and their draws on Treasury's Senior Preferred Stock Purchase facility.

than would otherwise be the case. As discussed previously, Ginnie Mae provides only a limited model for the establishment of such a government corporation or agency. Ginnie Mae guarantees the timely payment of principal and interest on MBS collateralized by mortgages, but federal agencies insure or guarantee such mortgages and lenders issue the MBS. Furthermore, Ginnie Mae is not responsible for establishing credit underwriting standards or monitoring lenders' adherence to them; rather, these functions are carried out by FHA, VA, PIH, and USDA/RD. In contrast, a government entity that issued MBS collateralized by conforming mortgages as is the case with the enterprises would be responsible for managing credit risk, including setting appropriate guarantee fees to offset such risk.[57]

As described in our previous work on FHA, government entities may lack the financial resources necessary to attract the highly skilled employees needed to manage complex business activities or the information technology necessary to help do so.[58] Furthermore, government entities sometimes are subject to laws and regulations that may limit their capacity to respond to market developments. In a range of recent reports, HUD's Office of Inspector General expressed concerns about whether FHA had the staffing expertise and information technology needed to manage the rapid increase in its mortgage insurance business since 2008.[59]

Oversight Structure That Could Help Ensure the Effective Implementation of a Government Corporation or Agency

To help ensure that a government entity could achieve its housing mission objectives while operating in a safe and sound manner, an appropriate oversight framework would need to be established. While such a framework would need to clearly define the roles and objectives of a government entity in the mortgage finance system, it would need to afford the entity sufficient flexibility to acquire adequate resources and manage its activities to fulfill its mission. The establishment of risk-sharing arrangements with the private sector, such as requirements that lenders

[57]See GAO, *Housing Finance: Ginnie Mae Is Meeting Its Mission but Faces Challenges in a Changing Marketplace*, GAO-06-9 (Washington, D.C.: Oct. 31, 2005).

[58]See GAO, *Federal Housing Administration: Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvement in Risk Management*, GAO-07-708 (Washington, D.C.: June 29, 2007) and GAO, *Information Technology: HUD Needs to Strengthen Its Capacity to Manage and Modernize its IT Environment*, GAO-09-675 (Washington, D.C.: July 31, 2009).

[59]House Committee on Financial Services, testimony of James A. Heist, Assistant Inspector General for Audit, U.S. Department of Housing and Urban Development, 111th Cong., 2nd sess., January 9, 2009.

that sell mortgages to the government entity retain some exposure to potential credit losses or that private mortgage insurance is obtained on such mortgages, could help mitigate the risk of potential losses. Such a government entity could be expected to reflect its risk and liabilities in the federal budget to help ensure financial transparency of its operations. Finally, robust congressional oversight of any such entity would be needed to help ensure that the entity was fulfilling its objectives.

Potential Trade-offs Associated with Reestablishing the Enterprises as For-profit GSEs

When mortgage credit markets stabilize, the enterprises as reconstituted GSEs might be expected to perform functions that they have performed for many years, such as purchasing conventional mortgages, issuing MBS, and perhaps managing a relatively small retained mortgage portfolio under some proposals. Through such activities, the enterprises might be expected to provide liquidity to mortgage markets during good economic periods, as well as provide standardization to the mortgage underwriting process and certain technical and procedural innovations. However, as for-profit corporations, significant concerns remain about how well the reconstituted enterprises would be able to support financial markets during stressful economic periods without substantial financial support from Treasury or the Federal Reserve.

Moreover, the reconstituted GSEs, like government corporations or agencies, might face challenges in their ability to support mortgage finance if their mortgage portfolios were substantially downsized or eliminated as envisioned under some proposals. For example, with substantially downsized or eliminated mortgage portfolios, the reconstituted GSEs might further limit their capacity to respond to financial crisis, in which case, the likelihood that Treasury or the Federal Reserve would need to respond by buying and holding mortgage assets on their balance sheets would be increased. In addition, substantially downsizing or eliminating the reconstituted GSEs mortgage portfolios could limit lenders' ability to sell conventional, conforming mortgages on the secondary market. Permitting the enterprises as reconstituted GSEs to maintain mortgage portfolios, albeit at lower levels than prior to their conservatorships, could help address these potential concerns.

Potential Capacity to Facilitate the Flow of Mortgage Credit Serving Targeted Groups

Similarly, decisions about the size of the reconstituted GSEs' mortgage portfolios would likely affect their capacity to support mortgage purchase programs to facilitate the flow of mortgage credit to targeted groups. If the reconstituted GSEs' mortgage portfolios were substantially decreased or eliminated, then their ability to purchase and hold multifamily mortgages that serve targeted groups might be limited. On the other hand, permitting the reconstituted GSEs to maintain a mortgage portfolio of an appropriate size could mitigate this potential concern. Another consideration associated with establishing the enterprises as for-profit GSEs is the potential conflict with a requirement to facilitate the flow of mortgage credit serving targeted groups. Alternatives to establishing a numeric mortgage purchase program to support homeownership opportunities for targeted groups could include assessing fees on the reconstituted GSEs to directly fund such programs, expanding FHA's mortgage insurance programs, or providing direct down-payment assistance to targeted borrowers.[60]

Potential Safety and Soundness Concerns

Continuing the enterprises as GSEs could present significant safety and soundness concerns as well as systemic risks to the financial system. In particular, the potential that the enterprises would enjoy explicit federal guarantees of their financial obligations, rather than the implied guarantees of the past, might serve as incentives for them to engage in risky business practices to meet profitability objectives. Treasury guarantees on their financial obligations also might provide the enterprises with significant advantages over potential competitors. Furthermore, FHFA's capacity to monitor and control such potentially risky business practices has not been tested. Since its establishment in July 2008, FHFA has acted both as the enterprises' conservator and safety and soundness and housing mission regulator. Under the conservatorship, FHFA has significant control over the enterprises' operations. For example, the FHFA Director has appointed the enterprises' chief executive officers and boards of directors and can remove them as well. But FHFA officials said that agency staff also have been monitoring the enterprises' business risks. It remains to be seen how effectively FHFA would carry out its oversight responsibilities solely as an independent regulator if the enterprises were reconstituted as for-profit GSEs.

