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Dwight Jaffee Follow Up From Wendy Edelberg

Wendy Edelberg

Dwight M. Jaffee

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Wendy Edelberg
Executive Director

Monday, June 14, 2010

Via E-mail and FedEx
Professor Dwight Jaffee
Haas School of Business
545 Student Services #1900
University of California at Berkeley
Berkeley, CA 94720-1900
jaffee@haas.berkeley.edu

Re: Follow-up to the Financial Crisis Inquiry Commission Forum

Dear Dr. Jaffee:

The Financial Crisis Inquiry Commission thanks you once again for your participation in the "Forum to Explore the Causes of the Financial Crisis" on February 26 and 27, 2010.

Enclosed are follow-up questions which were posed by the Commissioners during the forum, as well as additional questions which have arisen over the course of our investigation which we would like your assistance in answering.

Please respond to the questions by Friday, July 2, 2010. If you have any questions, or would like more information, please contact Scott Ganz at sganz@fcic.gov.

1. Please comment on the following excerpt from a statement by former Federal Reserve Chairman Greenspan to the Commission on April 7, 2010:

"Of far greater importance to the surge in demand, the major U.S. government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, pressed by the U.S. Department of Housing and Urban Development1 and the Congress to expand "affordable housing commitments," chose to meet them in a wholesale fashion by investing heavily in subprime mortgage-backed securities. The firms purchased an estimated 40% of all private-label subprime mortgage securities (almost all adjustable rate), newly purchased, and retained on investors' balance sheets during 2003 and 2004. That was an estimated five times their share of newly purchased and retained in 2002, implying that a significant proportion of the increased demand for subprime mortgage backed securities during the years 2003-2004 was effectively politically mandated, and hence driven by highly inelastic demand. The enormous size of purchases by the GSEs in 2003-2004 was not revealed until Fannie Mae in September 2009 reclassified a large part of its securities portfolio of prime mortgages as subprime.

"To purchase these mortgage-backed securities, Fannie and Freddie paid whatever price was necessary to reach their affordable housing goals. The effect

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was to preempt 40% of the market upfront, leaving the remaining 60% to fill other domestic and foreign investor demand. Mortgage yields fell relative to 10-year Treasury notes, exacerbating the house price rise which, in those years, was driven by interest rates on long-term mortgages." (footnotes omitted)

2. Please discuss the relationship of the GSEs' purchase of Alt-A mortgages and Alt-A mortgage-related private-label securities to their affordable housing goal requirements.

3. The United States has gone through other periods, e.g., with respect to FHA subsidized mortgage programs in the late 1960s, when credit was so freely available to low income borrowers that low underwriting standards led to large numbers of defaults and foreclosures. Please discuss the dynamics of such circumstances and the extent that there are relevant lessons for the current financial crisis.

4. During the forum, you described a paper prepared for Lyndon Johnson regarding the GSEs. Can you provide us a copy of the paper?

Sincerely,

Wendy Edelberg

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Dwight M. Jaffee

Haas School of Business
University of California
Berkeley, CA 94720-1900
Telephone: (510) 642-1273
Facsimile: (510) 643-7441
Email: jaffee@haas.berkeley.edu

Willis H. Booth Professor of Banking and Finance
Co-Chairman, Fisher Center for Real Estate and Urban Economics
Director, St. Petersburg University School of Management Program

July 20, 2010

Wendy Edelberg
Executive Director
Financial Crisis Inquiry Commission

Dear Wendy:

I am responding to your letter and questions of June 14.

1) Comment on excerpt from statement by former Chairman Greenspan on April 7, 2010

Chairman Greenspan states three "facts" in the except you provided:
1) That Fannie Mae and Freddie Mac purchased large amounts of subprime mortgages;
2) That the Fannie Mae and Freddie Mac purchases were not revealed until September 2009; and
3) That the Fannie Mae and Freddie Mac purchases were motivated significantly by HUD.

I agree fully with the spirit of points (1) and (2). My own testimony before the Commission documented the enormous purchases of subprime mortgages by Fannie Mae and Freddie Mac. I thought that the GSEs had revealed these purchases a bit earlier than September 2009; but they certainly postponed revealing that information until long after the purchases.

I do not agree with point (3)--also discussed in my own testimony. The GSEs revealed a desire for risk-taking wherever it could be found. Earlier, they took on huge amounts of interest rate risk. It was only the good fortune of generally stable interest rates that saved the GSEs from an even earlier failure from an interest rate shock. At my testimony, we also discussed another motives for the GSE foray into subprime mortgages, namely to recover the market share than had been lost to the private-market securitizers.

In summary, I would say that the GSE motivation to purchase subprime mortgages had a variety of motives, all of which pointed in the same direction: (1) increase expected profits through risk-taking; (2) recovery of lost market share; and (3) to satisfy the HUD housing goals. When we have limited data and three indicators point in the same direction, empirical data cannot select among them. I continue to believe that the incentive to maximize expected profits through risk-taking has been the consistent pattern in GSE behavior for at least at the last 20 years.

2) I do not have any technical or expert knowledge on the actual relationship between the GSE purchases of Alt-A mortgage securities and the Affordable Housing Goals. I will say, however:

(i) ALT-A refers to mortgages that were "alternative to the GSE normal underwriting standards". It is thus peculiar to find the GSEs purchasing mortgages that were explicitly contrary to their normal standards.

(ii) HUD has always maintained that the affordable housing goals were <u>never</u> meant to lead to a deterioration in the GSE underwriting standards.

3) I am unaware that FHA subsidized programs "led to a large number of defaults and foreclosures" in the late 1960s. I am glad to say that was before my time! We have to be sure we are discussing the same programs. My testimony, to the extent it touched on the FHA, concerning only their <u>single-family mortgage guarantees</u>. By law, these programs provide <u>no subsidies</u>. Or to be even more precise, if the programs do provide a subsidy, they must obtain an explicit Congressional appropriation. Almost always, they provide no guarantee and require no appropriation. HUD and the FHA, of course, run a myriad of programs, including multi-family programs, that do provide subsidies, and, I recall, did create defaults—although I think those were mainly due to fraud. Nether fraud nor default have characterized the non-subsidized, single-family, mortgage guarantee programs.

4) The paper that discusses the creation of the first GSE—Fannie Mae in 1968—was written by my Ph.D. student here at Berkeley, Sarah Quinn. The paper was also quoted in a NY Times article about the GSEs. Her entire thesis will soon be available. In the meantime, I am attaching her paper. To give you the executive summary: The Presidential Commission that created Fannie Mae was well aware of the possibility that a private firm with a public mission might try to maximize profits at the taxpayers' expense and reported this concern to the President. President Johnson, apparently, had no patience for these concerns: he had a Vietnam War to fight and a budget to balance, and privatizing Fannie Mae was a means to that end.

Things of Shreds and Patches:
Credit Aid, the Budget, and Securitization in America

Working Paper[1]
Revised as of September 2009

Sarah Quinn
Ph.D. Candidate
Department of Sociology
University of California, Berkeley

[1] This paper is drawn from my dissertation, which investigates the role of politics in the establishment of a market for securitization in the U.S. Selections from this paper were presented at the All-UC Group on Economic History (May 12, 2009), and it has benefited from the comments of discussant Larry Neal and conference participants, and at the Annual Meeting of the American Sociology Association (August 9, 2009). Suggestions are most welcome and should be forwarded to squinn@berkeley.edu.

ABSTRACT

Federal credit programs issue, purchase, insure, and guarantee loans. As the U.S. government accumulated assets through these programs in the postwar era, it began to sell them, sometimes using the proceeds to offset budget deficits. As early as the 1950s government agencies used put-options, guarantees, and pooling techniques to encourage these kinds of sales; in the 1960s President Lyndon B. Johnson expanded these practices in hopes of offsetting the large deficits caused by the Vietnam War and his Great Society Programs. When a budget committee's change of accounting standards thwarted this plan, his administration was forced to find an alternative. The one they devised would transform American housing finance. The administration immediately spun-off Fannie Mae, which removed the agency from the budget. It simultaneously devised a plan to get private capital to take the place of government funds in the secondary mortgage market, using a version of its own controversial debt instruments to do so. That is, the government set out to build a viable private market for Mortgage-Backed Securities (MBS), and provided an array of supports for it. Tracing these events, this paper examines how government efforts to circumvent the budget contributed to the rise of securitization in the U.S. This suggests that the relationship between the U.S. government and its markets may be more profoundly organized by the institution of the federal budget (and less driven by a laissez-faire ideology) than is suggested by the current literature.

Modern policy-makers' ingenuity . . . has created mechanisms for spending unknown in past ages; and extensive use of such devices has made modern budgets into things of shreds and patches.

Carolyn Webber and Aaron Wildavsky, 1986

In a number of cases, the Federal credit programs have pioneered in developing new credit fields.

House Committee on Banking and Currency, Federal Credit Programs, 1964

The Housing and Urban Development Act of 1968 was a turning point in American housing finance. It quietly dismantled the system of direct government mortgage purchases that was established in the New Deal to encourage lending. In its place, the Act laid the foundation for a new kind of secondary mortgage market organized around the privatized Fannie Mae and bonds backed by pools of mortgages called *Mortgage-Backed Securities* (MBS). Carruthers and Stinchcombe (1999) have argued that the sustained efforts of the U.S. government were integral to the creation of a liquid secondary mortgage market in the states. The Housing and Urban Development Act of 1968 was a key part of that effort.

We know a great deal about the problems in housing finance behind these events. The most fundamental issue is the unwieldy nature of mortgages as investments. The value of each mortgage depends on its unique location, property and owner, and this lack of standardization raises information costs and risks. For these reasons many investors historically dismissed mortgages as more trouble than they were worth. This created funding shortages for mortgage

lenders, shortages that worsened as pension and mutual fund managers controlled more and more capital that they refused to invest in housing finance. Since the New Deal the U.S. government had stepped in to provide support through an array of programs that included insurance for mortgages and the direct purchase of those insured mortgages.

This system of credit support, in place since the 1930s, was strained by the 1960s (Green and Wachter 2005; Sellon and VanNahmen 1988). Reliance on local Mortgage Banks and Savings and Loans in housing finance had resulted in an inefficient patchwork of markets across the nation (Sellon and VanNahmen 1988). Reserves of capital were locked up in accounts on the East Coast, leaving homebuilders in the rapidly-developing Sunbelt starved for credit. Some worried that the system could not accommodate the growing needs of the baby boomers as they settled down and had children (Ranieri 1996). These endemic problems were further exacerbated by inflation-driven disintermediation. In 1966 yields on U.S. Treasury bills rose above 4 percent for the first time in over 20 years and funds poured out of local accounts (Green and Wachter 2005). The subsequent credit crunch in housing caused the biggest dip in home building in 20 years (Fish 1979; Green and Wachter 2005). Facing a worsening set of credit shortages and a budget already strained by the Vietnam War and the Great Society programs, the Johnson Administration decided to support private investment in mortgages, hoping the market would better meet America's housing needs. The government encouraged the use of securitization[2] in order to advance that market.

