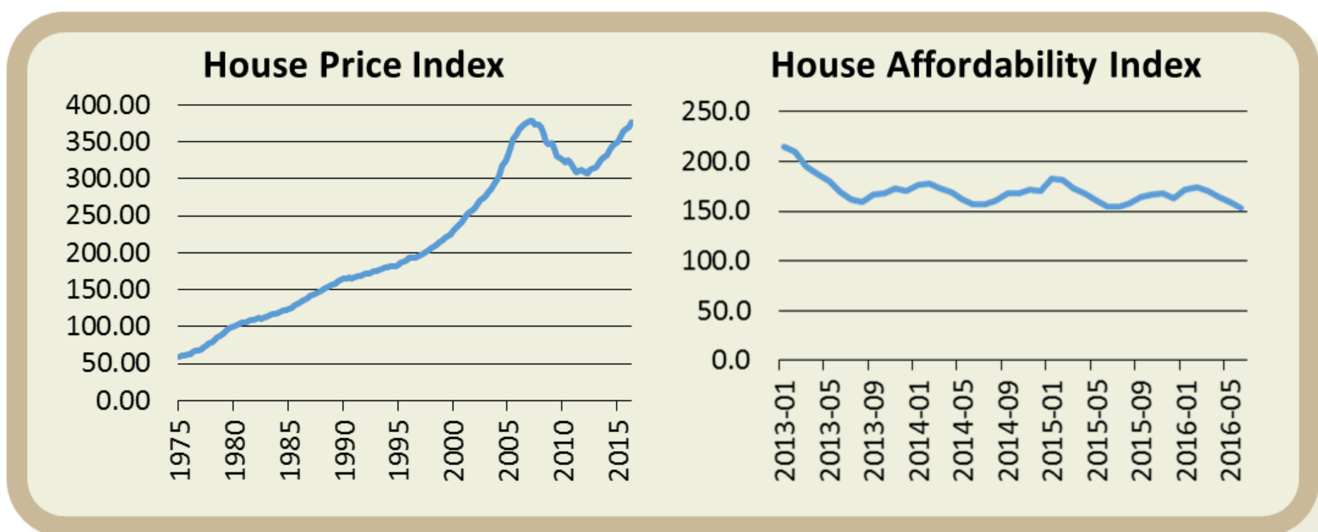
US Mortgage Market:
America's Biggest Nationalized Industry
By Kevin Chambers

The mortgage market in the United States has always been a cornerstone of American financial markets. Home ownership, a coveted part of the American Dream, is highly encouraged and sought after in the United States. Now the American housing market is the largest asset class in the world, slightly bigger than the entire US stock market. The total value of the housing market is $25.8 trillion, which puts it at an all-time high.

Many indicators have pointed to an improving housing market in the United States. Home prices have recovered nicely, nearly reaching 2007 highs. But when adjusted for inflation, they are still 20% below their 2006 peak (The Economist, 2016). The number of houses that are underwater has dropped dramatically in recent years from 12 million at the end of 2010 to 4 million as of March 2016. The value of those homes has dropped from $780 million to $300 million over the same period. Houses have also become more affordable as median incomes have risen faster than home prices.

The mortgage system is the foundation of the housing market. The difference between the value of housing stock and the mortgage debt is called housing equity. Through the 2007-08 crisis, the real loss in the housing market was a loss of equity. In historical terms, mortgage debt fell slightly but stayed relatively flat. The value of homes is what took a hit. Now, equity in the housing market is back to pre-crisis levels.



