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OVERSIGHT OF GOVERNMENT-SPONSORED ENTERPRISES: THE RISKS AND BENEFITS OF GSEs TO CONSUMERS

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FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY SUBCOMMITTEE

OF THE

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COMMITTEE ON GOVERNMENTAL AFFAIRS

FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY SUBCOMMITTEE

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MONDAY, JULY 21, 2003

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL MANAGEMENT,
THE BUDGET, AND INTERNATIONAL SECURITY,
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2 p.m., in room SD–342, Dirksen Senate Office Building, Hon. Peter G. Fitzgerald, Chairman of the Subcommittee, presiding.

Present: Senator Fitzgerald.

OPENING STATEMENT OF SENATOR FITZGERALD

Senator FITZGERALD. I would like to call this meeting to order. Let me first welcome our distinguished panel of experts here today. We appreciate all of you making time in your busy schedules to be here for this important topic.

Let me first set forth the purpose of this hearing, as I see it. The purpose is, No. 1, to examine the current status of Fannie Mae and Freddie Mac and possibly the Federal Home Loan Bank Boards, which are also Government-Sponsored Enterprises and are involved in housing. At least, the Chicago Federal Home Loan Bank is. And two, to engage in a balanced and healthy debate about the risks and benefits of these large corporations, which were established by Congressional charters.

Let us stipulate at the outset that the housing GSEs fulfill an important public policy mission that is built into their government charters, to facilitate home ownership by low- to moderate-income families. In my judgment, the housing GSEs have contributed meaningfully to this cause, helping to give us perhaps the best housing market in the world.

Second, GSEs, by charter, have prescribed limits on their activities. Unlike most companies, GSEs cannot enter into any business they want. In the case of Fannie and Freddie, they are limited largely to dealing in mortgages and mortgage finance. Moreover, the size of the mortgages they can deal in is carefully limited in their charters.

Third, the GSEs have effectively promoted access to mortgage credit throughout the Nation, including inner cities, rural areas, and underserved areas, by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

That being said, we cannot ignore continuing news reports regarding the size, complexity, and financial status of these housing GSEs, in particular, Fannie Mae and Freddie Mac. These news reports raise a number of questions. Is there adequate market discipline on Fannie and Freddie? Would more competition help in ensuring that Fannie and Freddie do not take unnecessary risks? Are they adequately capitalized? Are some of the features of their special status as GSEs necessary in today's sophisticated financial marketplace?

What are the implications of interest rate volatility? If lower interest rates lowered Fannie Mae's earnings, as were recently reported, what will happen when the Federal Reserve takes away the proverbial punch bowl and starts raising interest rates? Are Fannie and Freddie both completely hedged against falling and rising rates? And if they are perfectly hedged, how is it that they can earn a profit?

Is it appropriate for us to allow banks and S&Ls to have an unlimited amount of GSE debt on their balance sheets? By so aggressively promoting housing, are we not artificially sucking debt capital away from more productive enterprises, as American families move into larger and larger homes in ever-expanding metropolitan areas?

After several weeks of studying Fannie and Freddie, my own guess is that they are probably strong enough and sufficiently hedged enough to survive a serious downturn in the housing market. But perhaps they are not strong enough to survive the severest of financial downturns, such as we had in the 1930's. But then again, nor are many of our largest companies and financial institutions.

I am pleased to welcome our distinguished panel of witnesses, who collectively represent some of the best minds in this debate, both for and against. Unfortunately, we do not have representatives from Fannie or Freddie testifying today, but notwithstanding their absence, we have at least one GSE, the Federal Home Loan Bank of Chicago, represented by its President, Alex Pollock. My hope is that we can engage in a balanced but vigorous debate so that we can ensure the continued success of GSEs in fulfilling their mission.

I would now like to introduce our witnesses before calling on each of them for an opening statement.

Our first witness is Alex J. Pollock, the President and Chief Executive Officer of the Federal Home Loan Bank of Chicago. Mr. Pollock has had a distinguished financial career in my home State of Illinois and has been in his current position since 1991. He is known as the architect of the innovative Mortgage Partnership Finance program, which has grown to over $35 billion in assets since its introduction in 1997, and is the author of numerous articles on banking, financial systems, and management.

Mr. Pollock will be followed by Peter J. Wallison, Senior Fellow of the American Enterprise Institute and Co-Director of AEI's program on financial market deregulation. Prior to joining AEI in 1999, Mr. Wallison served as General Counsel of the U.S. Treasury

Department and Counsel to President Ronald Reagan and was a partner with Gibson, Dunn and Crutcher.

Next, we will hear from Bert Ely, who has specialized in deposit insurance and banking structure issues since 1981. Mr. Ely currently is the principal of Ely and Company, a consulting firm devoted to financial institutions and monetary policy. Mr. Ely has testified before Congress on numerous occasions to share his expertise in banking issues. Prior to the founding of his firm, Mr. Ely served as Chief Financial Officer of a public company and as a management consultant with Touche Ross and Company and was an auditor with Ernst and Ernst.

I would also like to welcome W. Michael House, Executive Director of FM Policy Focus and a partner with Hogan and Hartson. In these capacities, Mr. House concentrates on regulatory matters before Congress, representing national and multinational corporations, trade associations, and coalitions. Prior to his current position, Mr. House served as Chief of Staff to former U.S. Senator Howell Heflin from Alabama.

Next, we will hear from the Hon. James C. Miller III, Chairman of CapAnalysis Group, LLC, Senior Fellow at the Hoover Institution at Stanford University, and counselor to Citizens for a Sound Economy. From 1981 to 1985, Mr. Miller served as Chairman of the Federal Trade Commission and subsequently was named by President Reagan as Director of the Office of Management and Budget.

I would also like to welcome Bart Harvey, Chairman of the Board and Chief Executive Officer of the Enterprise Foundation. As Chairman and CEO, Mr. Harvey provides seed capital, operating funds, financing, technical assistance, and training to help rebuild low-income communities. Prior to joining the Enterprise Foundation in 1984, Mr. Harvey served in a number of domestic and international positions for the investment bank Dean Witter Reynolds.

To close our panel, the Subcommittee will hear from Dr. Susan M. Wachter from the Wharton School of Business at the University of Pennsylvania. Dr. Wachter is a professor of real estate, finance, and city and regional planning at the university, a position she has held since 1972. Dr. Wachter also serves as a visiting fellow at the Brookings Institution and has received numerous awards for her teaching excellence in the area of financial management.

Again, I would like to thank all of you for being available today to testify on the risks and benefits of Government-Sponsored Enterprises.

In the interest of time, I would ask that you summarize your testimony as best you can. I have read all of your statements and they are all very good. Some are very brief and actually could be read here, but others are much more lengthy, and for those of you who have written very lengthy opening statements, if you could submit those statements for the record, they will be included as part of the permanent record of this hearing. If you could just summarize your comments, I think that would keep us moving along much more quickly.

We try to give each of you 5 minutes for your opening statement and then we will go for a free-for-all debate, with both advocates, pro and con, on the panel and we will all have a very lively debate.

Mr. Pollock, thank you for coming from Chicago, and welcome.

TESTIMONY OF ALEX J. POLLOCK,[1] PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERAL HOME LOAN BANK, OF CHICAGO, CHICAGO, ILLINOIS

Mr. POLLOCK. Thank you very much, Mr. Chairman, and thank you for giving us the opportunity to share our views with you. We believe your hearings today are very appropriate.

The American single-family mortgage market is the biggest credit market in the world. It seems to us it is socially the most important. It is the current version of Thomas Jefferson's view that we ought to have a property-owning citizenry to have a vibrant republic. Fannie Mae and Freddie Mac are surely the most important factors in this extremely large and important market.

We take as the key question for today, in such a market in which Government-Sponsored Enterprises play the central role, how do we assure that the benefits of the GSE charter are passed through the mortgage finance system to benefit home-buying consumers? Before I give our thoughts on this, I do want to note that I am expressing the views of the Chicago Federal Home Loan Bank. There are 12 Federal Home Loan Banks. Each is a company. Each has its own management, its own board, and most distinctly, its own views. So this is the Chicago view, and given its market orientation, perhaps we fit in with other Chicago views and Chicago schools.

The Chicago view on today's key question can be summarized easily. It is: The best way for Congress to ensure that GSE charter advantages are passed through to consumers, is to encourage greater competition in the GSE sector.

Mr. Chairman, in your opening remarks, you mentioned market discipline. That is another word for competition, and indeed, we believe that the market forces of competition and the innovation and efficiency they induce are the best disciplines for all enterprises, including GSEs. No amount of regulation or redesign in regulators or thinking about regulatory structures, however important that may be, can substitute for the effects of competition.

There are, of course, three housing GSEs, as you mentioned, Mr. Chairman, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. We are all major sources of housing finance. We are all major issuers of debt, and indeed, we were all set up (in 1932 for us, 1938 for Fannie, and 1970 for Freddie), in times of economic stress and problems. The key function of all housing GSEs is to link the mortgage market to the bond market, so, of course, we are involved with bonds.

I think it is safe to say all three GSEs have evolved differently than their designers would ever have imagined, and that is part of the reason why it is a good idea to think about them now.

Of the three, there is no doubt that Fannie Mae and Freddie Mac dominate the secondary mortgage market. Last year, 2002, they represented more than 80 percent of the conforming loan volume. If you look at the outstanding loans of conforming size, that is to say, eliminating jumbos and FHA loans and sub-prime, Fannie and Freddie together have at least a 67 percent market share of all the outstanding single-family conventional loans, as defined. That is a

[1] The prepared statement of Mr. Pollock appears in the Appendix on page 41.

big share measured in any way. And on top of that, they have sustained a remarkable, extremely profitable record over many years, with rates of return on common equity year after year in the 25 percent range.

It seems clear to us, as part of this, that lending institutions who divest their credit risk to Fannie and Freddie by paying guarantee fees, pay very high fees relative to the losses involved. For example, last year, those guarantee fees averaged 19 basis points per year, but the losses were less than one basis point per year. It was a good credit year, but lenders are paying what we view as a noncompetitive fee.

We think that both businesses of the GSEs, that is the mortgage funding business and the credit guarantee business, are in need of more competition. It is that need which has, at the root, generated the debates about Fannie Mae and Freddie Mac, in which all of the distinguished panelists here today have played a role.

In our view, there are three possible outcomes to this debate. One is continued expansion and even more market dominance by Fannie and Freddie. The second is the privatization of GSEs and removing all their ties to the government. The third is creating a more competitive, economically efficient sector. I am not speaking of operationally efficient; I am speaking of economically efficient, which means the lack of the economic rents which today characterize the GSEs.

As to No. 1, it is easy to imagine continuation of the status quo, leading to ever greater market dominance by Fannie Mae and Fannie Mae.

As to No. 2, you can make very strong theoretical arguments that privatization is the right answer, and in fact, my good friend Peter Wallison has and does make such arguments. However, most people think the actual probability of privatization is something close to zero. We conclude that, as a practical matter, the only available way to improve this GSE sector (which has made great contributions, Mr. Chairman, we agree), in order to get greater consumer benefit is to increase competition.

As an essential fact in the mortgage funding business, only a GSE, because of the GSE advantages, can compete with another GSE. Therefore, the Home Loan Banks, through our Mortgage Partnership Finance business, have set out to compete in the mortgage funding business. Through the risk sharing structures of Mortgage Partnership Finance, we have put over 500 private financial institutions, all Federal Home Loan Bank members, into competition with Fannie Mae and Freddie Mac in the credit guarantee business. Because of this, credit risk which would otherwise be concentrated in Fannie and Freddie is now dispersed into hundreds of private institutions.

So we are making a serious effort to carry out our own theory of making the GSE sector more competitive, but I am sure there are many other additional pro-competitive possibilities which could be considered.

As Andrew Jackson said in 1832, when vetoing the rechartering of the Second Bank of the United States, the GSE of its day, if we cannot make our government all that it should be, at least we can take a stand against the grants of monopolies. I imagine that Andy Jackson would have extended that thought to duopolies, as well.

Mr. Chairman, thanks again for the opportunity to present our views.

Senator FITZGERALD. Thank you, Mr. Pollock. I had never thought of the Bank of the United States as a GSE, but I guess now that I think about it, you are probably right.

Mr. Wallison, thank you. You may proceed.

TESTIMONY OF PETER J. WALLISON,[1] SENIOR FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Thank you, Mr. Chairman. The title of these hearings, it seems to me, was quite well chosen, because the real question for Congress is whether the benefits provided by Fannie Mae and Freddie Mac outweigh their costs and the risks they create.

In my view, the case against Fannie Mae and Freddie Mac is very simple. They create enormous risks for the government, for the taxpayers, and for the economy as a whole, and yet—if I may disagree respectfully with your opening statement, Mr. Chairman, provide no significant benefit to homeowners today.

Fannie and Freddie have been doubling in size every 5 years and now have combined liabilities of almost $3.3 trillion. This is not a problem that can, in my view, be safely or responsibly put off.

Fannie Mae and Freddie Mac were created for a single purpose, to provide liquidity for the housing finance system by creating a market for mortgages made by banks and other mortgage originators. They did this very well. There is now a vibrant and efficient secondary market for residential mortgages. The structure will now operate without government assistance of any kind and does, in fact, in what is called the jumbo market. So Fannie and Freddie are no longer necessary for their original purpose. They should be thanked and sent home.

Fannie and Freddie know all of this, so they have been diligent in creating a rationale for themselves that does not depend on their providing liquidity to the housing market. They now say that they help put people in homes by lowering interest rates on home mortgages. They also suggest through their advertising that they disproportionately help minority home buyers. However, they do not really do these things.

Many studies have shown that Fannie and Freddie's activities reduce rates on home mortgages by a very small amount, somewhere in the range of 25 basis points, or one-quarter of one percent. If I can put this in some perspective, every time the Fed raises interest rates one-quarter of a point, it has the opposite effect. If that one-quarter point were as important as Fannie and Freddie suggest in their advertising, thousands and thousands of American families would be frozen out of home ownership every time the Fed raises interest rates by a quarter-point. I don't think that happens.

In any event, as shown by a Census Bureau study presented at an AEI conference in October, the monthly cost of owning a home is not the obstacle that prevents renters from buying homes. The

[1] The prepared statement of Mr. Wallison appears in the Appendix on page 45.

obstacle is the down payment. Most renters do not have the down payment necessary to buy a home. Accordingly, the claim by Fannie and Freddie that they put people in homes by reducing interest rates is not true.

Through their advertising, Fannie and Freddie also suggest that they provide special assistance to minority families hoping to become homeowners, but they do not do this, either. Instead, according to a study by Jonathan Brown of Essential Information, a Nader-related group, Fannie and Freddie buy proportionately fewer conventional conforming loans that banks make in minority and low-income areas than they buy in middle-class white areas.

So the U.S. housing finance system gets very little benefit from the continued existence of Fannie and Freddie as Government-Sponsored Enterprises. What, then, are the costs?

In 2001, CBO estimated that Fannie and Freddie receive an implicit subsidy from the U.S. Government, in effect, an extension of U.S. Government credit, with an annual value of at least $10.6 billion. But the costs, stated in terms of the risks they create, are far greater than this. Because Fannie and Freddie are implicitly backed by the U.S. Government, financial problems at either of them could require a government bailout. The government has done this before for other GSEs.

Until the recent problems at Freddie, we might have said, and I did say, that both were in such good financial health that a bailout was not at all likely. Now, because of doubts about the accounting of both of them, no one can be sure of this anymore. Given their $3.3 trillion liabilities, if even a small part of this obligation has to be made up by taxpayers, it will make the S&L bailout look insignificant.

But even that does not end the risks we all face with these two companies. Because they are integral to the health of the housing market, the failure of either of them could have a systemic effect, meaning an adverse effect on the economy as a whole.

One of the ways they might do this, incidentally, is through the holding of their securities by our financial institutions. If their securities decline in value, so does the capital of these institutions, reducing the amount that they can lend in any area, not just in the mortgage area.

Thus, since there are only two of these companies, it is accurate to say that the continued health of our economy depends on decisions by only two corporate managements. If one of them makes a grave mistake, the entire economy could suffer. And the recent events at Freddie Mac show that management judgments are not infallible.

So what is to be done? Congress can change this calculus in a number of ways. Although I favor complete privatization, there is a less dramatic way to reduce the risks Fannie and Freddie create. Congress should prohibit Fannie and Freddie from buying back their mortgage-backed securities or accumulating any substantial portfolio of mortgages. Most of the limited benefits that Fannie and Freddie provide to the mortgage market come from their issuance of mortgage-backed securities. Most of their financial risks come from buying back these securities and accumulating portfolios of mortgages.

Yet buying back MBS and holding mortgages in portfolio doesn't have any effect, positive or negative, on mortgage rates. So Congress, simply by prohibiting them from repurchasing their own mortgage-backed securities, can largely eliminate the risks they create without affecting mortgage interest rates. I respectfully recommend this to you, Mr. Chairman, and to the Committee.

That concludes my testimony. Thank you.

Senator FITZGERALD. Thank you, Mr. Wallison. Now, we would welcome your testimony, Bert Ely. Thank you very much for being here.

TESTIMONY OF BERT ELY,[1] ELY AND COMPANY, INC.

Mr. ELY. Mr. Chairman, thank you. I am here to testify today with regard to America's Government-Sponsored Enterprises. While I will focus on Fannie Mae and Freddie Mac, at times, I will touch on three other GSEs, the Federal Home Loan Bank System, the Farm Credit System, and Farmer Mac.

I will first summarize major problems Fannie and Freddie pose and then discuss what we do not know today about the two companies. After reviewing underlying problems caused by Fannie and Freddie's GSE status, I will comment on proposed GSE tweaks, none of which will solve the GSE problem. I will conclude by discussing longer-term solutions to the GSE problem, including complete privatization.

The Fannie and Freddie problem today and the broader GSE problems stem from their relatively rapid growth, which has been facilitated by their numerous privileges. This growth has been driven by management desires to enhance the wealth of GSE executives as well as the wealth of stockholders in the three stockholder-owned GSEs.

In addition to being unfair competitors, the GSEs pose increased systemic risk to the U.S. financial system and, therefore, the taxpayers. Fannie and Freddie are too big to fail. The financial markets clearly believe Congress will rescue any troubled GSE, as it has done twice before.

The potential for a third GSE rescue has been heightened by the troubling revelation of serious accounting problems at Freddie. Should those problems worsen, then a Congressional rescue of Freddie and its Siamese twin, Fannie, will become increasingly likely.

Particularly troubling is that we don't fully know what we don't know about Fannie and Freddie. So far, Freddie's problems have been characterized as just accounting problems driven by a desire to smooth its earnings. However, the ongoing investigation of Freddie's finances may reveal serious problems in its risk management practices. Concern about Freddie's risk management was expressed quite strongly by Senator Corzine at last Thursday's Banking Committee hearing on the GSEs. He is better placed than perhaps any other Member of Congress to express that concern.

One reason we don't know what we don't know about Fannie and Freddie stems from their inadequate financial disclosures, specifi-

[1] The prepared statement of Mr. Ely with an attachment appears in the Appendix on page 52.

cally the risk associated with their interest rate derivatives. There is also a troubling lack of comparability in the disclosures of the two companies.

OFHEO Director Armando Falcon has tried to soothe Congressional and public concerns about Freddie's financial condition by stating that the financial restatement process should not alter the result of its quarterly risk-based capital stress test. However, the test is both outdated and too rigid. Neither Congress nor anyone else should take comfort in that test today or in the future.

The special status, privileges, and benefits Congress has granted to the GSEs and particularly to Fannie and Freddie underlie the GSE problem. First, the GSE's arbitrage the interest rate yield curve and their GSE status through maturity mismatching on their balance sheets. They partially hedge their maturity mismatching through derivatives. A private sector mortgage investor could not safely operate today with such a high degree of maturity mismatching.

Second, America has an inefficient housing finance system stemming from its reliance upon the secondary mortgage marketplace and the creation of mortgage-backed securities.

Third, by lowering the cost of debt capital for those who can borrow from a GSE or whose debt is secured by a GSE loan guarantee, GSEs tilt capital flows away from other sectors of the economy, notably the productive sector.

Fourth, the United States is experiencing an unhealthy shift toward GSE financing and away from genuine private sector financial intermediation. Because GSEs are political creatures, it is extremely difficult to correct this shift.

Fifth, because they are a statutory construct, Fannie and Freddie represent relatively rigid features of the American financial landscape. They are largely exempt from the market forces constantly reshaping the financial institution landscape.

Sixth, according to CBO, Fannie and Freddie operate quite inefficiently in delivering a housing finance subsidy. Approximately 30 percent of the subsidy stayed with Fannie and Freddie in 2000, which explains the above-market equity rates of return Fannie and Freddie consistently earn.

Seventh, some portion of the Fannie and Freddie subsidy goes to the sellers of homes, not purchasers. A slight rise in housing prices fully capitalizes the subsidy, thereby shifting all of it to sellers.

Eighth, a substantial portion of the subsidy flows to existing homeowners, not to first-time home buyers.

Numerous proposals have been offered to rectify problems and risks Fannie and Freddie pose. These tweaks will not solve the Fannie-Freddie problem. Repealing the Fannie and Freddie SEC exemption is an easily executed reform, but that will not cure the problem.

Restructuring GSE regulation will be extremely difficult, but moving boxes around a government organization chart will not address the myriad of GSE problems. It would be better to move directly to more fundamental GSE reform.

Giving OFHEO more money and power will not suffice. Repealing the GSE State income tax exemption is highly meritorious, but extremely difficult to accomplish politically. Repealing the GSE's

Treasury line of credit would have symbolic value, but would be difficult to achieve.

Higher capital levels have surface appeal, but they might not have the desired effect because of their arbitrary nature. Further, the present credit risk leverage ratio for Fannie and Freddie may, in fact, be adequate.

Ending mission creep has been the goal of many, but hard to achieve because of the difficulty defining a new financial product.

The greatest public policy challenge facing Congress is what to do should one of the GSEs experience serious financial difficulties, for those problems could spill over to the other GSEs. Freddie's recent accounting problems and management shakeup highlight this problem.

Complete privatization is the only real solution to the GSE problem, but first, three points. If they do not exist today, would Congress create the GSEs? I doubt it, for the political impediments which sparked the creation of the GSEs have largely disappeared.

Second, little can be done to curb Fannie and Freddie's growth. Given their enormous political clout, Fannie and Freddie will succeed in repelling FM Policy Focus's containment initiatives.

Third, Fannie and Freddie should be barred from owning mortgages or MBS, as my good friend Peter Wallison has just mentioned, beyond that needed to facilitate ongoing securitization activities. This would help mightily to reduce, if not eliminate, the systemic risk they pose. Limiting Fannie and Freddie to just the credit guarantee business might encourage them to seek privatization.

Privatizing Fannie and Freddie would do five things. First of all, it would eliminate GSE risk to taxpayers.

Second, it would create a much more efficient housing finance system.

Third, it would build a level, competitive playing field among all private housing finance firms.

Fourth, it would create a more flexible and adaptive housing finance industry.

And finally, it would target delivery of the housing finance subsidy to just those home buyers on the cusp of home ownership.

A forthcoming paper will present my Fannie and Freddie privatization proposal in great detail. It will explain how market forces can restructure the housing finance marketplace so that the efficiencies of moving large blocks of debt capital to private sector mortgage originators can be fully captured. Market forces, not arbitrary capital regulations, will determine the amount of capital that institutional mortgage owners would hold.

The paper also will propose a housing finance tax credit modeled on the Earned Income Tax Credit that will go only to those home buyers on the cusp of home ownership. Finally, it will address all-important transition issues as well as the privatization of the Federal Home Loan Banks.

Mr. Chairman, the time is fast approaching when Congress must undertake fundamental reform of the GSEs by setting in motion the complete privatization of these anachronistic entities. I look forward to your questions.

Senator FITZGERALD. Thank you. Mr. House.

TESTIMONY OF W. MICHAEL HOUSE,[1] EXECUTIVE DIRECTOR, FM POLICY FOCUS

Mr. HOUSE. Thank you, Mr. Chairman. FM Policy Focus is a coalition of seven associations of financial services companies actively engaged in the mortgage industry. We were pleased to be invited to appear before you today and commend you for holding this hearing.

In 1938, Congress decided to rescue a distressed mortgage market. It was a genuine example of Congressional vision and we, as an organization, strongly support this vision through the continuation of the core mission of the two housing GSEs, Fannie Mae and Freddie Mac.

Our members also believe that more can be done to expand home ownership among all Americans and especially among minorities and households who find it financially difficult to afford a home of their own.

The GSEs play a vital role in this expansion, and for this reason, Congress subsidizes them to the tune of more than $10 billion annually. However, in order for the GSEs to be in full compliance with their charters and fulfill their Congressional mandated mission, they need effective government oversight founded on three important principles: Effective regulation, sound capital, and market discipline from enhanced disclosure.

From where we sit today, Fannie and Freddie are zero for three. They are weakly regulated by an underfunded and understaffed agency. They hold far less capital than that required by bank regulators, and they are the only two publicly traded companies in the Fortune 500 that are statutorily exempt from the Nation's security laws. If they were private institutions, homeowners and investors alike would be at great risk. But since Fannie Mae and Freddie Mac are Government-Sponsored Enterprises, taxpayers could go from being in the dark about their operations to being in the red to bail them out.

The first principle of effective regulation is the establishment of a strong single regulator. In 1992, Congress created OFHEO as the safety and soundness regulator, and while making HUD responsible for overseeing the GSEs affordable housing mission and new programs. Unfortunately, this regulatory system has failed us in all three categories.

It took 10 years for OFHEO to produce a complicated and inadequate capital rule for the GSEs. Moreover, the GSEs lag the private sector in promoting affordable housing. Don't just take my word for it: There are 24 separate studies based on HUD data that prove it. I have attached the list to my written comments.

In 1992, Congress passed an Act that also directed HUD to preapprove new programs of the GSEs, but the agency has never implemented a meaningful new program review. This failure takes on new urgency since many of the new activities that GSEs undertake are financial products targeted directly at consumers.

Therefore, FM Policy Focus recommends that Congress replace the existing ineffective regulatory regime with a strong single regu-

[1] The prepared statement of Mr. House with attachments appears in the Appendix on page 83.

lator in the Treasury with authority over safety and soundness and mission. This structure should have all the attributes cited by Chairman Greenspan in his testimony before the Senate Banking Committee just last week namely, expertise, regulatory authority, and power strong enough to keep the GSEs safe and sound.

The second principle is that the GSEs should be required to have capital standards similar to that required of banks, that is, bank-like capital. Fannie and Freddie are allowed to operate on a razor-thin capital base that doesn't even measure up to the capital held by the S&Ls in the 1980's prior to their collapse.

And the third principle is that the GSEs' exemption from the Securities Act of 1933 and the Securities and Exchange Act of 1934 should be repealed. At a time when the rest of corporate America is subject to stringent review, Fannie and Freddie continue to operate as islands unto themselves. It is especially dangerous in light of the revelations about Freddie Mac and its earnings restatement.

Mr. Chairman, the GSEs are too big to ignore. These two companies alone are larger than the entire S&L industry combined, and that is why the stakes of this debate are so high. The current regulatory scheme is bifurcated and it is weak and subject to undue influence from the GSEs. Fannie and Freddie already pose a significant risk to the financial markets, a risk that is compounded by their incursions into new activities that go beyond their core mission.

In closing, EM Policy Focus believes that Congress must restructure GSE regulation for all players to ensure that the GSEs are effectively regulated. I thank the Committee for allowing me to testify and ask that my entire statement be put in the record. I would be glad to respond to questions.

Senator FITZGERALD. Thank you. Without objection. Mr. Miller.

TESTIMONY OF JAMES C. MILLER III,[1] SENIOR FELLOW, HOOVER INSTITUTION

Mr. MILLER. Mr. Chairman, thank you for having me here. I have a statement with attachments I would ask be included in the record.

Senator FITZGERALD. Without objection.

Mr. MILLER. Thank you, sir. I understand the focus of this hearing is on the benefits and risks of the housing GSEs. It so happens that over the past couple of years, I have been involved in two major studies that are pretty much on target here and I would like to describe them briefly for you.

The first study was prepared by Dr. James Pearce of Welch Consulting and myself and it addressed directly the benefits and costs of the two housing GSEs of most substantial importance here, Freddie and Fannie. And what we did was estimate first the benefits to consumers, and the way we went about that was, in simplified form, looking at the difference between the interest rates paid by consumers in the conforming market, which Freddie and Fannie are able to facilitate, and the jumbo market, which is above

[1] The prepared statement of Mr. Miller with attachments appears in the Appendix on page 103.

that. Mr. Pollock mentioned that jumbo market is, in fact, competitive.

Well, what we found is that there is a big jump in the interest rates paid by consumers, or the mortgage rates paid by consumers when you traverse from the conforming rate into the jumbo rate. We estimated that the jump was at least 24 basis points. We also concluded there was an indirect effect in the jumbo market of at least five basis points, and if you multiply that by the conforming loans and jumbo loans that are outstanding, involving some ranges, because there was some discussion about different methodologies, different databases give you slightly different answers, we feel very confident that the benefits bestowed by the nexus that Freddie and Fannie have with the Federal Government generate on the order of $8.4 billion to $23.5 billion per year.

Then we looked and tried to measure directly the funding advantages these two GSEs realize because of their nexus with the Federal Government, and others have talked about the reasons for those. We found on short-term debt, there was about a 10- to 20-basis point advantage. On long-term debt, between 10 and 40 basis points. And with respect to MBSs, between 10 and 30 basis points. Given the amount of debt outstanding, or borrowing, this amounts to about $2.3 billion to $7.0 billion a year.

Now, importantly, what this shows is even the high estimate of the funding advantages to the GSEs is below the low end of our estimate of the advantages to consumers.

Now, I want to make a point here, Mr. Chairman, and that is that our study attempted to measure directly these benefits and directly the funding advantage. Others, including CBO, have used a model which is basically zero-sum. They estimate the funding advantages and take away from that the consumer advantages and there is a fee left over, ignoring the fact that these GSEs may contribute a great deal of value to the housing finance market by virtue of their greater efficiencies, the economies of scale, the innovations, and maintaining liquidity generally in the marketplace. I think their model is fatally flawed because you could find that your estimate of consumer benefits exceeded the amount of the funding advantage, which is a nonsensical result.

The second study is one that CapAnalysis, the group that I chair, did. As you know and was mentioned here, OFHEO recently promulgated a risk-based capital standard for judging the capitalization of these two GSEs. What this standard does is hypothesize a 4-year period during which there is a dramatic fall in housing prices, disruption of housing, and dramatic reductions in interest rates. That is one part of the test. The other part of the test is a rise in interest rates for a 4-year period. And then the question is, would these GSEs survive over a 10-year period?

Now, some questions were raised. Well, this is not just the usual kind of capital measures, capital-asset ratios, that apply to other federally-regulated financial institutions, and while Freddie and Fannie do have to meet certain capital requirements, it is not the same. So would this test really be very rigorous?

Well, what we did was hypothesize the thrift industry as being a single firm, as if it were a single firm, would it, in fact, meet this OFHEO risk-based capital standard?—and we applied it and guess what? In the case of the upward interest rate scenario, it failed after 7½ years. The industry failed the test. And, in fact, it would have needed $32 billion more in capital at the beginning of the period in order to survive the 10-year test period. It did pass the interest rate reduction scenario, but since it failed one part of the test, it failed it in total.

Mr. Chairman, we have an extraordinarily vigorous housing industry that is enabled by a comprehensive mortgage finance industry that is facilitated by Freddie and Fannie and other GSEs. All institutions, in my experience, can stand improvement. I have no doubt that is true of Freddie and Fannie and the other housing GSEs. But I think for somebody who has looked at a lot of them, it seems to me that these are very well-run enterprises and that they have done a substantially superior job of facilitating this very important market. Thank you.

Senator FITZGERALD. Thank you, Mr. Miller. Mr. Harvey.

TESTIMONY OF F. BARTON HARVEY III,[1] CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE ENTERPRISE FOUNDATION

Mr. HARVEY. Thank you, Mr. Chairman, for this opportunity. First, just a little bit about Enterprise. Enterprise is a national nonprofit organization that provides private capital to support affordable housing and economic development in low-income communities. We have raised and invested $4.4 billion to finance 144,000 affordable homes for low- and very-low-income families and individuals.

I can say at the outset, we have no more important partners in our work than the housing GSEs. Fannie Mae, Freddie Mac, and the Federal Home Loan Banks have been indispensable to Enterprise's efforts to expand housing opportunities for low-income and very-low-income homeowners and renters. In many cases, the GSEs alone were willing and able to help Enterprise meet these needs. Without the GSEs, much of our work simply would not be possible.

Now, we are no experts on macroeconomic benefits. You have got many of them here. We are not a research institute. We are a practitioner. I think we are the only practitioner on this panel. And we are one of the largest and representative of many more in the country who provide resources to consumers who are often left out of the mainstream housing market. Our testimony addresses how we, working with the GSEs, address the needs of low-income families and individuals.

First of all, the GSEs must meet, as you said yourself, strong Federal requirements to finance affordable housing. The legislation that provides Fannie and Freddie's legal and regulatory framework requires them to dedicate substantial portions of their business to serving low-income people and communities. In fact, as Frank Raines said in his 2002 annual report, "for Fannie Mae, focusing on underserved Americans is more than just the right thing to do or something we do on the side. It is the center of our business." That can be said for Freddie Mac, and in its own way for the Federal Home Loan Bank System.

[1] The prepared statement of Mr. Harvey with an attachment appears in the Appendix on page 168.

HUD substantially strengthened the public policy requirements for Fannie Mae and Freddie Mac in 2000. We strongly supported that. We are not aware of any other corporations that have such demanding public purpose responsibilities as Fannie Mae and Freddie Mac. And similarly, the Federal Home Loan Bank Boards are required to dedicate 10 percent of their net income every year to fund affordable housing. That has amounted to more than $1.7 billion that has financed $25 billion worth of affordable housing. And billions more are available, as Alex Pollock knows, at a slight discount for community investment.

I have served on the board of the Atlanta bank, which went beyond the mandatory and reached out voluntarily to serve their mission in other ways.

Enterprise has worked in productive partnerships with the GSEs to provide housing for many thousands of low-income families and individuals. For example, Fannie Mae, Freddie Mac, and the Enterprise Foundation pioneered the use of the corporate market for low-income housing tax credits in the late 1980's. Fannie stepped up to invest when few others would and encouraged other corporations to follow suit. Freddie Mac was a very early investor, as well. That credit today is the most important Federal incentive for the development of rental housing for low-income people in the country, and Fannie Mae and Freddie Mac are the most important sources of capital for it.

The pictures that you see here show you two examples of the kind of housing Fannie Mae and Freddie Mac, working with Enterprise, have made possible. I hope it gives a face to this sometimes abstract issue of the critical housing benefits that the GSEs provide. Ultimately, what we are talking about are peoples and families and communities.

The first here that you see, Sheldon Village in Eugene, Oregon, provides 35 homes and numerous supportive services for very low-income people, including formerly homeless individuals with special needs. It is located to provide easy access to educational and recreational facilities and public transportation for residents. Freddie Mac was the major financial partner.

The next example is Arbor Park Village with Fannie Mae. This is a large-scale development, 282 homes in 28 garden-style buildings, all for very low-income people. It is helping revitalize a neighborhood near downtown, Cleveland.

Now, these are just two of many examples that we could give you. We use the low-income housing tax credits. We could use many other types of financing mechanisms.

We believe the current statutory and regulatory framework for Fannie Mae and Freddie Mac has enhanced their ability and willingness to do this kind of work with organizations like Enterprise. These partnerships deliver housing resources to people and places that cannot take full advantage of our Nation's generally well-functioning housing system.

These companies have consistently met their affordable housing responsibilities, even as HUD steadily and substantially increased them over the past decade. They have the best people, the best technology, enormous access, broad partnerships, all working on ways to mainstream new products and services. They have the ability to test market ideas that people like us bring to them.

Congress has expressedly provided Fannie and Freddie the flexibility to respond to fast-moving market conditions and emerging needs. We believe that curtailing Fannie Mae and Freddie Mac's flexibility to innovate would undermine these gains and limit future progress towards meeting our Nation's most serious affordable housing needs.

Certainly, the safety and soundness of the housing GSEs is critical for consumers and the economy. Vigorous regulation is essential. But there is no reason that strong safety and soundness oversight should chill or constrain the GSEs' vitally important affordable housing activities. In fact, the interest of affordable housing and safety and soundness are very compatible if carried out the right way. Thank you.

Senator FITZGERALD. Thank you, Mr. Harvey. Dr. Wachter.

TESTIMONY OF SUSAN M. WACHTER,[1] WHARTON SCHOOL OF BUSINESS, UNIVERSITY OF PENNSYLVANIA

Ms. WACHTER. Thank you, Chairman Fitzgerald, for the invitation to testify today on Government-Sponsored Enterprises. I ask that my full statement be included in the record.

Senator FITZGERALD. Without objection.

Ms. WACHTER. Currently, the United States has one of the best housing finance systems in the world. The efficiency of this system has been advanced by the Federal chartering of Government-Sponsored Enterprises, particularly Fannie Mae and Freddie Mac. These institutions have enabled the securitization and the development of the secondary market for the funding of mortgages. Securitization and the efficient trading of mortgages and liquidity in secondary markets have achieved the integration of U.S. mortgage markets into national and international capital markets.

The goal of the Federal chartering of Fannie Mae and Freddie Mac is to achieve public policy objectives, including the promotion of home ownership for all Americans, and economic research indicates that this mission is being accomplished. Today, I will address how this mission is accomplished, how increased access to home ownership for all Americans has been accomplished through the Federal chartering of Fannie Mae and Freddie Mac.

In my testimony, I will specifically refer to a research paper authored by myself and colleagues, which I request be entered into the record.

Senator FITZGERALD. Without objection.

Ms. WACHTER. In addition, I believe the GSEs have had a critical role, through the strength of the U.S. housing market, in the recovery of the overall U.S. economy since the 2001 recession.

Based on my research and that of multiple colleagues, Fannie Mae and Freddie Mac have contributed to the expansion of home ownership in America, providing affordable residential mortgages for households who otherwise would not have had the opportunity to become homeowners. Freddie Mac and Fannie Mae's efforts have helped to advance gains in overall home ownership rates, as well

[1] The prepared statement of Ms. Wachter appears in the Appendix on page 181.

as in home ownership rates among minority and low-income households occurring over the past decade. This has been a phenomenal decade for home ownership which I do not believe would have been as strong without the role of the GSEs, a decade resulting in a record high home ownership rate of 68 percent in 2003.

GSEs have accomplished this, in part, through their special affordable lending programs, of which Bart Harvey has spoken. But also, the GSEs have accomplished this through lower mortgage interest rates and through lower down payment rates. These have been made possible through the innovation and technological advances that the GSEs have brought about over the last decade.

The findings of the recently-released research study, “The Impacts of Affordable Lending Efforts on Home Ownership Rates,” by myself, Roberto Guercia, and George McCarthy, which was published in March 2003 in the *Journal of Housing Economics,* indicate that affordable lending efforts can increase home ownership opportunities overall and for underserved populations. For example, they can result in a 30 percent increase in the relative probability of home ownership for younger households, 20 percent increase in the relative probability of home ownership for minority households, and a 15 percent increase for households residing in central cities.

The potential gains in home ownership are attributable, in part, to improved credit risk management, which enables lower down payments without an increase in credit risk. Thus, it is not just lower interest rates, mortgage rates, but also technical innovations, such as automated underwriting, that are responsible for increasing home ownership throughout this past decade.

The GSEs and a strong secondary market deliver a second major benefit, not only to homeowners but to the American consumer overall. Their role in accessing global capital markets and stabilizing U.S. mortgage markets was evident in August 1998 upon the defaulting of Russia’s foreign-held debt. In the global crisis, interest rates moved sharply higher and illiquidity appeared to be a growing concern worldwide. Purchasing a record number of mortgages, the GSEs staved off crisis by adding liquidity. Therefore, no credit crunch evolved in the U.S. residential sector, as opposed to other markets at the time.

This pivotal effect is even more evident in the recent role housing has played in stabilizing the overall U.S. economy. The role of mortgage market access to global capital markets as an automatic stabilizer with the U.S. economy has been demonstrated by the strength of the housing sector and its role in moving the economy out of the 2001 recession. It is access to international capital flows during a period of low and falling interest rates that has resulted in additional consumer spending, which has supported the U.S. economy.

This benefit that the GSEs and secondary markets deliver to the American consumer is, I believe, a major, if not the major, contributing factor to today’s housing market, which has helped stabilize and grow the U.S. economy. This, together with increased access to home ownership for all Americans, I believe, is a testimony to the role the GSEs have played and to the importance of ensuring that they continue to play this role going forward.

Thank you, Mr. Chairman.

Senator FITZGERALD. Dr. Wachter, thank you very much.

What I would like to do now is take a 2-minute recess so that you can all stretch and stand for a minute, and then we will resume and go quickly into the question and answer section. We will be right back.

[Recess.]

Senator FITZGERALD. If we could resume the hearing, I would appreciate it.

I would like to, at the outset, note there is so much money involved in the mortgage business, and some of you who are pro and some of you who are con, have relations with some of the companies involved on either side of the debate. I would like to explain any possible conflicts of interest to the media and the members of the public before we start going with the question and answer session.

I would start with Alex Pollock. You are President of the Federal Home Loan Bank of Chicago. Is it correct that the Federal Home Loan Bank of Chicago is trying to compete with Fannie and Freddie in the conforming loan market?

Mr. POLLOCK. That is very true, Mr. Chairman.

Senator FITZGERALD. Please pull the microphones close, and Mr. House and Mr. Miller, you are going to have to share your microphone because we only have six and there are seven witnesses.

But is that correct?

Mr. POLLOCK. That is correct.

Senator FITZGERALD. You are competing with them. You are a GSE yourself. You have nothing against GSEs, but you would like to compete with them on better terms, which I gather, would be a simple way of saying it?

Mr. POLLOCK. It is correct. We view anything as an advantage for the mortgage market and the country that makes the secondary sector more competitive. Clearly, I have an interest in this, being a competitor in the market, as you say, Mr. Chairman.

Senator FITZGERALD. And there have been calls, is it not correct, to get you out of the mortgage business or the mortgage securitization business that you are in?

Mr. POLLOCK. I don't want to give a speech on securitization. We are not in securitization per se. But certainly, a few ill-advised people have thought we shouldn't create this competition, yes, sir.

Senator FITZGERALD. OK. Dr. Wachter, have you been paid for any of your research by any party to this debate?

Ms. WACHTER. I have not been paid for my research. However, the paper that I have just mentioned has been supported by the Wharton Real Estate Center and has also received a small amount of funding support from Freddie Mac.

Senator FITZGERALD. OK. Mr. Harvey, I notice on The Enterprise Foundation website you received a $1 million contribution from the Fannie Mae Foundation last year, is that——

Mr. HARVEY. Let me just say, we solicit funds, loans, grants, capital, from all financial institutions and we have significant—as I said, we have received grants from Freddie Mac, from Fannie Mae, loans and other capital and from all financial institutions——

Senator FITZGERALD. And from a lot of banks?

Mr. HARVEY. From banks, as well.

Senator FITZGERALD. That maybe are part of the funding of FM Policy Focus, possibly. I am not sure.

Mr. HARVEY. That is right. [Laughter.]

Senator FITZGERALD. We will get to that in a minute.

Mr. Wallison, your research at AEI, is it funded by anybody?

Mr. WALLISON. No, it is not directly funded by anybody, but AEI does get contributions from organizations that are in the financial services industry and some of them, although I do not know, may be part of any of the organizations that are opposing Fannie and Freddie.

Senator FITZGERALD. OK. Mr. Miller, your study that you talked about in your opening statement, that was, am I correct, financed by Freddie Mac?

Mr. MILLER. Yes. It was a study commissioned by Freddie Mac.

Senator FITZGERALD. OK. And you were paid to do that study of the benefits?

Mr. MILLER. Yes, but I call them as I see them.

Senator FITZGERALD. OK. Mr. Ely, have you been paid by anybody?

Mr. ELY. First of all, the American Bankers Association is a client of mine with regard to the Farm Credit System. I have done three reports for the ABA on the Farm Credit System.

Senator FITZGERALD. To the Farm Credit System?

Mr. ELY. Yes, which, of course, is another one of the GSEs. In addition, with regard to Fannie and Freddie, I have received modest grants from AEI for several of the papers that I have done for AEI and for Mr. Wallison's program.

Senator FITZGERALD. OK. Mr. House, who funds FM Policy Focus, of which you are the Executive Director, and does "FM" stand for Fannie Mae or Freddie Mac?

Mr. HOUSE. It stands for both. [Laughter.]