[2] Sometimes the term securitization is broadly used to denote the creation of any bond backed by some kind of collateral (as with the German *Pfandbrief* developed in the 18th century). For this paper I adopt the more narrow definition of securitization used in the American housing literature, wherein securitization specifically refers to cases in which the collateralizing assets are removed from the issuers' balance sheets.

In most accounts of these events, budgetary politics are either absent or else discussed briefly as an exogenous pressure that comes into play only at the close of the 1960s. But my research indicates that the federal budget had a more extensive influence on America's MBS. This project puts budgetary politics at the center of this history. Below I present a brief overview of federal credit aid programs in the U.S. through the close of the 1960s and then consider the peculiar relationship these programs had with the Federal budget. I next examine how the combination of direct loan programs and budgetary pressures led to experiments with asset sales and debt instruments in the postwar era.

In reviewing this history, I seek to better understand the forces that contributed to the ascendance of securitization in the U.S. On a general level, I explore how federal credit lending set the stage for MBS by advancing the development of credit techniques and markets, by generating a large pool of federal loans ready for the taking, and by helping governmental officials gain expertise in the management of loans. More specifically, this paper argues that President Johnson's securitization-friendly policies culminated from years of experiments with credit lending and debt instruments which officials pursued in order to find a politically expedient way of intervening in markets without adding to the public debt. Connecting the history of credit lending with the creation of MBS, I argue that budgetary politics played an important role in the rise of securitization in America.

This effort is grounded in a growing body of scholarship that shows that the myth of American free markets is belied by a reality of enduring and widespread state intervention in the economy (see, for example, Block 2008; Krippner 2007, Popp Berman *forthcoming*; Tobey

1996). This flawed notion of laissez-faire America persists because of the peculiar form its state intervention typically takes. Many have observed a pattern wherein the U.S. government has sought to camouflage, hide, or understate the extent to which it actually intervened in the economy. David Moss argues that risk management policies in general owe some of their success to their ability "to reconcile [American's] laissez-faire and anti-statist sentiments with their pragmatic inclination to employ state power to solve social problems" (2002: 319). He further notes that policies designed to spread risk "may have proved particularly appealing in the United States because they tended to require little in the way of invasive bureaucracy and could easily be cast in the rhetoric of contract" (2002: 320). That is, Americans seem to like governmental interventions better when they are dressed up like the market. Along similar lines, Fred Block (2008) has identified a "hidden developmental state" behind a host of industrial and technological inventions, and Greta Krippner (Krippner 2001), examining monetary policy under Regan, identifies a "Neoliberal Dilemma," in which officials hide the extent of their market-managing policies in order to escape political responsibility for their actions.

Time and again, the U.S. government has veiled its market interventions by seeking to blend in with the market around it, masking its incursions using a kind of market camouflage. Securitization is another example of this pattern. And it is an especially useful example, because it points to how the federal budget may be a key institution that compels this strategy.

I begin, below, with a broad overview of federal credit programs because they offer a window into how and why this dynamic plays out. I argue that these programs are remarkable in the ways that they facilitated financial innovation throughout the postwar era. Designed to be an

inexpensive way of governing the economy, these programs came to target virtually every sector of the U.S. economy in the postwar era. In the process, they helped transform American finance.

Federal Credit Lending

Government regulation of the American economy traces back to colonial times (Novak 1996) and risk management is one of the most important and enduring strands of these efforts. In his historical investigation of state risk management programs, David Moss (2002) argues that across a wide variety of markets, businessmen have at times found themselves incapable of managing the tangle of risks that threaten markets.[3] The government is uniquely positioned to manage risks, however, because it can use its "power to compel"[4] participation in programs to more easily reallocate and redistribute risks as needed. So when private brains historically failed to devise independent solutions for risk management, the state stepped in. In his history of American risk management programs, Moss shows that risk management is one of the major, if most often overlooked, functions of the U.S. government, evident in interventions ranging from minting money and setting limited liability law, to overseeing social security and product safety.

While government risk management covers a broad range of activities, this paper addresses a subset of those efforts: federal credit aid, or programs that issue, guarantee, insure, and buy and sell loans. These programs sometimes inject capital directly into markets, and at other times encourage lending by allowing the government's credit to stand in for the borrowers'

[3] These risks include moral hazards, adverse selection, limited information, as well as problems with perception, commitment and externalization (Moss 2002).

[4] Or "the legitimate use of force," to recast this in Weberian terms. Weber, Max, Hans Heinrich Gerth, and C. Wright Mills. 1946. *From Max Weber: Essays in sociology*. New York,: Oxford university press.

credit. In both cases, the government encourages lending by bearing the risk of a default on a loan. A government report on the state of federal credit lending explains:

> . . . a Federal credit program arises when the Federal Government enters into the credit economy by interposing its own credit for that of various types of borrowers. . . Irrespective of the source of funding, the ultimate credit risk of any of these programs is borne by the Federal Government, even though as a practical matter, actual credit losses will, in most cases, be covered out of reserves for bad loans accumulated out of interest income or insurance premiums (House 1964: 17).

The above cited 1964 *Federal Credit Report*, commissioned by the House Banking and Finance Committee, is useful both as a snapshot of federal credit programs in the years leading up to President Johnson's transformation of housing finance and as a broader overview of the history of federal credit aid. Based on a survey of all government agencies in 1964, it offers a unique window into the growth of these programs in the postwar era. Before the Second World War, credit programs relied mainly on direct loans (see Table 1). After World War II, the use of guarantees and insurance overtook direct lending as the predominate mode of credit support, largely due to the expansion of housing insurance through the FHA and VA (see Figures 1 and 2). Throughout both periods the scope of credit assistance widened, but housing and agriculture remained the primary focus of support. In all, the report paints the picture of a set of programs that proliferated and became more complex over time. Even a limited look at the details of that history shines a light on the importance of federal programs in the development of American credit markets.

While the government had earlier forays into lending, the creation of the Federal Land Bank System in 1916 marked the beginning of the systematic use of credit aid in America (House 1964). Over the next decade, fifteen additional programs were created to support key

sectors like war finance, railroads, interstate commerce, and agriculture. The Depression spurred an influx of funds into existing programs and introduced a new generation of credit aid that included guarantees and insurance. In 1932 the Reconstruction Finance Corporation (RFC) was created to lend to financial institutions and railroads. Within the decade it grew into a financial behemoth that issued loans to states and local governments, purchased stocks and mortgages, and incubated other key lending agencies like the Federal National Mortgage Corporation (Fannie Mae) and the Commodity Credit Corporation (CCC).

The system of federal credit supports that would bolster homeownership throughout the 20th century was also built at this time. The government took multiple steps to stem a "wave of foreclosures" to the amount of 250,000 homes a year during the depression (Green and Wachter 2005: 94-95). Home Owners Loan Corporation (1933) was created as a stopgap for further foreclosures, and a year later the Federal Housing Administration (FHA) was chartered to insure mortgages and so encourage lending. The Federal Home Loan Bank System, designed like the Federal Reserve System, offered credit support to Savings and Loans (1932), while Fannie Mae (1938) further encouraged the use of FHA-insured loans by agreeing to purchase them. The Works Administration started the first loans for public housing programs in this period as well.

The development of the agricultural sector was another special focus of credit programs. A variety of approaches were used to support the nation's struggling farmers. In addition to the Federal Farm Mortgagee Corporation (1932) and Banks for Cooperatives (1933), which provided financial support to farmers, the Rural Electrification Administration used credit supports to help bring electricity to the 89% of farms that were without it in 1936. Like housing, agriculture would remain a central focus of credit aid as the federal programs developed.

Credit support was not limited to housing and agriculture. Direct lending was used to support employment efforts, often through the backing of state and local projects. In 1934 the Export-Import Bank was created to support the economy by lending money abroad for the purchase of American commodities. During World War II the growth of federal direct lending slowed. Still, “V-loans” guaranteed by the Defense Department were initiated to promote wartime production and credit assistance, especially for housing and agriculture. After the War the Veterans' Administration (VA) guaranteed home, farm, and business loans to veterans. The VA, along with the FHA, was behind a dramatic rise in the use of guarantees and insurance following the war. In the Depression years of 1932-36, the government issued a combined $14.3 billion in direct loans, and guaranteed just under a $1billion of loans. In the years following the war (1947-50) $16 billion of direct loans were issued, a relatively modest rise in comparison to the use of guarantees, which shot up to $19.5 billion (see Table 1).

When the House surveyed federal credit agencies in 1963, they found that the government contained 74 separate credit aid programs in its agencies, 51 of which issued loans directly. At the time, the government held $30 billion in assets and insured or guaranteed another $70 billion, three quarters of which derived from the FHA and VA (House 1964, PCBC 1967).[5] Commenting on the scope of federal credit aid, the committee noted, “the credit programs extended to every segment of the American economy—financial institutions, agriculture, business, private housing, State and local government, international trade, and individual households” (House 1964: 5).

[5] The report on *Federal Credit Programs* (House 1964) generally excluded non-recourse loans out of the Commodity Credit Corporation, and non-commercial foreign loans (like those out of A.I.D.) from calculations, since those programs were effectively grants and more like direct expenditures than a form of credit support.

By the 1960s federal credit aid had evolved into a sprawling, decentralized web of programs that offered a mix of guarantees, insurance, and loans. Jurisdictional overlaps sometimes led to competition among agencies and this complex system allowed for variation and flexibility that fostered innovations in the management of credit lending. For example, each agency used its own accounting methods to determine its own reserves. At one extreme were five programs without any reserves; at the other was the FHA, which calculated reserves that assumed a depression-level crisis (House 1964). Some programs were capped by monetary ceilings or number of grants, but fifteen agencies had no statutory limits, among them the FHA and VA. Some programs were funded through appropriations, others through the Treasury or capital markets (see Figure 5). Within the subgroup of direct loans programs, the type of support offered varied widely, from non-recourse loan programs at the Commodity Credit Corporation that were unlikely to ever be repaid, to non-commercial loans like those at A.I.D. ($12 billion of issued by 1967) where the likelihood of default was unknown, to more traditional commercial loans at the Export-Import Bank and Fannie Mae (House 1964). Even the less exotic commercial loans contained a wide array of terms. For example, loans to low-income people and businesses were subsidized in a variety of ways, "with longer maturities, smaller down payments, or lower interest rates than are generally available otherwise" (Budget 1965: 305).