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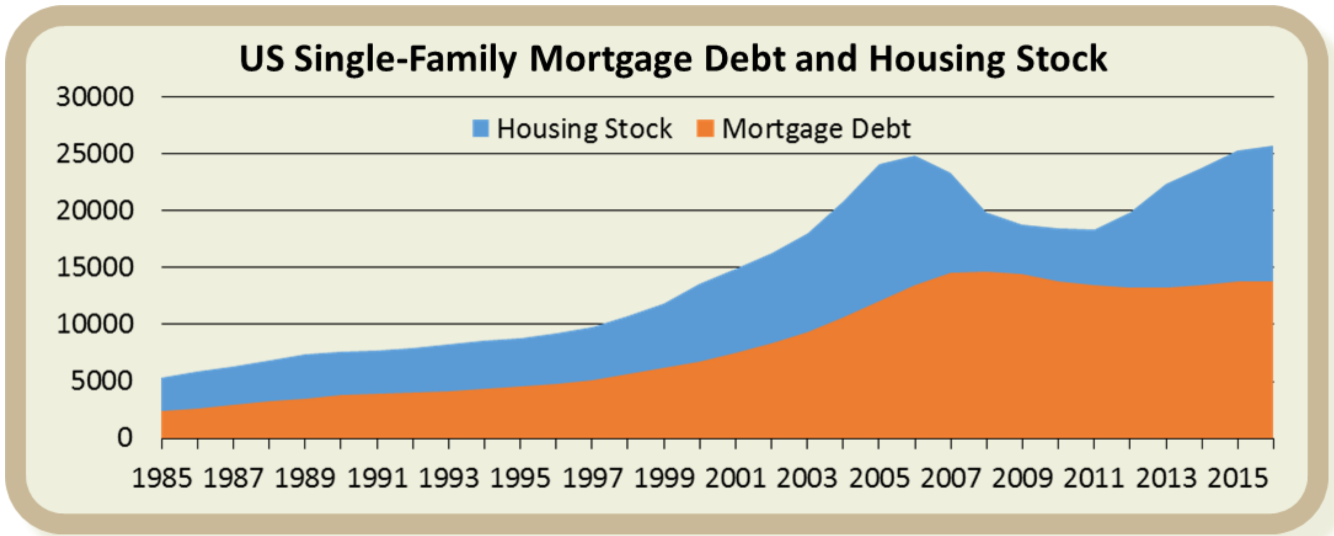

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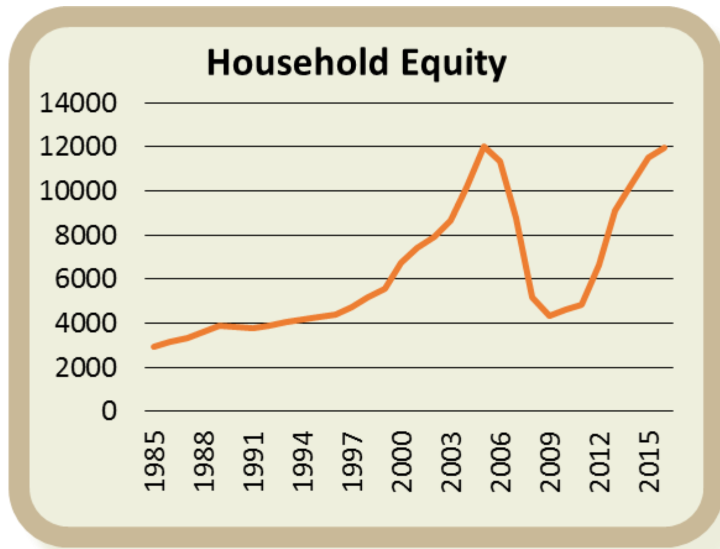

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Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac are often mentioned in the media. They played a huge role in the aftermath of the 2008 mortgage crisis. What are they and what do they do?

First of all, their common names are based on acronyms of their full names. Fannie is "The Federal National Mortgage Association." Freddie is "The Federal Home Loan Mortgage Corporation." Fannie Mae was created first in 1938 through the New Deal. The Great Depression pushed numerous borrowers to default on their mortgages and most of America's banks had a liquidity problem, much like in 2008. Fannie

