Towards a Market for Mortgage-Backed Securities:  
Credit Lending, the Federal Budget, and the Politics of Debt Management

Working Paper\(^1\)

Prepared for the  
University of California Group in Economic History  
May 2009

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

---

\(^1\) This research is an offshoot of my dissertation, which investigates how government officials and private entrepreneurs worked together to build the market for mortgage-backed securities from the 1960s to the 1980s. This paper represents first steps into a new line of inquiry, as well as an initial pass through some archival research. I welcome all advice and comments. Suggestions for relevant literatures, texts, and sources of data are especially appreciated. Please forward comments to squinn@berkeley.edu.
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*

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.

*Carol Webber and Aaron Wildavsky, 1986*

The Housing and Urban Development Act of 1968 was a turning point in American housing finance. It quietly dismantled a New Deal system wherein the government directly purchased mortgages from lending companies. In its place, the Act laid the foundation for a secondary mortgage market organized around the newly privatized agency Fannie Mae, and bonds backed by pools of mortgages called *mortgages-backed securities* (MBS). Carruthers and Stinchcombe (1999) have argued that the sustained efforts of the U.S. government were instrumental in creating a liquid secondary market for mortgages. That is, the government played a lead role in convincing Wall Street firms to use MBS to invest in housing finance. 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 that led up to these events. The most fundamental issue is that mortgages are troublesome 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 most of the 20th century many investors dismissed
mortgages as more trouble than they are worth. This created funding shortages for mortgage lenders. In response, the U.S. government stepped in to provide support through an array of programs that included insurance for mortgages, credit support for lending institutions, and the direct purchase of mortgages.

This system of credit support, in place since the 1930s, was showing signs of strain by the 1960s (Green and Wachter 2005; Sellon and VanNahmen 1988). Reliance on Mortgage Banks and Savings and Loans had resulted in an inefficient patchwork of local markets. Some believed the system could not accommodate the growing needs of baby boomers as they settled down and had children (Ranieri 1996). Reserves of capital were locked-up in accounts on the East Coast, leaving homebuilders in the rapidly-developing Sunbelt starved for credit. These endemic problems were punctuated by disintermediation crises. In 1966 yields on US 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 in hopes that the market could better meet the housing needs of Americans.

In most accounts of the rise of securitization, the role of budgetary politics is either not discussed or discussed briefly as an exogenous pressure that comes into play only at the close of the 1960s. But my research indicates that budgetary concerns have long influenced in the creation of MBS. This paper takes initial steps towards putting federal budgetary politics at the center of the history of securitization. Below I present a brief overview of the history and structure of federal credit lending programs, and then consider the peculiar relationship these
programs had with the 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 contributed to the rise of
securitization. On a general level, I explore how credit lending set the stage for securitization 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. Beyond that, this paper is working towards making a more formal
argument about how 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 way of intervening in markets without adding to the budget. That is, by connecting the history
of credit lending with the creation of MBS, I hope to make a case for the importance of
budgetary politics for the rise of securitization.

A Review of Federal Credit Lending

In the 1964 the House Banking and Finance Committee surveyed credit lending in all
government agencies. The resulting Federal Credit Report (House 1964) 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. Credit
programs proliferated and become more complex in this period. Between 1916 and 1930 the
government offered only direct loans, and from the 1930s through 1946 direct loans remained
the main tool the government used to offer credit support (see Charts 1.1 - 1.3). After 1946 the
use of guarantees and insurance rapidly increased and became the predominate mode of credit
support, largely due to the expansion of housing insurance through the FHA and VA (Chart 1.3). From the 1930s through 1950, the sectors that benefited the most from credit aid were housing, agriculture, and business. The details of that history shine a light on the importance of federal programs in the development of American credit markets.

Federal credit aid started with the creation of the Federal Land Bank System in 1916. In the next decade, 15 additional programs were created to support war finance, railroads, interstate commerce, agriculture, and more. The Depression spurred an influx of funds into existing programs, and introduced a new generation of credit aid, including programs that used guarantees and insurance instead of direct loans. 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 housed other key lending agencies like the Federal National Mortgage Corporation (Fannie Mae) and the Commodity Credit Corporation.