While converting the enterprises into multiple GSEs could mitigate safety and soundness and systemic risk concerns by minimizing concentration risks, it also likely would involve trade-offs. For example, multiple GSEs, due to their potentially small size, may not be able to achieve economies of scale and generate certain efficiencies for mortgage markets as has been the case with Fannie Mae and Freddie Mac. As discussed earlier, the

[60]For example, the FHLBanks manage the Affordable Housing Program, which assists in the development of affordable housing for low- and moderate-income households, through contributions of 10 percent of their previous year's net earnings.

enterprises, through their secondary mortgage market activities, have been credited with facilitating the development of a liquid national mortgage market and establishing standardized underwriting practices for mortgage lending.

Alternatively, converting the enterprises from their current structure as publicly owned corporations into cooperatives owned by the lenders that sell mortgages to them may offer certain advantages in terms of their safety and soundness. For example, as the owners of the enterprises, lenders may have financial incentives to ensure that the mortgages that they sell to the enterprises are properly underwritten so as to minimize potential losses that would affect the value of their investments. As discussed previously, Freddie Mac, as a cooperative, generally managed to avoid the financial problems that Fannie Mae, which was a publicly owned corporation, faced during the early 1980s. However, it should also be noted that the cooperative structure may also have limitations. For example, some FHLBanks, which are members of the cooperative FHLBank System, have faced losses recently due to their investments in private-label mortgage assets.

While the public utility model of regulation has been proposed as a means to help mitigate the risks associated with reestablishing the enterprises as GSEs, this proposal involves complexities and trade-offs. For example, it is not clear that the public utility model is an appropriate regulatory structure because, unlike natural monopolies such as electric utilities, the enterprises have faced significant competition from other providers of mortgage credit over the years. For example, as discussed previously, the enterprises' market share declined substantially from 2004 through 2006 due to the rapid growth of the private-label MBS market. Public utility-type regulation also has been criticized as inefficient and many states have sought to deregulate their electric and other markets. Furthermore, these proposals may have offsetting effects on the GSEs' financial viability. For example, former Treasury Secretary Paulson's proposal would subject their credit decisions and rate of return to preapproval by a public utility-type board, and impose fees on them to offset any benefits derived from government sponsorship of their activities. It is not clear if an entity subject to such business activity restrictions, regulations, and fees, even with Treasury guarantees on its financial obligations, would be able to raise sufficient capital from investors or purchase mortgages on terms that mortgage lenders would find cost-effective.

Potential Oversight Structure That Could Help Ensure the Effective Implementation of Reconstituted GSEs

A range of potential options exist for developing an appropriate regulatory structure to help ensure that any reconstituted GSEs would operate in a safe and sound manner while achieving housing mission objectives. For example, if maintaining safety and soundness is viewed as a priority over a numeric housing goal program, then eliminating retained mortgage portfolios may be viewed as appropriate. Alternatively, the retained mortgage portfolios could be substantially smaller and restricted to certain types of assets to help ensure safety and soundness while promoting housing mission achievement. Other steps that may be deemed appropriate could include establishing capital standards for the enterprises commensurate with their risk, additional restrictions on their activities, executive compensation limits, public utility regulation, appropriate financial disclosures of risks and liabilities in the federal budget, and strong congressional oversight of the enterprises' and FHFA's performance.

Potential Trade-offs Associated with Privatizing or Terminating the Enterprises

As with the preceding two sets of options, proposals that involve the privatization or ultimate termination of the enterprises involve a number of trade-offs. For example, if a consortium of large banks assumed responsibility for key activities (such as mortgage purchases and MBS issuances) of the enterprises, during good economic times it might be able to provide liquidity to the mortgage finance system, help ensure consistency through uniform underwriting standards, and potentially promote innovation in mortgage finance. However, the ability of private lenders to provide support to mortgage markets during stressful economic periods is questionable. As discussed previously, many private-sector lenders have failed or withdrawn from mortgage markets during the current economic downturn. The establishment of a federal mortgage debt insurer, as has been proposed, may facilitate private lenders' capacity to support mortgage markets during stressful periods.