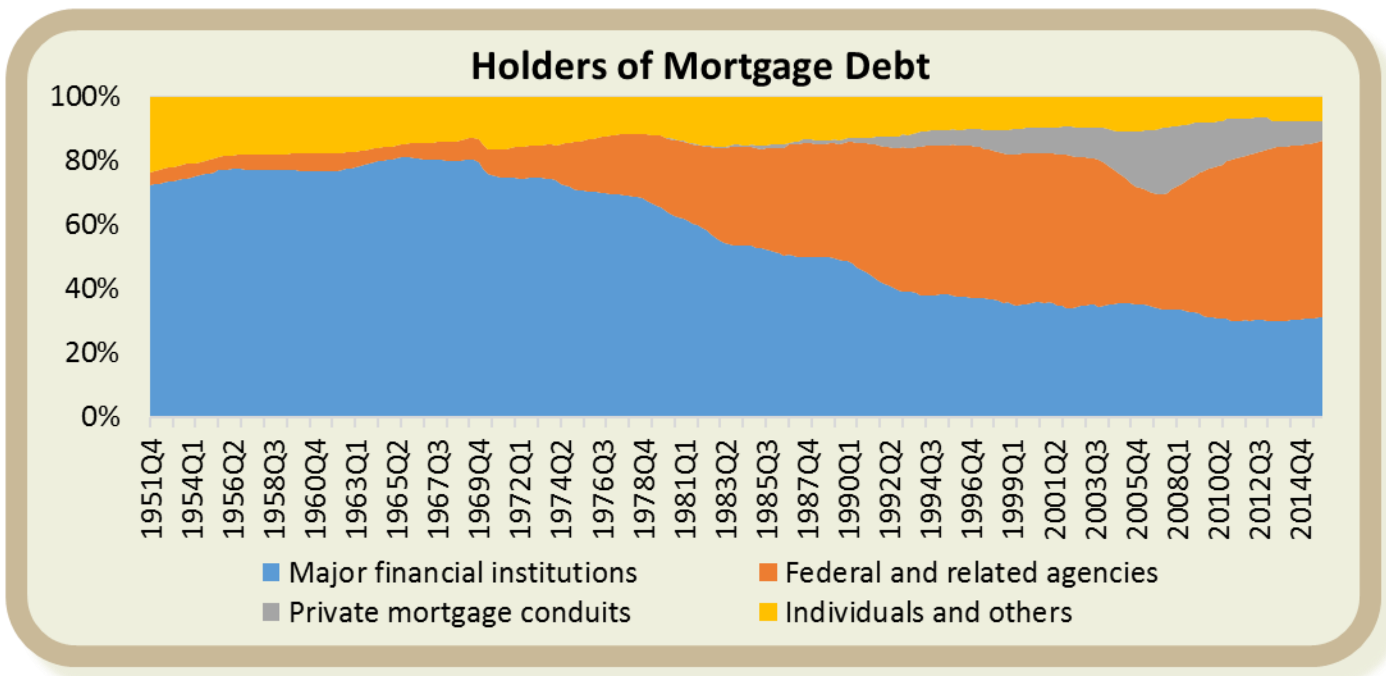
Mae was created as a government agency to buy mortgages from banks. This allowed the banks to use the cash to make more loans instead of being tied up in bad mortgages. They could then sell the mortgages to investors. This was the first creation of a secondary mortgage market. In other words, this is the first time an easily facilitated marketplace existed to buy and sell mortgages. It led to the creation of mortgage-back securities, where Fannie Mae would bundle a group of mortgages together and sell it as an investment product. It pushed a tremendous amount of liquidity into the mortgage market. It also freed up banks to take more risk in their mortgages and start to lend to borrowers who were previously deemed not credit-worthy (Pickert, 2008).

In the 1970s, with the pressure of the Vietnam War and other programs, President Johnson and Congress decided to make Fannie Mae a publicly traded company and take the balance of the mortgages off of the US Governments books. Investors could now buy stock in Fannie Mae. Fannie Mae was created to primarily work with big commercial banks. In 1970, Freddie Mac was established as a private corporation to give the same service to smaller banks, often called "thrift banks." Even though Fannie and Freddie acted as private corporations, many investors believed there was an implicit government guarantee, as the Federal Government kept a minority ownership in the corporations (FHFA, 2016).

In 2008, with the collapse of the mortgage market, Fannie and Freddie faced massive losses on their balance sheets and needed a huge bailout. Now the Federal government is the majority shareholder in both companies. The securitization of these loans is almost entirely backed by the government. All of the government housing agencies (including the VA, FHA and Ginnie Mae) own or guarantee combined $6.4 trillion in loans, accounting for over 60% of all mortgages in the US. At the peak of the crisis, they held over 80% of mortgages. Before 2007, the agencies held less than 40% of the market (The Economist, 2016).

