REFORMING FANNIE MAE AND FREDDIE MAC

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

REFORMING FANNIE MAE AND FREDDIE MAC

WEDNESDAY, JULY 11, 2001

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 1:30 p.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Cox, Castle, Royce, Barr, Weldon, Biggert, Hart, Kanjorski, Ackerman, Velázquez, Bentsen, J. Maloney of Connecticut, Hooley, Jones, Sherman, Meeks, Inslee, Ford, Moore, Hinojosa, Lucas, Shows and Israel.

Chairman BAKER. This hearing of the Capital Markets Subcommittee will come to order. The purpose of our hearing, of course, today is to receive comment from the two principal Government-sponsored enterprises with regard to the report issued by the Congressional Budget Office analyzing the effect, amount and utilization of the subsidy created by the charter authority of the Government-sponsored enterprises.

Additionally, we will hear comments from other interested parties as to their views of this matter, as well as comments with regard to H.R.1409, the matter now pending before the Committee with regard to the creation of a new regulatory structure for the enterprises.

And further, we will solicit opinion as to what, if any, additional modifications to the current regulatory model should be considered.

As everyone knows, this has been a subject of long-standing interest to the Committee and one in which we are moving very slowly and cautiously to ensure that all perspectives are heard and understood.

It would not be the intent as a result of our hearing today to reach any final disposition in this matter. And in fact, I would intend to convene additional hearings before the year is out on any approach which might be deemed advisable.

To that end, I am certainly appreciative of all who have expressed interest in this matter. It has received significant attention. And I think, as market conditions continue to change, the need for continued review and consideration of all perspectives is particularly important public policy responsibility.

With that, I'd like to recognize Mr. Kanjorski for any opening statement he may choose to make.

[The prepared statement of Hon. Richard H. Baker can be found on page 74 in the appendix.]

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Chairman, since we began our extensive examinations into GSEs 16 months ago, we have met nine times to discuss these matters.

I suspect that very few other entities have received such scrutiny in either the 106th Congress or the 107th Congress, particularly without corresponding legislative action.

During our numerous hearings, although I have consistently sought to identify the problems posed by GSE performance and regulation, I have so far concluded that no compelling reason exists for pursuing any legislation affecting them at this time.

Nevertheless, our inquiry today will focus on two issues.

First, we will again discuss the study compiled by the experts at the Congressional Budget Office on GSE subsidies. As we learned in May, Fannie Mae and Freddie Mac pass on about two-thirds of their Federal subsidies to homeowners in the form of lower mortgage prices, and this report confirms that GSEs are performing a function that Congress wants them to perform.

Namely, they are working to help lower home ownership costs without Government funding.

In return, the GSEs' stakeholders receive a share of the Federal subsidy to provide a financial reward for their efforts.

Our second topic concerns H.R.1409, the Secondary Mortgage Market Enterprises and Regulatory Improvement Act. This bill would dramatically restructure the current regulatory system for Fannie Mae and Freddie Mac.

In my opinion, it also represents a solution in search of a problem.

Nearly a decade ago, Congress created a rational, reasonable and responsive system for supervising GSE activities. That system, with two regulators, is operating increasingly effectively.

H.R. 1409 would unfortunately interrupt this continual progress.

Yet, some have continued to suggest that in order to avert another S&L crisis, we must act now to change the GSEs' regulatory structure.

In studying H.R. 1409, we should therefore review the lessons learned from that debacle. This examination will help to ensure that we do not create another troubling situation requiring bail-out legislation.

Before FIRREA, we had a Federal board which is currently serving as a chartering authority for some depository institutions and as their regulator. This same board also served as the operating head of a depository insurance program and supervised the activities of some housing GSEs.

During our extensive deliberations over FIRREA, we determined that this concentration of powers contributed significantly to the S&L crisis. Consequently, we separated these overlapping regulatory functions when restructuring the industry.

However, by moving the supervisory responsibility over the GSEs to the Federal Reserve, H.R. 1409 would again concentrate regulatory power in one entity and ignore an important lesson learned in the thrift crisis.

After all, the Federal Reserve, like the old Bank Board, already has chartering and regulatory authority over depository institutions.

In addition, it develops and oversees many of our Nation's consumer laws and it received significant new responsibilities in the financial modernization law.

Further, although it does not oversee deposit insurance, the central bank does manage our Nation's monetary policy. As a result, in times of hardship, the Federal Reserve might turn to GSE securities to help to manage interest rates and the money supply. That combination of conflicting duties could prove very dangerous and Congress should avoid creating it.

In other words, we should not follow the same legal recipe that led to the thrift crisis.

That said, Mr. Chairman, I am pleased that we worked together to put forward a balanced panel for today's hearing. Fannie Mae and Freddie Mac will have an opportunity to educate us about their concerns related to the CBO study and H.R. 1409. We will also—for the first time—finally hear from an individual representing FM Watch, which was noticeably absent from last year's GSE roundtable.

I additionally look forward to hearing the opinions of Martin Edwards with the National Association of Realtors, and James Miller, who headed OMB during the Reagan Administration.

Several others also wanted to participate in today's hearing but could not do so. The National Association of Homebuilders, for example, supports a strong GSE regulatory system that balances safety and soundness concerns with mission fulfillment.

Like me, it believes that the separation of powers among two regulators in the current system meets these objectives.

The homeowners expressed additional dismay that H.R. 1409 "ignores the extensive hearing record of the past year," and that it "exacerbates" the concerns that the group articulated about H.R. 3703 in the 106th Congress.

AARP, a number of mayors, and others, have also contacted me to express their apprehensions about H.R. 1409. To ensure that our hearing reflects these views, I ask unanimous request, Mr. Chairman, to submit these materials into the record.

In closing, Mr. Chairman, I share your desire to conduct effective oversight over the housing GSEs and to ensure that we maintain an appropriate and sufficiently strong supervisory system.

If we decide to continue to pursue GSE reform in the 107th Congress, I also hope that we will follow a prudent course. Perhaps we could again use a roundtable discussion to identify the problems among the affected parties, reach consensus about a suitable course of action, and then, only if necessary, work to write legislation.

Mr. Chairman, I have the unanimous consent request for the materials.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 87 in the appendix.]

Chairman BAKER. Without objection.

I thank the gentleman.

Ms. Velázquez.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman.

I would like to begin by thanking Chairman Baker and Ranking Member Kanjorski for holding this hearing and allowing the Members of this subcommittee the chance to hear the response of representatives of our housing GSEs to the CBO study recently released.

Of late, it has become fashionable to question the continuing value of our housing GSEs, particularly Fannie Mae and Freddie Mac. Arguments abound as to whether these two entities are overstepping their bounds or, conversely, not doing enough.

Is it mission creep that we must be aware of? Or are we concerned that the GSEs are not doing enough for the very people that they are designed to help?

We have looked at this issue, at the issue of safety and soundness, and we have reviewed the merit of the implied Government backing caused by the line of credit at the Treasury. We have pondered the question of whether these institutions are too-big-to-fail.

The issue of the day is the size and scope of the so-called Government subsidy provided to the GSEs, as calculated by the CBO, and whether or not the subsidy is being passed on to homebuyers.

At the last hearing on this topic, a number of my colleagues raised concerns about the methodology used by CBO to calculate its latest estimate of $10.6 billion annual subsidy.

While I acknowledge the validity of these concerns, I would also like to point out that when we get bogged down in the details of how this figure was reached, we obscured a larger point—that we need to be focused on ensuring that our rising home ownership rates survive the softening economy. And more importantly, that we continue to make strides in reaching our goals for increased home ownership rates among minorities.

Last year, then-HUD Secretary Cuomo announced a new policy initiative to bring Afro-American and Latino home ownership up to 50 percent within 3 years. We are one-third of the way to that deadline.

How are we doing? What steps have the GSEs taken to ensure that we get there? What can we in Congress do to encourage greater innovation to these entities in this process?

These are the questions that we should be asking and issues that should be concerning us.

Yesterday, the Appropriations Subcommittee on VA/HUD marked up a bill that, by all accounts, will be disastrous for housing. Earlier this year, the Republican leadership passed a tax cut that will place very serious limitations on spending for social programs.

The result is that now, more than ever, we need to encourage the activities of the housing GSEs. Their mission has become more important than ever.

I look forward to hearing the testimony of Fannie Mae and Freddie Mac and to working with my colleagues on this subcommittee to ensure that we move toward an environment in which the housing GSEs can continue to make strides in increasing home ownership opportunities for all Americans.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Velázquez.

Mr. Bentsen, do you have an opening statement?

Mr. BENTSEN. [Nods in the negative.]

Chairman BAKER. Ms. Hooley.

Ms. HOOLEY. Thank you, Mr. Chairman, and Ranking Member, for holding these hearings today.

I couldn't agree with you more that Congress needs to continue working to increase home ownership for all Americans. While over two-thirds of American families presently own their own homes, overall, that's only 3.6 percent increase in the last decade. And you have to keep in mind that this last decade was the best decade we've ever had, an economic boom.

But we still have a third not being able to share in the American dream.

Mr. Chairman, it's no secret who the majority of these citizens are who can't afford their own home. The census clearly indicates that Americans who classify themselves as minorities are far less likely than white Americans to own a home.

In the part of Oregon which I represent, these Americans tend to be of Hispanic origin, and although I know I'm hardly unique or special in that regard, Hispanics are the fastest-growing minority in the United States, and ignoring their problems, including the ability to purchase a home, will only erode the quality of life for all of our citizens.

As such, I don't believe that the stated goals of today's hearing genuinely addresses this problem. Clearly, our reliance on the GSEs to increase home ownership have helped get us where we are today.

I'm hoping they can do more. I'm not sure that doing away with their charter or subsidies or enacting H.R. 1409 would ultimately lead to lower mortgage rates for our constituents, or grow the mortgage money available for minority and low-income homebuyers.

Moreover, I'm equally doubtful that any of these options is necessarily going to increase home-buying opportunities for minority Americans.

That said, I'm sure that some of our witnesses will disagree and, in the interest of fairness, I look forward to hearing their views and I look forward to learning how we are going to increase home ownership for all Americans, particularly our minorities.

Thank you.

Chairman BAKER. Thank you, Ms. Hooley.

By time of arrival, Mr. Lucas, you're next for a statement. Do you have an opening statement, sir?

Mr. LUCAS. [Nods in the negative].

Chairman BAKER. Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman.

I want to thank you for the opportunity to be able to read a statement into the record. I welcome the opportunity to address the subcommittee on the important topic of housing and role played in housing finance by Fannie Mae and Freddie Mac.

I take particular interest in today's hearing because of the far-reaching ramifications of this subcommittee's action. There are a handful of issues that most profoundly affect the quality of all of our lives. Housing is certainly high among that list.

Home ownership and affordable housing is central to the fabric of a community and to building wealth and security among our constituents. Real people with real hopes, dreams and needs, people seeking to fulfill their desire for a piece of the American dream.

The question is how and who is getting it done?

In that vein, I thought it would be helpful to share my experience with Fannie Mae and the work they have been doing in my congressional district. After all, we can talk about affordable housing and getting people in homes. But the real goal for all of us is to make it happen.

Last fall, Fannie Mae and the National Association of Hispanic Real Estate Professionals launched a close-the-gap campaign. That campaign is intended to address the home ownership gap between the United States population at large and Hispanic and African-Americans.

The Anglo home ownership rate is currently estimated to be at 73.9 percent, outpacing the Hispanic and African-American home ownership rates by as much as 26.4 percent to 26.1 percent, respectively.

To diminish that gap in my district alone, Fannie Mae this spring provided $29.4 million in mortgage financing to 352 families to help ensure that home mortgage money was available at the lowest price.

As of March, 2001, Fannie Mae has bought or guaranteed $606.9 million in mortgage loans with 10,443 families served.

Mr. Chairman, as a former business owner, I know that our Fannie Mae housing is good business. Its charter as drafted by Congress was designed to give it specific competitive advantages as well as restrictions.

As an elected representative, I know that my constituents' housing needs are being addressed by the diligent work of Fannie Mae and Freddie Mac.

Can GSEs do more?

Certainly. And I will continue to call on them to do so. Likewise, as a purchaser of mortgages, Fannie Mae and Freddie Mac need the primary market to generate those loans. I will, therefore, look to lenders to keep pace with changing demographics and the credit needs of our communities.

Mr. Chairman, I know that the time has run out. But I would like to ask that the entire statement that I have prepared be read into the minutes.

[The prepared statement of Hon. Rubén Hinojosa can be found on page 83 in the appendix.]

Chairman BAKER. Without objection.

Mr. HINOJOSA. Thank you.

Chairman BAKER. Thank you, Mr. Hinojosa.

Ms. Jones, do you have an opening statement?

Ms. JONES. Thank you, Mr. Chairman, I sure do.

I'd like to say good morning to my Chairperson, Mr. Baker, Ranking Member Kanjorski, and Members of the subcommittee. I seek unanimous consent that my full statement be included in the record.

Chairman BAKER. Without objection.

Ms. JONES. We're here this morning to review another bill, H.R. 1409, that seeks to strengthen Federal regulation, supervision of Fannie Mae and Freddie Mac.

Many of us have been here before. We started with safety and soundness, then to transparency, mission creep, validation of subsidies, to strengthening Federal regulation.

I want to note at the onset that I feel that it's imprudent to offer new regulatory regimes when we've not allowed the existing schemes and processes to work.

On what basis do we abandon the ship on HUD and fail to set sail in new, untested waters with the Federal Reserve Board?

Mr. Chairman, I do not support efforts to increase the regulatory burden placed on GSEs, although I fully respect your decision to do so, burdens that will ultimately be passed on to customers.

If the information suggests that the GSEs have not done what they are required to do, let's fix it and move on. If the GSEs, however, are on track and accomplishing their mission again, let us move on.

My concerns relative to this legislation are many. Primarily, I fail to see the need to transfer housing policy to the Federal Reserve Board. I believe the Fed has enough responsibilities in simply handling monetary policy and working with banking institutions relative to improving CRA.

Moreover, this bill grants HUD authority over GSE housing goals, while yet basically transfers all housing powers to the Federal Reserve. One or the other ought to be in the same house.

It provides bank regulatory extensive powers over housing and approving new GSE business activities. These new powers do not mesh with me.

What historical knowledge does the Fed possess that will make it more effective in addressing housing issues of low- to moderate-income persons and minorities?

In essence, the Fed is an inappropriate regulator in this area.

Many of us on this Committee remember and sat through eight previous GSE hearings in which we examined with great detail Fannie Mae and Freddie Mac. From those hearings we examined safety and soundness to an exhaustive degree.

Afterwards, Fannie and Freddie Mac made pledges themselves to six voluntary commitments. For every one of these commitments, they have either completed or will complete. These commitments put them at the forefront of financial organizations.

I fear that H.R. 1409 does little to help or improve upon the GSEs' ability to fulfill their housing mission. Their mission is an important one and I'm not concerned about market share wars, but I'm concerned about affordable housing in my district and across this country, particularly special housing needs of the elderly, home ownership for those who seek the American dream.

I know I've run out of time, Mr. Chairman. I submit the rest of my statement for the record and would hope by the time we complete this hearing and the other ten or so hearings we've had, that we will get back to allowing Freddie Mac and Fannie Mae to meet the mission that they were originally set in place to do.

[The prepared statement of Hon. Stephanie T. Jones can be found on page 85 in the appendix.]

Chairman BAKER. The statement will be inserted in the record, without objection, as will all Members' statements.

Ms. JONES. Thanks, Mr. Chairman.

Chairman BAKER. Mr. Israel, did you have a statement?

Mr. ISRAEL. Thank you, Mr. Chairman.

Let me state again that I have enjoyed the opportunity to learn about your concerns for this issue. At the same time, I believe that Fannie Mae and Freddie Mac are true American success stories, created by Congress to ensure that Americans have access to low-cost mortgage funds. Fannie Mae and Freddie Mac help millions of Americans, including many in my district, achieve the dream of home ownership.

At each and every hearing of this subcommittee, I have commented that, while we ought to explore these concerns, and while there is always room for improvement, we should not hinder Fannie Mae and Freddie Mac's ability to perform their core competency of creating affordable housing opportunities.

Mr. Chairman, I wish to repeat that refrain this afternoon.

I'm pleased that former OMB director James Miller will be here to testify today and I look forward to that testimony. In fact, I have noted that Dr. Miller's study estimated total interest rate savings to America's families to be between $8 billion and $23 billion a year, compared to an annual funding advantage held by the GSEs of between $2.3 billion to $7 billion.

He concludes in this study, and I quote: "Even using the lowest estimate of consumer benefits and the highest estimate of the funding advantage in our range of estimates, the value of the consumer interest cost savings resulting from Freddie Mac and Fannie Mae's activities significantly exceeds the highest estimates of their funding advantage."

I also believe it's important to note that on calculating the benefits that the GSEs receive, our own CBO may have failed to calculate the value Fannie Mae and Freddie Mac provide to American homeowners.

In its calculations, CBO measures all of the costs, but only a portion of the benefits provided to consumers. For example, CBO concedes that it did not attempt to measure important benefits the GSEs provide, including their fulfillment of their statutory affordable housing goals, their investment in new mortgage products and technology innovations, and their continued commitment to increase minority home ownership.

In conclusion, we should be mindful of the important place Fannie Mae and Freddie Mac hold in the mortgage finance market before passing legislation or subjecting them to further unnecessary scrutiny which will only serve to make it more difficult for them to continue fulfilling their mission.

Again, we should always be mindful of various concerns. We should always seek improvements. But we should not inhibit these important GSEs from performing their core competency of creating affordable housing for my constituents and for all of our constituents.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, sir.

Mr. Shows, do you have an opening statement?

Mr. SHOWS. [Nods in the negative.]

Chairman BAKER. Mr. Moore.

Mr. MOORE. [Nods in the negative.]

Chairman BAKER. If no other Member has an opening statement, we'll proceed to our first panel.

I'd like to welcome here today individuals who are certainly no stranger to the issue.

We have representing Fannie Mae, the Vice President and Chief Financial Officer, Mr. Timothy Howard, as well as the Senior Vice President for Government Relations from Freddie Mac, Mr. Mitch Delk.

Mr. Howard, please proceed at your tempo.

STATEMENT OF TIMOTHY HOWARD, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, FANNIE MAE

Mr. HOWARD. Thank you. Thank you, Chairman Baker, Ranking Member Kanjorski, and Members of the subcommittee. My name is Timothy Howard. I'm Executive Vice President and Chief Financial Officer of Fannie Mae and a member of Fannie Mae's office of the chairman.

I appreciate this opportunity to continue our dialogue.

I've submitted written testimony, including our perspective on the recent CBO study regarding Freddie Mac and Fannie Mae, with an appendix providing our detailed response to the study.

To sum up my testimony, I'll briefly make three points this afternoon.

First, housing is a bulwark of our economy. The housing and mortgage market today is the strongest, most stable sector of the economy. It appears to be keeping the entire economy from falling into recession.

The recent strong appreciation in home values has boosted the average homeowner's net worth. In addition, we estimate that homeowners refinancing their mortgages to benefit from falling interest rates or to take some equity out of their homes is pumping an additional $40 billion of consumer spending into the economy.

Given the success of the American housing system and record home ownership, some theorists have begun to question whether this country is over-housed.

We would forcefully assert the contrary.

Housing is a powerful force in the economy precisely because the demand for housing continues to be so strong. Recent census data indicates that, if anything, we are heading toward a housing shortage, as demand outstrips supply.

So the most important issue is not whether the country is over-housed, but how to keep us from being under-housed. Which leads to my second point.

The housing sector depends on a strong, effective Fannie Mae.

Under our congressional charter, Fannie Mae's job is to ensure a steady flow of low-cost mortgage funds to communities at all times under all economic conditions, even when other financial institutions choose to withdraw from the market.

This was never more apparent than during the credit crunch of 1998, when Fannie Mae and Freddie Mac greatly increased their mortgage purchases, making sure that homebuyers had access to the lowest rates in a generation, at a time when many borrowers had no access to credit at all.

Today, the housing sector is counting on us for another reason—our unique focus on providing low-cost financing to historically under-served families, including minorities, families of modest means, women-headed households, new Americans, and other groups.

The home ownership rate for these Americans is still around 17 percent lower than the national rate. And according to the new census, a key driver in the potential housing shortage is a projected boom in immigration and minority household formation.

These families are Fannie Mae's bread and butter. Indeed, no company in America provides more home-buying funds for minority, lower income, and other historically under-served families than we do.

In 1994, we pledged to provide $1 trillion by the end of the year 2000 to help 10 million under-served families own or rent a home.

Last year, we met that pledge early and immediately launched our $2 trillion American dream commitment to help 18 million under-served families during this decade.

Within that plan, we will provide $420 billion specifically to help 3 million minority families. These commitments have transformed our business, making Fannie Mae the largest affordable housing company in America.

Today, more than three-quarters of our business goes to families targeted under these commitments. We would be proud to compare our record of expanding equal housing opportunity with any other financial institution in America.

And that leads to my third and final point today.

Fannie Mae's net benefit to consumers can be measured every day. From our point of view, the best measures of the public benefit of Fannie Mae are the spread between jumbo and conventional mortgage rates, currently worth up to $21,000 over the full life of the loan, how many consumers benefit from our low-cost financing and what those benefits cost the Government, which, in fact, is zero.

Our housing finance system is operating at peak performance. It's the envy of the world. The economy and millions of families depend on it. This means that any measure of our public benefit, or any proposed change to the housing finance system, must be based on indisputable, irrefutable analysis.

By that standard, we believe it is fully justifiable to closely examine both the approach and the results of the most recent CBO study.

Now let me preface my comments on that study by emphasizing our great respect for the Congressional Budget Office, its leadership, its public service in providing Congress with timely and nonpartisan analysis.

In attempting to calculate a GSE subsidy, which, by definition, can only be theoretical, the CBO has tried to do something that is unique and extremely difficult. We believe, quite candidly, that the CBO came up short in this effort.

Let me mention just five points that capture the bulk of our concerns with the study.

First, we think its fundamental premise is flawed. CBO has attempted to quantify the value of a subsidy that does not explicitly exist. That's problematic by definition. Fannie Mae does not receive a dollar of Federal funds. Put another way, if the Government were to revoke Fannie Mae's charter, it would not recover a single subsidy dollar. But homebuyers would certainly face higher mortgage rates.

Second, the Government's methodology for valuing express Government guarantees is detailed in the Federal Credit Reform Act of 1990, which can be used as a point of comparison.

When Price Waterhouse did a study using the Federal credit reform approach, it found that the cost to the Government if Fannie Mae mortgage-backed securities had an explicit guarantee would be zero.

Third, the study used the wrong data to calculate our funding benefits. It compared the yields on Fannie Mae and Freddie Mac debt to those of both A-rated and AA-rated financial companies, even though S&P has rated both Fannie Mae and Freddie Mac AA-minus on a risk to the Government basis.

CBO also misstated the amount of short-term debt the two companies issue. Correcting these two errors reduces the funding subsidy in 2000 from $6 billion to between $3 billion and $3.6 billion, and reduces the retained subsidy to virtually zero.

Fourth, the study overstated the benefits from our mortgage-backed securities business. It concluded that Fannie Mae and Freddie Mac receive a $3.6 billion benefit from our MBS. But later in the report, conceded that most of this benefit goes directly to mortgage lenders and not to us. Correcting this error would reduce the gross subsidy by $3 billion.

And fifth, the study understates our benefits to consumers. It takes the benefit to homebuyers of lower mortgage rates and applies that only to mortgages that Fannie Mae and Freddie Mac owner-securitize. Because of market competition, however, every borrower eligible for a conforming mortgage enjoys lower rates, regardless of whether their mortgage is part of a transaction that involves Fannie Mae or Freddie Mac directly.

Correcting all of these assumptions reverses the conclusion of the CBO study, erasing any net subsidy to Fannie Mae and Freddie Mac and taking our net benefit to consumers even higher.

But let me make one final point.

Even if one fully accepts the CBO's methodology and results, a benefit pass-through rate of 63 percent, which is the CBO's gross subsidy less the 37 percent retained subsidy, still would be quite high for any direct Government subsidy.

This discussion, then, is really about whether we pass on two-thirds of the benefits we receive, as CBO asserts, or a higher percentage, as we would claim.

Arguably, in either case, we are doing what Congress intended us to do. We are delivering billions of dollars in public benefits without using a penny of public funds.

The American housing finance system is the best in history and the best in the world, in large part because of the wise decision Congress made in 1968 to charter Fannie Mae as a private company.

We look forward to doing whatever we can to help make this great system even better. And I thank you once again for the opportunity to be here today.

[The prepared statement of Timothy J. Howard can be found on page 101 in the appendix.]

Chairman BAKER. Thank you, Mr. Howard.

Mr. Delk, welcome.

STATEMENT OF MITCHELL DELK, SENIOR VICE PRESIDENT, GOVERNMENT RELATIONS, FREDDIE MAC

Mr. DELK. Thank you, Chairman Baker, Mr. Kanjorski, and other Members of the subcommittee.

I am Mitchell Delk, Senior Vice President of Government Relations at Freddie Mac.

It's a pleasure to be here with you today.

Freddie Mac is in a great business—financing homes in America. Over the past 6 years, the home ownership rate has risen across all income, racial and ethnic groups. Minority families have experienced the fastest rate of growth.

For most families, their home is their most valuable asset and greatest source of financial security.

Chairman BAKER. Mr. Delk, if you could pull the mike a little closer. It's not real sensitive and we can't hear well.

Mr. DELK. Home ownership also plays a critical role in stabilizing our economy. Throughout 2001, the Nation's robust housing market has defied the softening evident in other parts of the economy.

Our system works so well, we often take it for granted. With Freddie Mac and Fannie Mae operating at the heart of the Nation's housing finance system, there is never a shortage of mortgage money. America's homebuyers enjoy the lowest possible rates. And they choose from an array of products.

Former Office of Management and Budget Director Jim Miller and economist Jim Pearce estimate that our activities save families up to $23 billion a year in mortgage interest—at no cost to the Government, I might add. They conclude that the benefits we bring consumers far outweigh the value derived from our charters.

This is not the conclusion reached by CBO. Nor, however, is it the first time CBO has been wrong.

Recently, CBO conceded having made errors totaling $2.1 billion when it first studied the issue in 1996. This is the exact amount CBO accused Freddie Mac and Fannie Mae of failing to pass on to homebuyers.

Unfortunately, CBO's latest report is another contrived academic exercise. CBO's casual use of the term, "subsidy," suggests that Freddie Mac receives a direct outlay of Federal funds.

In fact, the corporation has never received a cent of Federal money and is one of the Nation's largest taxpayers.

CBO's new report is based on wrong assumptions and flawed analysis. Simply correcting four of the largest errors would completely reverse the conclusion CBO appears determined to reach.

First, CBO unfairly compares our funding costs to companies with lower credit ratings. Of the 70 firms considered, only eight had ratings comparable to Freddie Mac's S&P risk-to-the-government rating of AA-minus.

Let me repeat this, please:

Of the 70 firms considered, only eight had ratings comparable to Freddie Mac's S&P risk-to-the-government rating of AA-minus.

Second, CBO grossly over-estimates our share of long-term debt, further inflating our funding advantage.

Third, CBO uses an arbitrarily low estimate of the difference between the conforming and jumbo mortgage rates. CBO's estimate of 22 basis points is well below the range documented in numerous studies. CBO itself used 35 basis points in 1996.

Fourth, CBO credits Freddie Mac and Fannie Mae with reducing mortgage rates only on loans we actually purchase.

In fact, thanks to our activities, all conforming market borrowers enjoy lower rates, whether we buy the loan or it's held in a bank portfolio.

These errors and omissions disqualify CBO's report from serious consideration. Not surprisingly, however, our critics have seized on it in an attempt to impugn us. Their latest collection of half-truths and distortions shamefully misrepresents our service to low-income and minority families.

Apparently, our critics haven't read Freddie Mac's annual report to Congress, which documents our outstanding support for affordable lending. I'd like to submit our report for the record.

Last year, 58 percent of Freddie Mac's business financed housing for one million families with low incomes or living in under-served neighborhoods. And nearly 14 percent of our business financed homes for minority families.

In addition, Freddie Mac is the unquestioned leader in combatting predatory lending. Our critics cannot begin to match such a strong track record.

Mr. Chairman, today you and Members of the subcommittee have a unique opportunity to question and assess the record of the subprime lenders, mega-banks and mortgage insurers criticizing us.

Everyone knows they are good at manufacturing sensational reports every time you hold a hearing. But how good is their service to low-income and minority borrowers and their efforts to combat predatory lending?

I predict their spin is more potent than their performance.

Now I'd like to say a few words about Freddie Mac's financial condition and regulatory oversight.

Freddie Mac is unquestionably safe and sound. The six voluntary commitments we announced last October with Members of the subcommittee, and which were fully implemented this spring, put Freddie Mac at the vanguard of world financial practices.

Effective regulatory oversight is an essential complement to our strong financial position.

We believe that the regulatory structure set forth in the GSE Act is fundamentally sound.

The regulatory structure ties capital to risk. It establishes a comprehensive set of enforcement authorities. And it provides substantive oversight without unnecessary intrusion. This enables

Freddie Mac to respond aggressively to market developments with innovations to meet our mission.

Mr. Chairman, in H.R. 1409, you propose changing the location of Freddie Mac's safety-and-soundness regulation. Given the gravity of this issue, any proposal to change the regulator should meet the following criteria:

First, the proposed entity must be highly competent and credible. It must have the confidence of Congress, the public, and the markets.

Second, it should support housing as an important public policy objective.

And finally, the entity should enjoy bipartisan support.

Mr. Chairman, Members of the subcommittee, I appreciate the opportunity to appear before you today. I look forward to working with you to secure the future of America's housing finance system and, with it, the dreams of millions of America's families.

Thank you.

[The prepared statement of Mitchell Delk can be found on page 112 in the appendix.]

Chairman BAKER. Thank you, Mr. Delk and Mr. Howard.

Last fall, we agreed, voluntarily or otherwise, to the terms for certain disclosures. And as part of that press conference, there was general agreement to proceed with the, quote "regulatory piece."

H.R. 1409 represents my take at it, which it's pretty clear, neither of the organizations seems to be enthusiastic about.

But I would wonder, since the date of that agreement and the public statement that we want to work on a regulatory reform that we would both like to have appropriate regulatory oversight, do either of you intend to forward any recommendation to me with regard to modifications to the current regulatory structure?

Mr. DELK. Mr. Chairman, we'll be glad to submit to you in writing comments on H.R. 1409, and our views on the current regulatory structure.

As I indicated in the oral testimony, we believe that the existing structure is a credible structure. Notwithstanding that, as I indicated also, we'd like to work with you and other Members of the subcommittee to address the concerns of the subcommittee.

Chairman BAKER. Well, I don't think I need additional comment on H.R. 1409. I believe I've read enough about that. But my real question is, do you think the status quo is sufficient, or will you recommend any modification at all?

Mr. DELK. We think the status quo is sufficient.

Chairman BAKER. OK. Contrary to the statement of last fall when we all agreed that we needed to have a stronger regulator.

Is that correct, Mr. Howard?

Mr. HOWARD. Well, let me first say that we would be pleased to continue discussions with you, Ranking Member Kanjorski, and others, on ideas for improving still further the efficiency of the housing finance system.

We think, though, that given the high level of efficiency in the system, proposals for change face a high hurdle of clearance.

Chairman BAKER. Let me move on because I will enforce the 5-minute rule today given the number of Members here today.

Would that mean, then, that when OFHEO's OMB stress test is finally promulgated, you will agree to whatever the outcome of that test is because you believe OFHEO to be a good regulator?

Mr. HOWARD. We have been engaged in discussions with a number of parties about the goals of the risk-based capital standard.

And we believe that OFHEO believes that it should attempt to, as closely as possible in the model, capture the risks as they exist in our business.

Chairman BAKER. But what I'm getting at is, if you believe OFHEO is a competent regulator and no change is required at all, and they finally, after a decade-long struggle, produce the long-awaited stress test—let me rephrase.

Have either of your organizations written the letter to OMB asking for an extension of the promulgation period from the current July 16th, which is a delay from the initial date, to any subsequent date?

Mr. HOWARD. We have urged OMB to take the time necessary to make sure that the risk-based capital test that OFHEO is working on is workable and properly reflects the risks that we take.

Chairman BAKER. Did that communication include an extension of the date?

Mr. HOWARD. We did send OMB a letter several weeks ago requesting an extension.

Chairman BAKER. Mr. Delk, did Freddie Mac do the same?

Mr. DELK. We did. Let me, if I can, follow up. I know time is of the essence.

I think you know, Mr. Chairman, for years, Freddie Mac has embraced the concept of risk-based capital. We have managed our company by a risk-based capital stress test for over 15 years. We supported the concept in the 1992 legislation and we're anxiously awaiting the completion of the risk-based capital rule.

Having said that, I think all concerned parties want to make sure, in fact, that the rule, in fact, does capture risk relative to the amount of capital we have.

Or said another way, that in fact, the capital requirement is, in fact, aligned with the risk we take. And it's certainly going to take some time for OMB to make this assessment. We all want to make sure that there are not unintended consequences. But I don't think that that in any way undermines our support for the proposal.

Chairman BAKER. Well, I was only making the point that if we are defending OFHEO here today as the premier regulator of the most sophisticated financial institutions in the modern world, and they finally come up with a decade-long weighted stress test to adequately assess risk, after the review by OMB, that there would be resistance to either enterprise in adopting whatever that regulatory structure might be.

That's my hope.

I would formally request copies of the correspondence sent to OMB requesting the extension of date.

One last question before I run out of time. Mr. Howard, I understand that Fannie is now engaged in the distribution and sale of debt securities in thousand-dollar denominational amounts.

I have concerns about that because of the impact of liquidity potentially on community and independent banks.

Does Fannie intend to sell those thousand-dollar denominational notes directly to investors?

Mr. HOWARD. Congressman, all of our debt, both debt that goes to retail investors and debt that goes to institutional investors, is available at denominations as low as a thousand dollars.

It's been true for retail investors since late 1996. We have made no change in the denomination of the investment product since that time.

What you may be referring to is, a few months ago, we took some steps to make the pricing of our retail securities more transparent to investors by posting visible rates that retail investors could compare with alternative fixed income instruments on a screen available to brokers and to retail investors.

So they had a better way of assessing the quality of securities that we've been selling since the early 1980s.

Chairman BAKER. But the distinction between having a note in thousand-dollar denominations and the total book value of a sale, that's a distinction of some significance.

For example, can I purchase directly from Fannie Mae a thousand-dollar denominational debt security today?

Mr. HOWARD. You could not.

Chairman BAKER. And why would that be?

Chairman HOWARD. We do not sell directly to individual investors.

Mr. BAKER. Well, that's what troubles me because on page 46 of your offering circular, sales directly to investors.

We may also sell debt securities directly to investors on our own behalf. We will not pay a commission to any dealer on direct sales.

I'm at the end of my time. I don't want to take any more time today to get into this exchange. Please just forward at your leisure an explanation of what appears to be a conflict in the issuing circular and your understanding of the matter.

Thank you very much.

Chairman HOWARD. I would be pleased to do that.

[The information referred to can be found on page 110 in the appendix.]

Mr. BAKER. Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Howard, what is your experience with OFHEO as a regulator? Do you think that finally, they have matured to the point where they are starting to perform in accordance with the mission that the Congress gave them?

Mr. HOWARD. Let me break that into two parts, Congressman.

First of all, I have been very impressed with the quality and thoroughness of the work done by the examination staff. I find them to be very well informed, highly professional, and committed to the work they do.

On the risk-based capital standard, the agency has set itself an extremely difficult task, which is creating a detailed model itself of two businesses engaged in enterprises that are complex.

We are on record as saying that we thought the initial choice that was made by the regulator to do its own model rather than to use models developed by the enterprises as other banking regulators said they would do, was problematic.

And I think that that has contributed to the delay in completing the risk-based capital standard.

Having said that, it now appears as if the OFHEO capital standards group is making progress on using what's inherently a cumbersome and difficult process to produce a standard that we hope will be workable.

And when we met with OMB, we wanted to make all parties aware of the benefit to be gained by making sure that this approach did properly model our risk, because it will affect our behavior and will affect the availability of credit throughout the mortgage system.

Mr. KANJORSKI. How soon do you think that the standards and the models established by the regulator are going to be complied with and arrived at?

