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If you've followed the media recently you've probably heard that mortgage giants **Fannie Mae** and **Freddie Mac** are both struggling financially and may be in need of an overhaul. If this happens, it may result in the two receiving more bailout funds than they were handed at the onset of the financial crisis.

The irony in the potential failure of the **mortgage lenders** is that unlike the other companies that received bailout funds, these two companies have always been backed by the government. So how did they reach the point of needing a massive restructuring? To understand, let's take a look at the downfall of Fannie and Freddie, as well as what overhauls these companies may need to get back on track.

The History Fannie Mae and Freddie Mac

Fannie Mae (Federal National Mortgage Association) officially got its start in 1938 under Franklin D. Roosevelt. Originally established to create a liquid secondary mortgage market, the agency bought Federal Housing Administration (FHA) insured mortgages to provide lenders with more money to originate loans.

In 1968, Fannie Mae was re-chartered as a private, shareholder-owned corporation with government sponsorship to remove its financial activity from the federal budget. It split into Fannie Mae and Ginnie Mae and was authorized to purchase both **FHA loans** and non-FHA insured mortgages.

Two years later, Freddie Mac (Federal Home Loan Mortgage Corporation) was created as a government-sponsored enterprise. Since Fannie Mae was growing, this company was meant to expand the secondary market for mortgages in the United States.

By the 1970s and 1980s, both companies had been authorized to issue mortgage-backed securities, which are ownership interests on numerous mortgage loans that have been bundled together and sold to investors. Unfortunately, these securities are what played a large role in the problems of these two companies.

The Problems with Fannie and Freddie

While the reason for creating the companies was to relieve the financial pressure **lenders** faced after issuing each mortgage loan they originated, some say that after they got into mortgage-backed securities, their foundations began to weaken.

In an op-ed written by William Poole of the *New York Times*, he stated the companies were given too much room to make mistakes and because they were backed by the government, they went ahead and took chances (like purchasing interest-only and Alt-A mortgages). Not to mention they were able to borrow at a low interest rate, invest at a higher one and hold very little capital--a recipe for disaster.

While investors were happy to take advantage of high returns, no one took into account that at some point, the very high cost of mortgages in the mid-2000s, offered to borrowers who couldn't afford them, and the surprise increases that came with adjustable rate mortgages would result in millions of homeowners defaulting on their loans.

Once the defaults occurred in droves, the companies suffered massive losses on the loans they'd purchased but wouldn't receive payments. While investors lost millions, too, the companies survived on these loans. Without them, they would fail.

Like Lehman Brothers, AIG and other major companies connected to mortgages, Fannie Mae and Freddie Mac had to be bailed out in 2008 to cover losses, resulting in both companies being taken over by the government. Unfortunately, the $148 billion in losses could increase to as much as $600 billion--or even $1 trillion as some estimate.

However, the biggest problem circling around the two companies is the number of mortgages tied to them. Last year, Fannie and Freddie owned three-fourths of all home loans, which means it would be nearly impossible to have one or even a few companies buy those loans out.

At this point, the companies are 80 percent owned by U.S. taxpayers, but clearly the cash isn't coming from directly from our pockets. It's coming from an unlimited line of government credit that is granted to ensure homebuyers can get loans at all.

Of course, the government will have to come up with a solution so that taxpayers are not footing the bill for homes they're not living in. This is where the overhaul comes into play.

The Fannie/Freddie Overhaul

In a recent statement from Michael Barr, Treasury Assistant Secretary for Financial Institutions, he explained that there would be major changes to the mortgage system. "Private gains will no longer be subsidized by public losses, capital and underwriting standards will be appropriate, consumer protection will be strengthened and excessive risk-taking will be restrained," he said.

To make changes like these to such a massive system is easier said than done, but lawmakers have come up with a few possible solutions to work with.

One major solution for the overhaul would be to only securitize high quality loans while refusing to back those that are considered high-risk and more likely to default. This means low-income borrowers would have to go through the FHA or Veterans Administration to have their loans backed, whether they had an **FHA mortgages** or not. This way, there wouldn't be as much of a risk of default.

The only problem with taking this route, some say, is that high-risk borrowers would likely have to pay hundreds more per month to take out loans and low-risk borrowers may even have to put more money down to take out their loans.

Another couple of options introduced by politicians have been to do away with the companies completely or break the massive firms into smaller companies. However, members of the Obama administration question whether the enormous task of remaking or replacing the firms would make enough sense to go through the trouble.

Plus, Fannie's and Freddie's purchases of mortgage-backed securities are needed not only to keep lending since many private lenders are reluctant to hand out mortgage loans, but also to help keep **mortgage rates** low by continuously purchasing mortgage-backed securities.

So it is up to the Obama administration to lay out a vision for the two firms, one that makes sure they benefit what's left of the housing market while also ensuring taxpayers don't have to foot the bill for anymore bailouts. While nothing is definite, the administration promises to have a concrete plan on the table for Fannie and Freddie by January 2011.

Stacey Bumpus started writing as a youngster, creating little fun newsletters to distribute to her elementary school friends. But it wasnt until she completed her bachelors and masters degrees in communication that she realized her fun pastime could become a career.

After spending years in corporate communications, she discovered that freelancing was her cup of tea and fell in love with finding the latest financial news. Now, providing news and tips about taxes, mortgages, banking and even logging her efforts to save toward retirement, she's not only fulfilling her childhood passion, but also helping others manage their finances responsibly.

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