Perhaps the most important legacy of these programs was their ability to change the rules of the game in credit markets, expanding notions of how a company could lend money, and to

whom.[6] The congressional report on *Federal Credit Programs* explains that they helped individual borrowers build credit histories and expanded lenders' willingness to accept new kinds of borrowers, loans and risks:

> From the viewpoint of the borrower, this private financing provides him with an opportunity to show the private lender that he is capable of administering borrowed funds and thereby helps to build a good credit record. In the future this credit reputation could enhance the possibility of his obtaining private loans at interest rates and other terms that are generally reserved for the better credit risks. . . . From the viewpoint of the lender, these credits serve to acquaint it with the financial attributes of borrowers or of types of loans to which heretofore it has not been accustomed. Familiarity coupled with a favorable loan experience might, in time, induce such lenders to make similar type loans on favorable terms, perhaps without reliance on Federal participation or insurance. . . . Furthermore, Federal credit administration also involves working with private lenders to induce them to alter their requirements or to change their concepts in order to participate in loans being made or insured by the Federal credit agency. (House 1964: 86)

In addition to this, many lending techniques we now take for granted owe their success to government programs: "Over the years the Federal credit agencies have pioneered a number of financial practices which were subsequently adopted by private lenders. Longer repayment periods, higher loan-to-value ratios, and the use of amortized repayments" (House 1964: 70). One example of governmental leadership can be found with mortgages on existing homes purchased in the postwar era, where FHA and VA insured loans led the conventional loans with longer maturities and larger loan-to-value ratios (see Table 2) (Carter, Gartner, Haines, Olmstead, Sutch, Wright, and Snowden 2006). Conventional loans in 1950 had a median maturity of twelve

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[6] Figures 3 and 4 chart the growth of Federal credit aid in the mortgage market. Please note, however, that the actual extent of the financial impact of these programs is much debated. For a more in-depth consideration of these debates as they pertain to housing finance, see Quigley 2006. Some scholars warn that it is easy to overstate the extent to which government credit programs have actually helped homeowners, insisting that they came to crowd out private investors who otherwise would have entered the market. Others argue that by bringing new homeowners into the lower end of the market, these programs benefited many homeowners who did not directly receive credit aid. Quigley himself concludes that these programs played a big role in developing housing markets, and now have increasingly small effects. Quigley, John M. 2006. "Federal Credit and Insurance Programs: Housing." *Federal Reserve Bank of St. Louis Review* 88:281-309.

years and a Loan-To-Value (hereafter LTV) ratio of 64%. In the same year, a government guaranteed mortgage had an average maturity that was nearly twice as long (20 years), with substantially higher average LTV ratios: 76% at FHA and 86% at the VA. By 1964, when the Federal report was published, conventional loans looked liked the FHA guaranteed loans issued fourteen years earlier, with a median maturity of 20 years and a LTV of 76%. By that time, the government guaranteed loans had even looser terms, with an average maturity of nearly 30 years, and LTVs of over 90%.

These programs profoundly shaped the terrain of American credit markets, and also generated expertise that government officials could use to address budget conflicts. Officials could also exploit the complexity of this sphere when budget problems forced them to face difficult trade-offs, as I discuss below.

Credit Lending and the Budget

Federal credit programs were not just blazing new paths in the field of credit. They were also at the forefront of efforts to manipulate the budget. According to Webber and Wildavsky (1986), the drive to achieve a balanced budget is a hallmark of early American Exceptionalism. As a result politicians have faced tremendous pressures to solve problems without spending money or by hiding the extent of their expenditures. The use of earmarking and special funds have long been used to get around the budget process (Webber and Wildavsky 1986). But Webber and Wildavsky note that the 1960s introduced of a new set of strategies that undermined the comprehensive reporting of public spending in governmental budgets in a variety of countries. They classified these strategies into four general types: tax deductions that forgo

revenues, entitlements that fall outside of annual controls, loan guarantees and pledges of credit, and the creation of quasi-public "off-budget" corporations. "When all of these developments are looked at together," they wrote, "the movement away from comprehensiveness is seen as a stampede" (Webber and Wildavsky 1986: 601).

Federal credit programs were a key part of this trend towards off balance sheet accounting in postwar America. Solutions were often selected on the basis of what had the least impact on the budget:

> Fiscal considerations, i.e. impact on the Federal budget and on the public debt, heavily influence the decision as to whether Federal credit assistance is to be financed through Treasury-financed direct loans, market-financed direct loans, or Federal loan guarantees. Efforts to circumvent the budget and the public debt through the use of market-financed direct loans or Federal loan guarantees result in increased interest costs. (House 1964; Stark 1964, in House 1964)

That budgetary politics seemed to trump the nation's credit needs, or what was the least expensive option in the long-run, was a major concern among regulators.

The relative impact of various types of credit aid on the public debt varies. Guarantees and insurance programs contributed the least to the deficit; this helped make them extremely popular. They generated enough in fees and premiums to cover their operating expenses and would only show up on the budget if the Treasury got involved to cover absorbed losses in excess of held reserves. The extra political value derived from their off-budget status likely contributed to the rapid growth of these programs; from 1961 and 1966 alone, their liabilities shot up by 75% (Budget 1965).

The budgetary ramifications of the direct loan programs were more complicated. In the long run the programs were very efficient. They brought in revenues, which gave them a low net

cost, and many programs were able to use collections and fees to cover operating expenses.[7] But in years when the government issued a great deal of loans, disbursements ran ahead of collections and repayments and the net difference would typically be reported as expenditures on the budget.[8] Even though these programs would eventually generate funds, their immediate budgetary impact could put them in danger of being cut. This created an incentive to fund loan programs through the capital markets. Perhaps the most well-known way of doing this was through the creation of semi-private government corporations. In 1963, for example, five agencies had the authority to issue their own debt: the Federal Land Banks, Federal Intermediate Credit Banks, Banks for Cooperatives, Federal Home Loan Banks, and the Secondary Market Operations at Fannie Mae. Since they were financed through the capital markets, the agencies were classified as private corporations that did not have to be included in the administrative budget. Since the agencies had to pay more than the Treasury to borrow funds, this approach saved political capital at expense of economic capital.

Other agencies experimented with drawing funds from capital markets as well. Since the Depression, the RFC had supplemented its direct loan program with "participation loans," which allowed banks to issue or own part of a much larger loan. RFC also developed a "deferred participation" program, wherein a private lender issued loans on the condition that the government would agree to purchase a portion of the loan at a later date if the lending company

[7] The Special Analysis of the Budget in 1963 explains, "Unlike almost all Government programs the initial expenditures involved for credit programs are largely or wholly repayable, so that the ultimate net cost is normally low. Some programs are full self-supporting; in most others, the income from interest payments or insurance and guarantee fees covers most of the current expenses and/or provides reserves for future losses." (Special Analysis, 1963: 305)

[8] In 1964, about half of the 74 credit programs were able to use revolving funds that allowed them to recycle their revenues back into their programs (see Figure 5), but I do not know how many of these were specifically direct loan programs. From the FCP: "Direct loans have a major budgetary impact since the difference between disbursements and repayments represents net expenditure or receipts. Federal guarantees and insurance of private loans, on the other hand, ordinarily have only minor effect on Federal expenditures, since they result primarily in expenditures by private financial institutions." (Special Analysis, 1963: 307)

wanted to sell it.[9] In other words, the RFC used put options to encourage private lending. Participations were also used by the Federal Reserve Banks, as well as to advance public housing, urban renewal, college housing public facility loans and others.

Another strategy was to sell government assets. This would prove to be an especially flexible tool for managing the budget, because proceeds from the sales were typically counted like collections and netted against expenditures, lowering the size of the deficit. Seymour Harris reports that Presidents Truman and Eisenhower both sold off accumulated assets to balance accounts:

> In four fiscal years (I954-57), the Eisenhower administration disposed of $1,780 million of certain capital assets; in the four preceding years the Truman Administration had disposed of but $364 million of corresponding assets. These sales yield cash for the budget, and the income rises relatively to outlays. But though the budget comes nearer to a balance, the net effect is no genuine improvement: one capital asset is sold and the income used to pay off debt or keep debt from rising. (Harris 1956: 359)

Kennedy and Johnson also relied on asset sales to lessen the size of the budget deficit. In 1963 substantial increases of lending from U.S. A.I.D were offset by sales at the Export-Import bank and the VA; through the use of netting, the government was able to report a relatively modest $1.8 billion in credit expenditures for the upcoming year, even though they expected $8.1 billion in disbursements (Tickton 1955). This was typical of the era. With the help of asset sales, the difference between outlays and reported expenditures for credit programs on the federal budget widened considerably from 1961 to 1966 (see Figure 6). These sales were mostly done through

[9] In more detail: "Three types of loans were made by RFC—direct loans, immediate participation loans, and deferred participation loans. Direct loans were authorized, disbursed, and serviced by RFC. Immediate participation loans were those made in cooperation with financial institutions, wherein part of a loan was disbursed by RFC and the balance by the participating institution, with servicing either by RFC or the participating institutions. Deferred participation loans were disbursed and serviced by participating institutions with an agreement with RFC under which the Corporation agreed to purchase a stated portion of the outstanding loan upon the request of the institution making the loan." (House 1964)

The Export-Import Bank and Fannie Mae because those agencies had the best, most sellable loans: "Most of the loans held by other federal credit programs have interest rates, maturities, or other terms which make them currently unattractive to private lenders except at sacrifice prices" (Budget 1965: 379).

Selling assets was useful but not always practicable. The federal credit system was made up of 74 programs and this decentralization meant high transaction costs. Additionally, as we saw above, selling subsidized loans and loans to people with lower credit was particularly difficult. As officials sought to expand the sale of loans, they soon discovered that they needed a better way to sell them. Seeking new ways of tapping capital markets and selling off assets, they began to experiment with tailoring debt instruments to fit their needs.

The Rise of Participation Certificates

Just as the credit programs had pioneered the use of new credit terms, the government now pioneered the use of complex debt instruments. They used pools of assets, put-options and guarantees to construct bonds that held wide appeal and could be more easily sold. That is, the government pioneered the use of securitization to fund its lending activities. These pool-based financial structures contained many different features as they developed. They varied by type of collateral and payment structure and whether they had put-options or carried some kind of guarantee from the government. But they tended to share a similar relationship to the federal budget: they were accounted for like other asset sales, which meant that revenues from sales were used to offset current expenditures.[10]

[10] LBJ Archives, White House Central Files. (FI) EX FI 4-2/1 1968; File: 6/1/67-10/23/67, Memo. "What are Participation Certificates?"

