

## **HOUSING FINANCE FROM THE GREAT DEPRESSION TO THE GREAT RECESSION**

Nearly eighty years ago, in the midst of the Great Depression, the federal government began implementing sweeping reforms to the American financial system. These reforms – deposit insurance, limits on the risks banks can take, better transparency and investor protections in securities markets, a stronger Federal Reserve – helped build a financial system that provided a solid foundation for America’s unprecedented prosperity. (Page 5)<sup>1</sup>

Improving how housing was financed was an important part of these broader Depression-era reforms. In the 1930s, following severe mortgage market disruptions, widespread foreclosures, and sinking homeownership rates, the government created the Federal Housing Administration (“FHA”), Fannie Mae, the Federal Home Loan Banks (“FHLBs”) and, several decades later, Freddie Mac to help promote secure and sustainable homeownership for future generations of Americans. (Page 5)<sup>1</sup>

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### **The Failure of Fannie Mae and Freddie Mac**

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The financial crisis also exacerbated fundamental flaws in the FHLBs, which help mostly insured depository institutions access liquidity and capital to compete in an increasingly competitive marketplace. Prior to the crisis, the FHLBs suffered from inadequate regulatory oversight, and were allowed to build large investment portfolios that subjected them to excess risk, while providing concentrated funding to banks engaging in unsound business practices. Today, eight of the twelve banks are under regulatory orders with respect to their capital or have voluntarily suspended dividends or the repurchase of excess stock. (Page 9)<sup>1</sup>

Because each of the twelve FHLBs is also liable for the losses of other FHLBs, additional losses could adversely affect the entire FHLB system, damaging the mortgage finance market and potentially constraining access to capital for financial institutions. Reforms to the FHLB system are necessary to restore its important primary role of providing a stable source of mortgage credit for financial institutions of all sizes. (Page 9)<sup>1</sup>

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### **I. Paving the Way for a Robust Private Mortgage Market**

Under normal market conditions, the essential components of housing finance – buying houses, lending money, determining how best to invest capital, and bearing credit risk – are fundamentally private sector activities. Although the government still has an important role to play in housing finance, private markets – subject to strong oversight and standards for consumer and investor protection – should be the primary source of mortgage credit and bear the burden for losses. The Obama Administration, in consultation with FHFA and Congress, will work to restrict the areas of mortgage finance in which Fannie Mae, Freddie Mac, and the FHLBs operate, so that overall government support is substantially reduced. (Page 12)<sup>1</sup>

#### ***Ensuring FHLB support for small- and medium-sized financial institutions***

The Administration believes the FHLBs have played a vital role in our housing finance system by helping smaller financial institutions effectively access liquidity to compete in an increasingly competitive marketplace. But these institutions also developed significant weaknesses as the housing market evolved that should be addressed as part of housing finance reform. HERA has already placed the FHLBs under stricter regulatory oversight, but further reform is required. We will also work with

<sup>1</sup> Paragraphs on this document were taken directly from the joint report produced by the Department of Treasury and the Department of Housing and Urban Development. The report, *Reforming America’s Housing Finance Market – A Report to Congress*, was presented to Congress on February, 2011.

Congress to consider additional means of advance funding for mortgage credit, including potentially the development of a covered bond market. (Page 14)<sup>1</sup>

- *Focusing on small- and medium-sized financial institutions.* The Administration supports allowing each financial institution to be an active member in only a single FHLB Bank. We also support limiting the level of advances, which would only have an impact on large financial institutions that can access capital markets already. (Page 14)<sup>1</sup>

- *Reducing portfolio investments.* Similar to Fannie Mae and Freddie Mac, several of the FHLBs were allowed to build up large investment portfolios. These portfolios should be reduced and their composition altered to better serve the FHLB's mission of providing liquidity and access to capital for insured depository institutions. We support FHFA's efforts to address this issue, and we will work with Congress to provide clarity to the FHLB's investment authority. (Page 15)<sup>1</sup>

## **II. Restoring Trust and Integrity in the Broader Housing Market**

Addressing Fannie Mae, Freddie Mac, FHA, and the FHLBs alone will not give rise to a housing finance market that meets the needs of families, lenders, and investors. Nor will it guarantee that private markets can effectively play a more dominant role in the mortgage market. Fundamental flaws occurred at almost every link in the housing finance chain. (Page 15)<sup>1</sup>

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### **A RESPONSIBLE PATH FORWARD FOR REFORM**

#### ***A path forward***

As the reforms outlined in the Administration's plan are implemented and new standards at Fannie Mae, Freddie Mac, FHA, and the FHLBs are established, we will ultimately need to complete the transition to a more privatized market. (Page 24)<sup>1</sup>

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