The system of federal credit supports that would bolster homeownership throughout the 20th century was also built at this time. Home Owners Loan Corporation (1933) was created to stem a tide of foreclosures, the Federal Housing Administration (1934) to insure mortgages. The Federal Home Loan Bank System, designed like the Federal Reserve System, offered credit support to Savings and Loans (1932), while Fannie Mae (1938) encouraged the use of FHA-insured loans by agreeing to purchase them. The Works Administration started the first loans for public housing programs at this time as well.

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

Many other sectors received credit support as well. Notably, 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, continued. 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.

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 directly issued loans. 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).² 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)

By the 1960s federal credit aid had involved into a sprawling, decentralized web of programs that offered a mix of guarantees, insurance, and loans. This complex system allowed

---

² 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.
for variation and flexibility that fostered innovations in the management of credit lending.

Jurisdictional overlaps sometimes led to competition among agencies. 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 Chart 1.4). Within the direct loans programs types of support varied widely, from non-recourse loan programs at the Commodity Credit Corporation that mainly resembled expenditures, to non-commercial loans like those at A.I. D. where the likelihood of default was totally unknown ($12 billion of these had been issued by 1967), 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)

What kind of impact did these programs have? 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, use of amortized repayments are some of the financial practices that were largely developed by the Federal credit agencies” (House 1964: 70).

These programs profoundly shaped the terrain of American credit markets, and also generated expertise that government officials could use to address budget conflicts. Additionally, the complexity of this sphere was something officials could exploit when budget problems forced them to face difficult trade-offs. In the next section I explore how this helped shape federal budget.

_Credit Lending and the Budget_

These 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 American Exceptionalism. As a result politicians have faced tremendous pressures to solve problems without spending money, or else to hide the extent of their expenditures. Of course, 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 a new set of
strategies that undermined the comprehensive reporting of public spending in the federal budget. 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. 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.

Guarantees and insurance programs had the least affect on the budget, and 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 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. But in years when the government issued a great deal of loans, disbursements ran ahead of collections and repayments; the net difference would typically be reported as expenditures on the budget. Even though these programs would eventually generate funds, the 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 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

---

3 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)

4 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 Chart 1.4), 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. In other words, the RFC seems to have 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, thus 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 (1954-57), 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 magic of netting, the government was able to report a relatively modest $1.8 billion in expenditures for the upcoming year, even though they expected to have $8.1 billion in expenditures (Tickton 1955). 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 chart 2.1). These sales were mostly done through The

---

5 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)
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 could be useful, but it faced considerable hurdles. The federal credit system was made up of 74 programs; 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 instrument to fit their needs.

The Use 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 all shared a similar accounting treatment on the federal
budget: they were accounted for like other asset sales, which is to say that revenues from sales were used to offset current expenditures.  

To my knowledge, the RFC was the first 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. 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. In a white paper reviewing the changing nature of budgetary concepts, Sydney Tickton (1955) explained that the pool was poorly structured and

---

6 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?”

7 The report on Federal Credit Programs offers a detailed explanation of this in its appendix: “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)

8 Note that this was Fall 1954, just as Fannie Mae’s secondary market operations were being reorganized into a quasi–public corporation (and so was removed from the budget). This suggests that Eisenhower’s efforts to balance the budget for 1955 were an important period deserving of further investigation.

the U.S. government ended up repurchasing the loans 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”\(^{10}\) 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.\(^{11}\) 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 took steps to massively expand the use of participation certificates with the Participation Sales Act of 1966. 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 addition to the obvious desirability if 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.¹²

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 without being accountable to
Congress.

In its original form, the Participation Sales Act would have authorized Fannie Mae to sell
$33 billion in loans held throughout the US 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
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”

¹² National Archives, RG51: Office of Management and Budget, Entry 37 Records of the Office of Budget Review,
Staff Paper (Memo to the President’s Commission Budgetary Concepts.) Loans, Participation Certificates, and
the Financing of Budget Deficits. See pp 12 and 15.
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 nicely articulated how private capital could be
used to manipulate public accounts. “Like all “crisis economics” proposals, this scheme blends
economic shakiness with political opportunism.” He went on,

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 US 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.”