Privatizing or terminating the enterprises also could affect the structure of mortgage lending that has evolved over the years. For example, lenders might be less willing to originate 30-year, fixed-rate mortgages, due to the associated interest-rate risk of holding them in portfolio, if any ensuing private-sector secondary market alternatives (such as a consortium of private-sector lenders) were less willing to purchase such mortgages than the enterprises had been. Additionally, privatization or termination could result in a relative increase in mortgage interest rates, because private-sector lenders might not have the funding advantages that the enterprises derived from their federal sponsorship over the years.[61]

Potential Capacity to Facilitate the Flow of Mortgage Credit to Targeted Groups

This option also could eliminate the traditional legislative basis for requiring that they facilitate the flow of mortgage credit serving targeted groups, particularly through the numeric mortgage purchase program. That is, the enterprises currently have a responsibility to help meet the mortgage credit needs of all potential borrowers due to the financial benefits associated with federal sponsorship, which would not be the case for private-sector lenders under the termination and privatization proposals. However, if new federal organizations were established, such as a mortgage insurer, to facilitate the transition to a mortgage finance system in which the enterprises no longer exist, then they could be required to assume responsibility for facilitating the flow of mortgage credit to targeted groups. For example, the Community Reinvestment Act's requirements that insured depositories, such as banks and thrifts, serve the credit needs of the communities in which they operate could be extended to nondepository lenders, such as independent mortgage lenders, which would obtain mortgage insurance from a new federal mortgage insurer.

Moreover, if a consortium of large lenders or other financial institutions assumed responsibility for key enterprise functions (like MBS issuances), or purchased a substantial share of their assets, then requirements that such institutions serve the credit needs of targeted groups also might be justified. For example, such institutions could be perceived as benefiting from implied federal guarantees on their debt or being too big to fail. We note that Treasury and the Federal Reserve have provided direct financial assistance to a range of financial and other institutions during the current financial crisis, which may create the perception in financial markets that the federal government is more likely to intervene in a future crisis.

Potential Safety and Soundness Concerns

The extent to which privatizing or terminating the enterprises mitigates current safety and soundness and financial stability risks is difficult to determine. Under one scenario, such risks would be mitigated because large and complex enterprises, which might engage in risky business practices due to the implied federal guarantee on their financial obligations, would not exist. Instead, private lenders would be subject to market discipline and consequently would be more likely to make credit

[61]GAO/GGD-96-120.

decisions largely on the basis of credit risk and other market factors. However, this scenario would be complicated if a federal entity were established to insure mortgage debt. If the federal mortgage insurer did not set appropriate premiums to reflect the risks of its activities, then lenders might have incentives to engage in riskier business practices than otherwise would be the case. In similar situations, such as the National Flood Insurance Program, federal agencies have faced challenges in establishing appropriate premiums to compensate for the risks that they underwrite. If large private-sector financial institutions assumed responsibility for key enterprise activities or purchased a significant portion of their assets, the perception could arise that the failure of such an institution would involve unacceptable systemic financial risks. Therefore, markets' perceptions that the federal government would provide financial assistance to such financial institutions could undermine market discipline.

Moreover, limitations in the structure of the current U.S. financial regulatory system could heighten concerns about the potential safety and soundness risks associated with large financial institutions assuming responsibility for key enterprise financial activities or becoming larger due to the purchase of their assets. In a recent report, we stated that the current fragmented regulatory system for banks, securities firms, insurance companies, and other providers evolved over many years and often in response to financial crises.[62] We stated that the large and complex financial conglomerates that have emerged in the past decades often operate globally across financial sectors and that federal regulators have faced significant challenges in monitoring and overseeing their operations. For example, the report noted that a Federal Reserve official recently acknowledged that, under the current structure, which consists of multiple supervisory agencies, challenges can arise in assessing risk profiles of these institutions, particularly because of the growth in the use of sophisticated financial products that can generate risks across various legal entities.

Privatizing or terminating the enterprises also could increase the relative prominence of other federal programs designed to promote homeownership and housing opportunities, which also may have safety

[62]GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009).

and soundness implications. Due to the diminished presence of the enterprises in mortgage finance under these proposals, market participants, such as banks and thrifts, increasingly might turn to the FHLBank System as a source of funding for their operations and lending activities. The FHLBank System could enjoy an advantage over other potential competitors in filling the void left by the enterprises because, as a GSE benefiting from an implied guarantee, it may be able to issue debt to fund its activities at relatively advantageous rates. However, some FHLBanks have recently reported losses due to investments in private-label MBS. Similarly, FHA's mortgage insurance programs might increase if the enterprises' diminished role limits the availability of mortgage credit in the conforming market.

Potential Oversight Structure That Could Help Ensure the Effective Implementation of Terminating or Privatizing the Enterprises

The development of an appropriate regulatory structure to help ensure housing mission achievement and safety and soundness, as deemed appropriate, would depend on the outcome of a range of contingencies associated with options to privatize or terminate the enterprises. For example, should Congress choose to establish a new public entity to insure all mortgage debt, with the federal government guaranteeing the insurance, then a new regulatory and oversight structure would be needed to oversee the operations of such an insurer. As with other options to reform the enterprises' structures, an appropriate structure for such an entity might involve a regulatory agency with authorities to carry out its activities and capital standards that reflect the risk of the entity's activities, disclosures of risks and liabilities in the federal budget to help ensure financial transparency, and robust congressional oversight. Furthermore, revisions may be necessary to help ensure that the U.S. financial regulatory system can better oversee the risks associated with large and complex financial institutions, which may assume responsibility for key enterprise activities or become larger over time through the acquisition of their assets. Our recent report identified a series of principles, such as establishing clear regulatory goals, ensuring a focus on systemwide financial risks, and mitigating taxpayer risks, for Congress to consider in deciding on the most appropriate regulatory system.[63]

[63]GAO-09-216.

