The MBS Market Is Operating without a Net

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There has been a meaningful shift in the composition of demand for agency mortgage-backed securities (MBS) over the past couple of decades. For years, Fannie Mae and Freddie Mac were the buyers of last resort in the market, stepping in to profit from widening spreads and, in doing so, putting a comforting outer bound on MBS volatility. Once they went into conservatorship, the government-sponsored enterprises (GSEs) were replaced in that role by the Federal Reserve, which stepped into the agency MBS market to calm much larger swings in the economy. All of this went unnoticed outside of the MBS market until recently, when the Federal Reserve finally ended its time in the stabilizing role, leaving the MBS market without a buyer of last resort for the first time in decades.

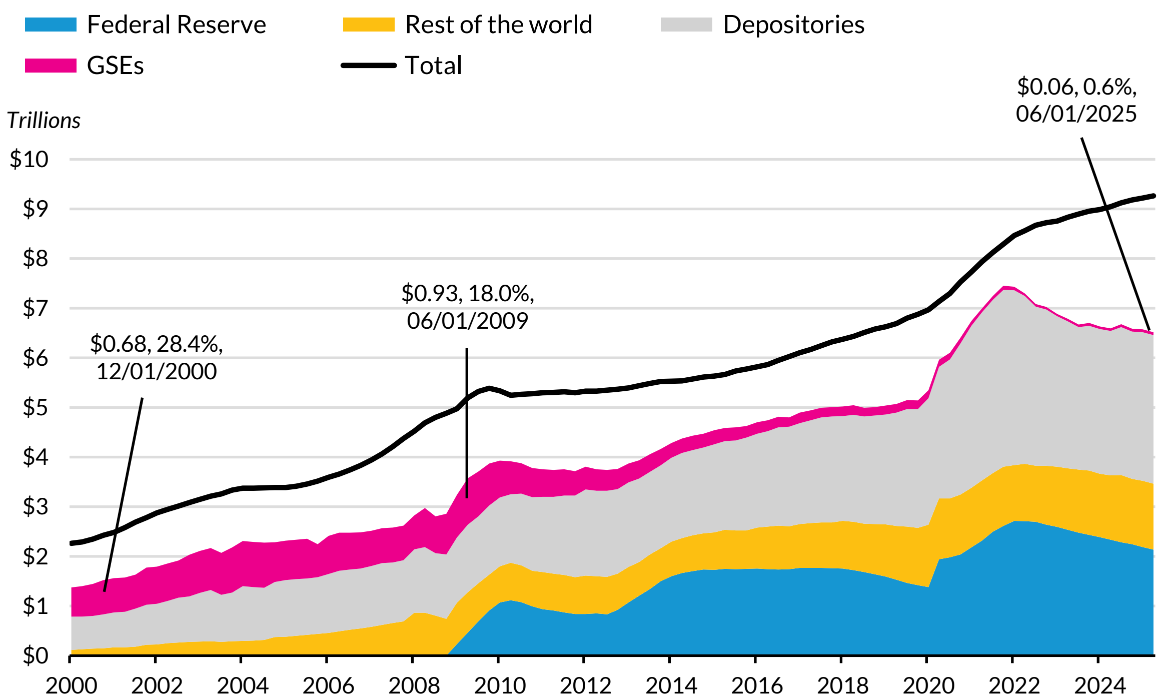
In this brief, we discuss that history, its implications for the market, and what could be done to restore some of that prior stability. Ultimately, we conclude that neither the Federal Reserve nor the GSEs are well positioned to return to the role and that the agency MBS market may have to get comfortable operating without a net.

The Role of the GSEs and the Federal Reserve in the MBS Market

There have been five dominant buyers of agency MBS over the past quarter century: large depositories, foreign investors, total return investors, the GSEs, and the Federal Reserve. Depositories, foreign investors, and total return investors maintained a steady presence through the period, with the GSEs and Federal Reserve alternating as the fourth major buyer (figure 1). The GSEs were the fourth major buyer until they were put into conservatorship in 2008, and the Federal Reserve stepped into the role in 2009 with quantitative easing. The relatively smooth distribution of market shares among these sources of demand obscures a wide variation in how and why each invests in the asset. Depositories, foreign investors, and total return investors lean in to agency MBS when its mix of yield and risk is better than what is available elsewhere in the market, the GSEs invest when the spread between the rate paid by mortgage borrowers and the 10-year Treasury rate widens, and the Federal Reserve invests when it is needed to calm market disruptions or stimulate the economy. The first three lean in when the market is most liquid and stable, and the latter two do so when the market is least liquid and stable.