Or does Congress have to take some action?

Mr. HOWARD. Based on what I have currently heard, my belief is that a regulation could be put out within a 90-day period, having been subjected to sufficient testing to let OFHEO and OMB know whether there are, in fact, any unintended consequences from putting this rule in effect.

Mr. KANJORSKI. Would that have been vetted by both Fannie Mae and Freddie Mac?

Mr. HOWARD. Vetted may not be the correct term. It would be useful for us to be able to compare the results of the OFHEO model with our own internal model to make sure that we are treating risk in a way that is consistent.

Mr. KANJORSKI. You're not in that process right now, but you will be as soon as the——

Mr. HOWARD. We are not in that process directly at the moment.

Mr. KANJORSKI. Mr. Delk, do you have anything to add in regard to the regulations being promulgated by the regulator?

Mr. DELK. Not much more than I said earlier, Mr. Kanjorski, other than to say that our conversations with OMB have been intended to ensure that there are no unintended consequences.

This is a very complex rule. It's the first of its kind. But, clearly, it is the way to assess and to determine capital adequacy based on the risk you take.

And so, I concur with Mr. Howard. I think that this will be completed imminently. I think everyone wants to complete it. But, again, I think no one wants unintended consequences because it will be a model for other financial institutions.

Mr. KANJORSKI. Do you concur with Mr. Howard's expressed evaluation of the regulators?

Mr. DELK. Yes. I would emphasize, I think, their examination staff is probably unparalleled. They have an individual heading the examination staff who has years of experience at the comptroller of the currency.

I think they recently announced that they are bringing in a deputy director who is an individual who had extensive experience, in fact, retired from the OCC.

So I think what they have done is put together a very good staff and I think Mr. Falcon deserves to be complimented for the staff he's put together.

Mr. KANJORSKI. In my opening statement, you heard me indicate my dissatisfaction with the Federal Reserve as a prospective regulator as established under H.R. 1409.

I wonder if in the 30 seconds remaining, either one or both of you could tell me, do you feel that we should look at a new regulator in the nature of the Federal Reserve, or should we stay with the existing regulator and just proceed?

Mr. DELK. Let me preface any comment on that question by saying that the Federal Reserve is the most august body regulating financial institutions in the world.

Having said that, I laid out in my opening statement three criteria that we would suggest that the Committee or subcommittee look at in considering whether a new regulator is warranted.

The first was that it be highly competent and credible. Unquestionably, the Federal Reserve is highly competent and credible.

The second was, does it support housing as an important public policy objective?

I think issues can be raised on whether, in fact, the Federal Reserve does support housing as a public policy objective. In fact, many economists at the Federal Reserve have raised the issue of whether we have too much investment in housing now.

That clearly is not Freddie Mac's view, but I think that has been a concern. So I think that would raise at least issues on whether they would be a regulator of choice. And finally, I said the regulators should enjoy bipartisan support.

We've heard today through opening statements a number of concerns through Members on the subcommittee about the Federal Reserve. So I'm not in a position to say whether they would or wouldn't. But at least under this criteria, at least two of the criteria, we raise serious concerns on whether that would be an appropriate policy choice.

Mr. KANJORSKI. Thank you, Mr. Delk.

Mr. Howard.

Mr. HOWARD. We have similar criteria to what Mr. Delk outlined and believe it is at Congress' discretion to assess a regulatory structure and make sure that it's satisfied.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Castle.

Mr. CASTLE. Thank you very much, Mr. Chairman.

I was just checking, but I wanted to ask questions about your legislation. That is part of this hearing, as I understand it.

First of all, gentlemen, I have a great deal of respect for both of your organizations. I think you do a tremendous amount to aid with the financing of housing across this country and have helped in many ways.

That doesn't mean it's perfect, however. That doesn't mean that there couldn't be things that could be done better.

I'd be interested in your comments on the legislation of Chairman Baker with respect to the regulation, the possible change from the Office of Federal Housing Oversight to the Federal Reserve Board.

I assume you're both adamantly opposed to that. Is that correct? Or your organizations are adamantly opposed to it, I should say.

Not you personally.

Mr. HOWARD. I think it is incorrect to say that we are adamantly opposed to it.

Mr. CASTLE. Can you do me a favor? Can both of you hold the microphones a little bit closer, or bring them closer to you?

Thank you.

Mr. HOWARD. I think it would be incorrect to characterize our position as adamant opposition to the Federal Reserve as a regulator.

We do, as Mr. Delk mentioned, have some concerns about their commitment to our housing mission. Assuming that an adequate division of responsibilities can be worked out between a mission regulator and the Federal Reserve as a potential safety and soundness regulator, the Fed has enormous credibility and respect on the safety and soundness front.

Mr. CASTLE. OK.

Mr. Delk.

Mr. DELK. I don't think I could add much more, Mr. Castle. I went through the criteria which we, in fact, think or would recommend that the subcommittee go through. And I do think that there are concerns regarding the Fed's interest in and commitment to housing.

Again, having said that, they are clearly the world's premier financial institution regulator. Anyone you canvassed worldwide would agree with that assessment.

So I think it makes it a difficult call. But the balance I think swings to the point that it would raise serious policy concerns on whether they would be a regulator of choice.

But having said that, again, we're not adamantly against it. But it does raise policy issues and we think that they are very serious policy issues.

Mr. CASTLE. I don't have a particular opinion, either, at this point. Nor do I have anywhere near the knowledge to be able to form an opinion.

But it just seems to me that this is a very significant question of very significant players in this field and it's something that we should all be paying attention to to see if we can come up with the right solution.

Mr. HOWARD. And we believe that given the importance of the role that we play in the housing finance system, it is absolutely critical that our oversight committee be totally confident in the regulator that oversees our activities.

Mr. CASTLE. Let me change subjects for a moment. And, again, I'm not that familiar with all of this, but I'm looking at the CBO testimony of May 23rd on the Federal subsidies for the housing GSEs.

My staff prepared a report which summarizes some of the things which reveals the value of Government subsidies to Fannie and Freddie as $10.6 billion a year with $3.9 billion, or 37 percent of that, being passed through to its shareholders instead of to mortgage borrowers.

We all know—I mean, there are arguments about whether you're a Government agency at all or not. There are arguments about whether there is truly a subsidy or not, which you pretty much made here in your statements in answering the questions so far.

And again, I'm not an expert on every word that's in here. But I assume that you disagree entirely with the underlying premise of what the CBO has said. You're not arguing about the numbers or anything of that nature. You disagree, because there are no direct subsidies, you disagree that there's anything that should be able to be encapsulated in terms of numbers one way or another.

Am I saying that correctly?

Mr. HOWARD. Let me attempt to be as clear as I can on this.

The CBO method, because Fannie Mae does not receive direct Federal outlays, the method is inherently theoretical. They build a construct and attempt to evaluate in dollars the benefits that the charter conveys.

Mr. CASTLE. What you said in your opening.

Mr. HOWARD. Because it's a theoretical approach, it is critically dependent on the assumptions that are made. And those assumptions can be made in a number of different ways which are reasonable, but which, if made in different ways, produce very different results.

So I do think it's incorrect to lock into one particular set of assumptions and say this is the right number and furthermore, that this number, which is done in a theoretical construct, has policy implications, because by changing those assumptions, we think that the CBO made the assumptions incorrectly in cases having to do with our debt cost.

Mr. CASTLE. But you're not saying, because it's a theoretical construct, it does not mean that it's completely invalid.

You're suggesting that the numbers may be invalid because you don't agree with them. But you're not suggesting that the whole idea of doing a theoretical construct because of your long-standing history with the Federal Government is necessarily completely wrong.

Or am I misstating? I want to make sure that I'm stating it correctly.

Mr. HOWARD. I think you are stating it correctly. We completely agree that the charter that Congress gave Fannie Mae and Freddie Mac has value and does convey a benefit to us.

We believe that that benefit flows very directly through our two businesses to the intended recipients, which are homebuyers. And we think that the CBO construct is one way, but not the only way, and we don't think the best way, of quantifying that flow of benefits.

Mr. CASTLE. I think I used up my time, Mr. Chairman. I meant to yield you some time, but I apologize.

Chairman BAKER. Mr. Bentsen, do you have questions?

Mr. BENTSEN. Thank you, Mr. Chairman.

In his testimony before this subcommittee a month or so ago, Mr. Crippen, I think, made clear—and I apologize. I was reading through the transcript—made clear that you could believe CBO's subsidy arguments if you agreed with the assumptions that are in there.

But, obviously, you all disagree with those set of assumptions. And I think that you make a very good point as well that—and I think we got Mr. Crippen to agree to this—that in fact, there's not one dollar of outlay from the Federal Government or from the taxpayers that goes to do this.

And furthermore, I think we got the agreement that even if you agreed with the assumptions on the ratings and the spreads and the like, that if you agreed with the $3.9 billion in the year 2000, that $1.2 billion of that could be associated with fees and taxes that are paid.

And yet, Mr. Crippen also said at that time in the testimony that he probably did not believe that were the Federal Government to just go ahead and appropriate $1.2 billion through some form of program, that we would be able to achieve the leverage that they otherwise found had been achieved.

And I think that's important for the record here.

I want to turn for a second to H.R. 1409 and ask you about a couple of provisions of it. And I don't want to focus on the question of whether the Federal Reserve is the appropriate regulator or not. There are some issues there and I'll wait for other witnesses to ask that.

But what I'm curious about, in your review of H.R. 1409, particularly as it relates to regulation and enforcement, how does it comport to the Bank Holding Company Act or the Gramm-Leach-Bliley Act?

Does it treat, would the bill treat the GSEs in the same way in terms of things like cease and desist, receivership, and the like, as it would treat holding companies under the Bank Holding Company Act or Gramm-Leach-Bliley?

Or does it give greater enforcement authority, comparably speaking, as it relates to the GSEs?

Mr. DELK. Mr. Bentsen, let me not draw on my knowledge of the issue, but refer you to the GAO report that was commissioned by Chairman Baker.

He requested GAO to look at this specific issue. And I think what GAO came back with, and I read this many, many times, nothing in that report suggests that there is a problem with the statutory enforcement structure that needs to be corrected.

In fact, that GAO found, and let me quote from the report: "Based on each regulator's powers and authorities, it appears that each regulator has statutory tools available to address significant safety and soundness concerns."

So while there might be some differences, at the end of the day, and I think that I would argue that this is substantiated by the GAO study, OFHEO has the functional equivalent authorities or tools that it needs to ensure that we operate safely and soundly.

Mr. BENTSEN. But as you look at H.R. 1409, would you see H.R. 1409 as increasing the amount of regulation over the operations of Fannie Mae or Freddie Mac? And how would you compare that to the existing regulatory authority they have over other financial holding companies?

Would you view it as more excessive, as going beyond what the Bank Holding Company Act provides for, or what Gramm-Leach-Bliley provides for as it relates to other financial holding companies?

Mr. DELK. I would argue that it, in fact, adds a lot of additional structure and oversight and involvement of the regulator that is, in fact, gratuitous.

It's interesting also, if you think about the 1992 statute and the way it was structured, it was structured only 3 years after FIRREA and only 1 year after FIDICIA.

And so, for anyone to argue, in fact, that Congress developed this in a vacuum I think is a little bit ludicrous.

They had the value of those two statutes, the value of the experience of those two statutes, and I think that was, in fact, the model that was used.

However, the structure was, in fact, created to, in fact, oversee two companies that are, in fact, quite different from financial institutions for many, many reasons.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

Mr. Barr, did you have questions?

Mr. BARR. Thank you, Mr. Chairman.

Mr. Howard, if you could, I know people use this term subsidy a great deal in talking about Fannie Mae and Freddie Mac.

What exactly does that term mean? What is the subsidy? I was looking here recently at an article from the *Wall Street Journal*, a very complimentary article and I think a very nice article. And all of a sudden, in the middle of the article, they all of a sudden launch into the use of the term, subsidy.

What exactly is the subsidy that people talk about in terms of your agencies?

Mr. HOWARD. As I indicated in my opening statement, the term subsidy is used somewhat loosely in referring to the benefits that flow from our charter.

Webster's definition of subsidy——

Mr. BARR. Is any benefit that flows from a charter a subsidy?

Mr. HOWARD. I would not call it a subsidy. But I wouldn't quibble with people who use that word to describe it. I just think using the term subsidy confuses the issue because, normally, a subsidy is a monetary outlay.

And in this case, our benefit is not a direct transfer of funds that we can then direct at will.

The benefit that we have is observable in the lower interest rates that attach themselves to loans that we can buy or guarantee versus loans that we can't.

Mr. BARR. And you're not doing anything improper in that.

Mr. HOWARD. I don't believe we are.

Mr. BARR. Is it similar—I know a couple of years ago, particularly here in our work in this Committee, there was legislation that dealt with credit unions. And there was a lot of talk at that time that the credit unions receive a subsidy because of the way the tax laws work.

Is that a subsidy in the same sense that people apply the term to Fannie Mae?

Mr. HOWARD. I'm not sufficiently familiar with the credit union structure to be able to opine on that.

Mitch, can you?

Mr. DELK. Mr. Barr, I think it's a very complicated subject matter when you talk about subsidies. I'm not an economist, and so I really am not familiar with what they are referring to. And therefore, I use kind of the commoner's definition of subsidy, as was articulated by Mr. Howard.

So, not being familiar with the credit union model, I don't know that I can opine on that.

Mr. BARR. The point I'm trying to make, I tend to agree with what I think you're saying, that people bandy this term about. And I'm not sure that either people that bandy it about really understand it. Perhaps they use it in a way to try and draw some negative implication from it. I don't know.

But I was just curious as to whether or not there really is something that you can grab onto and sink your teeth into.

Mr. DELK. Let me add one thing to what I said.

Mr. BARR. And I'm not sure there is.

Mr. DELK. Let me add one point, if I can. I don't want to be disingenuous and insinuate that there are not benefits that accrue from the charter.

Mr. BARR. No, I understand that, certainly. I understand that. And I think you all have been very forthcoming in that regard.

Mr. Chairman, I'd yield whatever time I have remaining. I think you might have some additional areas of inquiry.

Chairman BAKER. Thank you, Mr. Barr.

On the question of subsidy, that is a benefit of operation in the market place which others do not enjoy which result in an enhanced profitability or a lower cost of product.

In this case, currency is the product which, because of the implicit guarantee of the United States Government, and bond-holders making the assumption that the debt will be paid off by the United States Treasury in case of default, is a clear market advantage and therefore, defined as a subsidy.

If we were to look at the current operation of Fannie and Freddie, a large wave of prepayments potentially could be the largest exposure.

And I'm bringing this up to the Committee only because of the observations made by the S&L crisis in the 1980s. The United States Government paid no dollar into any S&L prior to their foreclosure. The S&Ls put premiums into an FSLIC fund which was used to pay off losses.

Unfortunately, the losses were far more widespread than anticipated. Therefore, the losses that needed to be covered exceeded the premiums' reserve by the industry, therefore calling on the United States taxpayer to pay off the losses.

This is no different. There is no outlay by the United States Government, nor exposure by the United States taxpayer, until such time as there would be an untoward economic reversal resulting in a dollar loss to the institutions which could not be covered by their capital adequacy.

Hence, the concern about leverage and capital adequacy is very important. Do we have a regulator who can tell us that it's adequate?

Well, it's only taken them a decade and now we're being told that we want a 90-day extension from July 16th to take another quick look.

In the meantime, pre-payment penalty I think is the largest potential exposure that they could have, as high-interest mortgage holders want to pay off those notes and refinance them at a lower rate.

Fannie and Freddie have to make very sure that they hedge against those downturns in interest cost because it has direct impact on their spread.

Said another way—can they make money?

They do this by using derivatives. Also issuing callable bonds that can be bought back before maturity, thus allowing them to pay, freeing them from the higher interest rate exposure and allowing them to issue replacement debt at the lower market rate.

However, this means that they have to get their derivatives distribution exactly right. Too little callable debt means the profit spread gets squeezed and in 1998, when mortgage pre-payments were rampant, Fannie's interest costs went up more quickly than interest income and therefore, they had a net 4-percent revenue increase from its retained mortgages.

That's not a good rate of return based on their history.

So the point is I think I understand this. There is a subsidy. It is handed off to the corporations in the term of benefits guaranteed by the taxpayer and it's all just ducky as long as we remain profitable.

Get a business reversal, a Jimmy Carter 21-percent interest rate, and hang onto your hat.

I thank the gentleman for yielding.

Ms. Velázquez. Ms. Velázquez is not here. I'm sorry.

Mr. Hinojosa.

Mr. HINOJOSA. Yes, thank you.

Mr. Howard, can you please tell me what you estimate the cost of Fannie Mae's restrictions to the housing market to be, and how the CBO estimate would change if those restrictions were factored in, in addition to your economic participation in the larger housing market?

Mr. HOWARD. The same complications that present themselves in attempting to quantify our benefits also present themselves in attempting to quantify the restrictions that come with our charter.

I could create a theoretical structure that would do that. But it wouldn't be particularly reliable.

So, put another way, I don't know how to quantify the restrictions. But you make an important point, that there are restrictions. And our charter, which gives us benefits, comes with obligations to meet certain housing goals, to direct all of our activities into a single line of business.

It comes with restrictions, loan limits, risk-based capital standards. All of those could be subject to some type of quantification.

We have chosen not to do it because it is inherently speculative. But that's the same basis on which I think one needs to be careful in interpreting the results of a study such as the CBO study.

It suffers the same challenge.

Mr. HINOJOSA. Let me ask another question, and I'll direct this one to Mr. Delk.

One of the main reasons for the creation of your organization was to increase home ownership across the Nation and to create a fair and accessible housing market for minorities, minorities in search of purchasing homes.

With that said, how is your enterprise helping increase home ownership and what have you done for the Hispanic community?

Mr. DELK. Well, by the creation of Freddie Mac, what you have done is create a uniform national mortgage market. Whereas, prior to 1970, you saw various rates in various sectors of the country, geographic areas of the country, in large part depending upon the supply and demand of deposits.

So by creating a secondary market, whereby there is a continuous flow of money into the country, what you have seen is the elimination of these pockets where money was plentiful and where there was a dearth of mortgage money.

So we've evened out that flow of mortgage funds across the country.

While we have done that, we have in fact, as we stated earlier in the oral statement, we've lowered the interest cost for all mortgages that we could buy by 25 to 50 basis points, which translates into a $10 to $15 billion savings to homebuyers every year.

So by lowering the cost, we're making mortgages more accessible.

Having said that, Freddie Mac is engaged in a number of initiatives to expand the home ownership for Hispanic-Americans.

We have recently announced an exciting initiative with the National Council of LaRaza and the National Association of Hispanic Real Estate Professionals to use an Internet-based program to reach out and educate Latino families about credit and home ownership through Latino real estate professionals.

And we believe this is an exciting initiative that will bring education to these families and present them with opportunities to, in fact, be part of the American dream.

Mr. HINOJOSA. Fannie Mae mentioned that they had a $1 trillion initiative and they met it. Then they started a new $2 trillion initiative.

What size is yours?

Mr. DELK. Well, we don't have a commitment of that nature. We, in fact, are subject to the same affordable housing goals they are. But we haven't announced any initiatives that are dollar-related.

Ours are more programmatic, including programs with various communities and various sectors within the economy and different groups.

Mr. HINOJOSA. Well, is there another goal besides, say, a dollar figure like Fannie Mae announced?

Mr. DELK. I'm sorry?

Mr. HINOJOSA. I said, if you don't have a dollar amount in this new announcement that you made, is there a goal in the number of homes?

How can I——

Mr. DELK. How can you judge whether we're being successful?

Mr. HINOJOSA. Yes, how can I judge how aggressive you're going to be?

Mr. DELK. OK. Well, let me say, if you look over the last half-decade, our numbers for minority purchases have increased every year and therein lies our objective, is to continue that increase of minority purchases.

Last year, as I indicated in the opening statement, our minority purchases were 14 percent. And it's our objective to keep that going up in order to bridge the gap that exists between white ownership and minority ownership.

Mr. HINOJOSA. Well, don't misunderstand my question. I really want to be supportive of you and Fannie Mae. But I do want you to get up on your tiptoes like they're doing and constantly be moving those targets further up so that we can close that gap amongst the minorities who want to own their own home.

So I'd like to work with you on that.

Mr. DELK. We would like to work with you. We share your objective of bridging that gap between white home ownership rates and minorities and, again, would be willing to work with you to ensure that, in fact, every year we're increasing our purchases by minorities, generally, but Hispanic loans in particular.

Chairman BAKER. If I may, Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, sir. I'd like to get Dr. Weldon in before the break.

Dr. Weldon.

Mr. WELDON. Thank you, Mr. Chairman.

I'll direct my question to both witnesses. In criticizing the CBO study, you note that CBO ignores the extent to which the GSEs must bear the costs of increasing home ownership for those with low incomes.

What is your estimate of the contribution of Fannie Mae and Freddie Mac to increased home ownership for individuals with low incomes?

Mr. HOWARD. Congressman, last year, over 49 percent of the business Fannie Mae did, was to individuals with incomes at or below the area median in which they live.

That was an all-time high that exceeded the statutory goal that was set for us by the Department of Housing and Urban Development.

It's something that we take very seriously. We have a whole host of programs that are designed to achieve very high results in that regard and we are proud of our record.

Mr. WELDON. You can't estimate the cost of actually doing that, reaching out to low income?

Mr. HOWARD. It's hard to do that. We have not attempted a dollar assessment.

Mr. WELDON. Mr. Delk, did you have anything to add to that at all?

Mr. DELK. I do not. We have not gone back and looked at and tried to quantify the benefits that were not included in the CBO study.

Having said that, one of the criticisms of the study are there are many, many benefits that we bring, in fact, that are not taken into account by CBO.

Certainly one you've cited would be a good example.

Another would be, for example, the cost of originating a mortgage which has substantially gone down over the last few years because of a number of the innovations that have been pioneered by Freddie Mac and Fannie Mae.

But these additional benefits to the consumer have not been attempted to be quantified.

Mr. WELDON. There was a study done by FM Watch called "Shuttered Dreams."

Are either of you familiar with that?

Mr. HOWARD. I am now.

Mr. WELDON. Do you want to respond at all?

Mr. HOWARD. To what?

Mr. WELDON. Their conclusions in that study.

Mr. HOWARD. If you have a specific question about it, I might be able to. But I'm not that familiar with it.

Mr. WELDON. Well, they made some conclusions about where exactly the part of the subsidy that you pass through actually goes.

Mr. DELK. Dr. Weldon, let me attempt to address that, if I could, very briefly.

Mr. WELDON. Sure.

Mr. DELK. My first comment would be, consider the source who issued that.

I think Freddie Mac and Fannie Mae have done more to finance low-income and minority households than any financial institutions in the country.

And I'm a little bit shocked that they would try to bring this subject matter up, given this coalition consists of sub-prime lenders and the mega-banks and the mortgage insurers.

Having said that, this paper is really a series of half-truths and distortions.

For example, the whole premise of the paper is based on the CBO study and it makes the assumption that the CBO study is flawless.

I think we've demonstrated, and I think others have demonstrated, that the CBO study is tremendously flawed and that the benefits we receive from the Federal charter that we have, in fact, are dwarfed by the benefits that go to consumers.

And so, I think the original premise that the CBO study is correct, the whole study put out by FM Watch falls on its face.

if that were not the case, it still would be a flawed study because it uses artificial and contrived methodologies to get to its desired results.

For example, they totally take out the benefit that refinancing mortgages to minorities in fact, and low-income people, would produce.

And so, they're really trying to crop the picture to, in fact, produce a subset of purchases and activities to, in fact, exaggerate the benefit we bring to minority and low-income borrowers.

Again, I would say that our record is outstanding on this and I would hope that during the second panel, you would take the opportunity to ask the witness from FM Watch what, in fact, the members of that organization are doing to aid low-income families and minorities, as well as what they're doing to combat predatory lending.

I think you'll be surprised at the answer.

Mr. HOWARD. I would add one thing to that. And that's that my quick read of the study suggests that these are contrived and made-up numbers.

What we report annually or more frequently are real numbers in detail to real regulators on our service to targeted communities. And if you want to know what we are doing, look at the real data, not data made up and misanalyzed by a lobbying group.

Mr. WELDON. I believe my time is expired. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Doctor.

Mr. Ford and Mr. Royce, you both have waived?

Mr. FORD. I just want to make sure that I can submit my statement for the record, Mr. Chairman, if you don't mind.

Mr. BAKER. Absolutely.

Mr. FORD. I want to raise the question that Mr. Delk raised regarding what are the FM Watch members doing to increase home ownership opportunities specifically as it relates to some of the communities in which Fannie Mae and Freddie Mac are both heavily involved, including mine in Memphis.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Ford. I'd like to support that request in that the Freddie Mac information statement of March 30, 2001, page 18, for the record, states that those conforming loans above 95 percent of LTV—which means poor people buying houses—the percentage of loans in the portfolio represented is 4 percent, which means for folks who are paying, who have an LTV below 70 percent, meaning folks who are putting down $10,000 to $20,000, you would be interested to know that in the year 2000, constituted 65 percent of the agency's portfolio.

So I appreciate the gentleman bringing that issueup.

Mr. DELK. Mr. Chairman, can I make one point?

Chairman BAKER. Certainly.

Mr. DELK. That statistic is in our circular. I will say, though, that that particular statement ignores seasoning of the portfolio.

Chairman BAKER. Certainly.

Mr. DELK. I just want to make sure that the record is clear, if you don't mind.

Chairman BAKER. I think what we'll do, if you don't mind, is we'll explore this down the road and we'll have an exchange on the details to fully understand it, without prejudice.

We will give you the opportunity.

I want to make one other statement because I don't want to detain you. We have three votes in a row.

Mr. Ford.

Mr. FORD. Mr. Chairman, I think it's only fair that you let him make the statement for the record.

Chairman BAKER. I'd like, if I can, Mr. Ford, to get it in writing. I've had discussions with folks before in the past that haven't proved fruitful, and I think we need to put this on a correspondence basis.

I'll follow this up, and I'll share it with you.

Mr. FORD. I mean, you put it on the record, these numbers. And if he has something that is different than that that speaks to something more current——

Chairman BAKER. Mr. Ford, I'd point out, this is the Freddie Mac information statement. This is not the CBO, the irresponsible party. This is the company's own sheet.

Now, if there's explanations to help us better understand what this data represents, that should be given to us in writing and that's what I'm asking the gentleman to provide.

Is that fair?

Mr. FORD. Fair enough, Mr. Chairman.

Chairman BAKER. Thank you, sir. I would make one other comment because I think I know your opinion on the matter. We are really down short of time. I don't want to hold you up for the votes. We'll go on to the second panel. But I wish to make you aware that I do intend to put on the record Mr. Crippen's response as I requested to your testimony and make that available to you.

And in that response, he responded to my question on the matter of increasing competition among GSEs would have on the subsidy pass-throughs.

CBO's analysis, which I understand you will fault, attributes the GSEs' ability to retain a portion of the subsidy to the fact that their GSE status limits competition from other financial institutions in the conforming mortgage market.

If the number of companies granted a GSE charter were increased, the secondary market would become more competitive resulting in a larger portion of the subsidy being passed through to borrowers.

That is a very interesting idea which I do intend to fully explore and wanted to put it in the record for both enterprises' awareness, and then would welcome your comments at a later time, and we'll provide a copy of this letter to you, as well as fleshing out in more detail what that means.

My assumption is that you don't want additional competition. My assumption is that creating another enterprise with the same standards and responsibilities, capital adequacy, same regulator, somebody who plays by the same rules, is something else that we perhaps should explore.

I don't want to hold you. You're welcome to stay if you choose to stay and respond. We're going to go run and vote. We will put the Committee temporarily in recess, and I leave it to you gentlemen. If you'd like to stay, you're welcome. If you choose to leave, we'll go on to the second panel.

Is that fair?

Mr. HOWARD. Yes.

Chairman BAKER. Thank you very much. We'll stand in recess.

[Recess.]

Chairman BAKER. We're back. If the witnesses and the audience would take their seats. Members are on their way to return.

I'd like to reconvene our hearing.

Let me welcome each of our panelists here this afternoon for our second panel. Members will be returning from the floor momentarily.

We'll proceed in what is our customary order, left to right, and welcome today our first witness on the panel, Mr. Richard Carnell, Associate Professor of Law, Fordham University School of Law.

We'd certainly welcome you back from your prior capacity in the former Administration. We enjoyed working with you then and it's a pleasure to have you back, sir.

STATEMENT OF RICHARD S. CARNELL, ASSOCIATE PROFESSOR OF LAW, FORDHAM UNIVERSITY SCHOOL OF LAW

Mr. CARNELL. Thank you, Mr. Chairman.

I'm pleased to have this opportunity to discuss Fannie Mae, Freddie Mac, and H.R. 1409.

I'll begin by briefly discussing some key provisions of the bill and I'll then touch on four broader themes that I develop more fully in my written statement.

These themes are:

First, Fannie and Freddie play a double-game over whether they do or don't have a Federal guarantee;

Second, Fannie and Freddie falsely argue that banks get a much bigger Federal subsidy than Fannie and Freddie;

Third, people often say Fannie and Freddie are too-big-to-fail. I'll explain why that doesn't have to be true; and

Fourth, regulators can act now to correct defects in the regulation of Fannie and Freddie.

Turning to the bill itself I believe the bill would take important steps to remedy weaknesses in current law.

Right now, OFHEO, a bureau of HUD, is responsible for keeping Fannie and Freddie safe and sound. The bill would abolish OFHEO and have the Federal Reserve Board regulate Fannie and Freddie.

I support moving GSE safety and soundness regulation out of HUD. Having OFHEO part of HUD creates two types of problems.

First, HUD lacks the will and the institutional credibility to stand up to Fannie and Freddie.

Second, and more subtly, having OFHEO in HUD encourages the White House in any Administration to regard the OFHEO director's job as a housing appointment and not a safety and soundness appointment.

Nonetheless, I have several concerns about having the Fed regulate GSEs. Regulating GSEs could conflict with the Fed's responsibility for setting interest rates, since so much of the GSEs' business involves managing the risk of changes in interest rates.

Regulating GSEs could also conflict with the Fed's role in making emergency loans to banks through the discount window. In particular, it could be seen as giving Fannie and Freddie a fast track to a Fed bail-out if they ever got into trouble.

I recommending keeping GSE safety and soundness regulation in OFHEO, but making OFHEO an autonomous bureau of the Treasury Department.

Another key provision of the bill would require Fannie and Freddie to comply with the public disclosure requirements of the securities laws, the same requirements as apply to all other large corporations.

This provision makes good sense. Fannie and Freddie say they already comply with those disclosure requirements. But if that's true, why do they object to having the disclosure requirements apply?

It's not enough for Fannie and Freddie to say they comply with the securities laws. All large corporations say that, but the SEC still finds violations.

Investors in Fannie and Freddie deserve the protection of the disclosure requirements.

Finally, the bill would rightly correct some glaring defects in the safety and soundness statutes governing Fannie and Freddie, statutes that certainly are not functionally equivalent to those governing FDIC-insured depository institutions.

The bill would strengthen regulators' authority to set capital standards, take prompt corrective action, and take enforcement action.

It would also give regulators the authority they need to deal with a GSE in an orderly way if it became insolvent or critically undercapitalized. This would fill a dangerous gap in current law.

Now to the first of my four broader themes.

Fannie and Freddie play an extraordinarily successful double-game in dealing with their relationship to the Federal Government. The double-game has two parts.

Fannie and Freddie emphatically deny that they have any formal, legally enforceable Government backing. So far, so good. But they do this in a way that leaves the impression that they have no Government backing at all. And yet, they then work to reinforce the market perception that the Government implicitly backs them.

Here's one example from Fannie Mae.

Fannie Mae emphasizes, quote, "the implied Government backing of Fannie Mae." That's Fannie's own words. And they then go on to say that that backing makes Fannie Mae securities, quote, "near-proxies for Treasuries."

Now think about that. Fannie says its implied Government backing is so strong, that its securities are almost as good as U.S. Treasury securities.

This double-game lets the GSEs have it both ways. It's sort of like telling Congress and the press—"Don't worry, the Government is not on the hook," and then turning around and telling Wall Street—"Don't worry, the Government really is on the hook."

It's amazing how they get away with this year after year, but they do.

My second broad theme involves how Fannie and Freddie mistakenly argue that the Government gives FDIC-insured banks more generous subsidies than it gives Fannie and Freddie.

Contrary to what you might expect, Fannie and Freddie get a greater net subsidy from their Government sponsorship than banks get from Federal deposit insurance. And there are six reasons for this which I detail in my written statement.

First, the market perception of implicit Government backing applies to all GSE obligations. It isn't limited to deposits and there is no $100,000 limit like there is with deposit insurance.

Second, if Fannie and Freddie were to become bankrupt, there's no legal mechanism to handle their bankruptcy, a defect that your bill would correct, Mr. Chairman.

The absence of this legal mechanism encourages the GSEs' creditors to believe that the Government would have to bail them out.

Third, unlike banks, Fannie and Freddie don't have to make payments into an insurance fund. They're not even responsible for each other. So if there were a Government bail-out, the taxpayers would be left holding the bag.

Fourth, Fannie and Freddie have their own special statutes. They're often exempt from having to comply with the same rules as other businesses.

Fifth, Fannie and Freddie get such a sweet deal from the Government, that it's hard for anyone except another GSE to compete with them effectively. This lack of effective competition lets Fannie and Freddie keep a large part of their Government benefits, instead of being forced to pass those benefits through to their customers.

Sixth, Fannie and Freddie do not have to provide public benefits that impose significant costs on their shareholders.

Considering the great value of the benefits Fannie and Freddie receive from the Government, they should be doing far more to increase home ownership at the margins, such as by the lower-middle class, the working poor, and members of historically disadvantaged minority groups.

My third broad theme involved systemic risk.

Fannie and Freddie are often called too-big-to-fail, meaning that if they ever got into trouble, the Government would have to bail them out to avoid unleashing systemic risk that would harm the financial system and the economy.

But systemic risk is not inevitable. It results from human decisions. And if investors expect the Government to rescue troubled GSEs, investors will tend to let GSEs take greater risks. This in turn will increase the chances of the GSEs getting into trouble.

But the Government, by acting in a timely way, can correct too-big-to-fail expectations. Congress did just that in the FDIC Improvement Act of 1991, which curtailed too-big-to-fail treatment of banks.

It worked.

My fourth and final theme involves opportunities for administrative action. Regulators can and should act now to improve the regulation of Fannie and Freddie. I suggest six ways they can do so without legislation.

First, bank regulators should obtain accurate data on FDIC-insured banks' investments in GSE securities.

Second, if banks have excessive concentrations of GSE risk, bank regulators should limit and correct those concentrations.

And let me emphasize—bank regulators can take care of both of those points right now. And in my opinion, they have no business running to this Committee and saying, give us more authority.

They have the authority they need right now.

Third, the SEC should end the mislabelling of mutual funds as, quote, "Government," or, quote, "U.S. Treasury funds when they actually contain large amounts of GSE securities."

Fourth, the Fed should review the current safeguards on the GSEs overdrawing their accounts at the Fed.

Fifth, HUD should tighten its scrutiny of the GSEs' activities and mission.

Mr. Chairman, you've taken on an admirable but unenviable challenge, seeking to fix problems before the crisis hits and before the scandal breaks.

Your bill would make significant improvements in the regulation of Fannie and Freddie. More broadly, the bill and this hearing are important in continuing to focus the spotlight on the GSEs, their valuable Government benefits, and the question whether they give the American people a return commensurate with those benefits.

Thank you, and I'll be glad to respond to questions at the appropriate time.

[The prepared statement of Richard S. Carnell can be found on page 127 in the appendix.]

Chairman BAKER. Thank you. I was going to interrupt your remarks and ask you to wind up a bit. But you got to the really good part and I wanted to make sure you got that in.

[Laughter.]

If you can, and I know that each of you has prepared testimony, we will have other Members participating. We're going to give flexibility here. If you need to go over 5 minutes, that's fine. But as best you can, try to keep it within the constraints.

Thank you.

Our next witness is Mr. Martin Edwards, Jr., Partner, Wilkinson & Snowden, Incorporated, who appears today here on behalf of the National Association of Realtors.

Welcome, Mr. Edwards.