To my knowledge, the first sales of pools of government assets happened in the 1930s, when the CCC sold off asset streams from pools of commodity loans, mainly cotton (Congressional Budget Office 1978). The RFC was the next government agency to sell bonds collateralized by pools of loans in 1953. At the time RFC was being disbanded and the government needed to do something with the over $2 billion worth of assets it held or administered. Its foreign loans went to the Export Import Bank, its disaster loans went to the Small Business Administration, and its mortgages went to Fannie Mae (House 1964: 203). 2,848 leftover smaller loans totaling $73.4 million were collected into a "RFC Loan pool," which collateralized "certificates of interest" that bore a 3% interest rate.[11] These were sold in September 1953.

A month later the Commodity Credit Corporation used a similar structure to sell "certificates of interest" that were collateralized by a pool of its loans. This was apparently an emergency measure taken in order to counter a budget overage of over $1 billion.[12] In a white paper reviewing the changing nature of budgetary concepts, Sydney Tickton (1955) explained that the pool was poorly structured and the U.S. government ended up repurchasing the loans

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11 "On September 28, 1953, the loans and securities portfolio of RFC, net of the assets later transferred (as described above), amounted to 6,650 loans, securities, and commitments totaling $618.6 million. There were 4,628 direct business loans and commitments outstanding amounting to $395.5 million and RFC was committed, on a deferred basis, to purchase participating shares in 1,676 business loans for $26.4 million. The outstanding balances on these loans ranged from under $100 to $48.4 million. To dispose of the smaller business loans in its portfolio RFC with the cooperation of a committee of commercial bankers appointed by the American Bankers Association and the Association of Reserve City Bankers established an "RFC Loan Pool." For this pool 2,848 loans, with individual balances outstanding, except for 2, under $500,000 and aggregating $73.4 million outstanding, were selected. To obtain immediate cash on these loans, the "pool" sold certificates of interest, bearing interest at the rate of 3% percent per annum to nearly 1,000 banks and private investors. The certificates, each representing an undivided share of the pool loans, totaled $47 2 million and were retired by July 5, 1956, out of repayment of the pool loans. In effect, the certificates of interest arrangement gave the participants a 3%-percent return on short-term loans, collateralized to the extent of 156 percent by loan assets whose repayment was reasonably assured. In December 1953 the Treasury 90-day bill rate was 1.63 percent; the interest rate on 9-12 month Treasury obligations was 1.61 percent; and the interest rate on 3-5 year Treasury obligations was 2.20 percent." (House 1964: 203)

12 Tickton 1955, filed in the National Archives, RG51: Office of Management and Budget, Entry 37 Records of the Office of Budget Review, Budget Methods Branch, 1952-1969.

from investors the next year for $1.5 billion. Despite this failure, agencies continued to experiment with these new debt instruments.

In 1962 the Export Import Bank adapted the use of the pooling technique, this time selling "Participation Certificates"[13] backed by the pools. In this case pooling was useful because the Bank did not have to release the names of the countries whose loans were being sold off. This anonymity allowed both the U.S. government and those countries to avoid potential political embarrassment from the sale. [14] Two years later the Omnibus Housing Act of 1964 authorized Fannie Mae to sell off participations in $300 million in mortgages. As the *Wall Street Journal* reported, this "concentrated the benefit" of repayments on those loans into 1964 and offset $300 million of spending in 1964 (Jessen 1964).

As costs of the Vietnam War and Great Society programs pushed the budget towards the debt ceiling, the Johnson administration moved to massively expand the use of participation certificates with the Participation Sales Act of 1966.[15] Johnson saw lending programs as a key element of his Great Society agenda. A governmental staff paper later commented on this,

> It is clear that the Executive Branch of the Government considers the Participation Sales Act as a tremendous breakthrough in financial management of Federal lending programs. It is also clear to many that Federal lending will be an increasingly important vehicle for the expression of public priorities in coming years. . . .
>
> Financing of Federal lending programs by direct Treasury debt issuance, of course, means financing under the public debt limit. Financing by the issuance of agency issues is outside of the debt limit. Therefore, in

[13] National Archives, RG51: Office of Management and Budget, Entry 37 Records of the Office of Budget Review, Budget Methods Branch, 1952-1969, File: Participation Certificates – 1962-65 Letter from Christopher Weeks March 26, 1962 on the Export-Import Bank Participation Certificate Sale.

[14] Tickton 1955, c.f. National Archives, RG51: Office of Management and Budget, Entry 37 Records of the Office of Budget Review, Budget Methods Branch, 1952-1969, Box 31.

[15] See also Congressional Budget Office, U. S. (1978). Loan Guarantees: Current Concerns and Alternatives for Control: A Compilation of Staff Working Papers. C. B. Office. Washington: xv, 58 p.

> addition to the obvious desirability of having a business-type enterprise stand on its own feet by doing its own borrowing, a further incentive is given to a preference for agency borrowing as a way to get around the debt limit when that limit is pinching the treasury rather badly.[16]

Thus it is possible that Johnson fully grasped the potential of finance as a means of intervention into the market, one that would allow him to assert his priorities while avoiding congressional accountability.

In its original form, the Participation Sales Act would have authorized Fannie Mae to sell $33 billion in loans held throughout the U.S. government. Facing fierce resistance from Republicans, the final version of the bill allowed Fannie to broker only $11 billion worth of loans from six agencies. At the center of the debate about the Participation Sales Act was concern over how to account for them in the Federal Budget. Part of the problem was that the PCs had a guarantee of payment of principal and interest from the government. This meant that in the last instance the Treasury would be on the hook if something went wrong with these deals. Some looked at this arrangement and asked: If the government processed the loans and retained their risks, then had it really sold the assets? And if this wasn't a real sale – if the Treasury was really on the hook just as it was for other government bonds – then wasn't this just another way of raising money? By this logic, the government hadn't reduced expenditures at all. It had done the opposite – it had issued a new kind of debt. Instead of spending less, it owed more.

First in committee and later on the floor, Republicans rallied against participation sales. Many longstanding debates about how to best finance and account for credit programs found

16 National Archives, RG51: Office of Management and Budget, Entry 37 Records of the Office of Budget Review, Budget Methods Branch, 1952-1969. Box 120. BOB Comments on PCBC Report – Chapter V. May 29, 1967 Staff Paper (Memo to the President's Commission Budgetary Concepts.) *Loans, Participation Certificates, and the Financing of Budget Deficits*. See pp 12 and 15.

voice in their objections. Republicans branded this a dangerous budgetary gimmick designed to "camouflage" the full extent of the Administrations spending. As a kind of "backdoor" accounting that bypassed appropriations, it concentrated power in the hands of the President. The sales were thought to render the budget ceiling toothless and the deficit meaningless. In a statement of his individual view, Rep. Paul Fino articulated how private capital could be used to manipulate public accounts. "Like all 'crisis economics' proposals," he said, "this scheme blends economic shakiness with political opportunism."

> The real reason for private capital being desired is that while Treasury borrowing would be of no budget camouflage assistance, private funds obtained through pool participation sales refinancing can be chalked up on the plus side of the budget ledger.
>
> Under the guide of "recruiting" private capital to share the burden of Government capital, the administration is offering a program the real thrust of which, in budget deficit years, the extent of the budget deficit can be camouflaged by receipts gained from a sale of Government assets for private funds. I hardly need to add that this is a mechanism for economic and political fraud (House 1966: 33).

Republicans further recycled concerns about the high costs of financing outside of the Treasury. Since Fannie Mae could not issue debt as cheaply as the Treasury, and since the government would have to subsidize some of the deals, participation sales meant the government would be paying a premium to hide the size of the budget: "What really happens though the participation device is that pooled assets are not sold, they are really refinanced in a more costly way because Fannie Mae cannot borrow as cheaply as the U.S. Treasury" (House 1966: 18).

Republicans insisted that if this were a true sale of assets they would have supported it, but that this was not a true sale. They objected that the purchaser would not receive a title to the

pooled asset or a pro rata interest in the pool, but rather "interest at a rate stated in the participation certificate" (House 1966: 18). They further noted that "the agency pooling the loan continues to bear the responsibility and burden of servicing the loans. The agency pooling the loans remains exposed to the risks of default" (House 1966: 18). Finally, they warned that the credit protection ran into moral hazard problems: since any bad debts were backed with credit protection from the government, they would sell at the same price as a good debt.

Publicly Democrats conceded that PCs padded the budget, but they also insisted that the primary impetus behind the bill was to bring private funds into the market (Congressional Quarterly 1966). Privately they were sometimes more candid. In a letter to Johnson's Special Assistant Barefoot Saunders, Democratic Representative Brock Adams explained, "The deficit is so bad that many of us who believe that these assets should be used either for emergencies or for long-term benefits and not to simply cover operating deficits have supported them because of the emergency caused by the Viet Nam spending."[17]

A close look at what happened when it was time for the government to sell participation certificates in 1967 suggests that for the White House, manipulating the budget took precedence over drawing private funds into the mortgage market. Recall that rising mortgage rates had caused a credit crunch in housing in 1966. In response Fannie Mae had purchased over $4 billion worth of mortgages. Johnson was eager to offset this, even in part. But selling participations in mortgages would divert funds from private investments, making money even more scarce. The Treasury sent a memo to the President telling him to avoid issuing PCs until market conditions changed. Johnson now had to choose between what was best for the housing market and what

[17] LBJ Archives, White House Central Files, LE, Legislation, LEF/FI 5-4. October 27, 1966. Letter from Brock Adams to Barefoot Saunders.

was best for his budget. In a game of financial chicken, the White House delayed the sale of PCs hoping for better market conditions to come around. But regardless of what state the market was in, they would only delay the sale of PCs until the end of 1967 so as make sure the sales could be counted in the budget.

At this point, the administration worked to reduce the impact of the sale on the housing market. Johnson and the Treasury had weighed *selling all the PCs back to the government,* but rejected this as a possibility because it would cause political embarrassment. Instead they had the Trusts invest in a smaller portion of the PCs. Contrary to his statements about bringing private funds into the housing market, in 1967 Johnson released as few PCs onto the market as he could politically get away with.