Senator FITZGERALD. It stands for both, OK. Who funds that?

Mr. HOUSE. That is funded, as I said, by people in the financial services industry. It is very interesting, because the GSEs have characterized our group as a group of competitors, and frankly, we are their customers. That is one of the reasons we are here today, because if they characterize us as competitors, then we have a real problem. That is why effective regulation is needed.

Senator FITZGERALD. OK.

Mr. ELY. Mr. Chairman, if I can just add one point.

Senator FITZGERALD. Yes?

Mr. ELY. Many people have suggested over the years that I have done consulting work for FM Policy Focus. As I am sure Mr. House will confirm, there has been absolutely no relationship between myself and FM Policy Focus.

Senator FITZGERALD. OK. I just wanted to get that out on the table so that everybody knows where everybody else stands.

Professor Wachter, I have a question for you. You are a professor of real estate finance at Wharton?

Ms. WACHTER. I am a professor of real estate and finance at the Wharton School.

Senator FITZGERALD. And finance, OK. Right now, the housing industry in America has been very strong with declining interest rates. The values of homes have been appreciating very rapidly as rates have declined. If we got into a situation where rates started to rise, would it not be the case that the value of homes themselves could plummet? In other words, a home worth $300,000 that is today with low interest rates of 4.5 percent, let us say, and if mortgage interest rates go back up to 7.5, 8, or 9 percent, that $300,000 home, all things being equal, may no longer be worth $300,000. Would you agree or disagree with that statement?

Ms. WACHTER. I would respectfully disagree with that statement. If mortgage interest rates increase, of course, there will be other factors that cause this increase. A most likely reason that they will increase is increased strength in the overall economy, and if that occurs, I do not believe that housing prices will plummet.

It is, I think, quite likely in that situation that housing prices will no longer appreciate at the rate that they have been appreciating, and in fact, they may appreciate less than the inflation rate. There has been no period in the recent history of the United States that we have documented where housing prices have declined in nominal terms.

Senator FITZGERALD. Not during the 1930's, during the Great Depression?

Ms. WACHTER. In the database that I have seen post-World War II, where we have good data, there has not been a recession where housing prices have decreased.

Senator FITZGERALD. Would anyone else like to comment on that? Mr. Wallison or Mr. Ely? What do you think would happen to the value of homes if interest rates go up sharply? What I am getting at is, right now, the loans that are securitized by Fannie and Freddie have strict underwriting requirements. They have to have a 20 percent downpayment. If they don't have a 20 percent downpayment, the borrower has to have mortgage insurance. Could not that downpayment or equity, the owner's equity in the home, disappear in a scenario where there is a substantial general rise in mortgage interest rates?

Mr. ELY. If I could add some thoughts to that, the question comes as to what is driving the increase in nominal interest rates. Is it a higher inflation factor, or higher inflation premium in the nominal interest rate, in which case the value of real assets are going to be increasing in nominal terms? On the other hand, if the real interest rate increases, then you will not see a plummeting, I wouldn't expect to see that, but as Dr. Wachter said, a slowing in the rate of appreciation.

There is one other thing that we want to keep in mind, too, as we look forward that may be somewhat of an overhang on the housing market going forward—the ratio of mortgage debt to the estimated market value of owner-occupied housing has been increasing significantly. We do not yet know what the implications are going to be, particularly from a macroeconomic standpoint, if the housing price appreciation slows down. As has been commented on by the panel, one of the drivers in the economy in recent years has been the fact that people have been cashing out some of their home equity through refinances. If interest rates go up, if the refinance activity slows down, if housing starts to get squeezed a little bit, then we may see some macroeconomic effects that will certainly not be positive for housing.

Mr. WALLISON. May I add something, Mr. Chairman?

Senator FITZGERALD. Yes.

Mr. WALLISON. I think Dr. Wachter's analysis is probably correct, and that is to say interest rates would not likely go up unless the economy were recovering and, therefore, housing prices might stabilize or not decline. On the other hand, we did have, in the 1970's, a period known as stagflation, when we had very high inflation and we had very little economic growth—indeed some decline in growth—and high unemployment, much higher than today. As a result, it is actually high unemployment which is the greater danger to Fannie and Freddie, and to the mortgage market in general, because that is when people can no longer afford to service their mortgages, when they are no longer employed.

So there are all kinds of scenarios that might occur in our economy which could result in many more defaults than we have seen in the 1990's and the early 2000's, and that is why financial institutions are required to maintain high levels of capital—financial institutions, I might add, other than Fannie Mae and Freddie Mac.

Senator FITZGERALD. Mr. Pollock, I want to go back to you to describe exactly what you are doing at the Federal Home Loan Bank of Chicago. You say you aren't securitizing mortgage debt per se, and I know in your opening statement, or in your written opening statement, you describe that you absorb the interest rate risk and allow the financial institution to keep the credit risk. How does that work? What exactly do you do?

Mr. POLLOCK. Mr. Chairman, what we do, we call "Mortgage Partnership Finance." We chose the name seriously because we create a partnership with our member institution, which is a commercial bank or a savings bank or a savings and loan, and each one of those partners takes one of Fannie Mae's or Freddie Mac's main businesses. As I said in my testimony, Fannie and Freddie have two businesses. The first is a credit guarantee business, the one that Peter and Bert want them to have to stick to. That happens to be one I think is better done by private financial institutions, because if you are the lender actually making the loan yourself, you ought to be fundamentally advantaged in knowing that credit and being able to manage it and bear the credit risk.

On the other hand, the other business is the mortgage funding business, and if you are dealing with 30-year fixed-rate, freely prepayable mortgages, you must have a long-term funding base, in my opinion, which is only available in the bond market and in the international hedging markets. In order to access that base efficiently with the current structures in the United States, you have to be a GSE to compete in the funding of long-term fixed rate mortgages. It is not advisable for private financial institutions to own 30-year cash flows and finance them on their deposit bases. That is a pretty clear lesson of our financial history.

So with Mortgage Partnership Finance, we take these two pieces, we put our member, which is a bank or a savings bank or a savings and loan, into the credit guarantee business, dealing only with loans they have made themselves in which they are fundamentally advantaged. Instead of divesting the credit of their own customer and paying a guarantee fee to Fannie Mae and Freddie Mac, they credit enhance the loan to us and we pay them what is in effect——

Senator FITZGERALD. For guaranteeing it?

Mr. POLLOCK. For guaranteeing it.

Senator FITZGERALD. You pay——

Mr. POLLOCK. We put them into a business they ought to be, and in fact, are, fundamentally advantaged in. We then provide the funding and the interest rate risk management, and if you put the two pieces together, you have the entire financing.

The competitive outcome is that in the credit guarantee business, we now have about 550 lending institutions approved to participate in MPF. So there are 500 new competitors——

Senator FITZGERALD. You are growing very rapidly now, aren't you?

Mr. POLLOCK. We are, yes, sir.

Senator FITZGERALD. How many billion in assets are you up to?

Mr. POLLOCK. The Mortgage Partnership Finance Program is approximately $70 billion, a little——

Senator FITZGERALD. Seventy-billion? So the figures I said, $35 billion, those are a year or two old?

Mr. POLLOCK. They were true when they were printed, Mr. Chairman. [Laughter.]

Senator FITZGERALD. OK, and growing very rapidly.

Mr. POLLOCK. Yes.

Senator FITZGERALD. Now, in talking to bankers in the Midwest, I am told that small community banks will have Fannie Mae, Freddie Mac, and the Home Loan Bank of Chicago all coming in to get their business. But I have also heard that for the conforming mortgages, there are private banks that come in and try to sell some services for those conforming mortgages to small banks, such as someone mentioned, ABN and ROE operating in the Midwest. What would those commercial banks do? It indicates to me that there is a degree of competition out there for Fannie, Freddie, and the Federal Home Loan Bank that isn't generally known to the public.

Mr. POLLOCK. It is very true for the smaller banks that they could deal with a GSE, and, of course, get a better deal if they have three bidders for their business compared to two. There are also large bank aggregators, as they are called in the mortgage business, who will buy loans from smaller correspondent banks. This is called the correspondent channel.

Senator FITZGERALD. OK.

Mr. POLLOCK. But those loans, in turn, are generally turned into Fannie Mae securities or Freddie Mac securities or also financed with us.

Senator FITZGERALD. So it is hard to see how that would be more profitable, to sell it to the correspondent bank which then resells to Fannie or Freddie. How could that make sense for the small bank?

Mr. POLLOCK. It is a question of whether you are a retailing or wholesaling part of the business, but I think that is a fair question.

Senator FITZGERALD. Now, Mr. Pollock, you said that the guarantee fees charged by Fannie and Freddie were 19 basis points and that they are too high. Do Fannie and Freddie both charge 19 basis points for guarantee fees?

Mr. POLLOCK. Mr. Chairman, guarantee fees are negotiated individually. The 19 basis points is the average for 2002 and Fannie and Freddie are quite similar in that level, approximately——

Senator FITZGERALD. Where was that average 10 years ago or so?

Mr. POLLOCK. In the 20s.

Senator FITZGERALD. So it has——

Mr. POLLOCK. It started off being 25——

Senator FITZGERALD. It has been coming down.

Mr. POLLOCK. Yes.

Senator FITZGERALD. OK.

Mr. POLLOCK. The 19, relative to losses, is still very high. A typical, good small bank lender will average losses on their mortgage portfolio of perhaps two basis points or less per year.

Senator FITZGERALD. In this kind of a market environment, though?

Mr. POLLOCK. Even in this market.

Senator FITZGERALD. But in a bad recession, say, like we had in the early 1980's——

Mr. POLLOCK. It is cyclical, but I am speaking of the averages, Mr. Chairman.

Senator FITZGERALD. OK.

Mr. POLLOCK. The long-term average, if I may just complete the thought, for Fannie and Freddie is about four or five basis points in their portfolio of annual losses per year. So you can think of that as the loss versus the guarantee fee being the insurance premium against that loss.

Senator FITZGERALD. Well, that brings up an interesting point, though, because Mr. Wallison recommended that Fannie and Freddie not be allowed to hold mortgage-based securities on their own balance sheet, and you suggested that there is a great deal of risk to having them do so. But as Mr. Pollock pointed out, when they are guaranteeing the mortgages of others, their losses are very small. My own experience as a bank lawyer, prior to being in the Senate, was that home mortgages are the safest loans you can make. People will allow you to repossess their car, they will put their business in bankruptcy, but they will work wonders to come up with the money to stay in their home.

Mr. WALLISON. May I respond to that, Mr. Chairman?

Senator FITZGERALD. Yes.

Mr. WALLISON. There are two kinds of risk, basically. There is credit risk, which is what Alex is talking about, and then there is interest rate risk. When they issue mortgage-backed securities and guarantee them, they are taking only the credit risk.

Senator FITZGERALD. Right.

Mr. WALLISON. That is the three or four basis points maximum that Alex was talking about. Interest rate risk is the risk that they are taking when they buy back their mortgage-backed securities and when they hold portfolios of mortgages. That is where their major risk comes from.

Senator FITZGERALD. Well, let me tell you what they tell me, and I did talk to an executive VP from Fannie. I wish he could have been here today to testify, but in fairness to him, I did not give adequate notification of this hearing, either.

But they claim that they are really fully hedged now, that they learned the lesson from the early 1980's in which we had the case of rising interest rates. They say that now in this era of declining rates, about 70 percent of their debt is callable, and, in fact, every day they are calling debt issued at higher interest rates and replacing it with low-yielding debt. And in a situation in which rates were to rise rapidly, they would simply keep their low-cost debt in place and not call it and that they have derivatives that hedge substantially all of their interest rate risk.

Does anybody care to comment on that? Why would that not be possible?

Mr. ELY. Well, first of all, let me provide a couple points of information here, not that the risk-based capital requirements are magic, but it is important to keep in mind that the minimum capital requirement on a strict leverage basis for Fannie and Freddie for credit risk is 45 basis points. For interest rate risk, it is 205 basis points. So there is in the statutes a recognition that there is much greater risk with interest rate risk.

The other thing about interest rate risk is that you can be partially hedged, fully hedged, or maybe engaged in speculation, which also is risky. The problem that we have with Fannie and Freddie is that we are much less certain as to where they are in the risk perspective in terms of their hedging activities. They may assert that they are fully hedged. As I listened to the telephone conference with analysts last week that Tim Howard, the Executive Vice President and Chief Finance Officer held when Fannie announced its second quarter results, he was not talking as if Fannie was fully hedged. Fannie has significantly reduced its duration gap, but it didn't strike me as being fully hedged.

So there is still a risk there, but there is also another very important factor to keep in mind. It is the assumption of interest rate risk by not only buying back MBS but also by holding mortgages in portfolio that causes the two GSEs' balance sheets to balloon, to loom as large as they do in the economy. If Fannie and Freddie were strictly credit guarantors, as Freddie was initially back in the 1970's, then they would have much smaller balance sheets today and, frankly the concern about systemic risk would be much less than it is today.

But also coming back to a point that Peter made, and I might add the Congressional Research Service, among others, has made, there is no value added to the housing marketplace and to the provision of affordable housing when Fannie and Freddie buy back their MBS. Why do they do that? Because there is more profit per mortgage dollar, if you are assuming interest rate risk. This, therefore, provides them with an avenue for maintaining their high earnings growth rate and their high ROE than is the case if they were just credit guarantors.

Senator FITZGERALD. Mr. Miller.

Mr. MILLER. Mr. Chairman, I think we are asking several "what if" kind of questions, sort of pulling them out of the air. This OFHEO risk-based capital test is a comprehensive, systematic test, a scenario of the sort where you have a lot of things going wrong, one in which interest rates rise, one in which interest rates fall. This comprehensive test applied to Freddie and Fannie show that they both pass for 10 years. They do not have a problem.

Senator FITZGERALD. And you said the S&L industry as a whole would not pass that.

Mr. MILLER. Did not pass, and that gives me an opportunity, Mr. Chairman, to correct an omission, not in my statement but in my oral presentation. I saw the light on. The fact that the thrifts failed the test should not really be viewed as evidence of a shortcoming of the capital requirements of the thrifts, but it should be viewed, I think, as evidence that this OFHEO risk-based capital test is a pretty tough test. Now, you can go in and change some of the parameters or whatever and you can ask a lot of "what if" questions——

Senator FITZGERALD. I would like to give Mr. Ely a chance to respond. You foretold the S&L debacle in the 1980's. In one of your papers, you point out now that most S&Ls hold variable interest rate mortgages only, and I think you cited Washington Mutual as 94 percent of their mortgages were floating rate mortgages on their books and they weren't holding long-term fixed-rate mortgages on their books. You would think if that is the case, the S&L industry as a whole would be pretty well hedged against rising or declining rates.

Mr. ELY. Well, two points. First of all, I am very skeptical of this finding that the thifts would fail the test in a rising interest rate market. One of the problems is, what is the database that you are working from? OFHEO has access to proprietary, non-public information in running the risk-based capital test for Fannie and Freddie. With regard to the thrift industry, I assume that Jim has worked with the same data the rest of us do, which is the so-called Thrift Financial Report or the Quarterly Call Report, which I would not want to try and read too much into.

Let me say something else also about the risk-based capital test. As I indicated in my testimony, it is a highly flawed test because it is based on the assumption that we are going to have a rerun of the interest rate environment of the late 1970's or early 1980's. It is an unfortunate test because it does not reflect present day realities.

But there is another fundamental problem with it. It is a snapshot that is taken four times a year. These two companies can look great on December 31 or March 31, but the question is, what do they look like on April 1 or March 30? It is dangerous to go too far in making judgments just based on how things look on a particular date. What is more important is what the range of values are over a period of time. We don't see that with the risk-based capital test.

Mr. HOUSE. Mr. Chairman, I think if you want to pursue this further, if you look at OFHEO, with the recent revelations of Freddie Mac, OFHEO has testified before the House and Senate and I would think that the members have been somewhat appalled by their response. I think if you would want to bring OFHEO here and ask them exactly what it is they knew, when they knew it, and also on their risk-based capital test, whether or not it is adequate, because it seems that from their own testimony, even they are not sure what—it took them 9 years, and they are still not sure exactly what it is.

That is important. I think Senator Corzine said last week, if we were talking about a $300 million situation here or something like that, I could understand it, but I think, if I am not mistaken, the quote was it is appalling that we are talking about a $3 billion miscalculation.

So my suggestion is, rather, we can argue all day back and forth here about whether it is good, bad, or whatever, but you may want to pursue that and really get into that because it may be that the test itself is fundamentally flawed, and that is important because today, for instance, the Central European banks, and this goes to something we were talking earlier about, whether or not you want worldwide, be able to have access to capital worldwide, the Central European banks said that they are looking into the amount that their banks should hold Fannie and Freddie on MBSs and when you——

Senator FITZGERALD. Did they say that or was that just a rumor?

Mr. HOUSE. That was a report today that we heard.

Senator FITZGERALD. OK.

Mr. HOUSE. That they are looking into it, nothing—but the point is, is that having a good, sound regulatory structure is important. So anybody that says that you shouldn't have a good regulatory structure because it will erode the markets, not having one is even worse, and I think with everything going on, nobody—Bert said it earlier. Nobody is sure what is going on, and I think it is very important that Congress really get in and understand exactly what is going on and what needs to be set up to make sure it doesn't happen again.

Mr. MILLER. Could I just say, I don't think the record will show that anyone here has argued against having a sound regulator for Freddie and Fannie. It is an empirical question, I guess, whether the risk-based capital test is sufficiently severe. But certainly——

Senator FITZGERALD. Is that test——

Mr. MILLER [continuing]. A test of a major industry, the thrift industry, that fails is to suggest it is quite significantly stringent.

Senator FITZGERALD. OFHEO says that Fannie and Freddie did well on their risk-based capital stress test. Did they release a study to the public or anything or do we just take their word for it, that they are fine?

Mr. ELY. We take their word for it, Mr. Chairman. Most of the data that goes into that test is proprietary to Fannie and Freddie. OFHEO sees it, but the world in general cannot. So we really have to take their word for it.

The other thing to keep in mind about the risk-based test, and this is a very unfortunate circumstance, is that it is written into statutory language in quite some detail, and, of course, as you know, it takes a little while to get laws changed around here. I am very concerned about its relevancy at this point in time. In other words, OFHEO is probably doing a pretty good job of trying to make this test work, but it is, unfortunately, a flawed test.

Senator FITZGERALD. They are doing the risk test that is set forth in a statute, whether or not it is necessarily the——

Mr. ELY. That is correct.

Senator FITZGERALD [continuing]. The test that should be applied. It is doing that test.

Mr. MILLER. Could I just say, Bert has had enough experience in Washington to know that if either one of these GSEs actually failed the test but OFHEO leadership went out and told the press it passed the test, surely, someone in the press would find out and the Nation would find out, so I don't think——

Senator FITZGERALD. But what do you say about the test being set in a statute on exactly what the parameters of the test should be? Certainly, it could be that the lobbyists for those entities have influenced what the test is, then. If it is in a statute, the regulator isn't empowered to come up with its own test.

Mr. MILLER. Well, you know, I think the regulator did come up with a pretty stringent test. At both Freddie and Fannie, some people there very much opposed its being implemented so soon, wanted to find out more about it, questioned it in some ways. But it is, in fact, in place today. But it is an empirical question of how stringent it is. You might want to have more flexibility, I would suggest, than having each element in statute because something may come up of a sort you think, well, maybe this is a part that ought to be added, or maybe this part of the test really isn't relevant at this time or something like that, or less relevant. So you might want to define——

Senator FITZGERALD. OFHEO does have people who came from the Controller of the Currency at it, is that not correct? My understanding is one of the on-site examiners at Fannie Mae actually used to be in charge of the detail at Citibank, so from what I am hearing, at least anecdotally, and it hasn't been confirmed to me, is that they do have some very good people over there. Does anybody wish to challenge that? Or, with respect to the effectiveness of the regulator, does anybody think that the regulation at the OFHEO—that the OFHEO personnel are not up to the task?

Mr. WALLISON. Can I make a general point on that?

Senator FITZGERALD. Yes.

Mr. WALLISON. I think we put a tremendous amount of stock in regulation, but the events of the last 6 weeks should show us that we are not fully protected by regulation no matter how extensive it is. Ultimately, the major decisions that affect the health of a company are made at the very top, and the regulators very seldom have access to that. We saw just in the case of Freddie Mae that OFHEO did not have access to the accounting problems that were roiling the top of the company.

Senator FITZGERALD. But are not the GAAP accounting problems that they had, a somewhat different issue? It may be that OFHEO is not necessarily relying on GAAP numbers. GAAP numbers are what you need to disseminate to the public for the securities reports. Freddie is seeking to voluntarily comply. I know from my own experience that bank regulators have a different set of accounting numbers that they like to see that may not have anything to do with GAAP, that are more stringent than GAAP.

Mr. WALLISON. We don't understand everything about what happened at Freddie Mac, nor do we actually know anything other than what the newspapers have reported. But it does appear that they were doing things with their derivatives that caused a problem with the reporting of income for certain periods. And OFHEO does look at their derivatives That is one of the functions that they are supposed to perform. How those derivatives are classified, what they are and so forth are things that OFHEO should have come across in the course of their investigation that would have given them a hint about how effectively these companies are operating.

May I say a couple of other things, Mr. Chairman, while I am talking? One is that when the tests were done on Fannie and Freddie, all kinds of tests have been run by OFHEO, including the stress test that Jim Miller was talking about. Fannie always came out very close to the line. Freddie came out way ahead most of the time. In fact, people would have said 2 months ago, if we are going to have any kind of accounting problem, we are going to have it at Fannie, because Freddie was always very well-managed, it seemed, from an accounting point of view. We would never have any difficulty there.

Well, it turns out, ironically, that it is Freddie with the accounting problems. Fannie, which was always very close to the line, taking a lot of risks, has not been challenged as yet. I think now that investigations have begun, Fannie will get a good going over and I think we will find, based on some of the stuff you see coming out of the private sector today, that they are having their own difficulties.

But in any event, you can't rely too much on a regulator to protect you, especially in a case where these two companies are the only two companies involved in this major part of our economy. If there is a major error by one of those companies, and the regulator does not recognize it, as I suggested in my prepared statement, we could have serious systemic problems in our economy.

Also, finally, on the question of whether they are profitable after the hedging that they have to do to address their interest rate risk, I think, Mr. Chairman, if I heard you correctly in your opening statement, you made the fundamental and true point that if a company is fully hedged, it is not going to be profitable. There is some risk that has to be taken in order to make a profit.

Senator FITZGERALD. I see a lot of witnesses want to address that issue. Dr. Wachter, can you get 100 percent hedged and still make a profit?

Ms. WACHTER. It does depend on the business that you are in. You can make a profit in other elements of your business. You could take additional interest rate risk and make profit on the interest rate risk. But as a general statement——

Senator FITZGERALD. But to hedge themselves, they have to do a series of things that add to their costs.

Ms. WACHTER. Absolutely.

Senator FITZGERALD. To hedge themselves on their liability side with respect to the debt they have issued, they have to make it callable. That requires them to pay higher interest rates. Investors who are going to hold callable debt want a premium and so forth. To buy all sorts of options and derivatives to cover everything in their portfolio, it gets very expensive. But you believe it is possible to——

Ms. WACHTER. Mr. Chairman, in an equilibrium setting, I absolutely agree with you. It would not be possible to make profit on hedging operations alone in equilibrium. But this is not necessarily an equilibrium market. That is, there is innovation going on. There are economies of scale. And separately, you can make money on other aspects of your business.

I also do want to address, if I may, Mr. Chairman, the very fact that, of course, regulation is very important here. I think it is a great advantage that these are regulated institutions. These are private institutions. And for all of the concern that has been expressed around this table—I am not saying that there shouldn't be concern—I think we also should look at the market response to the events of the questions on Freddie Mac's accounting and the market response was not very significant.

Senator FITZGERALD. Well, does not Freddie have a problem of having overstated their earnings as opposed to having understated their earnings, which is the opposite of Enron's problems? Mr. Miller.

Mr. MILLER. Mr. Chairman, could I first agree with Dr. Wachter. You can earn profits when you are fully hedged.

Senator FITZGERALD. Let me go back and correct myself. Freddie has a problem of having understated their earnings——

Mr. MILLER. Right. Right.

Senator FITZGERALD [continuing]. Whereas Enron overstated their earnings. Understating your earnings would be much less alarming, I would think, to investors than overstating.

Mr. MILLER. And one explanation of the phenomena that Dr. Wachter was just pointing to at the end is that there is a difference between, on the one hand, the accounting treatment of derivatives, over which there is some dispute, some suspicion, or some concern, and I think the jury is still out. We just ought not jump to conclusions until we have the evidence. That's on the one hand, and on the other hand is safety and soundness.

I think, at least the reports as I have read them, and the reaction to the question of the accounting of derivatives, is that the market interprets the two quite separately and believes in the fundamental safety and soundness of these two institutions.

Senator FITZGERALD. Mr. House, I want to get back to capital requirements. You suggested that Fannie and Freddie be required to have bank-like capital. Fannie and Freddie right now have to have 2.5 percent capital for the mortgages on their books and 0.45 basis points for the guarantees that they make. Banks are required to have 4 percent risk-based capital for mortgages that they keep on their books. My understanding is there is a new Basel round of international risk-based capital guidelines that will lower the capital requirements for banks holding mortgages. Is it down to——

Mr. ELY. The so-called Basel II capital standards could bring them down, some suggest to a range of 1.4 to 2 percent.

Senator FITZGERALD. That would be lower than Fannie and Freddie.

Mr. ELY. Well, that is before taking into account maturity mismatching. I was just the other night having a hard time getting to sleep and so I was reading through some of the Basel II discussion. [Laughter.]

There is an awful lot of judgment that is extended to the regulators in terms of how maturity mismatching is to be worked in there. So we want to be a little careful about quantifying the extent that the capital will be reduced. But in general, particularly for the larger banks that opt to go into Basel II, it appears that the capital requirement will drop somewhat.

There is a very important point here to understand, and that is that any kind of capital regulation is arbitrary because if you take no risk, if you are perfectly hedged, then you don't need much capital, if any at all, because you don't need a capital cushion to absorb loss. What we have with Fannie and Freddie is they have capital levels that, in effect, they can arbitrage. At 2.05 percent for interest rate risk, they have to take a certain amount of risk in order to be able to earn a return on that 2.05 percent. If their ratio is pushed up to, let us say, 4 percent, they are either going to have to charge higher interest rates, earn a greater spread, or take more risk.

A fundamental problem we have with capital standards, both as they apply to the GSEs as well as to the banks, is that they don't necessarily reflect the risk that the particular institution is taking. Instead, they become a target to arbitrage, and frankly, banks do that just as much as GSEs do. The difference is the lack of a level playing field. Presently, Fannie and Freddie don't have quite as high a capital hurdle to clear as the banks and, therefore, they have more room to arbitrage on credit risk, but more importantly on interest rate risk.

Senator FITZGERALD. Mr. House.

Mr. HOUSE. No matter where the Basel Accords come out, and that is—to say that is in flux is probably an understatement, and I can't believe—Bert, I will send you a book, a novel, if you stayed up reading that—— [Laughter.]

But I think the key thing—what Bert just said is very important. What we are really about is a level playing field. So, we think that they are large financial institutions, just like any other financial institutions, no matter how you cut it. So when it comes to SEC registration, when it comes to capital requirements, when it comes to other things, they should be treated just like any other financial institution.

Senator FITZGERALD. OK. So FM Policy Focus mainly wants, you have said, effective regulation, sufficient capital, and no exemptions from security acts. You don't have a problem with their overall mission, is that correct?

Mr. HOUSE. No, we don't. We have said that. As long as they are in the secondary market. I mean, the liquidity in the secondary market was why they were founded.

Senator FITZGERALD. It occurs to me that if Mr. Wallison's approach of privatization were ever adopted, Fannie and Freddie, in return for being privatized, would probably want to have restrictions on their operation lifted, too, so that they could compete in the jumbo mortgage market with many of your members. Would your group be opposed to that privatization and unleashing these giants in the areas where they have not heretofore tried?

Mr. HOUSE. From day one, we have said that we are opposed to privatization. That has been——

Senator FITZGERALD. So you are opposed to that.

Mr. HOUSE. In fact, I feel very——

Senator FITZGERALD. Is there self-interest involved in that?

Mr. HOUSE. No. I feel very comfortable. I have got privatization on my right. I have got business as usual on my left. I am sitting right here. [Laughter.]

So we are fine.

Mr. ELY. Mr. Chairman, if I could add to that, if there was a genuine privatization, it means basically peeling away or denying them all of the various special benefits they have now, including the implicit government guarantee. In that case, they would just be plain old business corporations. And then the question is, how well would they be able to compete, lacking any kind of meaningful origination capability, which comes back to this basic question: Is the secondary market really as efficient as we think it is, or does it look efficient only because of the GSE advantages that Fannie and Freddie have?

Senator FITZGERALD. Mr. Wallison.

Mr. WALLISON. The advantages that Fannie and Freddie provide, it appears from all the studies, is about 25 basis points. It also appears from the CBO study that that 25 basis points comes from the support they get from the Federal Government. So we don't find that Fannie and Freddie are adding very much to the value of the secondary mortgage market.

Senator FITZGERALD. They have to be adding a lot to the mortgage market, though, because of the statutory provision that says banks and S&Ls can hold an unlimited amount of their debt, and that prefers mortgage debt capital in this country to other debt capital, perhaps for more productive uses. Would it not be the case that we are putting an incredible, incredible emphasis in our country on mortgage financing and it must, at the end of the day, be sucking debt capital out of other perhaps more productive uses? Does anybody care to comment on that?

Mr. ELY. This is another area where we don't have a level playing field in terms of the allocation of capital within the economy. And, of course, it also happens through the tax code, too, with the favorable tax breaks that owner-occupied housing gets. That is why many would suggest that the middle class and the upper-middle class are over-housed in this country compared to other countries.

But there are two different issues. One is the competitive level playing field, which I think Mike House is addressing. And then the other more significant public policy question is, to what extent, if at all, do we want to tilt capital flows in one direction or another? There is clearly, for a variety of reasons, including the housing GSEs, a tilt towards shifting capital flows into housing and particularly owner-occupied housing.

Senator FITZGERALD. Dr. Wachter, is that a good idea, to tilt capital flows into housing as opposed to anything else? What about small business?

Ms. WACHTER. The issue of how interest rates overall are impacted by this is very complicated and it has to do with whether our growing deficit is increasing interest rates. So it is that literature that, in fact, needs to be—this needs to be.

In other words, Fannie and Freddie are accessing capital, not just in the United States, but global capital. So do they, in fact, increase overall interest rates? Do they, in fact, increase the share from a limited basket of funds? Do they increase the share from that limited basket of funds to housing at the expense of others, or is the effect to simply increase on the margin funds coming to the United States without any impact on other funding in the United States? This is an open question, and it may very well be that there is an impact drawing capital from small business. It may very well be, and I am not saying it isn't. I am saying it is an empirical question, to what degree that there is that impact.

Second, there may very well be, and I do believe it is the case that Fannie and Freddie increase the overall efficiency of this market. That is, interest rates are lower—mortgage rates, that is, are lower than they otherwise would be. Mortgage costs are lower than they otherwise would be because of the technical efficiencies that they bring to the market. If that is the case, then this is not due to their drawing funds from another source.

Senator FITZGERALD. You support the concept of the housing GSEs. Would you support the creation of GSEs in other areas that would promote equally as worthy sectors of our economy, such as small business? In other words, if housing GSEs are a good thing, since we all favor home ownership in this country, aren't small businesses a good thing and don't we want to encourage people to own businesses? Why not then create GSEs to securitize loans to small businesses? Do you think that would be a good idea?

Ms. WACHTER. No, I do not. See, I think that the fundamental—a fundamental factor in our democracy, and I believe it was Peter Wallison who started his comments with that, is the Jeffersonian concept of ownership, and I believe that it is the ability of ordinary American families to have substantial ownership in America. This means as America prospers, as America expands, as our productivity expands, and as a result of that, housing costs go up, that we will not have a Nation of "haves" and "have nots." And I don't think that there is anything more important than economic democracy along with political democracy.

Senator FITZGERALD. Owning your own home. But what about economic democracy, everybody owns their own business?

Ms. WACHTER. Well, I do believe that owning your own home and having access to capital at low rates is what enables people then to go out and start their own small business, what enables people to go out and invest in their children's education, and what has enabled people to protect themselves in their old age.

Senator FITZGERALD. Well, what about—do you favor Government-Sponsored Enterprises to further securitization of student loans? We used to have that with the student loan marketing GSE, but it has now been privatized.

Ms. WACHTER. Yes.

Senator FITZGERALD. Do you simply think housing is the most important and all other areas of the economy should not have any kind of special push, just housing?

Ms. WACHTER. Well, I actually think that home ownership and housing, because it is a basic need, but home ownership absolutely should. I don't really have a position on these others except for the fact that I have in my studies seen what happens to economies where home ownership is not equally accessed and the political difficulties that so arise.

And the other side of it is I believe we, in some sense, have the best of both possible worlds, which is that we have lower cost capital delivered in this very important sector. I think it is the ability, in part, to lower the costs of capital for housing through the diversification, etc., that comes through the secondary markets that wouldn't necessarily be able to be delivered to small businesses through secondary markets.

Senator FITZGERALD. All right. A question for all of the panelists. The issue of competition has come up several times, first and foremost from Mr. Pollock, who is competing to some extent now with Fannie and Freddie. If our country decides that GSEs for housing are a good thing, then why just have two of them? Why not have four or six of them? Certainly, Mr. Pollock, you don't mind being one. I would be interested in your thoughts on that. I suppose those who are against GSEs wouldn't want any more GSEs. Those of you who are for them, Mr. Miller, Mr. Harvey, Dr. Wachter, would you be for more GSEs or just limit it to Fannie and Freddie? Mr. Harvey.

Mr. HARVEY. I would just say, we would be for whatever competition increases either the efficiency of capital for lower-income Americans one way or another, and if you think there is a net benefit out of the competition, we would be all for it, between the GSEs.

I just have to point out, we also have a very unfair, or a tilted system, however you want to put it, as far as mortgage interest deduction goes in this country. It is far more favorable to the wealthier Americans than to lower-income Americans in this country. So there are a set of policies that are in place and you have to look at the totality of them.

One of the reasons I am for the housing GSEs is that it is a means of getting favorable capital and there is a public policy objective that is front and center and it makes Fannie and Freddie accessible and the Federal Home Loan Bank System far more accessible than Wall Street is to those of us who are trying to reach down into lower-income communities and to make sure that there is equity in the housing in this country.

Mr. ELY. Mr. Chairman, if I could throw in two points there. As you might have inferred from my remarks, I am not a fan of Fannie and Freddie and I support the notion of their privatization. But if we are going to look at the question of whether or not there should be more than two housing finance GSEs like Fannie and Freddie, their returns on capital indicate that there is clearly a lack of competition. As someone pointed out, we are seeing companies that consistently are earning returns on equity capital in the mid-20 percent range. That is clearly excessive compared to the type of competition and returns we see over time in other industries.

So the fact that their ROEs are so high is an indication that what we have is effectively a duopoly in which there is an implicit understanding between the two companies to compete but not too aggressively or not so aggressively as to reduce their return on equity.

Coming back to the question of the role that Fannie and Freddie play in terms of helping to level the playing field in favor of lower-income people who pay lower tax rates, if we take a look at the current conforming loan limit of $322,700 in order to meet that limit, you probably have to be able to buy a house worth at least $400,000, if not more. Those are not homes being bought by lower-middle-income, or lower-income people.

Much of the Fannie-Freddie subsidy goes to the middle class and the upper-middle class and beyond. A very important public policy question should be, to what extent should the middle class and upper-middle class be subsidized in this way, given the fact that they are already being subsidized tremendously because of not only the mortgage interest deduction and the deduction of real estate taxes, but also because of the now very liberal capital gains treatment with regard to owner-occupied housing?

Mr. POLLOCK. Mr. Chairman, could I take a try at addressing the question directly?

Senator FITZGERALD. Yes, Mr. Pollock?

Mr. POLLOCK. I think Bert is right, that if we got to a truly competitive GSE sector, we would know it because the returns on equity would be at the market competitive cost of capital, which in this country now is around 13 or 14 percent, as opposed to someplace in the 20s.

In terms of more GSEs, you could think of the Federal Home Loan Banks as one GSE, or you could perhaps more accurately think of them as 12, or think of us as 12, which would give you 14.

It seems to me that the burden of proof for creating a GSE must always fall on those who would wish to create a GSE. We have a long history, not always in the form of GSEs, but of governmental credit programs. You mentioned, Mr. Chairman, student loans. We have Farm Credit. We have the Pension Benefit Guaranty Corporation. We had the Federal Savings and Loan Insurance Corporation. A very large number of them had rather unhappy experiences, or continue to. So to those who would create such programs, as I say, I think that the burden of proof is on them.

My point is that if you already have GSEs and you are asking what can you do best now and you believe the GSEs will continue to exist, it is our view that the best thing you can do is to ensure at least that it is a competitive sector so that the benefits given to the GSEs, which turn into economic advantages, become consumer advantages as opposed to economic rents, to use the technical term, in the GSE.

But that is a “second-best” argument.

Senator FITZGERALD. Well, we have been talking here a lot about risk and what is the risk on their balance sheets. If they had more competition, would there not be much more risk of a financial——

Mr. WALLISON. Actually, Mr. Chairman, if I can respond to that——

Senator FITZGERALD. OK.

Mr. WALLISON If we had to have GSEs doing what Fannie and Freddie are doing, it would be better to have more of them than fewer of them for the reasons I said in my testimony, and that is that the two that we have, if one of them fails, could produce a disaster in our economy, whereas a management misjudgment at one of six or eight would not have that effect.

Senator FITZGERALD. The margins of Fannie and Freddie, then, would get thinner and thinner——

Mr. WALLISON. Yes, of course, and they should, and that is what benefits consumers. In fact, the ROEs that they are showing, as Bert suggested, reflect either one of two things. Either they are taking the risks that I said they were taking—they are not adequately hedging—or there is some sort of parallelism going on in their pricing.

Senator FITZGERALD. Well, banks don't ordinarily make that kind of return, but they have to have a lot more E, and so their R on the E is lower because there is much more E. Because Fannie and Freddie have such low levels of required capital——

Mr. WALLISON. That is given to them as a benefit.

Senator FITZGERALD. Yes.

Mr. WALLISON. Let me just complete a couple of thoughts here. So competition would be better than nothing, but why would we create more GSEs when we can eliminate the risk, as I suggested, simply by not allowing them to buy their own mortgage-backed securities which have already been sold to the market? We have developed—they have developed, or others have developed and they then picked up on—a very good technology in offering mortgage-backed securities. Investors will buy these instruments and take the interest rate on them. Why are we now allowing them to go out into the market, borrow money on the Federal Government's credit, and then go out and buy mortgage-backed securities to take additional risk away from investors?

Senator FITZGERALD. Mr. Miller, do you want to address that?

Mr. MILLER. I am not sure in which order to take these things. One reason——

Senator FITZGERALD. The one I would like you to address is Fannie and Freddie holding mortgage-backed securities on their balance sheets.

Mr. MILLER. That is the one I was going to start with.

Senator FITZGERALD. OK. [Laughter.]

Mr. MILLER. They have a comparative advantage in having those assets on their balance sheets because they know them better than anyone else.

Senator FITZGERALD. They don't know them better than the person or the bank or the S&L that made the loan. . . .

Mr. MILLER. No, but when they consolidate and do the MBS, they know what the MBS is.

Second, I want to get to the competition point, but let me return to the—you asked the question, should you establish new GSEs for other industries or other areas of economic activity, and I would distinguish two things there. One, is that an area that is appropriate for promotion? I don't think there is any question but that the Congress of the United States and administrations from one to another have viewed housing as being a priority, and the establishment of the housing GSEs, and continuation of the housing GSEs are a reflection of that priority. That is something for you to debate.

The second part, though, is the question of liquidity. If you were to establish that in such-and-such an industry there was a significant liquidity problem for which there were institutional barriers or some such, it might make sense to establish something that would increase liquidity there. The liquidity problems in the housing industry sources are very well known—regional problems, banking, finance that were not solved or are not completely solved even today.

But on the question of competition, I as an economist will tell you, yes, maybe rents are being earned, but the rents that are flowing are to increased skill at management, innovation, other things, not rents that are flowing to the firm because it limits competition.

My impression is, these two GSEs, first, they are very competitive with each other. Second, they are run by very smart people who are constantly innovating, coming out with new things, and that is the reason that the firms are doing well in terms of ROE. You find other firms in the economy that do very well, and, of course, in some industries, rates of return are much, much higher than for the GSEs.

Now, my own personal view is if you gave an opportunity for someone to enter under the same circumstances, that would be fine. But I would just caution you that if you established a GSE sort of organization, it would take a long time, if ever, for them to be competitive with Freddie and Fannie, in part because of their scale economy. So if you set something up, you might be buying a commitment to engage in a lot of Federal promotion and direct subsidy of such an enterprise over time.

Mr. HOUSE. But Mr. Chairman——

Senator FITZGERALD. We are going to wrap up in a few minutes. I will let everybody who wants have a final say here. Mr. House.

Mr. HOUSE. To go back, you asked our group how we would feel about competition. We would support it if you had proper regulation and a level playing field. Something that Mr. Miller just said really emphasizes that point. He said nobody understands the MBSs better than Fannie and Freddie, and this is something that Mr. Wallison talked about on MBS. So when the GSEs purchase their own MBS, it is called "cherry picking" because they do understand their MBS better than anybody else. This is exactly why we think they should have to register their MBSs under the SEC, so everybody knows, so everybody has the same information.

The next thing is, the GSEs were originally established to lead the market in providing for home ownership. And as I said earlier in my remarks, 24 studies say they are not leading the market. We think it is very important, and I think Mr. Harvey, I would hope, would agree that in order to do that—banks have to buy CRA loans—and I think the GSEs, which are exempt from CPA standards, should be required to invest in community reinvestment loans.

And the second thing is, in applying affordable housing standards, it is now done on a national average. We all know that you can play all kinds of games with national averages. So you say, gosh, I am going to meet my affordable housing standards. You can just play with those averages. Take those averages and take it down to MSA basis, which is the Metropolitan Statistical Area, so it is done by areas. So if you really want to increase affordable homeownership, those are the kinds of things you can do, instead of taking the GSEs' word for it. We think that is very important.

Senator FITZGERALD. Mr. Ely.

Mr. ELY. Just a couple of points I wanted to pick up on, responding to Jim. First of all, with regard to having more competition among the GSEs, you made a point about increased risk to these institutions. That is right, there would be increased risk and it is increased risk for the taxpayer because many of us believe that if a GSE gets into trouble, it will be rescued in some fashion by the government. Congress has done that twice in the last 16 years, first with the Farm Credit System in 1987 and then in 1997 with the FICO bonds, which gets back to a key difference between Fannie and Freddie, on the one hand, and the banking industry on the other.

Fannie and Freddie are a "heads we win, tails you lose" proposition because to the extent they are able to capitalize on their implicit Federal guarantee, then their shareholders are winners. If, on the other hand, one of them fails, then it is the taxpayers who are the loser. Deposit insurance, post-FDICIA, and post-FIRREA, doesn't work that way anymore. It is an industry-financed program, if you will, that is run by the government. So as we think about GSE risks, we have to realize that the GSEs are getting a free ride off of the taxpayer, which is showing up in their high ROE.

Just one other thing about the liquidity problem. The banking industry and the thrift industry have changed enormously from the time Fannie and Freddie were set up. Back then, and you will remember this very well, we had branching restrictions and relatively small banking companies. Today, we have large players out there as mortgage originators and as aggregators who are operating on literally a nationwide basis—Washington Mutual, Wells Fargo, J.P. Morgan Chase, Citi, and so forth.

And so the private sector, through the consolidation process and the lifting of branching restrictions, has been able to develop an ability to provide liquidity to the mortgage market. That vitiates one of the original reasons for creating both Fannie and Freddie.

Senator FITZGERALD. Mr. Wallison, we are getting to the end of the hearing. I do want to ask you if you favor privatization of the Federal Home Loan Banks, too.

Mr. WALLISON. By all means. [Laughter.]

They survive, in my mind, only as competition to Fannie and Freddie. [Laughter.]

Alex and I have talked about this at length.

Senator FITZGERALD. OK, and you are still friends. [Laughter.]

Mr. WALLISON. If we could not do anything about Fannie and Freddie, then it makes a lot of sense to have some competitive organizations.