Federal Efforts to Support Housing Markets during the Conservatorships and Certain Terms of Treasury Agreements Could Increase the Costs and Challenges Associated with the Transition to New Enterprise Structures

Since the beginning of the FHFA conservatorships, the enterprises have been tasked to initiate a range of programs, such as assisting homeowners struggling to make their mortgage payments to refinance or modify their mortgage terms, to respond to the current crisis in housing markets. These initiatives could benefit housing markets and, in so doing, potentially benefit the enterprises' financial condition. However, the initiatives also may involve additional risks and costs for the enterprises, which could increase the costs and challenges associated with transitioning to new structures over time. Similarly, certain provisions in the Treasury agreements with the enterprises may affect their long-term financial viability and complicate a transition to a new structure. Finally, any transition to a new structure would need to take into consideration the enterprises' dominant position within housing finance, even during the conservatorships, and, therefore, should be carefully implemented—perhaps in phases—to help ensure its success.

The following points summarize several of the initiatives that the enterprises have undertaken in response to the substantial downturn in housing markets:

- Under the Home Affordable Refinance Program (HARP), which was initiated in March 2009, borrowers that have current payment histories can refinance and reduce their monthly mortgage payments at loan-to-value ratios of up to 105 percent without obtaining mortgage insurance. On July 1, 2009, the program was extended to apply to mortgage loans with loan-to-value ratios of up to 125 percent.
- Under the Home Affordable Modification Program (HAMP), certain borrowers who are delinquent, or in imminent danger of default, on their mortgage payments may have the terms of their existing mortgages modified in order to make payments more affordable. Specifically, the program allows for interest rate reductions (down to 2 percent), term extension (up to 480 months), principal forbearance, and principal forgiveness. Under the program, the enterprises will provide up to $25 billion in incentives to borrowers and servicers for program participation and a successful payment history.[64]

[64]Under HAMP, Treasury will provide up to $50 billion in interest-rate reduction and incentives to servicers, mortgage holders/investors, and borrowers for the modification of nonenterprise loans.

- In November 2008, the enterprises suspended the initiation of foreclosure proceedings on mortgages that they held in their portfolios or on which they had guaranteed principal and interest payments for MBS investors. This initiative subsequently was extended through March 31, 2009. In March 2009, the enterprises also suspended foreclosure sales on mortgages that may be eligible under HAMP until borrowers' eligibility for HAMP has been verified.

While these federal initiatives were designed to benefit homebuyers, in recent financial filings, both Freddie Mac and Fannie Mae have stated that the initiative to offer refinancing and loan modifications to at-risk borrowers could have substantial and adverse financial consequences for them. For example, Freddie Mac stated that the costs associated with large numbers of its servicers and borrowers participating in loan-modification programs may be substantial and could conflict with the objective of minimizing the costs associated with the conservatorships.[65] Freddie Mac further stated that loss-mitigation programs, such as loan modifications, can increase expenses due to the costs associated with contacting eligible borrowers and processing loan modifications. Additionally, Freddie Mac stated that loan modifications involve significant concessions to borrowers who are behind in their mortgage payment, and that modified loans may return to delinquent status due to the severity of economic conditions affecting such borrowers. Fannie Mae also has stated that, while the impact of recent initiatives to assist homeowners is difficult to predict, the participation of large numbers of its servicers and borrowers could increase the enterprise's costs substantially.[66] According to Fannie Mae, the programs could have a materially adverse effect on its business, financial condition, and net worth.

However, FHFA officials said that they strongly believe the recent initiatives to support the housing markets, on balance, represent the best means available for the enterprises to preserve their assets and fulfill their housing missions. For example, FHFA officials said that, to the extent that their initiatives are successful in stabilizing housing markets, the enterprises will be the major beneficiaries as the number of delinquent mortgages and foreclosures is reduced. FHFA officials also commented

[65]Freddie Mac, "Form 10-K: Annual Report for the Fiscal Year Ended December 31, 2008."

[66]Fannie Mae, "Form 10-Q: Quarterly Report for the Quarterly Period Ended September 30, 2008."

that recent modification programs, such as HAMP, are more likely to be successful than modification initiatives dating to 2008, which had high redefault rates. FHFA officials said that the more recent loan-modification initiatives were more likely to reduce borrowers' monthly payments. According to an FHFA report, the traditional approaches to loan modifications (allowing borrowers to bring loans current by reamortizing past due payments over the remaining life of the loan) increased monthly payments and, therefore, often resulted in high redefault rates.[67] Furthermore, FHFA officials stated that recent loan-to-value ratio refinance programs only apply to mortgages that the enterprises already guarantee, so they already are exposed to the credit risks on these loans. FHFA officials said that such refinancings also should lower borrowers' payments and thereby further reduce the enterprises' existing credit exposure.

While FHFA's positions are plausible, it is too early to reach any conclusion about the effects that the initiatives will have on the enterprises' financial condition and preliminary data raise potential concerns. According to a report by the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS), loan modifications initiated in 2008 that reduced borrowers' monthly payments by 20 percent or more had significantly lower redefault rates after 1 year than modifications that left monthly payments unchanged or higher.[68] Specifically, the study found that, of the modifications that involved reductions of 20 percent or more, 38 percent were 60 or more days past due after 1 year, whereas the rate was nearly 60 percent for modifications that left monthly payments unchanged or higher. However, the fact that nearly 40 percent of loan modifications that substantially reduced monthly payments were already 60 or more days past due after 1 year raises concerns about whether the additional costs that enterprises incur in administering such programs will be effective. Furthermore, it is also not clear whether initiatives to suspend foreclosure proceedings will benefit the enterprises' financial condition. Our previous work has found that, for mortgage providers such as Fannie Mae and Freddie Mac, foreclosure costs may increase the longer it takes to maintain and sell foreclosed

[67]Federal Housing Finance Agency, *Foreclosure Prevention Report: First Quarter 2009* (Washington, D.C.: 2009).

