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Perfecting Housing Finance

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Increasing the rate of homeownership in the United States has been an important public policy goal since at least the 1930s. Although the Housing Act of 1949 promised a decent home for every American, it did not set goals for home *ownership*. Yet, many have noted that the intent of the Congress to promote ownership has been evident in decades of federal policy. Even before the act, homeownership rates were increasing, from 44 percent in 1940 to 55 percent in 1950. Since then, the percentage has increased at a slow, steady pace: to 61.9 percent in 1960, 63 percent in 1970, 65.6 percent in 1980, and approximately 68.3 percent of households at year-end 2003.

Perfecting the housing finance system has been an important part of federal homeownership policy. During the 1920s, thrift institutions (largely, savings and loan associations, or S&Ls) made approximately half of the nation's mortgage loans; these loans carried a conservative average loan-to-value ratio of 58 percent and, on average, matured in 11 years. The remainder of mortgage debt largely consisted of unamortized, rollover loans held by insurance companies and commercial banks, at maturities ranging from 2 to 4 years. Federal government involvement began during the 1930s with federal deposit insurance for housing-focused depository institutions (primarily S&Ls, but also some savings banks) and with the creation of federal housing agencies and sponsored enterprises. The latter include the Federal Home Loan Bank System established in 1932, the Federal Housing Administration (FHA) formed in 1934, the Federal National Mortgage Association (Fannie Mae) chartered in 1938, and the Farmers Home Administration formed in 1949. In 1968, the Congress assigned some of Fannie Mae's functions to the newly created Government National Mortgage Association and privatized Fannie Mae as a government-sponsored enterprise, or GSE. By 1970, both Fannie Mae and the newly chartered Federal Home Loan Mortgage Corporation (Freddie Mac) had broad powers to operate in the mortgage secondary market.[1] More recently, Farmer Mac joined Fannie and Freddie in 1988.

The relative importance of these two types of federal involvement has fluctuated through time. Initially, depository institutions prevailed, as the Federal Home Loan Banks assisted with liquidity and the FHA insured mortgages for lower- and moderate-income families. When deposit interest rate ceilings pinched S&Ls during the 1970s, the two GSEs—Fannie Mae and Freddie Mac—provided a conduit between mortgage and capital markets. Since the late 1980s, however, the role of the GSEs has expanded. The demise of the S&L industry is well known. During 1965-82, run-ups in interest rates depleted their capital. During the 1980s competitive pressures in mortgage markets so narrowed profit margins that, even with expanded lending powers, S&Ls could not earn their way back to health. Since 1989, the increase in the share of housing finance handled by federal agencies and enterprises approximately equals the decrease in the share held by thrift institutions. At year-end 1983, all federal agencies and sponsored enterprises held or guaranteed 27 percent of mortgage debt for one-to-four–family dwellings, while thrift institutions (S&Ls plus credit unions) and commercial banks, respectively, held 41 percent and 15 percent.[2] At year-end 2003, federal agencies and enterprises held in their portfolios or guaranteed through mortgage-backed securities 58 percent of mortgages, while thrift institutions and commercial banks held (directly) approximately 11 percent and 15 percent of mortgages, respectively.

Some observers have suggested that, because mortgage debt is large relative to income for most households, federal government involvement to mitigate economy-wide nondiversifiable (systemic) risk is essential for an efficient mortgage finance system. Such risks may, at times, become expensive for taxpayers: The combination of government regulation and federal deposit insurance used to resolve the insolvent S&L industry 15 years ago amounted, essentially, to nationalization of the industry. Recently, some observers have expressed concern that, because of their size and the widespread belief that the Congress would not allow the GSEs to default on their liabilities, inadequate regulation could expose taxpayers to uncomfortable risks. Despite the shift in the focus of federal housing finance from deposit insurance at S&Ls to conjectural guarantees at the GSEs, debates over the appropriate extent of federal involvement in housing finance and the regulation of government-related housing finance entities is likely to remain a part of federal homeownership policy well into the future.[3] ■

[1] For background, see chapter 8 in Marcia Stigum's *The Money Market*, Third Edition (Irwin, 1990).

[2] Figures are net of home equity loans. Source: Table L. 218, *Flow of Funds*, September 16, 2004 (Board of Governors of the Federal Reserve System). Calculations by the author.

[3] Suggestions for further reading: Van Order, Robert. "A Microeconomic Analysis of Fannie Mae and Freddie Mac," *Regulation*, 2000, *23*(2); Martinez, Sylvia C. "The Housing Act of 1949: Its Place in the Realization of the American Dream of Homeownership." *Housing Policy Debate*, 2000, *11*(2).

Views expressed do not necessarily reflect official positions of the Federal Reserve System.