affordable housing.

In the beginning, Fannie Mae existed as a government agency. In 1954, it was turned into a mixed, part-private, part-government agency, and in 1968, it was transformed into a totally private corporation, issuing its own stock, which was bought by private investors, and eventually became listed on the stock exchange. For the most part, all through this period, up to the mid-1970s, Fannie Mae fulfilled its original function: It brought liquidity into the housing market in moderate quantities, and functioned as a subordinate agency in that market.

However, starting in 1979-81, at precisely the time that then-Fed Chairman Volcker instituted the policy of "controlled disintegration of the economy," new lending policy changes were made at Fannie Mae. These changes were intended to bring eventually a flood of money into the housing market, from both outside "third party investors"—using the derivatives-like instruments called Mortgage-Backed Securities—and from the corporation itself. The seeds of the housing price explosion planted in 1979-81, came to fruition from 1995 to the present.

Prior to the late 1970s, there had been two principal forms of lending; this transformation added a third.

The first and simplest form of lending is the primary mortgage loan. The second form is that involving Fannie Mae: A mortgage-lending financial institution makes a mortgage loan, but instead of holding onto it, it sells it to Fannie Mae, and uses the cash to make a second loan. It can repeat the process, of selling the second loan to Fannie Mae, and make a third, fourth, and so on, loan. In this manner, a mortgage-lending financial institution could make five loans for $150,000. It sells the first four loans to Fannie Mae (which buys them with proceeds from the issuance of its bonds) and keeps the fifth loan. At the end of the process, the mortgage-lending institution has one loan totalling $150,000 on its books, and Fannie Mae has loans totalling $600,000 on its books.

These were the only two types of lending up to 1979-81, when the third type was introduced: Fannie Mae began creating Mortgage-Backed Securities. As the risk on the MBS became greater, the risk that Fannie Mae had became greater. But this is part and parcel of how the mortgage market, and thus the mortgage-bubble, expanded.

The Mortgage-Backed Security

In the case of the MBS, Fannie Mae gathers its purchased mortgages from different mortgage-lending institutions, and pools them together. For example, Fannie Mae may bundle a

The Origins of Fannie Mae

The Federal National Mortgage Administration (Fannie Mae) arose as a feature of the New Deal. During 1933-34, the Roosevelt Administration responded to a housing crisis, which developed out of the overall breakdown of the economy and financial system. Millions of workers lost their jobs, and without income, defaulted on their home mortgages; the banks foreclosed on hundreds of thousands of homes, and families were tossed onto the street. Banks, claiming fears that any *new* home mortgages would end in default also, cut back lending by 1934 to 60% below the pre-1929 peak. With the mortgage financing market drying up, new home construction shrivelled.

In response, the Roosevelt Administration created a new government agency, the Home Owners Loan Corporation (HOLC), as a subsidiary of the Reconstruction Finance Corporation. The HOLC attacked the problem of defaults. It enabled the refinancing of existing mortgages that were in default status, with new mortgages. Between 1933 and 1936, the HOLC refinanced one-fifth of existing urban home mortgages, which were either in default or close to default. As a result, very few mortgages ended up in liquidation, and this put a stop to the home foreclosures.

At the same time, the Roosevelt Administration addressed the issue of how to get the banks to make new home mortgage loans. In 1934, legislation created the Federal Housing Administration (FHA), with two principal purposes. First, the FHA provided for insurance of principal and interest payments on long-term home mortgage loans made by banks and lending institutions. Second, the FHA Act (under Title III) provided for a secondary housing market to be established. In 1938, under this provision, the Federal National Mortgage Association (Fannie Mae) was created. Fannie Mae would pay cash to buy any FHA-insured mortgage that a bank sought to sell. Fannie Mae would put the mortgage in its portfolio, collecting all the interest and principal to the maturity of the mortgage. With the cash for the mortgage that it sold to Fannie Mae, a bank could make a new mortgage, increasing the scope of mortgage financing.

Fannie Mae had the authority to issue its own bonds, in order to attract the funds with which it, in turn, bought mortgages from banks.

For the next three decades, Fannie Mae bought home mortgages from banks and lending institutions, but always with the objective of *keeping the housing market in such manner that homes were inexpensive, and affordable relative to average family income.* Its objective meant that there be no housing bubble like that of today.