STATEMENT OF MARTIN EDWARDS, JR., PARTNER, WILKINSON & SNOWDEN, INC., ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS

Mr. EDWARDS. Thank you, Mr. Baker.

Good afternoon, Members of the subcommittee. My name is Martin Edwards from Memphis, and I am President-elect of the National Association of Realtors.

As Chairman Baker mentioned, I'm a partner in Wilkinson & Snowden, a commercial industrial real estate firm in Memphis.

I'm taught real estate finance for a number of years at the University of Memphis, the National Association of Realtors, and the Mortgage Bankers Association.

Let me also introduce to you America's realtors, the nearly 780,000 members of the National Association of Realtors.

For the most part, realtors are small, independent contractors, successful to the extent of their own initiative. Nearly 77 percent of realtors work in firms with fewer than ten employees.

Together, we are the largest group of business entrepreneurs in America; realtors are extremely proud of our role in helping nearly 72 million people buy homes.

Almost 68 percent of Americans own homes, as you've heard today, with the highest home ownership rate in the Nation's history.

We are very proud that the Nation's housing industry is one of the only sectors of the economy that is standing tall as the U.S.

economy struggles. The housing sector contributes 14 percent of gross domestic product.

For nearly 30 years, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks have used benefits of the Federal charters that Congress granted them to help build a housing finance system that is the envy of the world.

Today's home ownership costs are lower and access to mortgage credit, even for borrowers with blemished credit, is easier and more equitable than ever before, due in no small part to the mortgage investment activities of Freddie Mac and Fannie Mae.

Realtors across this country know from painful experience that booming mortgage lending and real estate cycles inevitably will slow. But Fannie Mae and Freddie Mac, unlike primary market lenders, remain in the the markets during downturns.

In exchange for the advantages inherent in their Federal charters, the GSEs fulfill their charter obligations to benefit millions of America's homeowners and thousands of lenders.

Despite realtors' general support of the GSEs, we do have our differences. We disagreed when the GSEs opposed increasing the FHA mortgage limits 2 years ago. In the future, it is likely that we will clash again on this and other issues.

We've also had differences with the GSEs' disposition activities, but we are hopeful we can resolve these.

Realtors firmly believe that GSE regulatory reform should not be a vehicle to alter significantly the critical roles that Fannie and Freddie play in the American system of home ownership.

Transferring significant regulatory authority from HUD and OFHEO to the Federal Reserve, as proposed by H.R. 1409, would effectively hamstring the GSEs. It would reduce their effectiveness as mortgage investors, make them more vulnerable to attempts by the mega-banks to control the secondary market, and limit customers' financial choices and home ownership opportunities.

Mr. Chairman, the Federal Reserve has little experience regulating housing and real estate-related entities. We believe the central bank may have a natural conflict of interest in that the Fed's primary mission is to control the Nation's money supply by regulating the commercial banking system, particularly the bank holding companies, which are increasingly competing against the GSEs in the secondary mortgage market.

Furthermore, the Federal Reserve has generated its own share of controversy by raising the prospect of classifying real estate brokerage and property management as a financial activity under the Gramm-Leach-Bliley Act.

Realtors urge this subcommittee to consider the following questions before embarking on sweeping changes that affect the GSEs:

What would housing finance be like without strong GSEs? Would this Nation be as well housed? Would as many families have access to the American dream? Would housing be as strong a sector of the economy as it is today?

Chairman Baker, we share your concerns about improving the regulatory environment. However, we believe that the current GSE regulatory structure best serves the Nation's interests in housing.

We believe that the secondary market system works to the benefit of the mortgage lending industry, homeowners, and the Nation's housing policy.

Realtors believe that without strong and vital housing GSEs, the Nation would not be as well housed, nor would the dream of American home ownership be reached by as many American families as it is today.

Let me just close by making a comment regarding affordable housing and housing parity.

The National Association of Realtors, in partnership with five minority real estate professional associations, have embarked on a major program to promote parity among white and minority homeowners.

The Home Ownership Participation for Everyone, or HOPE awards, will recognize unsung heroes across the country who are helping to break down the barriers of minority home ownership.

As we go forward with this and other projects, we want to make sure that the mortgage market remains accessible to minorities. Two of the very strongest voices for minority home ownership have been Freddie Mac and Fannie Mae.

And I thank you for the opportunity to participate, Chairman Baker, and will stand for your questions.

[The prepared statement of Martin Edwards Jr. can be found on page 148 in the appendix.]

Chairman BAKER. Thank you, Mr. Edwards.

Our next witness is Mr. James C. Miller, III, the Director of LECG Economics-Finance.

Welcome, Mr. Miller.

STATEMENT OF JAMES C. MILLER III, DIRECTOR, LECG ECONOMICS-FINANCE

Mr. MILLER. Thank you, Mr. Chairman, congressmen. Thank you for holding this hearing and thank you for inviting me to participate.

As you probably know, I served as President Reagan's budget director, and before that, chairman of the Federal Trade Commission.

As you may not know, I was trained as an academic and have published over a hundred articles in journals and such, and have published nine books.

I have done some work in the GSEs, stretching back almost a decade, and have authored a series of reports over the past year or so.

In my experience, the decisions made by Government affecting private institutions or commercial institutions or market-based institutions tend to be more difficult than the decisions those institutions make themselves.

Why?

Because sometimes the decision rules are unclear. Sometimes the information tends to be wholly inadequate for making an informed decision.

Often, the incentives to make the right decision, the correct decision, aren't the best.

Now this doesn't mean that you shouldn't make reforms. But what I think it does is urge caution when you're going to restructure an industry that's working palpably well because there may be unintended consequences.

So I think it's important that you do have such hearings and look at these things with great care and in great detail.

Two issues before this Committee, I understand, from your letter, Mr. Chairman.

One is the CBO report recently issued, and the other is H.R. 1409. Let me comment on them seriatim.

In anticipation of the issuance of the new report, back last fall, Freddie Mac asked Dr. James Pearce, an economist at Welch Consulting in College Station, Texas, and me, to evaluate the 1996 CBO report and comment on it. And we did.

And they asked us also to provide our own assessment of the GSEs, the benefits and costs.

Briefly, we found that the 1996 report systematically overstated the benefits to the GSEs—they call them subsidies—and understated the benefits to consumers.

When we made technical corrections in the CBO numbers because of some mistakes we believe they made, it wiped out this difference. The characterization that the GSEs are a, quote: "spongy conduit," disappears.

Now I have a copy of the report that we submitted, and I have submitted that for the record and I would appreciate it, Mr. Chairman, if you would include that with my prepared statement and that report as an attachment.

Chairman BAKER. Without objection.

[The information referred to can be found on page 163 in the appendix.]

Mr. MILLER. We concluded independently that the benefits to consumers ranged between $8.4 billion and $23.5 billion annually, and that the benefits to the GSEs ranged between $2.3 billion $7 billion annually.

Now we did get an advanced copy of the 2001 CBO draft, and it's a draft that we guarded very carefully and it's confidence that we respected, and we responded to it.

We were very pleased that the CBO made certain changes in their methodology, certain corrections. And I think this improved the quality of their analysis.

However, they compounded their mistakes in some areas, in our judgment. They also changed the methodology for counting the "subsidy," from a flow method to a capitalized method, so they basically scored the subsidy when it happened, when the transaction took place, rather than over a period of time. And for reasons that I go into in the report, I think that's inappropriate.

But it seems to me the major problem with the CBO methodology is very simple.

In the minds of the CBO, in the model they adopt, and in the rhetoric that has been discussed so often about this, it's as if you, Mr. Chairman, and other Members of Congress lay on a subsidy, whether it's implicit or explicit, lay on a subsidy to the GSEs which they then parcel out to consumers, and they keep back a service charge.

And CBO says that that service charge is one dollar for every three they get.

This is totally incorrect. The institutional arrangement that you have put in place generates far more benefits than the funding advantage that is CBOs measure of the degree of the so-called subsidy.

I put the word "subsidy" in quotes every time I use it. I think Mr. Barr raised that question. I think that is an inappropriate way of looking at it.

Suppose that there were property rights in some area in the economy that were not defined and not enforced. And you, Mr. Chairman, and other Members of Congress were to pass a law identifying, assigning property rights and enforcing the property rights.

Well, we know that commerce then would flourish and the benefits generated from that would be far in excess of any kind of imputation of some subsidy to the firms, because you had put that law in place.

So it's the whole institutional arrangement that has to be analyzed. And that includes all of the effects that the GSEs have on the mortgage market in bringing about additional competition and lowering mortgage rates all across the board.

That was done in a limited way by CBO, but not in a thorough way.

Let me comment briefly on H.R. 1409.

I haven't gone through the regulatory morass facing the GSEs in great detail. It's very complicated, as you know. You know this far better than I do.

But I've had a lot of experience in regulation. I've written books about regulation. And if I understand your bill, and I read the bill at one time and one of your staff members was kind enough to send me a section by section, what it says is you're going to place in the hands of the Federal Reserve Board the authority to be the regulatory czar for the GSEs.

They cannot engage in additional kinds of activities without board approval. Under certain circumstances, the board could even fire members of the board of directors, can cap pay, can do a number of other things.

They have to make a finding that it's in the public interest. This is old public convenience and necessity regulation of the sort that we threw out, you threw out, with respect to the Interstate Commerce Commission, you threw out with respect to the Civil Aeronautics Board, and others.

Surely, one thing we've learned is this old economic regulation, whether it's maximum interest rates in financial institutions or it's regulation of transportation: it just doesn't work.

And surely, there would seem to be more cost-effective, less intrusive, more market-based ways of accomplishing the goals I think you want to achieve, and I want to achieve. And that is assuring safety and soundness.

So, to sum up, I think any public policy initiative based on CBO's report today would be an error. And second, I think that H.R. 1409 is premature, at best. I would strongly urge you wait and see what OFHEO is going to come up with in their risk-based capital standards and if they get them right.

Thank you, Mr. Chairman. I'd be glad to respond to questions.

[The prepared statement of James C. Miller III can be found on page 157 in the appendix.]

Chairman BAKER. Thank you, Mr. Miller.

Our next witness is Ms. Leslie Paige, Vice President, Citizens Against Government Waste, appearing today on behalf of the Homeowners Education Coalition. Welcome, Ms. Paige.

STATEMENT OF LESLIE K. PAIGE, VICE PRESIDENT, CITIZENS AGAINST GOVERNMENT WASTE, ON BEHALF OF THE HOMEOWNERS EDUCATION COALITION

Ms. PAIGE. Thank you, Mr. Chairman, Members of the subcommittee. Thank you for the opportunity to testify today.

My name is Leslie Paige. I'm the Vice President at Citizens Against Government Waste. We are a non-partisan, non-profit taxpayer watchdog group with more than one million members and supporters nationwide.

I'm also here today on behalf of Homeowners Education Coalition, which is a small ad hoc coalition of taxpayer groups, including the National Taxpayers Union, the Competitive Enterprise Institute, 60 Plus, the Free Congress Foundation, Capital Watch, the Small Business Survival Committee, and the American Association of Small Property Owners.

Home EC's mission in this issue is to raise questions about the Nation's largest housing GSEs, and to participate in this public dialogue about their activities and the impact of those activities on taxpayers and the economy as a whole.

The time to address the concerns of taxpayers regarding the GSEs is not at some future date when the GSEs might be facing a financial crisis.

Been there, done that.

We experienced exactly that same type of scenario in the 1980s with the savings and loan crisis, which cost taxpayers hundreds of billions of dollars. And that bail-out basically occurred because Government officials created an oversubsidized environment and then were ill-prepared to deal with the unforeseen consequences of its actions.

That sounds rather uncomfortably familiar to us.

With the release of the CBO update, it's no longer tenable in our opinion to continue to argue that there is no subsidy. And it's a little surreal, I have to say, with all due respect to the gentleman sitting to my right, to be arguing about what a subsidy is. We all know that a subsidy is the value of a benefit conferred by the Government, in this case.

And I appreciate, by the way, I wanted to tell you that I appreciated, Mr. Chairman, your earlier description of that.

There are as many ways of handing out Government benefits as there are Members of Congress who have an idea of how to do it. But at the other end of that subsidy is a taxpayer waiting to bail it out if it goes bad.

And the GSEs continue to try and tell us that there is no subsidy and it's tying them in rhetorical knots. They argue simultaneously that there is no subsidy, and then they go on to say that this non-existent subsidy isn't worth as much as the CBO says it is.

And that, furthermore, the benefits they convey far outweigh the value of this non-existent subsidy.

There are subsidies. The value is substantial. And 37 percent of the subsidies are soaked up by the GSEs, according to the CBO.

It's clear that they've converted their charters into very highly efficient profit-delivery systems. And we have nothing against the pursuit of profits, Mr. Chairman. But when this pursuit could result in another taxpayer bail-out of an out-of-control financial institution, we tend to take notice.

There are very real reasons to believe that Government would bail-out the GSEs, in spite of official disclaimers to the contrary. Actions speak louder than disclaimers.

The Federal Government has stepped in to bail out the farm credit system and Fannie Mae itself was afforded regulatory forbearance in the 1980s when it was in trouble.

This is not just an academic exercise. The GSEs, in fact, are too-big-to-fail and as such, they merit the scrutiny of this Congress.

Together, they either own or guarantee $2.4 trillion in mortgages and mortgage-backed securities. By 2003, they will have more debt and guarantees outstanding than the U.S. Treasury debt held by the public.

But more importantly, these mortgage giants now control 71 percent of the conventional conforming mortgage market, according to a recent analysis by the American Enterprise Institute, which I'd like to attach for the record. They will own or guarantee 91 percent of that market within 3 years at their current growth rate.

They are purchasing more and more of their own mortgage-backed securities, which is an inherently riskier practice and which has been described by the Congressional Research Service as the repatriation of debt with no discernible mission-related purpose.

In fact, we would submit that profit is the purpose and that motive is also the driving force behind their purchase of home equity loans, even though 70 percent of home equity loans are used for consumer purchases.

Fannie Mae is securitizing Home Depot loans, loans which will be used for remodeling or consumer purchases.

We'd like to know how this kind of financial activity gets low-income people into affordable housing. There are indications that they would like to get an increase in the conforming loan limit. That limit is already too high, in our opinion.

Those who can afford a mortgage of $275,000 are not low-income borrowers. Congress should block any attempts to raise the conforming loan limits.

The GSEs should not be subsidizing consumer loans, eyeing the jumbo market, getting into retail investment banking, or dabbling in e-commerce at a time when they are lagging in their mission to provide low-income people with affordable housing.

The affordable housing goal, by the way, has become nothing more than a politically convenient fig leaf, in our opinion.

What is or is not a secondary market is very vague. We believe that mission creep is a problem and it's an inevitable problem for several reasons.

The GSE charters are vague. Subsequent legislation hasn't done enough to clarify what the parameters are of the secondary mortgage market or what is an appropriate activity for a GSE to be engaging in.

As a result, they tend to just interpret their charters as more of a set of a loose guidelines where anything that make them a hefty profit can be construed as helping low-income people.

Strong supervision of the GSEs is a very advisable interim measure. But it is no substitute for market discipline, true market discipline.

The optimum, long-term reform that we favor, and that is Citizens Against Government Waste, as well as the other members of our group, is full privatization of the GSEs. Taxpayers no longer need to subsidize mature businesses engaging in normal business practices which could achieve success on their own.

Subsidy programs, whether they are implicit or explicit, they breed inefficiency, they breed waste, and they breed abuse. And they tend to hang on long after their mission has been accomplished and they put taxpayers at increased risk.

We've seen this in a lot of other Government programs, from agriculture to transportation to energy.

If Congress wants to promote home ownership among low-income people, which I believe is the intent of the charters, the real question they should be asking is, is this the most efficient way to do that?

The fact is that what we have now is that taxpayers are subsidizing mortgage debt and increasingly, consumer debt, and they are boosting the profits of the GSEs themselves.

We believe that this is the least efficient, least transparent, and least accountable subsidy delivery system.

On behalf of our one million members and supporters, we thank you, Mr. Chairman, for the opportunity to speak with you today and we are available to answer any of your questions.

[The prepared statement of Leslie K. Paige can be found on page 211 in the appendix.]

Chairman BAKER. Thank you, Ms. Paige.

Our next witness is Mr. Edwin Rothschild, Principal, Podesta Mattoon, here today on behalf of FM Watch.

Mr. Rothschild.

STATEMENT OF EDWIN ROTHSCHILD, PRINCIPAL, PODESTA MATTOON, ON BEHALF OF FM WATCH

Mr. ROTHSCHILD. Thank you, Mr. Chairman, Members of the subcommittee.

I am the Chair of the FM Watch affordable housing task force and I'm accompanied here today by my colleagues on that task force, Mr. David Tornquist, who has the distinction of having worked for both Mr. Miller and Mr. Raines, as a policy and budget analyst at OMB for 15 years, and Lottie Shackelford, who is the former Mayor of Little Rock, Arkansas and with the firm of Global USA, and is the current Deputy Chair of the Democratic National Committee and has a long interest in housing issues.

I'd like to, if I can, Mr. Chairman, just go through the study that was referred to in the earlier panel that we have just completed, called "Shuttered Dreams," and go through how we see the subsidy being allocated——

Chairman BAKER. If you would, that's fine. But pull that mike a little closer because if you turn away, we lose you.

Mr. ROTHSCHILD. All right. Is that better, Mr. Chairman?

Chairman BAKER. Yes.

Mr. ROTHSCHILD. OK. We have taken a look at the subsidy using the latest CBO study. We began this study prior to it using the 1996 study as a basis for that. But when you, Mr. Chairman, asked for an update, we decided to wait and issue our study with the most recent data.

The rest of the data that underlies this report is the data that the GSEs report, the GSE public use database that the GSes report to HUD, plus the HMDA database.

So all of this is the official——

Mr. BENTSEN. Mr. Rothschild, are these data in your appendices of your statement or not?

Mr. ROTHSCHILD. Yes, they are in the statement.

Mr. BENTSEN. Because I can't read that far away, but others may be able to.

Mr. ROTHSCHILD. OK. Well, Figure 1 would be on page 3 of my statement.

And if you look at that, I'm happy to go through what it details.

First, as the CBO calculated, 37 percent of the $10.6 billion subsidy is retained by stockholders. So that's the far right quadrant.

Then you have 29 percent of the subsidy that's passed through is in refinance loans. So basically, you have 66 percent of the subsidy not going to the home purchase market, which is 30 percent of the loans. And there's 4 percent in the other category which includes non-owner-occupied and multi-family homebuyers.

So that's the general distribution of the subsidy by those specific categories.

The next figure I'd like to refer to is Figure 2, where we looked at it on the basis of income distribution, the amount of the loans, the value of the loans going to home purchases.

Again, we're just looking at the home purchase category, the amount of the subsidy that actually goes to help put people into homes. Refinances are very, very useful because they help people pay less. But refinances don't put people into homes.

So you have, looking at the median household income of $40,000, that's half the people in the country. Less than 5 percent of the subsidy goes to those homebuyers.

We're talking about $500 million out of the $10.6 billion, while $3.9 billion goes to stockholders.

Purchasers above the median income receive 26 percent of that subsidy.

The next figure on page 5, Figure 3, we again divided the subsidy that goes to benefit home purchases by race, again using data submitted to HUD, HMDA data. And you can see there in terms of minority benefit, African-Americans, Hispanics, Asians, all received approximately 1 percent of the subsidy.

That's about $100 million each, while the stockholders got $3.9 billion.

One other category, unknown race, that's a problem with the data. There are reports that don't contain that information so we don't know the racial category of that grouping.

The last figure that we have here, we have more tables in our full report, but I think these summarize it adequately, you see the percent of the U.S. population. And this again refers to that quadrant of home purchases. And we divided that up to look at it in terms of percentage of the population versus the percentage of people who got the subsidy.

And you can see that, with respect to African-Americans and Hispanics in particular, in terms of the percentage of the population, a very small amount, much less than their percentage of the population went to those groups.

Now one thing we need to point out, and I think it has been mentioned from time to time, is that FM Watch is not coming up with this information.

The fact is that Fannie Mae and Freddie Mac are not fulfilling their mission of assisting and supporting low-income and minority, particularly African-American and Hispanic, homebuyers.

They have lagged the market. The private sector has done a far better job in supporting minority home purchases and low-income home purchases than Fannie Mae and Freddie Mac. That's been reported by HUD, by GAO, by the National Community Reinvestment Coalition and others.

I have a report here that was done by a very well respected housing analyst. It was done by the Public Justice Center, by Calvin Bradford, who looked at Baltimore, who said that the GSEs are lagging the market. They are not doing their job.

They could be. And our argument is that the 37 percent that's being retained by the stockholders of Fannie Mae and Freddie Mac, that portion could be used so that the institutions, the GSEs, could do more for the very groups that they were chartered by Congress to do. And the usual argument, for example, one of the suggestions that's been made by housing groups is that Fannie Mae and Freddie Mac could be buying more CRA loans from banks that make them, the banks that subsidize those loans with other loans.

But Fannie Mae, and we point out a statement by Fannie Mae's chairman, Mr. Raines, last year, in a question and answer session when he was asked by a housing advocate from Delaware whether or not he would use the resources of Fannie Mae to buy those loans, he basically said, no, we choose not to do that. We choose not to subsidize what the banks have subsidized.

But they could. And I want to just reinforce what the Congress chartered them to do. And this is "to provide ongoing assistance to the secondary market for residential mortgages, including activities relating to mortgages and housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities by increasing liquidity of mortgage investments and improving the distribution of investment capital available for home mortgage financing."

In other words, they could earn less.

Finally, I would like to point out that having listened to the testimony of the two witnesses from Fannie Mae and Freddie Mac, I am astounded because I think every time someone comes out with a report, no matter who it is, that is critical of these institutions, it's like they never met a report that they didn't like unless it was written by themselves.

It doesn't matter whether it's the CBO, whether it's HUD, whether it's the Fed, whether you, Mr. Chairman, hold a hearing on a particular date.

All of it seems to be something that they can't possibly have done or agree with.

And I would like to put into the record something that happened last year after *The Washington Post* reported on HUD's finding that Fannie Mae and Freddie Mac were lagging in loans to African-Americans.

Fannie Mae circulated charts here on Capitol Hill, particularly to the Congressional Black Caucus, showing how they were not lagging the market. That was one that they did in May, 2000.

In February, 2001, they showed, in fact, that they were doing better than the market in some years, from 1996 to 1999.

But I have also attached HUD's data, where Fannie Mae has continually decreased its support of homebuyers, African-American homebuyers. Freddie Mac has about stayed the same, a slight increase. But the market is much greater.

In other words, the private sector, when it comes to originating loans, is doing far better.

Mr. Chairman, I see my time is up. It was up before. So I'll stop and be happy to answer questions.

[The prepared statement of Edwin Rothschild can be found on page 220 in the appendix.]

Chairman BAKER. Thank you, Mr. Rothschild.

Mr. Miller, let me start with you. In meeting with the GSEs last year, we reached an agreement. Whether they call it voluntary or I call it involuntary, we got together. And as a consequence of that, we announced that we would like to do the regulatory piece, as it was called this year, and suggest that for the interest of the GSEs themselves, as well as stakeholders and taxpayers, it would be good to assure that we had strong regulatory oversight.

I wore out a good mailbox going back and forth every day, looking to see what they were going to send me. And it's still empty and I've got a new box, still waiting.

So I came up with H.R. 1409. And I'm not suggesting that that's the end-all. Even Mr. Carnell has suggested that there might be a more appropriate regulator.

Do you have any recommendations to change the status quo to assure taxpayers that what the GSEs tell us can be verified by a third party?

To date, every regulator who has issued an opinion, regardless of what they said, has been challenged by the GSEs.

Where can we get a credible regulator? What should it look like? And what do we do to get there?

Mr. MILLER. Well, Mr. Chairman, you need to establish the regulator and have oversight of the regulator's activities. And I think the regulator needs to establish the least intrusive means of assuring that the two enterprises are adequately capitalized, that they cover their risks.

Chairman BAKER. On that point, OFHEO has taken now a decade.

Mr. MILLER. Yes, I'm well aware of that, and I can understand your frustration. And I think you're quite justified in being upset about that.

I think it's important for them to come forward with a set of standards.

I do know enough about the standards that they propose to have a judgment about that. And that is that I think that they're not quite ripe and I think that it would be useful for them to withhold making them final for a few months in order to make sure that they work.

It's almost like debugging software. If they make the program final, then they can't do any debugging. And so I think that that is important to do.

It's in the interest of the taxpayer, as Ms. Paige is suggesting. It's in the interest of markets generally. It's in the interest of homeowners or prospective homeowners to have the GSEs in solid financial shape and to have very well understood, transparent standards and that their activities and that their capital be very transparent.

Chairman BAKER. So you feel that the work we're engaged in is appropriate. We may not have the right answer, but we shouldn't give up yet.

Mr. MILLER. I think what you're looking for, the objective, is in fact, the appropriate one.

As I indicated, I have significant, serious questions about the proposal to make the Federal Reserve essentially a regulatory czar.

I think there are less intrusive, more market-based ways of assuring that capital standard than the provision in H.R. 1409.

Chairman BAKER. Well, let me point out that OFHEO is the capital czar today and HUD is the product czar. And in the entirety of the application process that the GSEs have made to HUD, HUD has never to date denied one request for new product.

Now I'm not suggesting that there's anything wrong with that. Perhaps every submission has been perfect. But I do find it over the life of any enterprise a bit irregular.

If I may, let me jump to Mr. Carnell before I expire on my time.

The question of subsidy has come about repeatedly. And I recall, Mr. Carnell, I believe you were a member of the Administration when Under Secretary Gensler testified before the committee and made the reckless and unprofessional comment, as it was characterized by many, that the line of credit to the GSEs should be repealed.

Concurrent with that, almost to the minute, after the hearing was over, I found that the market volatility was rather dramatic.

Analysts, apparently, and shareholders, began to express some concerns with their pocketbook about the potential of your administration repealing that line of credit.

Is my recollection of history correct? And do markets perceive that that line of credit is an essential component of the value of the GSE charter?

Mr. CARNELL. Your recollection of history is exactly correct, except in one inessential detail, which is that I had left the Administration at that point, even though I fully concurred in what they said.

And it's worth noting that Mr. Howard, who sat in this seat at the first hearing, called Under Secretary Gensler's testimony irresponsible and unprofessional.

Now Mr. Gensler said that the Government did not guarantee Fannie Mae and Freddie Mac. What is irresponsible about that?

I can tell you as a law professor, that's the truth, the Government does not guarantee Fannie Mae and Freddie Mac.

Chairman BAKER. But when you read the face of the security, it's got it in type big enough I can read it without my glasses—not guaranteed by the full faith and credit.

Mr. CARNELL. That's right.

Chairman BAKER. I don't know how much more clear we can make it.

So why would the market react that adversely when we talked about repealing something that's not there?

Mr. CARNELL. Well, I think there is a problem in the disclosures so far, Mr. Chairman, which is that Fannie Mae and Freddie Mac have been allowed to go around and tell people that the Government implicitly backs them.

Implicitly backs is not a guarantee. That's why Under Secretary Gensler's testimony is not correct. But this comes back to the double-game that I talked about, where Fannie and Freddie say one thing to Members of Congress in this room and elsewhere, and they say something else on Wall Street.

It's like a sailor who has wives in two ports and they never come together.

Fannie and Freddie get to say different stories to different people and get away with it year after year. But the fact is that there is no Government guarantee here.

Essentially, what the capital markets are doing is pricing the political risk of whether the Government would or would not bail Fannie and Freddie out in the future.

If they feel that the Government is developing a backbone, then the risk is going to go up.

Chairman BAKER. I've exhausted my time.

Mr. Kanjorski.

Mr. MILLER. Mr. Chairman, could I offer an alternative explanation, I think?

Chairman BAKER. Sure. Yes, sir.

Mr. MILLER. And that is as follows. A lot of things can impact upon a company's price or the price of their stock.

If there's a perception that a movement by this Committee or others in Congress would disrupt the markets in whatever ways beyond the question of this line of credit, that could have a significant adverse effect on the price of Fannie Mae, Freddie Mac stock.

And that, I suspect, was the concern expressed.

They have never used that line of credit, I understand. It probably doesn't matter very much. They make it very plain, as you point out, in big type.

The people that make markets with Freddie Mac and Fannie Mae are very sophisticated people. They are not likely to have the wool pulled over their eyes about that issue and whether they might be misrepresented.

Chairman BAKER. No, I'm not alleging that at all. What I'm suggesting to you is, when I asked Fannie and Freddie directly, CEOs, since you don't use it, since you're so well capitalized, since you're so highly profitable, since it wouldn't equal a couple of weeks of your debt issuance, why don't we just get rid of it and clear it up?

After oxygen is applied, they usually say that that doesn't make sense.

Mr. Kanjorski.

Ms. PAIGE. May I also interrupt, or am I going to be impinging on your time, Mr. Chairman?

I want to address something that was said earlier about HUD.

Chairman BAKER. If you'll be brief, yes.

Ms. PAIGE. Very briefly. Thank you. HUD is not known to be one of the best managed agencies in the United States Government. In fact, it's very high-risk and it's been on our high-risk list and it's been the subject of lots of inquiries by Citizens Against Government Waste, as well as other members of HomeEC.

And when you mentioned earlier that they've never turned down a particular product request, I just wanted to mention the fact that the most recent thing that they did, that Freddie did, was the Lending Tree dot.com investment that they made in March, which was $2.5 million.

Admittedly, that's a very small amount of money by their standards. But the question I think that we should be asking, we should be asking HUD, who has not yet ruled on whether that's a permissible investment, is what are they doing investing in any kind of a dot.com startup company in a volatile e-commerce market?

Now HUD says that they're still waiting for data to make a decision. And I would humbly request that somebody ask HUD to finish up on a rule that they started last year which would start to define what kind of investments Fannie and Freddie are allowed to do that are supposed to be mortgage-related and non-mortgage-related.

Draw a bright line so that we know where that is as taxpayers.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Paige.

Mr. Kanjorski.

Mr. KANJORSKI. Listening to all the witnesses and their various positions, I'm somewhat astounded. I'm not sure whether I'm in the world of Oz.

My friends on this side of the aisle are for regulation, more strict regulation, control of product. And my friends on this side of the aisle seem to be reporting something different.

And then when I look down there and see the different groups you come from—let me start off first, Mr. Edwards.

From my observation of the present state of the American economy, manufacturing, for all intents and purposes, would be classified as being in recession.

The agricultural economy of the United States would be classified as being in recession.

The dot.com economy of the United States would be classified as depression.

There seems to be two fundamental industries that are still doing quite well, and that's home building and real estate. And perhaps the automobile industry if it still holds up, that are supportive of our present status of the economy.

Would it be that way if we were to do away with Freddie Mac and Fannie Mae?

Mr. EDWARDS. Thank you, Mr. Kanjorski.

As I said in my statement, we'll put together the home building and the real estate brokerage business into one industry and call it the housing industry.

The housing industry now is probably your strongest sector of the Nation's economy, and it's remained that way despite the slowdown. Perhaps is that the American public believes that the home is, first of all, shelter, and then a safe investment, or you wouldn't have 68 percent of ownership.

They—the American public—also believe that it is the right investment to get started in their financial future.

And so, I think those are some of the factors that have kept the home ownership rate growing. Among others, certainly a big part of that is that we've got a mortgage interest environment which is healthy as far as acquisition because, as those interest rates come down, the present value of the loan amounts go up. And so, people are able to buy a home and obtain mortgage financing.

Someone mentioned refinancing. Refinancing actually is healthy for the market because it keeps the markets and the neighborhoods stable. It keeps people in homes that might lose them otherwise.

So I think a lot of these factors, Mr. Kanjorski, have come together. But I truly believe that Americans believe that home ownership is, first of all shelter, then a good investment in their future and their children's future.

Mr. KANJORSKI. Thank you.

Mr. Miller.

Ms. PAIGE. Mr. Kanjorski, can I add something to that, please? I'm sorry, sir.

Mr. KANJORSKI. Very quickly, if you want.

Ms. PAIGE. Thank you. It's just that Mrs. Hooley made a comment earlier today about the modest increase in home ownership and I think that should be re-emphasized, that there's been a 4-percent increase in kind of a long period of time. And there could be other attributable factors to that, including low rates of interest rates and lots of other things.

Mr. KANJORSKI. Mr. Miller, you've had an opportunity to study this whole financing vehicle of real estate in the country.

Do you have an opinion as to whether or not it is, one, a very efficient system of delivery from the market place? And two, whether these are well-managed and operated companies as opposed to, say, 15, 20, 25 years ago?

Mr. MILLER. I have a reasonable degree of confidence that this institutional arrangement is working well. There are things that could be done to improve it. I'm not suggesting it's perfect.

I think these firms are managed well, from all that I've seen. And also, they're very competitive.

I don't see any—I said in my testimony that I'm not one of these people who say, "if it ain't broke, don't fix it," because that's the refuge of people that don't have much to say on their side.

But I don't see any reason for alarm that would cause precipitous action.

Mr. KANJORSKI. So you're talking about fixing around the edges, but not fundamentally changing the core of the product or the operations.

Mr. MILLER. I think you need to make sure that these GSEs do meet standards for risk-based capital and whether you accept what OFHEO is doing here or not, I think you need to see what they're going to do.

They're at the precipice of doing something rather substantial in the regulatory area. See what they do and then make a decision.

Mr. ROTHSCHILD. Mr. Kanjorski, can I just make one quick comment?

Mr. KANJORSKI. I just want to make an observation. I welcome you because we had a roundtable discussion and I don't think FM appeared at that when we had an opportunity for all these different interest groups to talk to each other.

I wish you had been part of that interchange because it would have helped us. I guess I want to make an observation with you.

You do not represent anyone who has conflicting interests with these two organizations in any way. You are coming here strictly out of the interest of national policy and home ownership for minorities.

You really do not have a financial interest, anybody that you represent in your organization.

Is that correct?

Mr. ROTHSCHILD. I think I would only comment that I think it's important for Congress to look at three elements. They've all been discussed. I'll answer that question if I can just get this one point out.

That, on the one hand, GSEs are not accomplishing the mission they were designed to do with respect to——

Mr. KANJORSKI. I'm going to stop you there. I listened to you before on that. And I know you represent a lot of the free enterprise sector of the community. I'm glad they're here. I'm glad they're active.

But where were they when we needed a secondary market?

It seems to me all these people show up to cast aspersions on organizations that the Congress created to create a viable market. It's rather successful. Certainly, when I first came to Congress Fannie Mae and Freddie Mac were not nearly as economically sound as they appear to be today.

And this is not to say—I agree with Mr. Miller. That's not to say that there's nothing we shouldn't be looking at.

But where were you all when the private sector could have developed the secondary market? Hell, we didn't have to do it in Government. It's just that you didn't step up.

Now I want to move to Mr. Carnell. I understand your philosophical position on GSEs. But it would be remiss for any of us to sit here and say that there isn't an implicit guarantee that the Federal Government in catastrophic economic circumstances wouldn't have to, for systemic risk, shore up these organizations.

We would shore up Mr. Rothschild's organizations. There are banks that are just too-large-to-fail.

Not too many years ago, we shored up Mexico because the catastrophic result of the domino effect would have been that the world economy could not afford a failure to step in.

So to make this argument that, I don't care whether they print it. It's not supportive. We know that anything that is dealing in trillions of dollars in a depressionary economy is going to have to be shored up, or we're going to have to give up the entire system, that I think we would do anything before we come to that situation.

Or do you really believe that the Congress, the American people, don't believe in the concept of too-large-to-fail?

Mr. CARNELL. I do not believe in the concept of too-big-to-fail. And as I said in my testimony, Mr. Kanjorski, whether or not too-big-to-fail is a reality is a matter of what you, other Members of Congress, and financial regulators do.

If during good times you say to yourself, there's not a problem, or, in fact, you reaffirm too-big-to-fail, you and others are creating too-big-to-fail in doing that.

One of my basic points is that there's a circularity with too-big-to-fail. Too-big-to-fail comes from expectations.

If you stoke too-big-to-fail expectations, you reduce market discipline and you increase the chances of problems, and you also increase the shock to the financial markets if you disappoint them.

In 1991, in the FDIC Improvement Act of 1991, which this Committee passed and was enacted, Congress made a major step back from the practice of treating banks as too-big-to-fail.