Let me mention a couple of things on competition. First of all, in my prepared statement, I noted that Fannie and Freddie compete against Treasury securities and they thus raise the cost of Treasury securities. The Treasury pays more interest because foreign central banks and others accessing the foreign capital markets are looking at Fannie and Freddie as U.S. Government securities, to some extent. So they are buying Fannie Mae and Freddie securities instead of buying Treasuries. The Treasury has to pay somewhat higher interest. No one has done a study—it is probably impossible to do a study of how much it is—but it is not insignificant. That is one of the costs that they cause the U.S. taxpayer.

It is certainly true that people have their wealth in housing in this country, but that is because of our national policy that causes a lot of investment to go into housing, Fannie and Freddie and the Home Loan Banks being part of that. If we didn't have that direction of funds into housing, people would have better jobs. People would have more income from the businesses that would have been established here and people would have more stock market investments than they have investments in their homes.

So that is the way—our economy is structured that way because of government policy. It is not because of any particular reason that we should organize our economy that way. We ought to realize what the trade-offs are when we push money into housing.

I heard an argument, I thought, that rents, economic rents, cause or help innovation. I was always under the impression that the more competition there is, the more innovation there will be, and that is certainly the lesson of our free market. So I can't imagine that we would want to encourage people to make profits, rent-type profits, in order to encourage innovation when, in fact, what it does encourage is waste and inefficiency in the economy.

And finally, the important thing that we should focus on here, what Congress should focus on, it seems to me, is eliminating the risk to the taxpayer and the risks to the economy. I happen to think that privatization does that more effectively than anything else. There is no good reason to have these organizations anymore. But if that is too big a bite for Congress to take, I do recommend that we look at simply the question of forbidding them to buy their mortgage-backed securities and accumulate portfolios of mortgages.

Since Fannie and Freddie were established, the technology involved in selling mortgage-backed securities, the distribution system, has been developed. It now works wonderfully without any government support in the jumbo market. It could work for the conforming and conventional market, too, if we simply eliminated the government support there, and we would then by that Act eliminate the risk. Thank you.

Senator FITZGERALD. Any final——

Mr. MILLER. Could I just make a correction?

Senator FITZGERALD. Yes.

Mr. MILLER. My reference to rents was the rent that is the return for innovative activity. It is not the way that was characterized by Mr. Wallison.

Senator FITZGERALD. Mr. Pollock.

Mr. POLLOCK. Mr. Chairman, I think you have conducted a great and a very lively discussion, but I did note there was one question you very pointedly asked and it didn't get answered, so I would like to try to answer it.

You discussed the presentation by Fannie Mae about being hedged and the different ways you could hedge a mortgage book with debt and hedges and you asked, is that reasonable? In my opinion, that is very reasonable as long as we don't talk about perfect hedging. I have been in the banking business one way and another about 34 years now and I have never met anybody who was perfectly hedged or even claimed to be perfectly hedged and I would greatly distrust anybody who did.

But if the question is, can you prudently hedge a book of mortgages with debt and with hedges, the answer is, you absolutely can if you are a GSE under current American circumstances.

I think as a general——

Senator FITZGERALD. Do you think private companies could absorb all those long-term fixed rates in America and hedge themselves?

Mr. POLLOCK. Not if they have to compete with GSEs, Mr. Chairman.

Senator FITZGERALD. If they didn't have to, you think they could?

Mr. POLLOCK. I think the market will always work that out.

Senator FITZGERALD. OK.

Mr. POLLOCK. Embedded in every hedge is somebody's cost of operations and cost of capital for providing the risk bearing or the risk distribution that the hedge represents. The market would work that out.

I do think it is very clear that every GSE, Home Loan Banks and Fannie Mae in particular, was set up with an important truth in mind: That is, if you are going to have long-term fixed-rate mortgages, you have to link them to the bond market in some way. You can't finance them with deposits, which are short-term by nature. Whatever system we would end up with, if we want to have fixed-rate mortgages, which I think the American people should want and do want, then we have to design a system that has a highly efficient bond market link. GSEs are one way to do that. Obviously, you could imagine others. And thank you very much, Mr. Chairman.

Senator FITZGERALD. Thank you.

I know you had some comments down here. These will be the last two, Mr. Harvey, then Dr. Wachter.

Mr. HARVEY. Great. Thank you, Mr. Chairman. I think one of the points that we have missed here is the huge productivity gains that have come over the last decade from Fannie and Freddie and from the Home Loan Bank System. But if I was to take, and this is a negative comparison, where the FHA is and Ginnie Mae has been over that period of time versus what has happened in Fannie and Freddie, there has been a huge benefit that has come out of the GSE system. They have been able to access technology, they have been able to have huge through-puts with the same amount of people. They have been able to have dedicated people and resources on their public mission goals, and every time the goals have gone up, they have been able to meet them or exceed them along the way.

So as an advocate for low-income people and housing, what is there to fix here, because it has been hugely productive. It has been a tremendously productive system.

As far as not leading the market, yes, I would love to stretch the GSEs to do more around CRA and other loans. What I fear is if you get a capital structure where they can't do that or that discourages them from taking the very prudent risk that they ought to take, then you are defeating some of the purpose as to why you have a GSE in the first place.

As far as not leading the market, I think you have to look—and in minority home ownership, you have got to look at the sub-prime market, which is a large part of the lending right now that goes to minorities in this country. It has grown exponentially over this period of time. Now, there is a sub-prime market that makes sense and there is a predatory market. They are different, but they are sometimes linked together, and this will probably horrify everybody on the stage, but I think the GSEs getting into that sub-prime market will make it more accountable, cleaner, better, with more efficient capital as long as you have accountability and oversight on it, and I applaud——

Senator FITZGERALD. But doesn't that put more risk on the GSE's balance sheets?

Mr. HARVEY. As long as they do the business the way the business ought to be done, and not in a predatory way, but in a way to get capital to those people that don't have perfect credit, and that can be done—I applaud every time Citibank takes over Associates and Associates has to clean up the way that they have been doing their business, and it was a huge fight, as you know, or Chase takes over, because they have a reputation they have to defend and it allows advocates and others to say, look, this hasn't been done the right way. There are parts of this business that make no sense at all for low-income home owners.

So I think the GSEs have worked remarkably. Of course, we believe in public-private partnerships to get to parts of the market that you can't get to otherwise.

Senator FITZGERALD. Thank you. Dr. Wachter.

Ms. WACHTER. Thank you. I believe that it is very much the ability to earn profits in the short run before technology is widely implemented that encourages innovation, and that is, indeed, part of the reason we have had so much innovation in this sector.

The investors will lose, obviously, if these institutions take on too much risk. This, too, is a safeguard. So it is, in fact, the genius of the private institution with public purposes that I think has accomplished so much and there is more to accomplish yet.

Senator FITZGERALD. All of you, thank you very much. This has really been a great panel. These are some of the best minds in the country on this issue. It was a delight to have all of you here.

Without objection, the hearing record will remain open for any additional statements or questions from Senator through 5 p.m. tomorrow.

With no further business to come before the Committee, this hearing is adjourned. Thank you.

[Whereupon, at 4:20 p.m., the Subcommittee was adjourned.]

APPENDIX

STATEMENT OF

ALEX J. POLLOCK
PRESIDENT AND CHIEF EXECUTIVE OFFICER
FEDERAL HOME LOAN BANK OF CHICAGO

TO THE
SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY

OF THE
UNITED STATES SENATE
COMMITTEE ON GOVERNMENTAL AFFAIRS

ON
"OVERSIGHT OF THE GOVERNMENT SPONSORED ENTERPRISES: THE RISKS AND BENEFITS TO CONSUMERS"

JULY 21, 2003

Good afternoon Chairman Fitzgerald, Senator Akaka, and members of the subcommittee. I am Alex Pollock, President and Chief Executive Officer of the Chicago Federal Home Loan Bank. I appreciate this opportunity to present our views on the costs and benefits of the three housing government sponsored enterprises (GSEs) and how their role in the American mortgage finance sector can be improved.

Allow me first to note that the views I am presenting represent only those of the Chicago Federal Home Loan Bank. As everyone who spends any time with the Home Loan Banks quickly learns, they are twelve different corporations, each with its own board of directors, its own management, and its own views on issues.

The Chicago FHLB provides mortgage financing products to and is entirely owned by our 882 member financial institutions in Illinois and Wisconsin. The twelve FHLBs are owned by more than 8,000 commercial banks, thrifts, credit unions and insurance companies across the country.

The Chicago view on today's topic can be summarized very simply:

> **The best way for Congress to ensure that GSE charter advantages are passed through to homebuying consumers is to encourage greater competition in the GSE sector.**

Our position rests on the belief that the market forces of competition and innovation are the best disciplines for all enterprises, including GSEs. We also recognize that, due to the special

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privileges conferred in GSE charters, only a GSE has the ability to compete with another GSE in the business of funding long-term mortgages.

Over the last 70 years, Congress has created three housing GSEs on different occasions in response to stressful economic events. It is probably not a system that would be designed on purpose from scratch. But all three GSEs have the same essential purpose: to promote housing finance by efficiently linking long-term residential mortgages with the bond markets. While the current structure has certainly advanced the goal of making economical mortgage financing available to most Americans, there is of course room for improvement.

The most evident problem with the current structure is the overwhelming role in the secondary mortgage market of two GSEs, Fannie Mae and Freddie Mac. Notwithstanding the current accounting issues at Freddie Mac, both are extremely capable and impressive companies. However, their enormous presence in the secondary markets is an issue. Last year, for example, available figures suggest they together funded more than 80% of the estimated total of all conforming mortgages made in the country. If you consider a different measure, the total outstanding of all single-family, conventional, conforming mortgages (meaning mortgages for one-to-four family homes of less than $322,700 and excluding government-insured mortgages) Fannie and Freddie appear to own or guarantee about 67% of the total. These estimates are formed by analyzing data from various sources, including the Federal Reserve reports and Fannie and Freddie's own disclosures.

This remarkable market presence, combined with rapid growth, has generated a series of debates about GSEs in which all of the distinguished panelists here today have played a role.

We see three possible outcomes to this public policy debate:

1) The first is the continued expansion and dominating role of Fannie Mae and Freddie Mac in the secondary mortgage market;
2) An alternative outcome would be the complete privatization of the GSEs by removing all their ties to the Federal government;
3) The third is creating a more competitive and economically efficient GSE sector.

In our view, more competition is needed in the secondary mortgage market. It appears to us that this is true of both of the GSE lines of business: credit guaranty and mortgage funding. For example, in 2002, the average guaranty fee charged by Fannie and Freddie was about 19 basis points, or 19 one-hundredths of a percentage point, per year of the outstanding balance of the loans. However, the actual credit losses experienced by the companies averaged less than 1 basis point. Mortgage lenders with high credit quality generally pay a guaranty fee (or insurance premium) which is very high relative to actual losses.

In a market which lacks alternatives, mortgage lenders, particularly smaller, community financial institutions, have had little choice but to pay the costly fees and pass them along to their homebuying customers. At the same time, Fannie and Freddie's growing market share has resulted in the concentration of credit risk in the GSEs. Some observers have called for the removal of all government ties to the GSEs to create a private market solution and insulate the government, and ultimately the American taxpayers, from the GSEs. Although very strong theoretical arguments can and have been made for this position, for example, by my friend Peter Wallison, most people do not believe there is any real chance of privatization occurring in the foreseeable future.

We conclude that, as a practical matter, the only way to improve the secondary mortgage market to benefit community lenders and American homebuyers is through greater competition. Realistically, competition in the mortgage funding business can only come from the third housing GSE, the Federal Home Loan Banks, because to compete with a GSE, you must have the advantages of a GSE.

That is why the Chicago FHLB began in 1997 the Mortgage Partnership Finance® (MPF®) Program to give our member lenders a competitive alternative to selling their mortgages in the secondary market. Unlike the other GSEs, the MPF Program uses a risk-sharing structure to optimally allocate the risks inherent in long-term, fixed-rate mortgage between the lender and the FHLB. Local community lenders, which know their customers better than any GSE can, sell the loans to their Home Loan Bank but continue to be responsible for the principal credit risk in MPF transactions. MPF lenders receive monthly fees to manage the credit risk of their mortgages instead of paying guaranty fees to a GSE. They retain the credit responsibility for their customers, rather than divesting it to a GSE. The Home Loan Banks provide the funding for the loans and manage the interest rate risk -- functions for which they are best suited.

While the MPF risk-sharing structure puts the FHLBs into competition with the other GSEs in the business of funding mortgages, the FHLB members are placed in competition with Fannie and Freddie in the credit risk business. Since well over 500 member lenders are approved to participate in MPF, the Program has created over 500 new competitors to Fannie and Freddie in this business. This development has important implications for American taxpayers because the mortgage credit risk that otherwise would be concentrated in two GSEs is instead dispersed among hundreds of private mortgage lenders.

The MPF Program gives FHLB members a new alternative for financing their customers' homebuying needs and carries out the FHLBs' housing finance mission. Every dollar of MPF funding directly helps a consumer finance a home.

We believe MPF's risk-sharing approach represents a significant step forward in the evolution of mortgage finance. The traditional lending model, in which thrift institutions simply kept the mortgages they made in their own portfolio and thereby kept all the risks associated with the loans, lasted until the interest rate shocks of the 1970s and 1980s exposed the dangers of that approach. From the 1980s until the present, the secondary market model, in which all risks are passed to the GSEs, has been dominant. The creation of MPF and its rapid market acceptance has shown the advantages of allocating risks among parties best suited to manage them.

Since beginning in 1997, the MPF Program has been enthusiastically embraced by mortgage lenders. Today, it is a rapidly growing program that has funded over $100 billion of mortgages in all 50 states and the District of Columbia, helping more than 730,000 families. As mentioned, over 500 FHLB member institutions are approved to participate in the program through nine FHLBs. The other three FHLBs offer a similar program, so today all twelve FHLBs are in the business of funding mortgages as competitors to the other GSEs.

In summary, Mr. Chairman, we strongly believe encouraging competition and innovation among the GSEs is the best way Congress can ensure that GSE benefits are passed through the mortgage finance system to American homebuyers.

Because it is so prominent as a current topic, I would like to add some final observations on the subject of SEC registration by GSEs. We recognize and understand the Administration's policy position on this subject, and have been discussing the specific issues presented by the unusual structure of the FHLBs with all the relevant parties, including the very knowledgeable staff of the SEC.

The FHLBs have always, by statute or regulation, been jointly and severally liable for each other's debt. Under SEC registration, it appears that this situation could give rise to the need for each FHLB to create an additional on balance sheet liability reflecting the "fair value" of this joint and several liability for the combined debt of all the other FHLBs.

Additionally, FHLB stock would be characterized, under current regulations, as being "mandatorily redeemable." As a result, although FHLB stock in my opinion is undoubtedly equity capital, there is a substantial risk under evolving FASB rules that it would not qualify for accounting purposes as equity capital. These circumstances create obvious difficulties for management in the exercise of our fiduciary responsibility unless it can be made entirely clear that FHLB stock, as defined by statute and regulation, will be appropriately treated for accounting purposes.

Of course, these discussions include many other complex technical details, which we continue to work on.

Mr. Chairman, this concludes my written remarks. Thank you again for allowing me the opportunity to present these views. I would be happy to answer any questions you or other members of the subcommittee may have.

Testimony before the Subcommittee on Financial Management
of the
Senate Committee on Governmental Affairs

Oversight of Government-Sponsored Enterprises:
The Risks and Benefits of GSEs to Consumers

July 21, 2003

Peter J. Wallison
Resident Fellow, American Enterprise Institute

Mr. Chairman and members of the Committee:

It is a privilege for me to testify this afternoon on the subject of Fannie Mae and Freddie Mac, and I'd like to congratulate and thank you, Mr. Chairman, for taking on an important task that deserves much more attention from Congress than it has received.

Also, the title of today's hearing, focusing on the costs and benefits of Fannie Mae and Freddie Mac, puts the issue in the right way. It is because the costs of and risks created by Fannie and Freddie overwhelmingly outweigh any benefits they provide that I believe they should be fundamentally changed.

The case against Fannie Mae and Freddie Mac is very simple: they create enormous risks for the government, for the taxpayers, and for the economy as a whole, yet provide no significant benefit to homebuyers. Accordingly, Congress should take steps to cut their links to the federal government. Like the S&L crisis many years ago, procrastinating will only put off the day of reckoning, and the problem will be worse and more costly when Congress is finally compelled to act. Fannie and Freddie have been doubling in size every five years, and now have combined liabilities of almost $3.5 trillion. This is not a problem that can be safely or responsibly put off.

Fannie Mae and Freddie Mac were created for a single purpose—to provide liquidity for the housing finance system by creating a market for the mortgages made by banks and other mortgage originators. They did this very well. There is now a vibrant and efficient secondary market for residential mortgages. The technology has been developed, investors have been educated, and a distribution system has been established. The structure will now operate without government assistance of any kind. In fact, in the so-called "jumbo" market—mortgages larger than Fannie and Freddie are permitted to buy—it operates entirely without any government backing. So Fannie and Freddie are no longer necessary for their original purpose. They should be thanked and sent home.

In fact, Fannie and Freddie know all of this. So they have been diligent in creating a rationale for themselves that does not depend on their providing liquidity to the housing market. They have been advertising instead that they "open the doors to home ownership" by reducing the cost of mortgages, or that they are in "the American dream business" because they enable people to buy homes who might otherwise not be able to do so, or—implicitly—that they help minorities to become homeowners.

However, they do not really do these things. Let me take them one at a time.

Helping people afford homes. The basis for this claim is the correct observation that interest rates on mortgages purchased by Fannie and Freddie are somewhat lower than rates on so-called "jumbo" loans—which are sold in an entirely private secondary market. There have been many studies of the degree to which Fannie and Freddie provide lower interest rates to buyers who can qualify for conventional conforming loans. Table 1, attached, is a compilation of such studies that was presented at an AEI conference in October 2002. It shows that the effect of Fannie and Freddie's activities is to reduce interest rates on home mortgages by a very small amount—somewhere in the range of 25 basis points, or ¼ of 1 percent. If I can put this in perspective, every time the Fed lowers interest rates by one-quarter point, it has the same effect, and the Fed has done this 12 times in the last two years. Similarly, every time the Fed raises interest rates ¼ point it has the opposite effect. If that ¼ point were as important as Fannie and Freddie suggest in their advertising, thousands and thousands of American families would be frozen out of home ownership every time the Fed raises interest rates by ¼ point.

Moreover, this benefit comes almost entirely from the implicit support Fannie and Freddie receive from the government, not because of anything particularly special that Fannie and Freddie bring to the market. The Congressional Budget Office has estimated that in 2000 Fannie and Freddie received implicit government support with a value of about $10.6 billion, of which about two-thirds was actually made available to the mortgage market through lower rates. The balance, presumably, increased the share values of Fannie and Freddie by increasing their bottom line profitability, and went to management compensation.

This small benefit, however, is not a very good argument for continuing the implicit government subsidy. First of all, it's a very inefficient way of subsidizing the housing market. About one-third of the benefit the government has conferred on Fannie and Freddie goes to their shareholders and managements, rather than to create lower interest rates. This is surely an extreme form of corporate welfare, in which two managements and their investors are enriched in order to confer limited benefits on homebuyers. If Congress wants to subsidize housing, it should be able to find a more efficient way to do it.

But second, and much more important, it isn't even clear that the subsidy—limited as it is—goes to homebuyers. It's entirely possible that it simply causes home prices to rise. In other words, it is a subsidy to home sellers and developers. I don't know of any studies that show this—or of any studies that show the opposite—but it is common sense that to the extent that the monthly payments required of homebuyers are reduced, it provides an opportunity for home sellers to raise their prices.

Putting people in homes. Fannie and Freddie argue that the small reduction in interest rates that they pass along to the mortgage markets out of their implicit government subsidy contributes to the growth of home ownership in the United States by helping people buy homes. However, a study by the Census Bureau, also presented at an AEI conference in October, showed that the monthly cost of owning a home is not the obstacle that prevents renters from buying homes. The obstacle is the down payment. Renters do not generally have the financial resources necessary to buy their first home. Accordingly, the claim that Fannie and Freddie put people in homes by reducing interest rates is not true. No amount of interest rate reduction will make it possible for some renters to become homeowners, because the problem for them is not the carrying cost of owning a home—it is the fact that they cannot accumulate the necessary down payment.

This reality led my colleague at AEI, Professor Charles Calomiris, to propose that Fannie and Freddie be completely privatized and the implicit subsidy they now receive used to provide down payment assistance to families who would otherwise be unable to purchase a home. Professor Calomiris estimated that this use of the Fannie and Freddie subsidy would permit more than 600,000 families, now renting, to buy homes.

Helping minority families. Through their advertising, which prominently displays photos of minority families in or in front of what are presumably their homes, Fannie and Freddie suggest that they provide special assistance to minority families hoping to become homeowners. And if they did this disproportionately—that is, helped minorities or low income borrowers more than they helped middle class borrowers—that would be a powerful argument for preserving their current status.

But they do not do this. Instead, according to a study by Jonathan Brown of Essential Information, a Nader-related group, Fannie and Freddie buy proportionately *fewer* conventional conforming loans that banks make in minority areas than they buy in middle class white areas. Other studies have shown that the automated underwriting systems that Fannie and Freddie use to select the mortgages they will buy approve fewer minority homebuyers than similar automated underwriting systems used by mortgage insurers. There is at least one lawsuit against Freddie Mac by a minority homebuyer, arguing that he was unable to get a conventional conforming mortgage because of the exclusionary nature of Freddie's automated underwriting system.

The sad fact is that Fannie and Freddie—two government sponsored enterprises that have a government housing-related mission—do less for minority housing than ordinary commercial banks. Studies have repeatedly shown that banks and other loan originators make more loans to minority borrowers than Fannie and Freddie will buy. That in itself should be a scandal, together with the fact that both companies seek through their soft-focus advertising to create the impression that they are actually using their government benefits for the disadvantaged in our society.

So the US housing finance system gets very little benefit from the continued existence of Fannie Mae and Freddie Mac as government sponsored enterprises. The reduction in interest rates that they can point to as a result of their activities is really the result of their implicit government support, which is small in any case, and is swamped by macro changes in interest rates as a result of economic conditions. In any event, it isn't even clear that the lower rates operate as a benefit to homebuyers rather than home sellers. This small reduction in interest rates does not put people in homes or improve home ownership rates in the United States because most renters lack the down payment necessary to buy a home, not because they could not afford the monthly carrying cost of homeownership. And finally, despite the implications of their advertising, Fannie and Freddie seem to discriminate against minority homebuyers rather than assist them.

The costs of Fannie and Freddie

So the benefits of continuing Fannie and Freddie as GSEs are meager to non-existent. What then are the costs?

I have already cited the CBO estimate that Fannie and Freddie receive an implicit subsidy from the US government—in effect an extension of US government credit—with an annual value of at least $10.6 billion. That, however, is not the extent of their cost to the taxpayers. Because their securities directly compete with Treasury securities—in fact they have begun to issue securities on a regular schedule, just like the Treasury, in order to be a more effective substitute—they cause Treasury interest rates to rise slightly, probably by a few basis points. On a total Treasury debt of several trillion dollars, those few basis points amount to hundreds of millions of dollars annually.

But these two costs do not begin to describe the costs to the government, the taxpayers and the economy of allowing Fannie Mae and Freddie Mac to continue to grow. Because Fannie and Freddie are implicitly backed by the US government, financial problems at either of them could require a government bailout. This is what Congress has had to do with other GSEs—most recently the farm credit system in the mid-1980s—and there is no reason to suppose that Congress would not step in if Fannie or Freddie, or both, were in financial trouble.

Until June of this year, when Freddie Mac dismissed its top three officers and announced that it would have to do a considerably bigger financial cleanup than we initially thought necessary, it was possible to say that both Fannie and Freddie were in strong financial condition and that there was no prospect of a bailout. Since then, however, there has been much more scrutiny of the financial statements of both companies, and at least some observers have pointed out that while Freddie might have been more profitable than it reported during the three years ending in 2002, Fannie Mae might actually have lost money, or made no profits, last year. That is not what Fannie reported, which was of course another huge annual increase in profitability. The problem is, because of the malleable nature of Generally Accepted Accounting Principles (GAAP), we don't really know how these complicated companies are doing. We would get a better picture of Fannie and Freddie's actual condition with better cash flow reporting, but that is not currently required by GAAP or the SEC.

In any event, however they are doing today, changes in interest rates and the economy generally could have a significant adverse effect on their financial health in the future, and the taxpayers are ultimately responsible for assuring that they meet their obligations. It is important to remember in this connection that, at the end of 2002, Fannie and Freddie had aggregate outstanding debt of $1.5 trillion, and aggregate outstanding guarantee obligations of $1.8 trillion—almost $3.5 trillion in liabilities. Even a small part of this obligation—if it has to be made up by the taxpayers—will make the S&L bailout look like a dimestore operation.

But even that does not end the risks we all face with these two companies. Because they are integral to the health of the housing market, the failure of either of them could have a systemic effect—meaning an adverse effect on the economy as a whole. It's relatively easy to see how this might happen. Fannie and Freddie, together, purchase almost all the conventional conforming mortgages that come on the market each year. They currently hold or guarantee 75 or 80 percent of all conventional conforming mortgages and almost half of *all* residential mortgages in the United States. If either Fannie or Freddie were to lose the confidence of the capital markets, and were unable to purchase their share of new mortgages as these came on line, the entire residential finance system would be seriously disrupted—at least temporarily. Interest rates would rise and residential mortgages would be harder to get. This would rapidly affect the rest of the economy. Home sales would decline, construction would fall, sales of furnishings and appliances would suffer.

This effect would be bad enough as it ripples through the economy. Much worse would be the effect on the financial system as a whole. Large numbers of banks and other financial institutions are major investors in the securities of Fannie and Freddie. They are encouraged to buy and hold Fannie and Freddie securities by a statutory exemption for these securities from regular restrictions on loans to one borrower. Declines in the value of Fannie and Freddie securities will reduce, and in some cases impair, the capital of all these financial institutions. Reduced or impaired capital will reduce the amount of credit they can provide, even outside the mortgage markets.

Altogether, then, the effects of a failure or severe financial crisis at either Fannie or Freddie could be systemic in character, not limited to the home mortgage markets. And since there are only two of these companies, it is accurate to say that the continued health of our economy depends on decisions by only two corporate managements. If one of them makes a grave mistake, the entire economy could suffer. And the recent events at Freddie Mac show that management judgments are far from infallible. We don't know the extent of the problems at Freddie, but we do know that the top management made serious errors of judgment. These, fortunately, do not appear to threaten systemic effects, but errors of judgment come in many shapes and sizes, and one day the error may be of a kind that cannot be repaired by accountants working around the clock.

What to do

So what is to be done? We have a situation in which two companies create enormous risks for the taxpayers and the economy, but offer little in the way of benefits to anyone. Congress has it within its power to change this calculus in a number of ways. My preferred answer would be to privatize Fannie and Freddie and at the same time break them up into five or six smaller entities. In nature, diversity protects a species; in finance, diversity can protect an economy.

However, I am aware that this solution is not for the moment on anyone's radar screen. So I have a more modest proposal: Congress should prohibit Fannie and Freddie from buying back or accumulating any substantial portfolio of mortgages or mortgage backed securities (MBS).

Today, these companies do business in two very different ways: (i) they create pools of mortgages which are used to collateralize MBS that they guarantee and sell to investors, and (ii) they buy whole mortgages and repurchase the MBS they have already sold to investors.

These are two very different ways of performing their functions, and have very different consequences. When Fannie and Freddie create pools of mortgages and sell MBS backed by these pools, they are guaranteeing that investors will receive a stream of revenue derived from the interest and principal paid into the pools by homeowners paying off their mortgages. In this case, Fannie and Freddie are taking only credit risk—the risk that homeowners will not meet their mortgage obligations. This is not a very significant risk, especially today, when losses on mortgage pools have been running at 1 or 2 basis points.

However, buying and holding mortgages or MBS is an entirely different story. In that case, Fannie and Freddie must take interest rate risk in addition to credit risk. Interest rate risk—that rates will rise or fall—is a far greater risk than credit risk, and requires Fannie and Freddie to buy derivatives of various kinds to protect themselves against the vicissitudes of the credit markets. To put this in perspective, it was interest rate risk that caused the failure of the S&Ls. They were holding mortgages that were paying, say, 5 percent, but in order to finance these loans they had to pay 10 or 12 percent for their funds. With a negative spread like that, they weren't solvent for very long. Fannie and Freddie are in the same position, but their risks run two ways. The same thing happens to them if interest rates suddenly go up—they are holding mortgages that may yield less than the new rate they have to pay for their funds. But they also run risks if interest rates go down, since a portion of their portfolio is funded with longer term debt. If interest rates decline, homeowners refinance, and Fannie and Freddie end up holding, say, 4 percent mortgages, that they've funded with 5 percent liabilities. Another losing proposition.

Why, you might ask would Fannie and Freddie take such risks? Why would they buy back from investors the MBS on which the investors are already taking the interest rate risk? The answer is that, even after buying all that hedging protection through derivatives, it is still profitable for them to buy and hold their own MBS. In fact, it has been estimated that Fannie and Freddie own, in the aggregate, 34 percent of all MBS currently issued. With their government backing, they can borrow money at rates low enough so that they can do a rather simple arbitrage, profiting from the spread between their cost of funds and what the MBS are yielding.

Now one might think that somehow buying back their MBS will have the effect of lowering interest rates for mortgages, but this is not the case. Economists point out that borrowing funds to buy back other credit instruments is simply a wash. It doesn't have any effect on mortgage rates, which are a product of all the funds available in the capital markets.

Accordingly, what we have here is the classic case of privatizing the profits and socializing the risk. Fannie and Freddie profit from arbitraging their government backing, but the people really taking the risk are the taxpayers.

Accordingly, if Congress does not currently have the stomach for privatizing Fannie and Freddie, it can at least reduce the risk they pose to taxpayers and to the economy generally by prohibiting them from buying back the MBS they issue and from holding a large portfolio of mortgages. Instead, their activities should be limited to forming pools of mortgages and selling MBS that they guarantee. The risks on this—which is simply credit risk—are far less than the interest rate risk they have been taking, and it would have no effect on mortgage interest rates.

This is at least a temporary solution to the problems posed by Fannie Mae and Freddie Mac. It significantly reduces the risk that these two enterprises currently create for taxpayers and the economy, but it would not have any effect on interest rates on conventional conforming mortgages.

That concludes my testimony, Mr. Chairman.

Oversight of Government-Sponsored Enterprises: The Risks and Benefits of GSEs to Consumers

Testimony by

Bert Ely

to the

Subcommittee on Financial Management, the Budget, and International Security

of the

Senate Committee on Governmental Affairs

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Oversight of Government-Sponsored Enterprises: The Risks and Benefits of GSEs to Consumers

by Bert Ely

I -- Introduction

Mr. Chairman, Ranking Member Akaka, and members of the Subcommittee, my name is Bert Ely and I am here to testify today with regard to America's government-sponsored enterprises, or GSEs. I am a financial institutions and monetary policy consultant in Alexandria, Virginia, with a long-standing interest in GSE issues. I am testifying on my own behalf today as I am not being paid for this appearance before the subcommittee.

While my testimony will focus on Fannie Mae and Freddie Mac, at times my testimony will touch on three other GSEs -- the Federal Home Loan Bank System, comprised of twelve Federal Home Loan Banks (FHLBs), the Farm Credit System (FCS), comprised of 105 Farm Credit banks and associations, and Farmer Mac. I will not discuss Sallie Mae, the sixth GSE, since it is well on its way towards being fully privatized. In the interest of full disclosure, I consult on a regular basis to the American Bankers Association with regard to FCS matters.

During my testimony this afternoon I will first briefly summarize the major problems Fannie and Freddie pose today and then discuss what we do not know today about the two companies. After discussing underlying problems caused by Fannie's and Freddie's GSE status, I will analyze proposed tweaks to the GSEs. Many of these tweaks have merit, but they are insufficient to solve the GSE problem. I will conclude my testimony by discussing longer term solutions to the GSE problem, including my proposal for completing privatizing Fannie, Freddie, and the other GSEs. Once the GSEs have been privatized, then there will be no need for government oversight of GSEs, the topic of this afternoon's hearing.

During the course of my testimony, I will refer often to a paper I will present this fall which will explain in great detail my proposal for fully privatizing Fannie and Freddie. Time constraints and the preliminary state of that paper preclude a detailed discussion of my privatization proposal this afternoon.

II -- The Fannie/Freddie Problem Today

There has been ample discussion in recent months of the Fannie/Freddie problems that exist today, so I will merely summarize them in my testimony. We must keep in mind, though, that Fannie's and Freddie's problems, and problems with GSEs generally, will continue to grow.

A -- Relatively rapid growth, leading to increased market share and marketplace tensions

The Fannie/Freddie problems today, and the broader GSE problem, stem from the GSEs' relatively rapid growth. This growth has been facilitated by the numerous congressionally granted privileges all GSEs enjoy. Growth in turn has been driven by management desires to enhance the personal wealth of GSE executives as well as the wealth of stockholders in the three stockholder-owned GSEs -- Fannie, Freddie, and Farmer Mac. The two cooperatively owned GSEs -- the FHLBs and the FCS -- have seen rapid growth in the compensation of their chief executive officers and others in senior management.

Higher executive compensation and rising GSE stock prices stem from the fact that the GSEs have been gaining market share in their respective markets. Far from being docile creatures and passive lenders of last resort in their markets, they have become aggressive competitors capitalizing on their preferential GSE status. In order to continue their rapid growth, the GSEs have repeatedly stretched their congressional charters, or missions, to find new areas of business to dominate. Not only have Fannie and Freddie pushed the envelope in the home mortgage lending field, but the FHLBs increasing compete with Fannie and Freddie through the MPF (mortgage partnership finance) program, the FCS increasingly finances non-farm activities and rural estates, and Farmer Mac has grown by providing credit enhancements to FCS associations.

Had the GSEs stuck to their knitting and not tried to dominate the markets they serve, we probably would not be here today discussing their problems and their fates. But, as could be predicted of human beings playing on a field tilted in their favor, that has not been the case. Hence today's hearing.

B -- Increased systemic risk as Fannie and Freddie continue to grow

In addition to being unfair competitors, the GSEs pose increased systemic risk to the U.S. financial system, and therefore to taxpayers, by virtue of their GSE status. Not only are Fannie and Freddie in particular too big to fail, but should either company get into serious financial trouble, Congress will surely ride to their rescue. The financial markets clearly believe that Congress will rescue any troubled GSE, and more importantly its debt holders, and for good reason -- Congress has done it twice before. Consequently, GSE debt carries yields that lie between the Treasury yield curve and yields on highly rated corporate debt. As the rating agencies readily admit, they award AAA ratings on GSE debt simply because that debt has been issued by a GSE.

The first GSE rescue occurred in 1987, with congressional enactment of a $4 billion line of credit for the FCS, which had been crippled by the collapse of farmland values in the early and mid-1980s, following FCS inflation of a farmland bubble in the 1970s.[1] Interestingly, the FCS bailout protected the equity contributions of its farmer owner-borrowers in addition to FCS debt. It therefore is an open question if Congress would protect stockholders or subordinated debt holders in the three stockholder-owned GSEs if one of them needed a congressional rescue.

The second GSE rescue occurred nine years later when Congress broadened the assessment base for deposit insurance premiums levied to pay $800 million annually of interest on bonds issued by the Financing Corporation, or FICO. FICO was a special purpose corporation Congress created, in the Competitive Equality Banking Act of 1987, to finance the early stages of the cleanup of the S&L debacle. FICO issued $8.17 billion of bonds between 1987 and 1989, with interest on them to be paid from a special deposit insurance assessment on S&L deposits. By 1996, shrinking deposits in a contracting S&L industry fueled concerns that FICO would default on its interest payments, which were not explicitly guaranteed by the federal government. Congress eliminated that default threat, in the 1997 omnibus appropriations bill, by broadening the FICO assessment base to include deposits in commercial and savings banks insured by the FDIC's Bank Insurance Fund.

The potential for a third GSE rescue has been heightened in recent weeks by the troubling revelation of serious accounting problems at Freddie Mac. Should those problems worsen, and extend to Freddie's risk-management practices, then a congressional rescue of Freddie, and its Siamese twin, Fannie Mae, will become increasingly likely. The systemic risk posed by these two companies was explored in "Nationalizing Mortgage Risk: The Growth of Fannie Mae and Freddie Mac," a monograph my fellow witness, Peter Wallison, and I wrote three years ago.[2] This potential for a third GSE rescue, and steps which can be taken to prevent it, should bring the GSE problem to the forefront of congressional concerns.

III -- We Don't Fully Know What We Don't Know Today

Particularly troubling is that we don't fully know what we don't know today about America's two biggest GSEs -- Fannie and Freddie. Freddie's recently disclosed accounting problems should greatly heighten congressional concerns about what Congress, and the public, do not know about these two companies.

A -- Freddie Mac's serious accounting problems

Freddie has been undergoing a slow strip-tease since January 22 of this year, when it announced that it was being forced by its new outside auditors, PriceWaterhouseCoopers (PwC), to restate its financial statements for 2000 and 2001 prior to issuing audited financial statements for 2002.[3] The news from Freddie has gotten only worse since then, culminating in the June 6 termination of three top officers, including Freddie's long-time chief executive officer (CEO), Leland Brendsal, and its long-time chief operating officer, David Glenn. A forthcoming investigative report by a law firm retained by the Audit Committee of Freddie Mac's Board of Directors may reveal even greater accounting problems at Freddie Mac.

Since June 9, Freddie has disclosed the breadth of the reaudit now underway, which encompasses "several hundred thousand securities records" reaching back into the 1990s[4] and the July 11 news report that Freddie will not complete its registration under the Securities and Exchange Act of 1934 (1934 Act) until mid-2004, two years after Freddie volunteered to register with the Securities and Exchange Commission (SEC) under that act.[5] I am puzzled, and troubled, that it will take Freddie nine months, or more, to complete its registration with the SEC after it issues restated financial statements through 2002, which it has claimed it will do by September 30 of this year. Perhaps Freddie's management is setting us up for a further delay in the issuance of its restated financial statements. Congress should demand that the new management at Freddie publish a detailed timetable for getting Freddie registered under the 1934 Act.

This witness's accounting and financial experience, gained over almost four decades, has been that the initial bad news about a company's financial problems is rarely the last bad news. Instead, the strip-tease usually continues, as probers dig deeper and deeper into the bowels of the troubled company's accounting. I am absolutely shocked, and appalled, by the depth and scope of Freddie's accounting problems, as they have been revealed to date, most recently in testimony last Thursday to the Senate Banking Committee by Armando Falcon,[6] the outgoing director of the Office of Federal Housing Enterprise Oversight (OFHEO). OFHEO is an independent agency within the Department of Housing and Urban Development (HUD).

So far, Freddie's problems have been characterized as just accounting problems driven solely by a desire to smooth earnings from one quarter to the next so as to maximize Freddie's stock price, and therefore the compensation of its executives. However, despite assertions by Director Falcon and Freddie officials, we should not be surprised if the ongoing investigation of Freddie's finances reveals serious problems in Freddie's risk management practices. Far from being the more conservatively managed of the Siamese twins, as was widely believed, it appears that Freddie was possibly the more recklessly managed company.

Concern that Freddie's problems might extend to its risk-management practices was expressed quite strongly at last Thursday's Banking Committee hearing by Senator Jon Corzine. As a former co-CEO of Goldman Sachs & Co., one of the largest and most sophisticated investment banking firms in the world, Senator Corzine is perhaps better placed than any other member of the United States Congress to express that concern. Mr. Chairman, as an experienced banking lawyer, you, too, may share Senator Corzine's concerns. Mr. Chairman and members of the Committee, prepare yourself for more bad news, and perhaps much worse news, to spew from Freddie Mac.

At this time, it is difficult to believe that Fannie's accounting and risk-management practices are flawless, or anywhere near flawless. Can we believe that of two fast-growing companies which are so alike in many ways, one badly bungled its accounting while the other has not? Hopefully OFHEO's just-announced review of Fannie's accounting practices will give us some comfort in this regard.

B -- Inadequate financial disclosures by both companies

One reason we don't know what we don't know about Fannie as well as Freddie stems from their inadequate financial disclosures. Despite their pretty annual reports, financial statements issued in compliance with Generally Accepted Accounting Principles (GAAP), table-ladened information statements, and now SEC filings in the case of Fannie, there is much we do not know about the financial risks they have assumed, particularly the risks associated with the interest-rate derivatives contracts they have entered. I will not dwell on these material disclosure shortcomings in this testimony as I catalogued them in a paper I wrote last year, "Fannie Mae's and Freddie Mac's Financial Disclosures: How Do They Stack Up." That paper, which I wrote for an American Enterprise Institute (AEI) conference, is appended to this testimony.[7]

While Fannie boosts, and once upon a time Freddie boosted, about their compliance with GAAP, the breadth of their financial and operational disclosures, and their voluntary registration with the SEC (but only under the 1934 Act), it is not enough for these two companies to match the financial and operational disclosures of genuine private-sector firms. Instead, as GSEs which pose enormous systemic and taxpayer risks, Fannie and Freddie should provide much more detailed and timely disclosures about their activities and financial condition. In particular, Fannie should commit, as Freddie has done, to issue quarterly "fair value" financial statements, as prescribed under Financial Accounting Standards (FAS) No. 107. Presently, FAS 107 disclosures have to be provided only annually, in a footnote to audited financial statements. It was unfortunate that Tim Howard, Fannie's chief financial officer, would not commit Fannie to quarterly FAS 107 disclosure statements during a July 15, 2003, conference call with stock analysts and investors.

C -- Insufficient disclosure comparability between Fannie and Freddie

Apart from inadequate financial and operational disclosures, there is a troubling lack of comparability in the disclosures of the two companies. These two companies are unlike any other financial firm in the world, yet their business strategies have converged greatly in recent years until today, Freddie in many ways is Fannie times four-fifths. While their top-level financial statements are sufficiently similar that they can be compared, without too much work, their detailed disclosures, in financial statement footnotes and their Management's Discussion and Analysis of Financial Condition and Results of Operations, are not, particularly with regard to their derivatives. Fannie will disclose information about "A" but not "B" while Freddie will do the reverse. My 2002 AEI paper on Fannie's and Freddie's financial disclosures discusses this lack of comparability on pages 7 to 10.

In addition to providing comparability on a much more detailed level, Fannie and Freddie should provide extensive, comparable disclosures about meeting their obligations as GSEs, notably their obligation to finance affordable housing. My 2002 AEI paper discusses these unique disclosure obligations on pages 10 and 11.

D -- A flawed risk-based capital stress test for Fannie and Freddie

Director Falcon and others have tried to soothe congressional and public concerns about Freddie's financial condition by stating that the financial restatement process now underway will not, or in any event should not, alter the results of its quarterly risk-based capital stress test. Fannie and Freddie are subjected to this test under a provision of the 1992 legislation which created OFHEO. Senator Corzine expressed great skepticism about this assertion at last Thursday's hearing, causing Director Falcon to back off somewhat, promising the rerun Freddie's past stress tests utilizing Freddie's restated financial information.

What has not been challenged is the efficacy of the stress test itself. While OFHEO has been diligent in implementing the test, which is prescribed in excessive detail in the authorizing statute (12 U.S.C. §4611-14), the test is both outdated and too rigid, given its statutory definition. Congress designed this test with the S&L fiasco fresh in mind, and specifically the $123 billion taxpayer bailout of the late and little-lamented Federal Savings and Loan Insurance Corporation (FSLIC)[8]. In particular, the test envisions as a key stress on Fannie and Freddie a sudden and prolonged 600 basis point (6%) shift in interest rates over a specified period of time and lesser shifts in interest rates over longer time periods. This focus on massive interest-rate swings reflects the interest-rate history of the late 1970s and early 1980s, when most of the maturity-mismatched S&L industry, as well as Fannie, dropped into insolvency, on a market-value basis, as high interest rates devastated the market value of their fixed-rate mortgages.

The stress test, to date, has been applied on a static basis. That is, the test assumes that the GSE will not purchase any new mortgages during the 10-year "stress period," other than those it already has committed to purchase (12 U.S.C. §4611(a)(3)(A)). In effect, the GSE will be assumed to be operating in a wind-down or "run-off" mode. That is a highly unrealistic assumption which ignores the impact on the housing marketplace if Fannie or Freddie suddenly stopped purchasing mortgages or committing to do so. Assuming the GSE would continue purchasing mortgages would have the effect of increasing its capital requirement under the stress test because its total assets and outstanding guarantees would increase due to the additional mortgage purchases. The OFHEO Director may, after conducting the appropriate studies, run the stress test based on the assumption that the GSE will continue to purchase mortgages (12 U.S.C. §4611(a)(3)(B)), "additional new business." However, that testing procedure has not yet been implemented.