FIGURE 1

Primary Holders of Agency Mortgage-Backed Securities



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Sources: Financial Accounts of the United States (Federal Reserve Board table L.211), Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, Fannie Mae, Freddie Mac, Moody's Analytics, and Urban Institute calculations.

Notes: GSEs = government-sponsored enterprises. Data are as of the second quarter of 2025. The GSE series is annual from 2000 to 2005 and quarterly from 2006 through 2025. Total return investors are included with "other," the white area.

The market disruption in summer 2003 offers a useful example of how complimentary these different investment strategies can be. The Treasury market sold off dramatically between late June and late August, with the 10-year Treasury note rising 105 basis points and mortgage rates rising 104 basis points. As mortgage rates rise, borrower behavior changes in ways that prompt a sell-off of mortgages, widening spreads and pushing mortgage rates up still further. Borrowers are less apt to prepay, prompting portfolio managers to sell mortgages to reduce their excess duration. And borrowers are more likely to close on a loan for which they have locked in a rate, prompting mortgage originators to sell more mortgages forward to hedge their rate locks. With both portfolio managers and originators unloading their mortgages more aggressively, MBS spreads widen. This is exactly when the GSEs look to enter the market, to profit from the increased difference between the rate they get on the MBS and their low cost of capital. So as spreads widened rapidly in the third quarter of 2003, the GSEs ramped up their purchase of agency MBS, buying close to $100 billion in 2003 and bringing their total holdings to $909 billion by year's end. This stopped and ultimately reversed the widening, with mortgage spreads ultimately ending close to where they were before the disruption.

The GSEs gave up their role as market stabilizer when they went into conservatorship and began reducing their portfolio under the terms of their bailout by the Treasury. The Federal Reserve then promptly stepped into the role. As part of its broader effort to shore up the market in the wake of the financial crisis, the Federal Reserve bought $1.25 trillion in agency MBS between January 2009 and March 2010 and bought another $823 billion between 2012 and 2014. Largely because of that aggressive posture, along with the bailout of the GSEs, the MBS market and mortgage liquidity generally remained stable through the depths of the crisis, a remarkable feat given the level of dislocation in the rest of the economy.

The Federal Reserve was then well positioned to handle the next major disruption in the MBS market, when financial markets seized up in the early days of the COVID-19 pandemic. In February and early March 2020, the financial markets froze, and investors were forced to sell their agency MBS to build cash reserves, pushing mortgage spreads wider by 75 basis points. The Federal Reserve stepped in in March, committing to buying agency MBS and Treasury securities "in the amounts needed to support smooth market functioning and effective transmission of monetary policy to broader financial markets and the economy."[1] True to its word, the Federal Reserve, over the next month, bought more MBS than the entire gross production of the securities, stabilizing spreads and, with them, mortgages rates. Spreads ultimately settled a bit higher than they had been before the pandemic, but that was attributable to volatility in fixed income and a refinance wave triggered by the drop in Treasury rates.

The MBS Market without the GSEs or the Federal Reserve

The Federal Reserve relinquished its role as the stabilizer of the agency MBS market when it pivoted to quantitative tightening in March 2022, ending its purchases of MBS and committing to running off its MBS portfolio. With the GSEs still operating under the portfolio constraints imposed in conservatorship, that left the market without a stabilizer for the first time in recent history.

To understand the implications of this shift in the structure of MBS demand, it helps to look at the first disruption this market has faced since the change. Not long after the Federal Reserve announced that it was easing out of the MBS market, commercial banks began retreating as well. Money markets were offering more attractive rates to consumers than depositories, leading to a drop in bank deposits and, with that, a drop in bank demand for MBS. The Federal Reserve also began to raise the federal funds rate, driving mortgage rates up over 100 basis points between March and May 2022. The spike in mortgage rates then led to the same sell-off of mortgages by portfolio managers and originators that we saw in 2003. This time, however, there was no market stabilizer, so mortgage spreads widened until money managers thought the return large enough to warrant entering the market. Spreads ultimately landed 42 basis points wider than before the disruption began in March.