The Fall Out and Spin-Off

Johnson won the battle over participation certificates, but it cost him. His credibility gap, so infamously associated with the Vietnam War, now caused problems with the budget. A staff paper prepared for a presidential commission to review the budget points to this:

> Whether or not the criticism is valid, it may be fairly said that the treatment of participation certificate sales as a reduction in budget expenditures and budget deficit, particularly since they have become sizable in amount, has perhaps done more to undermine public and congressional confidence in the integrity of budget totals than any single other issue.[18]

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18 National Archives , RG51: Office of Management and Budget, Entry 37 Records of the Office of Budget Review, Budget Methods Branch, 1952-1969. BOB Comments on PCBC Report – Chapter V. May 29, 1967 Staff Paper (Memo to the President's Commission Budgetary Concepts.) *Loans, Participation Certificates, and the Financing of Budget Deficits*.

Early in January of 1967 Henry Fowler, head of the Treasury, sent a memo to the White House explaining that debates about the budget were increasingly heated and acrimonious, citing the participation sales act as a "prime example" of this.[19] In order to smooth the waters he recommended the President convene a special committee to review the budget. Fowler argued that the political advantages of a more transparent budget (and, through that, protection from accusations of budget gimmickry) outweighed the potential negative of less flexibility. Three months later the White House announced that it had appointed the *President's Commission on Budgetary Concepts* (PCBC) to make a "thorough study" of the Federal Budget (Concepts 1967: 105). It would be headed by banker David Kennedy, and its members would include the heads of the Treasury, Bureau of the Budget, and General Accounting Office. The Chair and two minority members of the Appropriations committee would also serve on the PCBC, alongside a set of private experts.

The Commission called for a complete overhaul of the federal budget and the creation of the new "Unified Budget." Its members reached consensus on everything *except* participation certificates.[20] Over the strenuous objections of the Secretary of the Treasury, Henry Fowler, and the Director of the Bureau of the Budget, Charles Schultze, the Commission concluded that PCs were not a true sale of assets, which meant they were liabilities:

> In one sense, the sale of shares in a pool of loans is but a short, logical step beyond the sale of the asset itself; but it is a crucial step. When an asset is sold, the Federal Government retains no equity in it although it usually guarantees the loans it sells. When it is pooled, however – and participation certificates sold in the pool – the ownership (though not the

[19] National Archives, RG51: Office of Management and Budget, Entry 37 Records of the Office of Budget Review, Budget Methods Branch, 1952-1969, File: PCBC – Appointment of Commission Members. Jan – March 1967, Jan 12, 1967. Henry Fowler. "Memorandum for the President."

[20] LBJ Archives. Administrative Histories Collection. Administrative History of the Bureau of the Budget. The *Administrative History of the Bureau of the Budget, p.29*

> beneficial equity) is still retained by the federal government. Interest payments on the loan continue to flow to the Government and the Government continues not only to incur servicing costs but also to assume fully the risk of default on any individual loan as far as the investor in the participation certificate is concerned (Concepts 1967: 55).

If the government serviced the loans and held the risk, then the government owned those mortgages. This refuted the logic that ownership inhered in revenues and so could be parsed from risks and removed from balance sheets. The ruling would not merely prevent PCs from being used as budgetary reductions; now considered a liability, they would add to the deficit. It was therefore an expensive political problem for the Johnson Administration.[21]

The PCBC's decision triggered both the privatization of Fannie Mae and the transformation of participation certificates into mortgage-backed securities. Johnson's men recognized that the new accounting treatment meant that Fannie Mae's secondary market operations (that is, the part of Fannie Mae that purchased extant mortgages) would become very difficult to fund if they were listed on the budget without offsets.[22] At the same time, they felt that disregarding the President's own commission would be a "political impossibility"[23] and a "major tactical mistake."[24] They had to find a new solution to their problem with the budget.

A series of committees about mortgage finance had been meeting since 1966. Headed by James Duesenberry of the Council of Economic Advisors, who worked closely with Sherman Maisel of the Federal Reserve, the committees had been working through various options for

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21 See, for example, the Administrative History of the Treasury: "This was an extremely difficult issue because of its political connotations." (15) Administrative Histories Collection. Administrative History of the Treasury.

22 LBJ Archives. Lapin to Weaver 1/3/67. Subject: Budgetary Treatment of Secondary Market Operations

23 LBJ Archives, White House Central Files, Box **37**: EX FI 4-2/1 1968. File FI 5 Credit –Loans 4/21/66 – 9/6/66. March 9, 1968.DeVier Pierson. Memorandum for the President

24 LBJ Archives, White House Central Files, Box 37: EX FI 4-2/1 1968. March 6, 1968. File FI 5 Credit –Loans 4/21/66 – 9/6/66. Memorandum for DeVier Pierson. Subject: Secretary Freeman's proposal on Budget Concepts.

reforming housing finance, which included replacing Fannie Mae with a private company as well as the possibility of creating a long term mortgage-backed bond to replace the participation certificate. Following the PCBC's ruling, these committees were given priority.

At this point things moved quickly. In September, a full month before the Commission's report was even published, they reconvened as part of a Mortgage Finance Task Force; its "central proposal" was deemed "the creation of a new bond representing an interest in a bundle of federally-underwritten mortgages. . . The new bond would be similar to PC's in concept, but would work to infuse more money into the mortgage market . . ."[25] The new bond they discussed would become Pass-Through Certificates, which many people consider to be the first modern MBS. The Senate Housing and Currency Committee would later comment on the potential usefulness of these new instruments: "if such securities become well enough established so that many private issuers are issuing them, they could constitute a significant factor in attracting investment funds to the field of mortgage investment" (Senate 1968: 79).

At the same time as the government moved forward with its plan to develop a market for a new kind of mortgage bond, the White House began working with the Department of Housing and Urban Development and the Bureau of the Budget to spin-off Fannie Mae. Fannie Mae would be split into two organizations. Functions considered essential to the government would be incorporated into a new government agency, the Government National Mortgage Association, or Ginnie Mae. This new agency would be authorized to guarantee mortgage-backed securities issued by approved private companies as long as the mortgages they pooled were already insured by the FHA or VA. Thus the pools as planned at this point involved two kinds of governmental

25 LBJ Archives. White House Central Files, Federal Government Files, FG 600, Memo to the President from Califano about MFTF.

guarantees: (i) the FHA and VA's insurance of the loans going into the MBS pool, and (ii) a guarantee from Ginnie Mae of the return of principle and interest. The first guarantee protected the company issuing the debt in the case that homeowners defaulted; the second guarantee of the pool itself protected investors if a bank that issued the securitized bonds defaulted (Black, Garbade, and Silber 1981). Johnson's men had considered eliminating the second Ginnie Mae guarantee -- they worried that it could raise the very accounting objections they were working to solve[26] -- but the bankers they consulted insisted that investors would rather buy Treasury securities and would only invest with some kind of guarantee.[27] The White House, under pressure to avoid the debt ceiling, went ahead with the second guarantee. One government official later boasted that "the double federal guarantee should produce a virtually riskless security with broad market acceptability."[28] Eventually investors became comfortable enough with MBS that they no longer required such strong support. Still, these guarantees played a crucial role in normalizing MBS and establishing the market in the first place.

Whereas Ginnie Mae would retain essential government functions, the rest of the old Fannie Mae was to be privatized. The spin-off planning committee believed that Fannie would need to be highly leveraged to be successful. They proposed to congress that Fannie Mae should have no debt to equity ratio; if that met resistance, they suggested a ratio of 25 to 1. Even at the dawn of the securitization market MBS promoted a high degree of leverage.

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[26] National Archives, RG51: Office of Management and Budget, Entry 37 Records of the Office of Budget Review, Budget Methods Branch, 1952-1969, File" Participation Certificates – 1966. Feb 15, 1966. Minutes of the Advisory Committee on Financial Assets.

[27] Maisel Papers, May 11, 1967. Minutes of the Housing Credit Committee Meeting; National Archives, RG51: Office of Management and Budget, Entry 37 Records of the Office of Budget Review, Budget Methods Branch, 1952-1969, File: Participation Certificates – 1966. Feb 15, 1966. Minutes of the Advisory Committee on Financial Assets.

[28] LBJ Archives, White House Central Files, Finance Files.

There were differences between the PCs and the early MBS. Notably, the MBS were designed to be more of a true sale of assets. To that end, investors received a pro rata share of the pool and funds passed directly from the pool into the hands of investors. Yet the credit risks associated with its new mortgage-bonds would continue to be largely absorbed by the government. A Ginnie Mae guarantee and a $2.25 billion line of credit at Fannie Mae (and later at Freddie Mac[29]) meant that the Treasury was on the hook if there was a credit problem with these pools. But because the companies issuing the bonds were now fully private and the sales were structured differently, these debt instruments would not be considered government liabilities under the guidelines laid out by the PCBC.

Debates about the status of Fannie Mae and the proper accounting for those bonds did not end with the spin-off of Fannie Mae. The Nixon administration would later assert in the *Wall Street Journal* that Fannie Mae was effectively a shadow government agency, privatized only by Johnson to hide the size of the Vietnam War budget. [30] In 1971 the Federal Reserve suggested that the government reclassify GNMA securities in order to include them on the budgetary outlay totals; this was thought to pave the way towards putting *all* of the government's insured and guaranteed securities on the books, including the FHA and VA loans, to the amount of $25 billion annually (in comparison, the MBS at this time would add only $2 billion annually to the budget). The Treasury, OMB, and HUD strenuously objected: "We are absolutely unconvinced by this classification and appalled by the consequences."[31] The key point here is not that these MBS

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[29] In 1970 Freddie Mac was created in the same model as Fannie Mae. It was created under the FHLBB, in part because Savings and Loans preferred to work through the FHLBB than with Fannie, which had traditionally been aligned with the Mutual Banks and other investors that purchased FHA and VA insured loans. It was actually Freddie that took the lead in the issuance of MBS throughout the 1970s, while Fannie largely stuck to portfolio lending until the 1980s.

[30] LBJ Archives. Gaither Files.

[31] National Archives RG51, E202, Housing CVA: HUD 1971-1972 G.(2) GNMA Mortgage Backed Securities. August 4th, 1971 letter from James Hill.

necessarily belonged on the budget. Rather, the important thing to note is that the U.S. government was working in a hybrid area that could have reasonably been classified in different ways. Government officials, perhaps not unsurprisingly, seem to have picked the classification that served their interests. In doing so, they created a multipurpose financial tool that would have wide applicability once all the kinks were worked out.