The United States, and the industrialized world, operate in a very different interest-rate environment today. In particular, the financial markets have become extremely effective in crippling the ability of the Federal Reserve and other central banks in distorting interest rates to serve political ends. Sadly, Japan remains an exception to this healthy trend. Hence, the stresses upon Fannie and Freddie that Congress anticipated in 1992 are highly unlikely to strike today or in the future. The financial events that trigger a future crisis will have quite different roots, possibly in the financial derivatives Fannie and Freddie use to hedge the substantial on-balance-sheet interest-rate risk they deliberately take to enhance their profitability. The old saw, that generals always are fighting the last war, certainly applies to the Fannie/Freddie risk-based capital stress test Congress enacted eleven years ago. Neither Congress nor anyone else should take comfort in that test today or in the future.

IV -- The Underlying Problems Caused by GSE Status

Rather than dwell further on what we don't know about what we don't know about Fannie and Freddie, I want to summarize many underlying problems caused by the special status, privileges, and benefits Congress has granted to the GSEs, and particularly to Fannie and Freddie. I will explore these underlying problems in much greater depth in my forthcoming paper on how to privatize Fannie and Freddie.

A -- Yield curve arbitraging by virtue of being a GSE

All five GSEs finance their balance sheets in much the same manner that S&Ls did before the interest-rate crisis of the early 1980s rendered most S&Ls, and Fannie, temporarily insolvent (on a market-value basis), and in some cases, permanently insolvent. That is, they borrow short and lend long, or to use a more technical term, they engage in maturity mismatching. They then partially, but only partially, hedge the on-balance-sheet risk which derives from maturity mismatching by entering into interest-rate derivatives contracts, such as interest-rate swaps, swaptions (options on swaps contacts), interest-rate caps, and basis swaps. Maturity mismatching is an especially profitable activity during times, like recent years, when the interest rate yield curve is quite steep (short-term interest rates are substantially lower than long-term rates) and when mortgage prepayments are running at a high rate.[9]

While Fannie and Freddie do not publish an interest-rate "gap analysis" comparable to the gap analysis provided by the FCS and private-sector banks and thrifts, the average maturity of their short-term liabilities (due or repriceable within one year) can be estimated from their balance sheets and statement of cash flows. During 2002, Fannie's short-term debt accounted for 45% of its senior, unsecured debt. That short-term debt rolled over approximately 4.5 times in 2002, suggesting an average maturity of 81 calendar days. Freddie operated further down the yield curve in 2001 (2002 numbers are not yet available due to the restatement process now underway). While short-term debt accounted for 44% of Freddie's senior debt in 2001, it rolled that debt approximately 9.3 times during 2001, for an average maturity of 39 calendar days. Fannie and Freddie pale, though, in comparison to Farmer Mac, which in 2002 funded 67% of its balance sheet with short-term debt with an average maturity of just 16 calendar days.

In my opinion, a private-sector mortgage investor could not safely operate today with such a high degree of maturity mismatching. In fact, America's banks and thrifts engage in much less maturity mismatching, and with higher capital levels, than do Fannie, Freddie, and the other GSEs. I attribute the greater degree of maturity mismatching, and the greater risk associated with that mismatching, to the GSE status of the five entities.

B -- America suffers from an inefficient housing finance system

A statement made repeatedly, by members of Congress, other public officials, Fannie and Freddie, academics, and just about anyone else familiar with housing finance is that America has a highly efficient housing finance system. My forthcoming paper on privatizing Fannie and Freddie will challenge this widely held, almost religious belief.

In fact, America has an inefficient housing finance system, and an especially inefficient mortgage refinancing process, stemming from its reliance upon the secondary mortgage marketplace and the creation of mortgage-backed securities (MBS) to spread both interest-rate risk and in some cases credit risk across the U.S. economy. Creating mortgages, including refinance mortgages for sale and securitization in the secondary mortgage market, is a very expensive process. In effect, substantial real resources are expended to move small assets (mortgages) from mortgage originators to sources of debt capital. My forthcoming paper will argue that it would be more efficient to move large blocks of long-term, fixed-rate debt capital to mortgage originators who retain the ownership of the long-term, fixed-rate mortgages they originate. This is especially true for refinance mortgages; the refinancing process is simply a loan repricing, with perhaps a few thousands dollars tacked onto the loan amount. A straight-forward loan repricing should not cost $1,500, or more, yet today it does because the repriced loan must be saleable in the secondary mortgage market.

In my opinion, Fannie and Freddie have played a key role in fostering the secondary mortgage market albatross that has saddled America with an inefficient housing finance system. They do this in two ways -- first by arbitraging their GSE status, as discussed above, and second, by arbitraging bank capital requirements through the lower capital requirements under which they operate. Interestingly, the pending Basel II revision of bank capital requirements, at least as they will apply to America's ten to twenty largest banks, will significantly reduce Fannie's and Freddie's capital arbitraging opportunities. However, Basel II, if it ever kicks in, will not take effect for at least five years, and perhaps much longer.

In other words, banks and thrifts, as major mortgage originators and potential holders of long-term mortgages, operate at a competitive disadvantage to Fannie, Freddie, and non-bank investors because, one, they do not enjoy the GSE funding and maturity mismatching opportunities and, two, they have to hold more capital against their residential mortgage assets. Consequently, tens of billions of dollars are being spent annually to arbitrage artificial and unnecessary capital standards and the GSE concept. That is a terrible and indefensible waste of scarce economic resources.

C -- GSEs distort capital flows within the U.S. economy

GSEs lower the cost of debt capital for those who can borrow from a GSE or whose debt is secured by a GSE loan guarantee. This lower cost tilts capital flows towards those sectors of the economy favored under the GSE authorizing legislation, notably housing and to a much lesser extent, financially stronger segments of agriculture and rural America.

Given that there is a finite amount of savings during any time period, this tilt toward GSE-favored borrowing drains debt capital away from other sectors of the economy, notably the productive sector; i.e., non-farm businesses. Little wonder then, that middle-class and upper-middle-class Americans live in larger and larger homes amidst a growing urban sprawl. These outcomes were not intended when the GSEs were created. Therefore, the desirability of these outcomes should be subject for the first time to a political debate.

D -- GSEs tilt financial intermediation away from genuine private-sector firms

Less obvious than their distortion of capital flows is the steady shift underway in the United States towards GSE financing and away from genuine private-sector financial intermediation. Of course, officers and directors of the GSEs' private-sector competitors are keenly aware of this shift, but they are few in number. Because GSEs are political creatures, it is extremely difficult to correct this shift, as FM Policy Focus (formerly FM Watch) and its allies have learned, to their great dismay.

Japan and Germany, with the world's second- and third-largest economies, respectively, have financial intermediation systems even more heavily dominated by GSEs, although they are not called that in those countries. Japan, of course, has its Postal Savings System as well as several quasi-governmental financing entities, while Germany has several thousand state and municipally controlled public savings banks and co-operative banks that dominate German banking. It is not surprising that these two countries have deeply troubled economies, and especially Japan, financed by even more deeply troubled banking systems dominated by GSEs which have successfully resisted meaningful reform. China is an even more extreme example, with a banking system dominated by four large, state-owned banks burdened with hundreds of billions of dollars of bad loans.[10]

While America's GSE problem has not reached Japanese or German proportions, the trend is clearly in that direction. This trend must be reversed before it worsens. My forthcoming paper on how to privatize Fannie and Freddie will explain how that reversal can be executed.

E -- GSEs create marketplace rigidities that impair housing finance efficiency

Because of their statutory construct, Fannie and Freddie, as well as the other three GSEs, represent relatively rigid features of the American financial landscape. They are not subject to the market forces that ebb and flow through the economy, triggering the birth, decline, disappearance, and rebirth of genuine private-sector entities. Hence, even as they gobble up market share, capitalizing on their GSE status, the GSEs are largely exempt from market forces constantly reshaping the financial institution landscape. Hence, market forces cannot reshape the American financial system as freely as they should. Instead, market forces have to work around the presence of the GSEs, as if the GSEs were boulders plopped in the middle of a fast-flowing stream, distorting the currents coursing along. Marketplace rigidities are costly, particularly because of the work-around factor. Whatever good a GSE might initially provide, that good soon disappears as the marketplace adjusts to new realities.

F -- Fannie and Freddie are inefficient in delivering a housing finance subsidy

Reports issued by the Congressional Budget Office (CBO) in 1996 and 2001 quantified the extreme inefficiency of Fannie and Freddie in delivering a housing finance subsidy. Approximately 37% of the subsidy was consumed by Fannie and Freddie in 2000, in terms of higher profits for their stockholders and higher compensation for their executives[11]. The retained portion of the subsidy largely explains the substantial above-market rates of return Fannie and Freddie consistently earn on their equity capital.

G -- Some portion of the housing finance subsidy may flow to home sellers

The CBO deliberately avoided the question of who within the homeownership community receives the subsidy not retained by Fannie and Freddie. That is, how much of this subsidy flows to home purchasers, the intended recipient of the subsidy, versus sellers of existing homes and builders of new homes? To the extent the Fannie/Freddie subsidy is capitalized in housing prices, the subsidy flows to the sellers of homes, not purchasers. It is extremely difficult to estimate the division of this subsidy between buyer and seller, but housing prices do not have to rise very much to fully capitalize the subsidy, thereby shifting all of it to sellers.

The widely accept estimate of the Fannie/Freddie subsidy is 1/4% to 3/8%. That is, "conventional/conforming" mortgages purchased by Fannie and Freddie carry interest rates that are lower by 1/4% to 3/8%. Given present interest rates for the typical 30-year, fixed-rate mortgage, housing prices would have to rise just 2% to fully capitalize a 1/4% interest-rate subsidy; a 3% rise would fully capitalize a 3/8% subsidy. The question of who actually gets the Fannie/Freddie housing finance subsidy warrants a much closer examination.

H -- Only a small portion of the Fannie/Freddie subsidy flows to individuals on the cusp of home ownership

Fannie and Freddie widely advertise that they promote home ownership and have played a significant role, if not the dominate role, in raising the home-ownership percentage, a political goal that possibly ranks even higher than mom and apple pie. That is a highly dubious assertion as much of the Fannie/Freddie subsidy flows to middle-class homebuyers who have ample means to purchase a home without a financing subsidy (in part because they have sufficient funds for a down payment).

A substantial portion of the subsidy flows to existing home owners who are buying a larger, newer and/or better located home and to home owners who are refinancing the mortgage on the home they presently own, and plan to keep. Of course, these home owners already enjoy substantial tax benefits through tax deductions for interest paid on a home mortgage and real estate taxes paid plus the exemption of the capital gain upon the sale of a primary residence from the capital gains tax. This is another topic that warrants further investigation -- how much do Fannie and Freddie really help to raise the home ownership percentage?

V -- Proposed Tweaks to the GSE Problem Have Merit, But Are Insufficient

Numerous proposals have been put forth in recent years to rectify problems and risks Fannie and Freddie pose. I will comment briefly on these proposals, all of which represent tweaks on the operation and regulation of Fannie and Freddie rather than a major alteration in their corporate status.

A -- Full SEC registration by Fannie and Freddie

Reps. Christopher Shays and Edward Markey have introduced H.R. 2022 to bring Fannie and Freddie under the full scope of all SEC laws and regulations, and specifically the Securities Act of 1933, governing the registration of securities offered for sale to the public, and the Trust Indenture Act of 1939. This is a simple and easily executed reform, as evidenced by the fact that H.R. 2022 is merely a seven-page bill. Among other objections, Fannie and Freddie oppose paying SEC registration fees. However, a provision added to this year's version of Shays-Markey would hold their SEC assessments to a reasonable amount. Despite Fannie's and Freddie's vigorous protests, this is a straight-forward and obvious reform, particularly in light of Freddie's extremely serious accounting problems. Interestingly, Congress did not exempt Farmer Mac from SEC registration.

B -- Restructuring GSE regulation

Several proposals have surfaced that would restructure GSE regulation, or at least for Fannie and Freddie. Rep. Richard Baker recently introduced H.R. 2575, which would merge OFHEO into the Office of Thrift Supervision, which would be renamed the Office of Housing Finance Supervision, within the Treasury Department. Fannie's and Freddie's mission regulation would continue with HUD. While this restructuring would place OFHEO within a much larger financial agency, it makes little sense to combine GSE regulation with the regulation of a set of private sector institutions, thrifts (savings and loans and savings banks), operating increasingly as if they were commercial banks.

Rep. Ed Royce will soon introduce a bill that would merge OFHEO with the Federal Housing Finance Board in a new office within Treasury. This is a sensible approach that should be enhanced by also merging the Farm Credit Administration (FCA) into this new agency. The FCA regulates the FCS and Farmer Mac. The new agency would then regulate the five active and continuing GSEs, a concept Federal Reserve Chairman Alan Greenspan endorsed last Wednesday.[12]

Moving boxes around the government organization chart will not address the myriad of problems associated with the GSEs, and Fannie and Freddie in particular. Much more basic reforms are needed, as I will discuss in the last portion of my testimony today. Further, the political battling surrounding exactly how to restructure GSE regulation could drag on for several years. Therefore, it would be better to skip redrawing organization charts and move directly to fundamental reform, as I will discuss shortly.

C -- Increase OFHEO's budget and powers

On many occasions, most recently in his Senate Banking Committee testimony last Thursday, Director Falcon has pleaded for a bigger budget and stronger enforcement powers, as if that is all that is needed to solve the Fannie/Freddie problem. That seems to be the lament of failed regulators -- I need more money and more enforcement power. Interestingly, several members of the Senate Banking Committee expressed great skepticism about the payoff of giving OFHEO a bigger annual budget. Exempting OFHEO from the appropriations process does not address the question of how to determine the amount OFHEO can levy on Fannie and Freddie to cover its expenses. It is unlikely that Fannie and Freddie will accept the notion that OFHEO should have a blank check on their bank accounts.

D -- Eliminating state income tax exemptions

One of the many privileges Fannie and Freddie enjoy, along with the FHLBs and the FCS, is an exemption from state income and franchise taxes. Profits the FCS earns from loans secured by real estate also are exempt from federal income taxes; this is a particularly indefensible exemption.[13] Rep. Pete Stark recently proposed repealing this exemption for Fannie and Freddie. It would be highly meritorious to repeal this tax exemption for all GSEs, but that will be extremely difficult to accomplish in the present political environment.

E -- Repealing the so-called Treasury line of credit

Repealing the so-called Treasury line of credit that the stockholder-owned GSEs have at the Treasury would be symbolic for Fannie and Freddie; it would have a similar effect on the FHLBs but a more substantive effect on Farmer Mac. The Secretary of the Treasury has statutory authorization, at his discretion, to purchase up to $2.25 billion each of Fannie's and Freddie's debt, at a market rate of interest. This authority is granted, respectively, under 12 U.S.C. §1719(c) and 12 U.S.C. §1455(c). The maximum amount of the notes Treasury is authorized to purchase equaled .25% of Fannie's outstanding debt on June 30, 2003, and .35% of Freddie's outstanding debt at December 31, 2002 (more recent debt data is not available). Clearly, the funding Treasury could provide to either Fannie or Freddie is minuscule relative to their outstanding debt and liquidity needs.

The Secretary of the Treasury is authorized, at his discretion, to purchase up to $4 billion of FHLB obligations. At March 31, 2003, that amount equaled .58% of outstanding

FHLB notes and bonds. Farmer Mac can sell its notes to Treasury, up to a maximum of $1.5 billion, under a somewhat stronger line-of-credit arrangement. That amount equaled 39% of Farmer Mac's outstanding debt on March 31, 2003, the latest date for which data is available.

F -- Higher capital requirements for Fannie and Freddie

Numerous observers have suggested that Fannie and Freddie should operate with higher capital levels; some even suggest applying the same capital requirements to Fannie and Freddie as now apply to banks and thrifts. For leverage ratio purposes, which is higher than the capital which has been required under the risk-based stress test I previously have discussed, Fannie and Freddie have to hold equity capital equal to .45% of their credit risk exposure and 2.05% of their interest-rate risk.

Higher capital levels have a surface appeal, but they might not have the intended effect, for two reasons. First, because of their arbitrary nature, simple leverage ratio capital requirements usually bear no relationship to the risks assumed. The risk-based stress test is intended to cure this problem, but as I discussed previously, that has not necessarily happened. Therefore, leverage capital ratios usually are too high or too low, depending on the risks assumed. In effect, leverage capital ratios become something for management to arbitrage against, in part by securitizing assets which the marketplace believes do not require as much equity capital backing as required under a minimum leverage capital ratio.

Second, the present .45% leverage ratio for credit risk may in fact be adequate, provided Fannie and Freddie do not assume excessive credit risk, as one can reasonably infer from a 2001 Federal Reserve paper.[14] Since a financial institution can assume little interest-rate risk, if it so desires, I can easily envision situations where a 2.05% leverage capital ratio is more than adequate to absorb that risk. As I noted previously, the proposed Basel II capital requirements effectively move bank capital ratios for residential mortgages towards the present Fannie/Freddie leverage ratio capital requirements.

G -- Ending mission creep

Ending mission creep has been FM Policy Focus's principal policy objective, but that is difficult to achieve in practice because of the difficulty of defining what is or is not a new financial product. Even if armed with powerful pre-approval tools, there is always the danger that the mission regulator will become "captured" by those it regulates.

H -- What happens if either Fannie or Freddie gets into really serious trouble

The greatest public policy challenge facing Congress at this time is what to do should one of the housing GSEs begins to experience serious financial problems, for those problems could spill over to the other GSEs. This spillover potential is greatest between Fannie and Freddie. Freddie's recent accounting problems and management shake-up highlight this problem. The stronger enforcement and receivership powers Director Falcon has requested for OFHEO would be grossly inadequate should either Fannie or Freddie begin to experience liquidity problems or the financial marketplace loses confidence in the GSE. OFHEO discussed this possibility (Scenario #3) with some candor in a report it issued in February 2003.[15]

VI -- Longer Term Solutions to the GSE problem

The GSE tweaking I have just discussed does not provide a long-term solution to the GSE problem, a problem which is growing by the day. I have concluded that a complete privatization of each GSE is the only true solution to the GSE problem. Sallie Mae is well on its way to completing its privatization initiative. In 1999, I prepared a report[16] explaining in some detail how the FCS could be privatized. The paper I am writing on how to privatize Fannie and Freddie also will address the much easier privatization of the FHLBs. Farmer Mac, which has total assets of just $4 billion, would not be a challenge to privatize. Before discussing complete privatization, I need to address several issues.

A -- GSEs are anachronisms

If they did not exist today, would Congress create the GSEs? I doubt it, for the political impediments which impaired the development of the banking marketplace during most of the last century, sparking the creation of the GSEs, having largely disappeared. In effect, one set of bad public policies, banking restrictions, fostered another set of bad public policies, the creation of the GSEs. Branching restrictions, which have largely disappeared over the last decade, were the main impediment in the 20th century to the development of a modern U.S. banking system. Those restrictions have largely disappeared, making it much easier to privatize the GSEs, and particularly Fannie and Freddie. The lifting of lending restrictions, particularly on real estate lending, have further negated the need for GSEs.

B -- Containing/restraining the growth of Fannie and Freddie

As I have already noted, FM Policy Focus has taken the position that containing and restraining Fannie's and Freddie's growth will cure the Fannie/Freddie problem. I strongly disagree because FM Policy Focus's desire to curb Fannie and Freddie clashes violently with their desire to grow faster than the residential mortgage market so as to maintain their past rate of earnings growth, hopefully producing a steadily rising stock price. Fannie chief financial officer Tim Howard made this point abundantly clear in a July 15 news release in stating that "we will seek to accomplish this [core earnings per share] growth through increases in the market shares of our two businesses, increases in our business margins, and active management of our capital account.[17]" Given their enormous political clout, I believe Fannie and Freddie will succeed in repelling FM Policy Focus's containment initiatives.

C -- Bar Fannie and Freddie from holding mortgages and MBS in portfolio

The source of most of Fannie's and Freddie's earnings growth in recent years has come from rapid growth in their mortgage portfolios. This growth has largely occurred because Fannie and Freddie now buy back a substantial amount of the MBS they manufacture. As of December 31, 2002, Fannie had purchased one-third of the MBS it had issued as of that date. In so doing, they assume interest-rate risk, which represents the primary risk facing the two companies today, as well as the systemic risk facing the U.S. financial system. The complex derivatives contracts they enter into almost entirely hedge interest-rate risk; relatively little credit risk is hedged through derivatives.

As many have noted, including the Congressional Research Service (CRS),[18] Fannie's and Freddie's MBS buy-back programs do not advance affordable housing goals or mortgage market liquidity one whit. The MBS buybacks serve just one purpose -- to boost earnings growth. Therefore, barring Fannie and Freddie from owning mortgages or MBS, beyond that which is needed to facilitate ongoing securitization activities, would help mightily to reduce, if not eliminate the systemic risk these two companies pose. In effect, this action would turn both GSEs into institutions strikingly similar to the Freddie Mac of the 1970s. Limiting Fannie and Freddie to just the credit guarantee business might encourage them to seek privatization, just as two legislative enactments in 1993 encouraged Sallie Mae to take the privatization plunge.

D -- The merits of completely privatizing Fannie and Freddie

My forthcoming paper will discuss in great detail the merits of privatizing Fannie and Freddie. Briefly, though, these benefits are as follows:

- Eliminate GSE risk to taxpayers.
- Create a much more efficient housing finance system.
- Build a level competitive playing field among all housing finance firms.
- Create a more flexible and adaptive housing finance industry.
- Target delivery of the housing finance subsidy to just those home buyers on the cusp of homeownership.

E -- The Ely privatization proposal for Fannie and Freddie

My forthcoming paper will lay out my Fannie/Freddie privatization proposal in great detail. Specifically, it will explain how market forces can restructure the housing finance marketplace so that the efficiencies of moving large blocks of debt capital to private-sector mortgage originators can be fully captured. In particular, market forces, not arbitrary capital regulations, would determine the amount of capital that institutional mortgage owners would hold. The paper also will propose a housing finance tax credit, modeled on the Earned Income Tax Credit, that will go only to those home buyers on the cusp of homeownership and to existing homeowners experiencing temporary income declines. Finally, it will address all-important transition issues as well as the privatization of the FHLBs.

VII -- Conclusion

Mr. Chairman and members of the committee, I have appreciated the opportunity to testify today on this extremely important issue. The time is fast approaching when Congress must undertake fundamental reform of the GSEs by setting in motion the complete privatization of these anachronistic entities. I look forward to your questions.

Endnotes

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6. "Statement of the Honorable Armando Falcon, Jr. Before the Committee on Banking, Housing and Urban Affairs, United States Senate, July 17, 2003," Office of Federal Housing Enterprise Oversight.

7. Ely, Bert, "Fannie Mae's and Freddie Mac's Financial Disclosures: How Do They Stack Up," American Enterprise Institute, June 12, 2002.

8. "Executive Management Report, Financial Results (unaudited) for the three months ending March 31, 2003, Federal Deposit Insurance Corporation, pg. 10. Another $30 billion of cost incurred in protecting insured deposits in failed thrifts was borne in various ways by healthy thrifts and the banking industry.

9. Because of the time it takes (often two months, or more) for a borrower to close on a mortgage refinance, Fannie or Freddie can start to adjust the liability side of its balance sheet before the asset side readjusts due to the mortgage refinance; i.e., replacement of the paid-off mortgage with a mortgage carrying a lower rate of interest.

10. Kynge, James, "China tries new attack on bad loans," Financial Times, July 10, 2003.

11. "Federal Subsidies and the Housing GSEs," Congressional Budget Office, May 2001, pg. 29, Table 8.

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13. The FHLBs also are exempt from federal income taxes, but they pay special assessments, in the form of a contribution to an affordable housing program and interest on outstanding REFCORP bonds, that approximate what they would pay in federal income taxes were they subject to that tax.

14. Calem, Paul S., and Michael LaCour-Little, "Risk-based Capital Requirements for Mortgage Loans," Board of Governors of the Federal Reserve System, November 2001.

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Fannie Mae's and Freddie Mac's Financial Disclosures:

How Do They Stack Up

By Bert Ely

Presented at an American Enterprise Institute Conference

Are Fannie and Freddie Adequately Disclosing What Investors Need?

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Introduction

As Fannie Mae and Freddie Mac have grown into two of the United States' largest financial institutions, as well as the country's two largest government-sponsored enterprises (GSEs), there is increasing concern that investors, public officials, and the general public do not know enough about the two GSEs' finances and scope of activities. These concerns focus on the taxpayer risks they pose, the extent to which their activities exceed their legislatively authorized mission, and the degree to which they are serving their public mission.

This paper is divided into five sections. The first section explains why financial and operational disclosures are important for any publicly held firm, and especially so in the case of Fannie and Freddie. Good disclosure provides the financial transparency on which the market discipline of companies is based. The second section of the paper considers what constitutes adequate disclosure for a corporate owner of home mortgages.

The third section contrasts Fannie's and Freddie's financial disclosures with other firms heavily involved in financing home mortgages. While far from exhaustive, this contrast highlights significant differences in the disclosures by these two groups of companies, which reflects in part material differences in the risks they have assumed.

The fourth section examines the comparability, or lack thereof, of Fannie's and Freddie's financial disclosures. As Fannie and Freddie have grown more alike in financial structure and operating style, presumably their financial and operational disclosures would converge. In many ways, though, it is not easy to compare Fannie's financial disclosures with Freddie's, and vice versa, which raises serious public policy questions.

The final section of the paper addresses disclosure issues that go beyond investor concerns to legitimate concerns arising from their GSE status. These concerns include the unique taxpayer risks posed by any GSE, the competitive threat Fannie and Freddie pose to private-sector firms by virtue of their GSE privileges, and the adequacy of the manner in which they are meeting their affordable housing goals.

Why Financial and Operational Disclosures Are Important

Financial and operational disclosures are like sunshine -- they provide a powerful antiseptic that enhances corporate honesty and efficiency. The transparency arising from these disclosures creates the environment for market discipline, which will function only as well as the quality, quantity, and scope of a company's disclosures.

As Enron, and many, many other situations, have taught, the managements and board of directors of publicly held corporations cannot be trusted to perform as they should or promise they will. Oversight must come from outside the corporation, in the form of market discipline. Only by arming a corporation's publics with sufficient and timely information can they properly oversee and discipline its management and directors should they fail to perform adequately. Had there been sufficient disclosure of Enron's activities and liabilities, it most likely would never have grown to the size it did nor blown up on such a grand and destructive scale. The same holds true in other recent financial debacles, such as Tyco, Adelphia Communications, and numerous telecoms and energy trading companies.

Disclosure obligations imposed on GSEs, particularly publicly held companies such as Fannie and Freddie, must be far broader because of their unique, government-bequeathed privileges and obligations. However much they may contend to the contrary, Fannie and Freddie are not merely publicly held corporations accountable only to their stockholders. Instead, Fannie and Freddie have a much broader accountability, to assure their private-sector competitors that they are not abusing their GSE privileges to competitive advantage and to assure Congress and the American public that they are fulfilling the affordable housing mission that warrants their special privileges. These assurances can be achieved only through sufficient financial and operational disclosures. Management claims that they are doing right and doing good must be taken with the proverbial grain of salt.

Of course, sufficient disclosure is not enough. The various publics concerned about Fannie's and Freddie's performance must analyze and act upon those disclosures. But without sufficiently broad and detailed disclosures, there can be no basis for action.

What Constitutes Adequate Financial Disclosure for a Corporate Owner of Home Mortgages

Financial disclosure serves several related purposes. First, a firm's financial statements present its financial condition (balance sheet) and operating results (income statement). The balance sheet reports, as of a certain date, the firm's assets and liabilities. The difference between the two measures is net worth -- positive if assets exceed liabilities and negative if the reverse is true. The endless battling over the accounting principles to follow in measuring assets and liabilities does not negate the balance sheet's importance.

A firm's income statement reports financial results for a specified period of time (a month, quarter, or year), specifically its sales or revenues and its expenses. The difference is a profit, if revenues exceed expenses, or a loss, if the reverse is true. A profit also represents the amount of capital the firm created during the period while a loss represents the amount of capital destroyed. Statements of cash flows and stockholders' equity provide further insights into the firm's finances as do footnotes to the financial statements.

Second, supplemental financial disclosures, such as those presented in a management discussion and analysis of a firm's financial condition and results of operations, provide valuable insights into the financial risks a firm has undertaken that are not readily evident from its financial statements. For example, while a firm's equity capital leverage ratio (net worth divided by assets) can be calculated from a balance sheet, the amount of interest rate risk it has assumed cannot be. Interest rate risk relates to differences between the maturity of a firm's assets and its liabilities.

Likewise, credit risk cannot be assessed from balance sheet data. While two firms may each report owning $1 billion of single-family home mortgages, the amount of credit loss each portfolio will experience in the coming year could vary greatly, depending on a wide variety of factors regarding both borrowers and the homes they have mortgaged. These disclosures take the form of tables, charts, and explanatory text which can be linked or reconciled with a firm's financial statements.

Companies that originate and/or own home mortgages face two fundamental financial risks -- interest rate risk and credit risk -- that must be disclosed in sufficient detail so that investors and other interested parties can assess the threat these risks pose to the company's future earnings and financial solvency. These companies face a variety of subordinate financial risks that also must be disclosed with sufficient detail, including prepayment risk, basis risk, yield curve risk, lag risk, repricing risk, lifetime cap risk, counterparty risk, market capacity risk, liquidity risk, and operational risk. A detailed discussion of these subordinate risks lies beyond the scope of this paper.

Comparing Fannie and Freddie to Other Home Mortgage Owners

Fannie's and Freddie's financial disclosures cannot readily be compared to the financial disclosures of their private-sector competitors because they have adopted a business model reflecting their GSE status. That is, Fannie and Freddie have capitalized on their GSE status by adopting a business model which differs significantly from the business model their private-sector competitors can profitably follow.

In particular, GSE status gives Fannie and Freddie a decided competitive advantage in assuming the interest rate risk of holding long-term, fixed rate mortgages on their balance sheets. On a leverage ratio basis, Fannie and Freddie only have to maintain a 2.5% leverage capital ratio for their on-balance-sheet assets while a bank or thrift has to maintain at least a 5% leverage capital ratio against its on-balance-sheet assets in order to be considered a well-capitalized institution.

To avoid regulatory hassles, larger banks operate with leverage ratios well above the 5% minimum. At December 31, 2001, the 100 largest banks in the United States had an unweighted median Tier 1 capital leverage ratio of 7.21%, almost three times as much as Fannie's and Freddie's minimum capital ratio for their on-balance-sheet risks. The two GSEs operate much closer to their minimum capital ratios than do banks and thrifts. On

December 31, 2001, the amount of Fannie's core capital exceeded its minimum core capital requirement by just 4.1%; Freddie exceeded its requirement by 4.4%. Apparently, Fannie and Freddie feel more comfortable operating with a much thinner capital cushion over regulatory minimums than do banks and thrifts. Perhaps Fannie and Freddie are less fearful of their safety-and-soundness regulator, the Office of Federal Housing Enterprise Oversight (OFHEO).

Fannie and Freddie also have a significant capital advantage (.45% versus a minimum of 1.2%) in assuming the credit risk associated with guaranteeing securitized mortgages, again because of their GSE status. On December 31, 2001, the nation's 100 largest banks had an unweighted median Tier 1 risk-based capital ratio of 9.23%. Beginning in 2002, banking regulators have assigned a 20% risk weight to asset-backed and mortgage-back securitizations rated AAA or AA.[1] Therefore, the unweighted median Tier 1 risk-based capital requirement for guaranteeing high-quality asset securitizations among the 100 largest banks is 1.85% (9.23% x .2), which is four times the minimum capital ratio for Fannie's and Freddie's off-balance-sheet risks.

Because of Fannie's and Freddie's extremely favorable capital treatment, their private-sector competitors cannot earn a sufficiently high return on equity capital by owning significant quantities of long-term, fixed-rate mortgages. They either have to sell those mortgages to Fannie and Freddie or otherwise sell or securitize any such mortgages that they originate. In effect, the GSEs' private-sector competitors originate long-term, fixed-rate "conforming" mortgages and then pass the "hot potato" of the interest rate risk on these mortgages to Fannie and Freddie. Banks and thrifts sell to Wall Street for subsequent securitization "nonconforming" long-term, fixed-rate mortgages, such as jumbo mortgages, that they originate so as to shed their interest-rate risk on these mortgages.

Banks and thrifts retain two principal mortgage assets for themselves -- adjustable rate mortgages (ARMs) and mortgage servicing rights (MSRs). MSRs are created when a mortgage originator sells a mortgage but retains the right to service it. The asset value of an MSR equals the estimated present value of future profits arising from the right to service the mortgage.

ARMs largely hedge themselves in that they periodically reprice in line with interest rate fluctuations. However, because ARMs do not reprice themselves precisely when interest rates change or at the same magnitude of change, ARMs do carry a moderate amount of interest-rate risk, specifically lag risk, basis risk, and repricing risk. MSRs are subject to substantially the same interest-rate risks as the long-term, fixed-rate mortgages being serviced, but the value of MSRs represents a modest dollar amount relative to the amount of long-term, fixed-rate mortgages outstanding.

Comparing Fannie and Freddie with large private-sector mortgage originators illustrates the difference in business models. At the end of 2001, ARMs accounted for just

3% of Fannie's mortgage portfolio and 6% of Freddie's mortgage portfolio. Four private-sector firms, representative of America's largest mortgage originators, invest much more heavily in ARMs and other loans that reprice frequently, in line with changes in interest rates.

Golden West, which owns World Savings, probably represents the purest ARM lender among large thrifts. At December 31, 2001, its ARMS and variable-rate mortgage-backed securities (MBS) accounted for 94% of its total loans and MBS; assets repricing within a year accounted for 95% of its total interest-bearing assets. At Washington Mutual (Wamu), the nation's largest thrift, 73% of its loans repriced within one year as did 43% of its securities. While only 44% of Charter One's interest-bearing assets repriced within one year, as of December 31, 2001, its tangible equity capital financed almost all of its assets maturing or repricing more than 10 years into the future. Countrywide Credit Industries, the largest independent mortgage originator by far, sells almost of its mortgage production. Most of the mortgages and MBS it owns at any point in time eventually will be sold.

The data on the three thrifts in the preceding paragraph comes from an extremely useful disclosure that Fannie, Freddie, and Countrywide do not provide -- a table showing the time frame within which the amount of the thrift's various categories of assets, liabilities, and hedges are projected to mature or reprice. For example, Charter One broke out its assets, liabilities, and hedging impact, as of the end of 2001, into six maturity/repricing buckets -- 0-6 months, 7-12 months, 1-3 years, 3-5 years, 5-10 years, and over 10 years. For each time frame, the net amount of assets, liabilities, and hedges maturing or repricing in that period is shown. This "repricing gap," as Golden West calls it, is expressed in dollar terms as well as a percentage of total assets for each time period and on a cumulative basis, from the nearest time period to the furthest time period. This "gap analysis," as it is often called, provides important insights into a financial institution's interest-rate risk. While possibly not particularly relevant for Countrywide, it would be highly relevant for Fannie and Freddie. Interestingly, another GSE, the Farm Credit System, does provide a gap analysis, based on five repricing intervals, in the annual information statement it publishes.[2]

Fannie and Freddie do not do any mortgage servicing, so they do not own any MSR. MSR accounts for just .1% of Golden West's assets because it sells very little of its mortgage production. Countrywide is at the other end of the scale, with MSRs accounting for 16.4% of its assets at the end of 2001. MSRs accounted for 2.6% of Wamu's assets and .4% of Charter One's assets on December 31, 2001. Not only do these four companies have to hedge their MSRs, but also the uncapitalized MSR portion of the mortgages they have originated, but not sold.

Fannie and Freddie use derivatives contracts (principally interest rate swaps) to lay off a portion of their interest-rate risk on private-sector counterparties, which principally are large banks and other financial institutions. The substantial funding cost advantage Fannie and Freddie have over their private-sector competitors, by virtue of being GSE issuers of "agency" debt, provides them with the wherewithal to buy these swaps. That is, Fannie and Freddie swap away a portion of the interest cost savings they enjoy as GSEs in order to reduce their interest-rate risk. At the end of 2001, Freddie had $1.052 trillion of derivatives contracts outstanding, which equalled $1.70 per dollar of its assets. Although 30% larger in terms of total assets, on December 31, 2001, Fannie had half as much in derivatives contracts outstanding, $533 billion, or $.67 per dollar of its assets.

The three thrifts mentioned above are much less dependent upon interest-rate swaps and other types of derivatives to hedge their interest-rate risk because they own substantial amounts of ARMs. At the end of 2001, Golden West had $723 million in swaps outstanding, or 1.2 cents per dollar of assets. Wamu had $25.84 billion of outstanding derivatives contracts, or 10.7 cents per asset dollar. Charter One fell in the middle, with $1.68 billion of swaps outstanding, or 4.4 cents per dollar of assets. Countrywide was the exception -- it had $32.8 billion of swaps and related derivatives outstanding on December 31, 2001, or $.88 per asset dollar. However, 80% of these derivatives hedged its MSR asset.

The impact of Financial Accounting Standard (FAS) No. 133 on the reported net worth of Fannie and Freddie, when compared to the same four private-sector companies, reinforces the dramatic differences between the business models and risk characteristics of the two groups of companies. FAS 133, which first became effective in 2001, requires that "all derivatives be recognized as either assets or liabilities on the balance sheet at their fair value."[3] Further, fair value gains or losses on derivatives qualifying as "cash flow hedges" are reported, net of tax effects, as an adjustment to stockholders' equity rather then being reflected in the firm's income statement.

Cash flow hedges hedge a company's "exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction."[4] At the end of 2001, the initial adoption of FAS 133 plus losses on cash flow hedges during 2001 reduced Fannie's stockholder equity by 28.9%; Freddie's reduction was 29.9%. The three thrifts reported a zero or insignificant impact of FAS 133 on stockholders' equity. Countrywide did not break out the impact of FAS 133 from other components of its "other comprehensive loss" in 2001, which had the effect of reducing its stockholders' equity by 2.9%. Although FAS 133 does not require any reporting of the offsetting balance sheet effect of cash flow hedges, the net effect of Fannie's and Freddie's cash flow hedging on its net worth most likely is quite substantial compared with its private-sector competitors. It would be useful if Fannie and Freddie would disclose an estimate of that net effect.

Given how the mortgage marketplace has structured itself in the presence of Fannie and Freddie, arguably they have become riskier institutions than banks and thrifts, for three reasons. First, they operate with materially lower capital cushions. Second, their long-term, fixed-rate assets largely are not self-hedging, as are ARMs. Third, they do not match-fund their assets and liabilities because that is much less profitable than using derivatives to only partially hedge their maturity mismatching.

Due to the difference between the two business models, Fannie's and Freddie's financial disclosures should not fully parallel the disclosure requirements of their private-sector competitors. Disclosure comparability is further reduced by, one, the flexibility and latitude that generally accept accounting principles and the concept of "materiality" give corporate managements in constructing their financial disclosures and, two, the latitude corporate managements have in establishing the format for presenting specific disclosures. Consequently, as the next section of the paper discusses, greater attention must be focused on improving the comparability of the financial disclosures of Fannie and Freddie with each other.

Comparing Fannie and Freddie to Each Other

As discussed above, Fannie and Freddie are unique institutions because of their GSE status. Although they started out with dramatically different business models -- Fannie initially did not securitize mortgages while Freddie was largely a securitizer -- their business models today are nearly identical. That is, each company has gravitated towards a business model that seeks to maximize the benefits and profits of the nearly identical GSE charters that they possess. Consequently, differences between the two companies pale in comparison with their differences from private-sector financial firms.

Investors can gain a much better understanding of the risks each company poses by being able to easily compare their financial and operational data. That cannot be done today in any depth because specific data disclosures often are not directly comparable. Some examples and citations below will illustrate this shortcoming.

If the Shays-Markey bill (H.R. 4071) is enacted, presumably the Securities and Exchange Commission (SEC) would pursue greater comparability in Fannie's and Freddie's disclosures. In the meantime, there is no reason why OFHEO, Fannie's and Freddie's regulator, could not mandate greater comparability between the two companies when it concludes its "comprehensive review of the financial disclosure policies and practices of Fannie Mae and Freddie Mac."[5] But instead of merely measuring "the disclosure practices of [Fannie and Freddie] against those of other publicly traded companies to ensure [Fannie's and Freddie's] practices are at least comparable, if not better, where appropriate,"[6] OFHEO should establish additional disclosure requirements that fully reveal, in a comparative manner, Fannie's and Freddie's unique risks.

At the heart of the differences between Fannie's and Freddie's disclosures is a difference in interest-rate risk management philosophies. A recent Goldman-Sachs memorandum characterized this difference as follows:

> Freddie Mac's strategy is to pay today to insure long-term earnings growth regardless of the interest rate environment; Fannie Mae is less willing to

> sacrifice current period earnings, instead trusting its ability to hedge some future risks on an as needed basis.[7]

In effect, Fannie is willing to take greater long-term interest-rate risk than Freddie in order to maintain its cherished earnings growth objective of doubling its earnings every five years. This may be why, one, the notational amount of Fannie's pay-fixed interest rate swaps were 5.5 times the amount of its receive-fixed swaps at the end of 2001 while the comparable ratio for Freddie was just 1.3 and, two, why Fannie generally has earned a higher return on its equity capital than Freddie has.

The Goldman-Sachs report provides this valuable insight regarding differences in the interest-rate risk management philosophies of the two companies:

> How does one understand the differences in interest rate risk management -- and the significance of the differences -- between the two companies? This task is made doubly difficult because the two companies talk about and disclose their interest rate risk management philosophies differently and <u>both do not make some disclosures that would be helpful in this task</u>. [Emphasis supplied] For example, Fannie Mae discloses its duration gap. Freddie Mac disclosures its risk in terms of [portfolio market value sensitivity], which captures both duration and convexity risk. A reading of the company's disclosures indicates that it stresses the portfolio differently than does Fannie Mae to arrive at this value.
>
> Fannie Mae and Freddie Mac are in the same business and the interest rate risks they face are the same. They must be concerned with duration, convexity and volatility risk and the impacts from changes in the yield curve on prepayment behavior. So <u>differences in philosophy are expressed and must be understood at the margin</u>. [emphasis in the original][8]

Fannie's and Freddie's disclosures regarding their counterparty risks provide an excellent example of their disclosure shortcomings. Counterparties are large financial firms (primarily banks) to whom Fannie and Freddie have shifted a substantial amount of their interest-rate risk through various types of derivatives transactions. Counterparty risk nets down to the credit risk or exposure that each GSE has with its individual counterparties. That is, if the counterparty could not pay the amounts it was obligated to pay when called upon, how much would it cost the GSE to replace the derivative contracts under which the GSE was owed money. Fannie summarizes the credit risk associated with its derivative activities in a table on page 66 of its 2001 annual report; Freddie provides similar, but not identical, disclosures in Table 15 on page 40 of its 2001 annual report.

The credit rating of counterparties is critical to judging the credit risk they pose. Freddie's table lists the number of counterparties it has and the notational amount of the derivative contracts outstanding by specific credit ratings (AAA, AA+, AA, AA-, A+, etc.). Fannie's table is highly summarized -- it presents its counterparty data by broader credit rating categories (AAA, AA, A, etc.) and does not provide the number of counterparties or the notational amount of the derivative contracts with its counterparties. However, Fannie provides a maturity distribution of the credit risk under its derivative contracts as well as the netting effect of different contracts with the same counterparty while Freddie does not provide that data. Neither company names its counterparties.

Freddie does note, though, on page 40 of its annual report (Table 15) that $391 billion of its derivatives (37% of its total derivatives) "consisted primarily of exchange-traded derivatives." Exchange-traded derivatives do not have the counterparty risk associated with the rest of Freddie's derivatives contracts, which are customized, over-the-counter (OTC) contracts with named counterparties. Fannie does not provide any data regarding the split between its exchange-traded and OTC derivatives contracts.

Fannie's and Freddie's counterparty disclosures reveal another disclosure shortcoming -- the use of narrative text to present selected data in lieu of tables that present a complete picture. Two examples will illustrate this point. While Freddie presented the number of its derivatives counterparties in tabular form, Fannie presented selected information in textual form, such as:

> At December 31, 2001, eight counterparties represented approximately 78 percent of the total notational amount of outstanding derivatives transactions, and each had a credit rating of A or better (70 percent of this notational amount was held by counterparties with a credit rating of AA or better).[9]

Interestingly, there was no discussion of the credit risk exposure these eight counterparties posed to Fannie.