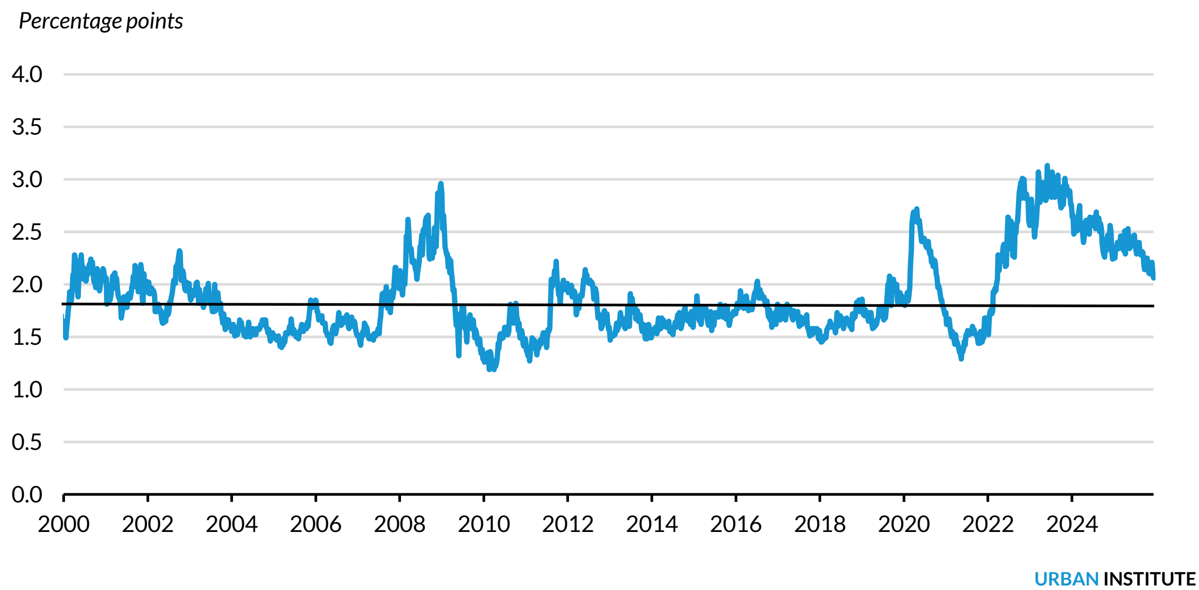
The experiences of 2003 and 2022 offer a useful contrast. In both cases, the 10-year rate backed up more than 100 basis points over two months. In 2003, the GSEs stepped in, and spreads eventually settled where they were before the disruption. In 2022, with *no* market stabilizer, spreads eventually settled 42 basis points *wider* than they were before the disruption. This difference of 42 basis points in spread translates into a 42 basis-point difference in the mortgage rate paid by borrowers, or a difference of $81 a month, or almost $1,000 a year on a $300,000 mortgage.

We can see these dynamics in figure 2, which shows spreads becoming more volatile in 2022 and ultimately settling wider than historical norms. They have come in a bit since mid-2025, attributable in part to the GSEs' surprising if cautious increase in their MBS holdings.

FIGURE 2

Primary Mortgage Market Survey Spread

Difference between the primary market 30-year fixed-rate mortgage and the 10-year Treasury rate



Sources: Freddie Mac Primary Mortgage Market Survey, Board of Governors of the Federal Reserve System, Moody's Analytics, and Urban Institute calculations.
Note: The black horizontal line shows the average from 2000 to 2024 (188 basis points).

What Could Be Done

This shift in the composition of demand for agency MBS has led market participants to call for either the Federal Reserve or the GSEs to return to their role as a market stabilizer. Both options face challenges.

The Federal Reserve views the purchase of agency MBS as falling within its mandate when it helps them maintain macroeconomic stability.[2] When the MBS market is swept up in economy-wide disruption, as it was during the financial crisis and the early days of the pandemic, the Federal Reserve has stepped in to stabilize those broader stresses in part through the purchase of agency MBS. There is little precedent for the Federal Reserve to shore up a specific asset class for the sake of consumer affordability absent such a macroeconomic disruption, however, as would be the case here. Indeed, it is not clear that the Federal Reserve would view that as falling within its mandate.

The constraint on the GSEs playing such a role, on the other hand, is not found in statute but in the terms of the backstop provided by the Treasury, the Senior Preferred Stock Purchase Agreements. Before conservatorship, the GSEs used their portfolios as hedge funds, leveraging their low cost of funding to purchase a wide range of risky assets, including subprime non-agency securities. As the market turned in 2008, these investments led to spectacular losses that ultimately overwhelmed both enterprises. To take that risk off the table going forward, the Treasury required as part of its bailout of the GSEs that the enterprises reduce their portfolios dramatically while in conservatorship. Today, each is allowed to hold as much as $225 billion in their portfolio, though together, they hold only $72 billion in agency MBS, down 92 percent from their 2003 peak.