Conclusion

President Johnson publicly proclaimed that the Housing and Development Act of 1968 was a way to bring private funds into a struggling market. But he glossed over important details about *why* the government was so eager to access capital markets. This omission mattered. It allowed Johnson to imply that the government was transforming housing finance mainly because it supported private enterprise and homebuilding. It is true that the administration wanted to support housing and private markets, but it is also true that the administration was driven by an urgent need to get public funds out of the housing market. Facing a fiscal crisis caused by the Vietnam War and the Great Society programs, Johnson first tried to solve his budgetary problems by using a weaker version of privatization, one that used debt instruments to tap private funds and remove the impact of Fannie Mae on the budget, but that kept control of housing finance squarely in government hands. It was only when this effort failed that Johnson spun-off Fannie Mae and laid the foundation for the American MBS market. Even then, the government continued to absorb mortgage risks in less direct ways but significant ways.

The basic form of the MBS was in place when the first one was issued in 1970. A group of assets would be combined into a pool and investors purchased the right to revenues accruing from the pool. The pool benefited from some kind of credit protection, a provision that reassured investors that they could still get paid even if assets in the pool defaulted or lost their value. Since all of this was done through a group of assets held in a Special Investment Vehicle that was thought to contain any risks, neither the buyer nor seller had to hold reserves equivalent to the amount required if they directly owned those collateralizing assets.

In the late 1960s and throughout the 1970s the government and a select group of investors worked hard to convince the business world at large that it was a good idea to invest in these new securities and, through them, in the housing market, using government supports to advance the market. Many of the biggest developments in securitization throughout the 1970s and 1980s – experiments with over-collateralization, insurance contracts, credit-default swaps, and, most importantly, tranching – were intended to create risk management tools robust enough to take the place of the Ginnie Mae guarantee.[32] In the middle of the 1980s, when all of this was in place, a truly private market started to take off.

Many developments beyond the rise of securitization helped cause the credit and housing bubbles that led to an economic crisis. In the 1970s and 1980s a series of deregulations stripped away important government controls in housing and financial markets. Low interest rates encouraged investors from around the world to pour money into American markets and especially into American housing finance. Credit agencies that were supposed to police credit markets were swayed by conflicts of interests and failed to adequately evaluate MBS risks. In

[32] Entrepreneurs also worked to changed tax laws, better managing prepayment risks, and educating investors.

this environment, securitization served as a powerful accelerant. I suspect that by the close of the 1990s the same things that made the MBS such an efficient solution for Johnson – a capacity to parse risk and ownership, the ability to move unwanted assets off a balance sheet, a level of obscurity that rendered these deals unintelligible to the lay person, and, most of all, a structure that justified a more risky, highly leveraged balance sheet – all served to fuel the subprime market and credit bubble.

Attending to the place of credit lending and budget politics in these events matters because it has implications for how we think about the ultimate misuse of MBS. When the U.S. government turned to credit lending to help promote its markets, it had ramifications far beyond the immediate development of housing or agriculture or small businesses. The government's credit programs helped change the techniques and concepts used across credit markets. They also reshaped the boundaries of the federal budget and pioneered the use of MBS, one of the most important financial technologies of our time. It is true that MBS were designed to manage risks and encourage lending. It is also true that they were designed to remove assets from balance sheets and increase leverage. So if we find today that MBS have made it difficult to measure what risks companies hold, or that they have encouraged companies to assume a higher ratio of obligations to equity, we would do well to remember that, to some extent, this is exactly what MBS were designed to do. As we collectively look back to make sense of the current economic meltdown, we should keep in mind that if the balance sheets of today's banks are things of shreds and patches, it is in part because they followed the lead of the federal budget.

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Table 1: Federal Credit Aid, 1932-1950 (in billions of dollars)

Sector	Program Type	1932-36	1937-41	1942-46	1947-50
Finance	Direct loans	3.681	0.256	0.055	0.008
Business	Direct loans	0.959	0.673	2.999	2.475
Business	Insured	0.074	0.086	1.878	0.452
Agriculture (real estate)	Direct loans	2.165	0.604	0.74	0.881
Agriculture (other)	Direct loans	2.935	3.947	6.273	8.703
Private housing	Direct loans	3.435	1.646	1.505	3.803
Private housing	Insured	0.908	4.356	5.614	18.509
Local government	Direct loans	1.062	1.719	0.467	0.262
Local government	Insured	0	0.057	0.677	0.549
Misc	Direct loans	0.144	0.158	0.073	0.115
Total		*15.363*	*13.502*	*20.281*	*35.757*

Note: “Insured” includes federal guarantee programs.

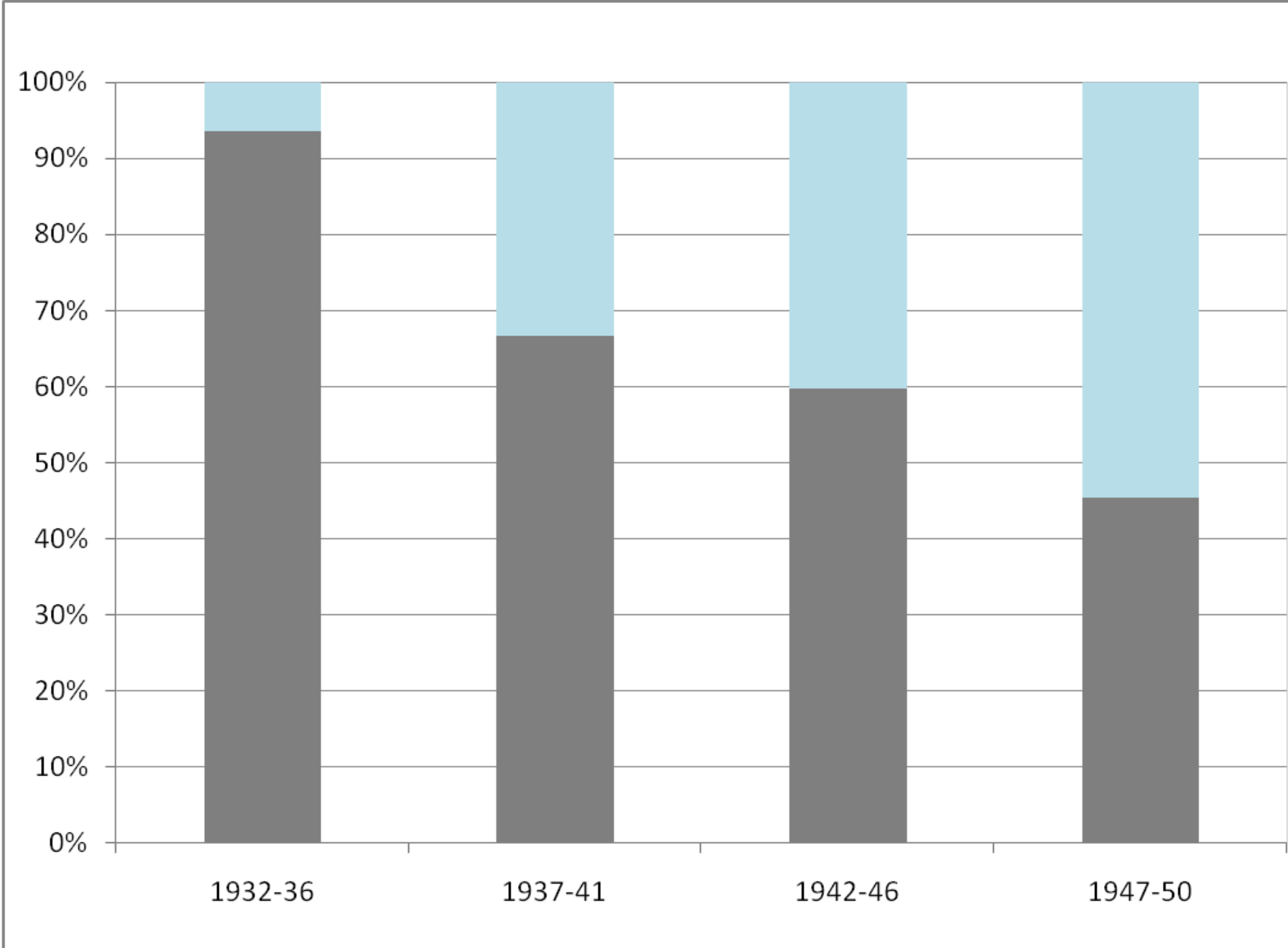
Source: R. J. Salunier, H. O. Halcrow, and N. H. Jacoby, "Federal Lending and Loan Insurance" (Princeton: Princeton University Press, 1958); Appendix A; "Final Report on the Reconstruction Finance Corporation" (Washington: Government Printing Office, 1969), tables in appendix; and data presented in tables A-2, A-3, sod A-4.; as cited in *Federal Credit Programs* (United States. Congress. House. Committee on Banking and Currency. 1964)

Table 2: Terms on Mortgages for Existing Homes, Selected Years

	Maturity			**Loan-to-Value Ratio**		
Year	FHA (Average)	VA (Average)	Conventional (Median)	FHA (Average)	VA (Average)	Conventional (Median)
1950	20.2	19.7	12.3	76.4	86.4	64.6
1952	19.7	18.7	13.9	76.1	80.3	64.1
1954	20.1	21.4	14.6	77.8	86.8	65.2
1958	24.2	22.3	15.5	88.1	87.4	68.9
1960	25.8	23.6	16.5	90.5	90.7	72
1962	27.4	26.6	18.8	92.1	94.9	75.1
1964	28.4	27.7	20.9	92.8	96.2	76.1
1966	28.4	27.8	22.2	93	96.8	74.5