[68]OCC and OTS, "Mortgage Metrics Report, First Quarter 2009" (Washington, D.C.: April 2009).

properties.[69] A potential risk of suspending pending foreclosure sales is that many borrowers facing foreclosure will not be able to obtain funds necessary to make their mortgage loan payments current.[70] As a result of delays in foreclosing on such properties, the potential exists that the properties will not be maintained or will become vacant, which could increase the enterprises' associated costs.

Treasury's agreements with Fannie Mae and Freddie Mac, which specify terms under which the department is to provide certain types of financial support to them, also may have long-term financial consequences. In connection with the agreements, quarterly dividends declared by the enterprises are to be paid to holders of the senior preferred stock (Treasury). These dividends accrue at 10 percent per year and increase to 12 percent if, in any quarter, they are not paid in cash. If either enterprise cannot pay the required dividends, then Treasury has a claim against the assets of the enterprise for the unpaid balance in a liquidation proceeding. Available financial data suggest that the enterprises, while in conservatorship and over the longer term, will face significant financial challenges in paying the required dividends to Treasury. For example, Treasury already purchased $50 billion in preferred stock in Freddie Mac, which translates into an annual dividend of $5 billion, and CBO estimated that the department will invest substantially more in the enterprise's preferred shares in coming quarters (up to the guarantee limit of $200 billion). Prior to the conservatorship, Freddie Mac's reported annual net income twice came close to or exceeded $5 billion, and the dividends that it distributed to shareholders in those years likely were substantially lower. In addition, the agreements require that, beginning on March 31, 2010, the enterprises pay a commitment fee to Treasury to compensate the department for the ongoing financial support that it is providing to them. While the size of the commitment fee is subject to negotiation, it represents another potential long-term challenge to the enterprises' financial viability. For example, like the dividend requirements, any unpaid commitment fees become a claim by Treasury against the assets of the enterprises in a liquidation proceeding, unless Treasury waives the fee.

[69] GAO, *Single-Family Housing: Opportunities to Improve Federal Foreclosure and Property Sale Processes*, GAO-02-305 (Washington, D.C.: Apr. 17, 2002) and GAO, *Department of Veterans Affairs: Actions Needed to Strengthen VA's Foreclosed Property Management Contractor Oversight*, GAO-08-60 (Washington, D.C.: Nov. 15, 2007).

[70] At the foreclosure sale, the mortgage provider, such as Fannie Mae or Freddie Mac, obtains title to the foreclosed property.

Although it is not possible to predict what effects federal initiatives to respond the housing crisis and the Treasury agreements with the enterprises could have on the transition to a new structure, they could be substantial. For example, under the proposal to reconstitute the enterprises as for-profit GSEs, potential investors might not be willing to invest their capital if the reconstituted GSEs had a substantial volume of nonperforming mortgage assets or substantial financial obligations to Treasury. To minimize this risk, the federal government could arrange a transition process in which the government would retain nonperforming assets in a "bad bank" and spin off the performing assets of the enterprises to a "good bank" and key functions, such as issuing MBS, to investors in a reconstituted GSE.[71] Or, the federal government could establish such a process as a means to terminate or privatize the enterprises. However, to the extent that the enterprises engage in activities during their conservatorships or incur financial obligations inconsistent with maintaining their long-term financial viability, the level of nonperforming mortgage assets and long-term costs to taxpayers ultimately may be higher than otherwise would be the case.

Finally, regardless of what changes are implemented, policymakers should pay careful attention to how a potential transition is managed to mitigate potential risks to the housing finance system. The enterprises evolved over many years to become dominant participants in housing finance and, in some respects, their roles have expanded during the conservatorships. Therefore, transitioning to a new structure could have significant consequences for housing finance and should be managed carefully and perhaps implemented in phases with periodic evaluations to determine if any corrective actions would be necessary. For example, any changes likely would require regulators and institutions to make system changes and undertake other activities that would take extensive time to complete. Our previous work also has identified other key issues that likely would be critical components of any transition process.[72] In particular, an effective communication strategy would be necessary to help ensure that all mortgage market participants, including lenders, investors, and borrowers, have sufficient information to understand what changes are being made and how and when they will be implemented. Moreover, it will be

[71]Such proposals generally involve the federal government maintaining existing guarantees on the assets in the "bad bank" as well as assets in the "good bank" as may be required.

[72]See GAO, *Homeland Security: Critical Design and Implementation Issues*, GAO-02-957T (Washington, D.C.: July 17, 2002).

important to put effective strategies in place to help ensure that, under whichever reform strategy is chosen, the new financial institutions and their regulators will have the staffing, information technology, and other resources necessary to carry out their missions.

Agency Comments and Our Evaluation

We provided a draft of this report to FHFA, the Federal Reserve, HUD, and Treasury for their review and comment. While he was still the FHFA Director, James B. Lockhart III provided us with written comments, which are summarized below and reproduced in appendix II, as well as technical comments, which we incorporated as appropriate.[73] Federal Reserve staff, HUD's Assistant Secretary for Housing-Federal Housing Commissioner, and Treasury also provided technical comments, which were incorporated as appropriate. We also provided excerpts of a draft of this report to seven researchers whose studies we cited to help ensure the accuracy of our analysis. Six of the researchers responded and said that the draft report accurately described their research, while one researcher did not respond.