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 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 tighter. 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 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. 14

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. 15 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. 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 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 to revenues, and so could be parsed from risks and removed from balance sheets. This ruling would not merely prevent PCs from

---

being used as budgetary reductions; now considered a liability, they would add to the deficit. This ruling was therefore an expensive political problem for the Johnson Administration.\textsuperscript{17}

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.\textsuperscript{18} At the same time, they felt that disregarding the President’s own commission would be a “political impossibility”\textsuperscript{19} and a “major tactical mistake.”\textsuperscript{20} 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 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

\textsuperscript{17} 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.

\textsuperscript{18} LBJ Archives. Lapin to Weaver 1/3/67. Subject: Budgetary Treatment of Secondary Market Operations


would work to infuse more money into the mortgage market . . .”21 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 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). In fact, Johnson’s men had considered not going forward with the second Ginnie Mae guarantee, because they worried that it could raise the very

---

21 LBJ Archives. White House Central Files, Federal Government Files, FG 600, Memo to the President from Califano about MFTF.
accounting objections they were working to solve.\textsuperscript{22} But the bankers they consulted insisted that investors would rather buy Treasury securities, and would only invest with some kind of guarantee.\textsuperscript{23} 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.”\textsuperscript{24} 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.

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.\textsuperscript{25} Yet the credit risks


\textsuperscript{24} LBJ Archives, White House Central Files, Finance Files.

\textsuperscript{25} These provisions seem to have caused big problems with the market for Pass-Through in the 1970s. Most Thrifts still could not sell their assets without absorbing large losses, since their portfolios were made up of long term mortgages held at fixed rates set lower than the high nominal interest rates of the inflation-plagued decade (Sellon and VanNahmen 1988). At the same time, potential investors -- namely mutual and pension funds -- also didn’t like how the payments flowed through, as this clashed with their bookkeeping and reporting schedules. The legal terms of the sale, however, required that the payments flow directly through to the investors, so this could not legally be changed without invalidating the entire deal structure. Sellon & VanNahmen (1988) write that in response to these problems investment bankers worked with thrifts to create Mortgage-Backed Bonds (MBB) in
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\textsuperscript{26}) 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 \textit{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.\textsuperscript{27} In 1971 the Federal Reserve suggested
that the government should reclassify GNMA securities and include them on the budgetary
outlay totals, and this was thought to pave the way towards putting \textit{all} of the government’s
insured and guaranteed securities on the books. This would include 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.”\textsuperscript{28} The point I’m
working towards here is not that these MBS necessarily belonged on the budget. Rather, the
important thing to note is that the U.S. government was working in a hybrid, grey-area that could

\textsuperscript{26} 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.

\textsuperscript{27} LBJ Archives. Gaither Files.

\textsuperscript{28} National Archives RG51, E202, Housing CVA: HUD 1971-1972 G.(2) GNMA Mortgage Backed Securities.
August 4th, 1971 letter from James Hill.
have reasonably been classified 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 publically proclaimed that the Housing and Development Act of 1968 was a way to bring private funds into a struggling market. But he left out 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 simply 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 securitization market. Even then, the government continued to absorb mortgage risks in less direct ways but significant ways.

Attending to the role of credit lending and budget management in these events has implications for how we think about the later misuse of MBS in American markets. When the U.S. government turned to credit lending to help promote its markets, this had effects far beyond
the immediate development of housing or agriculture or small businesses. First, the
government’s credit programs helped change the kinds of techniques and concepts used across
credit markets. Second, these programs reshaped the boundaries of the federal budget. Third,
they pioneered the use of securitization, one of the most important financial technologies of our
time. It is true that MBS were designed to manage risk and encourage the development of
housing. 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
because they followed the lead of the federal budget.
Bibliography


Jessen, Richard. 1964. "Housing Bill, Signed by President, Lifts Aid to Persons, Cities, Firms: Johnson Calls $1.5 Billion Act Milestone Though It Lacks Some Sections He Sought." in *Wall Street Journal*.


Chart 1.1: Direct Lending by the Federal Government, 1932 – 1950 (in millions)

Chart 1.2: Federal Credit Aid, 1932-1950: Direct versus Insured Loans (in millions)

Chart 1.3: Federal Credit Aid, 1932-1950: Direct and Insured Loans by Type (in millions)

Chart 1.4: Financing of Federal Debt Programs in 1964

Chart 2.1 Budgeting for Federal Credit Programs, 1961 to 1966: Disbursements and Expenditures