While Freddie provided more detail on its hedging in many regards than did Fannie, its discussion of its 2001 hedging activity (page 80 of its 2001 annual report) provided a dense narrative of its fair value hedges and cash value hedges. The author could not reconcile the figures in that discussion with the total notational amount of Freddie's outstanding derivatives on December 31, 2001. Fannie's 2001 annual report, on the other hand, provided a clear tabular breakdown of its various types of derivatives between fair value hedges and cash value hedges. Hopefully, OFHEO and eventually the SEC will provide more specific guidance to Fannie and Freddie on the tabular presentation of their financial disclosures.

Another aspect of Fannie's and Freddie's counterparty risk disclosures illustrates a broader problem with their financial disclosures -- they merely presented snapshot data as of

December 31, 2001. The use of snapshot data creates an incentive for Fannie and Freddie to engage in "window dressing;" that is, to engineer financial transactions so that they present exceptionally favorable numbers on the snapshot date. On numerous occasions in 2002, Fannie and Freddie have bragged about how little credit exposure they had to their counterparties at the end of the year, but how representative are those numbers of their credit exposure over the course of 2001?

Window dressing can be reduced to a great extent by requiring the publication of data showing the minimum, maximum, and average amount of a particular value over a period of time. For example, while Fannie reported that its net credit exposure to counterparties was $110 million on December 31, 2001, its average and maximum exposure during the year might have been much higher. The latter numbers would be much more important to investors in assessing the earnings and solvency risk Fannie and Freddie pose. Interestingly, at a recent financial services conference, Treasury Under Secretary Peter Fisher recommended that all financial services firms provide range data, instead of just snapshot numbers, in order to reduce the window-dressing problem.

Unique Disclosure Issues for Fannie and Freddie

As Fannie and Freddie readily admit, and often boast, they have been endowed with a public mission in the housing arena, specifically to promote affordable home ownership. Hence, the two companies have a broader accountability than do private-sector corporations. Further, as congressional creatures, the two GSEs are implicitly backed by the federal government, which creates a taxpayer risk not present in private corporations or even in federally insured banks and thrifts.[10] The 1987 taxpayer bailout of the Farm Credit System made federal backing of all GSEs quite explicit. Therefore, Fannie's and Freddie's financial and operational disclosures must not only meet investor needs, which they presently do not, but they also must provide the data needed to fully assess their taxpayer risk and the degree to which they fulfill their public mission.

Arguably, expanded disclosures sufficient to inform Fannie and Freddie investors, both debt and equity, about the risks they face should be adequate to assess the taxpayer risk Fannie and Freddie pose. That is an issue to address once their investor disclosures are improved and made much more comparable.

As Fannie and Freddie have grown, affordable housing advocates have repeatedly complained that Fannie and Freddie are not doing enough to meet the affordable housing finance goals that Congress has established for them. Various studies by neutral parties generally support this opinion. The affordable housing advocates should be asked to offer specific recommendations to OFHEO and the SEC for more detailed disclosures by the two GSEs on their affordable housing activities.

For example, Fannie and Freddie could be required to disclose income, net worth, l credit score ranges of the borrowers whose loans they purchased or guaranteed. Also, ·rage home appraisal values could be shown for loans with loan-to-values (LTV) falling /arious ranges. Presently, Fannie and Freddie show LTV data for loans at origination and rently outstanding, as of the end of the year, while Fannie also provides LTV data on ns originated during the year. However, it is not possible to relate the LTV data to rowers' income, wealth, or home value. Does Fannie's or Freddie's purchase of a)0,000 mortgage on a $350,000 home owned by a family with an annual income of)0,000 and a net worth of $700,000 constitute the financing of affordable housing? More ailed disclosures about the housing and income characteristics of the borrowers whose rtgages Fannie and Freddie are purchasing or guaranteeing would provide greater insight) their success, or lack thereof, in fulfilling their affordable housing mission.

More detailed disclosures also could provide answers as to whether or not Fannie l Freddie are expanding beyond their mission, and in so doing, trampling on their private-tor competitors. A more detailed breakdown of their revenues would be helpful, ticularly the fees they charge for loan origination services, such as fees the two GSEs lect for use of their automated loan underwriting systems. As with the affordable ısing issue, Fannie's and Freddie's competitors should be called upon to specify the npetition-oriented disclosures the two GSEs should begin to make.

Conclusion

While Fannie Mae and Freddie Mac profess to disclose substantial amounts of ıncial and operational data, a close examination of their disclosures reveals many ırtcomings, given their special status as GSEs. Further, it is difficult, and often ›ossible, to compare specific disclosures the two companies make. While one will close "A" but not "B," the other will disclose "B" but not "A." Both GSEs should close both "A" and "B" as well as "C," "D," and perhaps even an "E." However, it is not sonable to expect Fannie and Freddie to voluntarily expand and conform their financial l operational disclosures. That task must fall to their regulatory masters. In the first tance, that would be OFHEO, with encouragement and possibly guidance from the SEC l the Treasury Department. Upon passage of the Shays-Markey bill, the SEC would ume the primary responsibility for expanding and improving Fannie's and Freddie's ıncial and operational disclosures.

dnotes

Prior to 2002, these guarantees were subject to a 100% risk weight, which gave Fannie and Freddie an even gre ıpetitive advantage as guarantors.

Farm Credit System Annual Information Statement for 2001, table on pg. 42.

3.. Fannie Mae 2001 Annual Report, pg. 54.

4.. Financial Accounting Standard No. 133, paragraph 4.b.

5.. News Release, Office of Federal Housing Enterprise Oversight, April 8, 2002.

6.. Ibid.

7.. Mortgage Finance & Specialty Finance: Interest Rate Risk Management Survey, Goldman Sachs, May 7, 2002, pg. 38.

8.. Ibid,, pg. 47.

9.. Fannie Mae 2001 Annual Report, pg. 66.

10.. Contrary to frequent assertions by Fannie and Freddie officials, taxpayers are not directly exposed to a risk of loss federally insured banks and thrifts. Instead, in the aftermath of the S&L debacle, Congress restructured the financing federal deposit insurance to ensure that healthy banks and thrifts will, through deposit insurance assessments, pay whatever expense the Federal Deposit Insurance Corporation incurs in protecting insured depositors against loss. No similar insurance or cross-guarantee mechanism exists for the GSEs. Hence, taxpayers are directly at risk should a GS become insolvent or nearly so, as the 1987 bailout of the Farm Credit System so clearly demonstrated.

Testimony of W. Michael House
Executive Director
FM Policy Focus
Before the
Senate Governmental Affairs Committee
Subcommittee on Financial Management, the Budget and International Security
Hearing
Oversight on Government Sponsored Enterprises:
The Risks and Benefits to Consumers
Monday, July 21, 2003
2:00 p.m.

Chairman Fitzgerald, Sen. Akaka, and Members of the Subcommittee: my name is Mike House. I am the Executive Director of FM Policy Focus, a coalition of seven associations of financial services companies actively engaged in the mortgage industry. Our members include the American Financial Services Association; the Association of Financial Guaranty Insurers; the Consumer Bankers Association; the Consumer Mortgage Coalition; the Financial Services Roundtable; the Mortgage Insurance Companies of America; and the National Home Equity Mortgage Association.

Together, we are proud to be a vital part of an industry that helps millions of Americans realize the American Dream of homeownership each year. On behalf of our members, I want to thank you for the opportunity to participate in this important and timely hearing. I bring a special greeting on behalf of our Chairman, former Congressman J.C. Watts, who regrets that he could not be here today.

It is hard to believe, but Alan Greenspan was 12 years old, the average home cost less than $5,000 and America had just 48 states when Congress first decided to use taxpayer dollars in 1938 to subsidize an organization to support the secondary mortgage market. It was a genuine example of vision on the part of Congress, and our members strongly support the continuing secondary mortgage market mission of Fannie Mae and its sibling Freddie Mac.

The members of FM Policy Focus have some of the most enviable jobs in the industry: They get to sit across the table from new homeowners and see the looks on people's faces when they are handed the keys to their new homes for the first time. As it should be in a nation built on free enterprise, homeownership and affordable housing are driven overwhelmingly by the private sector. But while we sit on the front lines, it is a strength of our system that Fannie Mae and Freddie Mac buy the mortgages that our members originate and insure, freeing up even more capital to put more Americans in their own homes.

For that reason, Congress continues to subsidize Fannie Mae and Freddie Mac each year to the tune of about $10.6 billion, according to a 2002 Congressional Budget Office analysis.
FM Policy Focus strongly supports maintaining the special relationship and the special responsibilities of these government-sponsored enterprises (GSEs) in the nation's mortgage markets. When in full compliance with their charters, the GSEs *do* provide this vital function of sustaining a liquid secondary mortgage market, which is the healthiest in the world.

The problem is that for Fannie Mae and Freddie Mac to be in full compliance with their charters and fulfill their congressionally-mandated mission, they need effective government oversight – oversight founded on the same three principles that guide the oversight of the world's largest banks and make up the three pillars of the Basel Accord: namely, sound capital, effective supervision, and market discipline from enhanced disclosure.

From where we sit today, Fannie Mae and Freddie Mac are 0-for-3.

Together, they are weakly regulated by an under-staffed, under-funded agency. They hold 20-50 percent of the capital required by bank regulators for depository institutions holding mortgages. And they are the only two publicly traded companies in the Fortune 500 that are exempt from routine Securities and Exchange Commission (SEC) disclosures required to ensure transparency and standards of investor accountability.

If this combination were present at a private institution, its customers, debt-holders and stockholders would be at great risk in the event of failure. But since Fannie Mae and Freddie Mac are government-sponsored enterprises, which are perceived to be backed by the Federal Treasury, it is taxpayers that would be on the hook to bail out Fannie Mae and Freddie Mac in the event of failure. In one fell swoop, taxpayers could go from being in the dark about Fannie Mae and Freddie Mac's operations to being in the red trying to bail them out.

Given that Fannie Mae and Freddie Mac carry about $1.5 trillion in debt between them today, the failure of either one of them could potentially make the savings and loan crisis of a decade ago look minor.

All of our members are proud to be partners of Fannie Mae and Freddie Mac. But like any good partners – just like any good friends -- we tell our partners when we think they're wrong. FM Policy Focus makes it a priority to alert the public to actions of Fannie Mae and Freddie Mac that benefit the interests of their investors at the expense of homebuyers and taxpayers. We support market competition that results in increased access to affordable housing for consumers. We support federal policies that do not allow the GSEs to move beyond their unique charters to deal directly with homebuyers and consumers or into markets well served by the truly private sector. And we support Federal policies that prevent taxpayer exposure to unnecessary risks that could require a massive bailout.

FM Policy Focus believes Congress should enact legislation this year that will bring greater accountability and transparency to the GSEs and their operations, while reducing the risk to taxpayers. We believe that any reform bill should:

- Strengthen GSE regulation by moving this responsibility from the Department of Housing and Urban Development (HUD) to the Department of the Treasury;
- Make the new regulator a member of the Federal Financial Institutions Examination Council (FFEIC);
- Provide the new regulator with powers comparable to those available to bank regulators, including the approval of new products and activities;

- Require that GSEs hold bank-like capital;
- Fund the new regulator through assessments on the GSEs, comparable to those supervisory fees which fund bank regulators;
- Tighten the national affordable housing standard that now applies to the GSEs by making that standard apply within individual metropolitan statistical areas;
- Repeal Fannie Mae's and Freddie Mac's exemptions from the Securities Act of 1933 and the Securities Exchange Act of 1934;
- Repeal the GSEs' exemption from the privacy provisions which, under Gramm-Leach-Bliley, apply to all other financial institutions;
- In the context of maintaining a liquid secondary market and adequate capital, cap the amount of their own and each other's mortgage-backed securities (MBS) which the GSEs may hold in their own portfolios;
- Limit the GSEs' non-mission portfolio assets and investments;
- Cap the amount of debt the GSEs may issue without seeking Treasury approval; and
- Establish a clear limit on the GSEs' business activities to a strictly secondary market role that prohibits encroachment into primary market activity.

We recommend these changes together because none is adequate by itself.

A Single Strong Regulator

The GSEs are complicated financial giants: they have \$1.6 trillion in combined assets; \$1.4 trillion in retained mortgages in portfolio; \$1.5 trillion in outstanding debt; and \$1.5 trillion in notional derivatives. In addition, outstanding mortgage-backed securities guaranteed by the GSEs, but held by third parties, total \$1.7 trillion.

Every day, Fannie Mae and Freddie Mac behave in the same way as other large financial institutions: they trade, borrow, and raise capital in the world's debt and equity markets. Unlike other large sophisticated financial institutions, the GSEs are subject to minimal regulatory oversight. This creates systemic risk if something goes wrong because the ordinary market disciplines – capital and disclosure among them – are not in place to create a buffer against GSE risk.

In the private market, bank regulators of large financial institutions have an array of weapons in their arsenal: minimum and core capital standards about twice as high as those imposed on the GSEs, which bank regulators can raise still further as risk warrants; a panoply of supervisory powers to stop any activity deemed unsafe or unsound, including executive compensation practices or relations with third parties; authority to review and approve all new activities of significance, with most proposed first for public comment to ensure the bank regulators know all they need before a new line of business is allowed; the ability to put an insured depository into receivership; and a variety of disclosures required by the bank regulators that are supplemented by SEC-mandated disclosures of parent publicly traded companies.

The GSEs' safety and soundness regulator, the Office of Federal Housing Enterprise Oversight (OFHEO) has been given supervisory and examination powers over Fannie Mae and Freddie Mac, but these are far less potent than those authorized for federal banking regulators. Congress did ask OFHEO in 1992 to govern not only the new minimum capital standards – about half those imposed on banks for high-quality mortgages – but also to issue new risk-based capital standards. Congress wisely required OFHEO to produce a risk-based capital rule for the housing GSEs to establish how much capital they needed to survive a period of difficulty. Of course, nine years later, OFHEO finally published a rule that ran nearly 700-plus dense and detailed pages, ultimately raising more questions than it answered. As we know from the last few runs of the OFHEO risk-based capital rules, it found acceptable for a GSE leverage ratios of 300:1 or even more – hugely higher capital ratios than those accepted by U. S. and international bank regulators for comparable mortgage-related risk.

Recent developments at Fannie Mae and Freddie Mac have further demonstrated the woeful inadequacy of the current regulatory structure. In recent weeks, any doubts about the inadequacy of GSE supervision must have been put to rest. Last year, Fannie Mae went far outside its own self-imposed interest-rate risk standards, but OFHEO did not know about this until Fannie had to tell the financial markets, and it only took action after House Capital Markets Subcommittee Chairman Richard Baker demanded that it do so. Freddie Mac, of course, is embroiled in a restatement for several years of its earnings. As OFHEO Director Armando Falcon made clear in testimony on July 17, 2003 before the Senate Banking Committee, the regulatory agency was woefully behind the firm's own lax internal auditor and even now seems unaware of many key issues affecting the long-term stability of Freddie Mac.

The remainder of GSE regulatory responsibilities, those related to setting affordable housing goals and making certain that Fannie Mae and Freddie Mac meet those goals and engage only in activities within their charter that are in the public interest and safe, was left to HUD.

The GSEs have a vital role to play in expanding access to mortgage finance. More than ten years ago, Congress directed them to lead the market in promoting affordable housing, a mission strongly endorsed by the members of FM Policy Focus.

Yet the GSEs lag the private sector in promoting affordable housing. Don't just take my word for it – there are 24 separate independent studies that prove that the full power and resources of Fannie Mae and Freddie Mac are not being applied to their affordable housing mission today. I have attached a list of these studies to this testimony.

Our members originate and insure the loans the GSEs buy, and we hope they will do more to promote our own affordable housing activities, especially with regard to minority homebuyers. Many members of FM Policy Focus are subject to the Community Reinvestment Act (CRA), which requires a special focus on low- and moderate-income home purchasers. The GSEs today do not buy many CRA loans, and we would like to work with them to do so, thereby enhancing their affordable housing responsibilities.

Congress did not give the GSEs' safety and soundness regulator power over new programs – in sharp contrast to the mandate for bank regulators ratified as recently as the Gramm-Leach-Bliley Act of 1999. Instead, HUD is currently required to provide prior approval for new GSE programs. However, HUD has never implemented a meaningful new program review process. Only once did it review a new program, and then only at the direct request of a Member of

Congress. This failure has taken on new urgency: Most of the programs that the GSEs are proposing today are new financial products, targeted directly to consumers, and more broadly used for general consumer lending, rather than focusing on home mortgage finance for under-served market segments. FM Policy Focus believes the GSEs' charter, though often vague, confines Fannie Mae and Freddie Mac to the secondary mortgage market. Yet increasingly, over the last ten years, Fannie Mae and Freddie Mac have engaged in a series of primary mortgage market activities. This must not be allowed to continue.

Every outreach into broader and more complex financial products holds the potential of undermining the safety and soundness of the GSEs. HUD is unfamiliar with the types of highly complex transactions in which the GSEs engage and does not or cannot stop a GSE from implementing risky ventures.

For example, Fannie Mae has launched itself into something it calls PaymentPower™, an entry into high-risk consumer lending. At other large financial institutions, such transactions – even if approved by a bank or insurance regulator – would require considerable capital and experienced effective risk management, and draw the attention of dozens of experienced regulators looking into every aspect of the new program.

But at present HUD has not more than seven people responsible for oversight, not just of the PaymentPower™ program itself, but overseeing *all* of Fannie Mae and Freddie Mac's activities. Little wonder that HUD has so far taken no action PaymentPower™. Moreover, since Fannie Mae and Freddie Mac are exempt from state insurance and consumer laws, even these reliable consumer-oriented regulators have no standing to question PaymentPower™ or any other GSE products.

It is clear from these examples and many more that Congress must enact legislation to reform the regulation of the GSEs. They are simply too big to ignore. The current regulatory scheme is bifurcated, weak, and subject to undue influence from the GSEs. FM Policy Focus recommends that Congress replace the existing, ineffective regulatory regime with a strong single regulator, which has all the attributes cited by Federal Reserve Chairman Alan Greenspan in his testimony before the Senate Banking Committee on July 16, 2003, namely: expertise, regulatory authority, and powers strong enough to keep the GSEs safe and sound.

We think it makes the most sense to move these functions to the place where this kind of regulatory expertise already resides: the Department of the Treasury. At FM Policy Focus, we support a plan to move the GSEs' regulator from HUD to an independent agency within Treasury comparable to, but separate from, the Office of Thrift Supervision and the Office of the Comptroller of the Currency -- with authority over safety and soundness, mission and affordable housing. The new regulator should also join other banking regulators as a member of the FFEIC.

We urge that these responsibilities be moved outside the appropriations process, relying instead as banking regulators do, on the assessment of fees on Fannie Mae and Freddie Mac.

We want to reiterate that we believe such a regulator should approve new activities for the GSEs only after determining that the new activity fulfills the GSEs' primary missions of providing a liquid secondary market and promoting the availability of affordable mortgage finance. Any new program, activity or investment should be approved only after a process comparable to that used by the banking regulators: first, there should be a broad proposal about the activity to ensure that the regulator receives a full range of views on it; then, any GSE wishing to use the new power should give the regulator prior notice that provides ample information on its financial and managerial capability to engage in the new activity. In all cases, the new activity or investment should be allowed only if, as under current law, it is consistent with the GSE charter, in the public interest and found to be safe and sound.

Require Bank-Like Capital

Second, we believe that the GSEs should be required to have capital similar to that imposed by the Federal Reserve on large bank holdings of comparable mortgage risk – that is, bank-like capital.

It's no mystery why capital is important – when crises flare in the financial markets, a strong capital base makes any institution better able to weather a storm without running the risk of permanent injury to itself or to the taxpayer. Sufficient capital helps protect against mistakes and unpredictable circumstances.

Consider what happened with the savings and loan industry in the 1980s. S&Ls grew increasingly larger, entering new lines of business, while sitting atop an ever-shrinking capital base. When things went badly, taxpayers were left on the hook to the tune of $250 billion or more. In turn, Congress wisely instituted minimum capital standards for banks and saving associations, and further required that only well-capitalized firms could become financial holding companies.

But today, Fannie Mae and Freddie Mac are allowed to operate on a capital base that doesn't even measure up to the capital held by S&Ls in the 1980s before the crash, let alone after the reform.

As William Poole, President of the Federal Reserve Bank of St. Louis, pointed out in remarks at an OFHEO Symposium in March of this year, the low GSE capital base is especially dangerous because:

> Capital is especially important for the GSEs because their short-term obligations are large. Fannie Mae and Freddie Mac have debt obligations due within one year of about 45 percent of their debt liabilities. Any problem in the capital markets affecting these firms could become very large, very quickly. What might 'very quickly' mean? Because of the scale of the short-term obligations of the GSEs, the GSEs are rolling over many billions of dollars of obligations each week. For this reason, a market crisis could become acute in a matter of day, or even hours.

In other words, as Thomas Schatz, President of Citizens Against Government Waste, said in testimony before the House Capital Markets Subcommittee on June 25, 2003, "the risks posed by Fannie Mae and Freddie Mac are more dangerous than those posed by the Federal Home Loan

Banks because Fannie Mae and Freddie Mac are so large, so thinly capitalized, and so dominant in their field."

We concur with Federal Reserve Chairman Greenspan, who states in an April letter that:

> ...the existence, or even the perception, of government financial support for financial institutions undermines the effectiveness of market discipline. Thus, in the case of the housing-related GSEs – Fannie Mae, Freddie Mac, and the Federal Home Loan Banks – to ensure that these institutions do not pose a systemic threat regulators cannot rely wholly on market discipline and must assess whether these institutions hold appropriate amounts of capital relative to the risks they assume and the costs they might impose on others, including taxpayers.

More Disclosure Should Be Required

As I mentioned earlier, with their special status, Fannie Mae and Freddie Mac are the only two publicly traded companies in the Fortune 500 that are exempt from regulation by the SEC.

A year ago, under pressure from Congress, Fannie Mae and Freddie Mac agreed to register their equities under the Securities Exchange Act of 1934 with the SEC and adhere to the agency's annual and quarterly financial reporting rules. Fannie Mae followed through and registered early this year; Freddie Mac still has not done so and recently said it did not expect to do so before the middle of next year, nearly two years after making its original promise.

This agreement, worked out by the GSEs with the Treasury, the SEC, and OFHEO, was touted by the GSEs as being a "voluntary" commitment, yet one which was arrived at after months of bitter resistance to making any such commitment. Moreover, we question the GSEs' good faith as they simultaneously asked for and received No-Action letters from the SEC, detailing all the provisions of the securities laws which still do not apply. Copies of those letters are also attached to this statement.

We have seen the folly of such "voluntary" agreements. Freddie Mac has volunteered to tell us very little of what got it – and potentially the taxpayers – in trouble.

The reason Fannie Mae and Freddie Mac enjoy this special treatment is because they remain exempt from the Securities Act of 1933, which would require Fannie Mae and Freddie Mac to register their mortgage-backed securities and debt offerings. They continue to remain exempt from key provisions of the Securities Exchange Act of 1934, including the rules governing tender offers and public reporting of trades by insiders. A chart comparing the application of these laws to other publicly traded companies and to the GSEs is attached to this testimony.

At a time when the rest of corporate America is subject to stringent review of its activities, the GSEs continue to operate as islands of their own.

We think this is a prime case where the government should lead by example: send the right message to investors and the rest of corporate America, and require full disclosure and full SEC registration by the GSEs of all their securities. Fannie Mae and Freddie Mac protest that such compliance will have adverse affects. But we agree with the findings of a joint study by the Treasury Department, OFHEO, and the SEC this past February, which concluded:

> The Task Force finds more persuasive the argument of other investors and market participants who counter that any adverse affects from additional disclosure would be short-term, and ultimately be outweighed by the benefits of greater information flowing into, and therefore more informed analysis of, the MBS market.

This view has been supported in recent months by the Congressional Budget Office and Moody's Investor Service, both of which argued that disclosure would not disrupt the secondary mortgage market. It's time to let the sun shine in on Fannie Mae and Freddie Mac.

FM Policy Focus also supports disclosure to the GSE regulator through quarterly reports like bank "call reports." Such disclosure would be made even stronger if regulators demanded stand-alone ratings from the rating agencies to truly assess GSE risk. A stand-alone rating means the rating that would be given to Fannie Mae and Freddie Mac as if they were completely private enterprises, with no tie to the Federal government. Current ratings incorporate unlimited access to debt markets because of the GSEs' special status. For investors looking to compare apples to apples in this market, stand-alone ratings would be a valuable source of information.

Taken together, the appointment of a single strong regulator, the requirement of bank-like capital, and the requirement of full disclosure would dramatically improve oversight of Fannie Mae and Freddie Mac in a way that would more ably protect taxpayers from the possibility of potential systemic risk, and would bring the GSEs more in line with the standards that apply to every other large financial institution.

Benefits For Consumers and Taxpayers

It's been said that homeownership is the triple crown of social policy – helping people buy their own homes is great economic policy, with housing and housing-related activities contributing 20 percent to our GDP; it is good social policy, because homes frame families, which are the building blocks of our society; and it is great community policy, because nothing builds stronger neighborhoods where people care about what happens on their street and look after each other like homeownership – whether it's the South Bronx, South Alabama, or Southern California. That's why our members are so proud to play a vital role in this industry.

The changes I've outlined here today are a win-win for consumers and taxpayers as well. For consumers, effective regulation and oversight of the GSEs mean lower mortgage costs – because better regulation and more capital is good for purchasers of GSE debt and MBS who will be willing to accept lower interest rates on GSE debt and MBS, knowing that there is more real capital and protection behind each bond and GSE-guaranteed mortgage-backed security. Lower interest rates demanded by bond and mortgage-backed securities purchasers mean lower capital costs for the GSEs, which the GSEs can then pass through to borrowers.

Improved regulation can only usher in an expanded focus on affordable housing, because a unified regulator is in a better position to require the GSEs to address the mission they so proudly profess in their television commercials, rather than trying to boost earnings through artificial accounting or other high-risk ventures.

Finally, improved regulation offers the best deal for taxpayers. Higher capital and more careful regulation mean the taxpayer will less likely be asked to pick up the implicit federal guarantee of the GSEs. In turn, a stronger housing finance system -- with GSEs focusing on maintaining a liquid secondary market and not moving into other high-risk businesses currently well-served by the private market – will advance economic development across the country.

Closing

In closing, Mr. Chairman, the members of FM Policy Focus urge Congress to take an active role to ensure that an appropriate new regulatory structure is crafted, and that all views have a chance to be heard. We're grateful for your leadership on this point, and for your insistence that several points of view be included here today.

APPENDICES

1. Bibliography, studies of GSE funding of affordable loans
2. No Action, Interpretive and/or Exemptive Letter: Response of the Office of the Chief Counsel, Division of Corporate Finance, U. S. Securities and Exchange Commission to Federal National Mortgage Association, July 12, 2002.
3. No Action, Interpretive and/or Exemptive Letter: Response of the Office of the Chief Counsel, Division of Corporate Finance, U. S. Securities and Exchange Commission to Federal Home Loan Mortgage Corporation, July 12, 2002.
4. Securities Act of 1933: Side-by-side comparison of statute and application to the GSEs.
5. Securities Exchange Act of 1934: Side-by-side comparison of statute and application to the GSEs, prepared by Peter J. Romeo, Partner, Hogan & Hartson, LLP.

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Exchange Act of 1934 - Section 12(g)

No Action, Interpretive and/or Exemptive Letter:

Federal National Mortgage Association

July 12, 2002

Response of the Office of the Chief Counsel
Division of Corporation Finance

Re: Federal National Mortgage Association
Incoming letter dated July 12, 2002

Based on the facts presented in your letter, the Division of Corporation Finance concurs in the views expressed in your letter regarding the effect of voluntary registration under Section 12(g) of the Securities Exchange Act of 1934 on the treatment of Fannie Mae and its securities under the Securities Act of 1933, the Exchange Act and the Trust Indenture Act of 1939.

The Division of Market Regulation has asked us to inform you that, based on the facts presented in your letter, the Division of Market Regulation concurs in the views expressed in your letter regarding the effect of voluntary registration under Section 12(g) of the Exchange Act on the treatment of Fannie Mae and its securities under the Exchange Act.

The Division of Investment Management has asked us to inform you that, based on the facts presented in your letter, the Division of Investment Management concurs in the views expressed in your letter regarding the effect of voluntary registration under Section 12(g) of the Exchange Act on the treatment of Fannie Mae and its securities under the Investment Company Act of 1940.

The above positions are based solely on the facts presented in your letter. Any different facts or circumstances might require another conclusion.

Sincerely,

Martin P. Dunn
Deputy Director

Incoming Letter:

July 12, 2002

Martin Dunn, Esq.
Deputy Director
Division of Corporation Finance
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Dunn:

As we have indicated previously, Fannie Mae is considering registering voluntarily its common stock under Section 12(g) of the Securities Exchange Act of 1934. While we already make available to investors a very substantial amount of information through periodic disclosures, we are not required to file periodic reports with the SEC because our Charter Act provides that all securities issued or guaranteed by Fannie Mae "shall, to the same extent as securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, be deemed to be exempt securities within the meaning of laws administered by the Securities and Exchange Commission." Voluntary Exchange Act registration will obligate Fannie Mae, pursuant to Section 13 and the rules thereunder, to file periodic reports with the SEC. Voluntary Exchange Act registration will also subject Fannie Mae to the provisions of the Exchange Act, and to the SEC's enforcement jurisdiction thereunder, applicable to issuers with securities registered under Section 12(g), except where the Exchange Act or the rules thereunder explicitly exclude "exempted securities."

Once the registration of our common stock becomes effective, the only means for termination of our Section 12(g) registration will be as provided in Section 12(g)(4) and Exchange Act Rule 12g-4. Fannie Mae also will recommend that our Board of Directors adopt an amendment to our Bylaws to the effect that Fannie Mae shall take no action in furtherance of termination of Exchange Act registration without unanimous action of all members of our Board of Directors then in office.

In connection with voluntary registration of our common stock under the Exchange Act, we are seeking the staff's concurrence with our views that voluntary registration will not cause any alteration of the existing treatment of Fannie Mae with regard to whether:

- Securities issued or guaranteed by Fannie Mae are exempt securities under the Securities Act of 1933 and may be sold without registration under the Securities Act;

- Securities issued or guaranteed by Fannie Mae are exempted securities and government securities under the Exchange Act;

- Fannie Mae is excluded from the definitions of "government securities broker" and "government securities dealer" under the Exchange Act;

- Debt securities issued or guaranteed by Fannie Mae are government securities for purposes of Rule 15c3-1(c)(2)(vi)(A) under the Exchange Act;

- Securities issued or guaranteed as to principal or interest by Fannie Mae are government securities for purposes of the Investment Company Act of 1940;
- Fannie Mae is an agency, authority or instrumentality of the United States for purposes of the Investment Company Act;
- Since the Trust Indenture Act of 1939 does not apply to securities issued by Fannie Mae, the Federal Reserve Banks may remain the fiscal agent of Fannie Mae, and no independent trustee is required, for Fannie Mae's unsecured debt securities or mortgage-backed securities;
- Sections 14(a) and 14(c) of the Exchange Act are inapplicable to Fannie Mae.[1]
- Section 16 of the Exchange Act is inapplicable to Fannie Mae's officers, directors and shareholders;[2] and
- The provisions of Regulation 14E of the Exchange Act are inapplicable to Fannie Mae and Fannie Mae securities.

We are also seeking the staff's concurrence with our view that, once our registration under Section 12(g) is effective:

- Holders of 5% or more of Fannie Mae's common stock will be subject to Sections 13(d) and 13(g) of the Exchange Act and will be required to make any required filings on Schedule 13D or Schedule 13G; and
- Bidders for 5% or more of Fannie Mae's common stock will be subject to Sections 14(d) and 14(f) of the Exchange Act and will be required to make the appropriate filings thereunder.

If you have any questions on any of these issues, please do not hesitate to contact us. All of us at Fannie Mae are looking forward to working with you on our voluntary registration and required continuing disclosures.

Very truly yours,

Ann M. Kappler

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1 If we register our common stock under Section 12(g) of the Exchange Act, we intend to prepare our proxy statement in accordance with SEC requirements and to file our proxy statements with the SEC. Exchange Act Form 10-K permits incorporation by reference of information from filed proxy statements into Part III of that form. Those proxy statements must be filed within 120 days after the end of the reporting company's fiscal year end. We will file a Form 8-K containing that Part III information within that time frame and incorporate that information by reference into the Form 10-K. Based on our discussions with the staff of the SEC, we understand that we may follow this procedure.

2 If we register our common stock under Section 12(g) of the Exchange Act, we will file with the SEC reports of our officers and directors under our Securities Transactions Supervision Program, which follows the provisions of Exchange Act Section 16.

Exchange Act of 1934 - Section 12(g)

No Action, Interpretive and/or Exemptive Letter:

Federal Home Loan Mortgage Corporation

July 12, 2002

Response of the Office of the Chief Counsel
Division of Corporation Finance

Re: Federal Home Loan Mortgage Corporation
Incoming letter dated July 12, 2002

Based on the facts presented in your letter, the Division of Corporation Finance concurs in the views expressed in your letter regarding the effect of voluntary registration under Section 12(g) of the Securities Exchange Act of 1934 on the treatment of Freddie Mac and its securities under the Securities Act of 1933, the Exchange Act and the Trust Indenture Act of 1939.

The Division of Market Regulation has asked us to inform you that, based on the facts presented in your letter, the Division of Market Regulation concurs in the views expressed in your letter regarding the effect of voluntary registration under Section 12(g) of the Exchange Act on the treatment of Freddie Mac and its securities under the Exchange Act.

The Division of Investment Management has asked us to inform you that, based on the facts presented in your letter, the Division of Investment Management concurs in the views expressed in your letter regarding the effect of voluntary registration under Section 12(g) of the Exchange Act on the treatment of Freddie Mac and its securities under the Investment Company Act of 1940.

The above positions are based solely on the facts presented in your letter. Any different facts or circumstances might require another conclusion.

Sincerely,

Martin P. Dunn
Deputy Director

Incoming Letter:

July 12, 2002

VIA FAX AND COURIER

Martin P. Dunn, Esq.
Deputy Director, Division of
Corporation Finance
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Dunn:

As we have indicated previously, Freddie Mac is considering registering voluntarily its common stock under Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"). While we already make available to investors a very substantial amount of information through periodic disclosures, we are not required to file periodic reports with the SEC because our Charter Act provides that all securities issued or guaranteed by Freddie Mac "shall, to the same extent as securities that are direct obligations of or obligations guaranteed as to principal or interest by the United States, be deemed to be exempt securities within the meaning of the laws administered by the Securities and Exchange Commission." Voluntary Exchange Act registration will obligate Freddie Mac, pursuant to Section 13 and the rules thereunder, to file periodic reports with the SEC. Voluntary Exchange Act registration will also subject Freddie Mac to the provisions of the Exchange Act, and to the SEC's enforcement jurisdiction thereunder, applicable to issuers with securities registered under Section 12 (g), except where the Exchange Act or the rules thereunder explicitly exclude "exempted securities."

Once the registration of our common stock becomes effective, the only means for termination of our Section 12(g) registration will be as provided in Section 12(g)(4) and Exchange Act Rule 12g-4. Freddie Mac also will recommend that our Board of Directors adopt an amendment to our Bylaws to the effect that Freddie Mac shall take no action in furtherance of termination of Exchange Act registration without unanimous action of all members of our Board of Directors then in office.

In connection with voluntary registration of our common stock under the Exchange Act, we are seeking the staff's concurrence with our views that voluntary registration will not cause any alteration of the existing treatment of Freddie Mac with regard to whether:

- Securities issued or guaranteed by Freddie Mac are exempt securities under the Securities Act of 1933 ("Securities Act") and may be sold without registration under the Securities Act;

- Securities issued or guaranteed by Freddie Mac are exempted securities and government securities under the Exchange Act;

- Freddie Mac is excluded from the definitions of "government securities broker" and "government securities dealer" under the Exchange Act;

- Debt securities issued or guaranteed by Freddie Mac are government securities for purposes of Rule 15c3-1(c)(2)(vi)(A) under the Exchange Act;

- Securities issued or guaranteed as to principal or interest by Freddie Mac are government securities for purposes of the Investment Company Act of 1940;

- Freddie Mac is an agency, authority or instrumentality of the United States for purposes of the Investment Company Act;

- Since the Trust Indenture Act of 1939 does not apply to securities issued by Freddie Mac, the Federal Reserve Banks may remain the fiscal agent of Freddie Mac, and no independent trustee is required, for Freddie Mac's unsecured debt securities or mortgage-backed securities;

- Sections 14(a) and 14(c) of the Exchange Act are inapplicable to Freddie Mac;[1]

- Section 16 of the Exchange Act is inapplicable to Freddie Mac's officers, directors and shareholders;[2] and

- The provisions of Regulation 14E of the Exchange Act are inapplicable to Freddie Mac and Freddie Mac securities.

We are also seeking the staff's concurrence with our view that, once our registration under Section 12(g) is effective:

- Holders of 5% or more of Freddie Mac's common stock will be subject to Sections 13(d) and 13(g) of the Exchange Act and will be required to make any required filings on Schedule 13D or Schedule 13G;

- Bidders for 5% or more of Freddie Mac's common stock will be subject to Sections 14(d) and 14(f) of the Exchange Act and will be required to make the appropriate filings thereunder; and

- If applicable, Freddie Mac will cause its Thrift/401(k) Savings Plan to file Annual Reports on Form 11-K with respect to the Freddie Mac Stock Fund offered as an investment option under the Plan.

If you have any questions on any of these issues, please do not hesitate to contact us. All of us at Freddie Mac are looking forward to working with you on our voluntary registration and required continuing disclosures.

Very truly yours,

Stephen L. Dinces
Vice President and Deputy General Counsel

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1 If we register our common stock under Section 12(g) of the Exchange Act, we

intend to prepare our proxy statement in accordance with SEC requirements and to file our proxy statements with the SEC. Exchange Act Form 10-K permits incorporation by reference of information from filed proxy statements into Part III of that form. Those proxy statements must be filed within 120 days after the end of the reporting company's fiscal year end. We will file a Form 8-K containing that Part III information within that time frame and incorporate that information by reference into the Form 10-K. Based on our discussions with the staff of the SEC, we understand that we may follow this procedure.

2 If we register our common stock under Section 12(g) of the Exchange Act, we will file with the SEC reports of our officers and directors under our Securities Trading Policy, which follows the provisions of Exchange Act Section 16.

SECURITIES ACT OF 1933

Disclosure Statute	Application to the GSEs
- ***Registration*** of all offers and sales of securities, unless exemption available	Not applicable, due to available exemption
- ***Antifraud*** [no exemptions]	Applicable [but only to disclosures chosen to be made]
Disclosure Requirements for Registrants	**If registration exemption eliminated:**
- ***Registration forms*** specify disclosures to be included in offering prospectus	(1) Would have to conform to SEC prospectus disclosure requirements
- ***Abbreviated registration forms*** available to seasoned issuers	(2) Would be eligible to use abbreviated registration forms [thereby allowing relatively brief prospectuses]
- ***Shelf registration*** available for rapid offerings by seasoned issuers	(3) Would be eligible for shelf registration and add-on registration [thereby eliminating most timing concerns]
SEC Processing	
- ***IPOs*** always reviewed	IPO review not applicable
- ***Other offerings*** reviewed on selective basis [less than 15% reviewed fully]	SEC unlikely to review more than a handful of MBS and other offerings annually
Costs	**If registration exemption eliminated:**
- ***Registration fees*** (§6(b)) [expected to be lower in future years]	Registration fees would apply, but would be capped for all companies by HR 2022
- ***Offering expenses*** [accounting, legal, printing, etc.]	Additional offering expenses, due to added costs of dealing with SEC
Liability	
- ***Strict liability*** for false or misleading filings by issuer	Liability currently a concern only if disclosures are materially false or misleading
- ***Damages*** limited to difference between price paid and current value	**If registration exemption eliminated:**
- ***Administrative sanctions*** [C&D orders, injunctions, fines] available for major violations	Would also be liable for material failure to conform to affirmative disclosure requirements of applicable registration form

Prepared by Peter J. Romeo, Partner, Hogan & Harston LLP

SECURITIES EXCHANGE ACT OF 1934

General Framework	Application to the GSEs
- ***Regulation of markets***	Limited applicability [SEC and NYSE]
- ***Trading Restrictions***	Limited applicability (see below)
- ***Disclosure requirements*** [for public companies and their insiders]	Not applicable (see below)
Trading Restrictions	
- ***Antifraud*** [Rule 10b-5 - no exemptions]	Applicable
- ***Short-swing profit disgorgement, short sale prohibition*** [insiders under § 16]	Not applicable to insiders, who are free to buy and sell without restrictions applicable to other public company insiders
Disclosure Requirements	
- ***Registration*** [§12] [for public companies]	Not applicable, due to exemption
- ***Periodic reporting*** [§§ 13 and 15(d)]	Not applicable, due to exemption
- ***Proxy*** [§14(a)]	Not applicable, due to exemption
- ***Tender offers*** [§§ 13 and 14(e)]	Not applicable, due to exemption
- ***5% Owners*** [§ 13(d)]	Not applicable, due to exemption
- ***Officers, directors and 10% owners*** [§ 16]	Not applicable, due to exemption
SEC Processing	
- ***Selective review*** of filings [less than 15%]	If exemption eliminated, SEC likely to review filings once every two years
Costs	
- ***No SEC fees***	
- ***Preparation and filing expenses***	Preparation expenses may increase, due to need to conform to SEC requirements
Liabilities	
- ***Liability*** for losses due to fraud	Liability a concern only if disclosures are materially false or misleading
- ***Administrative sanctions*** available [C&D orders, injunctions, fines]	

Prepared by Peter J. Romeo, Partner, Hogan & Harston LLP

CAP ANALYSIS

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PREPARED STATEMENT of James C. Miller III before the Subcommittee on Financial Management, the Budget, and International Security of the Committee on Governmental Affairs United States Senate July 21, 2003

Mr. Chairman, Senator Akaka, and other Members of the committee: thank you for inviting me to participate in this hearing. As you may know, I served as Director of the Office of Management and Budget (1985-1988) and as Chairman of the Federal Trade Commission (1981-1985) during the Reagan Administration. Currently, I am Chairman of The CapAnalysis Group, an economic, financial, and regulatory consulting firm affiliated with the international law firm, Howrey, Simon, Arnold, and White. In addition, I am privileged to serve as a member of the Board of Governors of the U.S. Postal Service, and I also serve as a consultant to Freddie Mac. A copy of my curriculum vitae is attached to this statement.

The focus of this hearing, as I understand it, is on the benefits and costs of the housing GSEs (government-sponsored enterprises). During the past several years I have participated in two major studies that address this issue (at least in part). The first, coauthored with Dr. James E. Pearce, vice president of Welch Consulting in College Station, Texas, is an appraisal of the benefits and costs of Freddie Mac and Fannie Mae's work in facilitating the secondary loan market and lowering housing costs.[1] The second, produced by CapAnalysis, addresses the stringency of OFHEO's (Office of Federal Housing Enterprise Oversight's) new risk-based capital stress test – as a measure of how confident we might be in the safety and soundness of the two housing GSEs (Freddie Mac and Fannie Mae) that are required to meet.[2] Both studies are attached to this statement.

Benefits and Costs of Freddie Mac and Fannie Mae's Mortgage Program

In our analysis of the benefits and costs of Freddie Mac and Fannie Mae's roles in the secondary mortgage market, Dr. Pearce and I found that they save American consumers between $8.4 billion and $23.5 billion per year in the form of lower mortgage costs. We also found that the funding advantage these GSEs derive from their nexus with the federal government amounts to between $2.3 billion and $7.0 billion per year. We computed ranges for each, to be conservative and because of different data sources and different plausible methodologies. Notably, however, the lowest estimate for consumer benefits exceeds the highest estimate of funding advantage.

In brief, we obtained our estimate of the benefits from Freddie Mac and Fannie Mae's operations by comparing mortgage rates at the upper end of the conforming loan limit ($240 thousand, in 1998), with mortgage rates on mortgages exceeding this limit. The data show clearly that where Freddie Mac and Fannie Mae are allowed to operate, mortgage rates are at least 24 basis points lower. And although Freddie and Fannie cannot operate in the higher-end ("jumbo") market, they have an indirect effect, reducing those mortgage rates at least 5 basis points. This translates into significant savings for consumers overall – between $8.4 billion and $23.5 billion annually. Since there are other consumer benefits that we could not quantify – such as the maintenance of liquidity in mortgage markets during turbulent times and the expansion of home ownership among minority citizens – these figures should be viewed as lower-bound estimates of the benefits associated with these two GSEs.