In his comment letter, Lockhart stated that the report is timely and does a good job of summarizing the dominant proposals for restructuring the enterprises and summarizing their strengths and weaknesses. Lockhart also stated that initial attention should be to the role of mortgage finance in our society and how the government wants the institutions and markets that supply it to function and perform. In particular, he said this includes determining the most appropriate roles for private and public entities, competition and competitiveness, risks and risk management, and the appropriate channels and mechanisms for targeting the underserviced and protecting consumers. Further, he identified key questions and principles that he believes should be included in the debate on restructuring the enterprises. These principles include (1) deciding what the secondary market should look like, before considering specific institutions; (2) ensuring that the enterprises or any successors have well-defined and internally consistent missions; (3) ensuring that there is a clear demarcation of the federal government and the private sector in the secondary market; (4) establishing a regulatory and governance structure that ensures prudent risk-taking; and (5) ensuring that housing finance is subject to systematically prudent supervision that incorporates countercyclical capital to limit booms and busts.

[73] Lockhart announced his resignation on August 6, 2009, and left FHFA on August 28, 2009.

We concur with the thrust of the view that revising the enterprises' structures should take place in a measured way and in the context of a broader assessment of the housing finance system. As discussed in our report, the enterprises have been key components of the housing finance system for many years and, therefore, any changes to their structures are likely to have broad implications for that system and market participants. In this regard, we stated that it will be important for Congress to reevaluate the enterprises' roles, structures, and performance, and consider structural reform options to facilitate mortgage finance while mitigating safety and soundness concerns. These options, under certain scenarios, envision very different approaches to structuring the secondary market for mortgage loans and facilitating housing opportunities for targeted groups, and we believe the broad implications of these various options need to be carefully considered before any final decisions are made. For this reason, our report addresses implications for various participants in the mortgage markets, including FHA. Further, we discussed that a carefully managed and potentially lengthy transition process needs to be established to help ensure the successful implementation of whatever structural reform option for the enterprises is chosen by Congress and the Executive Branch.

Additionally, Lockhart said that FHFA, in its role as the enterprises' conservator, as well as their mission and safety and soundness regulator, is working diligently with the Treasury and Federal Reserve to maintain or restore safe, sound, liquid, and vibrant mortgage markets. He said a principal focus of FHFA's efforts has been facilitating the enterprises' participation in the Home Affordable Modification and Refinance Programs. While he said the enterprises' participation in these programs may result in near-term costs, he believes the programs will result in stronger and more stable housing markets, which will also benefit the enterprises.

Finally, he made several suggestions regarding certain aspects of the draft report. These suggestions and our responses are described below:

- The draft report should make clear that the structural reform options presented in the report are not exhaustive or mutually exclusive and that hybrids of these options also are possible and may prove to be the most appealing. We agree and, as the report notes, the options for revising the enterprises' long-term structures generally fall along a continuum with some overlap between key features. For example, as Lockhart noted, options for privatizing or terminating the enterprises may involve establishing a government entity to insure mortgages originated by private lenders. In addition, the government entity and reconstituted GSE options generally involve focusing enterprise activities on issuing MBS while downsizing or eliminating their mortgage portfolios.

- The draft report should mention the enterprises' performance in providing liquidity to mortgage markets. We agree that any discussion of the future roles of the GSEs should include consideration of their roles in providing securities that support an active and liquid mortgage market. As the report notes, providing liquidity to mortgage markets has been a key housing mission objective of the enterprises and that, while their secondary market activities have been credited with helping to establish a national and liquid mortgage market, their performance in providing support to mortgage markets during stressful economic periods is not clear.

- While the draft report's discussion of the safety and soundness concerns related to the government entity option is reasonably balanced and fair, it is short on negative details. In particular, (1) the draft report is organized in such a way that makes it easy for the reader to conclude that the safety and soundness benefits of the government entity option outweigh the added risks; (2) the table in the draft report's Highlights page states that the lack of a "profit motive" for a government entity may mitigate risk should be rephrased to state that the option "addresses the conflict between private profits and public sector risk bearing;" and (3) the discussion in the draft report on the potential elimination of the enterprises' mortgage portfolios fails to recognize that such an action is a component of some but not all proposals to reconstitute the enterprises as GSEs or to establish a government entity, and therefore, mentioning the benefit of doing so under one option (the government entity option) and not the other (the reconstituted GSE option) is a significant inconsistency.

  Regarding (1), we do not agree that the order of the text in the draft report implied that the benefits of the government entity option outweigh its risks. While this option offers potential safety and soundness advantages such as addressing deficiencies in the traditional enterprise structures and eliminating their mortgage portfolios, it also has potentially significant drawbacks, which need to be considered. In particular, we stated that managing the enterprises' ongoing MBS business may be complicated and challenging, and government entities may lack the resources and expertise necessary to manage such challenges and risks effectively. Regarding (2), we agree with the thrust of this comment and have modified the text in the table in the Highlights page to make it consistent with the related figure and text in the body of the report. Regarding (3), we agree that any assessment of the options for revising the housing enterprises' long-term structure should include discussion of the implications of retaining mortgage portfolios. As described in the report, the government entity options we identified advocated the elimination of the enterprises' portfolios. In contrast, the options we identified for reconstituting the enterprises as GSEs generally called for reducing the enterprises' portfolios while one proposal called for their complete elimination. The report includes analysis of the potential implications of taking such steps regarding the enterprises' mortgage portfolios under both options, as well as the possible elements of regulatory and oversight structures that could mitigate any potential safety and soundness and systemic stability risks.

