

For many Americans, the names “Fannie Mae” and “Freddie Mac” became much more prominent during the 2008 economic crisis. With the collapse of a number of investment firm-traded derivatives that were based on extremely risky mortgages, the industry came under greater public scrutiny. As bad as the crisis was, the situation didn’t come anywhere close to the Great Depression, which was similarly influenced by derivative securities. One of the biggest differences between the 1920s and 2008 was the existence of Fannie Mae and Freddie Mac.

Despite their importance in protecting the economy, these organizations still remain in the background for many people, and their specific functions are not widely understood. This article examines what exactly Fannie Mae and Freddie Mac do, explores their history and role in the economy today, and provides an overview of their impact on the financial market specifically. While these organizations are large and play a significant role in the U.S. economy, their mission is straightforward and relatively easy to understand.

What are Fannie Mae and Freddie Mac?

Fannie Mae and Freddie Mac are government-sponsored enterprises, which are private businesses that receive much more involvement from the government than most companies. They are officially chartered by Congress and subject to much greater governmental scrutiny and regulation than other companies. As a result, they blur some of the boundaries between public and private companies.

While Fannie Mae and Freddie Mac must operate within strict guidelines set out by Congress, they also benefit from the government’s influence. This influence grants them access to an expectation of more governmental assistance in the event of a crisis or other problem. Despite being two different companies, Fannie Mae and Freddie Mac have essentially the same mission. This mission consists of several parts.

- 1. Increase Liquidity in the Mortgage Market** - Unlike flashier financial assets, stable mortgages involve large investments of capital at generally lower interest rates. These lower rates make them accessible to individuals and businesses that lack the cash on hand to purchase properties outright and rely on banks to fill that void. Fannie Mae and Freddie Mac provide another layer of investment that allows banks to create mortgages without tying up too much of their asset pool.
- 1. Stabilize the Mortgage Market** - The real estate market, when left unregulated in its entirety, is volatile. Mortgages, which are heavily influenced by property value, are then subject to a variety of pressures that can make such long-term and large-scale investments seem undesirable during poor economic climates. Fannie Mae and Freddie Mac minimize the impact of these unstable conditions and allow mortgages to remain available at all times.
- 1. Create Additional Financial Tools** - Mortgages on their own are largely inflexible, as each represents sinking a large amount of capital into a single investment. In the aggregate, mortgages can lock up a significant portion of the lending market, limiting desirability due to the limitations that mortgages would place on banks’ and financial firms’ investment portfolios. Fannie Mae and Freddie Mac create additional financial tools by purchasing and bundling mortgages into sets of securities that free up the banks’ capital and create new investment opportunities that can be financed piecemeal.

These core objectives are built into the structure of these enterprises’ charters and help the public in numerous ways. Despite the fact that their primary functions interact with banks more so than the public, the public derives significant benefits from the banks receiving greater liquidity, a more stable mortgage market, and increased economic activity from mortgage-backed financial tools. This combination ensures that more people have access to non-predatory mortgages as long as they are in reasonable financial health.

History of Fannie Mae and Freddie Mac

Prior to the Great Depression, the American economy was subject to incredible boom-and-bust cycles, with incredible economic growth being followed by crushing stagnation and recessions. This instability dramatically affected individuals and organizations, allowing for both the staggering wealth of the 1920s and the miserable privation of the 1930s.

One reason why the boom-and-bust cycle had such a high amplitude, bouncing between those heights and depths, is because the financial market was largely unregulated. The complicated factors that drive the economy were left to their own devices and influenced primarily by separate actors who were driven primarily by self-interest. Even though a rising tide lifts all ships, it's impossible for economic growth to continue indefinitely without any hiccups. The moment those hiccups occur, investors withdraw to protect their assets, triggering a cascade of illiquidity and a market crisis.

Considering how important mortgages are, the size of those loans, and the troubles caused by unregulated repackaging of risky mortgage debt in the 1920s to create an inflated sense of economic growth, Congress recognized the need to intervene in this market particularly. Congress chartered Fannie Mae in 1938 to operate with the goals outlined above. From its original government charter, Fannie Mae has grown in importance but transitioned to a form wherein it is publicly traded but still chartered originally by the government.

On its own, Fannie Mae was insufficient to fully stabilize the economy, which is beyond its scope anyway. Nevertheless, it provided valuable services that minimized the negative effects of economic downturns and participated in the positive economic conditions that came to define the 1950s in America. As time went on, Congress saw the need to expand operations in this large market so that citizens continued to have access to affordable and secure mortgages. Therefore, Congress chartered a second organization, Freddie Mac, in 1970.

Together, Fannie Mae and Freddie Mac have served to drive liquidity and stability in the market, contributing to improved market conditions and reducing the impact of other financial blunders in the market. The 2008 crisis was caused ultimately by speculative derivatives based on low-quality mortgages bundled together into securities, then those bundles being repackaged and rebranded before being sold as stable securities. While this issue was nearly the same as what caused the Great Depression, the results were far less devastating to the economy this time around. One of the most important differences between these crises was the existence of Fannie Mae and Freddie Mac to maintain an even keel in some aspects of the mortgage market despite the treacherous conditions.