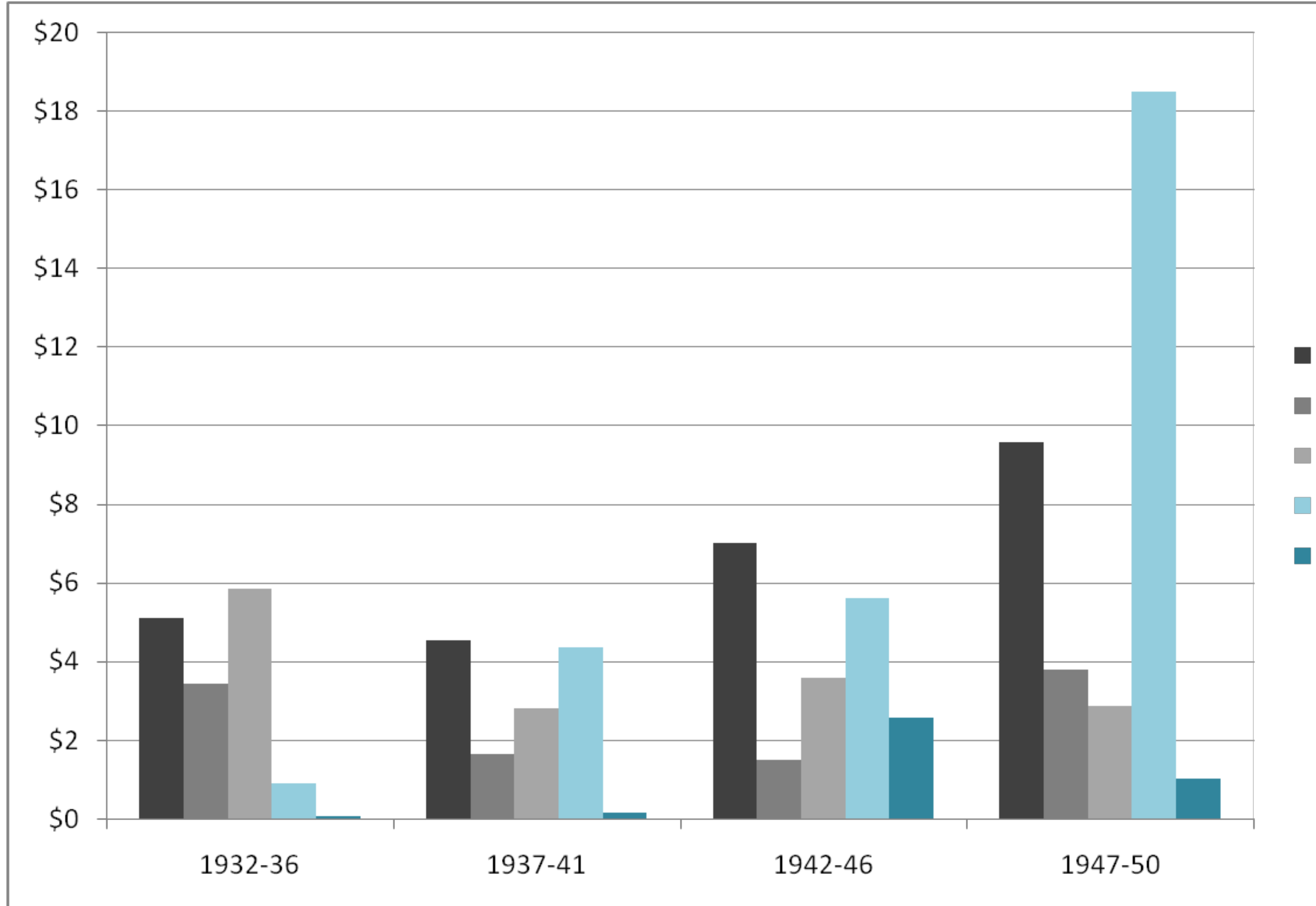
Source: Snowden, Kenneth A., “Terms on nonfarm home mortgages, by type of mortgage and holder: 1920–1967.” Table Dc1192-1209 in Carter et al. 2006.

Figure 1: Direct vs. Insured Loans as a Portion of Federal Credit Aid, 1932-1950



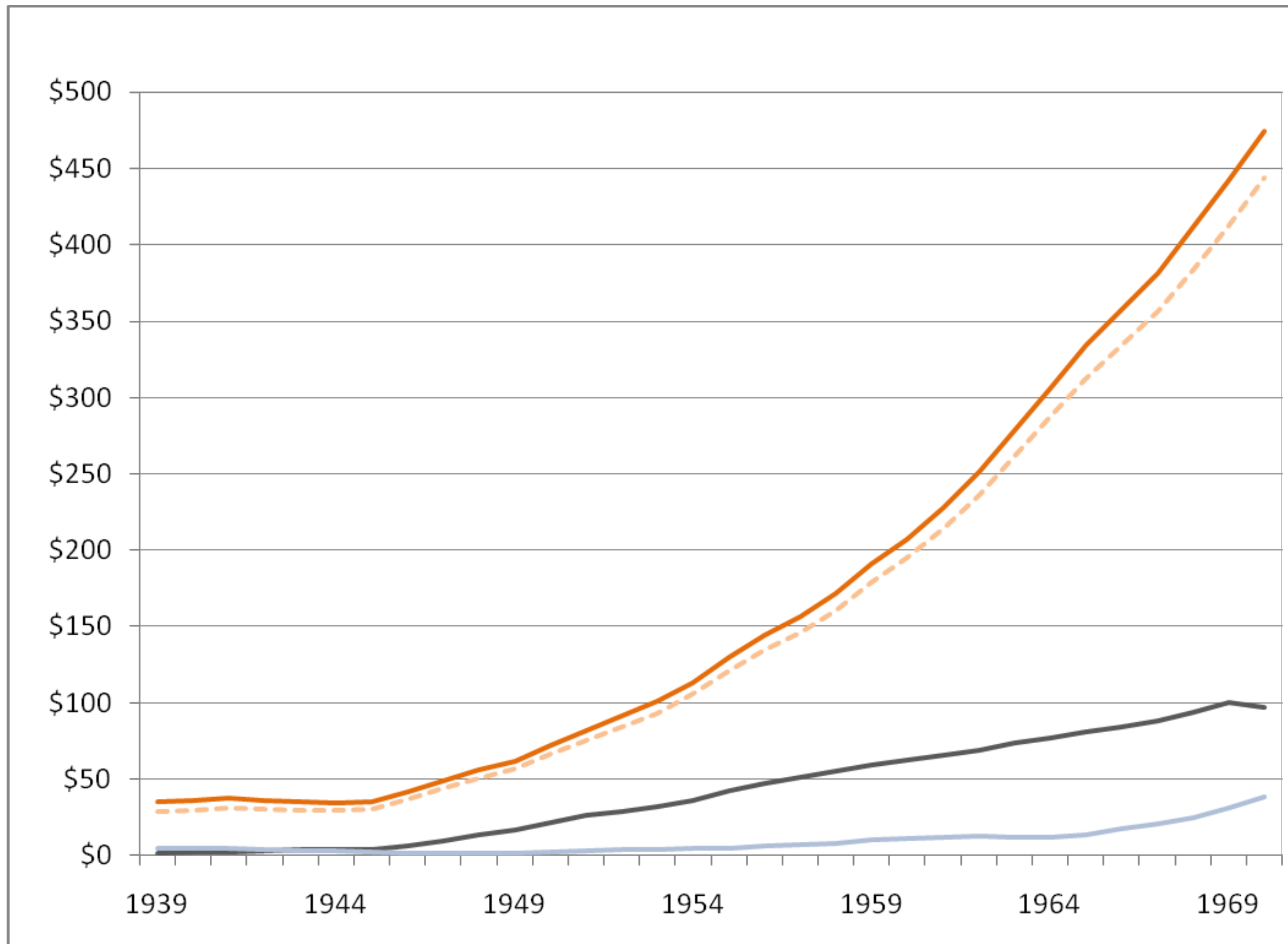
Source: R. J. Salunier, H. O. Halcrow, and N. H. Jacoby, "Federal Lending and Loan Insurance" (Princeton: Princeton University Press, 1958); Appendix A; "Final Report on the Reconstruction Finance Corporation" (Washington: Government Printing Office, 1969), tables in appendix; and data presented in tables A-2, A-3, sod A-4, as cited in *Federal Credit Programs* (House 1964).

Figure 2: Federal Credit Aid, 1932-1950: Direct and Insured Debt by Sector (in billions)



Source: R. J. Salunier, H. O. Halcrow, and N. H. Jacoby, "Federal Lending and Loan Insurance" (Princeton: Princeton University Press, 1958); Appendix A; "Final Report on the Reconstruction Finance Corporation" (Washington: Government Printing Office, 1969), tables in appendix; and data presented in tables A-2, A-3, sod A-4; as cited in *Federal Credit Programs* (House 1964).

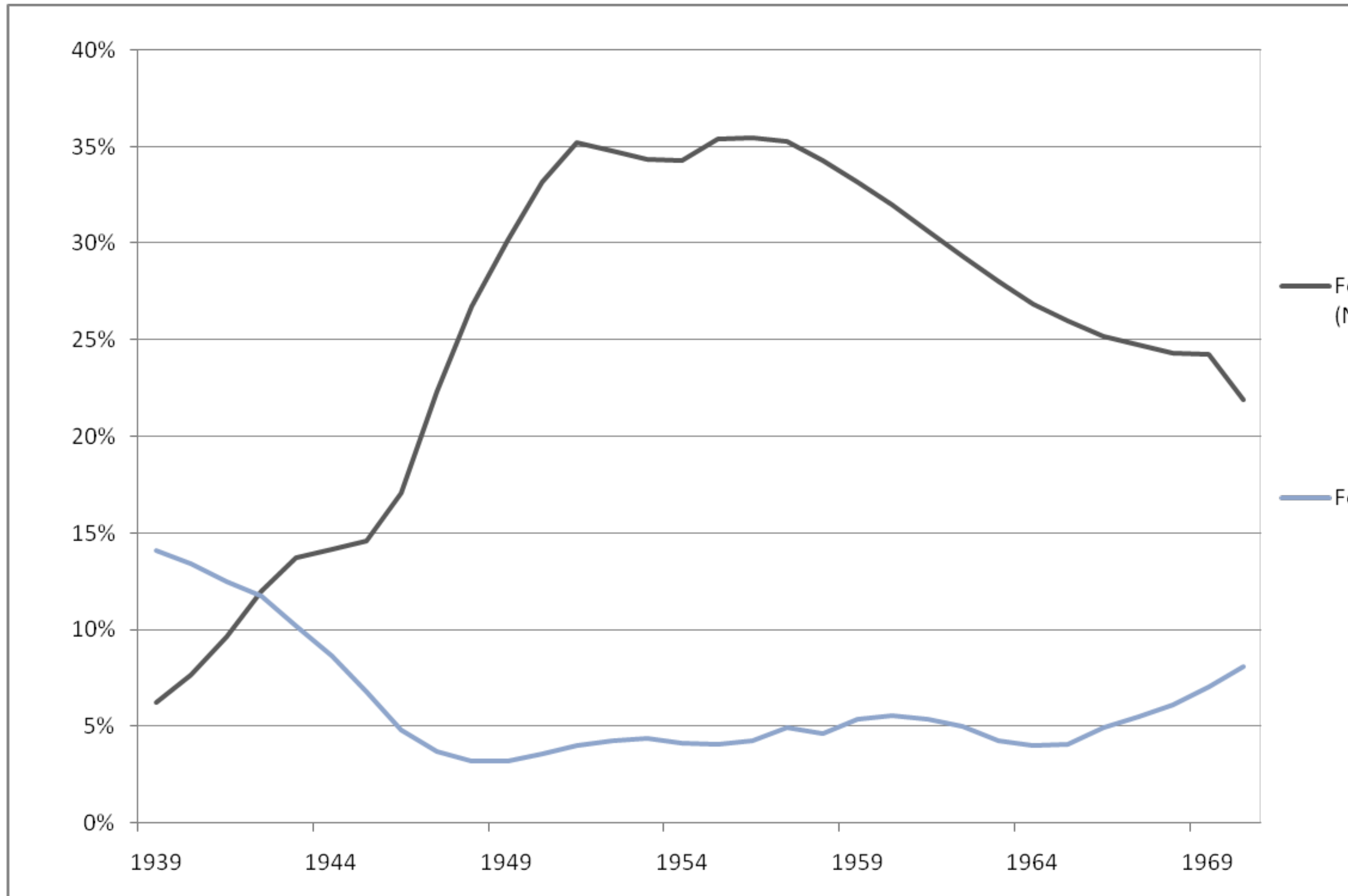
Figure 3: U.S. Mortgage Debt, 1939-1970 (in billions)



Note: The numbers for federally held debt represents farm and nonfarm debt; the federally underwritten portion is calculated based on nonfarm debt only. For federally underwritten debt from 1939-1944, values represent only FHA and VA loans on 1-4 family homes and so are likely a small underestimation. For 1944 onwards, this is total federally underwritten nonfarm debt.