We are sending copies of this report to interested congressional committees and members. In addition, we are sending copies to FHFA, Treasury, the Federal Reserve, HUD, financial industry participants, and other interested parties. The report also is available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please contact William B. Shear at (202) 512-8678 or shearw@gao.gov or Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix III.

Gene L. Dodaro
Acting Comptroller General of the United States

List of Committees

The Honorable Christopher J. Dodd
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

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Chairman
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The Honorable Scott Garrett
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Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
Committee on Financial Services
House of Representatives

Appendix I: Objectives, Scope, and Methodology

The objectives of our report were to (1) discuss how the enterprises' roles, structures, and activities have changed over time and their performance in achieving key housing mission objectives; (2) identify various options for revising the enterprises' eventual structure; (3) analyze these options in terms of their potential capacity to achieve key housing mission and safety and soundness objectives; and (4) discuss how the federal government's management of the conservatorships and response to the housing crisis could affect any transition.

To address the first objective, we reviewed reports and studies on the enterprises and their regulation, including GAO reports, as well as reports from the Department of Housing and Urban Development (HUD), the Federal Housing Finance Agency (FHFA), the Office of Federal Housing Enterprise Oversight (OFHEO), the Congressional Budget Office (CBO), the Congressional Research Service (CRS), and independent researchers. We also reviewed legislative and charter documents, as well as an internal history of Fannie Mae, and financial performance data from a variety of sources. Through this research, we sought to identify key housing mission, safety and soundness, and other objectives that have been associated with the enterprises over the years, as well as their performance in meeting such objectives. In doing so, we identified and summarized recent literature that addressed the impact of the enterprises on affordability and opportunities for target groups. While GAO reviewed these studies and included those that were sufficiently methodologically sound for our limited purposes, users of this report should note that these studies are based on data prior to 2001 and contain limitations. Finally, we used data from the Securities Industry and Financial Markets Association (SIFMA) and OFHEO. As SIFMA's data on mortgage-related issuance were consistent with other data sources and highlight well-established trends in mortgage-backed securities (MBS) and collateralized mortgage obligation activity, we found them and the OFHEO data on the balance sheets of the enterprises sufficiently reliable for our purposes.

To address the second objective, we reviewed a variety of studies and proposals that have been made prior to and during the conservatorships to revise the enterprises' structures. The inclusion of these studies and proposals is purely for research purposes and does not imply that we deem them definitive or without limitations. We also met with the authors of many of these studies and with researchers who have knowledge about housing finance, the operations of the enterprises, or who have made proposals to revise the enterprises' structures. We met with representatives from FHFA, the Department of the Treasury (Treasury), the Federal Reserve, HUD, the Government National Mortgage Association

(Ginnie Mae), CBO, the enterprises, bank and mortgage organizations, and trade and community groups. These interviews provided us with the different viewpoints about the proposals.

For the third objective, we analyzed the proposed options for restructuring the enterprises in terms of the potential each proposal offered to achieve key housing mission and safety and soundness objectives. In our analysis, we also relied on principles associated with effective regulatory oversight. While it is not possible to conclusively determine the potential implications of the various proposals, we grounded our analysis of likely outcomes on previous research and evaluations. We also sought to include, where appropriate, assessments of how recent developments in financial markets (particularly actions by federal agencies to provide financial support to troubled banks and other institutions) could affect the various options. We recognize that a variety of factors, such as the condition of credit markets and the financial performance of the enterprises while in conservatorship, could change over time and affect our analysis of the options.

For the final objective, which discusses how the federal government's management of the conservatorships and response to the housing crisis could affect the transition of the enterprises to a new structure, we reviewed the actions undertaken by FHFA, Treasury, and the Federal Reserve, as authorized by the Housing Economic and Recovery Act of 2008. We also reviewed financial data from Fannie Mae and Freddie Mac, including their quarterly 10Q and annual 10K filings. We reviewed and considered the future impact on the enterprises' financial condition from recent initiatives such as the Homeowner Affordability and Stability Act and foreclosure initiation suspensions. We also discussed relevant issues with Treasury and enterprise representatives.

We conducted this performance audit from October 2008 to September 2009, from Washington, D.C., and in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Comments from the Federal Housing Finance Agency

FEDERAL HOUSING FINANCE AGENCY
Office of the Director

August 19, 2009

Mr. Wesley Phillips, Assistant Director
Financial Markets and Community Investment
Government Accountability Office
441 G St., NW
Washington, DC 20458

Dear Mr. Phillips:

Thank you for the opportunity to review and comment on the GAO draft report entitled *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-term Structures* (GAO-09-782). As both the regulator of the housing GSEs (Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System) and the conservator of Fannie Mae and Freddie Mac, the Federal Housing Finance Agency (FHFA) has a keen interest in the recovery of the American housing and housing finance sectors. FHFA appreciates the timeliness of GAO's contribution to understanding the choices Congress and the Administration confront with respect to Fannie Mae and Freddie Mac (the Enterprises). The report does a good job of summarizing the dominant proposals for restructuring the Enterprises and assessing some of their strengths and weaknesses.