The Role of Fannie Mae and Freddie Mac in the Economy

Fannie Mae and Freddie Mac serve as an intermediary between financial investors and banks, which provides several significant benefits to the economy as a whole. In line with their missions, these entities play an important part that would be extremely difficult to replace with an organic, grassroots business enterprise. The government's influence on their charter has enabled them to succeed as private organizations that nevertheless protect the public and maintain conditions necessary for economic growth.

- **How They Increase Liquidity** - To achieve this goal, Fannie Mae and Freddie Mac purchase conforming mortgages from banks. These purchases directly provide the banks with liquid funds to continue their lending activities—enabling more economic activity—since banks are under less pressure to pick and choose which individuals and organizations merit the loans. However, the stipulations that Fannie Mae and Freddie Mac put on conforming mortgages ensure that these loans are not too risky, which means that banks are not at liberty to throw money into situations that are likely to collapse at any moment.
- **How They Stabilize the Mortgage Market** - The same tools used to increase liquidity help stabilize the market when taken in conjunction with the regulations that Fannie Mae and Freddie Mac establish. Banks that want access to the increased liquidity and security that comes from Fannie Mae and Freddie Mac participating in the mortgage market

are thereby pressured to issue mortgages that meet their requirements. As a result, mortgages, in general, will conform to higher standards of quality, meaning that foreclosures and defaults are far less common than they would be otherwise. This dearth of financial failure then maintains the market's stability and preserves economic activity even during market downturns.

- **How They Create Additional Financial Tools** - Despite the negative impact that derivatives based on high-risk mortgages have, mortgage-backed securities that are built on the kind of stable mortgages that Fannie Mae and Freddie Mac encourage can genuinely help the economy. First, these securities become stable investments that can be broken down and made accessible to investors that don't want to fully finance mortgages due to a lack of capital or a desire for more profitable investments. Stable mortgage-backed securities nevertheless form a core part of many investment portfolios by providing a safe ground for investors to reduce their overall risk and exposure to speculative investment.

Fannie Mae and Freddie Mac encourage a positive feedback loop that helps lenders and borrowers on both ends. As more investors participate in the stable mortgage-backed securities that these organizations create, the more money they have to purchase mortgages from banks and increase liquidity. The increased liquidity then permits banks to feel secure to issue more mortgages that conform to the standards established by Fannie Mae and Freddie Mac. These mortgages are easier for borrowers to manage and pay back, which thereby increases the availability and quality of the mortgage-backed securities that Fannie Mae and Freddie Mac produce.

The Impact of Fannie Mae and Freddie Mac on the Financial Market

The positive impact that Fannie Mae and Freddie Mac have on the economy as a whole is centered within the financial market. In some ways, these organizations can serve as reasonable and conservative players that rein in the excesses of the good times and avoid the panics that create traditionally illiquid conditions when there is more uncertainty. By being so heavily involved in the mortgage market and having a perception of greater stability due to their association with the US government, Fannie Mae and Freddie Mac also serve as magnets to bend the market toward more stable activities.

The constant supply of stable mortgage-backed securities shapes the financial market's landscape by providing a baseline level of secure investments that otherwise would not exist. The fact that these investments are available as part of a mixture of different assets lets investors take mixed risks on other investments.

While conforming loans are the majority of mortgages issued in the financial market, there are still jumbo loans and other non-conforming loans that banks can choose to issue. The added comfort of conforming mortgages can allow banks to make riskier loans that pay significant dividends and drive more investment opportunities. This parallel mortgage market is no longer a significant driving factor for the financial market, which bolsters confidence across the board.

Fannie Mae and Freddie Mac in Brief

Although these organizations were chartered by Congress, they are still shareholder-owned entities and not directly managed by the government. This hybrid form gives them a unique character among financial firms and drives their mission, which blends maintaining profitability with establishing stable market conditions in the mortgage industry. Fannie Mae and Freddie Mac, therefore, have a tremendous impact on the economy as a whole by strongly influencing mortgages and mortgage-backed securities in the financial market.

As a response to troublesome economic activities, Fannie Mae and Freddie Mac have proven to be remarkably successful. Despite the mortgage market's complexities, Fannie Mae and Freddie Mac plug into the system at a crucial juncture, being exactly where they're needed to buffer banks' mortgage investments from the worst tendencies of speculative

investment. Through their firm requirements regarding mortgage quality, banks are encouraged to avoid unnecessary risks, and investors who participate in their mortgage-backed securities reasonably possess a high degree of confidence in the actual quality of those securities.

No organization is perfect, and this solution has had its own limitations, as revealed by the 2008 financial crisis. Despite their positive influence, Fannie Mae and Freddie Mac are just one part of a broader series of protections and measures necessary to keep the economy stable and growing. In conjunction with measured regulations, the financial industry can curb its excesses while still maintaining the flexibility to foster growth conditions for the country as a whole.