Source: Snowden, Kenneth A. "Mortgage debt, by type of property, holder, and financing: 1939–1999." Table Dc929-949 in Carter et al 2006. Online: http://dx.doi.org/10.1017/ISBN-9780511132971.Dc903-1288

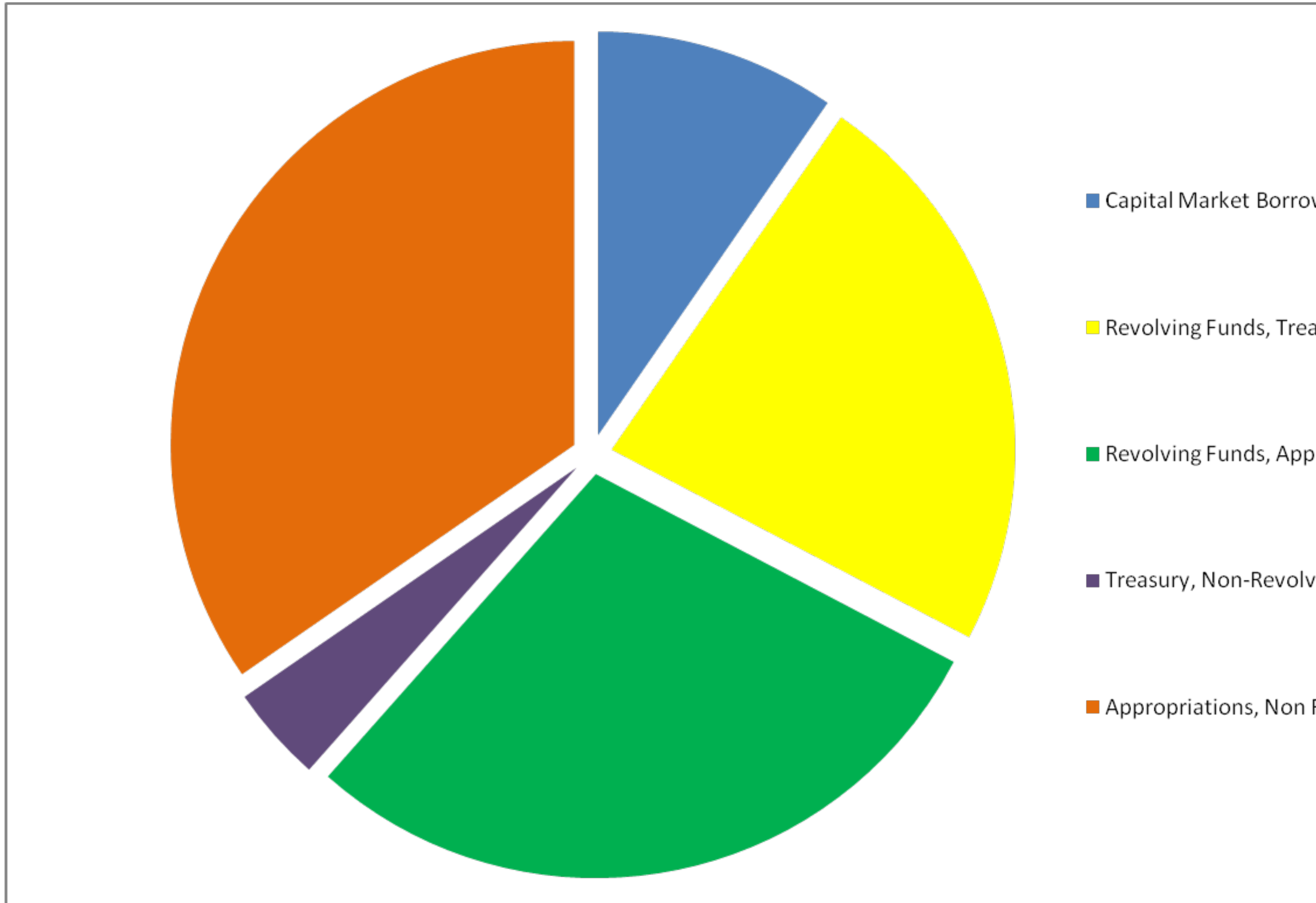
Figure 4: Federal Mortgage Credit as a Portion of U.S. Mortgage Debt, 1939-1970



Note: The numbers for federally held debt represents farm and nonfarm debt; the federally underwritten portion is calculated based on nonfarm debt only. For federally underwritten debt from 1939-1944, values represent only FHA and VA loans on 1-4 family homes and so are likely a small underestimation. For 1944 onwards, this is total federally underwritten nonfarm debt.

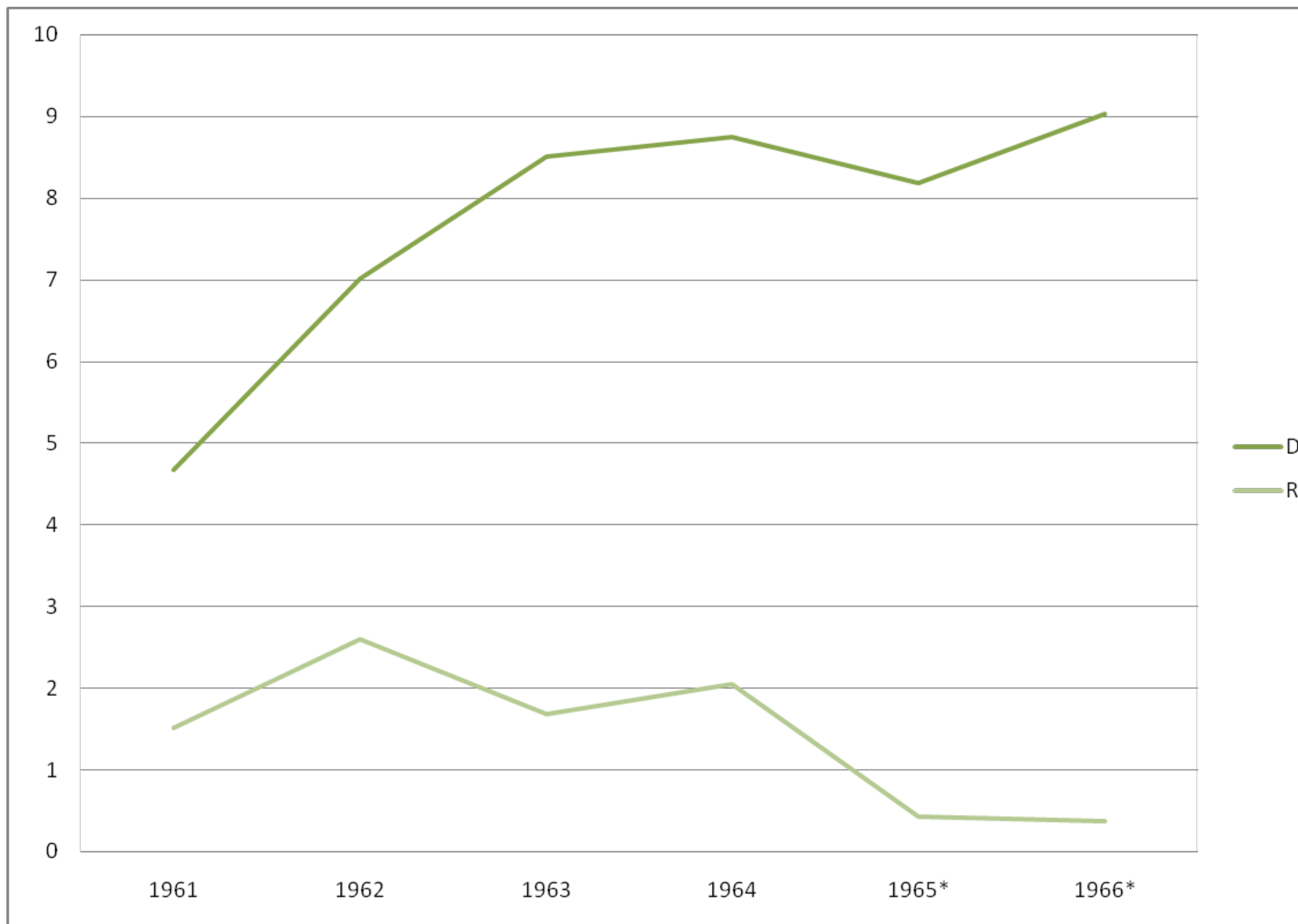
Source: Snowden, Kenneth A. "Mortgage debt, by type of property, holder, and financing: 1939–1999." Table Dc929-949 in Carter et al 2006. Available online: http://dx.doi.org/10.1017/ISBN-9780511132971.Dc903-1288

Figure 5: Financing of Federal Credit Programs in 1964



Source: *Federal Credit Programs* (United States. Congress. House. Committee on Banking and Currency. 1964)

Figure 6: Actual Disbursements vs. Reported Expenditures for Federal Credit Programs, 1961 to 1966



Note: Amounts for 1965 and 1966 are estimates. Actual amounts are provided from 1961-1964.
Source: *Special Analyses: Budget of the United States Government,* Washington, D.C.: Executive Office of the President. 1963, 1964, 1965, 1966