Although the federal government does not guarantee Freddie Mac and Fannie Mae's debt, some presume these GSEs, like certain other financial institutions, are "too big to fail," and for this reason and because of their nexus with the federal government, their cost of borrowing is less than it is for financial institutions generally. Dr. Pearce and I estimated this funding advantage by comparing these GSEs' cost of funds with the costs incurred by others. We found that with respect to short-term debt, Freddie Mac and Fannie Mae enjoy a funding advantage of between 10 and 20 basis points. On long-term debt, the advantage is between 10 and 40 basis points. And for mortgage-backed securities, the funding advantage is between 10 and 30 basis points.

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[1] James E. Pearce and James C. Miller III, Freddie Mac and Fannie Mae: Their Funding Advantage and Benefits to Consumers, January 9, 2001.

[2] The CapAnalysis Group, OFHEO Risk-Based Capital Stress Test Applied to U.S. Thrift Industry, March 17, 2003.

Given the distribution of debt at the time (September 2000), this implied an overall funding advantage of between $2.3 billion and $7.0 billion annually.

Note that in this approach, we measure benefits and costs directly. We do not assume, as some have (including the Congressional Budget Office), that somehow there is a "federal subsidy" to these institutions – only some of which they pass through to consumers. Under this second approach, anytime the estimate of benefits to consumers exceeds the estimate of funding advantage to the enterprises, one has the implausible task of explaining how this can be when these GSEs more than cover costs and provide a return to stockholders each year. The fact that such a surprising result is possible with this methodology means that it is fatally flawed.

Freddie Mac and Fannie Mae's Safety and Soundnesss

As are other major financial institutions, Freddie Mac and Fannie Mae are subject to regulations designed to assure their safety and soundness. The basic idea is to make sure such institutions are capitalized sufficiently to weather "hard times." Recently, after an extended period of development, OFHEO issued a new risk-based capital stress test to apply to these two GSEs. This test goes beyond the approach currently applied to federally-insured institutions, which is based on simple ratios of capital to assets. The new test is designed to measure whether an institution can sustain an extended period of stress and incorporates not only capital-to-asset ratios but takes into account the nature of the institution's assets and liabilities.

Because when this new risk-based capital test was announced some questions were raised about its overall stringency, Freddie Mac sought to give it a real-world test by applying it to the thrift industry – as if it were one large firm. So, the question was: would the thrift industry meet the new OFHEO risk-based capital test? In performing this test, Freddie Mac asked The CapAnalysis Group to consult with it and to audit its application of the OFHEO standards and its interpretation of the results.

The OFHEO risk-based capital test simulates how the institution in question would cope over a ten-year period with a rapid and dramatic rise in interest rates, and also how it would cope with a separate (alternative) ten-year period in which interest rates decline rapidly and dramatically. Under both interest rate scenarios, housing prices are assumed to fall calamitously nationwide, causing a serious deterioration in the (credit) quality of the institutions's mortgages. To pass the test, the institution must remain solvent under both scenarios.

Using publicly-available data, Freddie Mac applied the OFHEO risk-based stress test to the thrift industry, making reasonable, and conservative assumptions where the specifics of the available data required some qualifying to fit the OFHEO standard. The result was that the thrift industry failed the test. While it survived the falling- (interest) rate scenario, it failed the test 7.5 years into the rising-rate environment. The thrift industry's initial capital ($76 billion) is $32 billion short of what it would need to survive this rising-rate part of the test.

The purpose here is to demonstrate the stringency of the new risk-based capital test applied by OFHEO rather than to question the stringency of the thrift industry's current capital standards.

Concluding Remarks

The housing industry is enabled by an extraordinarily comprehensive mortgage industry which, in turn, is facilitated by the activities of the housing GSEs, primarily Freddie Mac and Fannie Mae. The U.S housing finance market has few rivals. This is a record about which we should be proud – and on which we can build.

Housing has been particularly important in recent years, where it has been an exceptionally vigorous part of the U.S. economy. Freddie Mac and Fannie Mae have enabled and encouraged this growth.

All institutions – public and private – may be improved, and the housing GSEs are no exception. But as one who has evaluated my share of both in the past, it is clear that Freddie Mac and Fannie Mae have performed superbly in carrying out their Congressional mandate to promote home ownership.

Freddie Mac and Fannie Mae:

Their Funding Advantage and Benefits to Consumers

by

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Executive Summary

The benefits that American consumers derive from the activities of Freddie Mac and Fannie Mae and the advantages these private corporations receive from their federal charters are central issues in the public discussion of their role in the housing finance system. At the request of Freddie Mac, we independently analyzed a 1996 report that the Congressional Budget Office prepared on this subject (the "1996 Study") and then addressed the benefits to consumers and to the corporations.

- We first find that the 1996 Study both understated the consumer benefits and overstated the firms' advantage in borrowing funds (the "funding advantage"). The study used faulty data and inappropriate methodology.

- We estimate that Freddie Mac and Fannie Mae generate interest-cost savings for American consumers ranging from at least $8.4 billion to $23.5 billion per year. In contrast, we estimate that the value Freddie Mac and Fannie Mae indirectly receive from federal sponsorship in the form of their funding advantage ranges from $2.3 billion to $7.0 billion annually. Thus, even using the lowest estimate of consumer benefits and the highest estimate of the funding advantage in our range of estimates, the value of consumer interest-cost savings resulting from Freddie Mac and Fannie Mae's activities significantly exceeds the value of their funding advantage.

  - Freddie Mac and Fannie Mae also provide benefits beyond those that can be quantified in terms of savings on mortgage interest expense by homeowners. These include the maintenance of liquidity in the mortgage market during periods of financial turbulence and the expansion of homeownership opportunities for low-income and minority families. No attempt to quantify these additional consumer benefits was made here.

- We also find that federal sponsorship of Freddie Mac and Fannie Mae provides a "second best" structure for a housing finance system assuming that the "first best" system would have no government involvement at all. This is because Freddie Mac and Fannie Mae supply housing finance more efficiently than could the depositories alone. Banks and thrifts receive federal support in the form of deposit insurance, access to Federal Reserve Bank liquidity, and Federal Home Loan Bank advances and as a result they have an average cost of funds lower than Freddie Mac and Fannie Mae.

In summary, the 1996 Study was deficient in many respects. A more accurate approach shows that, under current federal sponsorship of Freddie Mac and Fannie Mae, consumers receive benefits significantly greater than the funding advantage received by the two corporations.

I. Introduction

Congressman Richard Baker (R-LA), Chairman of the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee on Banking and Financial Services of the U.S. House of Representatives, has requested that the Congressional Budget Office ("CBO") update its 1996 estimates on the funding advantage and benefits to families resulting from Freddie Mac and Fannie Mae's activities (the "1996 Study").[1] The 1996 Study attempted to quantify the advantages that Freddie Mac and Fannie Mae derive from their Congressional charters and the benefits Freddie Mac and Fannie Mae provide to consumers. The Department of the Treasury, the Department of Housing and Urban Development, and the General Accounting Office prepared similar studies.[2]

Freddie Mac and Fannie Mae are government-sponsored enterprises ("GSEs") that play an important role in the secondary market for residential mortgages. Operating under essentially identical federal charters, the two firms benefit from lower costs and larger scale than they would have in the absence of federal sponsorship. Freddie Mac and Fannie Mae use these advantages to reduce the cost of mortgage credit and provide other benefits to homeowners. The lower yields they pay on their securities are often characterized as a "funding advantage" or even as a "subsidy" when comparing Freddie Mac and Fannie Mae to purely private corporations that have no nexus to the government. The 1996 Study attempted to quantify the funding advantage resulting from federal sponsorship and the benefits conveyed to mortgage borrowers.

The 1996 Study generated substantial controversy. It was well received by those who support a change in the charters of Freddie Mac and Fannie Mae. Others observed that the analysis contained serious flaws that led to an understatement of the net benefits provided by the

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[1] Letter dated July 12, 2000 from Representative Richard H. Baker to Mr. Dan L. Crippen, Director, Congressional Budget Office, requesting updates of estimates contained in Congressional Budget Office (1996).

[2] Department of the Treasury (1996); Department of Housing and Urban Development (1996); and General Accounting Office (1996).

two housing enterprises. In anticipation of the forthcoming CBO report, we were asked by Freddie Mac to review the 1996 Study and provide current analyses.

In this report, we address these fundamental questions:

- Are there major errors in the 1996 Study, and, if so, what are they?
- What are reasonable values for the funding advantage that Freddie Mac and Fannie Mae receive and the benefits that Freddie Mac and Fannie Mae's activities provide consumers?
- Would consumers be better or worse off in the absence of federal sponsorship of Freddie Mac and Fannie Mae?

These questions are answered in the following sections. Section II addresses errors in the data and methodology used in the 1996 Study. That study was deficient in many respects. We find that it systematically overstated the funding advantage received by Freddie Mac and Fannie Mae and understated the benefits to consumers. A repeat of these mis-measurements in the new report would render its findings and conclusions without credible foundation. Section III quantifies the funding advantage realized by Freddie Mac and Fannie Mae through their charter relationship with the federal government. Section IV addresses the benefits provided to consumers by the activities of Freddie Mac and Fannie Mae. We find that the benefits are much greater than the funding advantage. Section V includes an analysis of the market for mortgage credit and identifies certain efficiency-enhancing effects that follow from Freddie Mac and Fannie Mae's charters. We find that federal sponsorship of Freddie Mac and Fannie Mae supplies housing finance more efficiently than would depositories alone. The final section contains concluding remarks.

We find that the funding advantages and benefits must be expressed as ranges of estimates rather than as particular values. This follows from the underlying changes in market conditions over time and from the inability to obtain precise estimates of key relationships. Our fundamental conclusion is unqualified, however. Under present institutional arrangements in the mortgage lending industry, it would be a mistake to withdraw or curtail federal sponsorship of Freddie Mac and Fannie Mae. Because of Freddie Mac and Fannie Mae, consumers enjoy savings on their mortgages that are substantially greater than the funding advantages that are derived from Freddie Mac and Fannie Mae's charters.

II. The Approach Used by CBO in 1996 Overstated the Funding Advantage and Understated Benefits to Consumers

The CBO used a simple framework to quantify the funding advantage and the benefits to consumers. The first step in deriving the funding advantage was estimation of spreads that measure the differences in yields on Freddie Mac and Fannie Mae securities and similar securities issued by fully private firms. The second step was multiplying those spreads by the outstanding balances of Freddie Mac and Fannie Mae securities. A parallel procedure was used to derive the benefits to consumers. A spread estimating the effect of Freddie Mac and Fannie Mae on mortgage interest rates was applied to the outstanding amount of conforming mortgages held by Freddie Mac and Fannie Mae. In applying this framework in 1996, CBO overstated the funding advantage and understated the benefit to consumers.

The 1996 CBO estimate of the funding advantage was overstated in that:

1. It treated all Freddie Mac and Fannie Mae debt as long-term debt, ignoring the lower funding advantage on short-term debt.
2. It incorrectly measured the funding advantage on long-term debt and mortgage-backed securities ("MBS");

The 1996 CBO estimate of the consumer benefits was understated in that:

1. It ignored the benefits of Freddie Mac and Fannie Mae's activities on conforming mortgages not purchased by them;
2. It failed to recognize that the unadjusted spread between rates on jumbo and conforming mortgages does not capture the full impact of Freddie Mac and Fannie Mae on mortgage rates.

Overstating the Funding Advantage

Freddie Mac and Fannie Mae issue four types of securities to fund their purchases of mortgages: short-term debt (with maturities less than one year); long-term bullet debt; long-term callable debt (which can be called or retired early); and MBS. CBO overstated the funding advantage for Freddie Mac and Fannie Mae for each of these securities. First, the funding advantage on long-term debt was used for short-term debt even though empirical evidence demonstrates that short-term debt receives a lower funding advantage. Second, CBO failed to adjust its estimates of the funding advantage on long-term debt to account for the better liquidity of GSE debt. Third, the funding advantage on long-term callable debt was mis-measured, resulting in a significant overstatement of the funding advantage on this debt. Fourth, CBO overstated the funding advantage for MBS.

Overstatement of the funding advantage on short-term debt

The distinction between long-term and short-term debt is significant. The range of estimates for the funding advantage on short-term debt is substantially lower than for long-term debt. As we discuss further in the next section, the estimated funding advantage for short-term debt ranges from 10 to 20 basis points, while the corresponding range for long-term debt is 10 to 40 basis points.[3] At the same time, the share of short-term debt is large. The proportion of debt outstanding at year-end 1995 that was due within a year was about 50% for both Freddie Mac and Fannie Mae. At the end of third quarter 2000, the proportions were 41% for Fannie Mae and 45% for Freddie Mac.[4] This difference in the term of debt, and its implication for estimating the funding advantage, were ignored by CBO in its 1996 report. The appropriate approach is to compute separate funding advantages for short-term and long-term debt.

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[3] Freddie Mac's and Fannie Mae's practice of synthetically extending the maturity of debt with swaps and other derivatives does not matter for the assessment of the short-term funding advantage. They participate in the swap market at the same prices as other large financial institutions. Thus, the funding advantage on short-term debt whose maturity is extended is no higher than the funding advantage for short-term debt whose maturity is not extended.

[4] These figures were obtained from the 1996 annual reports and third quarter, 2000 investor-analyst reports of Freddie Mac and Fannie Mae.

Measuring spreads on long-term debt

Analysts estimate the Freddie Mac and Fannie Mae funding advantage in debt issuance by comparing yields on debt issued by Freddie Mac and Fannie Mae and debt issued by firms that lack federal sponsorship but are perceived as otherwise similar to Freddie Mac and Fannie Mae. Such comparisons are sensitive to the choice of firms judged to be similar to Freddie Mac and Fannie Mae, to the period under consideration, and to how similar other private securities are to Freddie Mac and Fannie Mae securities with respect to such technical characteristics as default risk, callability, time-to-maturity, and amount issued. No such comparison is perfect. There are always some differences between the Freddie Mac and Fannie Mae securities and the comparators.

For its 1996 report, CBO utilized spreads from a commissioned study by Ambrose and Warga (1996). The authors were careful to limit their comparison of Freddie Mac and Fannie Mae securities to private securities that were similar in a number of important respects. However, they did not take into account the higher liquidity of Freddie Mac and Fannie Mae debt that results from the scale of their security issuances and the consistency of their presence in the securities markets. Withdrawal of federal sponsorship might reduce the amount of debt they issue, but they would still likely be among the largest private issuers in the market. Large issues generally are more readily marketable and therefore carry lower yields. Thus, yield comparisons that do not take issue size, volume outstanding, and other determinants of liquidity into account will overstate the yield spreads.[5]

[5] The Ambrose and Warga study has other methodological deficiencies that were revealed by academic reviewers at the time the study was prepared (see, for example, Cook (1996) and Shilling (1996)). The spreads reported are averages obtained from monthly data. The sample of comparable debt issues varies widely over the ten-year period studied, but the authors report very limited information on how the levels and dispersion in the distribution of spreads varies over time. This may be a concern because months in which the number of possible comparisons is small receive as much weight in arriving at the final averages as months with large numbers of possible comparisons. Because the margin of error is higher in the months with few comparisons, those months should

Misuse of spreads on callable debt

The 1996 CBO procedure uses a weighted average of the spreads on callable and bullet debt to derive its estimate of the funding advantage. Because the spread on callable debt used by CBO was extraordinarily high (more than twice the spread on bullet debt), this approach resulted in an average spread on long-term debt that was considerably higher than would have been obtained from spreads on bullet debt alone.

Callable debt generally has an initial period where the debt cannot be called, after which it may be called, or bought back by the issuer at a stated price before maturity. It is far more difficult to compare yields across callable bonds because yields are extremely sensitive to the specific call features of a bond, for example, the length of the initial non-call period, the call price, and the maturity. Further, the projected yield depends on one's forecast of the volatility of interest rates over the investor's holding period of the bond, as volatility effects the probability that interest rates will fall sufficiently to trigger a call.

The difficulty of comparing yields on callable debt is exacerbated by the lack of data on callable bonds by other issuers. Freddie Mac and Fannie Mae issue significant amounts of callable debt because it provides an effective hedge for the mortgage assets that they are funding. Few other corporations have this need and regularly issue callable debt. In 1999, the GSEs accounted for most of the callable debt market.

Incorporating callable spreads into the derivation of the funding advantage on long-term debt was inappropriate. First, the callable spreads are very difficult to measure, as noted above. Second, there is no evidence to indicate that the funding advantage on callable debt is larger than that on non-callable debt. Callable debt is essentially long-term debt with an "option" to turn the debt into short-term debt. Market prices for callable debt reflect the value of the bullet debt plus the value of the call provision. The value of the call provision is determined in the derivatives market where Freddie Mac and Fannie Mae have no advantage over other market participants.

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receive less weight in the overall average. Failure to reflect these deficiencies in its application of the Ambrose and Warga data led CBO to treat the funding advantage as being more precisely estimated than it actually was.

Therefore, a more appropriate approach to estimate the funding advantage on callable debt would be to use spreads on long-term debt that can be more accurately measured.

Funding advantage on MBS

CBO included a component for MBS in its estimate of the overall funding advantage. As with the debt component, the funding advantage on MBS was derived from an estimated spread using yields on Freddie Mac and Fannie Mae securities relative to yields on comparable securities issued by other firms. The difficulty with this approach is that "private-label" MBS are very different from Freddie Mac and Fannie Mae MBS. Private-label MBS have lower volume, less frequent issuance, less liquidity and more complex features that investors must analyze. In particular, private-label MBS are typically "structured" securities where the cash flows on the underlying mortgages are divided among various investors. Consequently, estimates of the relevant spreads are very rough approximations. Most are based on the impressions of market participants rather than documented statistical comparisons subject to verification by other researchers. If these estimates were to be used, the estimates would need to be adjusted downward for the much greater liquidity of Freddie Mac and Fannie Mae securities.

After assessing the available information, CBO concluded that the relevant MBS spread was between 25 and 60 basis points. Although this range errs on the high side, we appreciate the recognition, reflected in the broad range, that the spread is not subject to precise estimation. However, the CBO did not carry this cautious approach into the calculation of the funding advantage. The agency used 40 basis points as its baseline value to estimate the MBS component of the funding advantage, and its sensitivity analysis considered a deviation of only 5 basis points from that value.

We believe that the relevant MBS spread is significantly less than 40 basis points and would fall between the spreads on short-term and long-term debt. In part, the basis for this opinion is the recognition that Freddie Mac and Fannie Mae are earning modest rates of return on their MBS business. Annual reports indicate that the two enterprises earn guarantee fees of approximately 20 basis points, which must compensate them for bearing default risk and other costs. Thus, Freddie Mac and Fannie Mae do not appear to be retaining much, if any, funding advantage through the issuance of MBS. Furthermore, MBS are backed by or "collateralized" by the underlying mortgages. Debt, on the other hand, is uncollateralized. As a result, perception of credit quality plays less of a role in valuing MBS than debt, because the investor has the assurance of quality from the mortgage collateral. Therefore, the funding advantage on MBS would be less than the funding advantage on the long-term debt.

Understating Benefits to Consumers

CBO estimated the benefits to consumers from Freddie Mac and Fannie Mae by multiplying a long-term average of the spread between interest rates on jumbo and conforming fixed-rate mortgages by the volume of mortgages financed by Freddie Mac and Fannie Mae.[6] This procedure understates the savings to borrowers on two accounts. First, it does not incorporate the effect on *all* conforming mortgage rates of the activities of Freddie Mac and Fannie Mae, including the reduction in rates on the conforming mortgage loans they do not purchase. Second, the jumbo-conforming spread understates the full effect that Freddie Mac and Fannie Mae have on mortgage rates.

The jumbo-conforming spread

Nearly all observers agree that Freddie Mac and Fannie Mae reduce interest rates on all conforming mortgage loans. The most dramatic evidence of this fact is found in comparisons of interest rates for loans above and below the conforming loan limit.[7] These rate comparisons can be found listed in newspapers around the country.

Freddie Mac and Fannie Mae are not allowed to purchase loans for amounts above the conforming limit. The effect this limitation has on interest rates is graphed in Exhibit 1. In this chart, the average interest rates in a range of loan size categories are shown relative to average interest rates for the category just below the conforming loan limit (which in 1998 was

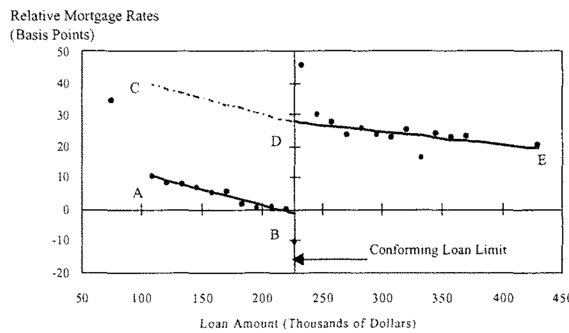
[6] In practice, the amount financed is measured as the (annual average) balance outstanding of mortgages in portfolio or pooled into MBS.

[7] The 2001 conforming loan limit is $275,000 for one-family properties. Higher limits apply in Alaska, Hawaii, Guam and the U.S. Virgin Islands.

\$240,000).[8] The graph shows that mortgage interest rates decline steadily with loan size until the conforming limit is reached. Then rates take a sharp jump upward before resuming their decline. This relationship is consistent with the proposition that net economic costs of originating and servicing decline with loan size.[9]

The gap between the dotted line, CD, and the solid line AB, is the direct measure of the jumbo-conforming spread.

Exhibit 1
Relative Mortgage Rates and Loan Amount
(Fixed Rate Mortgages, California, 1998)



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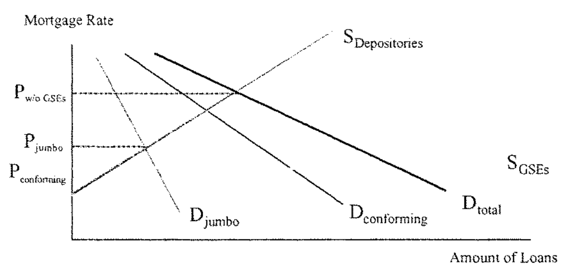
[8] The exhibit plots relative mortgage interest rates for fixed-rate loans in the Monthly Interest Rate Survey ("MIRS") after adjusting for origination week, lender type, new versus existing home, and loan-to-value intervals. The points plotted are averages computed over intervals with width of \$12,500. Exceptions are the endpoints and the average for loans made for exactly \$240,000. Readily obtainable mortgage rates found in newspapers make none of these adjustments.

[9] This phenomenon underlies empirical specifications that have been used in previous research on the conforming loan limit. See Cotterman and Pearce (1996) and Hendershott and Shilling (1989). The reasons for the inverse relationship between loan size and net economic costs include significant fixed costs of origination, servicing and real-estate-owned disposition that cause average costs per loan dollar to decline dramatically with loan size. These

Freddie Mac and Fannie Mae reduce rates on jumbo loans as well as on conforming loans

CBO used the average jumbo-conforming spread estimated over the 1989-1993 interval as its measure of the effect of Freddie Mac and Fannie Mae on mortgage interest rates. This approach assumes that the line CDE in Exhibit 1 represents the relationship between mortgage rates and loan size that would be observed in the absence of Freddie Mac and Fannie Mae. As we show below, this assumption understates consumer benefits because Freddie Mac and Fannie Mae almost certainly reduce interest rates on jumbo loans as well as on conforming loans.

Exhibit 2
Jumbo-Conforming Spreads Understate Consumer Savings



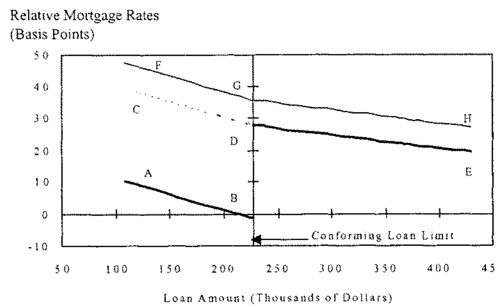
A theoretical argument for this point is illustrated in Exhibit 2. In this graph, the mortgage interest rate in the absence of Freddie Mac and Fannie Mae is found at the intersection of the depository supply curve ($S_{Depositories}$) and the total mortgage demand curve (D_{total}). When supply from Freddie Mac and Fannie Mae is introduced, there emerge two mortgage rates, both

factors more than offset a slightly more expensive prepayment option for jumbos and some evidence that default rates are higher for very-low-balance and for super-jumbo loans.

lower than the rate that would prevail in their absence. The rate for jumbo loans is determined by the intersection of the depository supply curve and the demand curve for jumbo loans (P_{jumbo}). The rate for conforming loans is determined by the intersection of the GSEs supply curve and the demand curve for conforming loans ($P_{conforming}$). Thus, the presence of Freddie Mac and Fannie Mae reduces rates on both jumbo and conforming loans, and the jumbo-conforming differential understates the savings to mortgage borrowers.

This reasoning suggests that mortgage rates in the absence of Freddie Mac and Fannie Mae would lie on line FGH in Exhibit 3 rather than line CDE. The jumbo-conforming spread would understate the effect of Freddie Mac and Fannie Mae on mortgage rates by the distance between segments CD and FG.

Exhibit 3
Freddie Mac and Fannie Mae Also Lower Jumbo Rates
(Fixed Rate Mortgages)



Partial versus full benefits to borrowers

This analysis does not take into account the fact that Freddie Mac and Fannie Mae are restricted to a market that has other federally-subsidized participants. Depositories have been, and continue to be, substantial holders of residential mortgages. They have access to insured deposits, which carry explicit federal guarantees, and low-cost advances from the Federal Home

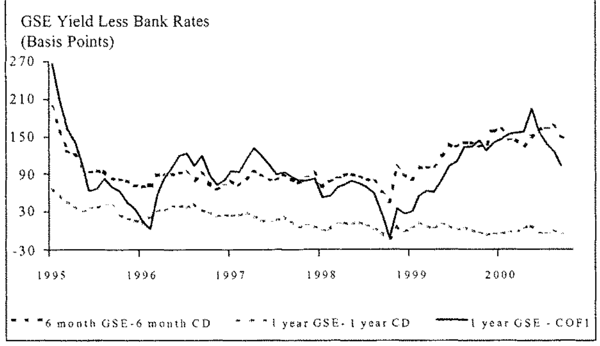
Loan Banks ("FHLBs") — institutions with federal sponsorship similar to that of Freddie Mac and Fannie Mae.

Consequently, Freddie Mac and Fannie Mae compete with other subsidized participants. Thus, the estimates of the spreads on securities are not strictly comparable with the estimates of the interest rate effect. The security spreads are estimated on a *gross* basis, while the effect on mortgage interest rates is *net* of the effect of depositories. The amount by which depositories reduce interest rates on jumbo loans would have to be added to the effect indicated in Exhibit 3 to obtain the total effect of Freddie Mac and Fannie Mae on conforming mortgage rates.

The point that depositories also receive a funding advantage relative to firms without access to any federally supported sources of funds is illustrated in Exhibit 4.[10] The chart shows that the 11th District Cost of Funds Index ("COFI"), which reflects the cost of funds for western savings associations, is below the yield on comparable Freddie Mac and Fannie Mae debt. Similarly, the spreads to certificates-of-deposit ("CD") yields show that banks have lower cost of funds.

[10] The yield spreads are 6-month GSE debt less the 6-month CD yield, one-year GSE debt less the one-year CD yield, and one-year GSE debt less the 11th FHLB district COFI.

Exhibit 4
Amount by which Bank Cost of Funds are Below GSE Yields



An issue deserving further research is the extent to which the funding advantage accruing to banks benefits consumers. Exhibit 5 demonstrates that, unlike Freddie Mac and Fannie Mae, the depositories provide substantial support to the jumbo market.[11] As well, relative to Freddie Mac and Fannie Mae, these depositories, the largest FHLB advance holders, have a lower share of net mortgage acquisitions (originations plus purchased loans, less loans sold) in the low- and moderate-income market. In the Home Mortgage Disclosure Act ("HMDA") data, 93 percent of all jumbo loans for which income is reported are made to borrowers with incomes above 120 percent of the area median. From the data presented in Exhibit 5, one can infer that approximately one-half of FHLB advances are being used to fund jumbo mortgage loans, loans

[11] Source: FHLB System 1999 Financial Report, Thrift Financial Reports, 1999, Home Mortgage Disclosure Act data, 1999. FHLB advances for the top 10 advance holding members are from page 17 of the Federal Home Loan Bank System 1999 Financial Report. FHLB advances for Commercial Federal Bank, Dime Savings Bank, and Standard Federal Bank are from their respective Thrift Financial Report filings line item SC720 (Advances from FHLB). Low- and moderate-income shares are the percent of dollars reported in HMDA going to borrowers with incomes less than the area median income; includes all conventional refinance and home purchase loan originations and purchases for single-family residences, net of loans sold.

made disproportionately to upper-income borrowers. In contrast, despite being given access to low-cost funding from the FHLBs, the top FHLB advance holders extended only 20 percent of their net conventional, single-family mortgage acquisitions (weighted by dollars) to low- and moderate-income borrowers in 1999, according to HMDA. Freddie Mac's 31 percent low-and moderate-income share (dollar-weighted) is higher than every one of the top FHLB advance holders.

Exhibit 5
Federal Home Loan Bank Advances and Shares of Net Mortgage Acquisitions (1999)

Institution	FHLB Advances December 31, 1999 (Millions of Dollars)	Low and Moderate-Income Shares (Percentages)	Jumbo Shares (Percentages)
Washington Mutual Bank, FA, Stockton, CA	45,511	14	55
California Federal Bank, San Francisco, CA	23,377	2	75
Washington Mutual Bank, Seattle, WA	11,151	19	41
Sovereign Bank, Wyomissing, PA	10,488	18	44
Charter One Bank, SSB, Cleveland, OH	9,226	22	38
PNC Bank, NA, Pittsburgh, PA	6,651	17	46
Bank United, Houston, TX	6,593	4	68
Norwest Bank, MN	6,100	23	37
World Savings Bank, FSB, Oakland, CA	5,655	18	42
Astoria FS&LA, New York City, NY	5,305	4	77
Commercial Federal Bk, a FSB, Omaha, NE	4,524	27	24
Dime Savings Bank of NY, New York City, NY	4,463	2	58
Standard Federal Bank, Troy MI	4,222	21	30
Top FHLB advance holders (total)	143,265	14	52
Freddie Mac	n.a.	31	0
Fannie Mae	n.a.	29	0

Benefits to consumers in addition to reductions in mortgage rates

Efficiencies in underwriting and increases in low-income and minority homeownership

Freddie Mac and Fannie Mae provide benefits beyond reductions in interest rates on mortgage loans. These benefits include increased availability of information provided to consumers, standardization of the mortgage lending process, and more objective qualifying criteria through the development of automated underwriting. Freddie Mac and Fannie Mae have also increased the availability of low-down-payment mortgages. Such loans make mortgage financing more available to low- and moderate-income families. Recent research indicates that home ownership for these families and minority families are 2% to 3% higher as a result of the efforts of Freddie Mac and Fannie Mae (Quercia, McCarthy, and Wachter (2000), and Bostic and Surette (2000)).

Improved dynamic efficiency and liquidity

Freddie Mac and Fannie Mae also increase the dynamic efficiency of the mortgage market, a point ignored by CBO. In periods of turbulence in the capital markets, Freddie Mac and Fannie Mae provide a steady source of funds. These conditions occur relatively frequently. Since 1992, the capital markets have had two episodes of abnormal shortages of liquidity—one beginning in late 1994 following the Orange County bankruptcy and another in 1998 and 1999 when important developing countries devalued their currencies and Russia defaulted on some bonds. Recent research indicates that the activities of Freddie Mac and Fannie Mae " ... returned capital to the mortgage market. That action not only stabilized the price of mortgage-backed securities, it also stabilized home loan rates during the credit crunch of 1998" (Capital Economics (2000)).

Lower risk to taxpayers

If the roles of Freddie Mac and Fannie Mae were reduced substantially, many presume that withdrawal of federal sponsorship would reduce taxpayer risk in direct proportion to the removal of risk from the books of Freddie Mac and Fannie Mae. This presumption ignores the likely expansion of other federally-sponsored participants that support housing. Yezer (1996) notes that such charter revocation would lead to expansion of the demand for Federal Housing Administration ("FHA") mortgages. The analysis of Miller and Capital Economics (2000), discussed in Section V (and illustrated in Exhibits 2 and 12) indicates that mortgages held by depositories would also increase. These reallocations of mortgage credit would shift additional risk to the FHA insurance and deposit insurance programs. Additionally, families would bear more interest rate risk because, when faced with higher rates on fixed-rate mortgages, they will increase their use of adjustable-rate mortgages ("ARMs"). On balance, in addition to reallocating resources to less efficient housing finance participants, charter revocation would likely increase risks to taxpayers.

Summary

In summary, CBO's 1996 report was deficient in many respects. The approach used overstated the funding advantage Freddie Mac and Fannie Mae derive from their charters, understated some components of consumer benefits, and ignored others. In addition, the use of point estimates for the various spreads, rather than ranges, provides the misleading impression that the funding advantage and benefits to consumers can be quantified precisely. A repeat of these mis-measurements in the new report would render its findings and conclusions without credible foundation.

We turn next to our own assessment of the advantages afforded Freddie Mac and Fannie Mae through their federal charters, followed by our assessment of the benefits derived by consumers.

III. Estimates of Funding Advantages to Freddie Mac and Fannie Mae

CBO overstated the subsidy involved in debt-funded mortgages. The 1996 CBO report estimated that the funding advantage to Freddie Mac and Fannie Mae between 1991 and 1994 was 70 basis points. As we show below, this figure is far above the range of estimates available from other sources. Recall that the CBO estimate is a weighted average of estimates for callable and noncallable long-term debt, and it treats all debt as long-term debt.

Several alternative measures are summarized in Exhibit 6. The LIBOR[12] - Agencies spread indicates that Freddie Mac and Fannie Mae issue short-term debt at 10 to 20 basis points below LIBOR, which is a *short-term* funding cost of certain highly rated banks.[13] The long-term, noncallable spreads show how yields on Freddie Mac and Fannie Mae debt compare with yields on debt rated AA.[14] The estimates cover a range of sources and methodologies. The first estimate, 10 to 30 basis points, is from a study by Salomon Smith Barney that compares specific

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[12] London Inter-Bank Offer Rate ("LIBOR").

[13] In this table, we use spreads to Agencies as reported in Bloomberg. Bloomberg includes Freddie Mac, Fannie Mae, the FHLBs and government agencies that issue debt in its "Agencies" category.

Freddie Mac or Fannie Mae issues with specific securities issued by two of the largest non-financial corporations and one large financial corporation. All the comparable securities were AA-rated, with large outstanding issue volumes. The second estimate, from Bloomberg, uses a proprietary methodology to adjust for important differences in the characteristics of the securities being compared. The third row is taken from a study by Toevs (2000) using data on Fannie Mae debt and market data from Lehman Brothers. The last estimate is from Ambrose and Warga (1996), a study whose deficiencies were discussed above.

Exhibit 6
Estimates of the Debt Funding Advantage

Short-Term Spreads	Basis Points
LIBOR – Agencies Spread: [1]	10-20
Long-Term Spreads	
Highly liquid AA Debt-Freddie Mac & Fannie Mae[2]	10-30
Highly liquid AA Debt – Agencies[3]	37
AA Financials Debt –Fannie Mae[4]	34
AA Financial Debt – Fannie Mae[5]	32 - 46

[1] Bloomberg data, 12-month term, short term debt.
[2] Salomon Smith Barney (August 2000).
[3] Bloomberg data, 5-year average.
[4] Toevs (2000) for the period 1995-1999.
[5] Ambrose & Warga (1996) for the periods (1985-90) and (1991-1994).

Exhibit 6 does not include any entries for spreads on callable debt. These spreads are difficult to measure accurately because callable debt securities are not issued in significant amounts by other corporate issuers and are very heterogeneous. In particular, appropriate comparisons of callable debt must hold constant the restrictions on the call options of the various securities. A given callable debt issue typically will have some restrictions, such as how soon the issuer may exercise the call option. These restrictions can be important to the value the debt issue commands in the marketplace. For example, a security that allowed the issuer to exercise

[14] Standard and Poor's (1997a) rated Freddie Mac and Fannie Mae AA- on a stand-alone basis.

the option after one year will have a lower value than a security that does not allow the issuer to exercise the option until five years have passed. Thus, given the difficulty in obtaining valid spreads for callable debt, a preferable approach is to use spreads on noncallable debt.[15]

Exhibit 6 illustrates that alternative estimates of the relevant noncallable spread range from 10 to 40 basis points. The estimates are obtained from a variety of sources and were generated using several methodologies. They are all substantially below the 70 basis points used in the 1996 CBO report. Use of a weighted average of spreads on callable and noncallable debt accounts for some of the inflation in the CBO estimate. We understand that CBO may not incorporate callable spreads into its analysis in the forthcoming report, and if this is true the change will move the CBO estimate closer to the alternative estimates. But the spread will still likely be overstated if the Ambrose-Warga methodology is used to estimate noncallable spreads.

CBO's Sensitivity Analysis

As exhibited above, it is necessary to use ranges rather than single numbers to express the extent to which Freddie Mac and Fannie Mae benefit from a funding advantage for long-term debt. In its 1996 report, CBO recognized that it was using spreads that were measured imperfectly and included a brief sensitivity analysis[16] to illustrate the effect of variation from baseline assumptions for some key parameters, including the spreads on long-term debt. The Ambrose-Warga presentation of results on yield to maturity used mean values for relatively long intervals. This provided almost no basis to assess the stability of the spreads over time or the amount of dispersion in spreads at a point in time. In the absence of either of these elements, it is difficult to have confidence in the estimates. This is particularly true given the methodological

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[15] An alternative would be to estimate the fair value of the call option through an option-adjusted spread calculation before the yields are compared. See Kupiec and Kah (2000).

[16] Although we agree that including a sensitivity analysis is, in principle, a useful exercise, we believe that the analysis in the 1996 CBO report understated the dependence of the CBO's conclusions on assumptions about the precise values of key parameters. In the case of debt funding spreads, CBO's attempt to conduct a valid sensitivity analysis was handicapped by the limited information on dispersion in yield spreads between Freddie Mac and Fannie Mae and other private companies provided in Ambrose and Warga's study.

shortcomings identified above and the disparity between the Ambrose-Warga estimate and the available alternatives we present in Exhibit 6.

The CBO sensitivity analysis of the debt funding advantage would have benefited from additional information on how spreads vary, both over time and across other debt issues at a point in time. In the absence of such information, CBO considered a very small reduction in the debt spreads, of 10 basis points, from the 70 basis points used in the primary calculations. This reduction covered only a small fraction of what we know of the possible dispersion of spread values and it closes little of the gap between the CBO figure and alternative estimates. Thus, the sensitivity analysis did not accurately portray the fragility of the 1996 CBO estimates of the funding advantage.

Estimates of the Funding Advantage

Using the information in Exhibit 6, and debt and MBS balances outstanding for Freddie Mac and Fannie Mae, funding advantage spreads are provided in Exhibit 7. The spread on the MBS, reflecting both its long-term nature, and its collateral value, likely falls between the values of the spreads on short-term and long-term debt. We calculate the MBS funding advantage using a spread of 10 to 30 basis points.[17] Higher amounts would be inappropriate given the 20 basis point guarantee fees that the corporations earn and the significant liquidity differences between their MBS and private-label MBS.

[17] Freddie Mac and Fannie Mae's MBS are backed by real-property collateral as well as a corporate guaranty. Thus a proxy for the funding advantage on MBS, net of liquidity and credit quality, could be the yield spread between five-year, AAA-rated bullet debt and comparable Freddie Mac and Fannie Mae debt. In a report, Freddie Mac (1996, p. 33) computed this spread to be about 23 basis points over 1992-1996.

Exhibit 7
Estimates of the Funding Advantage
(Data as of September 30, 2000)

	Balances Outstanding (Billions of Dollars)				
Security Type	**Freddie Mac**	**Fannie Mae**	**Totals**	**Spread (basis points)**	**Funding Advantage (Billions of Dollars per Year)**
Short-term Debt	181	251	432	10-20	0.4 - 0.9
Long-Term Debt	226	356	582	10-40	0.6 - 2.3
MBS	559	701	1,260	10-30	1.3 - 3.8
Total Funding Advantage					2.3 - 7.0

Exhibit 7 summarizes our estimates of the total funding advantage received by Freddie Mac and Fannie Mae through their government sponsorship. Since this calculation is based on a range of spreads for individual components (short-term debt, long-term debt, and MBS), the resulting aggregate must be expressed as a range as well. In each case above, we have been careful to reflect reasonable estimates – on the high side as well as the low side. While we might be inclined to narrow this range, out of an abundance of caution we have included the results of reputable analyses and methodologies that bracket what we consider the more likely figures.

Multiplying the spread range of 10 to 20 basis points for short-term debt by the short-term debt balances outstanding of Freddie Mac and Fannie Mae gives an estimate of their annual funding advantage for short-term debt that ranges from $0.4 billion to $0.9 billion. Similarly, the estimates for the annual funding advantage on long-term debt and MBS are $0.6 billion to $2.3 billion and $1.3 billion to $3.8 billion respectively. Thus, our estimate of the total annual funding advantage for Freddie Mac and Fannie Mae ranges from $2.3 billion to $7.0 billion.

IV. Estimates of the Benefits to Mortgage Borrowers Provided by Freddie Mac and Fannie Mae's Activities

Estimates of the full benefits to mortgage borrowers must take consideration of several factors. First, Freddie Mac and Fannie Mae operate directly only in the conforming market. They may only purchase loans at or below the conforming loan limit. The bulk of these loans are fixed-rate mortgages. However, Freddie Mac and Fannie Mae also affect the rates on adjustable-rate and jumbo mortgages, effects ignored by the previous CBO analysis. Additional evidence on the benefits of Freddie Mac and Fannie Mae activities can be inferred from borrower behavior, such as borrowers' utilization of adjustable- versus fixed-rate loans. Measuring the full effect of Freddie Mac and Fannie Mae on conforming loans requires estimates of their effect on jumbo loans and estimates of the effect of depositories on jumbo loans.

Estimates of the Jumbo-Conforming Spread

Direct estimates of the effects on conforming, fixed-rate mortgages

The 1996 CBO report used a figure of 35 basis points as its estimate of the jumbo-conforming spread. CBO derived this figure from the commissioned study by Cotterman and Pearce, which evaluated the spread from 1989 through 1993. The 35 basis points reflected an average of relatively high values in the early part of the period and relatively low values toward the end.

Since 1993 the differential has fluctuated. Exhibit 8, from Pearce (2000), charts the path of rates on conforming, fixed-rate mortgages between 1992 and 1999. Three measures are charted in the exhibit. Two are extensions of the 1996 Cotterman and Pearce analysis estimating the differential for California and for 11 states with large numbers of jumbo loan originations. These estimates adjust for risk factors and loan size. The third is an extension of the series charted in Freddie Mac (1996).[18] Averages for these series, over the 1992-99 period, range

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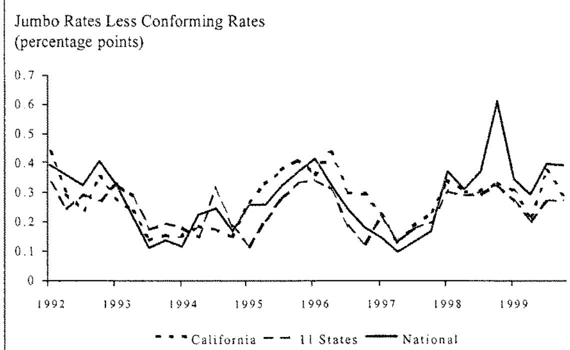
[18] The data used for the national series for jumbo rates come from HSH Associates (1992-1998), and Banxquote (1999), and for conforming rates from the Primary Mortgage Market Survey (Freddie Mac). This series is not risk-adjusted.

between 24 basis points and 28 basis points. All three series are in the neighborhood of 30 basis points in 1998 and 1999, when origination rates were very high.

Exhibit 8
Jumbo Rates Exceed Fixed-Rate Conforming Mortgage Loan Rates



Indirect estimates of the jumbo-conforming spread using ARM shares

Exhibit 8 displays unadjusted and risk-adjusted direct estimates of the jumbo-conforming differential. Additional evidence on the benefits of Freddie Mac and Fannie Mae activities can be inferred from borrower behavior, such as borrowers' utilization of adjustable-rate versus fixed-rate mortgages ("FRMs"). Freddie Mac and Fannie Mae activities have larger effects on rates of FRMs than ARMs because their funding cost advantage is larger on long-term debt than on short-term debt.[19] First-year rates on ARMs are generally below rates on FRMs, and research by Nothaft and Wang (1992) (as well as others cited by Nothaft and Wang) has shown that the ARM share will decrease generally as the spread between rates on ARMs and FRMs narrows. Thus, Freddie Mac and Fannie Mae reduce the ARM share of conforming loans by narrowing the

[19] ARMs are priced off short-term yields, whereas FRMs are priced off long-term yields. For spreads see Exhibit 7.

spread between rates on ARMs and FRMs. This effect was noted previously by Hendershott and Shilling (1989).