If you looked back in 1990, you would see that the FDIC was protecting all depositors at banks as small as $500 million.

And in fact, a senior official of the OCC, echoing sentiments a little bit like what you said earlier, said to 200 London financial market people in my presence in 1990, that the FDIC's practice meant that you did not have to worry about losing a cent, no matter how much money you had on deposit at a U.S. bank, if the bank had more than $500 million in assets.

Now go forward 2 years.

On October 30th, 1992—this is less than 2 years after that statement by the number-three person at the OCC, and just 4 days before the Presidential election. The OCC closed a group of banks in Texas that had almost $9 billion. So that's 18 times the size that was described as being too-big-to-fail.

And the financial markets took it in stride. The financial markets took it in stride because this Committee and other concerned Members of Congress had gone about changing market expectations.

So the markets made adjustments. They weren't shocked. And it was possible to deal with things in stride.

So what I'm saying, Mr. Kanjorski, is that too-big-to-fail expectations are not like hurricanes or earthquakes. They're something that we as human beings, they're something that you and other policymakers create by your decisions about how to act or not act.

And they're something that financial market participants create by their decisions about risk-taking.

Mr. KANJORSKI. So it's your opinion that the Congress should have penalized the Federal Reserve when they went to the rescue of Capital Management.

Mr. CARNELL. I think the Federal Reserve's action was irresponsible. I think it was and I said so privately at the time.

As a Treasury official, I was not free to say so publicly at the time.

Mr. KANJORSKI. How about the Mexican bail-out?

Mr. CARNELL. That's a tougher issue. Let me emphasize that the U.S. had no legal obligation to go to the aid of the Mexican government.

The issue is, were we better off tiding Mexico over that time, using an arrangement that, in fact, posed almost no risk to the U.S. Treasury because we got a complete claim on their stream of foreign oil.

Mr. KANJORSKI. If you're having a hard time making that decision that that was a successful bail-out, then we have a difficult time communicating.

Now I was not in favor of it at the time and if it had come to the Congress of the United States, it would have failed.

I think the Administration took probably one of the best acts at that time that significantly saved the world economy.

Mr. CARNELL. I'm not criticizing the Mexican bail-out. What I am saying is——

Mr. KANJORSKI. You were there. Looking with your hindsight, did you make a mistake or didn't you?

That's a simple answer.

Mr. CARNELL. There are two parts to it. I think that——

Mr. KANJORSKI. You are definitely now in a classroom situation. Put yourself back in Treasury. You've got to make a decision one way or the other.

I mean, don't try to carry water on both sides. Condemn the man you served as president and the Federal Reserve for the acts they did when they bailed out Mexico. Or agree that it was a wise decision.

I'm going to go you one further, Mr. Carnell. I've served on this Committee long enough to know that in 1989, George H. Bush took the office of the President and in 7 days, he came up here with the RTC bail-out for the S&Ls.

I thought that was one of the most politically courageous acts anyone had done. And I'm a Democrat. I can say that about a Republican President.

And I will tell you about a second great act he did in 1991. He went against his pledge for no new taxes and raised taxes, and I think participated to a large extent in the 8 years of the fantastic economy that we have just gone through.

Now, I don't find that difficult as a Democrat to pay attention and pay respect to I think two courageous chapters in the profiles in courage. Lost his presidency because of it.

No question in my mind.

Mr. CARNELL. I agree that both of those actions by the first President Bush were courageous and right. I think you put very well the case for them.

Let me emphasize that what the Government was doing in 1989, was not bailing out the thrift institutions themselves, but making sure that the Government could honor its own guarantee to their depositors.

So it can be true that actions like this can be responsible. It can be true that they can be courageous. But I think we would be very mistaken to say that bail-outs in general are right and heroic and responsible.

Mr. KANJORSKI. I'm not saying bail-outs in general. I'm saying that if any of us are sitting in this room and we are delusional enough to think that there aren't institutions in this system that are too-large-to-fail, because of the ramifications that would be caused both in the domestic and the international market, I think we're being intellectually dishonest with ourselves.

Chairman BAKER. Would the gentleman yield?

Mr. KANJORSKI. Yes.

Chairman BAKER. I would just trying to join in, Mr. Kanjorski, to steer it just a little bit in the conversation.

The purpose of all of this is not to decide what we shall do in the vent of failure. The purpose of this is to determine how we can preclude the conditions for failure.

And I am not confident, given the enormous amount of information the Committee has reviewed over the many months that we have been back and forth, that we are in a position to be able to say without question of conscience that we know for certain the status of these enterprises.

That's all. However we get there is of no difference to me. I will take any game plan anyone chooses to put forward.

But I don't think we have that assurance.

Mr. KANJORSKI. Mr. Chairman, I agree with you. The only thing I'm disturbed about is that I think the next 3 to 6 months in the American economy is probably the most crucial period of time that we will experience in our lifetime.

And, for either the Congress or this Committee or the Administration or the leaders of industry and the economy of this country to further jeopardize this very delicate moment, I think is very dangerous.

Chairman BAKER. Correct.

Mr. KANJORSKI. So that's the reason I asked Mr. Miller, if these organizations are not being well run, or if he feels that they are at economic risk, then we do not have any alternative because of how large they are, we may have to bail them out.

But we are not pressed with that time. For us to be attacking a fundamental pillar that's holding our economy up at this time, for whatever reason, because it doesn't philosophically, politically, or otherwise, appeal to us, I think perhaps it may be a misspent opportunity on our part.

Chairman BAKER. Well, I would only respond this way.

It's a very large ship on which all the future of every homeowner and every taxpayer and every economic interest, not only in the United States, but internationally, rely to a great extent.

There are now 74 foreign central bankers, Alan Greenspans around the world, who hold billions of dollars on deposit at the New York Fed.

This is of no mere incident, that this is of enormous significance.

And whether that ship stays on course, I'm not suggesting that we take a crew down to the basement of the ship and start cutting a hole in the hull.

What I'm suggesting is there may be a few rusty spots that we need to examine or to go take a look at before we run aground and find ourselves in a circumstance from which we cannot extricate ourselves.

I am indeed worried about it.

Mr. KANJORSKI. I think you're looking at the ship as a cruise ship and I'm looking at it as a lifeboat.

Chairman BAKER. Well, whether it's life or cruise, if it sinks, we all go down.

Mr. Cox.

Mr. COX. Thank you, Mr. Chairman, and I thank our witnesses. I think we've had a great discussion.

I was just remarking privately up here that our witnesses are very aggressive advocates for their respective points of view.

Chairman BAKER. Welcome to Financial Services.

[Laughter.]

Mr. COX. If I might just put a question to Mr. Edwards because I think your testimony is crystal clear. You certainly don't want to throw out the baby with the bathwater here. You want us to be cautious, and I hope that we will be.

I want to ask a question on a very discrete subject. I hope it's also a discrete question.

And that is, SEC registration of publicly traded securities issued by GSEs.

The GSEs take the view that they essentially conform to existing Federal norms of disclosure. Would the realtors support, oppose or be neutral on making sure that those disclosures were exactly what is required of all other issuers?

Mr. EDWARDS. Mr. Cox, I think I'd have to have a little bit more information to comment on that. I would be happy to get back to you. But I really don't know that we've considered it or what have you.

Mr. COX. And actually, that tells me something, that at least that's not at the core of your concerns.

Mr. EDWARDS. Right. I would like to make one other comment.

There's been several questions, and maybe this will help on the issue of home ownership. Ms. Paige and others have made a comment about there's only been a certain increase in the percentage of home ownership in a number of years.

I would remind the Committee that the two GSEs are not only involved in home ownership. They're very much involved in rental housing.

I have been involved in rental housing in my city and I have seen the help and—I'll call it the foundation—the support that we've gotten out of the GSEs as far as rental housing.

That is to me one of the real large problems in this country, is the disappearance of rental housing.

And so, it's not just home ownership we're talking about. It is the support of the rental housing community which is a lot of the lower income housing that you're talking about.

This is a very serious issue in this country and I think we can't walk away without remembering that this support of not just home ownership, but good, quality housing.

Mr. COX. I appreciate that. Mr. Miller, I wonder if I could ask you as the representative on the panel, the only one speaking, in your case, indirectly, for the GSEs, what your view would be on the question that I just put to Mr. Edwards.

Would repeal of the exemption from the securities laws be material to your concerns?

Mr. MILLER. It strikes me, Congressman Cox, that the system today with the exemption is working well, lowers cost. I don't see any abuse of the sort that SEC registration——

Mr. COX. Do you think that SEC regulation—that is to say, just the registration requirements imposes on new costs, that aren't already being borne by the GSEs in their disclosure?

Mr. MILLER. Just the process of registration requirements, other regulations.

Mr. COX. Because it strikes me that if the smallest business in my district has to register its securities, that, surely, somebody with a multi-trillion-dollar portfolio could afford to do it.

And markets since the 1930s have become accustomed to a certain style and form of disclosure. And I think we're this close anyway.

I just want to make sure that we're not going further than necessary in granting Government exemptions to people if it doesn't do any good and certainly, there's no investor protection involved.

Mr. MILLER. The logical implication is that maybe some of the firms in your district might well be exempt. Rather than not exempting anyone, maybe there should be selective additional exemptions, or the regulations should be less onerous.

Mr. COX. Since I practiced securities law for a decade, I don't consider the registration requirements to be all that burdensome and unlike other laws and regulations, they don't change very often.

Furthermore, the investing community is used to seeing this style and format of disclosure.

And furthermore, I think the GSEs would tell us that they're pretty much there already anyway, that they attempt to do this even though they're exempt.

So I don't know what we're buying by fighting it.

Mr. MILLER. And the market-makers there are very sophisticated. I'm not speaking on behalf of the GSEs. Let me just make that clear, in any of my comments today.

Mr. COX. I'm just going to you because you're as close as I can get on this panel. So I'm going to put that burden on you one more time and ask you, on the subject of encroachment, which has been raised by some of the panelists, you remember that President Reagan issued an executive order that essentially said that the Government should not compete with the private sector if the private sector could do the job.

Do you think that same thing should be true for Government-sponsored enterprises?

Mr. MILLER. No, I think that basic philosophy ought to apply here for reasons that I outline in the attachment, the second attachment.

I looked at this, and because basically the financial institutions, the other financial institutions have an upward-sloping supply curve for loanable funds, whereas the GSEs supply curve is very elastic, that to take away from the GSEs the same kinds of advantages that are now given to the other financial institutions would result in an inefficient mix of financial institutions, accounting for loanable funds.

We're in the world of the second best. If we could start all over and clear out all the undergrowth of the Government, and so forth, and streamline everything, you would probably not have any special arrangement for GSEs.

The problem is, as my mentor, Jim Buchanan, says, where you go from here depends on how you got here.

And I think we have to work with where we are. I don't see Congress making dramatic changes in the financial institutions and the nexus between Government and the financial institutions.

And therefore, I don't see good reason to make fundamental changes in the charters—let me put it a different way.

I see reason not to.

Mr. COX. Across the hall, I've spent some time worrying about Internet taxes. In fact, we're going to be dealing with that when the moratorium expires in October, dealing with it, hopefully, before that time.

And of course, in connection with passing the Internet Tax Freedom Act in the first place, I spent an awful lot of time, several years, talking to the Nation's Governors before winning the endorsement of the National Governors Association and the mayors and the county executives and so on because they are worried about their tax base.

And I think the realtors actually share that concern. They're worried about making sure that we don't short-change State and local tax bases.

Do you think that, given the financial success of the GSEs, that they should continue with an exemption from all State and local income taxes?

Mr. MILLER. Mr. Cox, you know that my position on taxes is that whenever you can eliminate a tax, do it.

There is a tendency for governments to reach too far and to tax too much. You can make a case for non-differential tax rates or not exempting some from taxes, whereas you do exempt others.

But this would not be a high priority for me.

Mr. COX. Well, I think the Chairman is probably indicating my time is up. But I've got——

Ms. PAIGE. Congressman Cox, could I respond to that for just one second? Or not?

Mr. COX. In fact, I won't ask any more questions. And if the Chairman will just permit the panelist to answer the questions.

Ms. PAIGE. Thank you, Mr. Chairman. I couldn't disagree with Mr. Miller more on the charters and the taxation issue.

The charters are possibly where the problem resides. They're very vague and the subsequent legislation doesn't do enough to clarify where secondary mortgage market parameters are.

We are not kind of advocating some wholesale privatization that's going to happen tomorrow. I think that's politically untenable and everyone knows that it's not going to work that way.

But I think a continuing dialogue lays some groundwork for some future enactment of some reforms that would be helpful to taxpayers without harming homeowners or the economy or the GSEs.

And we would hope we would ramp up to an idea where we could discuss privatization. We're not going to be doing it tomorrow.

And if they are as successful as they say they are, and we all say that they are supremely well managed, they can pay their taxes, and there are other things. They could probably pay their SEC fees as well.

And it isn't even the fees that they're objecting to. It's just registering. It's having somebody look at their investments to be sure that they're safe and sound. They're objecting to that as well, besides the fees.

So there are a lot of things that I think that they could be doing. And every time we suggest something, they say, well, we'll have to pass that on to the consumer.

I'd like to see them maybe look at some other options, like taking less of a profit, since their mission requires them to look at affordable housing. And that's what they're supposed to be doing.

Chairman BAKER. Thank you.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Just for clarification, I think, if I understand this correctly, and for sort of full disclosure for the Members that are here, I think they is us because Fannie Mae and Freddie Mac are in existence only because Congress created them and they did not choose to not pay taxes somewhere. They did not choose to not file SEC registration.

Congress chose that.

Now there is a strong case that could be made that Congress has made mistakes along the way during the last 200-plus years.

[Laughter.]

Again, that's a judgment call. We'll let everybody decide.

To my knowledge, they haven't made many mistakes in the last 7 years on anything that I've voted for.

But, in any event, I think we need to clarify that.

Now, I also, and I'm sorry that Mr. Cox has left, but he raises an interesting point which is worth some review because with respect to the registration issue, it may be that the concern is not so much the registration as it is that it brings the Securities and Exchange Commission into the picture as a regulatory entity that they otherwise would not be.

It's something to think about. Moreso than the cost question.

But I have a number of questions that I'd like to go over.

Mr. Carnell, you talked about the implicit guarantee question. I think this is correct, that we also provide for a perceived implicit guarantee as it relates to FICOs and REVCORPs.

They're backed by the funds or by the assessments. But the market has always treated them as having an implicit guarantee. And in fact, for legal purposes, many escrows are allowed to hold those, including public escrows, in the same way that they're allowed to hold a Treasury.

So I don't think that we can say that the GSE debts are unique in that respect, that there have been subsequent times when we have allowed this.

Mr. CARNELL. Just as an aside, Mr. Bentsen, I would note that FICO and REVCORP were created as sham GSEs. That is, FICO was created as a way to provide money, a little bit of money, to protect thrift depositors without it going on budget.

And so what they did was they used the GSE model as a precedent for it.

Mr. BENTSEN. I understand that. But nonetheless, they were created.

And second of all, and I don't have all criticism for your statement. But second of all, I think we have to be careful when we make a direct comparison between the savings and loan industry prior to FIRREA or FIDICIA and the GSEs today because I think the savings and loan industry was a much different animal. I think the structure was much different. I think the markets were much more different.

And while you had funds to protect that, we all know that the taxpayers ended up spending a considerable amount of money in doing that.

Now I do want to say that you were on point in your discussion of the regulator. And you hit the points exactly right when it comes to the inherent conflict of the Federal Reserve.

I would add one other point.

The way I read H.R. 1409 is the Federal Reserve would have veto power over the Treasury in allowing the GSEs to hit the line of credit which raises another conflict at the same time that the Fed may be conducting open market operations using GSE debt, which I think they are in the process of doing or, if not, strongly considering doing.

But I think you're on target there, that if we were to consider a new regulator, that we would move in that direction.

And I'm going to run out of time, although I would ask for the Chairman's indulgence because we had this long discussion about the relationship between the GSEs and the bail-out of the peso. And so, I'm going to get there.

[Laughter.]

And you can do this for the record, if you will, because the individuals from the GSE really didn't get to this point.

The Chairman's bill, in providing for the GSEs to be under the regulatory authority of the Federal Reserve, provides for a number of new regulatory oversight and enforcement mechanisms.

And what I want to know is where those comport or conform with other financial institutions as per the Bank Holding Company Act or Gramm-Leach-Bliley.

Chairman BAKER. If the gentleman would yield.

Mr. BENTSEN. Sure.

Chairman BAKER. I can maybe help cut that sort.

We requested the GAO, pursuant to last session, to go through and do an analysis of current bank regulatory authority and GSE authority. And where there was a disparity in the enforcement action given to the regulator, we move to the bank standard for enforcement.

For example, if the GSE gets to a condition of insolvency, you can't put them into a receivership. You can only move them to a conservatorship.

The distinction between the two is that in a receivership, stakeholders, creditors, shareholders, can take a haircut. In a conservatorship, they do not.

So it's a very distinct difference in consequence to markets. Therefore, there's confidence that the GSE's debts will be honored.

That's just one. But there were a litany of things.

So anything that the gentleman sees in the bill that appears to be new regulatory authority, are only those provisions identified in current bank regulatory authority made applicable to the GSEs.

Thank you.

Mr. BENTSEN. Well, I appreciate that.

But I would appreciate for the record if you would——

Mr. CARNELL. I would be glad to do that, Mr. Bentsen. And if I could just very quickly respond to your three points just for now.

The first is that the Chairman's bill moves in the direction of making GSE safety and soundness regulation, for example, enforcement authority and prompt corrective action, more comparable to bank enforcement authority.

But we're not talking about something here, despite the moaning and groaning from the previous panel, we're not talking about regulatory overkill.

The fact is that OFHEO's authority right now in many respects is much weaker than that of the Federal banking agencies.

And the Chairman's bill reduces some of that weakness.

Second, I would note that in making the GSE line of credit at the Fed contingent on the regulator recommending it, I think that's a good move in the Chairman's bill because it means that the step of the GSE going to the Treasury and borrowing that money has the regulator complicit in it.

In other words, that increases the political risk to the regulator of the GSE going on the public dole through borrowing from the Treasury.

I think, institutionally, that's helpful. It puts a little bit more backbone.

Mr. BENTSEN. But the current law, if I understand it, allows— it's up to the Treasury Secretary to make that determination.

Mr. CARNELL. Correct.

Mr. BENTSEN. And so this would be a belts and suspenders effect, that you would have two regulators, one a political appointee and one theoretically not a political appointee.

Mr. CARNELL. Yes. But I think the concept, as you suffer my testimony, I don't favor making the Fed the GSE regulator.

Mr. BENTSEN. Right.

Mr. CARNELL. But if they were, I think the Chairman's bill is right on this point. And I think that if it stays at OFHEO, it would be right to enact a comparable provision saying that OFHEO needs to recommend it to the Treasury.

Mr. BENTSEN. With the Chairman's indulgence, let me move on.

Mr. Rothschild, in your statement, you talk a lot about refinances as a percentage of—I think you were just talking about the year 2000 in those numbers.

And I would ask you or Mr. Edwards, since he's speaking for the realtors, just in the general market, not just the GSE market, what percentage of mortgages originated in 2000 were refinances versus actual new mortgages?

Mr. EDWARDS. Mr. Bentsen, I don't know that I have an answer to your question. We can certainly try to find an answer to your question.

Mr. BENTSEN. If you could find out because I know in various years, depending upon interest rate comparisons, refis have been a large portion of the mortgage.

Chairman BAKER. Let me add on to your question. I'm not trying to cut you off.

Mr. BENTSEN. Yes.

Chairman BAKER. If whoever is going to prepare the answer to that one, also needs to know how much of it was cash out because a lot of that refi stuff, people took money out and went and bought boats and stuff, just if we have that data.

Mr. BENTSEN. Right.

Mr. ROTHSCHILD. Just a clarification. Our data for refis and the home purchase, it was all based on 1999 HMDA and GSE data.

Mr. BENTSEN. OK. Well, then, for 1999, so we're talking apples and apples.

And then, Mr. Miler, you actually hit on a point that I thought about, which I thought is very interesting in this last exchange, or one of the prior exchanges.

I don't disagree with the argument of the subsidy. And I'm not particularly afraid of the subsidy. I think what we're doing here is we're leveraging credit of the United States. And we do that in various instances.

And there are groups like Ms. Paige's group and the Libertarians and others who think that that's an awful thing that we ought to do, and there are others who believe it's a good idea.

But we do it in the municipal bond market. We do it all over the place.

Nonetheless, you raise the issue of the supply curve for loanable funds. And I haven't read your report, but I'll take a look at it.

The argument has been made, not today, but made before, that the fear—and it was referenced with the rising amount of debt—the fear that the GSEs have access in effect to cheap money because of the subsidy and the lower borrowing rate that that creates.

And as such, when an entity has access to more and more cheap money, then they will be chasing cheaper and cheaper credit along the way.

And I'd like you to comment on that because it seems to me, at least under their initial structure, they are somewhat limited in where they can put their dollars, which is in mortgages in some form or fashion.

And if you look at where mortgages are written, they are written pretty much from the top of the income scale down and they come down to a certain point to where people basically can't afford to buy a house or don't know that they can afford to buy a house. And there's a small percentage in there of people who voluntarily choose not to own a house or whatever, and there's a small percentage who pay cash.

But I'm curious whether or not we're being contradictory where we say, on the one hand, they're borrowing too much to make too many loans and on the other hand, they're not making enough loans down the income scale because down the income scale, the credit risk does increase.

Chairman BAKER. And to whom is that directed? Which witness is that?

Mr. BENTSEN. Well, to Mr. Miller and Mr. Rothschild can answer it.

And that's it.

Chairman BAKER. I need to get two more Members in before we get called for a vote. And whoever would choose to respond.

Mr. ROTHSCHILD. In our report, page 11 that we published, you can see the percentage of loans purchased by income group by Fannie and Freddie.

And what you find is that although, and this is not on the basis of 100 percent of the loans that are out there that they can buy in the conventional conforming market.

So those who are making between zero and $40,000 a year, they're buying 26 percent of those making between zero and $20,000, 39 percent between $21,000 and $40,000.

And yet, for the upper income categories, they're buying much more. Between $61,000 and $100,000, they're buying 52 percent of all the loans that are out there.

You find a similar pattern of their purchases when you look at it by race.

For whites and Asians——

Mr. BENTSEN. Of course, we realize that Ginnie Mae is in that market, in that lower end market as well, where they're created to buy those loans.

And I guess the point I'm trying to make is that FM Watch and other groups have come back and said that they're issuing too much debt, they're chasing too much credit and creating the systemic risk in the market.

And I think we do know that even though all of us want to see them go down the income scale, that there is greater risk the more you go down the income scale.

Mr. ROTHSCHILD. Well, in a lot of those loans, there isn't greater risk. There may be lower cost, lower money to be made on those loans because they're smaller loans.

So if you spend your time going after larger loans, you're going to make more money for every larger loan you buy versus the smaller loans.

Mr. BENTSEN. The Chairman is about to step on me here, but I just don't agree with that statement at all. I think that statement is illogical.

I don't know if anyone else wants to comment on this.

Chairman BAKER. For the gentleman's perspective, I believe there's academic study which indicates a review—it's more a question of the amount of downpayment as opposed to income levels.

And as long as someone has their own equity at risk, the relative risk ratio between lower income and higher income is not statistically significant in my view.

But that's something that we can explore. Somebody jump in and then I've got to get to Mr. Meeks.

Mr. MILLER. I will give back the balance of my time.

Chairman BAKER. Thank you.

Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

Real briefly, and I apologize. There's been a lot going on today, for not being here to hear all the testimony. But let me just ask a couple of questions.

You may know that I represent a district that's predominantly minority homeowners.

And so, my first question goes out to Mr. Rothschild. Besides having GSEs purchase CRA loans, and I know that they're doing that and pushing that and that's good, despite when I initially got here, we found when we were doing the banking bill that there was a lot of opposition from banks that wanted to do CRA or continue CRA.

But I'm interesting in making sure that more minority homeowners exist.

Let me just ask, what is your organization doing to help increase minority home ownership?

Mr. ROTHSCHILD. First of all, Congressman Meeks, our organization represents a number of trade associations.

So, first of all, we don't do that as an organization. But I think if you look at the data, which is what we analyze, that is, the private sector in terms of its origination of loans to low-income, to moderate-income, to minorities, is doing as a percentage of their business, of all of the business that they do, is doing a far better job of doing those kinds of loans, making those kinds of loans, than the GSEs are at purchasing them.

Mr. MEEKS. Some data that I have seen and that we still see with a lot of the financial institutions, still in the year 2001, minorities with equivalent financial status as their white counterparts, are still being turned down.

And just indicating, what I'm trying to find out, I believe in your study, Shattered Dreams, you also indicated that the GSEs have not done as much as they should to support minority home ownership, when I know also that, at least in my community, it seems as though a lot of individuals, a lot of minorities are being pushed toward the sub-prime lending market and/or for whatever the reason, advertisements or not feeling comfortable, being pushed toward the sub-primes.

And so, I know, therefore, you object to the GSEs moving into, if I understand right, moving into the sub-prime market. But if they are to increase their support of minority home ownership, wouldn't it then be a logical extension to go into the sub-prime market so that you're going after where African-Americans and minorities are going because of what the trend has been thus far?

And they've been paying much too much money in the sub-prime market now at any rate.

Mr. ROTHSCHILD. The fact is that HUD looked at this. They took out the sub-prime loans out of the analysis of the data that they analyzed, the HMDA data.

And they found that, in fact, taking out the sub-prime loans, the GSEs are still not doing as well as the private sector in making the loans to minorities, to African-Americans, to Hispanics and to low-income.

There are studies done just this past December by HUD that document that.

This study that was done on the City of Baltimore, and it's fairly thick, shows that really what takes place is that when the GSEs come into a community, they are sort of the bellwether.

They announce that if they're going to come into the community, the lenders follow and make those loans.

So you have to consider the role of the GSEs. They're two institutions. They buy most of the loans. They are the organizations, they're a duopoly that buy the bulk of the loans in the conventional conforming market.

That's the market they buy in.

Mr. MEEKS. Is that a good thing?

Mr. ROTHSCHILD. Is it a good thing that they buy loans?

Well, of course it's a good thing.

Mr. MEEKS. And the market follows.

Mr. ROTHSCHILD. FM Watch supports the fact that the GSEs are important to provide liquidity.

Go back to the CRA loans. If the GSEs bought more CRA loans, which everyone that I know from the housing community says is a good idea, then the banks would have more money to make more loans.

That's liquidity. That makes a lot of sense.

But they're not doing it. They're very, very limited in the amount of CRA loans they want to buy. They don't want to use their subsidy to basically buy the loans that the banks have subsidized in making CRA loans.

I think that's a very, very important issue. I'll give you another issue.

There are different definitions for CRA that define low- and moderate-income. They are lower than they are for the housing goals.

If the housing goals definition conformed to CRA, it would direct the GSEs to buy far more low-income loans, which would make a big difference in the amount of low-income loans they buy.

Mr. MEEKS. I want to follow up but I know that we're limited. I know that there's a vote coming up. But I want to just ask Ms. Paige a question also, real quickly, because I know that your organization says that it supports reasonable spending by the Government on behalf of the taxpayer.

And I've not been too long elected to Congress. But since I've been here, and you tell me whether I'm wrong or right.

Ms. PAIGE. You're right. You're right. Whatever it is, you're right.

Mr. MEEKS. It seems to me that GSEs have brought private-sector liquidity to the secondary mortgage market and a sound investment for its investors and industry leading management practices without the need for Congress to appropriate a dime for these organizations, which seems to be based upon what your organization stands for, a good thing.

So I was wondering, would your organization support such an innovation by Congress?

Ms. PAIGE. Thank you for the question, Mr. Meeks. And let me say that, without being too blunt about it, the GSEs are not private.

The last time I checked, private organizations don't have a $200 billion line of credit with the Treasury. They don't have board members who are appointed by the President. They don't get to borrow at preferred rates. They don't get tax exemption.

Most banks and financial institutions, mortgage bankers, they pay taxes.

There's a raft of benefits that the GSEs get that put them in a hybrid situation. They're half and half. They've got a charter that gives them special benefits that are worth a lot of money, whether you agree with Mr. Miller's analysis or the CBO's analysis.

It's a lot of money. It's billions of dollars.

As they do that, they put the taxpayers at risk. We're what stands behind them, basically, us taxpayers and the Congress of the United States.

So it isn't fully private. And so, we would want it to be fully private. And we're not suggesting that they would suddenly go away. What we're saying is that they would become players in the private market along with other players in the private market and there would be increased competition.

This is not as if—our suggestion would not suddenly make the GSEs disappear. They would become private organizations. They would compete with other private organizations.

We don't know what that environment would be like. But I would dare say that it would be more competitive than it is even now because right now they compete with each other and that's it.

Thank you, Mr. Chairman. I hope I answered your question.

Chairman BAKER. Mr. Meeks, if I may, let me get Mr. Ford's question on the record. And if you don't have to dash off, I want to engage with you. You make some excellent points and I want to provide a little explanation, if I may.

Mr. Ford.

Mr. FORD. Thank you, Chairman. Before I start, I see so many friends in the audience, the distinguished Mayor from Arkansas, from Little Rock, Ms. Shakelsford, my dear friend. And certainly, all of the panelists are wonderful people. But there's really a wonderful person on the panel from Memphis.

Chairman BAKER. Mr. Ford, since you're being so nice, please pull that mike close so that we can all hear you.

Mr. FORD. It's always good to see people from Memphis, Mr. Chairman, the President of the National Association of Realtors, my friend. We're delighted to have you here.

If I could, Mr. Chairman, I know that a lot of things have been said about minority home ownership.

FM Watch sounds so sinister, but those members of this organization who are here today to express their opposition to the GSE subsidy, FM Watch sounds a little—I think the people who make up the organization are good people. I disagree with them. I think you're wrong on this issue. But I hate to refer to you as FM Watch. But for lack of a better term. There's been a lot of talk about how minorities perceive, or blacks or Hispanics, perceive and there's been a lot of talk here about it.

I do hope that this subcommittee at some point will take up an issue that appeared on the front page of the *New York Times* over the 4th of July holiday, squeezing out some other news about a particular congressman here in the House that dealt with how Nissan might be charging higher finance rates to African American car buyers.

I hope it's an issue that the oversight investigations arm of our Committee will take up at some point.

In relation to that, I know that the National Black Caucus of State Legislators, as well as the chairlady of the Congressional Black Caucus, both issued statements regarding this hearing and the impact that the GSEs have had on minority home ownership rates over the past years.

And if I could submit them to the record I would appreciate it, Mr. Chairman.

Chairman BAKER. Without objection.

[The information referred to can be found on page 78 in the appendix.]

Mr. FORD. I guess my question, or my thoughts, I hope home ownership rates increase for everybody, not just black folks. I happen to be African-American, but I think it's a good thing when people own homes.

And as much as this debate may create a greater appetite for those in the financial services industry to provide opportunities for home ownership, it's a good thing.

Now for both sides to dual back and forth about who is doing more in the low-income and middle-income housing markets is a good thing because you both could be doing a lot better.

But to suggest that the GSEs have not provided enhanced opportunities for particularly black home ownership and home ownership in areas that have been overlooked by this market, I think is a little misleading.

I understand what my friend, Mr. Rothschild, who comes from a great organization himself that he's a part of, but I think it's important to recognize that Fannie Mae, as well as Freddie Mac, and I know the distinguished professor made some points with my good friend, Mr. Bentsen, who is far smarter than me talking about all these financial terms and all.

But I think his larger point is that I think it's hard to measure this in a zero-sum game, or hard to analyze or assess this from a zero-sum approach.

My great Chairman of this Committee, who understands these issues as well as anyone, whom I also disagree with, I think would also have to agree that, in large part, the GSEs have performed some good things for the economy and made possible home ownership opportunities for a lot of people who had been left out of the market and shut out of some of these opportunities.

It's important to note that the realtors, the homebuilders and a whole array of organizations who sometimes agree, sometimes don't agree, all agree that the GSEs have indeed provided a valuable part and an important part of home ownership growth across this Nation.

I guess my question would be directed to the professor and to Mr. Rothschild in particular.

FY Watch uses HUD studies to compare Fannie Mae to the primary mortgage market.

And forgive me for reading this. I'm not smart enough to understand this without being able to read this, Mr. Rothschild, so just bear with me:

"But there are serious issues with respect to HUD's methodology, including questions about the appropriate use of HMDA data, the importance of missing race data, and the treatment of sub-prime and manufactured housing lending.

"The correct comparisons show that probably over time, Fannie Mae has led or met the market in lending to low- and moderate-income households and to minorities."

Perhaps you can respond to that or correct me or correct the record as it relates to that issue. And I would love to open it up to the professor as well, if he would be so kind.

Mr. CARNELL. And since you mentioned FM Watch, let me just mention that there's somebody here representing FM Watch, and that's not me.

I have no ties to them.

Mr. FORD. They're not a bad group of folks to be associated with, but I appreciate your correcting the record.

Chairman BAKER. If you can withhold to say a couple of minutes, because I want to make sure that we wrap this up before the next vote occurs.

Mr. ROTHSCHILD. Sure. I would like to give my colleague here, who has been dying to make a comment, and it's a perfect segue because he did all the data work and can talk about the HMDA data.

Chairman BAKER. And please identify yourself for the record, sir.

Mr. TORNQUIST. My name is David Tornquist. I'm also a principal at Podesta Mattoon. I worked on the FM Watch study.

The criticism that you raise about the HMDA data has, of course, been raised by Fannie and Freddie in response to every study that has come out that criticizes their performance in the market.

HUD has looked at the criticisms that Fannie and Freddie have made of the HMDA data and they have issued a report back, I think it was 2 years ago, where they have said that Fannie and Freddie exaggerate the problems with the HMDA data.

And I would point out that they say that the HMDA data is acceptable to use to make assessments of the market shares of the GSEs' activities in the mortgage market, as well as the fact that HMDA is what HUD uses to enforce the affordable housing goals.

But also, I would like to point out that we did not just simply rely on the HMDA data. We also relied on the GSEs' own data. From the GSEs' own data, we got the same results that we got from the HMDA data.

So there shouldn't be a question of the accuracy of the numbers. You can argue about what you want to do about the numbers, but the numbers still show that Fannie and Freddie buy fewer loans from low-income people than from wealthier-income people and fewer loans from minority borrowers than they do from white borrowers.

Chairman BAKER. Anyone on the other side want to respond, or defense the data?

Mr. CARNELL. I would just note that the general point that's being made there about Fannie and Freddie doing proportionately less is consistent with the Federal Reserve's study by Canter & Passmore. It's consistent with the 1996 Treasury study, as well as with the HUD report.

One of the issues here is how much of the credit risk is being borne by Fannie and Freddie, as opposed to how much is borne by banks and thrifts.

And the conclusion of all of these three studies that I mentioned is that banks and thrifts were doing more to extend home ownership in the groups we're talking about here than Fannie and Freddie were.

And I want to note that that's all the more remarkable because Fannie and Freddie don't pay for their Government benefits, whereas banks do.

The net subsidy to Fannie and Freddie is significantly greater than the net subsidy to banks, if indeed there is a net subsidy to banks.

Mr. FORD. Mr. Chairman, I know that Mr. Miller addressed some of that in his remarks as well.

If the president would speak.

Chairman BAKER. We'll give a couple of minutes to both Mr. Edwards and Mr. Miller.

Mr. Edwards.

Mr. EDWARDS. Well, I think I'd like to comment back on what I mentioned a while ago. We continue focusing on just home ownership and buying loans and not buying loans and home ownership.

I've got to re-emphasize that Fannie Mae and Freddie Mac are also involved in rental housing. And that housing supplies housing for a lot of people that are not buying a home or are never going to buy a home.

Chairman BAKER. Do you know what the percentage of their business is represented by what?

Mr. EDWARDS. I do not know the percentage, but I will get it for you.

I do know in our market place, Mr. Chairman, that they have been very successful and a very big part of assisting us in rental housing renovation and what have you.

And so, I will get those numbers for you. But I think it's important for this group to know that we're not talking about just home ownership. We're talking about where people live in total housing.

Mr. ROTHSCHILD. And it's a very small percentage of their overall business, Mr. Chairman. And when they do get into multi-family type of housing, it's usually at the upper end rather than at the lower end.