A shift from 2008

The domination of Fannie and Freddie in the mortgage market is a new phenomenon. Big banks are no longer



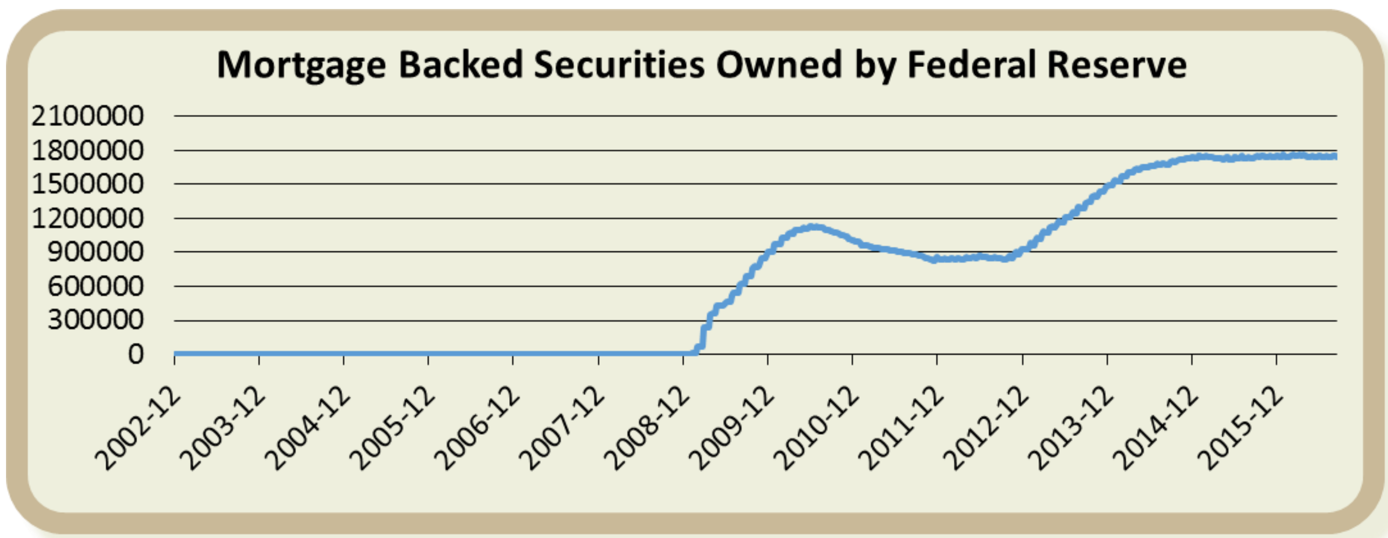
Source: Federal Reserve

keeping mortgages on their books. They are selling them off, primarily to the government. Since the crisis, banks have taken advantage of low-interest rates to build a war chest to protect themselves. The banking industry core capital is at $1.2 trillion. That is double their pre-2007 levels, making the current banking system reasonably robust. The banks are doing well, protected, and profitable. That being said, they are also less involved in the mortgage industry as they used to be. Just as lightning tends to not strike the same tree, financial crises often don't hit the same plane twice.

Mortgages are often still resold and packaged, like in pre-crisis. Much of collateralized debt obligation and other products that drove the 2008 crisis have now left the market, especially after their huge losses. This makes the secondary mortgage market safer, yet it hasn't gone away. The difference is that now the repackaging of mortgages is being done almost exclusively by Fannie and Freddie, not Goldman and JP Morgan. To see the significance of this shift, just look at the ***Holders of Mortgage Debt*** graph (page 3). As Fannie and Freddie are nationalized, the section of the mortgage market that is owned by the Federal government jumps up dramatically. This is an unprecedented change.

This shift has happened in concert with the Federal Reserve buying billions of dollars' worth of mortgage-backed securities from Fannie and Freddie (graph below). The program started in November 2009 with an initial buy of $500 billion. Now mortgage-backed securities are over $1.7 trillion and represent 41% of the open market securities owned by the Federal Reserve.