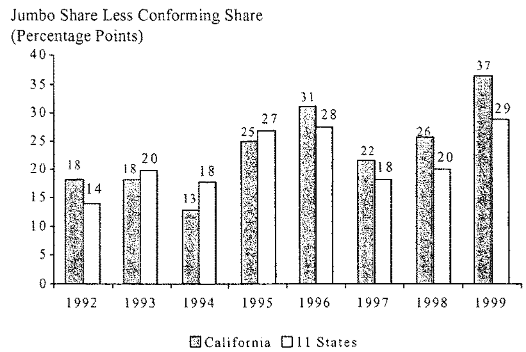
The research on the determinants of ARM shares indicates that we should expect that a 30-basis-point narrowing of the spread between rates on FRMs and ARMs will produce a 10-percentage point reduction in ARM share.[20] The estimates presented in the exhibit above indicate that between 1992 and 1999 rates on conforming FRMs averaged 24 to 28 basis points below rates on jumbo FRMs. This difference implies that we should expect the ARM share to be about 8 to 10 percentage points lower for conforming loans than for jumbo loans.

Pearce (2000) compares the ARM shares in the jumbo and conforming markets using the MIRS data. The comparison was restricted to loans with 15- and 30-year terms to maturity and loan-to-value of at least 60%. The ARM share among conforming loans for amounts between 75% and 99% of the conforming limit was compared to the ARM share among jumbo loans between 115% and 150% of the conforming limit.

The results are shown in Exhibit 9. The jumbo-conforming difference in ARM shares is much larger than the 8 to 10 percentage points expected from the directly-estimated conforming loan differential. The difference in ARM shares ranges between 13 and 36 percentage points in California and between 14 and 29 percentage points in the 11-state aggregate. The differences in ARM share averaged 23.6 percentage points in California and 21.6 percentage points in the 11 states. Differences of this magnitude are consistent with conforming loan differentials much larger than 30 basis points. If a differential of 30 basis points in rates on FRMs was expected to reduce ARM share by 10 percentage points, a 20+ percentage point reduction in ARM share among conforming loans is consistent with a reduction in interest rates on conforming FRMs of 60 basis points or more.

[20] Nothaft and Wang (1992). Also, in their concluding section, Hendershott and Shilling (1989), estimate that a 30-basis-point conforming loan differential would reduce the conforming ARM share by 10 percentage points in 1987 and 11 basis points in 1988.

Exhibit 9
Jumbo ARM Shares Exceed Conforming ARM Shares



Incorporating effects on jumbo loan rates

So far we have presented two approaches, direct and indirect, to quantifying the difference between rates on jumbo and conforming fixed-rate loans. The direct estimates quantify differences in interest rates that can be observed directly. We use a range that spans two measures for the direct estimates.[21] The first is an unadjusted measure of the empirical differences between the two sets of loan rates. The second is a risk-adjusted differential obtained by Pearce's update using the Cotterman and Pearce methodology. As an alternative, indirect measure, obtained from inferring the jumbo-conforming differential through the ARM share effect, we use the Nothaft and Wang methodology. These direct and indirect measures are substitute methods for examining the jumbo-conforming differential. The indirect estimates take intangible considerations into account. However, neither of these approaches identifies the full effect of Freddie Mac and Fannie Mae on conforming, fixed-rate loans. Neither takes into account the effect of Freddie Mac and Fannie Mae on jumbo loan rates. Furthermore, neither takes into account the effect that depositories would have on mortgage rates in the absence of federal sponsorship of Freddie Mac and Fannie Mae. Thus, both are *partial* measures of the effect of the two housing enterprises on mortgage rates.

Measuring the full effect of Freddie Mac and Fannie Mae on conforming loans requires estimates of their effect on jumbo loans and estimates of the effect of depositories on jumbo loans. Unfortunately, the data to obtain either of these estimates do not exist because we do not observe a fully private market. In the discussion below we will estimate the dollar amount of borrower savings by applying interest-rate effects to outstanding mortgage balances. In order to recognize the presence of these hard-to-measure effects, we will use a conservative value of 5 basis points for each. Thus, the directly-measured effect yields a partial reduction in mortgage rates of 29 to 33 basis points when the effect of Freddie Mac and Fannie Mae on jumbo rates is added and a total reduction of 34 to 38 basis points when the effect of depositories on jumbo rates is added. Similarly, the indirectly-measured spread (of 30 to 60 basis points) yields a partial reduction of 35 to 65 basis points and a total reduction of 40 to 70 basis points.

An additional benefit that needs to be accounted for is the reduction in rates on conforming ARMs. Evidence from the Primary Mortgage Market Survey (PMMS) indicates that rates on conforming ARMs are about 5 basis points lower than rates on jumbo ARMs. This suggests that the direct effect of Freddie Mac and Fannie Mae on conforming ARM rates is about 5 basis points. Assuming that depositories reduce jumbo ARM rates by about 5 basis points, the total effect on ARM mortgages is about 10 basis points.

Estimating Dollar Savings to Borrowers

The savings to borrowers are estimated by applying the interest rate reductions to the appropriate balances. The discussion above identified separate interest rate effects for fixed-rate conforming loans, adjustable-rate loans, and jumbo loans. It also pointed out that the estimates of the jumbo-conforming spread should be adjusted for the effects that Freddie Mac, Fannie

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[21] The average difference in commitment rates on fixed-rate, conforming mortgages over the 1992–1999 period is 28 basis points. The average effect from application of the Cotterman and Pearce methodology over this time period provides a range of 24 to 26 basis points.

Mae, and the depositories have on jumbo loan rates. In the discussion below, we present two series of benefit estimates that begin with the jumbo-conforming spread and progressively incorporate the various adjustments. At the end we present two alternative ranges.

The most conservative estimate applies the directly-estimated jumbo-conforming spread, a range of 24 to 28 basis points, to the outstanding balances of conforming, fixed-rate mortgages, which is currently about \$3.3 trillion.[22] This procedure yields a range of \$7.9 billion to \$9.2 billion. This estimate is a counterpart to the 1996 CBO benefit estimate, except that it includes all conforming fixed-rate mortgages rather than just those that have been purchased by Freddie Mac and Fannie Mae. Although this range understates the full effect of the two GSEs on conforming mortgage interest rates, it lies completely above the \$2.3 to \$7.0 billion range estimated for the funding advantage. If we add in benefits to borrowers using conforming ARMs (5 basis points applied to \$0.37 trillion) and jumbo loans (5 basis points applied to \$0.65 trillion), the range increases to \$8.4 billion to \$9.7 billion.

These ranges do not adjust the jumbo-conforming spread for the separate effects of Freddie Mac and Fannie Mae and depositories on jumbo loan rates. We have assumed that these two effects, which we cannot measure, would each be about 5 basis points. Incorporating this assumption raises the range on the (fixed-rate) jumbo-conforming spread to 34 to 38 basis points, and the total benefit range becomes \$11.7 billion to \$13.0 billion.

A parallel set of estimates can be constructed using the indirect estimate of the jumbo-conforming spread of 30 to 60 basis points. This range implies that benefits to borrowers using conforming, fixed-rate loans range from \$9.9 billion to \$19.7 billion. Adding in benefits to conforming ARM and jumbo borrowers implies a range of \$10.4 billion to \$20.2 billion. Adjusting the fixed-rate, jumbo-conforming spread for the effect of Freddie Mac and Fannie Mae and the depositories on jumbo rates brings the total to \$13.6 billion to \$23.5 billion.

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[22] The outstanding balances cited in this paragraph are based on the following figures: conventional loans totaling \$4.30 trillion, of which 15% are jumbo and 85% are conforming. Within the conforming market, 90% are assumed to be fixed-rate and 10% are assumed to be ARMs.

Overall, then, we have two *alternative* ranges for the full benefits. Using the directly-estimated spread, the range is $11.7 billion to $13.0 billion. Using the indirectly-estimated jumbo-conforming spread, the range is $13.6 billion to $23.5 billion. Both these ranges are well above our range for the funding advantage ($2.3 billion to $7 billion).

Exhibit 10

Effects on Conventional Mortgage Rates, 1992 - 1999

		Measurement*	Spread (basis points)
Effects on Mortgage Rates of Freddie Mac & Fannie Mae	Conforming Fixed-Rate Market: Alternative Measures	1. CFRM: Direct Estimate (Commitment Rates)	28
		2. CFRM: Direct Estimate (Pearce, 2000)	24 – 26
		3. CFRM: Indirect Estimate (Pearce, 2000)	30 – 60
	Jumbo Market	4. JFRM: (Assumed)	5
	Conforming ARM Market	5. ARM: (Commitment Rates)	5
		Partial Benefits Range: (Conforming + Jumbo)	
		CFRM: Direct (1&2 + 4)	29 – 33
		CFRM: Indirect (3 + 4)	35 – 65
		ARM: (5)	5
Effects on Jumbo (FRM & ARM) Rates from Subsidies to Other Financial Institutions		6. (Assumed)	5
		Full Benefits Ranges:	
		FRM Direct (1&2+4+6)	34-38
		FRM Indirect (3 + 4 + 6)	40-70
		Conforming ARM (5 + 6)	10
		Jumbo (4)	5
		Partial Direct**	**$ 8.4 - $ 9.7**
TOTAL BENEFITS ($billions)		**Full Direct**	**$11.7 - $13.0**
		Full Indirect	**$13.6 - $23.5**

* CFRM: conforming, fixed-rate market; JFRM: jumbo fixed-rate market. The fixed-rate conforming single-family market, is $3.3 billion. The ARM market is $0.37 billion and the jumbo market is $0.65 billion (9/30/00). **Direct without depositories' measures $8.4 to $9.7. Direct with depositories' having a five basis point effect on jumbo rates measures $11.7 to $13.0.

It is important to recognize that the jumbo-conforming differential understates the measure of the benefits provided by Freddie Mac and Fannie Mae because the jumbo rate is already lowered by benefits provided to the jumbo market by financial institutions with government support. That is, the jumbo market also benefits directly from government support through both the existence of the FHLBs and deposit insurance, and indirectly from Freddie Mac and Fannie Mae. The *total* benefit to consumers, including direct and indirect effects of Freddie Mac and Fannie Mae on conforming, fixed-rate mortgages and the additional effects on fixed-rate mortgages from subsidies held by all financial institutions in the jumbo market is in the range of $13.6 to $23.5 billion.

V. Freddie Mac and Fannie Mae Increase Efficiency

To this point we have focused on the key question raised in the 1996 CBO report—the extent to which the Freddie Mac and Fannie Mae funding advantage generates benefits to consumers or been absorbed by the two enterprises. Our findings in this area effectively rebut CBO's 1996 conclusion that a large percentage of the funding advantage is absorbed. They do not, however, address a more general objection to federal sponsorship that has been raised in discussions of Freddie Mac and Fannie Mae. This objection claims that federal sponsorship through the credit markets distorts the allocation of resources that would otherwise arise from the interaction of supply and demand in competitive markets. In the case of housing-related GSEs, the claim is that their activities result in "too much" housing at the expense of other components of the nation's capital stock, such as factories, offices, and business equipment.

In this section we address that point. As we have pointed out, Freddie Mac and Fannie Mae are not the only federally sponsored entities participating in the residential mortgage market. Federally insured depositories (banks and thrifts) fund over half—$2.4 trillion—of the conventional mortgages outstanding, either directly through their loan portfolio or indirectly though their MBS holdings (Exhibit 11).[23] Freddie Mac and Fannie Mae fund about one-third of

[23] The total residential market includes single-family and multifamily mortgages. The sources for these data were the Federal Reserve Board, Federal Deposit Insurance Corporation, Office of Thrift Supervision, Freddie Mac and Fannie Mae; data were as of June 30, 2000.

this amount. The remainder is divided among the FHLBs, mortgage companies, insurance companies, pension funds, individuals, and other investors. Analyzing economic efficiency and the benefits and subsidies requires understanding the cost structures and the risk characteristics of the mortgage market.

Exhibit 11
Holders of Residential Mortgage Assets
as of June 30, 2000

Mortgage Debt	Trillions of Dollars
Total Residential	**$5.4**
FHA/VA/RHS/Ginnie Mae	$0.8
State & Local Governments	$0.1
Total Conventional	**$4.5**
Depositories & FHLBs	$2.4
Freddie Mac & Fannie Mae	$0.8
Households	$0.1
Other	$1.2

Competitive Balance

The competitive balance in the industry depends on which charter can provide funds and manage risks at the lowest cost.[24]

Freddie Mac and Fannie Mae are more efficient than the depositories in three activities:

- Channeling funds from the global capital markets to mortgage markets;
- Managing mortgage interest-rate risk; and
- Managing mortgage credit risk.

In the management of interest rate risk, Freddie Mac and Fannie Mae take advantage of opportunities to issue callable debt. They also operate at a large scale and are able to spread the expense of sophisticated interest rate risk management across a large volume of risks. IPS Sendero (1999) documents the continued existence of significant interest rate risk in the thrift industry.

In the management of credit risk, the traditional advantage held by Freddie Mac and Fannie Mae has been superior exploitation of geographic diversification. Quigley and Van Order (1991) and Regional Financial Associates (1998) document the importance of geographic diversification in risk reduction. Although elimination of restrictions on branching makes this advantage potentially smaller today than it was in prior decades, it is still an important consideration, because many local and regional banks and thrifts hold significant mortgage portfolios.

Another important advantage for Freddie Mac and Fannie Mae in credit risk management is their prominent role in the development of automated underwriting systems. Credit risk evaluation and management is rapidly shifting from the rules of thumb used in manual underwriting to the rigorous statistical analysis of default risk that supports mortgage scoring and automated underwriting. Straka (2000) and Standard and Poor's (1997b) summarize this transformation. Freddie Mac and Fannie Mae have access to larger and more comprehensive data files on loan performance than other major mortgage market participants. This resource gives them an advantage in development of models with strong predictive power across a broad range of risks.

Depositories have a few advantages of their own, beyond their federal sponsorship. They have more local-market knowledge that can be exploited in the assessment of credit risk. They also have opportunities to sell other products to their mortgage customers. These advantages enable depositories to fund some loans at costs below what they otherwise would incur.

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[24] Van Order (2000a) describes the "dueling charter" framework for depositories and Freddie Mac and Fannie Mae, while Van Order (2000b) provides a more technical discussion.

Second Best Solution

Some critics of Freddie Mac and Fannie Mae contend that their federal sponsorship distorts resource allocation in that credit is diverted into residential real estate from other uses that, at the margin, have higher values. It is not our purpose here to address the desirability of promoting the financing of housing. Rather, we simply note that this argument fails to take into account the distortions introduced by federal deposit insurance.[25]

Exhibit 12 presents an analysis of the removal of the funding advantage to Freddie Mac and Fannie Mae in a situation where the implicit subsidization of the mortgage market through depositories is retained. The exhibit is taken from an illustration by Miller and Capital Economics (2000), who conclude that "... revoking the GSEs' charters would reduce welfare (economic efficiency). Thus, we conclude that revoking Freddie Mac's and Fannie Mae's charters cannot be justified on the grounds of economic efficiency" (page 14).

[25]Chairman Greenspan has often noted the existence of a funding advantage for banks. "Government guarantees of the banking system – deposit insurance and direct access to the Fed discount window and payment system guarantees – provide banks with a lower cost of capital than would otherwise be the case." Testimony, House of Representatives, Commerce Committee, April 28, 1999.

Exhibit 12
Efficiencies from Freddie Mac and Fannie Mae: the Second Best Argument

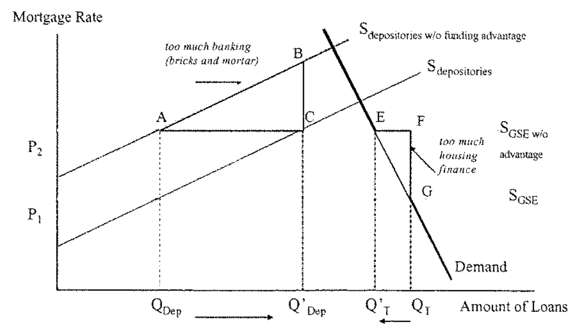

Exhibit 12 indicates that Freddie Mac and Fannie Mae provide an efficient allocation of resources from a "second best" perspective. Elimination of Freddie Mac and Fannie Mae's funding advantage would provide an efficiency improvement (triangle EFG) in that some of the excess housing finance would be removed from the market. This improvement would be more than offset by an efficiency loss resulting from an increase in (high cost) production by depositories (triangle ABC). Thus, elimination of Freddie Mac and Fannie Mae's federal sponsorship would lead to a loss of allocative efficiency, not a gain.[26] The loss would be greater the larger is the funding advantage of depositories relative to Freddie Mac and Fannie Mae. We next consider what the magnitude of the funding advantage, given deposit insurance, might be for the depositories.

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[26] This result depends on the relative elasticities of the demand and supply curves. See Capital Economics (2000) for the full discussion.

Cost of Funds Comparisons

The GSE-AA spreads presented in Exhibit 6 do not provide a complete picture of the funding of Freddie Mac and Fannie Mae relative to other financial market participants. One must also address the sources of funds available to banks and thrifts issuing federally insured deposits. Exhibits 13 and 14 (as well as Exhibit 4 provided earlier) show that Freddie Mac and Fannie Mae have no funding advantage at all relative to depositories. Exhibit 13 lists average spreads from 1995-2000 between depository instruments and relevant GSE yields. Exhibits 4 and 14 plot these spreads on a monthly basis.

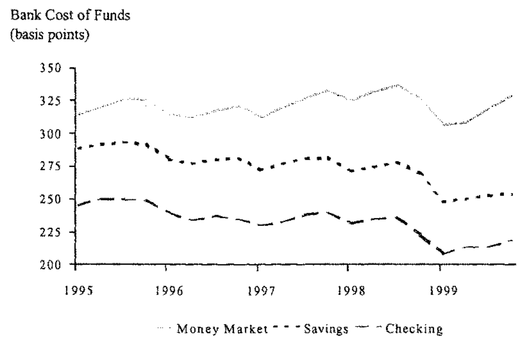
Exhibit 13
Bank Cost of Funds Are Below GSE Yields

Bank Cost of Funds less GSE Yields:

6 month CDs:	-103 bps
One year CDs:	-16 bps
11^{th} District COFI:[1]	-95 bps
Money Market:	-322 bps
Savings Accounts:	-274 bps
Checking Accounts:	-233 bps

[1] The FHLB-San Francisco, 11th District, Monthly Weighted Average Cost of Funds

Exhibit 14
Bank Cost of Funds (1995-1999)



Using several alternative series based on data from bank call reports and Bloomberg, we clearly demonstrate that depositories have an average cost of funds below that of Freddie Mac and Fannie Mae. As shown above, this implies that charter revocation of Freddie Mac and Fannie Mae would lead to less efficiently supplied housing finance.

VI. Conclusions

The funding advantages that Freddie Mac and Fannie Mae derive from their federal charters and the benefits they provide to homeowners cannot be measured precisely and are better expressed as ranges. Reasonable estimates of the ranges reveal that the benefits to homeowners far exceed the funding advantages of Freddie Mac and Fannie Mae. We find:

- The 1996 CBO study overstated the funding advantage received by Freddie Mac and Fannie Mae and underestimated the benefits provided by them. CBO incorrectly treated all debt as long-term debt despite the lower funding advantage on short-term debt and included separate spreads for callable debt and noncallable debt despite the difficulties inherent in measuring callable spreads. Rather than the 70 basis point funding advantage contained in CBO's 1996 report, we believe a better estimate places that funding advantage in the range of 10 to 40 basis points. Further, the 1996 CBO report did not incorporate the effect Freddie Mac and Fannie Mae have on conforming loans not purchased by them or on jumbo loans.

- Benefits to consumers provided by Freddie Mac and Fannie Mae far exceed the Freddie Mac and Fannie Mae funding advantage. The benefits to consumers are at least $8.4 billion and may be as high as $23.5 billion. The funding advantage to Freddie Mac and Fannie Mae lies between $2.3 billion and $7.0 billion.

- In addition, Freddie Mac and Fannie Mae provide benefits, not measured in this paper, beyond those that can be quantified in terms of savings on mortgage interest expense by homeowners. These benefits include maintenance of liquidity in the mortgage market during periods of financial turbulence and expanding homeownership opportunities for low-income and minority families.

- Given that depositories would subsidize housing finance in the absence of Freddie Mac and Fannie Mae, federal sponsorship of Freddie Mac and Fannie Mae provides a second best structure that supplies housing finance more efficiently than could the depositories alone. Depositories receive funding advantages through deposit insurance, access to Federal Reserve Bank liquidity and FHLB advances and have an average cost of funds lower than Freddie Mac and Fannie Mae.

In summary, CBO's 1996 report was deficient in many respects. The methodology used overstated the funding advantage Freddie Mac and Fannie Mae derive from their charters, and the evaluation of consumer benefits understated some components and ignored others. A repeat of these mis-measurements in the new report would render its findings and conclusions without credible foundation. A more accurate approach shows that the current arrangement benefits consumers much more than any funding advantage received by Freddie Mac and Fannie Mae.

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OFHEO Risk - Based Capital Stress Test Applied To U.S. Thrift Industry

The CapAnalysis Group, LLC

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OVERVIEW

This study reviews a simulation of the financial performance of the thrift industry under the risk-based capital stress test (the RBC Test) recently finalized by the Office of Federal Housing Enterprise Oversight (OFHEO). The RBC Test represents a novel and sophisticated method of establishing regulatory capital requirements that differs substantially from the capital-to-asset ratio tests that most financial regulators have used historically. The Federal Home Loan Mortgage Corporation (Freddie Mac), which along with The Federal National Mortgage Association (Fannie Mae), is subject to the new standards, sought to ascertain the stringency of the RBC Test by applying it to the U.S. thrift industry, which currently maintains a relatively high capital-to-asset ratio under traditional capital adequacy measurements. Freddie Mac engaged The CapAnalysis Group, LLC (CapAnalysis) to conduct an independent review of the methodology and results of its application of the RBC Test to the thrift industry and to give its independent judgment about the correctness of the application and the robustness of the conclusions.

As is described in greater detail below, CapAnalysis agrees with Freddie Mac that the thrift industry would not be able to pass the RBC Test. This conclusion implies that the RBC Test is a much more stringent test for judging the safety and soundness of a financial institution than is a traditional capital-requirements test. Because the RBC Test relies on a sophisticated evaluation of potential risks, it is able to identify exposures that would remain undetected using a basic ratio test. This finding is consistent with the higher ratings that nationally recognized statistical ratings organizations (NRSROs) have assigned consistently to Freddie Mac in comparison to the ratings they have assigned to thrift institutions. In addition, this finding is consistent with the results of a 1999 study by IPS-Sendero, which examined how the thrift industry would perform under a stress test with conditions similar to those specified in the 1992

Federal Housing Enterprises Financial Safety and Soundness Act, the legislation that specifies the requirements of the RBC Test.[1]

A summary of Freddie Mac's application of the RBC Test to the thrift industry is set forth in Table 1. Meeting this test requires sufficient capital to pass two specific scenarios – one with rising interest rates over a four-year period, and one with declining interest rates over the same period. The thrift industry would not pass the up-rate scenario and would fail approximately 7.5 years into the simulated rising-rate environment. It would, however, pass the down-rate scenario incorporated in the test. But since the industry fails one part of the test, it fails the test overall.

Table 1: Application of OFHEO's Risk-Based Capital Stress Test to U.S. Thrift Industry

Measure	Up-Rate Scenario	Down-Rate Scenario
Initial Capital	$76 billion	$76 billion
Required Capital	$108 billion	$41 billion
Excess (Deficit)	($32 billion)	$35 billion
Time to Failure	7.5 years	---

BACKGROUND

OFHEO is the safety-and-soundness regulator of Freddie Mac and Fannie Mae (Freddie Mac and Fannie Mae together are referred to as the Enterprises). Congress established OFHEO in 1992 as an independent office within the U.S. Department of Housing and Urban Development (HUD) and gave it responsibility for examining and regulating the Enterprises and ensuring that they are adequately capitalized. Part of OFHEO's mandate was to develop a risk-based capital standard.

OFHEO's RBC Test ascertains the amount of capital an Enterprise would need to survive a ten-year period of substantial credit losses and significant movements in interest rates. If the Enterprises' current capital is sufficient to meet this test, they meet

[1] IPS Sendero, *Risk-Based Capital and the Thrift Industry: Implications of Risk-Based Capital Stress Test Requirements* (February 1, 1999).

OFHEO's risk-based capital regulatory standard. The Enterprises also must meet minimum capital requirements determined through a traditional ratio-based approach (see below). An Enterprise's actual capital requirement at any given time is the higher of either its risk-based capital requirement or its minimum capital requirement.

The RBC Test differs significantly from the approach that regulators traditionally have used to establish capital requirements. Under a conventional approach, capital requirements are determined by a simple ratio of capital-to-assets. In contrast, the RBC Test takes into account characteristics of an institution's assets and liabilities and establishes a capital requirement designed to ensure that the institution is able to withstand a protracted financial stress. While an institution's starting capital position is a factor in the RBC Test, the nature of its portfolio of assets and liabilities is generally more important to its ability to survive the adverse and long-lasting economic conditions simulated in the RBC Test.

In order to demonstrate the stringency of the RBC Test, Freddie Mac applied it to the thrift industry – an industry that currently maintains a relatively high capital-to-asset ratio. While the RBC Test was designed specifically to assess the operations of the Enterprises, it is reasonable to use it to evaluate other entities involved primarily in mortgage lending, such as the thrifts.[2] The principal risks to mortgage lenders are mortgage credit losses and exposure to changing interest rates, and these risks are the focus of the RBC Test.

The thrift industry consists of approximately 940 institutions and is regulated by the Office of Thrift Supervision (OTS). Each is required to hold capital equal to approximately 4 percent of its total mortgage assets, and at present the capital-to-asset

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[2] Approximately 85percent of the assets held by the thrift industry correlate to specific inputs into the RBC Test. For the remaining assets, Freddie Mac applied supportable assumptions that are conservative, in that they tended to enhance the industry's performance on the RBC Test. The most significant of these assumptions are described in Table 2.

ratio of the industry is more than twice the required amount.[3] By this conventional measure, the thrift industry is well-capitalized. Accordingly, application of the RBC Test to the industry should provide a valuable assessment of the stringency of the RBC Test. With this objective, Freddie Mac prepared an analysis of the thrift industry's performance under the RBC Test and requested that The CapAnalysis Group review and evaluate the results.[4]

METHODOLOGY AND SCOPE

To perform this test, Freddie Mac took publicly available data from OTS relating to the thrift industry and ran it through OFHEO's stress test model. The data used was the aggregate thrift industry data as reported in the Office of Thrift Supervision Industry Aggregate Report, Schedule CMR (December 31, 2001). Accordingly, the simulation under the RBC Test treats the entire thrift industry as a single financial institution. This approach is conservative and will tend to understate the thrift industry's risks, because the approach implicitly assumes that losses at individual institutions can be offset by the capital of others. CapAnalysis reviewed the source and completeness of the information relating to the thrift industry; assessed and validated the assumptions used to correlate the information to the proper data input into the RBC Test; and analyzed and evaluated the results of Freddie Mac's application of the RBC Test to the thrift industry.

DESCRIPTION OF RBC TEST

Overview – OFHEO issued its final rule implementing the RBC Test on September 13, 2001. The test determines the amount of capital each Enterprise would

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[3] As of December 31, 2001, the thrift industry's capital-to-mortgage asset ratio was 8.13 percent. In contrast, Freddie Mac's capital-to-asset ratio on that date was 3.13 percent. Comparable data for 2002 is not yet available.

[4] The CapAnalysis Group, LLC is a consulting firm with extensive experience in economic, financial, regulatory, valuation, and litigation matters. CapAnalysis' staff of over 50 professionals includes Economists, Certified Public Accountants, Certified Management Accountants, Certified Valuation Analysts, and other accounting and financial experts, as well as regulatory analysts with a degree in a technical specialty and experience in the rulemaking and legislative process.

need to survive a ten-year period (stress period) characterized by large credit losses and large movements in interest rates, with an assumption that an Enterprise not purchase any new mortgages during that period.[5] Specifically, the test determines the amount of starting capital that would permit an Enterprise to maintain a positive capital position throughout the stress period, adding 30 percent of that amount to cover management and operations risk.

Interest Rate Stress – OFHEO's RBC Test specifies two interest-rate scenarios -- one with falling rates (down-rate scenario) and the other with rising rates (up-rate scenario). The down-rate scenario assumes that during the first year of the stress period the ten-year Constant Maturity Treasury (CMT) yield falls by the lesser of 600 basis points below the average yield during the nine months preceding the stress period or to 60 percent of the average yield during the three year period preceding the stress period, but in no case to a yield less than 50 percent of the average yield during the preceding nine months. The up-rate scenario assumes that during the first year of the stress period the ten-year CMT rises by the greater of 600 basis points above the average yield during the nine months preceding the stress period or to 160 percent of the average yield during the three years preceding the stress period, but in no case to a yield greater than 175 percent of the average yield during the preceding nine months.

Under both interest-rate scenarios the ten-year CMT changes in twelve equal monthly increments from the starting point and then remains constant for the final 108 months of the test. The RBC Test establishes the Treasury yield curve for the stress period in relation to the prescribed movements in the ten-year CMT. In the down-rate

[5] Both the General Accounting Office and the Congressional Budget Office have recently concluded that it would not be desirable to include assumptions regarding new business during the stress period into the RBC Test. *See* United States General Accounting Office, *OFHEO's Risk-Based Capital Stress Test; Incorporating New Business is Not Advisable* (June 2002); Letter from Dan L. Crippen, Director, Congressional Budget Office to the Honorable Paul S. Sarbanes, Chairman, Committee on Banking, Housing and Urban Affairs (January 3, 2003; the attached report concludes that: [i] the no new business assumption does not understate Enterprise capital requirements for the RBC Test; [ii] the impact of new business assumptions on Enterprise capital requirements would depend primarily on the assumptions; and [iii] if new business assumptions were incorporated into the RBC Test, assuming that new business during the stress period would be profitable is more realistic than assuming it would be unprofitable).

scenario, the yield curve is upward sloping during the final nine years of the stress period; in the up-rate scenario, the Treasury yield curve is flat for the last nine years of the stress period.

Because many different interest rates affect the business performance of an Enterprise, rates and indexes other than Treasury yields must be established for the entire stress period. The RBC Test sets those rates and indexes using an average of the spread of each non-Treasury rate to its comparable CMT for the two-year period prior to the start of the stress period. Indexes of mortgage interest rates are calculated using the average absolute basis-point spread for the same two-year period.

Credit Stress – In order to simulate the stressful conditions that are the basis for credit losses in the RBC Test, OFHEO employed a methodology based on historical analysis of newly originated, fixed and adjustable rate, first-lien single family and multifamily mortgages. Using this methodology, OFHEO identified the worst cumulative credit losses experienced by loans originated during a period of at least two consecutive years in contiguous states comprising at least five percent of the U.S. population. Currently this benchmark is determined by loans originated in Arkansas, Louisiana, Mississippi, and Oklahoma in 1983 and 1984; approximately 14.9 percent of mortgages defaulted in those states during these years.

To simulate mortgage performance during the adverse conditions of the stress period, the RBC Test uses statistical models to project default, prepayment and loss severity rates during the stress period. The models simulate the interaction of the patterns of house prices, residential rents, and vacancy rates from the benchmark time and place with specified interest rates and mortgage risk characteristics to predict the performance of Enterprise loans throughout the stress period. The default and prepayment models calculate the proportion of the outstanding principal balance for each loan group that defaults or prepays in each of the 120 months of the stress period. The models are based on the historical relationship of economic conditions, mortgage risk factors, and mortgage performances, as reflected in the historical experience of the Enterprises. In the case of defaults, a loss severity rate is calculated which takes into consideration not only the loss of principal but also transaction costs related to foreclosure, property holding costs, and disposition costs.

Additional Stress Test Considerations – Other factors included in the RBC Test are mortgage credit enhancements and counterparty default rates. Credit enhancements are contractual arrangements with third parties that reduce Enterprise losses on defaulted loans. Counterparty default rates reflect the creditworthiness of companies and financial instruments to which the Enterprises have credit exposure. These credit exposures include most mortgage credit enhancement counterparties, securities held as assets, and derivative contract counterparties. The RBC test reduces, or applies "haircuts" to, the amounts due from these instruments or counterparties according to their level of risk, which is determined by public credit ratings at the start of the stress period.

Calculation of Capital Requirement – To determine an Enterprise's risk-based capital requirement, the RBC Test calculates monthly stress period cash flows for every loan group and individual instrument reported by the Enterprise. Haircuts are applied to these cash flows to reflect the credit risk of securities and counterparties. The cash flows are used to create pro forma financial statements that reflect the Enterprise's total capital for each month of the stress period. The capital balance for each month is then discounted back to the start of the stress period using the six-month Treasury rate when the Enterprise is a net lender and the six-month Enterprise Cost of Funds rate when the Enterprise is a net borrower. The lowest discounted monthly balance is subtracted from the Enterprise's initial capital, with the result representing the smallest amount of starting capital required to maintain positive capital throughout the stress period. This amount is then multiplied by 1.3, which adds a 30 percent risk premium to protect against management and operations risk.[6] The final result is the Enterprise's risk-based capital requirement.

APPLICATION OF RBC TEST TO THE THRIFT INDUSTRY

Because the core business of both the Enterprises and the thrift industry is mortgage lending, the thrift industry is a good candidate for evaluation under the RBC Test. OFHEO developed the RBC Test to evaluate the risks associated with mortgage lending – specifically, credit risk and changes in interest rates. By applying the RBC Test to a similar industry, which is regulated by a different entity using a different approach to capital standards, it is possible to derive significant insights into the stringency of the RBC Test.

Data used to apply the RBC Test was obtained from the Thrift Financial Reports, which all thrift institutions are required to file with OTS. These reports provide detailed information on the industry's balance sheets, income statements, off balance sheet activities and rates -- all of which are necessary to ensure a valid application of the RBC Test.

While the core business of the thrift industry is analogous to that of the Enterprises, there are differences that must be accounted for in applying the RBC Test to this industry. For example, unlike the Enterprises, the thrift industry underwrites commercial loans, consumer loans, and construction loans in addition to its principal business of residential mortgage lending. With respect to mortgage lending, the thrift industry underwrites "jumbo" mortgage loans as well as the "conforming" residential mortgages that the Enterprises are able to purchase. A further difference is that the thrift industry also generates fees from mortgage servicing.

Because OFHEO designed its model specifically to evaluate the activities of the Enterprises, differences between the businesses of the Enterprises and thrift institutions

[6] Notably, the Basel Committee on Banking Supervision recently agreed to eliminate the separate floor capital requirement for operation risk that had been proposed previously as a component of its bank capital standards. *See* www.bis.org/press/p020710.htm (July 11, 2002).

are not addressed in the RBC Test. Furthermore, certain Enterprise data evaluated in the RBC Test is not available in the same level of detail for the thrift industry in the reports issued by OTS. To properly account for these differences and lack of detail, certain assumptions had to be made in the application of the RBC Test to the thrift industry.

CapAnalysis has reviewed the assumptions made by Freddie Mac in applying the RBC Test to the thrift industry and concludes that the decisions made are reasonable. In making required assumptions, Freddie Mac treated the data in a manner that is logical. Where assumptions necessarily required subjective judgments, Freddie Mac favored choices that tended to improve the performance of the thrift industry in the RBC Test. To verify Freddie Mac's treatments of thrift industry data, CapAnalysis traced all data inputs into the RBC Test back to the thrift industry reports issued by OTS. To the extent that information contained in the reports could not be input directly into OFHEO's model, Freddie Mac made reasonable assumptions as to how to incorporate this data into the RBC Test, often using data on their portfolios. Review by CapAnalysis indicates that these assumptions are reasonable. A summary of the major assumptions is shown in the table below.

Table 2: Assumptions in Application of RBC Test to Thrift Industry

Item	Assumption	Notes
LTV Ratios	Thrift industry's portfolio has the same breakdown of LTV ratios found in Freddie Mac's portfolio.	Publicly available data indicates that Freddie Mac tends to purchase lower-risk mortgages than does the thrift industry.[7] Assuming that LTV ratios for the thrift industry are the same as for Freddie Mac improves the thrift industry's performance in the RBC Test.
Credit Quality of Mortgage Assets	Thrift industry has the same asset quality as Freddie Mac.	Because net charge-offs for the thrift industry have been more than 20 times greater than those of Freddie Mac in recent quarters, assuming that the thrift industry's assets are comparable improves the thrift industry's performance in the RBC Test.
Credit Enhancements	Mortgage insurance is the only credit enhancement and two-thirds of all loans with an original LTV ratio greater than 80% have mortgage insurance.	Freddie Mac's charter requires all mortgages with an original LTV above 80% to have mortgage insurance or other specified credit enhancements. Publicly available data (MIRS, published by FHFB) indicates that the thrift industry has mortgage insurance on approximately two-thirds of its loans with an original LTV above 80%.
Counterparty Credit Rating	Half of all mortgage insurance is issued by AAA-rated insurers, with the remaining half issued by AA-rated insurers.	This assumption is conservative, based on the actual industry ratings break–down of MI coverage. (Less than half of aggregate coverage is provided by AAA-rated issuers.) In the RBC Test, AA-rated insurers receive a greater haircut (up to 12.5%) than do AAA-rated insurers (up to 5%).
Construction & Land and Commercial Loans	These loans are included with Multifamily ARMs, using the weighted average remaining maturities and weighted average coupons.	The RBC Test does not model these loans. The effect of this assumption is to reduce thrift industry assets that must be funded over the 10-year period of the RBC Test. This assumption substantially improves the thrift industry's performance in the RBC Test by boosting the short-term yields and shortening the remaining terms of these loans.
Adjustable Rate Consumer Loans	These loans are included with adjustable rate second mortgages.	The RBC Test does not model these loans. Similar to the assumption concerning construction & land and commercial loans, this assumption improves the thrift industry's performance on the RBC Test. However, the beneficial impact is less here due to the lower unpaid balance of adjustable rate consumer loans.
Fixed Rate Consumer Loans	Included with fixed rate second mortgages.	The RBC Test does not model these loans. Similar to the assumption concerning construction & land and commercial loans, this assumption improves the thrift industry's performance in the RBC Test.
Servicing Rights	Not modeled.	The RBC Test does not model servicing rights. Not modeling these assets effectively converts them to cash, improving the thrift industry's performance in the RBC Test because servicing values become significantly impaired when mortgages default.
Swaps, Caps and Swaptions	Modeled with average characteristics of comparable instruments in Freddie Mac's portfolio.	While actual notional values are available and are used, other characteristics are derived from instruments in Freddie Mac's portfolio, which are assumed to be typical.
ARMs	Lifetime caps set to 600 basis points.	This assumption is based on typical characteristics of these types of loans.

[7] G. Canner, W. Passmore, B. Surrette, "Distribution of Credit Risk among Providers Mortgages to Lower Income & Minority Homebuyers," *82 Federal Reserve Bulletin No. 12* (December, 1996), pp. 1077-1102.

RESULTS

Assessed under the RBC Test, the thrift industry would not have sufficient capital to survive the entire stress period in the up-rate scenario, though it would have sufficient capital in the down-rate scenario. Accordingly, the industry would fail the RBC Test. Calculated as specified in OFHEO's model, the industry's initial total capital is $76 billion. The industry's monthly discounted total capital at the end of the stress period (in the up-rate scenario) is negative $7 billion. Thus, the industry's required risk-based capital at the beginning of the stress period would be $108 billion (($76B – (-$7B)) x 1.3). In other words, the thrift industry's capital is $32 billion less than would be necessary to pass the RBC Test in the up-rate scenario ($76B – $108B).

Up-Rate Scenario Details – In the up-rate scenario, the thrift industry's total capital turns negative in the 90th month of the 120 month stress test period. At the end of the first 12 months of the stress period, the industry's aggregate income statement shows a loss of $2.07 billion on net interest income of $18.72 billion. Both mortgage and debt balances fall to 82 percent of their starting balances.

In OFHEO's model, mortgage balances are reduced due to maturities coming due, defaults, and prepayments resulting from refinancing activity and curtailments. Prepayments in the model's up-rate scenario are greatly reduced, however, as fixed-rate borrowers are assumed to have no incentive to refinance due to higher rates. The model assumes relatively more refinancing by adjustable rate mortgage (ARM) holders, as ARMs adjust to the rising rates and become expensive relative to current market rates. In addition, there is a certain amount of frictional prepayment activity built into OFHEO's model that occurs due to exogenous factors, such as the relocation or death of the homeowner.

The thrift industry's interest income was 118 percent of its starting level after the first 12 months of the stress period. Most of this increase stems from the rates on ARMs rising with the market rates, although periodic and lifetime caps keep this income from increasing as much as do market rates. Fixed rate mortgages also limit the amount that interest income can grow, and their long lives at below market rates hurt growth in interest income.

Interest expense at 12 months rises to 176 percent of its starting level. In OFHEO's model, assumed short-term debt funding of assets requires the debt to roll over to higher rates much more quickly than the assets. The model's slowdown in prepayment speeds exacerbates this effect.

By the end of the 120th month of the stress period, the thrift industry's mortgage and debt balances would still follow each other roughly, with 21 percent of mortgage balances still remaining, and 24 percent of the starting debt balances remaining on the aggregate balance sheet. Interest income would drop to 31 percent of its starting level. This percentage is higher than the remaining asset and liability balances as a result of ARM borrowers who are assumed not to refinance their mortgages. This would occur to the extent that such borrowers are rate insensitive or do not keep up with market rates. Or, such borrowers could have loans with short remaining terms or be in other circumstances where refinancing is not a financially attractive option.

The thrift industry's interest expense at the end of month 120 would be 70 percent of its initial starting level. The high rates in the market coupled with the continual roll over of the short term debt instruments would keep these expense levels high.

The following tables show balance sheets and income statements for the thrift industry during the up-rate scenario of the ten-year stress test.