Chairman BAKER. Mr. Miller.

Mr. MILLER. Let me say that, I won't take time now, but I might want to respond if you would allow, Mr. Chairman, in writing to the question of this vertical lending practice.

Chairman BAKER. Absolutely.

Mr. MILLER. Also, I want to take issue with Professor Carnell on the issue of to what extent the financial institutions, other financial institutions receive a similar benefit as bestowed upon the GSEs.

Chairman BAKER. Without question.

Mr. FORD. Would you summarize—I just think it's important, Mr. Chairman, that he be given one minute because that was at least part of your testimony that I had the opportunity to read.

You touched on that a little bit. And since I relish the opportunity to agree with you on something, Mr. Miller, I'd appreciate it if you would just give us a little, maybe a minute summary of what it is that you talked about in your remarks.

Mr. MILLER. It's worth noting our agreement, isn't it, Mr. Ford?

Mr. FORD. Absolutely.

[Laughter.]

Mr. MILLER. In my judgment, while the other financial institutions do pay fees for some insurance, they have other benefits bestowed on them.

If you will look in the second attachment to my testimony, there will be identification of some of those. I'd be glad to respond to you in writing about them.

But there are similar benefits that are received by the other financial institutions. And it goes to the point that I think you raised a while ago that I was going to respond to when I conceded back my time. Dr. Pearce and I believe that there is a similar benefit at each level of loanable funds that goes to the other financial institutions. They have an upward sloping supply curve, the GSEs have essentially a horizontal supply curve.

And for that reason, if you took away the so-called benefit from the GSEs, you would essentially have the financial institutions granting too many loans and the GSEs too few, and you would have an inefficient outcome in that case.

There is something that Mr. Bentsen, raised, and the argument that because of the support of the mortgage market, too much money, too many loanable funds are going into the mortgage market.

That is a very valid argument.

But I don't take issue with that in my analysis. It is a policy determination of the Congress whether to promote home ownership or not promote home ownership.

Chairman BAKER. Thank you, Mr. Miller.

Mr. FORD. Mr. Chairman, I think this is such a wonderful thing, regardless of what happens with the Committee. I do have my opinion on this.

But for poor people and low-income people and moderate-income people to force the attention of you incredible minds on this issue and to have the GSEs engage, and FM Watch engage.

When you pay attention to people in any market, good things can happen.

So on behalf of all the poor people in my district, I say, thank you, Mr. Chairman, and I thank those of you who are here because, in the end, those who want to own homes and who are willing to make the commitment, will indeed have that opportunity.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Ford. I just want to respond to the gentleman's observation, and that of Mr. Meeks as well.

I have concerns about the affordability for homes for working people. And I don't believe that any sector of the current financial system is doing enough.

On average, when you look at the portfolio of Fannie, Freddie, and a commercial bank, Fannie and Freddie will be somewhere below 5 percent of their portfolio fits the criteria of concerns you're looking at.

A similar analysis using the same standards through a commercial bank portfolio will be roughly 13 percent.

I don't think the argument today should be they're doing bad things, we're doing good things, regardless of the team. I think they both need to be doing better.

Let's take an example.

I'm a former realtor. Let's assume that a person wants to buy a $60,000 house.

To have a conforming loan means you've got to have a 20-percent downpayment, unless you want to have private mortgage insurance. A $60,000 house, you've got to have $12,000 cash for a $48,000 conforming loan balance.

Now I haven't in my real estate experience—you've got to add on 3 percent closing costs on average. The lawyers have got to get their cut.

So you're up to $15,000.

How many working families do you know who are buying a $60,000 house are going to put 15 grand into it? Well, they don't. They have to have special programs.

97 percent loan-to-value is a customary kind of program that Fannie has. It's a great program. They even have interest rate buydowns. You also have downpayment help programs.

If you live there long enough, you get credit each year for having lived there. You've got to go through a home ownership school.

Those are wonderful programs.

But Fannie and Freddie don't originate the loans. They buy the loans.

You go to your hometown banker. He fills out the mortgage application. He services it, takes your credit, all that, and then he cranks it into this mystical box that Fannie and Freddie have called an underwriting system.

All that means is you put the application in and if you don't come back looking right, you don't get approved. If you happen to have a septic tank on the property line, that's a non-conforming loan because it doesn't fit the secondary market criteria.

So there is a cookie cutter that stamps your loan. And if it fits, you get access to credit. If you don't, you're out.

So a lot of the independent community bankers who are portfolio lenders, they extend the credit because they know you. And they hold it 15, 20 years, and they manage the entire risk of that mortgage inside their bank, are relatively few.

On the other hand, when you go to Freddie Mac's own information sheet, which I found to be quite troubling, and I mentioned to the gentleman earlier in the day I wanted to get the response from Freddie, which they indicated it needed to be seasoned.

It would take 12 pounds of cayenne pepper to get this in good shape.

[Laughter.]

But I'm going to be looking at that response very carefully and I invite both gentlemen to sit down with me in a non-biased discussion of what these folks are really doing.

Let me tell you, if you get close to five, you're going to know you had something.

Now, in looking at this data, in describing the people I was just talking about, the ones you and I both think ought to get a better shake out of all of this, the loans according to their loan-to-value ratio range that are above 95 percent in loan-to-value, so that individuals putting 5 percent or less down, 3 percent closing close, that's somewhere manageable for a $65,000, $70,000 house.

Two percent of the portfolio. Two percent.

Now where is the rest of it going? Folks are getting loans below 70 percent of LTV. Or let's go to 80. 80 and down. That's the folks putting up the $12,000 on the $60,000 house and, frankly, that's not where it's happening. It's in the big-ticket houses.

You could come to Baton Rouge today, buy a $342,000 house, make that downpayment and have a $275,000 mortgage. That's a mortgage that Fannie and Freddie can buy. That's a conforming loan under the current rules.

73 percent of the portfolio, according to the Freddie Mac information statement, not CBO, not Treasury, not any irresponsible party, of their portfolio is made up in those loans.

That's my problem, guys.

We are paying a lot of money in a subsidy to provide a housing opportunity for low-income individuals and it ain't working.

Now on top of that, I'm not convinced that the safety and soundness questions are properly supervised. I'm willing to take anybody's deal on any front. If we can get the low-income portfolio percentages up to ten percent, sign me on. You all figure out what you want, I'm with you.

At the same time, we can figure out that the safety and soundness is there, so we have a secondary mortgage market security act, the worst thing in the world, for your interest, my interest, taxpayer interest, is to make the presumption that they are operating in a safe and sound fashion, don't do the due-diligence, and wake up one morning in a high-interest rate environment when they can't find a counter-party to hedge their risk, and we're all in the tank.

That's what it's about.

Now I appreciate you gentlemen staying for that explanation, because I've had frustration in trying to get folks to understand this is not all that I think it should be. And it's a very expensive delivery mechanism to provide a limited amount of benefit to the targeted community.

And I don't like it. I just knocked over my ice.

Mr. MEEKS. Let me——

Chairman BAKER. Yes, sir.

Mr. MEEKS. I haven't studied the report, but I don't know how much of that is bumped up by a city like New York City or Chicago or San Francisco.

Chairman BAKER. I think we ought to find out.

Mr. MEEKS. Where you can't buy a $60,000 house.

Chairman BAKER. Right.

Mr. MEEKS. And if you're going to buy a house generally in New York, even poor people, it has to be $200,000, $250,000.

Many times, it's a two-family home and so, therefore, they try to do what they have to do with the income from the two-family home, but that will bump up that price.

Chairman BAKER. I'm saying to the gentleman, let's find out.

Mr. MEEKS. In New York, that's what we're looking at doing.

Chairman BAKER. I'm saying, you may be right, I may be wrong, the old song.

I may be crazy, that's the next line.

But I think we owe it to ourselves to sit down, find some folks—if we don't trust HUD and we don't trust CBO, you tell me where we can find somebody we can talk to who's got real numbers and find out.

We owe it to ourselves to determine that.

Mr. Ford.

Mr. FORD. I couldn't agree with you more, Chairman. But one probably objective way, if we can use that term, and we've used it somewhat loosely here, is if we see home ownership rates increasing, isn't that somewhat of an objective indicator that maybe some of these efforts on behalf of the GSEs, as well as those in the FM Watch and all of the competitors of the GSEs, isn't it some indicator that perhaps the system is working?

I do think that Mr. Meeks' point is a valid one when you look at the price of the housing market in Washington.

Chairman BAKER. I won't dispute the gentleman. And I'm not saying that they are without merit or that they don't provide a service.

What I'm suggesting is that the service we get for what we pay may be not in balance, and that the percentages of resources that flow through to low-income families are not what they should be.

And I'll say it on the private side as well. I don't think either team is getting where they need to be in light of what we are saying as a congressional chartering operation, this is what you're in business to do.

Are you in business to make 22 percent rate of return on equity, one of the highest rates of return—always in the top 20 of the Fortune 500 and now the third and sixth largest assets corporations in the world.

I don't know what compensations look like over there. I'm sure they're probably all right.

But the point is that there may be a way to squeeze money out of that operation toward the intended purpose, as opposed to saying, we don't need to change anything. This thing's great.

Mr. FORD. But if they weren't making money, we'd probably hold hearings to bring them to task on that.

I hear you. I just think that at some point, that home ownership rates and whether they're going up or down has to be considered or weighed in a far heavier way than perhaps some of the things that——

Chairman BAKER. And the gentleman makes a great point. If this was 1979, we'd be having hearings because Fannie's insolvent.

It's happened. They were insolvent for 5 years.

So it's not something that can't happen. All we need to do is two things. Make sure we understand the risk, have a regulator we can blame so Congress isn't at fault, and encourage them to do the right thing by low-income individuals, and I go away.

[Laughter.]

But right now, we've got the worst of both worlds. They make a bunch of money. They don't help low-income folks. And we can't say for sure that it's not our responsibility.

I don't see how any Member of Congress could just take that pill.

Mr. FORD. Greg Meeks and I will sign on right away to the Richard Baker Immunity Act and GSE Failure right away to make sure that you're not responsible.

Chairman BAKER. Let me tell you, I'm going to sleep better tonight just because of that.

[Laughter.]

I want to cover one more thing before we call this thing to an end.

Mr. Miller, let's come at this horse from a different end. I'm going to suggest that they're well-managed, that they're highly profitable, no potential of risk, a model of business excellence that ought to be held up to the world, envied by all, showing the path to home ownership with floodlights on every corner.

It is an extraordinary model of business perfection in which I am in awe.

I would suggest that, however, there might be one group of four or five people—let's just say the homebuilders and the realtors get together, and they want to make application for a GSE charter.

Knowing that you are a Reagan Republican who believes fiercely in competition, what would be wrong with that?

Mr. MILLER. I would have no objection to that.

Chairman BAKER. Wonderful.

Mr. MILLER. But let me just say this. The problem that you have to address is the one that we talked about earlier briefly.

And that is, what signals you're giving to the market. To the extent that the market might interpret action by this Committee, whether it is to propose, for example, withdrawing the line of credit, which they don't use, anyway, or some other initiative as taking Draconian action with respect to the GSEs, that would harm markets, harm their ability to carry out their mission of increasing liquidity in the mortgage markets.

To the extent that the markets might view such an action that you just described as being the precursor of Draconian measures, that would harm markets and so, that would need to be avoided.

But in the abstract, as a thought experiment, I don't have any problems with that.

Chairman BAKER. Well, while I'm thinking about it, we do it all on the same terms and conditions, no special privilege. Whatever capital adequacy requirements, whatever regulatory oversight that appears to be so capable and efficient that we currently now have would be applied to the new applicants.

We could have Treasury review it, have the Fed review it, have everybody review it. But at the end of the day, having more competitive housing GSEs would drive the intended subsidy to the targeted groups and perhaps result in a more efficient and less costly and less risk exposure to the taxpayer.

And I want to explore that.

Mr. MILLER. That's where we would disagree. I do not believe that numbers are a necessary condition for competitive outcomes.

My view based on observations, some testing, is that these GSEs are quite competitive. There are 12 other home loan banks around engaged in similar kinds of activities. There are private entrepreneurs engaged in similar kinds of activities.

I don't think the addition of, as you characterize, another GSE or two GSEs or three GSEs, would change the behavior of the market very much.

Chairman BAKER. Well, let's look at it this way. If we only had two banks instead of 8500, somebody would call that a concentration risk.

If you had 12 GSEs instead of two, some folks might say that that might diminish risk. We wouldn't be creating new mortgage product because, as we all know, we have 70 percent home ownership only because of Fannie and Freddie. That can't possibly be improved on.

So what it might mean is that if a GSE offered a lower rate, there would be a little refinancing going on.

But let me ask—and I do have regard for your intellect on this matter. And any member of the panel who would choose to respond, or anybody else out there who wants to speak——

Mr. MILLER. Could I just clarify again, though?

I think the question of the signal you send to markets would be important. We're going to set that aside.

I don't have any reservation about your doing this as a thought experiment. But I would just caution—in my judgment, you would not change the behavior of the market. You would not, in the model that the CBO adopted and you implicitly seemed to be affirming, get more of this, "subsidy" passed along to consumers.

As you know, I have a very different perspective of how all of that works.

I don't think there would be improvements in the performance of that industry if you were to add another GSE.

Chairman BAKER. I'd just come at this very simply. If I'm in the suit-making business and I'm the only one in town and everybody's required to wear a suit, I figure I can charge what I want.

If some yahoo moves in down the street and makes a good-looking suit for about $20 less, I might have to start looking at my prices.

I may be wrong. But I'd like to request participants' recommendations, analysis of the concept. There are some academic papers of history out there on the subject.

I just want to thank everybody for their long-standing tolerance. No one would have expected that you would have been here, including myself, at this hour of the day on this subject.

I do appreciate very much your contribution and the two Members—yes, Mr. Meeks.

Mr. MEEKS. Mr. Chairman, Mr. Ford and I were just talking. We thought it would maybe a good idea for the CBO to do a study where you maybe take out the five largest markets and the five smallest markets and see then where we come with the median income, with reference to the cost of housing that Fannie Mae and Freddie Mac had.

Chairman BAKER. I don't have any problem with the gentleman's suggestion in getting a study. I suggest, based on reactions to the current study, we may want to get somebody else other than CBO or—and I'm serious.

Let's try to get folks that at the end of the day, there's not going to be people looking over their shoulder saying, this one doesn't make sense.

We'll talk. Let's try to come up with a way of putting this together. I didn't think Mr. Kanjorski's idea of a roundtable last summer was going to be that productive and I was wrong. It turned out to be real good.

This might be something where we might want to do a roundtable kind of thing later in the fall.

I think we owe ourselves an honest discussion about the benefits that accrue and where they might be going sideways. And if I'm wrong, I'll say so. I've been wrong before. I've got H.R. 1409.

I know I'm wrong.

[Laughter.]

I have two statements that I would like to introduce for the record. One is by Chairman Mike Oxley and the other is a statement by the Council of Federal Home Loan Banks regarding the subject matter of today's hearing.

Unless any Member has further comment—I've been reminded to announce that we will have, much to the dismay of many, another hearing on this matter later in the year, perhaps centered around the competitiveness concept, depending on the interim studies that may be engaged in.

But thank you for your—oh, yes. And we are very much interested in the Administration's position, once formulated, on the whole matter.

Hearing adjourned.

[Whereupon, at 5:37 p.m., the hearing was adjourned.]

A P P E N D I X

July 11, 2001

Opening Statement
The Honorable Richard H. Baker, Chairman
House Financial Services Committee Subcommittee on
Capital Markets, Insurance and Government Sponsored Enterprises
Hearing, July 11, 2001
"Reforming Fannie Mae and Freddie Mac"

I want to thank all of the witnesses appearing before the subcommittee today. We will hear from each of them their specific thoughts on legislative reform for Fannie Mae and Freddie Mac. But of more immediate concern is for them, particularly Fannie and Freddie, to comment on the recent study by the Congressional Budget Office (CBO), which reported that of the $10.6 billion annual federal subsidy they receive, the two companies and their shareholders retain for themselves an astounding $3.9 billion.

I hope that all members of the subcommittee, particularly those with strong concerns for the homeownership gaps among Hispanics, African-Americans, and lower-income Americans, would seriously consider the enormity of this retained portion of the subsidy. Rather than killing the messengers, be it their "methodology" or their "motive," consider the message: think about how much good this $3.9 billion could do for the lives of your constituents desperately in need of homeownership opportunities to be opened for them.

Congress helped create the subsidy so that the whole of it would pass through to assist these traditionally underserved homebuyers, not to be divvied up for the sake of doubling the annual profits of the government-sponsored middlemen. The main point we should be debating, I believe, is what kind of bipartisan reforms we can adopt to ensure that as close to 100 percent as possible of the subsidy passes through to the people its meant for.

Over the last several weeks I have been intrigued to consider an almost unanimously agreed upon solution in reports and commentary I instructed my staff to explore. Last month the Federal Reserve released a paper showing, in short, that Fannie and Freddie lower mortgage rates and hence benefit homebuyers only to the extent that they act competitively. Further, in the CBO's defense of their subsidy study, they also conclude that the percentage of the subsidy Fannie and Freddie pass through to homebuyers is directly related to the extent to which they compete against each other.

These commentaries led us to take a second look at a letter Chairman Greenspan sent last year. And it turns out he also expresses the notion that one of the main factors contributing to how well the subsidy helps lower mortgage rates is determined by the GSEs themselves and how intensely they compete with one another.

I ask members to consider, with genuine agreement that we are not trying to take anyone down but instead want good policy on our side to help more people. *If we all agree on the point that what the housing GSEs do is important and valuable, why not create more of them?* Both the Federal Reserve and CBO, while not advocating any policy, seem to be suggesting that Fannie and Freddie would perform even better if faced with real competition.

I have to confess that I am not yet fully sold on this idea because of my concerns about how it might help solve safety and soundness problems and the growing threat of taxpayer risk. On the other hand, I am willing to consider that the purely regulatory route may not be ambitious enough in scope, and there may be creative alternatives that help us address the whole host of issues surrounding the GSEs. I assume a certain amount of openness for entertaining market-oriented competition solutions from my Republican colleagues. But I would particularly invite, on the other side of the aisle, ranking member Kanjorski and perhaps members of the Congressional Black and Hispanic Caucuses, to work with me to see how this concept of enhancing secondary-mortgage-market competition could help address their concerns for the various homeownership gaps.

We will hear today from a Democrat former Treasury official who will discuss problems he has discovered with the housing GSEs' mission and safety and soundness. We will also hear from a Democrat who on behalf of Fannie's and Freddie's competitors will tell us about further problems the GSEs seem to have in channeling even that portion of the subsidy that passes though to mission-targeted homebuyers.

Both of these witnesses attest to the reality that GSE reform can be a bipartisan issue. In fact, I was led to ask their presence here today to see, in the context of discussing H.R. 1409, whether the bill meets the standards of another Democrat former administration official, Mr. Frank Raines, who before this subcommittee last year posed the following four questions as a litmus test for good legislation:

1) Does it reduce costs for consumers? 2) Does it improve the safety and soundness of the housing finance system? 3) Does it expand opportunities for homeownership? 4) Does it allow innovation in the market without cumbersome regulatory requirements?

The CBO report demonstrates that all four of these goals do in fact need improving. To the extent that my bill may focus too strongly on the safety-and-soundness point, while additional creative remedies like the increased competition concept may help address the other three, I am open for discussion. Indeed, over the coming months I will be seeking opinion about these matters from many people, including the current administration.

These matters are too important, the opportunities too great, for us to remain silent while faced with the need for real reform, and I for one will be continuing this effort for as long as it takes to bring about the best possible public policy for American homeowners and taxpayers.

Congressman Harold Ford, Jr.
Capital Markets Hearing on GSE Reform
July 11, 2001

Fannie Mae and Freddie Mac were chartered by Congress to ensure that Americans have access to mortgage funds at the lowest cost. On a daily basis, Fannie Mae and Freddie Mac fulfill their mission by helping millions of Americans achieve the dream of homeownership.

We are here today to discuss both Chairman Baker's proposed legislation, HR 1409, and to revisit the recent CBO Study on the benefits Fannie Mae and Freddie Mac receive as a result of their status as GSEs.

HR 1409 would represent a dramatic change in the current regulatory structure of Fannie Mae and Freddie Mac – a change I believe is unnecessary and unwise.

Chairman Baker's proposal will shift authority over Fannie Mae and Freddie Mac to a single regulator -- the Federal Reserve Board. While HUD will retain its regulatory power over fair lending and affordable housing goals, the Fed will have significant powers to second-guess HUD with respect to those housing goals.

The Fed will also have the power to make unilateral decisions as a regulator. As an independent agency, its regulations are not reviewed by OMB, nor are its regulations reviewed by either body of Congress, as are those of HUD.

Moreover, the Fed has no familiarity with housing needs and no particular commitment to advancing affordable housing. Finally, it is unclear whether the current Board of the Federal Reserve even supports this significant change to the its regulatory structure.

Fannie and Freddie are safe, sound, and well-run institutions that are continuing to achieve their congressionally-chartered mission of bringing down the cost of homeownership. Our system our housing finance is the envy of the world. 68 percent of Americans own their own homes. And while we still have work ahead of us in advancing homeownership among minority families, the African American and Hispanic homeownership rate are at their highest levels ever.

We are on the right track, and we should stay on that track.

As for the CBO study, at our last hearing it was shown that the study suffers from several fundamental errors. It seems to be based on a methodology predesigned to produce a desired result. In sum, the CBO study overestimates the advantages of the GSE charters while dramatically understating the benefits the GSEs provide to American homebuyers.

From the perspective of America's mortgage-paying families, the benefits of Fannie Mae and Freddie Mac are evident in the thousands of dollars they save in payments and the fact that many of my constituents can get a mortgage at all. Fannie and Freddie save America's families thousands of dollars on mortgage payments without a penny of government appropriations.

Taxpayers can only dream that there were more institutions like Fannie Mae and Freddie Mac.

The contributions of the GSEs are evident in my state of Tennessee, where Fannie Mae is fulfilling a five-year, $7 billion commitment. They are evident in the Orange Mound community in Memphis, where Fannie Mae has worked with MemphisFirst Community Bank to finance the construction of a new, safe and affordable homes. While the neighborhood residents and the Orange Mound CDC have made the plans, Fannie Mae was the catalyst. Fannie Mae has also made substantial investments in the Uptown Memphis Project, partnering with St. Jude's Hospital and others to leverage the economic resources of the community.

In Memphis and in communities across the nation, Fannie Mae is on the side of healthy communities and affordable housing.

That said, I welcome the opportunity to discuss Fannie Mae and Freddie Mac's crucial role in housing and homeownership. While I look forward to hearing again from the representatives of Fannie Mae and Freddie Mac, I am especially looking forward to hearing from their critics.

Fannie Mae and Freddie Mac play an important role in the US housing market. Largely because of the importance of the positive role they play, they are constantly subject to criticism from organizations like FM Watch and Citizens Against Government Waste.

When I hear some of these criticisms, I ask myself the question, "Just what is FM Watch doing to increase affordable housing opportunities for my constituents?" That is the kind of question we should be asking at these hearings.

Thank you Mr. Chairman.

THE NATIONAL BLACK CAUCUS
OF STATE LEGISLATORS

Rep. James L. Thomas, AL
President

For Immediate Release

Contact: LaKimba DeSadier, NBCSL
202-6245457

Joint Press Release
of the
The National Black Caucus of State Legislators (NBCSL) Opportunities Industrialization Centers of America (OIC),
and,
the World Conference of Mayors (WCM)

Washington, D.C -- A few days ago NBCSL, OIC, and WCM unanimously passed a Resolution in support of Fannie Mae and its tremendous initiatives aimed at increasing affordable housing for their constituents.

"I am extremely proud that our members have collaborated with members of two national organizations to affirm our collective support for Fannie Mae," said Rep. James Thomas (AL), NBCSL President. "We already know that Fannie Mae is the single largest private source of home financing for African Americans. We already know that Fannie Mae is the largest source of home financing for low-income Americans. NBCSL, OICA, and the WCM applaud Fannie Mae's continuing commitment to expand home ownership in our communities," Thomas said.

Members of all three organizations collectively refuted any suggestions that Fannie Mae has done anything other than an outstanding job in fulfilling its chartered mission. "NBCSL members are well aware of Fannie Mae's 10-year, $2 billion American Dream Commitment," Thomas said. "Under Frank Raines, Fannie Mae has surpassed its own goals in recent years, and those goals were lofty. I find it personally appalling that other companies employ lobbying groups to distort Fannie Mae's record by providing faulty studies that misrepresent and distort Fannie Mae's efforts. Tearing down barriers to homeownership, so that all Americans who want to can achieve the dream of homeownership, is Fannie Mae's goal. Our organizations stand together to be a voice of reason and support for Fannie Mae as a vital institution and one that is fulfilling its mandate."

#

Congresswoman

Eddie Bernice Johnson

News Release

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CONGRESSWOMAN JOHNSON VALUES THE CONTRIBUTIONS MADE BY FANNIE MAE REGARDING COMMUNITY EMPOWERMENT

FOR IMMEDIATE RELEASE
June 27, 2001
Contact: Cedric Mobley at (202) 225-8885

Washington, DC—Congresswoman Eddie Bernice Johnson (D-TX30), Representative from Texas District 30 and the Chair of the Congressional Black Caucus (CBC), today reacted to recent negative comments by FM Watch related to Fannie Mae and Freddie Mac. She reiterated her belief that government sponsored enterprises, such as Fannie Mae, provide a tremendous service to the entire American population. She continues to support those organizations based on her belief that they help to ensure that low and moderate-income families can purchase homes. She has previously questioned a Congressional Budget Office Study critical of Fannie Mae and Freddie Mac "government subsidies."

"The percentage of minority communities who own homes is still far too low," said Congresswoman Johnson. "All financial institutions can upgrade their outreach and support for minorities who seek to buy homes. Fannie Mae and Freddie Mac, however, have done much more than most to make home ownership a reality. I have to question the sincerity of organizations that attack Fannie Mae and Freddie Mac and ask what the attacking organizations have done to advance home ownership. Fannie Mae and Freddie Mac are the largest source of home financing for poorer Americans and Americans of color. They have made commitments to do even more and, unlike some other organizations, Fannie Mae and Freddie Mac consistently back up their commitments with action. I know that those two organizations work extremely hard to empower the dreams of District 30 residents and the dreams of my colleagues' constituents."

"Recently, Members of the CBC joined with Fannie Mae, Freddie Mac and the Congressional Black Caucus Foundation (CBCF) to announce the CBCF's W.O.W. initiative (With Ownership, Wealth). This initiative, which is being launched in the districts of the 38 CBC Members, is designed to add one million new African-American families to the home ownership rolls by the year 2005. My minority constituents know that they have a harder time getting loans than members of other ethnic groups. Statistics show that blacks and Hispanics are underrepresented as homeowners. I applaud the efforts of all partners in the W.O.W. initiative. Fannie Mae is a major partner and I encourage others to join in similar efforts. Until all relevant parties are engaged, we need to figure out how to support institutions like Fannie Mae and Freddie Mac, who are working to fulfill federal mandates designed to help everyone in this country achieve the American dream. I encourage FM Watch to work as hard as Fannie Mae does to help empower families.

Congresswoman Eddie Bernice Johnson is serving her fifth term representing the Thirtieth Congressional District of Texas. She is the highest-ranking Democratic Member on the House Committee on Science Subcommittee on Basic Research, and the highest-ranking Texan on the House Committee on Transportation. She is Chair of the Congressional Black Caucus for the 107th Congress and named by Ebony Magazine as one of the Ten Most Powerful African-American Women in the country. ###

HAROLD E. FORD, JR.
9TH DISTRICT, TENNESSEE

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July 30, 2001

Mr. Franklin D. Raines
Chairman and Chief Executive Officer
Fannie Mae
3900 Wisconsin Avenue, NW
Washington, DC 20016-2892

Dear Chairman Raines:

I am writing to seek clarification on several points raised during the July 11 hearing of the Financial Services Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises.

In a discussion of the Fannie Mae and Freddie Mac's contribution to affordable housing, Subcommittee Chairman Richard Baker made a series of assertions about the size of Fannie Mae and Freddie Mac's average loan purchases, the loan-to-value ratios reflected in the mortgages that Fannie Mae and Freddie Mac purchase, and about the companies' service to low- and moderate-income households.

In debating the critical issues relating to Fannie Mae and Freddie Mac's contribution to affordable housing, it is important that we use objective and accurate statistics. Can you clarify for me the figures Chairman Baker cited in the hearing around average loan size and the loan-to-value ratios for loans that Fannie Mae purchases? Can you also provide information about the percentage of Fannie Mae's business that is invested in mortgages to low- to middle-income Americans?

I look forward to your response.

Sincerely,

HAROLD FORD, JR.
Member of Congress

FannieMae

Franklin D. Raines
Chairman and
Chief Executive Officer

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202 752 7380
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July 31, 2001

The Honorable Harold E. Ford, Jr.
United States House of Representatives
325 Cannon House Office Building
Washington, D.C. 20515

Dear Representative Ford:

I would like to thank you for your letter asking for clarification on certain issues that arose during the July 11th hearing of the Financial Services Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises.

It is my understanding that one of the issues that arose at that hearing concerned the size of the mortgage loans that Fannie Mae purchases. As you know, our Congressional charter restricts the maximum size mortgage we can purchase nationally to a conforming loan limit that is adjusted annually based on an index published by the Federal Housing Finance Board. This loan limit is known as the conforming loan limit and Fannie Mae is prohibited from buying loans above this amount. In 2000, our conforming loan limit was $252,700 for a single-family, one-unit home; in 2001, the conforming loan limit is $275,000.

However, it is important not to confuse the conforming loan *limit* with the average size of a loan that we purchase. In 2000, for example, the average size of a loan purchased by Fannie Mae was $120,023. If one considers Fannie Mae's entire book of business the average outstanding principal balance per loan is $96,240.

I would also like to clarify that Fannie Mae purchases a large number of loans with loan-to-value ratios greater than 80 percent. At that hearing it was stated that Fannie Mae only purchases loans that require 20 percent down payments. Last year, we purchased $69 billion in loans with LTVs greater than 80 percent – 31.2 percent of Fannie Mae's total single-family business. Moreover, we have been an industry leader in advancing very low-down payment lending. As an example, in MyCommunityMortgage – an on-line service to support lenders' CRA efforts – we now have loan products available with 100 percent LTVs. Last year alone we purchased nearly $6 billion in high LTV loans, loans with less than 5 percent down.

This pattern is also shown in the data for the 9th Congressional District in Tennessee. In 2000, the average size of an owner-occupied, first mortgage loan that Fannie Mae purchased in your Congressional District was $103,629. For the entire Fannie Mae book of business in your district, the average outstanding loan balance is $70,018. In 2000, Fannie Mae purchased $160 million in loans in your district, with 40.5 percent having loan-to-value ratios above 80 percent.

Your letter also asks about the percentage of Fannie Mae business serving low- and moderate-income households. In its regulation of Fannie Mae's affordable housing goals, the Department of Housing and Urban Development (HUD) sets a low- and moderate-income housing goal for Fannie Mae measured as a percentage of the total units – both owner-occupied and rental – that Fannie Mae finances in a single year. In 2000, 49.5 percent of the total units Fannie Mae financed served low- and moderate-income households – greatly exceeding the goal for that year of 42 percent. To my knowledge, no large commercial bank could meet this standard.

Thank you for your interest in this matter. I hope that the information we have provided to you is useful.

Very truly yours,

FDR/wmh

Opening Statement of Congressman Rubèn Hinojosa
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing on the Regulatory Reform For The Housing Government Sponsored Enterprises

WEDNESDAY, JULY 11, 2001

Mr. Chairman, thank you. I welcome the opportunity to address the Subcommittee on the important topic of housing and the role played in housing finance by Fannie Mae and Freddie Mac. I take particular interest in today's hearing because of the far-reaching ramifications of this Subcommittee's Action.

There are a handful of issues that most profoundly affect the quality of all of our lives: housing is certainly high among that list. Homeownership and affordable housing is central to the fabric of a community and to building wealth and security among our constituents: real people, with real hopes, dreams and needs -- people seeking to fulfill their desire for a piece of the American dream. The question is how and who is getting it done?

In that vein, I thought it would be helpful to share my experience with Fannie Mae and the work they have been doing in my district. After all, we can talk about affordable housing and getting people in homes, but the real goal for all of us is to make it happen.

Last fall Fannie Mae and the National Association of Hispanic Real Estate Professionals launched a "Close the Gap" campaign. That campaign is intended to address the homeownership gap between the U.S. population at large and Hispanics and African Americans. The Anglo homeownership rate is currently estimated to be 73.9% outpacing the Hispanic and African American homeownership rates by as much as 26.4% and 26.1%, respectively.

To diminish that gap in my district alone Fannie Mae:

-- This Spring provided $29.4 million in mortgage financing to 352 families to help ensure that home mortgage money was available – at the lowest price;

As of March 2001, Fannie Mae has bought or guaranteed $606.9 million in mortgage loans with 10,443 families served.

Mr. Chairman, as a former business owner I know that for Fannie Mae housing is good business. Its charter as drafted by Congress was designed to give it specific competitive advantages as well as restrictions. As an elected representative I know that my constituent's housing needs are being addressed by the diligent work of Fannie Mae and Freddie Mac.

-- Can GSEs do more? Certainly —and I will continue to call on them to do so. Likewise, as a purchaser of mortgages Fannie Mae and Freddie Mac need the primary market to generate those loans. I will, therefore, look to lenders to keep pace with changing demographics and the credit needs of our communities.

-- Should they be carefully regulated? Absolutely. But let's give HUD and, especially OFHEO, a chance to do its work without the Congress seeking to change regulators. For instance, I am very hopeful that Secretary Martinez can make good on his personal commitment to raise homeownership rates among Hispanic and African American families, a plan that relies greatly on Fannie Mae and Freddie Mac being able to continue their work.

-- Should they be more active in the Subprime lending market? Without doubt, we should insist upon it. We should not tolerate otherwise creditworthy individuals, often the most vulnerable members of our society getting steered toward loans with interest rates that are often 4-5% higher than loans for which they would otherwise qualify -- just because lenders prey on the uneducated financial consumers.

I would like to see this Subcommittee move beyond alleging the improper conduct of Fannie Mae and Freddie Mac, for they are only conducting business in the fashion that is certain to close the gap between minority and general housing ownership. Which at present time has the Hispanic community trailing the market with a home ownership rate of 47% compared to 67% percent overall.

Instead, I would like us to discuss how Fannie Mae and Freddie Mac heavily invested into the subprime lending market and has driven out predatory lenders and will continue to invest in this market until predatory lending is out of existence.

That, Mr. Chairman, is what we should be doing in this Subcommittee—addressing issues of affordable housing, predatory lending, housing stock shortages and meaningful issues that are keeping our constituents from achieving their dreams.

I look forward to working with you and my colleagues on those issues in the future. Thank you.

OPENING STATEMENT

H.R. 1409, Secondary Mortgage Market Enterprises Regulatory Improvement Act
Rep. Stephanie Tubbs Jones

Good Morning, Chairman Baker, Ranking Member Kanjorski and Members of this Committee. Mr. Chairman, I ask unanimous consent that my full statement be included in the Record.

Mr. Chairman, we are here this morning to review another bill, H.R. 1409, that seeks to strengthen federal regulation and supervision of Fannie Mae and Freddie Mac. Many of us have been here before.

We started with safety and soundness, then to transparency, mission creep, validation of subsidies to strengthening federal regulation. I want to note, at the onset, that I feel that it is imprudent to offer new regulatory regimes when we have not allowed the existing schemes and processes to work. On what basis do we abandon ship on HUD and OFHEO to set sail in new, untested waters with the Federal Reserve Board.

Mr. Chairman, I do not support efforts to increase the regulatory burden placed on GSEs, burdens that will ultimately be passed on to consumers. If the information suggests GSEs have not done what they are required to do, let's fix it and move on. If the GSEs, however, are on track and are accomplishing their mission, again, let us move on.

My concerns relative to this legislation are many. Primarily, I fail to see the need to transfer housing policy to the Federal Reserve Board. I believe the Fed has enough responsibilities in simply handling monetary policy and working with banks relative to improving CRA.