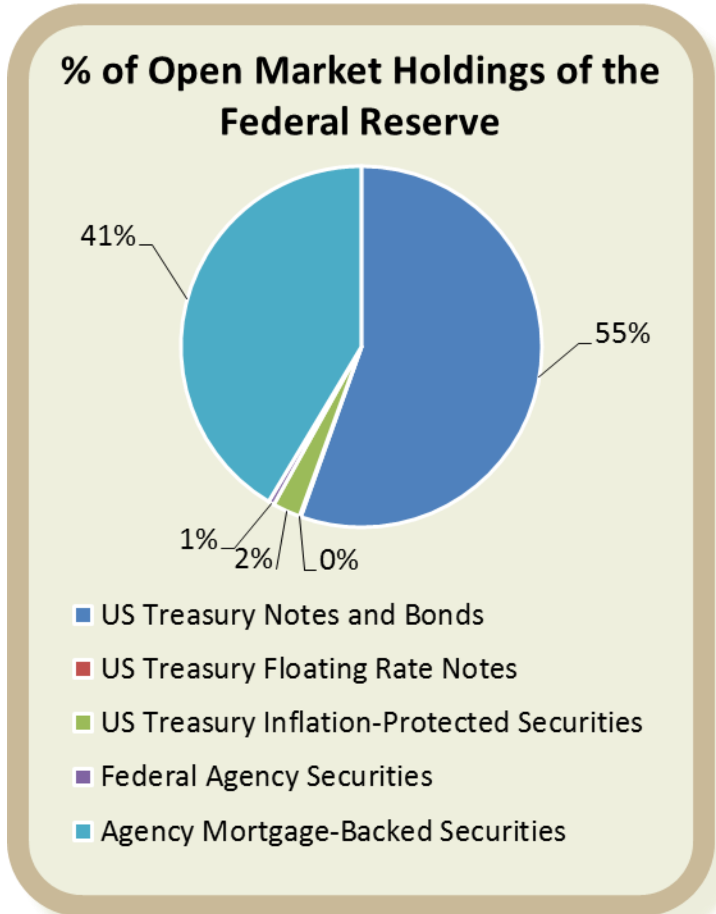
The Mortgage industry has changed considerably since the crisis. Trading activity of the risky Collateralized Debt Obligations (CDOs), Collateralized Loan Obligations (CLOs), and other subprime securities has dropped by 90% and are not a significant part of the mortgage industry (The Economist, 2016).



Source: FRED

However, the mortgage system in the United States has been largely nationalized. The big banks are not carrying the risk of the next housing crash, it's on the shoulders of the Federal Government. Not only through Fannie, Freddie, and other agencies, but our central bank is also buying unprecedented amounts of the products the agencies are creating. The mortgage market has a concentrated risk on the US Government. The banks have built up a big cash cushion, but the mortgage system, dominated by federal agencies is not as liquid.

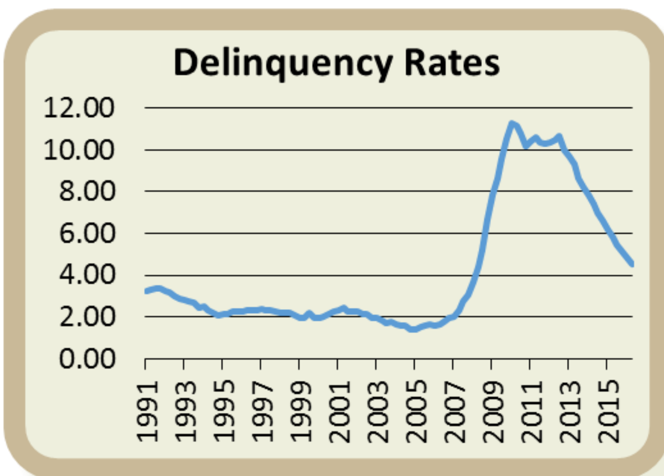
The US Government is truly "too big to fail" and no one is worried about the US Government not being able to back these securities. Nevertheless, it would be a big blow to our economy if the Federal Government needs to bail out Fannie and Freddie. Moody's analytics estimated the cost to the government to save the mortgage industry if we see another housing crisis would be between $300 billion – 600 billion. That is using 2-4% of US GDP to bail out Fannie and Freddie (The Economist, 2016).



Source: Federal Reserve

Going Forward

There is no indication that there is any pending trouble for the housing market . Continued low interest rates have allowed buyers to originate or refinance their homes at historically low rates, leading to very reasonable monthly payments. Delinquency rates have continued to fall, new home sales are rising, and prices are rising. There may still be pent-up demand, as the percent of homeowners and the amount of residential investment is still below their term averages (Irwin, 2016).



Source: FRED

Crises come frequently from places we least expect. Nevertheless, the consolidation of housing and mortgage market risk within the US Federal Government is concerning. At Headwater Investments, we create diversified portfolios, to spread risk across asset classes. When there is a grouping of risk in one place, we have a reason for concern. We don't expect another housing crisis around the corner, but there has been very little coverage of US Government involvement. Going forward, it will be a situation we will be following very closely.

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