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Introduction to Financial Services: The Housing Finance System

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

The Mortgage Market

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

Primary Market. A potential borrower applies for a mortgage from a lender (a *mortgage originator*) in the primary market. The lender *underwrites*, or evaluates, the borrower and decides whether and under what terms to extend a loan. Different types of lenders make home loans, including banks, credit unions, and finance companies (institutions that lend money but do not accept deposits).

The lender usually requires some additional assurance that it will be likely to recoup the amount it is owed even if the borrower does not repay the mortgage. Typically, lenders receive such assurance through a down payment (which reduces the amount that is borrowed relative to the home value), mortgage insurance, or a combination of the two. Mortgage insurance protects the lender when a borrower does not repay a mortgage. It can be provided privately or through a government agency, such as the Federal Housing Administration (FHA). Mortgage insurers set requirements that vary by provider, and borrowers typically pay explicit fees for the insurance. FHA is the largest provider of government mortgage insurance, but the government also provides access to the mortgage market through programs offered by the Department of Veterans Affairs and the U.S. Department of Agriculture.

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

Secondary Market. The secondary market is the market for buying and selling mortgages. If a mortgage originator sells the mortgage in the secondary market, the purchaser of the mortgage may choose to hold the mortgage itself or to *securitize* it. When a mortgage is securitized, it is pooled with other mortgages to create a *mortgage-backed security* (MBS), and the payment streams associated with the mortgages are sold to investors.

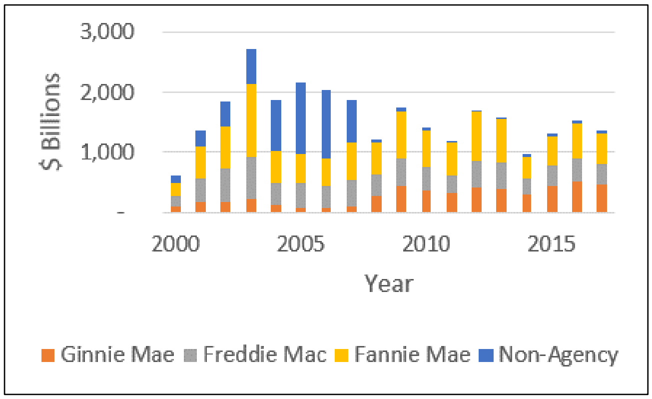
Mortgages can be securitized through three channels:

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

MBS generally are divided into two broad categories: *agency MBS*, which includes GSE and Ginnie Mae MBS, and *non-agency MBS*, which is only PLS. Investors that purchase mortgages and MBS are an important source of funding for mortgages originated in the primary market. Investors in MBS are typically large institutional investors, such as pension funds, domestic banks, foreign banks, and hedge funds. Investors choose which type of MBS to purchase based on the type and amount of risk they wish to bear and the expected return from their investment.

Figure 1 illustrates the changing role of various MBS issuers since 2000. In the early 2000s, Ginnie Mae played a minor role and non-agency issuers played a growing role. During and after the financial crisis of 2007-2010, Ginnie Mae's market share increased and PLS issuance became negligible.

Figure 1. MBS Issuance Volume



Source: Inside Mortgage Finance Publications, *2018—Mortgage Market Statistical Annual.*

Another key supplier of mortgage funding is the Federal Home Loan Bank (FHLB) System, also a GSE. The FHLB System is composed of 11 regional banks owned by their members, such as banks and other financial institutions involved in housing finance. The FHLBs extend credit to their members, primarily to support mortgage lending.

Government Regulation of the Mortgage Market

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

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

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

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

The Bureau of Consumer Financial Protection (BCFP or CFPB), created by the Dodd-Frank Act (P.L. 111-203), regulates certain bank and nonbank participants in the mortgage market and administers certain rules intended to protect consumers, including requirements that lenders verify a borrower's ability to repay the mortgage and standards related to mortgage servicing. The CFPB also has authority under additional federal consumer laws to regulate parts of the mortgage market.

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

Policy Issues

The bursting of the housing bubble in 2007, the ensuing multiyear downturn in the housing and mortgage markets, and the recovery from that downturn have raised several issues for Congress, some of which are discussed below.

Financial Status of the GSEs and FHA. Fannie Mae and Freddie Mac experienced significant financial losses due to the housing downturn. FHFA placed them in voluntary conservatorship in September 2008, where they currently remain. They have received approximately $191 billion in assistance from the government and in exchange have made dividend payments to the government in excess of that amount. FHA also experienced financial stress from the housing downturn and received $1.7 billion from Treasury in FY2013 to ensure it would have enough funds to cover its expected future costs. Although FHA and the GSEs have been more financially stable of late, Congress continues to conduct oversight of the GSEs and FHA.

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

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

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

CRS Resources

CRS Report R42995, *An Overview of the Housing Finance System in the United States*.

CRS Report R45296, *Housing Issues in the 115th Congress*. In particular, see the "Housing Finance Issues in the 115th Congress" section.

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