Moreover, this bill grants HUD authority over GSE housing goals, while yet basically transferring all housing powers to the Federal Reserve. It provides "bank" regulator extensive powers over housing in approving new GSE business activities. These new powers do not mesh with me. What historical knowledge does the Fed possess that will make it more effective in addressing housing issues of low-to moderate income persons and minorities. In essence, the Fed is an inappropriate regulator.

Many of us, on this committee, remember and sat through eight previous GSE hearings in which we examined, with great detail, Fannie Mae and Freddie Mac. From those hearings, we examined safety and soundness to an exhaustive length.

Afterwards, Fannie Mae and Freddie Mac pledged themselves to six Voluntary Commitments. For every one of these commitments, Fannie and Freddie have either completed or will complete. These commitments put them at the forefront of financial services organizations.

Mr. Chairman, I fear that H.R. 1409 does little to help or improve upon the GSEs ability to fulfill their housing mission. Their mission is an important mission. I am not as concerned about market share wars, but I am concerned about affordable housing in the 11th Congressional District, special housing needs of the elderly, and homeownership for those still seeking the American dream.
Housing, Mr. Chairman, is still a key public policy concern. Despite the pundits who claim that we do not need to improve homeownership rates, I believe the opposite. GSEs were established to address these problems. Let's let the process work.

I realize Mr. Chairman that putting a family into a home is much more mortgage origination, automated underwriting systems or implicit/explicit relationships. Putting a family into a home provides a family with, in many instances, its first real asset or even provides a legacy for future generations. Homeownership, I believe, is one of the key first steps to true empowerment.

Mr. Chairman, I believe in the importance of safety and soundness, disclosure and market discipline. I believe the GSEs have met this challenge. Eventually, Mr. Chairman, our GSE review becomes counterproductive. I am sure, in light of predatory lending abuses, insurance abuse and financial scams impacting citizens and pension plans, there are other critical areas ripe for our subcommittee's review.

Do not misunderstand me. I have greatly appreciated the process of reviewing institutions that play very critical roles in financial services and capital markets. But, I do not know of any other entity that have received this amount of attention and yet, have shown they operate within charter and mission and are sound operationally.

I hope that our review this afternoon serves to clear the record about GSE safety and soundness. I realize that there is much more to be done by GSEs. While homeownership rate sit at or around 67%, there is still room for improvement for those left out of this nation's prosperity. Let them improve.

I am glad today that we have representatives from the GSEs to make their own case. I want to extend a welcome to Timothy Howard, Executive Vice President and Chief Financial Officer, Fannie Mae and Mitchell Delk, Senior Vice President, Government Relations, Freddie Mac. I look forward to their testimony as well as testimony from individuals on the second panel.

Thank you, Mr. Chairman, for the opportunity to present my remarks. I look forward to this hearing.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON REGULATORY REFORM FOR THE HOUSING GOVERNMENT SPONSORED ENTERPRISES

WEDNESDAY, JULY 11, 2001

Mr. Chairman, since we began our extensive examinations into government-sponsored enterprises, or GSEs, sixteen months ago, we have met nine times to discuss these matters. I suspect that very few other entities have received such scrutiny in either the 106th Congress or the 107th Congress, particularly without corresponding legislative action. During our numerous hearings, although I have consistently sought to identify the problems posed by GSE performance and regulation, I have so far concluded that no compelling reason exists for pursuing any legislation affecting them at this time.

Nevertheless, our inquiry today will focus on two issues. First, we will again discuss the study compiled by the experts at the Congressional Budget Office on GSE subsidies. As we learned in May, Fannie Mae and Freddie Mac pass on about two-thirds of their federal subsidies to homebuyers in the form of lower mortgage prices, and this report confirms that the GSEs are performing a function that Congress wants them to perform. Namely, they are working to help lower homeownership costs at no real cost for the federal government. In return, the GSEs' stakeholders receive a share of the federal subsidy to provide a financial reward for their efforts.

Our second topic concerns H.R. 1409, the Secondary Mortgage Market Enterprises Regulatory Improvement Act. This bill would dramatically restructure the current regulatory system for Fannie Mae and Freddie Mac. In my opinion, it also represents a solution in search of a problem. Nearly a decade ago, Congress created a rational, reasonable, and responsive system for supervising GSE activities, and that system with two regulators is operating increasingly effectively. H.R. 1409 would unfortunately interrupt this continual progress.

Yet, some have continued to suggest that in order to avert another savings and loan crisis we must act now to change the GSEs' regulatory structure. In studying H.R. 1409, we should therefore review the lessons learned from that debacle. This examination will help to ensure that we do not create another troubling situation requiring bailout legislation.

Before FIRREA we had a federal board concurrently serving as the chartering authority for some depository institutions and as their chief regulator. This same board also served as the operating head of a depository insurance program and supervised the activities of some housing GSEs. During our extensive deliberations over FIRREA, we determined that this concentration of powers contributed significantly to the savings and loan crisis. Consequently, we separated these overlapping regulatory functions when restructuring the industry.

However, by moving the supervisory responsibility over the GSEs to the Federal Reserve, H.R. 1409 would again concentrate regulatory power in one entity and ignore an important lesson of the thrift crisis. After all, the Federal Reserve, like the old Bank Board, already has chartering and regulatory authority over depository institutions. In addition, it develops and oversees many of our nation's consumer laws, and it received significant new responsibilities in the financial modernization law.

Further, although it does not oversee deposit insurance, the central bank does manage our nation's monetary policy. As a result, in times of hardship the Federal Reserve might turn to GSE securities to help it manage interest rates and the money supply. That combination of conflicting duties could prove very dangerous, and Congress should avoid creating it. In other words, we should not follow the same legal recipe that led to the thrift crisis.

That said, Mr. Chairman, I am pleased that we worked together to put forward a balanced panel for today's hearing. Fannie Mae and Freddie Mac will have an opportunity to educate us about their concerns related to the CBO study and H.R. 1409. We will also -- for the first time -- finally hear from an individual representing FM Watch, which was noticeably absent from last year's GSE roundtable. I additionally look forward to hearing the opinions of Martin Edwards with the National Association of Realtors and James Miller who headed the Office of Management and Budget during the Reagan Administration.

Several others also wanted to participate in today's hearing, but could not do so. The National Association of Homebuilders, for example, supports a strong GSE regulatory system that balances safety and soundness concerns with mission fulfillment. Like me, it believes that the separation of powers among two regulators in the current system meets these objectives. The Homebuilders have expressed additional dismay that H.R. 1409 "ignores the extensive hearing record of the past year" and that it "exacerbates" the concerns that the group articulated about H.R. 3703 in the 106th Congress. AARP, a number of mayors, and others have also contacted me to express apprehensions about H.R. 1409. To ensure that our hearing reflects these views, I ask unanimous request, Mr. Chairman, to submit these materials into the record.

In closing, Mr. Chairman, I share your desire to conduct effective oversight over the housing GSEs and to ensure that we maintain an appropriate and sufficiently strong supervisory system. If we decide to continue to pursue GSE reform in the 107th Congress, I also hope that we will follow a prudent course. Perhaps we could again use a roundtable discussion to identify the problems among the affected parties, reach consensus about a suitable course of action, and then, only if necessary, work to write legislation.

AARP

May 22, 2001

The Honorable Paul E. Kanjorski
Ranking Member, House Subcommittee on Capital Markets,
Securities and Government Sponsored Enterprises
2353 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Kanjorski:

When we met earlier this year we discussed AARP's interest in ensuring that Fannie Mae and Freddie Mac are held accountable for maintaining the best possible safety and soundness business practices. Since we met, the Subcommittee held another hearing (March 27th) which purpose was to confirm that the voluntary agreement reached last year with Fannie Mae and Freddie Mac (to enhance their capital strength, disclosures and market discipline) was being implemented. While continued diligence will always be required, the Subcommittee has clearly been successful in improving these GSE practices.

We also discussed how important it is that reform of the GSE regulatory structure be considered in the context of maintaining Fannie Mae and Freddie Mac's critical public mission -- to expand the supply of affordable mortgage credit in order to stimulate the production of housing for underserved low and moderate income Americans. In addition to constant Congressional and regulatory vigilance, this important public commitment requires sufficient financial capacity.

AARP's members are directly affected by the housing finance industry by virtue of being housing consumers (renters as well as owners), as federal taxpayers, and importantly, as a source of market investment. For both our working as well as our retired members, equity in their homes is often the single-biggest source of wealth creation. Some come to rely on reverse mortgages financed by Fannie Mae and Freddie Mac as a way to tap that equity while remaining in their homes.

With respect to the latter role, many of our members look to mutual funds that include Fannie Mae and Freddie Mac mortgage-backed securities as part of their retirement income planning. Many of our members invest in Fannie Mae and Freddie Mac bonds because of their safety and reliable income. The importance of these GSEs to the maintenance of a healthy and reliable mortgage credit market can be seen, when:

- Inside MBS & ABS, a trade publication, estimates that the total value of mortgage-backed securities (MBSs) outstanding, from all sources, as of mid-year 2000 was $2,783.4 billion;

- Inside MBS & ABS also estimates that $269.0 billion worth of MBSs were held by public and private pension funds.
- The FY 2002 Appendix to the President's Budget proposal reveals that for mid-year 2000, Fannie Mae or Freddie Mac guaranteed over 55 percent of all outstanding MBSs;
- It is evident from a simple cross-reference that pension fund holdings of housing GSE MBSs are sizable; and
- Fannie Mae and Freddie Mac corporate securities, in addition to the mortgage-backed securities that they back, are widely held by many portfolio managers.

We understand that Chairman Baker is scheduling another Subcommittee hearing in the near future to consider his revised regulatory proposal, the "Secondary Mortgage Market Enterprises Regulatory Improvement Act" (HR 1409), in light of the Congressional Budget Office's release of current subsidy estimates for the housing GSEs. As the subcommittee considers changes to established housing GSE business practices we urge that it bear in mind the potential impact on retiree pension fund stability -- to the extent they have significant positions in GSE instruments – as well as on individuals with retirement income based on direct GSE investment. It has been reported that during the past year (2000) statements regarding restructuring Fannie Mae and Freddie Mac business practices, have had a negative effect on their stock prices, and increased their cost of borrowing.

With the reduction in the availability of U.S. Treasury securities (through the federal government's debt reduction program) housing GSE securities will likely play a greater role. We hope that caution will be exercised during these deliberations, and in making any determination to redefine or restructure the basic housing GSE business model so that unintended effects are avoided.

AARP supports the effort to shape a streamlined and effective regulatory structure for the housing GSEs. The issues and scenarios being considered by the Subcommittee regarding proposed regulatory changes to the secondary mortgage markets, require a balanced examination of the likely impact that the proposed changes will have on housing consumers, federal taxpayers and the full range of investors.

We appreciate the opportunity to have discussed these important issues with you, and we look forward to working with you, Chairman Baker, and the other members of the Subcommittee to accomplish our shared goals. If you have any questions, please do not hesitate to contact me at 202-434-3750, or have a member of your staff contact Roy Green of our Federal Affairs staff at 202-434-3800.

Sincerely,

Martin Corry

Martin A. Corry
Director
Federal Affairs

BARBARA LEE
9TH DISTRICT, CALIFORNIA

COMMITTEES:
FINANCIAL SERVICES
Housing and Community Opportunity Subcommittees
Domestic and International Monetary Policy
INTERNATIONAL RELATIONS
Subcommittee on Africa

Congress of the United States
House of Representatives
Washington, D.C. 20515-0509

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May 1, 2001

The Honorable Richard Baker
Chairman
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515-6050

Dear Chairman Baker:

I would like to provide comment on Chairman Baker's legislation that would move the regulatory control over Fannie Mae and Freddie Mac from OFHEO and HUD to a single regulator - the Federal Reserve. I support any initiative to expand home-ownership, but this proposal would not achieve that goal.

First, as a regulator, the Federal Reserve, unlike HUD, has unilateral authority and is not subject to oversight by either Congress or the OMB. This will allow the Fed to exercise independent authority with virtually no oversight and no review. Second, as the mission regulator of Fannie Mae and Freddie Mac, the Fed would be exercising authority over an area in which it is entirely unfamiliar. The Fed has never regulated housing nor has it shown any commitment to advancing affordable housing – the mission of both Fannie Mae and Freddie Mac.

Fannie Mae and Freddie Mac are committed to helping all Americans, especially low-income and minority families, achieve the dream of homeownership. While these two companies have made significant gains in the past few years in increasing homeownership opportunities, there is still much more to do.

The homeownership rate among minorities in the U.S. is significantly lower than the national rate of 67.5%. In the fourth quarter of 2000, the homeownership rate of African-Americans in the U.S. was <u>under</u> 50 percent, at 47.8 percent. Similarly, in the same period, the homeownership rate for Hispanic Americans was even lower, at 47.5 percent. Compared with the 71.2 percent homeownership rate of white Americans in the same period, the minority homeownership rates have a long way to go.

We should be cautious in exercising our authority to oversee these two institutions. Putting more and greater restrictions on Fannie Mae and Freddie Mac's ability to achieve their mission, as evidenced by Chairman Baker's draft legislation, will only serve to impede low-income and minority families from achieving the homeownership dream.

Thank you for your attention to this very important matter.

Sincerely,

Barbara Lee

Barbara Lee
Member of Congress

cc: Hon. Mike Oxley, Hon. John LaFalce, Hon. Paul Kanjorski

OFFICE OF THE MAYOR
CITY OF BIRMINGHAM

BERNARD KINCAID, MAYOR

April 5, 2001

Representative Michael Oxley, Chairman
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Oxley:

On April 4, Subcommittee Chairman Richard Baker introduced the "Secondary Mortgage Market Enterprises Regulatory Improvement Act," a bill that I suggest may seriously harm the housing mission focus of Fannie Mae.

Here in Birmingham we consider Fannie Mae a partner in providing affordable housing options for our citizens. The Fannie Mae Alabama Partnership Office works throughout Alabama but has made a priority of increasing home ownership opportunities in the City of Birmingham. An example is the employer-assisted housing program the Fannie Mae Office helped the Baptist Health Systems develop. Under this program, Baptist Health System employees receive forgivable down payment and closing cost assistance loans if they purchase homes in west Birmingham neighborhoods and in Woodlawn. Fannie Mae is further supporting this initiative with a $2 million rehab mortgage underwriting variance to provide additional mortgage options for Birmingham families. Another example is the work of the Partnership Office with the Housing Authority for the Birmingham District to consummate the new Section 8 home-ownership program.

We are pleased with these results in our community and are already working with our local Alabama Fannie Mae office to develop additional housing options program for Birmingham employers and city employees. It is precisely this type of local public-private partnership that makes Fannie Mae an important part of our community.

710 NORTH 20TH STREET BIRMINGHAM, ALABAMA 35203 (205) 254-2277 FAX (205) 254-2926

I recite these details because the proposed bill would limit the ability to create these types of partnerships – and no legislation should be focused on undermining the ability of Fannie Mae to fulfill its housing mission of increasing home-ownership. Without Fannie Mae's charter emphasis on their housing mission we believe many Americans would not be able to benefit from the type of programs such as those we have developed with Fannie Mae here in our city. Changes like those proposed in the bill such as the provision to stop Fannie Mae from introducing new mortgage products could prevent the innovative partnerships we so sorely need in older cities like ours.

The bill Chairman Baker proposes appears to repeat many of the same provisions from earlier legislation that failed. I am worried that this bill is repeating the mistakes of the past and rather than solving problems, it creates new ones.

Thank you for listening to my thoughts on this important issue.

Sincerely,

Bernard Kincaid

Bernard Kincaid, J.D., Ph.D.
Mayor

BK/kbr

cc: Chairman Richard Baker
Rep. Paul Kanjorski, Ranking Member
Chairman Spencer Bachus

CHARLOTTE

April 9, 2001

The Honorable Michael Oxley
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

On April 4, the "Secondary Mortgage Market Enterprises Regulatory Improvement Act," was introduced by Subcommittee Chairman Baker. I understand most of the reasoning behind Congressman Baker's introduction of this legislation, however, I hope to ensure that good intentions do not have unintended consequences. As your committee deliberates on this legislation, I ask that you safeguard or build in provisions that promote innovation and creativity in the secondary mortgage market, while protecting the consumers.

The Fannie Mae North Carolina Partnership worked with the City of Charlotte to create the award-winning HouseCharlotte program, providing over 300 families with downpayment and closing cost assistance. (Winner of HUD's Best Practices Award, 1999.) Fannie Mae also introduced last year Timely Payment Rewards, a mortgage product designed to save Charlotte families with impaired credit tens of thousands of dollars over the life of the loan compared to predatory loans. And just two weeks ago, Fannie Mae announced with Nonprofit Industries, Inc., a local nonprofit, a website database of affordable rental housing to match low-income families and agencies trying to help them with affordable rental housing opportunities. Altogether, Fannie Mae has helped to reduce costs and eliminate barriers to affordable homeownership and rental housing opportunities in the City of Charlotte. I would not want any change to adversely affect their ability to introduce innovative loan products or participate in these efforts to address Charlotte's affordable housing or community development needs.

Our current mortgage finance system can only be described as "the best in the world." Hopefully through your efforts and legislation that promotes innovation, more Americans will have the opportunity to live the American Dream by owning a home of their own.

Thank you for your consideration.

Sincerely,

Pat McCrory

Patrick McCrory
Mayor

c: The Honorable Richard Baker
The Honorable Paul Kanjorski

Patrick L. McCrory, Mayor
Office of the Mayor 600 East Fourth Street Charlotte, NC 28202-2839 704/336-2241

City of Columbus
Mayor Michael B. Coleman

Office of the Mayor

City Hall / 90 West Broad Street
Columbus, Ohio 43215-9014
614/645-7671
FAX 614/645-8955
TDD 614/645-6200

April 23, 2001

The Honorable Michael Oxley
United States House of Representatives
2233 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Oxley:

On April 4, Financial Services Subcommittee Chairman Richard Baker introduced the "Secondary Mortgage Market Enterprises Regulatory Improvement Act". I am concerned that this bill would seriously limit the continued ability of Fannie Mae to address the toughest housing problems in my community through innovative and flexible mortgage initiatives.

Increasing homeownership is a priority of my administration. In recent years, Fannie Mae has had a tangible positive effect on homeownership in Columbus, Ohio. By working with local partners such as Columbus Compact, housing organizations like Columbus Housing Partnership, as well as builders, developers and lenders, Fannie Mae has demonstrated commitment to increasing the economic and social viability of our neighborhoods. The Fannie Mae Central and Southern Ohio Partnership Office is working with us to establish the Columbus Housing Trust Corporation which will leverage private and public resources for affordable housing development.

Fannie Mae is able to work with local partners to create mortgage initiatives and products that directly address the unique housing problems that we, as a city, are faced with on an everyday basis. I am concerned that this legislation could negatively affect the ability of Fannie Mae to meet their affordable housing mission due to the excessive restraints that would be imposed on the company. The types of public-private partnerships that Fannie Mae fosters are vital to Columbus and I am opposed to any legislative vehicle that would lessen these opportunities. I do hope that other cities will express their support of Fannie Mae and the good work they are doing in our communities.

I appreciate the opportunity to express my views and thank you for taking the time to listen.

Sincerely,

Michael B. Coleman
Mayor

cc: Representative Richard Baker
Representative Paul Kanjorski

City of Los Angeles

CITY HALL
LOS ANGELES, CALIFORNIA 90012
(213) 847-2489

OFFICE OF THE MAYOR

RICHARD J. RIORDAN
MAYOR

April 6, 2001

Honorable Michael Oxley
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

I understand that Subcommittee Chairman Baker has introduced the "Secondary Mortgage Market Enterprises Regulatory Improvement Act" to change how Fannie Mae and Freddie Mac are regulated. I am writing to express concerns about this Bill and its impact on housing in Los Angeles.

Specifically, this bill will impede the ability of Fannie Mae and Freddie Mac to quickly create new financing programs and tools, in response to market needs. Fannie Mae has been instrumental in assisting Los Angeles to rebuild from the Northridge Earthquake, providing the necessary skills and resources to fund our teachers' home purchase program, and most recently, collaborating with us to launch a major effort with the Enterprise Foundation to reclaim distressed properties in our toughest neighborhoods. Fannie Mae has invested more than $10.5 billion in financing homeownership and affordable rental housing for Angelenos in the last eight years alone. All of these efforts required that they respond to our needs quickly, efficiently and creatively.

The proposed Bill would add new layers of regulation that seems counterproductive to the goal of increasing quality housing for our residents. Fannie Mae is filling an admirable role in the housing industry and onerous regulatory changes may inhibit their ability to meet marketplace needs. Large cities like Los Angeles need partners who can help them address issues without cumbersome regulations.

I appreciate your consideration of this issue and your support for meeting the housing needs for residents of our City.

Sincerely,

Richard J. Riordan
Mayor

cc: Honorable Richard Baker
Honorable Paul Kanjorski

NAVY FEDERAL CREDIT UNION

Office of the President

PO Box 3000 • Merrifield VA • 22119-3000

April 18, 2001

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
Washington, D.C. 20515-3811

Dear Congressman Kanjorski:

I am writing to applaud your response to the proposed legislation (H.R. 1409) that would transfer regulatory oversight of three Government-Sponsored Enterprises (GSEs) to the Federal Reserve and impose onerous restrictions on the operations of GSEs.

Navy Federal is the world's largest natural person credit union with over $13 billion in assets and more than two million members. We serve Department of Navy personnel, their dependents, and their family members in all 50 states, the District of Columbia, and around the world. We have been making mortgage loans to our members since February 1979. Selling mortgage loans ensures that we have the funds necessary to make new loans to our members. On average, we sell over $1 billion in mortgage loans into the secondary market each year.

Like you, we believe that the proposed legislation is a solution in search of a problem. I am particularly concerned with H.R. 1409's requirement that the Fed review all new loan programs that would be purchased by the GSEs. This requirement would delay the introduction of loan programs that could help more consumers purchase homes. Historically, many of these new programs reduce the cost of buying a home.

Of further concern is the possibility that the Fed would require that any requests to offer new products be published in the Federal Register and be subject to a 30-day public comment period. I believe that the lobbying efforts by special interest groups would have delayed or prevented the introduction of programs such as Navy Federal's conventional loan programs that do not require private mortgage insurance (PMI) and our no down payment conventional loan program.

The stated purpose of the proposed legislation is to provide "strict accountability through streamlined but strengthened regulation." However the addition of the review process severely complicates and delays the current process of new product introduction and effectively requires government approval of product development in the private sector. This type of review is not required by any other financial services regulator and does nothing to enhance the safety and soundness of the GSEs.

In October 2000, the GSEs voluntarily committed to maintain more than three months' worth of liquidity as set forth by the Basel Committee on Banking Supervision, made changes to their debt issuances to further strengthen their financial position, implemented interim stress tests, and publicly disclosed the results of various risk tests. These measures addressed many of the concerns that had been raised about the potential risks posed by the GSEs.

H.R. 1409 purports to address safety and soundness issues, but the GSEs are doing their jobs well and are financially sound. They have not demonstrated a propensity for making careless decisions in running their businesses, in introducing new programs, or in conducting their secondary market activities. In fact, they have been particularly innovative and continue to offer stability to the national secondary market. On April 5, 2001, even Congressman Baker publicly stated, "Fannie and Freddie are managed well."

The existing secondary marketing system works well and I have serious concerns with any effort to change that system. Any modifications could have serious, negative, and far-reaching implications for the housing industry by affecting the smooth operation of the secondary mortgage market, the availability of funds for home loans, and the interest rates paid by consumers. I do not believe that this proposal provides any benefits to the GSEs, lenders, consumers or taxpayers.

If you have any questions or concerns about Navy Federal's position, I will be happy to discuss them with you.

Sincerely,

B. L. McDonnell
President

BLM/jc

cc: Mr. Dan Mica, President, Credit Union National Association, Inc.
Mr. Fred Becker, President, National Association of Federal Credit Unions

The Honorable George W. Bush
President of the United States
The White House
1600 Pennsylvania Avenue NW
Washington, DC 20500

May 16, 2001

Dear Mr. President:

We lead cities of very different economic, demographic and political backgrounds, however, we all share a strong commitment to housing and understanding its critical importance to the life and health of America's cities. We are writing to you to urge your continued support for housing and homeownership, especially in America's cities.

Mr. President, recently, some have called into question the role that Fannie Mae and Freddie Mac play in our economy, and whether or not their role is still needed. We have read with concern the views of some that America has made too large an investment in housing – that our homeownership rate may be too high. Others have argued that Fannie Mae and Freddie Mac should be restrained from further lowering the costs of homeownership, especially for individuals who have not been well served in the past.

We respectfully urge you to reject these views as anti-consumer and anti-housing. Please be aware that in our experience, Fannie Mae and Freddie Mac play a critical role in our economies, making it possible for lenders to provide ready capital and flexible, innovative and responsive underwriting products. Fannie Mae and Freddie Mac are private sector companies with a public mission. These companies accomplish this housing mission without costing the government one penny while paying billions in federal income tax – a tremendous success for both government and the private sector. And Fannie Mae and Freddie Mac can also play a critical role in making your housing priorities a success. They are by far the largest providers of mortgage funds to minority Americans. They are leaders in innovative approaches to solving America's toughest housing problems, including using Section 8 vouchers for homeownership, supporting the innovative use of tax credits for community development, and creating mortgage products tailored to the needs of the historically underserved.

As you and your staff address issues important to America's cities, we hope that you will continue to support a system of housing finance that is working exceptionally well and is by far the envy of the world.

Sincerely,

H. Brent Coles, Mayor
Boise, Idaho

Dennis W. Archer, Mayor
Detroit, Michigan

Wellington Webb, Mayor
Denver, Colorado

Patrick McCrory, Mayor
Charlotte, North Carolina

Statement of J. Timothy Howard

Executive Vice President and Chief Financial Officer, Fannie Mae

Before the House Subcommittee on Capital Markets,

Insurance, and Government-Sponsored Enterprises

House Committee on Financial Services

July 11, 2001

Thank you Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee. My name is Tim Howard, and I am Executive Vice President and Chief Financial Officer at Fannie Mae and a member of our Office of the Chairman. I am pleased to be here again to continue our dialogue on Fannie Mae's business and our role in the marketplace. Today I will update the Subcommittee on a variety of initiatives and developments since I last testified before the Subcommittee in March of this year, and provide Fannie Mae's perspective on the Congressional Budget Office's recent report on Fannie Mae and Freddie Mac.

Congress plays a central role in guiding U.S. housing policy, and continued Congressional oversight of the housing finance system and of Fannie Mae's role, in particular, is crucial to our ability to fulfill our mission. I commend the Members of the Subcommittee for their ongoing commitment and energy, and I look forward to our discussion today.

Housing as a Driver of Economic Growth

To set the proper context for today's hearing, it is important to remember the role that housing plays in our larger economy and to understand some of the forces shaping the housing sector. Housing is a bulwark of the economy, helping to drive economic growth even in the current economic slowdown, and it is a source of wealth and financial security for many households.

The housing and mortgage markets are the strongest sector in the economy today, and they are major reasons why economists do not expect the overall economy to sink into recession. A generation ago, the housing industry was more volatile, and when the economy slowed, the housing sector slowed as well. Today, the housing sector -- which accounts for between 8 and 22 percent of annual gross domestic product -- is more stable than other sectors of the economy.[1] Indeed, while manufacturing has been in a

[1] If defined to include only residential housing expenditures for single-family housing, renovations and improvements, and other residential housing, housing accounts for about 8 percent of GDP. If defined more broadly -- i.e., to include residential housing expenditures plus housing-related expenditures

downturn, overall job growth has slowed sharply and orders for high-tech equipment have dropped significantly, housing activity has remained robust. In fact, total home sales in the first five months of 2001 reached a record level.

The strength of the housing industry translates into greater financial stability for American families. For most Americans, purchasing a home is the largest investment they will make. Strong home price appreciation in recent years has increased the average net worth of homeowners, and these gains in housing wealth have helped offset declines in equity wealth.[2] With the declining trend in mortgage rates -- from 8.16 percent in June 2000 for 30-year fixed-rate mortgages, to the current rate of 7.19 percent (and the recent low of 6.89 percent in March) -- many homeowners have refinanced, allowing them to reduce their monthly mortgage payments. The savings that result from refinancing can then be deployed for other purposes, helping cushion the slowing economy. We estimate conservatively that consumer spending may increase by $40 billion this year as a result of refinancing activity, and, as columnist Ken Harney wrote this past weekend, this added spending "play(s) a key role in keeping the U.S. economy chugging along."[3]

The role that Fannie Mae plays in the secondary mortgage market -- through all types of economic environments -- is one reason that the housing sector is so stable. Despite home price declines in the oil patch states in the mid 1980s, in California in the first half of the 1990s, and in New England in the early 1990s, Fannie Mae delivered a steady supply of financing to lenders across the country and consistent earnings to our investors. During the credit crunch of late 1998, Fannie Mae and Freddie Mac stepped up their mortgage purchases and ensured that U.S. homebuyers had access to the lowest rates in a generation, even as other credit markets suffered. Our strong financial performance over time is a key factor in drawing investors from around the world to invest their capital in U.S. housing finance -- and thereby keeping mortgage rates low for American homebuyers. The role we play in providing liquidity and stability to the market for conforming mortgages means that, this week, borrowers with a conforming mortgage will save as much as $20,800 over the life of their loan, compared with a jumbo loan.

The "Over Housed" Myth

Housing continues to be a huge force in the economy in large part because the need and demand for housing continues to be very strong. While some assert that the country is "over housed", recent Census data indicate that, if anything, we are looking at the prospect of a housing **shortage** as demand for housing outstrips supply.

(predominantly furniture and appliances) and other housing activity -- housing accounts for 22.4 percent of GDP. See Andrew J. Filardo, "The Outlook for Housing: The Role of Demographic and Cyclical Factors," Federal Reserve Bank of Kansas City, *Economic Review*, Third Quarter 1996, pp. 39-61.

[2] According to the House Price Index from the Office of Federal Housing Enterprise Oversight, the year-over-year average increases in home prices in 1998, 1999, and 2000 were 5.5 percent, 5.7 percent, and 8.1 percent, respectively.

[3] Kenneth R. Harney, "Research Shows How Home Sales Power the Economy," *The Washington Post*, June 7, 2001, p. H1.

Specifically, Census data show that the national vacancy rate for owner-occupied homes decreased from 2.1 percent in 1990 to 1.7 percent in 2000. Moreover, the supply of unsold homes (especially looking at the inventory-to-sales ratio) is at historical lows. Not only have favorable economic conditions helped drive housing demand, but important demographic trends have fueled this growth. The number of new households increased by 1.35 million a year during the past decade -- approximately 200,000 more per year than previously estimated.

Key drivers of this growth in household formation include rising immigration rates and an increase in the rate of minority household formation. A recent study released by Harvard's Joint Center for Housing Studies found that, since 1995, immigrants have accounted for one-third of household growth.[4] Minority households have made up fully two-fifths of the record net gain in homeownership over the past six years.[5] As immigration continues to increase, as efforts continue to close the gap between minority and white homeownership rates, and as more and more "echo-boomers" reach adulthood, the demand for housing will likely continue to grow. The Joint Center projects household growth over the next decade at or above the 11.5 million new households of the 1990s and estimates that, factoring in immigration, minorities will make up roughly two-thirds of net household growth.[6]

The greater number of financing options available for those seeking to attain homeownership for the first time has further fueled this demand. As a recent *Wall Street Journal* article noted, new prospective homeowners,

> *(H)ave taken advantage of new, low-down-payment loans and other new mortgage products designed to boost homeownership among minorities, immigrants, and low-income families.*[7]

Continued strong demand for housing and housing finance poses both challenges and opportunities for those of us in the housing industry and for policymakers with responsibility for guiding housing policy. We look forward to working with our industry partners and with policymakers to meet this challenge.

Now I would like to provide the Subcommittee with an update in three important areas since I testified in March:

- **American Dream Commitment.** We have had an excellent start our American Dream Commitment (ADC), the goal we announced in March of 2000 to devote $2 trillion over ten years to increase homeownership rates and serve 18 million targeted families. Through May of this year -- less than 18 months into this initiative -- working with lenders and many other partners, we already have made

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[4] Joint Center for Housing Studies, "The State of the Nation's Housing," 2001, at 11.
[5] Id. at 13.
[6] Id. at 9.
[7] Patrick Barta, "Looming Need for Housing A Big Surprise," *The Wall Street Journal*, May 15, 2001, p. B1.

available over $341 billion in targeted housing finance, serving over 3.4 million underserved families, including 535,000 minority borrowers. The ADC includes a national initiative to increase minority homeownership, with a commitment to invest more than $420 billion over the next decade. As part of this, we have entered into several alliances with national lenders focused on serving minority and immigrant borrowers. We also have launched efforts such as the "Welcome Initiative: A New Home in a New Country," a comprehensive bilingual marketing campaign to help lenders respond to the needs of immigrant borrowers. The ADC also includes a promise to finance at least $175 billion in multifamily housing. Through May of this year, we have already provided $20 billion in multifamily housing finance toward this goal.

- **Safety and Soundness.** While other financial regulators issue annual reports to Congress, only OFHEO reports publicly on the exam results of the two companies it regulates. In its annual report to Congress issued on June 15 of this year, OFHEO found the companies to be financially sound and well managed. Furthermore, OFHEO gave each company its highest possible rating -- "exceeds safety and soundness standards" -- in each of the six examination areas.

- **Voluntary Initiatives.** Last fall, Fannie Mae and Freddie Mac, along with the leadership of this Subcommittee, announced a set of six voluntary initiatives aimed at enhancing our safety and soundness and at further increasing the level and transparency of information available to policymakers and investors about our risk management. I reported to you in March that we implemented all of these initiatives fully -- and in some cases went beyond the commitment from last fall -- during the first quarter of 2001. In the second quarter, we continued to make the regular disclosures that we announced last fall. Also, in addition to the $1.5 billion in 10-year subordinated debt that we issued in January, we issued $1.5 billion in 5-year subordinated debt in early May. Both issues of our subordinated debt have continued to trade at yields ranging between 17 and 29 basis points above Fannie Mae senior debt of similar maturities. This difference in yields indicates that the market views our sub debt differently than our senior debt.

The 2001 CBO Report

The principal reason for my testimony before the Subcommittee today is to provide Fannie Mae's perspective on the Congressional Budget Office's 2001 update to its 1996 estimate of the costs and benefits of Fannie Mae and Freddie Mac. Fannie Mae released a detailed response shortly after CBO issued its update. This response is posted on our website at www.fanniemae.com/cboresponses.html, and I respectfully request that it be included in the hearing record.

CBO solicited our comments on the draft of the 2001 report prior to its release. While CBO ultimately chose not to incorporate our suggestions, we appreciated the dialogue and hope it will continue.

The 2001 CBO report is flawed in its premise and in its treatment of specific aspects of our business. The premise underlying CBO's work is that it can estimate the value of a "subsidy" that does not explicitly exist. Clearly, we receive benefits as a result of our charter -- benefits that we help transform into greater market efficiencies and home buyer savings -- but these benefits should not be equated with an outlay of taxpayer dollars. Fannie Mae and Freddie Mac do not benefit from any appropriation of federal funds, and we are required by law to tell investors that our securities are not guaranteed by the federal government.[8] By virtue of our unique position in the U.S. housing finance system, our borrowing costs are lower than those of other "AA" borrowers; but if the government were to revoke the Fannie Mae charter, it would not recover a single "subsidy" dollar -- and homebuyers would face higher mortgage rates.

CBO tackles the understandably difficult task of trying to estimate a nonexistent funding stream by creating an analytical framework unique to Fannie Mae, Freddie Mac, and the Federal Home Loans Banks, and applying it to them alone. This framework is based on the assumption that the difference between our borrowing costs and the borrowing costs of banks, less the difference between jumbo and conforming mortgages, should equal the amount of "subsidy" that Fannie Mae, Freddie Mac, and the Home Loan Banks retain.