First, I hope that in focusing attention primarily on the futures of specific institutions, we don't put the cart before the horse. Our initial attention should be to the role of mortgage finance in our society and how we want the institutions and markets that supply it to function and perform. In particular, that includes determining the most appropriate roles for private and public sector entities, competition and competitiveness, risks and risk management, cyclicality, and the appropriate channels and mechanisms for targeting the underserviced and protecting consumers. In my June 3, 2009 testimony to the House Financial Services Committee, I posed some key questions which policymakers both in Congress and the executive branch must confront:

1. How can mortgage lending, including mortgage securitization, be changed to better serve our society? What is the role of regulation in achieving that goal?
2. How can financial institutions involved in mortgage lending and their supervision be reformed in order to protect overall financial stability better?
3. Beyond prudential regulation and supervision, does the government need to perform directly any specific functions in the secondary mortgage market? If so, how could the government best perform any such functions?

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As the key questions above suggest, very important decisions have to be made about the future of the mortgage market and the appropriate role of the secondary mortgage market, including the roles of government regulation and programs, before we get to the future of the Enterprises themselves.

I also stated in that testimony and in speeches a number of principles that I believe should guide decisions. Those principles include

1. Decide what the secondary market should look like, before considering specific institutions.
2. The Enterprises or any successors should have a well-defined and internally consistent mission.
3. There should be a clear demarcation of the respective roles of the federal government and the private sector in the secondary mortgage market, and any federal risk-bearing should be provided explicitly and at actuarial cost.
4. Regulatory and governance structure must ensure risk-taking is prudent.
5. Housing finance should be subject systemically prudent supervision that incorporates countercyclical capital to limit booms and busts.

Whether Congress and the Administration adopt some or all of these principles, FHFA is proceeding under the authorities provided by the Housing and Economic Recovery Act of 2008 (HERA) to address those that it can. Since September 2008, FHFA is acting as both the conservator of Fannie Mae and Freddie Mac and the mission and safety and soundness regulator of all the housing GSEs. As such, FHFA is working with the housing GSEs, Treasury, and the Federal Reserve to maintain or restore safe, sound, liquid, and vibrant mortgage markets. FHFA is also working diligently and creatively to find ways to reduce the cyclical effects of our regulations and of GSE behavior on housing and housing finance and to integrate the public missions of the housing GSEs with institutional and systemic safety and soundness.

A principal focus of our efforts has been facilitating Enterprise participation in the Home Affordable Modification and Refinance Programs (HAMP and HARP). These programs seek to both aid distressed homeowners and stabilize housing markets by reducing the inventory of houses for sale during a period of market distress. FHFA believes that, while the Enterprises' participation in those programs may result in near-term costs, they will ultimately benefit from the stronger and more stable housing markets.

Elsewhere, FHFA has provided you specific suggestions on the report. I would like to reiterate three of those comments here.

- The options analyzed are not necessarily exhaustive or mutually exclusive. We should recognize that, ultimately, some hybrid of those options and others may prove to be the most appealing. One such possibility would be a market characterized by many privately owned issuers of MBS with the government providing insurance against catastrophic losses, either directly or in partnership with private companies.
- In considering the performance in achieving key housing finance support objectives, their important role in providing securities that form the basis for an active and liquid TBA market for mortgage-backed securities (MBS) should be mentioned.

- While, overall the discussion of the potential safety and soundness concerns related to the government options is reasonably balanced and fair, it is short on negative details. In addition, the order of the arguments makes it easy for a .reader to conclude that the safety and soundness benefits outweigh the added risks. It is unclear that such a conclusion is supported by the evidence. Some effort should be expended to mitigate that misinterpretation. Finally, FHFA has a number of concerns about the summary table entries related to this section. In the first summary table at the front of the report, the phrase "may mitigate risk due to the lack of a profit motive" could be rephrased as "addresses the conflict of interest between private profits and public sector risk bearing." The lack of a profit motive is neither sufficient nor necessary to insure good risk management. In addition, "the elimination of existing mortgage portfolios" is a component of certain, but not all, proposals to reestablish the Enterprises as GSEs and proposals to establish a government corporation or agency. Mentioning the safety and soundness benefit of eliminating those portfolios under one set of proposals and not the other is a significant inconsistency.

  One aspect of this issue that is not directly addressed relates to the Enterprises' fundamental role as insurers of MBS. My own experience at OFHEO, Social Security, the Pension Benefit Guaranty Corporation (PBGC), and now FHFA, has taught me that government insurance comes with significant risks of moral hazard and perverse incentives. In addition, a key advantage of a well-managed insurance program is that money is charged in the form of premiums in good times to offset losses during future bad times. Government insurance programs, including the FDIC have found it difficult to charge adequate premiums, especially in good times. This set of issues is touched on later, in the context of proposals to reconstitute the GSEs, but applies to any proposals that implicitly or explicitly include an insurance role for the government.

Again, we thank you for the opportunity to comment on your draft report and look forward to working with you and your staff in the future.

Sincerely,

James B. Lockhart III

James B. Lockhart III
Director

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

William B. Shear, (202) 512-8678, or shearw@gao.gov

Staff Acknowledgments

In addition to the individual named above, Wesley M. Phillips, Assistant Director; Triana Bash; Martha Chow; Lawrance Evans, Jr.; Marc Molino; Robert Pollard; Barbara Roesmann; Stacy Spence; Paul Thompson; and Barbara Williams made key contributions to this report.

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