Table 3: Thrift Industry Balance Sheet as of 4Q01 (RBC Up-Rate Scenario; $ in Millions)

Year	0	1	2	3	4	5	6	7	8	9	10
ASSETS											
Mortgages net	$774,088	$638,209	$540,094	$448,238	$375,430	$316,640	$276,346	$244,252	$202,795	$179,567	$159,206
Investments	44,023	82,114	53,685	53,085	50,957	49,683	48,025	3,694	2,924	2,637	2,219
Cash & equiv.	47,183	-	-	-	-	-	-	-	-	-	-
Accr. int. rec.	4,089	4,652	4,232	3,300	2,770	2,352	2,045	1,587	1,261	1,089	937
Other assets	13,116	12,782	14,766	8,386	6,809	5,232	4,604	3,976	3,348	2,721	2,093
Foreclosed property, net	948	-	-	-	-	-	-	-	-	-	-
TOTAL	$883,447	$737,757	$612,776	$513,008	$435,966	$373,906	$331,021	$253,510	$210,329	$186,014	$164,456
LIABILITIES AND STOCKHOLDERS' EQUITY											
LIABILITIES											
Debt sec., net	$812,662	$669,313	$550,021	$461,891	$396,170	$344,877	$314,035	$250,368	$217,840	$204,555	$194,726
Accr. int. pay.	-	(201)	554	381	372	456	(64)	(1,761)	(1,761)	(1,761)	(1,745)
Other liabilities	-	85	36	36	36	36	36	-	-	-	-
Sold mort. allowance	-	-	-	-	-	-	-	-	-	-	-
Subordinated borrowings	-	-	-	-	-	-	-	-	-	-	-
SUBTOTAL	$812,662	$669,197	$550,612	$462,309	$396,579	$345,369	$314,007	$248,608	$216,079	$202,794	$192,981
STOCKHOLDERS' EQUITY											
Common	$ 503	$ 503	$ 503	$ 503	$ 503	$ 503	$ 503	$ 503	$ 503	$ 503	$ 503
Preferred	1,116	1,116	1,116	1,116	1,116	1,116	1,116	1,116	1,116	1,116	1,116
Paid-in capital	33,837	33,837	33,837	33,837	33,837	33,837	33,837	33,837	33,837	33,837	33,837
Ret. earnings	35,329	33,105	26,709	15,244	3,932	(6,918)	(18,442)	(30,553)	(41,206)	(52,236)	(63,981)
Unrealized losses AFS sec., net of tax	-	-	-	-	-	-	-	-	-	-	-
OCI	-	-	-	-	-	-	-	-	-	-	-
Treas. Stock	-	-	-	-	-	-	-	-	-	-	-
SUBTOTAL	$ 70,785	$ 68,560	$ 62,165	$ 50,699	$ 39,388	$ 28,538	$ 17,013	$ 4,902	$ (5,751)	$(16,780)	$(28,526)
TOTAL	$883,447	$737,757	$612,776	$513,008	$435,966	$373,906	$331,021	$253,510	$210,329	$186,014	$164,456
OFF BALANCE SHEET ITEMS											
Derivatives Outstanding (Notional Amount)	45,312	40,735	40,735	-	-	-	-	-	-	-	-

Total capital	$ 76,461	$ 76,871	$ 71,633	$ 60,930	$ 50,196	$ 39,761	$ 28,688	$ 16,858	$ 6,488	$ (4,159)	$(15,507)
Allowance for Loan Loss	(5,676)	(8,311)	(9,468)	(10,231)	(10,809)	(11,223)	(11,675)	(11,956)	(12,239)	(12,621)	(13,019)
Total Balance Sheet Equity	$ 70,785	$ 68,560	$ 62,165	$ 50,699	$ 39,388	$ 28,538	$ 17,013	$ 4,902	$ (5,751)	$(16,780)	$(28,526)
Minimum Required	$ 22,086	$ 18,444	$ 15,319	$ 12,825	$ 10,899	$ 9,348	$ 8,276	$ 6,338	$ 5,258	$ 4,650	$ 4,111
Excess (deficit)	$ 48,699	$ 50,116	$ 46,845	$ 37,874	$ 28,488	$ 19,190	$ 8,738	$ (1,436)	$(11,009)	$(21,431)	$(32,637)

Table 4: Thrift Industry Income Statement (RBC Up-Rate Scenario; $ in Millions)

Year	1	2	3	4	5	6	7	8	9	10	Total
INTEREST INCOME:											
Income from mortgage portfolio	$51,444	$ 52,093	$ 44,985	$ 37,991	$ 32,521	$ 28,260	$ 25,010	$ 21,352	$ 18,652	$ 16,702	$329,009
Interest on investments	3,508	3,233	3,041	2,918	2,763	2,860	2,496	189	238	175	21,421
SUBTOTAL	54,952	55,326	48,026	40,909	35,284	31,120	27,506	21,541	18,890	16,878	350,430
INTEREST EXPENSE:											
Interest Expense on debt securities	36,229	50,214	44,681	38,715	33,627	31,011	28,572	21,960	20,155	19,213	324,376
NET INTEREST INCOME	$18,724	$ 5,112	$ 3,345	2,194	$ 1,657	$ 109	$ (1,066)	$ (420)	$ (1,266)	$ (2,335)	$ 26,054
OTHER INCOME:											
Guarantee fees	-	-	-	-	-	-	-	-	-	-	-
Other, net	-	-	-	-	-	-	-	-	-	-	-
TOTAL OTHER INCOME, NET	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
OTHER EXPENSES:											
Provision for mortgage losses	-	-	-	-	-	-	-	-	-	-	-
Other Losses	21	59	100	145	192	104	125	56	64	62	928
Administrative expenses	21,965	16,107	14,566	13,216	12,170	11,384	10,811	10,177	9,700	9,348	129,443
TOTAL OTHER EXPENSES	$21,985	$ 16,166	$ 14,666	$ 13,360	$ 12,362	$ 11,488	$ 10,936	$ 10,233	$ 9,764	$ 9,410	$130,371
NET INCOME :											
Before income taxes	$(3,262)	$(11,053)	$(11,321)	$(11,166)	$(10,705)	$(11,379)	$(12,002)	$(10,653)	$(11,030)	$(11,745)	$(104,317)
Provision for income taxes	(1,194)	(4,803)	-	-	-	-	-	-	-	-	(5,998)
NET INCOME	$(2,068)	$ (6,250)	$(11,321)	$(11,166)	$(10,705)	$(11,379)	$(12,002)	$(10,653)	$(11,030)	$(11,745)	$(98,319)
Preferred stock dividends											
Fixed rate	$ 157	$ 145	$ 145	$ 145	$ 145	$ 145	$ 109	$ -	$ -	$ -	$ 991
Floating rate	-	-	-	-	-	-	-	-	-	-	-
Common stock dividends	-	-	-	-	-	-	-	-	-	-	-

Down-Rate Scenario Details – In the down-rate scenario, the thrift industry's total capital remains positive throughout the entire 120-month period of the RBC Test. In the first 12 months of the stress period, the industry would lose $1.10 billion on net interest income of $19.83 billion. Mortgage balances fall to 67 percent of their starting balances after 12 months while debt is reduced to 72 percent of its starting balance. The steeper drop in mortgage balances (relative to the up-rate scenario) reflects the increased speed of prepayments in OFHEO's model due to refinancing and curtailments. The percentage difference between the decline in mortgage and debt balances results from the fixed term of debt relative to the continual stream of mortgage prepayments over the initial 12-month period.

Over the same 12-month period, the industry's interest income would fall to 68 percent of its starting level while interest expense would fall to 67 percent of its starting level. The decline in interest rates would trigger faster mortgage prepayments and the reduced funding costs in OFHEO's model.

At the end of the stress period in the down-rate scenario, the thrift industry's mortgage balances would be 4 percent of starting levels, and debt balances would be removed completely. The dramatic prepayments assumed in OFHEO's model, combined with the model's "no new business" assumption leaves only a few assets that require funding. At the end of the stress period, the industry's interest income also falls to 4 percent of its starting level, with no debt expense remaining as debt balances are retired.

The RBC Test calculates the down-rate risk-based capital requirement using the same methodology described above for the up-rate scenario. The thrift industry's initial total capital is the same $76 billion as in the up-rate scenario. The industry's monthly discounted total capital at the end of the stress period is $45 billion. Thus the risk-based capital requirement in the down-rate scenario is $41 billion (($76B - $45B) x

1.3). This means the thrift industry's capital is $35 billion ($76B - $41B) more than required under this scenario.

ANALYSIS

The results of the application of OFHEO's RBC Test (*i.e.*, inadequately capitalized in the up-rate scenario and adequately capitalized in the down-rate scenario) are consistent with expectations given the characteristics of the industry's assets and liabilities and limitations on the industry's ability to hedge exposure to interest rate risk. The vast majority of the industry's revenues are generated from interest income on single-family mortgage portfolios and mortgage-backed securities, while the biggest expense is interest on the liabilities incurred to fund these mortgage assets. The industry's assets are primarily long-term, with the amount of adjustable rate mortgages being slightly higher than the amount of fixed rate mortgages ($273 billion vs. $224 billion). These assets are funded predominantly by short-term liabilities, consisting primarily of customer deposits. Only 21 percent of the industry's debt is classified as long-term.

The major factors affecting the spread between the thrift industry's interest income and interest expense are mortgage prepayment rates and interest-rate lag. In an up-rate environment, there is little incentive for borrowers with fixed rate mortgages to prepay, with the result that effective interest rates on such mortgages lag behind market rates. With respect to adjustable rate mortgages, periodic and lifetime caps cause increases in the effective interest rate on that portion of the industry's asset base to lag behind the rising market rate. In contrast, the rate of interest that the industry is paying on its short-term liabilities rises in step with the market rate. Thus, in an up-rate environment, the spread in the rates between interest income and interest expense narrows. This phenomenon contributes to the failure of the thrift industry in the up-rate scenario under the harsh conditions imposed by the OFHEO model.

In a down-rate environment, there is an incentive for borrowers to refinance to a lower interest rate, thus increasing the amount of prepayments. This increase in prepayments lowers the effective rates on both fixed and adjustable rate mortgages, as well as reduces the burden of carrying long-term assets funded by short-term liabilities. The drop in the effective rates, however, tends to lag behind the drop in the market rates due to borrowers wanting to try to catch the "bottom" of the cycle and the time involved to process a refinancing. However, the rate of interest paid on the short-term liabilities tends to decrease in step with the market and can actually have the effect of increasing the spread between interest income and interest expense. Thus, the down-rate scenario presents a considerably lesser challenge to the thrift industry than does the up-rate scenario.

The difficulties that the up-rate scenario presents to the thrift industry also highlight the inherent limitations on the industry's ability to hedge interest rate risk. In an up-rate environment, longer-term liabilities on the industry's balance sheet would mitigate the erosion in the spread between interest income and interest expense. And, the use of callable debt and swaptions could provide a hedge against any risks that such longer-term liabilities would introduce in a down rate environment. (Swaptions are put options on interest rate swaps and allow an institution to lock in fixed rates in a rising rate environment, or switch to an adjustable or floating rate portfolio in a falling rate environment.) The thrift industry is limited, however, in its ability to extend the effective life of its liabilities because most of its funding is in the form of customer deposits, which typically are shorter-term obligations.

CONCLUSION

With a capital-to-asset ratio of approximately 8 percent, the aggregate capitalization of the thrift industry is well above what is deemed to be "safe" by OTS. Nevertheless, the industry does not have sufficient capital to pass the RBC Test, which is applied to both Freddie Mac and Fannie Mae. Notably, several assumptions made in applying the RBC Test to the thrift industry would operate to reduce the severity of this application significantly. This conclusion should not be interpreted as indicating that the thrift industry is undercapitalized. Rather, the fact that the thrift industry is not able to pass OFHEO's RBC Test is an indication that the RBC Test is extremely stringent and that it is able to evaluate risks that are not addressed by traditional ratio tests.

This conclusion also demonstrates the value of hedging as an effective strategy to mitigate interest rate risk. In an environment of significant and sustained interest rate shifts, even a relatively high capital-to-asset ratio will not insulate institutions that retain a high level of long-term fixed-rate assets. The fact that the Enterprises are able to pass the RBC Test affirms the value of prudent hedging practices as an effective risk-mitigation device. Because of the nature of its business, the thrift industry has only limited opportunities to reduce its risks through hedging. Without the ability to offset the risks associated with long-term fixed-rate assets, an institution would be unlikely to perform satisfactorily under the protracted stresses incorporated in the RBC Test.

Testimony of F. Barton Harvey III
Chairman of the Board and Chief Executive Officer
The Enterprise Foundation

On "Oversight of Government-Sponsored Enterprises: The Risks and Benefits to Consumers"

For the Senate Committee on Governmental Affairs
Subcommittee on Financial Management, the Budget and International Security

July 21, 2003

Thank you, Chairman Fitzgerald, Ranking Member Akaka and members of the Subcommittee for this opportunity to share with you The Enterprise Foundation's views on the benefits to consumers provided by the housing Government Sponsored Enterprises (GSEs): Fannie Mae, Freddie Mac and the Federal Home Loan Bank (FHLB) system.

I am Bart Harvey, chairman of the board and chief executive officer of The Enterprise Foundation. Enterprise is a national nonprofit organization that provides private capital to support affordable housing and economic development in low-income communities. Enterprise and its wholly owned subsidiary companies have invested $4.4 billion to finance 144,000 affordable homes for low-income families and individuals, including more than 12,000 in 2002. We are currently investing half-a-billion dollars a year to help connect low-income people and communities to the mainstream economy. Our sole mission is to serve low- and very low-income households and to rebuild communities.

We have no more important partners in our work than the housing GSEs. These institutions have been indispensable to Enterprise's efforts to expand housing opportunity for low-income homebuyers and renters. In many cases, the GSEs alone were willing and able to help Enterprise meet the needs of the people and places we serve. Without the GSEs, much of our work simply would not be possible.

In the interest of full disclosure, the Committee should know that Enterprise regularly seeks support from major financial institutions, including the housing GSEs. They (and in the case of Fannie Mae and Freddie Mac, their corporate foundations) along with other financial institutions have been major contributors to The Enterprise Foundation. In addition, we have sought out senior executives from financial institutions to lend their talent, energy and personal contributions to our cause. Franklin Raines, Fannie Mae's chairman and chief executive officer, and Barry Zigas, senior vice president and executive director of Fannie Mae's National Community Lending Center, are Trustees of The Enterprise Foundation. Mr. Zigas has served since his days as executive director of the National Low Income Housing Coalition. Finally, I recently completed a term on the board of directors of the Federal Home Loan Bank of Atlanta.

We understand that the Committee will hear testimony from other witnesses that addresses the macroeconomic benefits the GSEs provide consumers. It certainly seems clear that Fannie Mae and Freddie Mac's participation in the secondary mortgage market lowers home mortgage rates for consumers. Rates on the "conventional" loans these GSEs finance are significantly lower than rates on the "jumbo" loans they do not. The lower rates Fannie Mae and Freddie Mac make possible cut monthly mortgage costs for low-income homeowners and help enable renters to buy their first home.

We are not experts on the extent of these and other macroeconomic benefits. Enterprise is not a research institution, but a practitioner—a provider of resources to those consumers who are often left out of the mainstream housing market. Our testimony addresses how we, working with the GSEs, address the needs of these low-income families and individuals.

We do not purport to speak for all the low-income housing consumers who have benefited from GSE products, programs and services or the other organizations that have worked with the GSEs to address America's housing challenges. We speak solely from our own experience over two decades of partnership with Fannie Mae, Freddie Mac and the FHLBank system. While some of the initiatives we have undertaken with these institutions have been groundbreaking or unique, we believe they are broadly representative of the tools the GSEs and partners like Enterprise have developed to fill gaps and correct failures in the housing market.

We suspect that the Committee will hear a great deal in connection with this hearing about the federal benefits the GSEs receive. It is equally important, we believe, for the Committee to be aware of the strong federal requirements on the GSEs to finance affordable housing.

Consider Fannie Mae and Freddie Mac. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires these companies to dedicate substantial portions of their business to serving low-income people and communities. They must meet annual goals, established by HUD, and expressed as a percentage of all the housing units for which the institutions provide financing, in the following categories: loans to low- and moderate-income borrowers (minimum 50 percent of all units financed by each company for 2003); loans in central cities, rural communities and other underserved areas (31 percent); and loans to very low-income borrowers and low-income borrowers living in low-income areas (20 percent).

When HUD established the current affordable housing goals for Fannie Mae and Freddie Mac in 2000 it substantially increased the percentage-of-business targets in each category. We strongly supported increasing the goal levels at that time. We have long encouraged Fannie Mae and Freddie Mac to increase their affordable housing activities. We are pleased that the companies affirmatively embraced the increased goal levels and have been meeting them, in a disciplined, prudent fashion. We are not aware of any other corporations that have such demanding public purpose responsibilities.

The Federal Home Loan Banks are required to dedicate 10 percent of their net income each year to fund the Affordable Housing Program (AHP). The AHP is a federal program that provides grants and loan interest rate subsidies for affordable rental and for-sale housing development. The AHP program has provided $1.7 billion in investment that has financed nearly 360,000 affordable homes. The Banks also offer other affordable housing initiatives, including billions of dollars of loans near cost for community investment opportunities through member Banks. While I served on the board of the Federal Home Loan Bank of Atlanta, the president and board granted additional earnings to pioneer an economic development program, create a secondary market for small multifamily loans and reach out to historically black colleges and minorities, among other activities.

Enterprise has worked in productive partnerships with the GSEs to provide housing for many thousands of low-income families and individuals. For example, Fannie Mae, through Enterprise, was one of the first institutions to invest in the Low Income Housing Tax Credit (LIHTC), in 1987. Fannie Mae's commitment to this fledgling federal incentive sent a strong signal to the marketplace that the Credit was a sound investment at a time when few corporations were willing to utilize it. Fannie Mae agreed to commit $25 million in investments and go on the road with us to convince other corporations to invest. Together, we helped create the corporate market in LIHTC investments.

Freddie Mac joined Fannie Mae several years later in helping to expand the market of LIHTC investors by making matching pledges for state and local LIHTC investment. With Enterprise, Fannie Mae started the first national LIHTC equity fund for special needs housing, Corporate Housing Initiatives, in which Freddie Mac was the other key investor. Since those early years of the LIHTC's history, Fannie Mae and Freddie Mac have been leaders and innovators in the LIHTC industry, pioneering new products and best practices in financing LIHTC developments. Attached to our testimony are descriptions of several LIHTC developments we have financed with Fannie Mae and Freddie Mac.

The LIHTC is now the most important federal incentive for the development of rental housing for low-income people. It accounts for $6 billion in housing investment that produces more than 115,000 affordable apartments for working families, seniors, homeless individuals and people with special needs every year. Essential to the LIHTC's efficiency and effectiveness is strong corporate support for it. Fannie Mae is the largest investor in the Credit and Freddie Mac is among the very largest.

Fannie Mae and Freddie Mac also have been leaders in the creation of innovative lending programs to finance affordable housing. For example, Fannie Mae and Enterprise created a $150 million lending program, Enterprise Mortgage Investments (EMI), that provides low-cost capital and credit enhancement for rental housing for low-income working families.

EMI primarily provides financing for smaller developments outside major cities that conventional banks are reluctant to support. EMI fills a critical, often overlooked market segment. EMI's status as a Special Fannie Mae lender, with fully delegated underwriting and servicing authority, enables it to provide resources that otherwise would not be available. One example:

- Prior to redevelopment made possible by EMI and Fannie Mae financing, Edgewater Village Apartments in northern Maryland was home to an open air drug market that generated one-third of all police calls in the southern part of the county. As a result of redevelopment, drug dealers are gone from the community, now called the Village at Lakeview. The community has 223 apartments for low-income renters, in 19 garden-style buildings, and a community room for after school programs and social services. Across the street is a Police Athletic Center that provides child care services.

Enterprise also has worked with Federal Home Loan Banks on innovative initiatives to provide affordable housing. One example is the "Home of Your Own/Portland" initiative, through which Enterprise, the Federal Home Loan Bank of Seattle and the Housing Authority of Portland, Oregon are enabling very low-income public housing residents to become homeowners.

Fannie Mae and Freddie Mac have been enormously productive and creative, which is part of their value added. They have very talented people, have innovated with state-of-the-art technology, reduced dramatically transaction costs and found a way to mainstream products and services that were considered "too risky" before. They have a mandate to find ways to make markets in affordable products work, which Wall Street does not.

The examples we have cited are a few among that show how the GSEs are serving low-income consumers and communities. We believe that the current statutory and regulatory framework for the GSEs, Fannie Mae and Freddie Mac in particular, has enhanced their ability and willingness to forge partnerships with organizations like Enterprise to deliver housing resources to people and places that cannot take full advantage of our nation's generally well functioning housing system.

The 1992 law that revised Fannie Mae and Freddie Mac's charter and regulatory structure allowed and encouraged the companies to be innovative in meeting their new affordable housing requirements. Congress expressly provided Fannie Mae and Freddie Mac the freedom and flexibility to respond to fast moving market conditions and emerging needs. The companies have consistently met their affordable housing responsibilities, even as HUD steadily and substantially increased them over the past decade. Millions of low-income people have a decent, affordable home as a result. Curtailing Fannie Mae and Freddie Mac's flexibility to innovate would undermine these gains and limit future progress towards meeting our nation's affordable housing needs.

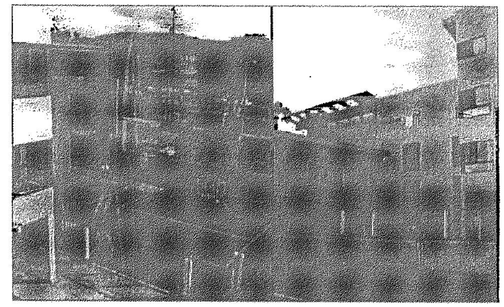
Certainly, the safety and soundness of the housing GSEs is critical for consumers and the economy. Vigorous regulation is essential. There is no reason that strong safety and soundness oversight should chill or constrain the GSEs' vitally important affordable housing activities.

In fact, the interests of affordable housing and safety and soundness are very compatible, if carried out the right way. Enterprise itself has a long history of proving this thesis. For instance, in the mid 1980's, Enterprise was confronted with the perception that risk capital for investments using the LIHTC for multifamily housing must be set at a very high level, given prior multifamily housing default history. The miniscule default rate in our multi-billion dollar portfolio of LIHTC investments over 15 years has disproved this concern. Over time, the LIHTC marketplace has acknowledged this point, as equity investments now price like bonds, meaning more cents per tax credit dollar goes into affordable housing. Similarly, our and others' low downpayment loans, carefully underwritten, have performed within the tolerance level of mainstream products.

Finally, we have room to innovate, take risks, try new products and find ways that we can create capital flows in distressed communities. Inevitably, one of the GSEs is the first investor willing to take calculated risks to find new markets.

We hope these comments from one organization's real world, on-the-ground perspective will help the Congress as it devotes appropriate attention to the housing GSEs and the indispensable, irreplaceable benefits they provide millions of low-income consumers.

Amistad Apartments
Los Angeles, California



Project Description

Developer/Sponsor: A Community of Friends

Units: 49

Equity Status: Closed

Investor(s): Freddie Mac, Bank of America

Description: Located in the Lincoln Heights neighborhood just outside of Los Angeles, Amistad Apartments is the new construction of 49 one-, two-, three- and four-bedroom apartments. Six interconnected structures built around courtyards and subterranean parking provide a two-story townhouse-style setting for the project. The surrounding area is a mix of residential, commercial and institutional buildings, including Plaza de la Raza, a large park, community arts center and recreational area. Smaller grocery stores, commercial services and schools are located nearby. Public transportation is easily accessible to the residents.

Developer: A Community of Friends was formed in 1989 to provide affordable housing to people with chronic mental illness. Since inception, ACOF has expanded its services to assist individuals and families with and without disabilities. ESIC has partnered with ACOF on 13 low income housing tax credit projects to create 475 affordable housing units serving families and special needs populations.

Rents: Affordable to families with incomes ranging from 20–50 percent of the area median income. Twelve of the 49 units are set aside for homeless or formerly homeless families, and an additional 11 units are set aside for residents with either a physical or mental disability.

Amenities: Include laundry facilities, a community room, computer room, porches or balconies, and courtyards with garden benches and gazebos. Child care services are provided on site. Security includes a keyed entry system and electronic gated garage entry and a pedestrian intercom system. A part-time security guard is also on site.

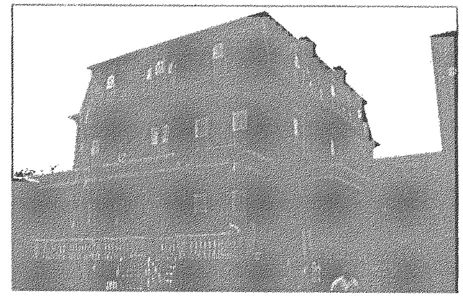
Social Services: The 23 special needs units receive supportive services from ACOF staff and outside service providers. These services include parent/child counseling, mental health counseling, case management, substance abuse prevention and counseling, education and employment services, and independent living skills.

Project Financing:

City of Industry	$2,170,000
Federal Home Loan Bank–AHP	$300,000
Supportive Housing Program Grant	$400,000
Freddie Mac, Bank of America	$6,256,498
Total Development Costs	$9,126,498

July 2003

218 Gates Avenue
Brooklyn, New York



Project Description

Developer/Sponsor:	Pratt Area Community Council
Units:	72
Equity Status:	Closed
Investor(s):	Fannie Mae
Description:	Located in the Bedford-Stuyvesant neighborhood of Brooklyn, 218 Gates Avenue is the rehabilitation of an existing three-story building and new construction of a four-story addition. A one-story corridor connects the two structures. 218 Gates Avenue provides 71 single room occupancy studio units and one two-bedroom superintendent's unit. The property sits between two clusters of privately developed, newly constructed townhomes. Additional housing stock in the area includes three- and four-story rowhouses. Residents have easy access to public transportation.
Developer:	Pratt Area Community Council (PACC) was founded in 1964 to focus on improving the quality of life for community residents and maintaining the area's economic, ethnic and racial diversity. In 1980, PACC decided to pursue a more aggressive agenda focused on affordable housing development, tenant protections and small-homeowner services, and has grown to become a leading community development organization. PACC serves the Fort Greene, Clinton Hill and Bedford-Stuyvesant neighborhoods in Brooklyn.
Rents:	The project has four rent levels. There are units set at $750 and $480 per month that are focused on people with AIDS. Those rents are subsidized through Shelter Plus Care and New York City, respectively. The balance of the units are renting at $250 and $350 for very low-income individuals.
Amenities:	Include a kitchen with common dining facilities, a library, nurse's office, and laundry facilities. Each unit will have a private bathroom and kitchenette.
Social Services:	Include social work case management, meals for those tenants who have AIDS, substance abuse counseling, and security.

Project Financing:	
New York City HPD - HOPWA	$8,396,186
General Partner Capital	$385,018
Fannie Mae	$1,575,361
Total Development Costs	$10,356,565

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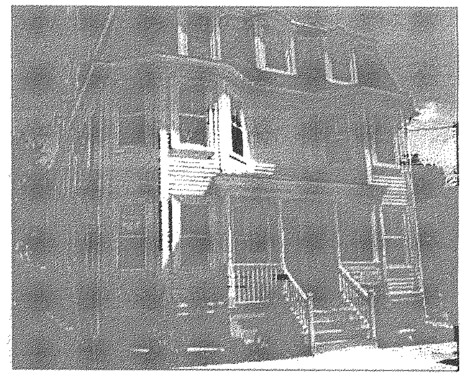
Photograph courtesy of The Enterprise Social Investment Corporation

Operation Hope Renewed

Providence, Rhode Island



Photograph courtesy of The Enterprise Social Investment Corporation

Project Description

Developer/Sponsor: West Elmwood Housing Development Corporation

Units: 19

Equity Status: Closed

Investor(s): Fannie Mae

Description: Operation Hope Renewed III is the substantial rehabilitation of seven three-story buildings into 19 units of housing for families. The configuration consists of 1 one-bedroom/one-bath unit; 10 two-bedroom/one-bath units; 3 three-bedroom/one-bath units and 5 four-bedroom/two-bath units. The project is located on scattered sites within West End and surrounded by historic neighborhoods. Residents have easy access to food and shopping, medical facilities, schools, a community center, library and park.

Developer: The West Elmwood Housing Development Corporation (WEHDC), formed in 1972, is a nonprofit group founded to promote the stabilization of the West End neighborhood by empowering the people who live, work and invest in the community. Located on scattered sites, the project is the successor to an earlier effort by the developer to rehabilitate and stabilize the West End neighborhood in Providence. In 1993, WEHDC began the first phase of improvements for the West End neighborhood including constructing new sidewalks, converting a vacant lot into parking and green space, and providing technical assistance for home repair, as well as the construction of two single family homes. WEHDC also assisted a local organization in the development of a 40-unit scattered site project.

Rents: Units are affordable to families with incomes between 48 - 53 percent of area median income.

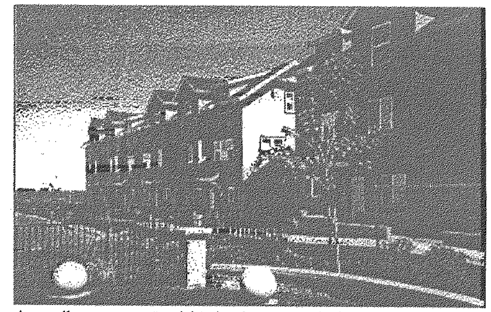
Amenities: Security system and two-way communication/buzzer system; 28 parking spaces and one handicapped-accessible unit.

Project Financing:

Rhode Island Housing & Mortgage Finance Corporation	$209,880
RIH HOME Loan	$163,493
Community Development Block Grant	10,000
RIH Targeted Loan	339,846
HOME Acquisition	$132,061
Fannie Mae	$1,446,310
Total Development Costs	$2,301,590

Sheldon Village Phase II

Eugene, Oregon



Project Description

Developer/Sponsor: Housing and Community Services of Lane County

Units: 35

Equity Status: Closed

Investor(s): Freddie Mac

Description: The new construction of Sheldon Village II is part of a two-phase effort to create "nodal " development or high density, pedestrian-friendly housing that fits into the existing setting. Contained in six three-story buildings, Sheldon Village II provides 35 affordable housing units, with a mix consisting of 12 one- and two-bedroom flats, 19 two- and three-bedroom townhomes, and 4 "twints" - 4 two-bedroom units that are classified as 8 SROs and share living room and kitchen space. The first phase of Sheldon Village involved the new construction of 43 units with a similar mix. As this development effort provides for higher density, transit-oriented type housing-- meaning less parking space availability, residents are within easy walking distance of shopping, recreational and educational facilities, and public transportation.

Developer: Created in 1949, the Housing and Community Services of Lane County (HACSA) administers the public housing and Section 8 programs for Eugene and Lane County, Oregon. HACSA owns and operates more than 700 public housing units, of which approximately 290 are family units. HACSA has developed six tax credit projects that total 200 units. Sheldon Village Phase II is HACSA's seventh project for which ESIC has syndicated the tax credits.

Rents: Six units are restricted to households with incomes no higher than 30 percent of area median. The remaining 29 units serve households with incomes up to 50 percent of the area median. Two units are handicapped accessible, and six units are targeted to serve homeless households with special needs.

Amenities: Include a community building with meeting room, kitchenette, and computer room from Phase I. Each unit is equipped with a washer/dryer. Children have an open play area.

Social Services: Credit counseling, parenting classes, cooking and nutrition classes and computer training. The six units set aside for special needs residents receive supportive services from various local agencies. Services include case management, life skills training, counseling, vocational training and medication management.

Project Financing:

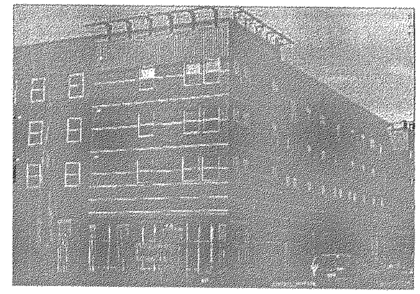
Network for Oregon Affordable Housing	$372,904
GP Loan (HOME)	$290,805
GP Loan (HTF)	$100,000
Freddie Mac	$3,088,815
Total Development Costs	**$3,852,524**

July 2003

Photograph courtesy of The Enterprise Social Investment Corporation

Renassiance at Off Broadway Lofts

Denver, Colorado



Photograph courtesy of The Enterprise Social Investment Corporation

Project Description

Developer/Sponsor: Colorado Coalition for the Homeless

Units: 81

Equity Status: Closed

Investor(s): Fannie Mae

Description: Located in downtown Denver just a few blocks from the Central Business District, the newly constructed Off Broadway Lofts provides 81 studio, one-, two- and three-bedroom apartments. In addition the four-story, loft style elevator building contains 4,750 square feet of ground floor commercial space, and a below grade parking garage. Twenty-six of the 81 apartments offer permanent housing for homeless families, four units are fully handicapped accessible and all units are handicapped adaptable. The surrounding neighborhood includes commercial and office space, and smaller residential properties. There is substantial redevelopment occurring in the immediate neighborhood.

Developer: The Colorado Coalition for the Homeless (CCH) is one of the strongest non-profit housing developers and homeless service providers in Colorado. For nearly 20 years, CCH has provided services to homeless individuals and families across the state, including transitional and permanent housing, housing vouchers, health care, child care, family support services, and mental health counseling. CCH is an experienced developer, having completed six Low Income Housing Tax Credit projects syndicated by ESIC, producing 545 units of housing. CCH's developments are highly successful and have won many awards, including the Met Life Asset Management award.

Rents: Thirteen units are affordable to residents at 40 percent of area median income (AMI); 12 are affordable to residents at 50 percent of AMI; 32 are affordable to residents at 60 percent of AMI; and 24 units are affordable to residents at 30 percent of AMI. These 24 units plus an additional two units are set-aside as permanent housing for formerly homeless individuals and families participating in Colorado Coalition for the Homeless programs.

Amenities: Community room; and fenced, landscaped courtyard. Each residential level (Floors 2–4) is equipped with laundry facilities. Access to the garage is by a remote controlled gate.

Social Services: A wide array of supportive services, including case management, health care, employment training, substance abuse counseling, and child care are available to the formerly homeless residents. Residents will also receive rental assistance through CCH's Shelter + Care Section 8 grant. Proximity to CCH offices and the Stout Street clinic will enhance CCH's ability to efficiently deliver services to these residents.

Project Financing:	
US Bank	$1,975,000
GP Loan (HOME)	$485,000
GP Loan (HOME)	$600,000
GP Loan	$815,000
GP Loan (AHP)	$300,000
Developer Fee Loan	$360,908
GP Capital	$183,483
Fannie Mae	$6,314,000
Total Development Costs	**$11,033,391**

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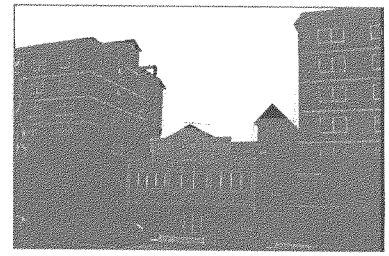
Allen Cathedral Senior Residences

Queens, New York



Project Description

Developer/Sponsor: Benjamin Development Corp. and Greater Allen Cathedral of NY

Units: 221

Equity Status: Closed

Investor(s): J.P. Morgan Chase, Freddie Mac, Fannie Mae

Description: A vacant site that was purchased from the City of New York now contains a newly constructed 221-unit senior residence that serves both the elderly and the frail elderly. The 208 one-bedroom and 13 two-bedroom apartments are housed in two seven-story elevator towers connected by a two-story community facility. Located on Merrick Boulevard, a major street in Jamaica, Queens, the project is surrounded by residential, commercial and manufacturing. Most of the residential properties are single-family homes, duplexes and mid-rise apartment buildings. A supermarket, convenience stores and a hospital are nearby. Public transportation is easily accessible. On-site parking is available.

Developer: Greater Allen Cathedral of NY and Benjamin Development Corp. are co-developers. Benjamin Development Corp. is a wholly-owned entity of Alvin Benjamin who has over 40 years of experience as a builder and developer of multi-family apartments, nursing facilities and office and commercial space. Mr. Benjamin has built or developed over 10,700 units of housing, 1,000 beds in health facilities and 360,000 square feet of office and commercial. Greater Allen Cathedral of New York is a large church based in Jamaica, Queens that is pastured by Rev. Floyd Flake, who is a former Congressman. Greater Allen has done a tremendous amount of housing development and economic development.

Rents: Affordable to seniors with incomes in the 50–60 percent of median income range.

Amenities: Include a large community facility with a kitchen and dining area, classrooms, and a craft room; a landscaped recreation area. Laundry facilities are located on each floor of the residence towers. Security cameras are located in the common areas, and an on-site security person is stationed in each of the two towers.

Social Services: Are provided to those residents in need and include a meal plan; on-site nursing services such as home health care, skilled nursing, and health education; and on-site medical services. Fifteen percent of the units are set aside for the "frail elderly," which the State's Division of Housing defines as persons 55 years of age and older who require assistance with one or more activities that are instrumental to daily living, and those age 55 or more who have mental capacity or emotional strength limitations.

Project Financing:	
J.P. Morgan Chase Bank	$5,700,000
New York State DHCR–Housing Trust Fund	$3,600,000
Deferred Developer Fee	$2,646,585
J.P. Morgan Chase, Freddie Mac Fannie Mae	$19,797,505
Total Development Costs	$31,744,090

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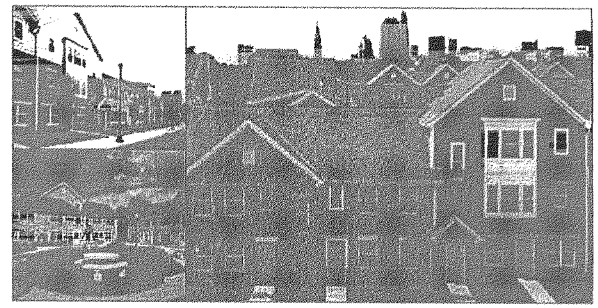
Photograph courtesy of The Enterprise Social Investment Corporation

Arbor Park Village I

Cleveland, Ohio



Project Description

Developer/Sponsor: The Finch Group

Units: 282

Equity Status: Closed

Investor(s): Fannie Mae

Description: The redevelopment of Arbor Park, formerly Longwood Estates, is being built in three phases to create 629 affordable rental townhomes and a more traditional city street grid with secure open space. Arbor Park Village I is the new construction of 282 of those housing units for families. The project consists of 28 two- and three-story buildings that contain one-, two-, three- and four-bedroom townhomes. Located near downtown Cleveland in the Central neighborhood, Arbor Park I is bordered by a mix of residential, industrial and institutional buildings. Many of the residential structures are undergoing significant renovations. Its easy access to downtown provides accessibility to employment centers, schools and churches.

Developer: The Finch Group (TFG) has been involved in real estate transactions since 1972 and has experience with multiple financing resources, including HUD 236, 221(d)(3) and (4), and low income housing tax credits. From New England to New York, and Chicago to Cleveland, TFG has provided expertise in the areas of finance, development and property management for housing properties.Over the past 16 years, TFG has participated in 28 projects that have been funded through the Low Income Housing Tax Credit program.

Rents: Affordable to residents with incomes at or below 50 percent of area median. Project-based Section 8 vouchers have been awarded to the property. These residents pay no more than 30 percent of their income towards rent.

Amenities: Include a community room, a computer lab, playgrounds and a park. Interactive cameras are located throughout the development and are monitored 24-hours a day. A private security patrol is on-site for 12 hours a day.

Social Services: Are available to the residents and include computer classes, employment training, GED and adult education conducted on-site, and health screenings.

Project Financing:

Tax-Exempt Bond Proceeds	$17,000,000
Upfront Grant Financing	$11,280,000
Interest earned during construction	$449,649
Fannie Mae	$16,320,599
Total Development Costs	$45,050,248

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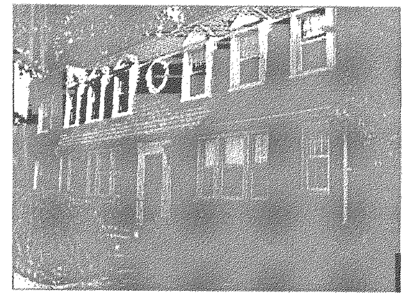
Photograph courtesy of The Enterprise Social Investment Corporation.

Colonial Village West Apts.

Arlington, Virginia



Photograph courtesy of The Enterprise Social Investment Corporation

Project Description

Developer/Sponsor: AHC, Inc.

Units: 70

Equity Status: Closed

Investor(s): Freddie Mac

Description: Colonial Village West Apartments is the acquisition and moderate rehabilitation of 70 garden style apartments. Located in the Courthouse neighborhood of Arlington, an area of increasing commercial and luxury residential development, Colonial Village West was purchased by AHC in 1981 in partnership with a for-profit organization. AHC purchased the property from the existing partnership in 2001 to preserve the affordability of the development and finance property upgrades, including new roofs, kitchens, and other interior upgrades. All 70 apartments are covered by Section 8 rental subsidies and continue to be affordable to the low- and moderate-income residents currently residing at Colonial Village West. The development is well served by shopping and other services.

Developer: AHC Inc. is a private, nonprofit developer of low- and moderate-income housing. Formerly known as Arlington Housing Corporation, AHC has worked to preserve and expand affordable housing opportunities in Arlington County and the surrounding Washington region. AHC develops and manages affordable rental housing; provides home-ownership opportunities; offers housing rehabilitation services; and coordinates social services for residents. AHC owns and operates 19 multifamily rental properties in Arlington, providing 1,700 affordable apartments to more than 5,000 low- or moderate-income residents. Their five homeownership programs have helped more than 800 families rehabilitate and repair their aging homes, and assisted 200 families in buying their first home. Colonial Village West Apartments is the first partnership between ESIC and AHC.

Rents: Affordable to households at or below 60 percent of area median income.

Amenities: Includes a tot-lot, laundry facilities and parking.

Social Services: AHC's resident services staff works with the property's site staff to keep residents informed of Arlington County programs and social service programs. Residents receive a quarterly newsletter, are invited to participate in an annual spring planting day and a holiday party for children.

Project Financing:	
Tax-Exempt Bond	$4,700,000
Sponsor Loan	$161,000
General Partner Capital	$834,000
Deferred Dev. Fee	$27,070
Freddie Mac	$1,575,884
Total Development Costs	$7,297,954

July 2003

The Role of the GSEs in Providing Access to Homeownership and Global Capital Markets

Presented to a Hearing of the:

Governmental Affairs Subcommittee on Financial Management,

the Budget, and International Security

U.S. Senate

Washington, D.C.

on

July 21, 2003

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Chairman Fitzgerald, Senator Akaka, and distinguished members of the Subcommittee:

Thank you for the invitation to testify today on government-sponsored enterprises and their risks and benefits to consumers. My name is Susan M. Wachter. I am the Richard B. Wormley Professor of Financial Management and a Professor of Real Estate and Finance at The Wharton School of the University of Pennsylvania. I am a former Assistant Secretary of Policy Development and Research at the U.S. Department of Housing and Urban Development. My testimony is taken from studies that I have authored or co-authored on the affordability of housing and government-sponsored enterprises.

Currently, the United States has one of the best housing finance systems in the world. The efficiency of this system has been advanced by the federal chartering of government-sponsored enterprises (GSEs), in particular Fannie Mae and Freddie Mac. These institutions have enabled the securitization and the development of a secondary market for the funding of mortgages. Securitization and the efficient trading of mortgages in secondary markets have integrated the U.S. mortgage market into the international financial system.

The goal of the federal chartering of Fannie Mae and Freddie Mac, further articulated by the 1992 regulatory legislation that established OFHEO, is to achieve public policy objectives including the promotion of nationwide homeownership through the purchase and securitization of mortgages. The Federal government provides a number of economic privileges to the GSEs, most important of which is the implied Federal government guarantee which decreases the enterprises' funding costs. Given the contingent liabilities to the U.S. taxpayer, GSEs are and must be monitored for their safety and soundness as well as for their mission achievement.

Today, I will address the increased access to homeownership for all Americans and, in particular for the underserved, which, I believe, is achieved by the Federal chartering of the GSEs. In my testimony, I will specifically refer to a research paper, authored by myself and colleagues, which details the extent that affordable lending products advance homeownership. In addition, I believe the GSEs have had a role in the recent strength of the U.S. housing market which has contributed towards the stabilization of the overall U.S. economy.

Based on my research and that of my colleagues, Fannie Mae and Freddie Mac have contributed to the expansion of homeownership in America, providing affordable residential mortgages for low- and moderate-income households who otherwise might not have the opportunity to become homeowners. Specifically, Freddie Mac and Fannie Mae efforts have helped to advance gains in overall homeownership rates and in homeownership rates among minority and low-income households occurring over the past decade, resulting in the record high homeownership rate in America of 68% in 2003.

GSEs have accomplished this in part through their special affordable lending programs but also importantly through lower mortgage and down payment rates that would not prevail but for the presence of the GSEs. The findings of the recently released research study "The impacts of Affordable Lending Efforts on Homeownership Rates" by Roberto Quercia, George McCarthy, and Susan M. Wachter, published in the *Journal of Housing Economics* (Volume 12, Number 1, March 2003), indicate that affordable lending efforts increase homeownership opportunities overall and for underserved populations in particular. Affordable lending products including those which permit low downpayments have large impacts on the homeownership outcomes of all Americans and larger impacts for underserved groups, including a 27 percent increase in the relative probability of homeownership for young households, a 21 percent increase in the relative probability of homeownership for African Americans, and a 15 percent increase for households residing in central city.

The gains in homeownership are attributable in part to improved credit risk management, which have enabled the lowering of downpayments. Thus, it is not just lower mortgage rates, but also the technical innovations, such as automated underwriting, developed by the GSEs in the 1990s that are responsible for increasing homeownership.

The GSEs and a strong secondary market deliver a second benefit, besides expanded homeownership opportunity, to the American consumer. Their role in accessing global capital markets and stabilizing U.S. mortgage markets was evident in August 1998 upon the defaulting of Russia's foreign-held debt. In the crisis, MBS yields moved sharply higher and illiquidity appeared to be a growing concern. Purchasing a record number of mortgages, the GSE's staved off crisis by adding liquidity to mortgage markets; therefore, no credit crunch evolved in the U.S. housing sector as opposed to other markets of the time. This pivotal effect is even more evident in the recent role housing has played in stabilizing the overall U.S. economy. The role of mortgage market access to global capital markets as an automatic stabilizer for the U.S. economy is demonstrated by the strength of the housing sector and its role in moving the economy out of the 2001 recession. Access to international capital markets during a period of low and falling interest rates and possible deflation has resulted in additional consumer spending which has supported the U.S. economy. This benefit that the GSEs and secondary markets provide the American consumer is a major contributory factor is today's strong housing market which has helped to stabilize and grow the U.S. economy.

Chairman Fitzgerald, Senator Akaka, and distinguished members of the Subcommittee, this concludes my prepared statement, and I would be pleased to respond to any questions that you may have.

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