Herein lies our first serious concern with the CBO calculation. Following CBO's logic, any reduction in the companies' cost of funds achieved through their own efficiency or expertise increases the government "subsidy." We are constantly trying to improve our funding with initiatives such the liquidity-enhancing regularity of Benchmark securities, sale of debt through Dutch auctions, the use of derivatives, Internet debt placement, and enhanced debt marketing efforts. However, such market-driven innovations -- innovations which helped earn Fannie Mae *Euromoney* magazine's 2000 award for "Best Borrower of the Year" -- would, under CBO's approach, represent a further increase in the government "subsidy."[9]

Under the CBO methodology, if we run our business efficiently, the "subsidy" that CBO posits grows -- without any change in either our Congressional charter or our regulatory regime. Even less understandably, if we run our business poorly, the "subsidy" actually shrinks. This single assumption, by leading inevitably to an irrational result, greatly reduces the value of CBO's analysis for policymaking purposes. Should the government instruct Fannie Mae and Freddie Mac to operate less efficiently to minimize the so-called "subsidy"? Should the government forbid Fannie Mae and Freddie Mac from issuing innovative debt instruments that reduce the companies' debt costs and in turn reduce mortgage rates for consumers -- again, because these innovations increase the value of CBO's theoretical "subsidy"?

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[8] Each Fannie Mae security is required by law to state on its cover that its "obligations, together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality other than the corporation."

[9] For instance, many analysts estimate that Fannie Mae's Benchmark Note program has saved the company 5 to 7 basis points compared with funding operations prior to the introduction of the program.

Fortunately for U.S. homebuyers, Fannie Mae does not have the choice to operate less efficiently. Our obligation to our shareholders and the competitive environment in which we operate requires that we strive for efficiencies in every part of our business every day. Our success in managing credit and interest rate risk has led the market to view us as an exceedingly safe company. Fannie Mae, through effective credit enhancement and aggressive loss mitigation strategies, has steadily reduced its credit losses, which now total less than one basis point (0.01 percent) over our entire book of business. Our successful hedging of interest rate risk has led to consistent earnings growth in a wide range of interest rate environments.

Our second serious concern with CBO's analysis relates to its comparison of our borrowing costs to those of banks. One might suppose from the CBO calculation that banks and Fannie Mae finance their operations with long and short-term borrowings in much the same way. However, banks and Fannie Mae use debt very differently. Indeed, senior debt is the highest cost and smallest component of a bank's funding base. Banks have access to non-interest and other low-cost insured deposits and to low-cost advances from Federal Home Loan Banks, while Fannie Mae and Freddie Mac can only raise funds by issuing debt. As a result, banks' average cost of funds is actually lower than that of Fannie Mae and Freddie Mac, and CBO's comparison of yields on our debt to yields on bank debt overstates any relative funding benefit we receive by ignoring the funding advantages available to banks by virtue of their government-provided benefits.

Our third major concern relates to CBO's failure to account for the restrictions and obligations in our Congressional charter and to capture fully the benefits we provide to the mortgage market. If, as CBO states, others would be willing to pay for a government-sponsored enterprise charter, then presumably the price they would be willing to pay would include the costs of the business restrictions and obligations in that charter. Fannie Mae and Freddie Mac are restricted to the business of residential housing in the U.S., may only purchase or securitize loans below the conforming limit (in 2001, $275,000 for single family mortgages), must have credit enhancements such as mortgage insurance on loans with less than 20 percent borrower equity, face rigorous capital requirements, and must meet three specific percent-of-business housing goals. CBO's calculation includes none of these restrictions or obligations.

Similarly, in terms of the benefits we deliver to homebuyers, CBO captures the lower interest rates only on the loans that we purchase or securitize, despite the fact that all conforming loans enjoy lower interest rates because of our presence in the secondary market. Fannie Mae and Freddie Mac also provide liquidity and stability to the housing finance market, support innovation that removes barriers to homeownership, and invest in targeted housing finance for underserved borrowers, yet CBO captures none of these benefits.

One example I would like to highlight -- and there are others in our detailed response -- is our investment in multifamily housing. Fannie Mae has become the nation's largest investor in multifamily housing, with a book of business of $65 billion at the end of 2000. In 2000 alone, Fannie Mae made $13.5 billion in multifamily investments, creating or preserving affordable housing for more than 266,000 households. In addition, Fannie Mae's $1.3 billion in equity investments, through the purchase of low-income housing tax credits, makes us the largest investor in the nation's most significant program for the production of affordable rental housing. None of these investments, benefits to the market, or business restrictions are included in the CBO calculation.

In addition to the main points I have just set out, we have concerns with many other elements of the CBO calculation. These concerns are discussed in detail in our May 23rd response. Briefly,

- CBO compares the yields on Fannie Mae debt to that of both 'A' rated and 'AA' rated financial companies, even though S&P rated Fannie Mae's "risk to the government" as 'AA-' -- which means that the most accurate comparison would be to 'AA' rated firms. CBO also misstates the amount of short-term debt the two companies issue. Correcting these errors reduces the funding "subsidy" from $6 billion to between $3.0 billion and $3.6 billion for 2000.

- CBO mismeasures any "subsidy" attached to MBS issued by Fannie Mae and Freddie Mac. CBO concludes that there is a $3.6 billion "benefit" from MBS guarantee activities. This $3.6 billion MBS benefit is based on a 30 basis point "subsidy" that is 10 basis points more than the gross revenue the companies receive from their guaranty fee. Correcting the errors in the MBS benefit calculation would decrease it from the reported $3.6 billion to a range between zero and $0.6 billion.

- As described above, CBO applies the benefit to homebuyers of lower mortgage rates only to the mortgages Fannie Mae and Freddie Mac own or securitize. Because of market competition, every borrower eligible for a conforming mortgage enjoys lower rates, regardless of whether their mortgage is part of a transaction that involves Fannie Mae or Freddie Mac. Correcting this mistake increases the homeowner benefit from $6.7 billion to a range of between $10.4 billion and $13.3 billion.

Correcting these errors changes CBO's "retained subsidy" of $3.9 billion to a net benefit to homebuyers ranging from $5.6 billion to $9.7 billion. As a result, those who claim that Fannie Mae and Freddie Mac are not fulfilling their public mission by "retaining" this $3.9 billion clearly are incorrect -- as Fannie Mae and Freddie Mac pass along to American households far more than they receive in benefits.

I also would like to address briefly a June 21 letter from CBO Director Dan Crippen to Fannie Mae Chairman and CEO Frank Raines, which CBO posted on its website last week. In that letter, Director Crippen took issue with Fannie Mae's response to the CBO report.

We engaged in a dialogue with CBO throughout their work on this report, and we stand by our critique of the final product. Our analysis is relevant because it points out the limits of the framework CBO has chosen and the flaws in the estimate it provided. We commend our critique to policymakers so they can weigh for themselves the relevance and reliability of CBO's estimate.

Indeed, prior to the release of the report, we suggested to CBO that publishing a range of estimates would provide policymakers with more information about the range of reasonable assumptions and the types of benefits we provide that are difficult to measure. Instead, CBO conveyed a false sense of precision by reporting point estimates, and it chose not to quantify in any way important benefits we provide.

The Regulatory Regime

There has been some discussion recently of changing the regulatory regime for Fannie Mae and Freddie Mac. The starting place for any such discussion is the regulatory structure that Congress established in 1992 -- a unique regulatory regime with a high level of rigor and unparalleled transparency. Fannie Mae and Freddie Mac are subject to and exceed the highest standards of safety and soundness. OFHEO has conducted a comprehensive, continuous, on-site examination program since 1994, the scope and rigor of which equals or exceeds that to which any other regulated financial institution is subject. We consistently receive OFHEO's highest examination marks. We must meet minimum statutory capital standards, and, furthermore, we voluntarily adhere to an interim risk-based capital test pending OFHEO's publication of its final risk-based capital regulation. We are the only financial companies in the world to issue subordinated debt in large volume and on a regular basis. And we voluntarily release financial information on our interest rate risk, credit risk, and liquidity at a level consistent with the most recent recommendations of Basel and others, including the Shipley Commission. The combination of all our sub debt issuances and our numerous disclosures make Fannie Mae and Freddie Mac among the two most transparent firms in the world.

Of course, we are always ready to engage with policymakers on these issues. From our perspective, two considerations are of paramount importance: one, that any regulator of Fannie Mae and Freddie Mac have the confidence of policymakers in the Congress and the Executive Branch; and two, that such a regulator recognize the importance of balancing safety and soundness with our mission to expand homeownership and affordable rental housing.

Conclusion

We find ourselves in a period of tremendous opportunities and challenges. The homeownership rate in America today stands at a record 67.5 percent, up by 3.6 percentage points from ten years ago. As the most recent Census showed, 49 States have higher homeownership rates than they did ten years ago, and demand for housing continues to grow. But the gap between whites and minorities is huge. Seventy-four percent of white Americans own their homes, but that figure is less than 50 percent for African Americans and Hispanics. We have the best housing finance system in the world, and this system's success translates into financial strength for the economy as a whole and at the level of the individual household. Now we must make it work for more American families.

Fannie Mae is well positioned to help bring the housing finance system to the next level in terms of our ability to deliver the American Dream of homeownership to more and more families. We operate successfully under the most rigorous of safety and soundness regimes; we are subject to a high level of market discipline and provide the marketplace with world-class disclosures; we fulfill our obligations to our shareholders; and most importantly, we do the job that Congress gave us -- we provide liquidity and greater access to affordable homeownership for all Americans.

Clearly, there is a great deal of value that flows from the efficient operation of the U.S. housing finance system and from the role that Fannie Mae plays in this system. Yet, there is much more that our housing finance system could accomplish. In this context, I would like to reiterate the straightforward test Frank Raines proposed a year ago for examining policy proposals that affect the housing finance system:

- Do they reduce costs for consumers?
- Do they improve the safety and soundness of the housing finance system?
- Do they expand opportunities for homeownership?
- Do they allow innovation in the market without cumbersome regulatory requirements?

We believe these questions remain relevant, particularly in view of the challenges we continue to face in expanding homeownership opportunities for all Americans.

Thank you for inviting me to testify before you today. I look forward to working with the Subcommittee on these important issues.

FannieMae

Timothy Howard

Executive Vice President and Chief Financial Officer

3900 Wisconsin Avenue, NW
Washington, DC 20016-2892
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July 27, 2001

The Honorable Richard Baker
Chairman
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

At the Subcommittee hearing on July 11, you expressed some concern that Fannie Mae intended to sell Investment Notes directly to consumers. I wanted to take this opportunity to provide you with information responsive to your concern and about Investment Notes more generally.

Fannie Mae debt securities have been sold to retail investors by securities dealers since the early 1980s. Dealers began selling Fannie Mae senior debt to retail customers in increments of $1,000 in late 1996, and now all Fannie Mae debt is available in increments of $1,000. The enhancements we announced with Investment Notes make pricing more transparent to individual investors, allowing *all* investors to buy the same structure at the same price. Fannie Mae Investment Notes are a variation of a standard offering used by several other large borrowers, including GMAC, Caterpillar, Bank of America, Household, and United Parcel Service. The Notes are sold through Merrill Lynch as the principal dealer, along with a group of 21 other participating dealers. Fannie Mae does not know or have access to the names of individual investors in Investment Notes.

Fannie Mae has never sold debt directly to retail investors, and has no intention of doing so with Investment Notes or any other Fannie Mae debt instrument. Our business strategy relies on a partnership with investment bankers and dealers to distribute our securities to end investors. The dealer community has the organizational structure, expertise, and experience to perform this task. Fannie Mae does not.

The basis for your concern at the hearing appeared to be language in the offering circular for the Notes that says that Fannie Mae may sell debt securities to investors on our own behalf. The language in the offering circular to which you referred in the hearing has been included in each of our offering documents since 1987. The purpose of the language is to give us flexibility to accommodate private placement requests from institutional investors without issuing a new set of offering documents. Over the last fourteen years, we have done just a handful of these private placements with institutional investors.

Should you have any additional questions about this matter, please do not hesitate to contact me.

Sincerely,

WRITTEN STATEMENT OF MITCHELL DELK

SENIOR VICE PRESIDENT

FREDDIE MAC

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS,

INSURANCE

AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

July 11, 2001

Good afternoon Chairman Baker, Congressman Kanjorski and Members of the Subcommittee. It is a pleasure to appear before this committee. I am Mitchell Delk, Senior Vice President of Government Relations at Freddie Mac.

EXECUTIVE SUMMARY

Freddie Mac plays a vital role in financing homeownership and rental housing for the nation's families. Mortgage funds are available whenever and wherever they are needed. Mortgage rates are lower, saving homeowners thousands of dollars in interest payments. Thirty-year fixed-rate mortgages are plentiful, protecting families from unexpected interest-rate increases. In addition, the availability of low-downpayment loans has helped open the door of homeownership to more low- and moderate-income families.

The benefits Freddie Mac brings far outweigh the value we derive from our Congressional charter. In a recent report, former Office of Management and Budget Director Dr. James Miller and Dr. James Pearce estimated the total interest-rate savings to America's families resulting from the activities of Freddie Mac and Fannie Mae to be between \$8 billion and \$23 billion each year, compared to an annual funding advantage of between \$2.3 billion to \$7.0 billion. They conclude: "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 highest estimate of their funding advantage."[1]

Freddie Mac's ability to continue to provide these benefits rests on our financial strength. As a result of our superior risk management capabilities, strong capital position and state-of-the-art information disclosure, Freddie Mac is unquestionably a safe and sound financial institution. Effective and credible regulatory oversight is an essential complement to our already strong financial position. In this regard, we believe that the regulatory structure set forth by the Federal Housing Enterprises Financial Safety and Soundness Act (the GSE Act) is fundamentally sound. It ties capital to risk; provides a comprehensive set of enforcement authorities; provides oversight without unnecessary intrusion and enables the enterprises to respond aggressively to market developments with innovations to meet their mission.

In addition to an appropriate regulatory structure, it is critical that the regulator have the confidence of Congress, the public and investors. Mr. Chairman, you have put the question of the location of Freddie Mac's safety-and-soundness regulation before the Subcommittee. Freddie Mac is committed to continuing our constructive working relationship with the Office of Federal Housing Enterprise Oversight (OFHEO) and to providing any input and assistance that you believe would assist you in these deliberations.

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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," at 29 (2001).

I. U.S. HOUSING FINANCE SYSTEM IS THE WORLD'S BEST

Freddie Mac is in a great business: financing homes in this nation. People in America almost universally aspire to owning a home of their own. The nation's homeownership rate reached a record high of 67.4 percent in 2000. Over the past six years, the homeownership rate has risen across all income, racial and ethnic groups, with minority families experiencing the fastest rate of growth.[2]

For most families, their home is their most valuable asset and greatest source of financial security. Children of homeowning families do better in school and have fewer behavioral problems.[3] Homeownership strengthens neighborhoods and contributes to a sense of belonging and community.

The housing and mortgage markets also play a critical role in stabilizing our economy. Throughout 2001, the nation's robust housing market has defied the softening evident in other sectors of the economy. As noted by Harvard University's Joint Center for Housing Studies, this year's "flurry" of mortgage refinancing has "offset the drag on economic growth from rising energy prices and falling stock prices."[4]

Because of the importance of housing and homeownership in people's lives, the strength of our communities and in the nation's economy, it is critical that the nation have an uninterrupted source of mortgage funds on a grand scale.

That's exactly what we have in this country. There were a trillion dollars in mortgages originated last year alone, with $1.5 trillion expected for 2001. Based on current estimates of population growth and household formation, America's families will need an additional $6 trillion to finance their homes over the next decade.

Fortunately, America's housing finance system is up to the monumental task of opening the door of homeownership to millions of new homebuying families. Our system works so well, we tend to take it for granted. Many of the benefits Freddie Mac brings to America's families are described below:

Constant availability. There is never a shortage of mortgage money. Freddie Mac's high-quality, liquid mortgage and debt securities attract global investors to finance America's housing. A diversified investor base makes the housing finance system highly resilient and stable. When other markets face disruption – as they did during the global financial turmoil in the fall of 1998 – Freddie Mac ensures a steady supply of low-cost mortgage funds.

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[2] Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing (2001)*, at 1. The paper is available on the Joint Center's website (http://www.gsd.harvard.edu/center).
[3] Donald Haurin, Toby Parcel and R. Jean Haurin, "The Impact of Homeownership on Child Outcomes," Ohio State University (2001). The paper is available on the Homeownership Alliance website (http://www.homeownershipalliance.com).
[4] Joint Center for Housing Studies of Harvard University at 5.

Low cost. By linking local communities with global investors, Freddie Mac enables homebuyers to compete for funds in the capital markets alongside the largest corporations. Perhaps the best evidence of how we save consumers money is in the weekly real estate section of major newspapers. For example, in its Saturday Real Estate section, *The Washington Post* provides two sets of mortgage interest rates: those for conforming mortgages, which are eligible for Freddie Mac purchase (currently up to $275,000 for a single-family home), and those for higher-balance jumbo loans. Invariably, rates on conforming mortgages are lower than those on jumbo loans by between 25 and 40 basis points.[5] Furthermore, Freddie Mac's activities lower mortgage interest rates on *all* conforming loans, as well as on jumbo loans, not simply the loans we purchase. Regardless of whether Freddie Mac purchases a conforming loan or it is held in portfolio by a bank or a credit union, mortgage rates are lower for all borrowers.

Expanded homeowning opportunities for low- income and minority families. Lower mortgage interest rates strongly impact homeownership. For example, a 0.5 percent reduction in fixed-rate mortgage rates would increase the U.S. homeownership rate for low- and moderate-income and minority families by as much as 3 percent.[6]

In 2000, fully 58 percent of Freddie Mac's business financed housing for nearly a million families with very- low-, low- or moderate- incomes or who live in underserved areas. Our purchases funded mortgages for more than 206,000 minority families, comprising 13.6 percent of our total mortgage purchases in 2000. Apart from Freddie Mac and Fannie Mae, no other shareholder-owned financial institution provides this level of support to expanding opportunities for these families.

Uniformity. Freddie Mac purchases mortgages in every community in the country. As a result, a borrower in Baton Rouge pays the same for a mortgage as a borrower in Wilkes-Barre. This stands in sharp contrast to 1970 – the year Freddie Mac was established – when mortgage interest rates differed by as much as one and a half percentage points across the country.

Product choice. America's families choose from a broad array of mortgage products, including the 30-year fixed-rate mortgage with a low downpayment – without the need for government insurance. In many other countries, this type of mortgage is simply not available.

Innovation. From the development of the mortgage securities market in the 1970s to the development of automated underwriting in the 1990s, Freddie Mac has been at the forefront of innovation in the mortgage market. Borrowers are the direct beneficiaries of Freddie Mac's innovation.

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[5] For example, on July 7, 2001, *The Washington Post* showed an average 26 basis point jumbo-conforming spread on 30-year fixed-rate mortgages and a 36 basis point spread on 15-year fixed-rate mortgages.
[6] R. Quecia, G. McCarthy and S. Wachter, "The Impacts of Affordable Lending Efforts on Homeownership Rates," (June 2000).

In 1995, Freddie Mac introduced automated underwriting to the market with our Loan Prospector® automated underwriting service. Loan Prospector has revolutionized the mortgage origination process, reducing the time and expense of getting a loan. Automated underwriting also brings greater objectivity and fairness to lending decisions. Every piece of information is evaluated the same way for every borrower, every time, with an accuracy no human underwriter can match. This high degree of accuracy has led to the development of new products that would have been deemed too risky a few years ago. Harvard's Joint Center for Housing Studies concludes that these products enable "more income-constrained and cash-strapped borrowers at the margin to qualify for mortgage loans."[7] Furthermore, an article in the latest issue of *Real Estate Economics* stated that Freddie Mac's activities have helped reduce mortgage origination costs by more than $2 billion.[8]

High standards. By bringing competition, standardization and accountability to the mortgage market, Freddie Mac promotes responsible lending. We have taken a leadership role in combating predatory lending practices. For example, in 2000 Freddie Mac became the first major mortgage market participant to ban the purchase of mortgages carrying single-premium credit insurance. As a result of our leadership, many financial institutions have stopped offering this high-priced product, which has been associated with the abusive practice of equity stripping. In addition, Freddie Mac's highly effective Don't Borrow Trouble campaign is raising public awareness and giving consumers the information they need to protect themselves from abusive lending practices. Following the initial launch in 12 cities, we recently partnered with the U.S. Conference of Mayors to bring this campaign to cities across the U.S.

II. CONSUMER BENEFITS FAR OUTWEIGH CHARTER ADVANTAGES

These public benefits flow directly from the charter and efficiencies of Freddie Mac, as Congress intended. In 1970, Congress created Freddie Mac and authorized Fannie Mae to create a secondary mortgage market for conventional mortgages.

The Congressional charters contain restrictions to ensure that the two shareholder-owned corporations maintain a constant and singular focus on financing America's housing. In addition, the charters provide tools to assist Freddie Mac and Fannie Mae in providing a stable supply of low-cost mortgage funds. With these tools and operating under the discipline of private-market incentives, Freddie Mac has proven our ability to reduce consumer costs, champion innovation and manage the risk of our business effectively. The combination of Congressional charter, public purpose and private capital uniquely positions Freddie Mac and Fannie Mae as linchpins of our nation's vibrant and resilient housing finance system.

The benefits Freddie Mac brings far outweigh the value we derive from our Congressional charter. In a recent report, former Office of Management and Budget

[7] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing (1999)*, at 4.
[8] Steven Todd, "The Effects of Securitization on Consumer Mortgage Interest," 29 *Real Estate Economics* 1, 29-55(2001).

Director Dr. James Miller and Dr. James Pearce estimate that as a result of Freddie Mac's and Fannie Mae's activities, America's families save between $8 billion and $23 billion in mortgage interest each year. In contrast, they estimate the funding advantage resulting from our charter ranges between $2.3 billion and $7.0 billion. They conclude: "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 highest estimate of their funding advantage."[9] This analysis is included at Appendix A.

In stark contrast to the body of research documenting the significant benefits Freddie Mac brings is the May 2001 report by the Congressional Budget Office (CBO) entitled *Federal Subsidies and the Housing GSEs*. The report updates CBO's 1996 study, *Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac*. As with the 1996 report, CBO's new report is a flawed academic exercise. CBO's use of the term "subsidy" gives the impression that Freddie Mac receives a direct outlay of funds from the federal Treasury. In fact, the corporation has never received a cent of federal money, and is one of the nation's largest payers of federal income tax.

Flaws of CBO's 1996 Report

CBO's 1996 study estimated a total annual "subsidy" of $6.5 billion, compared to total benefits of $4.4 billion. The difference of $2.1 billion was attributed to a "funding subsidy retained." [10] In the 2001 report, however, CBO concedes having made significant errors that overstated the funding advantage in its 1996 report – in the amount of $2.1 billion. [11] This is the exact amount CBO accused Freddie Mac and Fannie Mae of failing to pass on to borrowers.

The 1996 report treated all Freddie Mac and Fannie Mae debt as long-term debt, ignoring the lower funding advantage on short-term debt. In addition, it incorrectly measured the funding advantage on long-term debt and mortgage-backed securities.[12]

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[9] James E. Pearce and James C. Miller III, "Freddie Mac and Fannie Mae: Their Funding Advantage and Benefits to Consumers," at 29 (2001).

[10] Congressional Budget Office, "Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac," at xi (May 1996) (the "1996 CBO Report").

[11] Congressional Budget Office, "Federal Subsidies and the Housing GSEs at Table B-1 (May 2001) (the "2001 CBO Report"). Table B-1 updates CBO's subsidy estimates using the 1996 methodology. Using the 1996 methodology, CBO estimated that the "Total Annual Subsidy" during 1995 to Fannie Mae and Freddie Mac was $6.5 billion. In Table B-1, based on new analysis that concedes serious errors in the 1996 study's methods and findings, the CBO presents new figures that make a significant downward adjustment of $2.1 billion in their funding advantage calculation. This is the same amount as the purported "funding subsidy retained" that CBO claimed to exist in its 1996 study. Two significant errors that CBO corrected were the failure of the 1996 study to account for the much smaller funding advantage that Freddie Mac has on its short-term debt and the 1996 study's substantial overestimate of the funding advantage on callable debt.

[12] James E. Pearce and James C. Miller III, "Freddie Mac and Fannie Mae: Their Funding Advantage and Benefits to Consumers," at 6 (2001).

These kinds of mistakes have real consequences. For this reason, we urged CBO to amend the draft version of the 2001 report prior to publication, but our comments were disregarded.

Flaws of CBO's 2001 Report

Overall, we find CBO's 2001 report to be fatally flawed. While the report corrects some of the mistakes in the 1996 study, substantial problems remain and, in fact, several major new errors were introduced. It also introduces a new, inappropriate accounting methodology.

In contrast to the report's expansive view of Freddie Mac's funding advantage, the report is exceedingly narrow with regard to the benefits we bring. As a result, the report overstates Freddie Mac's funding advantage and understates the benefits we bring to America's families. Appendix B provides Freddie Mac's detailed analysis of the 2001 CBO report.

As shown below, simply correcting four of the largest errors would completely reverse the conclusion CBO appears determined to reach.

1. CBO overstates the funding advantage on long-term debt by $1.2 billion

The error: The 2001 CBO report estimates a 47 basis point funding advantage on long-term debt based on a comparison of our debt yields to those of primarily "A" rated debt. This is a faulty comparison. Standard & Poor's assigned Freddie Mac a "risk to the government" rating of AA- in February 1997, which was reaffirmed earlier this year.[13] Comparing Freddie Mac to primarily single-A firms skews the analysis and overstates our funding advantage. Our funding costs necessarily are lower than A-rated companies because of our greater financial strength.[14]

The correction: Use the same database used by CBO but exclude the A and A-minus rated debt issues from the comparison group. This lowers the funding advantage to about 30 basis points.

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[13] To compute the funding advantage on long-term debt, CBO relies exclusively on one academic study that compares Freddie Mac's borrowing costs to the average for a group of firms, most of which have debt with lower credit ratings. See Brent W. Ambrose and Arthur Warga, "An Update on Measuring GSE Funding Advantages," November 6, 2000. Of the 70 firms considered by Ambrose and Warga, only eight issued debt with 'AA' ratings (which ranges from AA- to AA+) while 63 issued debt rated 'A' (one firm issued both "A" and "AA" rated debt). Moreover, 45 of the firms had ratings of A or A-, which are at least two categories below the AA- "risk to the government" rating that Standard & Poor's assigned to Freddie Mac.
[14] In addition to this $1.4 billion error, CBO further overstates the funding advantage Freddie Mac obtains from our Congressional charter by ascribing the entire liquidity premium to the charter – without giving any credit to our success in creating a broad investor base and a liquid market for our securities. Irrespective of our charter, Freddie Mac securities command a liquidity benefit because we are large, well managed and highly capitalized compared to other corporate issuers. Moreover, the market rewards our financial innovations. Studies previously submitted to CBO demonstrate the importance of liquidity in financial markets.

2. CBO understates the share of short-term debt, inflating the funding advantage by $1.0 billion

The error: The 2001 CBO report used 20 percent as its estimate of the share of short-term debt, excluding any short-term issuance that was part of swap agreements. In fact, approximately 40 percent of Freddie Mac's and Fannie Mae's debt is short-term. The relevant funding advantage should reflect the term of the debt at issuance because swap agreements do not have a substantive effect on the funding cost of the debt.

The correction: Use the actual short-term share of 40 percent.

3. CBO understates the jumbo-conforming spread, reducing the mortgage interest savings we bring by $1.0 billion

The error: The 2001 CBO report uses an arbitrarily low estimate of the difference between conforming and jumbo mortgage interest rates. In contrast to the report's use of a single point estimate of 22 basis points, numerous studies estimate a jumbo-conforming spread between 25 and 40 basis points.[15] CBO itself used a spread of 35 basis points in its 1996 study.

The correction: Apply the more realistic spread of 30 basis points to the loans we purchase.

4. CBO understates the benefits we bring to all fixed-rate conforming market borrowers by $4.0 billion

The error: The 2001 CBO report credits Freddie Mac and Fannie Mae with reducing mortgage interest rates only on loans actually purchased. In fact, as a result of Freddie Mac and Fannie Mae, *all* conforming market borrowers enjoy a reduced mortgage interest rate. Without Freddie Mac, even jumbo loans would carry higher mortgage rates.

When the government implements a policy to lower gasoline costs by selling oil from the nation's reserve, the effectiveness of the decision would not be measured solely in terms of gasoline price reductions directly attributable to the actual oil sold from the reserve. Instead, the government would measure the impact on supply and demand – and consumer prices – of the overall market reaction. Similarly, it is appropriate to measure Freddie Mac's and Fannie Mae's impact on the overall mortgage market.

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[15] *See, e.g.*, Cotterman, Robert F. and James E. Pearce, "The Effects of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation on Conventional Fixed-Rate Mortgage Yields", in *Studies on Privatizing Fannie Mae and Freddie Mac*, ed. by U.S. Department of Housing and Urban Development, 97-168 (1996); Hendershott, Patric H. and James D. Shilling, 'The Impact of the Agencies on Conventional Fixed-Rate Mortgage Yields', *Journal of Real Estate Finance and Economics*, 2: 101-115 (1989); Toevs, Alden L. A Critique of the CBO's Sponsorship Benefit Analysis. New York: First Manhattan Consulting Group. 2000; Pearce, James E. *Conforming Loan Differentials: 1992-1999.* Welch Consulting. November 2000.

The correction: Apply the more realistic 30 basis point estimate of the jumbo-conforming spread to the rest of the conventional mortgage market.

Making these four corrections alone would reverse CBO's conclusion and show that the benefits Freddie Mac and Fannie Mae bring to consumers outweigh the advantage they derive from their Congressional charters.

The CBO report ignores other benefits that are extremely important to America's families and the strength of our economy. Without Freddie Mac and Fannie Mae, the flow of low-cost mortgage funds would be susceptible to shocks in global capital markets, homeownership rates would be lower, and fewer lower-income and minority families would own a piece of the American dream.

Compounding these mistakes is the CBO report's "capitalized subsidy" treatment of our funding advantage. This accounting method has never been used by anyone – whether within or outside the government – to measure either the benefits we bring or our funding advantage. CBO provided little in the way of justification or documentation for using this very complex and contrived approach. Drs. Pearce and Miller reviewed the draft version of CBO's 2001 report, with particular attention to the capitalized subsidy treatment, and concluded that CBO applied this methodology inappropriately and inconsistently.[16] Their analysis can be found at Appendix C.

Prior to the May 2001 publication of its report, CBO provided Freddie Mac a draft version for comment. The draft showed the effect of different methodologies on the estimate of the funding advantage. Correcting its own errors in the 1996 study reduced CBO's estimate of the subsidy by $4.1 billion.[17] The capitalized subsidy treatment added $2.0 billion back.[18]

Thus, only by using this inappropriate accounting treatment is CBO able to assert that Freddie Mac and Fannie Mae derive a funding advantage of approximately $10 billion from their Congressional charters. If CBO had simply corrected its 1996 report, there would be no retained funding subsidy whatsoever. CBO would have concluded that Freddie Mac passes the entire value of the funding advantage through to borrowers in the form of lower mortgage interest rates.

Finally, CBO questions the benefits and advantages of Freddie Mac in a vacuum, without similarly questioning those of other financial institutions. In fact, depositories receive funding advantages through deposit insurance, access to Federal Reserve Bank liquidity and FHLB advances and have an average cost of funds that is lower than Freddie Mac's.

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[16] James E. Pearce and James C. Miller III, "Response to CBO's Draft Report: Federal Subsidies and Housing GSEs," at 5 (2001).
[17] Draft version of CBO's 2001 report at Table B-1. The table shows the technical adjustments growing to $4.1 billion in 2000.
[18] Table 6 shows "subsidies to securities" issued by Freddie Mac and Fannie Mae during 2000 of $4.2 billion and $5.5 billion, respectively, for a total of $9.7 billion under the "capitalized subsidy" treatment. This estimate is $2.0 billion larger than the $7.7 billion estimate.

Such comparisons would demonstrate the significant benefits and efficiencies of Freddie Mac and Fannie Mae.

Freddie Mac is a great Congressional success story. We have a 30-year track record of bringing enormous benefits to America's families and stability to our nation's housing finance system. For proof we need only look at our country's record homeownership rate, the quality of our housing stock, the strength of the housing market in today's economy and the stable supply of low-cost mortgage funds.

III. REGULATORY STRUCTURE IN GSE ACT IS FUNDAMENTALLY SOUND

As a result of our superior risk management capabilities, strong capital position and state-of-the-art information disclosure, Freddie Mac is unquestionably a safe and sound financial institution. The six voluntary commitments we announced last October with Chairman Baker, Ranking Member Kanjorski and other Members of the Subcommittee, and which were fully implemented by this spring, put Freddie Mac at the vanguard of world financial practices. Freddie Mac asked William Seidman, the former Chairman of the FDIC, for an assessment of our commitments. He concluded:

> *Your package of disclosures and standards puts [Freddie Mac] in a position of providing more and better public information than any another financial institution, both regulated and non-regulated, of which I am aware.*[19]

Our six commitments set the pace for other institutions to adopt similar practices and to enhance their public disclosures. In fact, Moody's Investors Service said that the commitments "set new standards not only for themselves [Freddie Mac and Fannie Mae], but for the global financial market."[20] They added:

> *The leadership shown by Freddie Mac and Fannie Mae could prove difficult for other firms to ignore, and could usher in a wave of enhanced financial risk disclosure. This may prove to be one of the most important ramifications of the GSEs' initiatives.*[21]

Effective and credible regulatory oversight is an essential complement to our already strong financial position. In this regard, we believe that the regulatory structure set forth by the GSE Act is fundamentally sound. It ties capital to risk; provides a comprehensive set of enforcement authorities; provides oversight without unnecessary intrusion and enables the enterprises to respond aggressively to market developments with innovations to meet their mission.

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[19] Memorandum of L. William Seidman to Freddie Mac (December 13, 2000).
[20] *New Freddie Mac & Fannie Mae 'Open Book' Policy: A Positive Credit Development*, Moody's Investors Service (October 2000).
[21] Ibid.

Regulatory Structure Ties Capital to Risk

Freddie Mac supports a regulatory structure that closely ties capital to risk. Over the past few years, global experts in financial regulation have embraced principles of risk management that are forward-looking and market-oriented. Supported by sophisticated analytical techniques and technologies, this approach is superior to the traditional reliance on static leverage ratios, which have been the primary tool for regulating financial institutions for the past several decades.

This new thinking about capital adequacy is embodied in the first "pillar" of the capital framework set forth by the Basel Committee on Banking Supervision in its June 1999 consultative paper.[22] It also is aligned with the views of U.S. financial regulatory experts "that, to be effective, regulatory capital charges need to be reasonably attuned to underlying economic risks."[23] In recent testimony, Federal Reserve Chairman Alan Greenspan stated "the nature and complexity of risk undertaken by many larger organizations have made the blunt traditional measures of capital adequacy...less meaningful."[24]

Not only is Freddie Mac highly skilled at managing risk, we are extremely well capitalized for the risks we take. We manage our business to hold enough capital to withstand ten years of economic stress resembling the Great Depression. In addition to our own rigorous capital management, the GSE Act provides a comprehensive regulatory capital structure, subjecting us to both a minimum capital requirement as well as a stringent risk-based capital standard. The minimum capital requirement applies to both on-balance-sheet and off-balance-sheet assets, unlike bank capital standards. The risk-based capital standard is the industry's toughest, requiring us to withstand ten years of extremely severe stress.

The risk-based capital standard required by the GSE Act is innovative, stringent, dynamic and more responsive to risk than any ratio-based capital regulation.[25] It requires Freddie Mac to maintain sufficient capital to withstand a ten-year period of extreme swings in both credit and interest-rate risks.

The credit risk portion of the stress test is based on the assumption that defaults and losses on mortgages occur throughout the United States at a rate and severity equal to the highest default rates experienced in a regional downturn.[26] The interest-rate risk portion

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[22] Basel Committee on Banking Supervision, *A New Capital Adequacy Framework*, Consultative Paper on Capital Adequacy No. 50, (June 1999) (the "1999 Basel Consultative Paper").
[23] Remarks by Governor Laurence H. Meyer, Annual Washington Conference of the Institute of International Bankers, Washington, D.C. (March 5, 2001): "In short, the increasing sophistication of markets demands that, to be effective, regulatory capital charges need to be reasonably attuned to underlying economic risks."
[24] Testimony of Chairman Alan Greenspan on the Condition of the U.S. Banking System before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (June 20, 2001).
[25] 12 U.S.C. §4611.
[26] 12 U.S.C. §4611(a)(1).

of the test mandates a stress test in which yields on 10-year Treasury bonds fall or rise by as much as 600 basis points.[27] Further, the GSE Act requires a 30 percent add-on to required stress test capital to account for management and operations risk.[28]

A pioneer in the use of risk-based stress tests, Freddie Mac believes that a well-implemented capital standard must produce specific and accurate determinations of required capital. Assigning too little capital or too much both have negative consequences. Too little capital could jeopardize our ability to withstand an extreme downturn in the economy. On the other hand, requiring too much capital would impose unnecessary costs on the nation's families. Mortgage rates would rise, and mortgage products attractive to lower-income borrowers would become more expensive or unavailable.