The administration could remove these contractual constraints on the use of the GSEs' portfolios, but such a move should not be considered without limits on the use of these portfolios that ensure that they are used only to stabilize the market, not simply to drive GSE profits—a charge that is easier said than done.

Policymakers could develop a binding collar to determine when the GSEs must buy or must sell MBS, drawing the GSEs into the market when spreads exceed some relatively rare threshold and pushing them back out when spreads fall below a second, more normal threshold. The Federal Housing Finance Agency could publish the thresholds on a regular basis, giving the market certainty about when the GSEs will step in to stabilize the market and when it will then step back out again. This alone would bring spreads in as markets price in the reduction in volatility.

There are considerable challenges to this idea, however. If policymakers were to define exactly how much the GSEs can buy once the initial threshold is crossed, unless the limit is so large the market assumes the GSEs cannot hit it, spreads will widen as they close in on the limit of their purchasing authority, worsening rather than quelling the volatility. This likely renders the idea untenable, leaving policymakers with little choice but to impose either no limit at all or one that is remarkably high, and leaving the GSEs with every incentive to swell their balance sheets to enormous levels during these periods of volatility. A second threshold to sell when spreads come in would help bring the portfolios back down to reasonable levels, but it does not solve the underlying problem. There is an unavoidable tension between the need to give the GSEs discretion over when and how much to buy or sell to maintain market stability and their incentive to grow the portfolio for greater profitability, exposing taxpayers once again to considerable risk. Until we know which path it will be for the GSEs—profit-seeking enterprises or mission-focused utilities—the risk of giving them this market-stabilizing role simply outweighs the cost of forgoing a market stabilizer altogether.

The GSEs would also be returning to a different market than the one they stabilized decades ago. They built up much of their portfolio when the nation maintained only a modest deficit and thus issued little debt, creating significant demand for the GSEs' debt with which they funded their MBS purchases. Today, the deep national deficit and aggressive issuance of debt would make it more costly for the GSEs to issue their own debt and strain the market for Treasury securities when they do.

These and other challenges leave us skeptical about putting the GSEs back into a market-stabilizing role, particularly absent some clarity around the broader role we want them to play over the long term. If the GSEs are to remain mission-focused utilities as they have been in conservatorship, then building out their policy capabilities to manage the stability of the agency MBS market is at least worth thinking through. If, on the other hand, they are to be released back into private hands and are free to focus on a return for their shareholders, the incentive to use this role to maximize their returns would simply be too strong, posing considerable risk to the housing finance system. In such a case, policymakers should look elsewhere for a policy answer, perhaps to the Treasury to set up a facility to purchase agency MBS during times of disruption.

Where This Leaves Us

There is, of course, a cost to waiting. Homeowners pay for the lack of a market stabilizer in a couple of ways. Spreads will drift wider in times of stress, as the market will not correct until money managers see margins widen enough to warrant moving in, which will be later than the GSEs or the Federal Reserve would have moved in in years past. And investors will price this increased volatility into the agency MBS market, leaving spreads wider even in calm periods. In both cases, wider spreads will translate into higher mortgage rates. If policymakers ultimately decide to turn the GSEs into utilities, it will be worth expanding that role to reducing this costly volatility. Until then, however, it is a cost the market will likely just have to bear.

Notes

1 Board of Governors of the Federal Reserve System, "Federal Reserve Issues FOMC Statement," press release, March 23, 2020, https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323a.htm.

2 Dave Na, Ellie Newman, and Bernd Schlusche, "The Evolution of the Federal Reserve's Agency MBS Holdings," *FEDS Notes*, Board of Governors of the Federal Reserve System, last updated September 20, 2024, https://www.federalreserve.gov/econres/notes/feds-notes/the-evolution-of-the-federal-reserves-agency-mbs-holdings-20240920.html.

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Laurie Goodman is an Institute fellow and the founder of the Housing Finance Policy Center at the Urban Institute. The center provides policymakers data-driven analyses of housing finance policy issues they can depend on for relevance, accuracy, and independence. Before joining Urban, Goodman spent 30 years as an analyst and research department manager at several Wall Street firms. From 2008 to

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