Furthermore, it is critical that the test be operationally workable. For Freddie Mac to purchase mortgages on a daily basis, we must be able to calculate the amount of capital that will be required and incorporate it into our business planning and processes.

Finally, the stress test should recognize prudent risk management. For example, the test should not penalize the use of swaps and other securities contracts, the function of which is to manage interest-rate risk. This is an essential risk management strategy that we and other large, well-capitalized financial institutions use every day. A standard that ties capital to risk would appropriately recognize this strategy with a lower capital requirement. According to Chairman Greenspan, regulators must "develop ways to improve their tools while reinforcing incentives for sound risk management."[29]

Regulatory Structure Provides Adequate Oversight Authority

The regulatory structure set forth by the GSE Act provides the regulator of Freddie Mac and Fannie Mae adequate authorities to discharge its statutory responsibilities. The provisions relating to supervisory review, examination and enforcement were explicitly crafted to dovetail with the risk-based capital standard. The stringent risk-based stress test, combined with the minimum capital standard and the capital add-on for management and operations risk, represents a comprehensive set of regulatory controls that is unprecedented. Thus, individual authorities should not be viewed in a vacuum, but in terms of the entire regulatory structure.

Moreover, the "package" of authorities conferred on the regulator of Freddie Mac and Fannie Mae was uniquely designed for the oversight of two GSEs engaged in one line of work: financing mortgages. In contrast, examiners of large banks must inspect activities ranging from annuities to foreign currencies to commercial loans to credit cards taking place at hundreds of subsidiaries here and around the world.

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[27] 12 U.S.C. §4611(a)(2).
[28] 12 U.S.C. §4611(c)(2).
[29] Testimony of Chairman Greenspan, at 1 (June 20, 2001).

Congress based many of the enforcement and prompt corrective action provisions in the GSE Act on provisions contained in banking statutes.[30] Other enforcement provisions are unique to the regulation of the GSEs. For example, OFHEO is required to report the results and conclusions of its examinations to Congress,[31] a reporting requirement unique among financial regulators. This periodic public disclosure by our regulator provides independently reviewed financial information to Congress and the public about Freddie Mac's and Fannie Mae's condition and results of operations. This type of detailed, independent, safety-and-soundness review is not available for any other regulated financial institution.

In a recent report, the General Accounting Office (GAO) examined the various enforcement authorities possessed by OFHEO, the Federal Housing Finance Board and federal banking regulators. Noting that the regulatory bodies differ somewhat in the authorities accorded to them, the GAO nonetheless concluded that "based on each regulator's powers and authorities, it appears that each regulator has statutory tools available to address significant safety and soundness concerns."[32]

Regulatory Structure Facilitates Enterprises' Housing Mission

Effective regulatory oversight must fully satisfy the challenge of ensuring Freddie Mac's and Fannie Mae's safety and soundness while enabling the enterprises to vigorously innovate to achieve their housing mission. The existing regulatory structure explicitly takes into account our public mission "to promote access to mortgage credit throughout the Nation."[33] Congress embedded this important public purpose in our charter, and affirmed it with explicit statutory findings when it enacted the GSE Act. Congress found that "the continued ability of [Freddie Mac and Fannie Mae] to accomplish their public missions is important to providing housing in the United States and the health of the Nation's economy..."[34] Thus, an effective regulator of Freddie Mac and Fannie Mae must be mindful of Congress' intent that Freddie Mac fulfill its mission.

In the GSE Act, Congress entrusted the Secretary of Housing and Urban Development (HUD) with ensuring that Freddie Mac is accomplishing the purposes for which Congress chartered us and created OFHEO as an office within HUD.[35] Entrusting a regulator with a role to encourage the accomplishment of public purposes is not unique to the GSE Act.

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[30] *See, e.g.,* the Legislative History in the Senate Report accompanying the 1992 Act: "The procedural requirements for cease-and-desist proceedings parallel those applicable to similar proceedings by federal banking regulators against insured depository institutions and institution-related parties under section 8 of the Federal Deposit Insurance Act and related authorities" and "These grounds [for appointing a conservator in the 1992 Act] resemble established grounds for appointment of a conservator for federally insured depository institutions, including national banks, under the Federal Deposit Insurance Act and the Bank Conservation Act." S. Rep. No. 102-282 at 58, 62 (1992).

[31] 12 USC §4521(a).

[32] Letter from the United States General Accounting Office to the Honorable Richard H. Baker regarding a Comparison of Financial Institution Regulators' Enforcement and Prompt Corrective Action Authorities, at 2 (January 31, 2001).

[33] 12 U.S.C. §1451(b)(4)(Note).

[34] 12 U.S.C. §4501(2).

[35] 12 U.S.C. §§4541, 4511.

The authorizing statute of the Office of Thrift Supervision requires the Director of the OTS to "exercise all powers" to "encourage savings associations to provide credit for housing safely and soundly."[36] Similarly, the Federal Housing Finance Board is charged with ensuring that "the Federal Home Loan Banks carry out their housing finance mission" among its other duties.[37]

Regulatory Structure Allows for Innovation

In keeping with the explicit intentions stated by Congress, the regulatory structure should not stifle mortgage innovation. Freddie Mac's rapid response to market developments with private sector-based innovations has proven effective in expanding homeownership broadly, including opening new doors of opportunity for low- and moderate-income families. Effective oversight should allow Freddie Mac to vigorously pursue our housing mission in a safe and sound manner and within the bounds of the Charter. In establishing OFHEO's unique role, Congress stated:

> *The Committee does not mean for the Director [of OFHEO] to impose his or her business judgment on, or interfere with, the normal management prerogatives of an enterprise that has sound financial controls, and is adequately capitalized, and profitable. Congress created the enterprises under private ownership and management to bring the entrepreneurial skills and judgments of the private sector to bear on the accomplishment of public purposes related to housing. The Committee does not mean to upset this unique structure or to encourage any government official to second guess decisions of enterprise management arrived at through the exercise of honest, unbiased judgment of what is in the best interests of the enterprise.*[38]

In summary, we believe the regulatory structure envisioned by the GSE Act is fundamentally sound. It ties capital to risk; provides a comprehensive set of enforcement authorities; provides oversight without unnecessary intrusion and enables the enterprises to respond aggressively to market developments with innovations to meet their mission.

Notwithstanding the appropriateness of this regulatory structure, it is critical that the regulator have the confidence of Congress, the public and investors. Mr. Chairman, you have put the question of the appropriate location of Freddie Mac's safety-and-soundness regulation before the Subcommittee. Other policymakers, including HUD Secretary Martinez, have expressed support for retaining OFHEO's safety-and-soundness oversight responsibilities.[39]

Our view on this important matter is that if there were a change in location of the regulator, that entity should be highly competent and credible; should support housing as an important public policy objective; and should enjoy bipartisan support. Freddie Mac

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[36] 12 U.S.C. §1463(a)(3).
[37] 12 U.S.C. §1422(a)(3)(B)(ii)
[38] S. Rep. No. 102-282, at 25 (1992).
[39] "U.S. Housing Chief - Strengthen Mortgage Agency Regulator," Reuters, June 21, 2001.

remains committed to continuing our constructive working relationship with OFHEO and to providing any input and assistance that you believe would be helpful to your deliberations.

IV. CONCLUSION

America enjoys the world's best housing finance system because of the high level of support provided by Freddie Mac and the secondary market. By attracting global capital to finance homeownership in America, we reduce mortgage costs, saving families billions of dollars. The extraordinary liquidity we bring to the nation's mortgage markets also helps stabilize our nation's economy.

To meet our mission, Freddie Mac is relentlessly wringing out every unnecessary cost and barrier to homeownership; we are pushing the limits of technology; and we are searching the globe to find the lowest cost funds for housing. As a result of our activities, more families than ever before can afford to buy a home. In addition, they compete on an equal footing with the largest corporations for low-cost funds in the world's capital markets. The value we bring to America's families and to the nation's economy far outweighs the funding advantage we derive from our Congressional charter.

Freddie Mac's strength and vitality ensure that we are able to meet the housing finance needs of the future. Our superior risk management capabilities, strong capital position and state-of-the-art information disclosure make Freddie Mac unquestionably a safe and sound financial institution. Effective and credible regulatory oversight is an essential complement to our already strong financial position. The regulatory structure contained in the GSE Act is forward-thinking, comprehensive and appropriate to the enterprises and the mission we serve.

* * * * *

Thank you for the opportunity to appear today. I look forward to working with Chairman Baker, Congressman Kanjorski and the members of this Subcommittee to secure the future of our housing finance system and, with it, the dreams of millions of families.

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REFORMING THE REGULATION OF FANNIE MAE AND FREDDIE MAC

Statement of Richard S. Carnell

**Before the Subcommittee on Capital Markets,
Insurance, and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives**

July 11, 2001

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SUMMARY

Choice of Regulator

I support moving safety-and-soundness regulation of Fannie Mae and Freddie Mac out of the Department of Housing and Urban Development. HUD lacks both the will and the institutional credibility to stand up to the GSEs. Having such regulation in HUD encourages White House personnel officials to regard the top regulator's job as primarily involving housing rather than safety and soundness.

But having the Federal Reserve Board regulate Fannie and Freddie would: conflict with the Fed's responsibility for monetary policy; conflict with the Fed's role as lender of last resort through the "discount window"; rely on an agency institutionally ill-suited to confront Fannie and Freddie; and create a potentially unhealthy concentration of power without adequate accountability. I recommend retaining the Office of Federal Housing Enterprise Oversight ("OFHEO") as Fannie and Freddie's safety-and-soundness regulator, and making OFHEO an autonomous bureau of the Treasury Department.

Registration and Reporting Under the Securities Laws

The bill would rightly repeal Fannie and Freddie's exemption from the registration and reporting requirements of the federal securities laws. This anachronistic exemption sends exactly the wrong signal: that the two firms are so "special," so close to the government, that investors in their securities have no need for the protections afforded by the registration and reporting requirements.

Correcting Defects in GSE Safety-and-Soundness Statutes

The bill would rightly correct some glaring defects in the safety-and-soundness statutes governing the two government-sponsored enterprises ("GSEs"). It would strengthen regulators' authority to prescribe capital standards and to take prompt corrective action or enforcement action. It would also fill a troublesome gap in current law by authorizing regulators to appoint a receiver for a critically undercapitalized GSE.

The GSEs' Double Game

In dealing with their relationship to the federal government, Fannie and Freddie play an extraordinarily successful double game. They emphatically deny that they have any formal, legally enforceable government backing. In so doing, they leave the impression that they have no government backing at all. At the same time, they work to reinforce the market perception of implicit government backing (which all three statutory disclaimers of taxpayer liability fail to correct).

Properly Comparing Banks and GSEs

Fannie Mae and Freddie Mac wrongly argue that the federal government gives FDIC-insured banks benefits comparable to or greater than those it gives the two GSEs, and that the GSEs' success simply reflects their greater efficiency. Fannie and Freddie have lower overhead than banks because they do a different business than banks: a wholesale rather than a retail business. Moreover, contrary to what you might expect, the government's perceived implicit backing of Fannie and Freddie actually tends to provide a greater net subsidy than FDIC insurance, for six structural reasons: (1) unlimited coverage of all GSE obligations; (2) no receivership mechanism; (3) no cross-guarantees to protect the taxpayers; (4) company-specific statutes that avoid the discipline of having to comply with the same rules as thousands of other businesses; (5) protection from effective competition; and (6) not having to pay fees or to provide public benefits that would impose significant costs on the GSEs' shareholders.

Systemic Risk

Fannie and Freddie are often characterized as "too big to fail"—meaning that the government would be forced to rescue them lest their failure unleash "systemic risk" that would harm the nation's financial system and economy. Yet there is nothing inevitable about such systemic risk; it results from human decisions. If investors expect the government to rescue troubled GSEs, investors will tend to let GSEs take greater risks than they otherwise would have. This weakening of market discipline on GSEs will, in turn, increase the risk that the GSEs ultimately will get into trouble. Thus "too big to fail" and "systemic risk" are to a large extent circular: they have their roots in prevailing expectations, and they easily become self-fulfilling prophecies.

But this circularity also has a positive side: by acting in a timely way, the government can correct "too big to fail" expectations. Congress did just that in the FDIC Improvement Act of 1991, which curtailed "too big to fail" treatment of banks.

Opportunities for Immediate Administrative Action

Regulators can and should act to improve the regulation of Fannie and Freddie by (1) obtaining accurate data on FDIC-insured banks' investments in GSE securities, (2) limiting any excessive concentrations of GSE risk in banks' investment portfolios, (3) ending the mislabeling of mutual funds, (4) properly controlling the GSEs' daylight overdrafts, and (5) tightening scrutiny of the GSEs' mission.

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The views expressed here are my own, and not necessarily those of Fordham University or Fordham University School of Law

STATEMENT OF RICHARD S. CARNELL

Mr. Chairman, Mr. Kanjorski, Members of the Subcommittee:

I am pleased to have this opportunity to discuss Fannie Mae, Freddie Mac, and H.R. 1409, the Secondary Mortgage Market Enterprises Regulatory Improvement Act.

As government-sponsored enterprises, Fannie and Freddie are privately owned, profit-oriented corporations that have Congressional charters and receive an array of federal benefits not available to businesses generally. More importantly, however, capital market participants believe that the government implicitly backs each GSE—and would not let the GSE's creditors go unpaid. This perceived implicit guarantee is the GSEs' most important and most distinctive characteristic. It enables Fannie and Freddie to borrow over $1 trillion at rates below those available to even the most creditworthy fully private borrowers.

In my testimony today, I will:

(1) discuss the major provisions of H.R. 1409—including its choice of GSE regulator, its requirement that Fannie and Freddie comply with the securities laws, and its safety-and-soundness reforms—and also suggest some additional provisions;

(2) describe the double game by which Fannie and Freddie deny that they have "full faith and credit" government backing—in ways that leave the impression that they have no government backing at all—even as they work to reinforce the market perception of implicit government backing;

(3) analyze the GSEs' attempt to liken FDIC-insured banks to GSEs and to argue that we should not concern ourselves with GSE subsidies because the government gives banks greater subsidies;

(4) examine so-called "systemic risk"—particularly the argument that if a GSE got into financial trouble, the government would have no choice but to rescue it, lest its failure unacceptably damage the financial system;

(5) point to some opportunities for regulators to take immediate administrative action to improve the regulation of Fannie and Freddie; and

(6) identify nine important questions that Fannie and Freddie persistently manage to avoid answering.

H.R. 1409

The bill would take important steps to remedy weaknesses in current law. I believe that most of these changes merit enactment, with one major exception: rather than shifting GSE regulation to the Federal Reserve Board, I would keep the Office of Federal Housing Enterprise Oversight in existence and make it an autonomous bureau of the Treasury Department.

Choice of Regulator

Under the bill, the Federal Reserve Board would take over from OFHEO responsibility for the GSEs' safety and soundness, and take over from the secretary of Housing and Urban Development responsibility for the GSEs' housing mission.

In selecting an agency to regulate GSEs' safety and soundness, we should seek (1) competence, (2) resistance to special-interest pressure, and (3) no problematic conflicts of mission.

I support moving safety-and-soundness regulation out of HUD. Despite OFHEO's autonomy within HUD, having OFHEO part of HUD creates two types of problems. First, HUD—a wounded agency for decades—lacks both the will and the institutional credibility to stand up to the GSEs. Second, having OFHEO part of HUD encourages White House personnel officials to regard the directorship of OFHEO as a housing appointment rather than a safety-and-soundness appointment.

Although I believe that the Federal Reserve Board would capably regulate Fannie and Freddie, I have several concerns about transferring regulation to the Fed.

First, GSE regulation would potentially conflict with the Fed's responsibility for monetary policy. Managing interest-rate risk is a crucial part of Fannie and Freddie's business. What if good monetary policy called for a sharp and sustained increase in interest rates and yet such an increase would take a serious toll on the GSEs' safety and soundness? Such circumstances arose during the early 1980s, when high interest rates rendered Fannie market-value insolvent,[1] and they may arise again.[2]

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[1] U.S. Department of Housing and Urban Development, 1986 REPORT TO CONGRESS ON THE FEDERAL NATIONAL MORTGAGE ASSOCIATION 99-101 (1987).

[2] In designing the Thrift Savings Plan for Federal Employees, Congress may well have recognized the potential for a similar conflict of mission. Under the Senate bill, the chair of the Fed would also have

Second, having the Fed regulate Fannie and Freddie would potentially conflict with the Fed's role as lender of last resort through the "discount window." Such a regulatory relationship would tend to reinforce market participants' expectation that the government would rescue Fannie and Freddie if they ever got into trouble. Indeed, it might well be seen (however unfairly) as giving Fannie and Freddie a fast track to borrowing whatever sums they needed from the Fed, instead of having to face the delays and uncertainties of a legislative bailout. The Fed has authority to make emergency loans to any corporation, including Fannie and Freddie. 12 U.S.C. § 343.[3]

Third, the Fed would tend to be institutionally averse to facing down Fannie and Freddie, lest it risk a legislative rollback. The Fed's overriding institutional priority is to maintain its independence. Congress seldom has occasion to vote on what the Fed does, and the Fed tends to approach legislative battles warily. The potential for GSE-driven legislative setbacks would heighten the conflict between GSE regulation and monetary policy. For example, if a necessary but unpopular tightening of monetary policy had left the Fed politically isolated, the Fed would be reluctant to tighten GSE policy (e.g., safety and soundness standards) in ways that would risk conflict with Fannie and Freddie, even if tighter policy were appropriate.

Fourth, having the Fed regulate GSEs could create a potentially unhealthy concentration of power in a relatively unaccountable agency.

I recommend retaining OFHEO as Fannie and Freddie's safety-and-soundness regulator, making OFHEO an autonomous bureau of the Treasury Department, and assuring that OFHEO would in no way depend on the annual appropriation process.

Registration and Reporting Under the Securities Laws

Section 109 of the bill would rightly repeal the two GSEs' exemption from the registration and reporting requirements of the federal securities laws. It would thus require Fannie and Freddie to comply with the same public-disclosures rules as other large investor-owned corporations.

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chaired the Federal Retirement Thrift Investment Board; the House bill excluded the Fed from that board. Congress adopted the House approach. 5 U.S.C. § 8472; H.R. Conf. Rep. No. 99-606, at 138 (1986).

[3] Potential conflicts of mission already exist between the Fed's bank-regulatory responsibilities and its monetary-policy and discount-window responsibilities. But having the Fed regulate GSEs would add a new, untried function—beset from the start by the longstanding expectation that the government would rescue any troubled GSE.

The GSEs' securities-law exemption has long been an anachronism. Fannie originated as a government corporation (as Ginnie Mae, the Tennessee Valley Authority, and the U.S. Postal Service still are). The federal government wholly owned and controlled Fannie, and Fannie sold investors only debt securities backed by the government's full faith and credit.[4] Thus exempting Fannie from securities registration and reporting requirements made sense. But that changed in 1968, when Fannie became an investor-owned company. Congress should have repealed Fannie's exemption then, and should not have given Freddie a similar exemption.

The exemption long ago lost any principled justification. It now sends exactly the wrong signal: that Fannie and Freddie are so "special," so close to the government, that investors in their securities have no need for the protections afforded by the registration and reporting requirements.

Fannie and Freddie seek to perpetuate that wrong signal. They argue that they already fully comply with those requirements. But if that is true, why do they so resist having the requirements apply? Would the Securities and Exchange Commission require fuller disclosure of the GSEs' risk exposure? Would the SEC conclude that the GSEs transgress generally accepted accounting principles? We do not know. But it is not enough for Fannie and Freddie to say that they comply. All large U.S. corporations say that they comply with the securities laws and with GAAP, and yet the SEC has occasion to disagree. Fannie and Freddie should undergo the same scrutiny.

Correcting Defects in the 1992 Safety-and-Soundness Legislation

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 ("1992 Act") drew on banking law to strengthen the safety-and-soundness regulation of Fannie and Freddie. The 1992 Act required a new, more rigorous set of capital standards, and it included prompt corrective rules and new regulatory enforcement authority. But these provisions unwisely tended to deny OFHEO authority possessed by bank regulators. As a result, OFHEO has (in Tom Stanton's apt phrase) "a sort of parody of the authority of the federal bank regulators." H.R. 1409 would take important steps to correct these defects.

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[4] According to the Department of Justice, "when Congress authorizes a federal agency or officer to incur obligations, those obligations are supported by the full faith and credit of the United States, unless the authorizing statute specifically provides otherwise." 6 Op. Ofc. Legal Counsel 262, 264 (1982).

Capital

Bank regulators have broad authority to prescribe capital standards, including authority to impose new standards or toughen existing standards in light of experience. 12 U.S. Code §§ 1831o(c)(1), 3907(a). OFHEO, by contrast, faces major constraints on the form and content of capital standards. Id. §§ 4611-4612. Sections 112 and 113 of the bill would give the regulator some additional freedom to adjust the risk-based capital test. I would have concern about the potential for using section 112(3) to weaken the risk-based test, particularly if the regulator were part of HUD.

Prompt Corrective Action

Prompt corrective action seeks to resolve financial institutions' problems before they give rise to large losses. The prompt corrective action rules governing Fannie and Freddie (12 U.S.C. §§ 4614-4619, 4622) are conspicuously weaker than the rules governing FDIC-insured depository institutions (id. § 1831o). For example, an undercapitalized bank cannot increase its total assets unless (1) the bank has an acceptable capital restoration plan, (2) the asset growth comports with the plan, and (3) the bank's capital ratio increases at a rate sufficient to enable the bank to become adequately capitalized within a reasonable time (id. § 1831o(e)(3)). Yet no statute bars Fannie and Freddie from continuing to grow while undercapitalized, even if they have no capital restoration plan or if the growth conflicts with such a plan (id. § 4615). The prompt corrective action statute authorizes growth restrictions only against a significantly or critically undercapitalized GSE, and makes such sanctions purely discretionary (id. §§ 4616(b)(2), 4617(b), (c)(2)). Sections 131 through-133 of the bill would corrective some of the most conspicuous weaknesses of the current GSE prompt corrective action statute.

Enforcement

OFHEO's authority to take enforcement action against Fannie and Freddie (id. §§ 4631-4636) is conspicuously weaker than that of its banking agency counterparts (id. § 1818). Sections 151-156 of the bill would take appropriate steps to strengthen enforcement authority over GSEs.

Receivership

Bank receivership laws facilitate rapid, efficient, and orderly resolution of claims against a failed or failing bank. The FDIC can take control of the bank, give insured depositors ready access to their money, and preserve any going-concern value. But no comparable receivership mechanism exists for Fannie and Freddie. Neither OFHEO nor anyone else has statutory authority to appoint a receiver. OFHEO can appoint only a *conservator*, which generally has the powers of a GSE's shareholders, directors, and officers (id. § 4620(a)). But these powers do not include requiring a GSE's creditors to accept less than 100 cents on the dollar or to swap debt for equity. Thus, for example, if a GSE's assets were worth less than its liabilities, a conservator could not resolve the insolvency, and pressure for a taxpayer bailout would mount.

Section 134 would remedy this defect in current law by authorizing the GSE regulator to appoint a receiver for a critically undercapitalized GSE. This would avoid troublesome uncertainty about how to deal with such a GSE.

Recommendations for Additional Legislative Action

I suggest that H.R. 1409 include several additional provisions.

First, the bill should correct the faulty statutory disclaimers of federal liability for Fannie and Freddie (discussed below in the section entitled "The GSEs' Double Game").

Second, the bill should correct sloppy language in the Secondary Mortgage Market Enhancement Act of 1984 stating that for some purposes Fannie and Freddie securities "shall be considered to be obligations issued by the United States." 15 U.S. Code. § 77r-1(a)(1)-(2).

Third, the bill should prohibit any GSE from representing that the government directly or indirectly backs the GSE (except in discussing formal, legally enforceable obligations of the government) with the intent to induce anyone to rely on that representation in connection with the purchase or sale of any security.

Fourth, the bill should clarify that the GSEs must limit their activities to the secondary mortgage markets.

THE GSEs' DOUBLE GAME

In General

In dealing with their relationship to the federal government, Fannie and Freddie play an extraordinarily successful double game: they deny that they have any formal, legally enforceable government backing, even as they work to reinforce the market perception of *implicit* government backing. Let's look more closely at the two parts of the double game.

First, Fannie and Freddie emphatically deny that they have any formal, legally enforceable government backing—in itself, a valid point. But the GSEs make this point in ways designed to convince the uninitiated that the GSEs enjoy *no government backing at all* (an implication directly conflicting with the second part of the double game). The GSEs stress that "Every one of our debt securities clearly states, in plain English, it is not backed by the full faith and credit of the government."[5] They argue that they operate "with entirely private capital" and that their activities "are entirely supported by [their] revenue . . . and the capital of private investors and are *not in any way guaranteed by the federal government.*"[6]

Second, Fannie and Freddie work to reinforce the perception of implicit government backing. Consider three examples involving Fannie. First, Fannie sought legislative history stating that Fannie and Freddie "are *implicitly backed by the full faith and credit of the U.S. Government.*"[7] Second, Fannie attacked Treasury Under Secretary Gensler as "irresponsible" and "unprofessional" when he testified before this Subcommittee on March 22, 2000, that "the government does not guarantee [GSEs'] securities."

Third, in a 1998 letter to the Office of the Comptroller of the Currency, Fannie argued that "all GSE issued securities merit" more favorable treatment under the federal banking agencies' risk-based capital standards than all "AAA-rated [non-GSE] asset-backed securities." Thus the mere fact that a GSE issues a security makes that security more creditworthy than any non-GSE security. An IOU issued by a financially troubled GSE (such as the Farm Credit System before its 1987 bailout) would, under Fannie's reasoning, still be more creditworthy than a top-tier asset-backed security guaranteed by the nation's healthiest fully private corporation. Fannie bases this argument squarely on what it calls "the implied government backing of Fannie Mae":

> GSE issues generically, and Fannie Mae-guaranteed MBS in particular, are viewed by the capital markets as *near proxies for Treasury securities* in terms of credit worthiness.

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[5] Franklin D. Raines, Remarks at Conference on Money Markets and the News: Press Coverage of the Modern Revolution in Financial Services, March 19, 1999.

[6] Fannie Mae, FM Watch Observer: Glossary of Terms, www.fmwatch-observer.com/glossary.html (emphasis added).

[7] When I worked for the Senate Banking Committee on a Glass-Steagall repeal bill in 1987-88, Fannie asked that I include such language (emphasis added) in the section-by-section analysis, which I declined to do.

> Fannie Mae standard domestic obligations, like Treasuries, typically receive no rating on an issue-by-issue basis, because investors and the rating agencies view the *implied government backing of Fannie Mae* as a sufficient indication of the investment quality of Fannie Mae obligations. . . .[8]

Thus Fannie asserts that in assessing credit quality, investors and rating agencies do not (and presumably need not) look beyond "the implied government backing of Fannie Mae," which in Fannie's view renders Fannie's securities "near proxies for Treasuries." These assertions are all the more remarkable in that Fannie made them in a formal comment letter to a bureau of the Treasury Department. We may reasonably infer that when Fannie meets with rating agencies and securities analysts—out of earshot of government officials—it makes arguments at least as strong as those quoted above.

The double game is objectionable insofar as the GSEs imply, or even expressly assert, that they enjoy no federal backing at all—which directly conflicts with the GSEs' simultaneous efforts to stoke the market perception of implicit federal backing. No one argues that the government has any formal, legally enforceable liability for the GSEs' securities. The real issue is whether the government would nonetheless rescue the GSEs—for example, because public officials believed that default by the GSEs would unacceptably harm the nation's financial system.

Ineffective Statutory Disclaimers

In seeking to limit the taxpayers' exposure to the GSEs, Congress has enacted three disclaimers of liability. But the phrasing of these disclaimers, far from hindering the GSEs' double game, fits it neatly.

First, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the "1992 Act") declares that "neither the [two] enterprises . . . , nor any securities or obligations issued by the enterprises . . . , are backed by the full faith and credit of the United States." 12 U.S.C. § 4501(4). But this disclaimer merely restates the obvious: that the government has no formal, legally enforceable liability for the GSEs' securities. It does not disclaim implicit backing, nor does it signal that market participants err in perceiving such backing. It thus avoids the real issue.

Second, a statutory section entitled "Protection of taxpayers against liability" declares that the 1992 Act "may not be construed as obligating the Federal Government,

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[8] Letter from Anthony F. Marra to OCC, Feb. 3, 1998 (emphasis added).

either directly or indirectly, to provide any funds" to Fannie or Freddie "or to honor, reimburse, or otherwise guarantee any obligation or liability" of Fannie or Freddie. Id. § 4503. This disclaimer also avoids the real issue. No one argues (so far as I am aware) that the 1992 Act *created* implicit backing where it did not already exist. Market participants had long believed such backing to exist under the GSEs' charters. Congress did not act to correct that perception.[9]

Third, each firm's securities must include "appropriate language . . . clearly indicating" that the securities "are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality thereof" other than the GSE in question. Id. §§ 1455(h)(1), 1719(b), (d)-(e). This requirement repeats the fundamental weakness of the first disclaimer: it disclaims formal, legally enforceable liability (which is not the issue), even as it fails to disclaim implicit backing (which is). "Indeed, the disclaimer itself hints at a special federal relationship; completely private firms do not need to disclaim federal backing because no one believes such backing exists."[10]

Subsidy Denial

The GSEs' double game helps the GSEs argue that they get little or no government subsidy. Yet no one can honestly dispute that Fannie and Freddie receive valuable benefits not available to businesses generally. These benefits include exemption from most state and local taxes and exemption from the registration and reporting requirements of the securities laws. The benefits also include a line of credit at the U.S. Treasury and special rules relating to the GSEs' securities—for example, rules that: equate those securities with U.S. Treasury securities for some purposes; permit issuance and transfer of those securities over the system used for issuing and transferring U.S. Treasury securities; and fail to limit FDIC-insured banks' investments in those securities. This special treatment strongly abets the market perception of implicit federal backing. The recent Congressional Budget Office report demonstrates the great value of these special benefits.

Yet Fannie, in particular, insists that it receives no subsidy. Relying on a narrow dictionary definition to the effect that a "subsidy" is "monetary assistance granted by a

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[9] The second disclaimer also replicates the weakness of the first disclaimer in declaring that the 1992 Act "may not be construed as implying that any such enterprise . . . , or any obligations or securities of such an enterprise . . . , are backed by the full faith and credit of the United States." Id. § 4503.

[10] Ronald C. Moe & Thomas H. Stanton, *Government-Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability*, 49 PUB. ADMIN. REV. 321, 323 (1989).

government to a person or private commercial enterprise," Fannie asserts: "Fannie Mae does not receive a penny of public funds. To the contrary, last year our federal tax liability was $1.6 billion. True subsidies also are tangible. Fannie Mae's government benefits are not."[11] Fannie's reasoning—that a subsidy involves only a tangible payment of money by the government—produces absurd results. If Congress were to exempt Fannie from ever again having to pay any corporate income tax, that would supposedly not be a subsidy because it would involve no cash payment to Fannie. Similarly, if a foreign government gave an energy-intensive, capital-intensive export industry unlimited access to free electricity and low-cost government-guaranteed loans, that would supposedly not be a subsidy, either. These examples highlight the unreality of Fannie's arguments.

Subsidy-denial has provided cover for a vast outpouring of GSE debt even as the nation has made real progress towards getting its fiscal house in order. From FY 1992 to FY 2000, the federal budget went from a $290 billion deficit to a $236 billion surplus. But over that same period the three housing GSEs' net outstanding debt securities rose from $0.3 trillion on December 31, 1992, to $1.7 trillion on December 31, 2000, and their net outstanding mortgage backed securities rose from $0.8 trillion to $1.3 trillion. Thus the GSEs had $2.5 trillion in net outstanding obligations—compared with a privately held marketable Treasury debt of $2.5 trillion.

PROPERLY COMPARING BANKS AND GSEs

Fannie Mae and Freddie Mac often argue that the federal government gives FDIC-insured banks[12] benefits comparable to, or even greater than, those it gives Fannie and Freddie; that concern about subsidies to Fannie and Freddie is accordingly unwarranted and even hypocritical; and that any greater financial success shown by Fannie and Freddie simply reflects their greater efficiency.

Let's start with the issue of efficiency. Fannie and Freddie have lower overhead than banks because they do a different business than banks. Most banks do a predominantly retail business. To deal directly with large numbers of small customers, they have more offices and larger staffs than they otherwise would. By contrast, Fannie and Freddie do a wholesale business, which enables them to have lower overhead.

[11] Timothy Howard, Fannie Mae's Benefits to Home Buyers: The Business Perspective, Remarks to Federal Reserve Bank of Chicago Annual Conference on Bank Structure and Competition, May 11, 2001.

[12] For simplicity I use "banks" to refer to all FDIC-insured depository institutions, including thrift institutions.

Now let's turn to the issue of relative subsidy. FDIC insurance has a different set of costs and benefits than the government's sponsorship of Fannie and Freddie. You might expect FDIC insurance to provide a greater net subsidy.[13] After all, FDIC insurance is established by law and carries the government's full faith and credit. Yet the government's perceived implicit backing of Fannie and Freddie actually tends to provide a greater net subsidy than FDIC insurance, for six structural reasons.[14]

*1. **Unlimited Coverage.*** Federal deposit insurance applies only to deposits and then only up to a $100,000 limit. The FDIC can protect a failed bank's uninsured deposits and nondeposit creditors (such as bondholders) only under very narrow circumstances. By contrast, the government's perceived implicit backing of GSEs has no limits: it applies to all of a GSE's obligations, with no dollar ceiling.

*2. **No Receivership Mechanism.*** When an FDIC-insured bank fails, the FDIC becomes *receiver* for the bank: it takes control of the bank, gathers the bank's assets, and pays the bank's creditors in a specified order of priority. The bank's depositors must get paid in full before the bank's other creditors can get paid at all. If the bank's liabilities exceed its assets, its shareholders lose their ownership interest, its nondeposit creditors normally incur a partial or total loss, and its uninsured depositors often incur some loss. Similarly, when an ordinary nonfinancial company fails, it is liquidated under chapter 7 of the Bankruptcy Code. The bankruptcy court appoints a trustee, who takes control of the company, gathers its assets, and pays creditors in a specified order of priority.

No credible, workable receivership mechanism exists for Fannie and Freddie. Their charters do not provide for receivership, nor does the 1992 Act. The Bankruptcy Code does not permit Fannie or Freddie to become a debtor in a bankruptcy proceeding.[15] The lack of a receivership mechanism reinforces the market perception that the government would assure full payment of Fannie and Freddie's creditors.

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[13] The gross subsidy represents the total value of the special benefits provided by the federal government—benefits not available to businesses generally or even financial institutions generally. The net subsidy represents the difference between the gross subsidy and the offsetting costs that the entity must incur as a bank or GSE—costs not imposed on financial institutions generally.

[14] I have set forth these arguments more fully in *The Structure of Subsidy: Federal Deposit Insurance Versus Federal Sponsorship of Fannie Mae and Freddie Mac*, to published as chapter 4 of SERVING TWO MASTERS, YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC (forthcoming 2001).

[15] As federal instrumentalities, Fannie and Freddie are "governmental units" under § 101(27) of the Bankruptcy Code and thus under § 101(41) are not a "person." Under § 109(a) only a "person" can become a "debtor" in a bankruptcy proceeding. See 11 U.S.C. §§ 101(27), (41), 109(a).

3. No Cross-Guarantees to Protect Taxpayers. Federal deposit insurance involves strong safeguards designed to ensure that banks—rather than the taxpayers—bear any losses incurred in protecting insured depositors. Banks must normally pay premiums large enough to ensure that the FDIC's insurance funds have at least $1.25 in reserves for each $100 of insured deposits. This obligation to pay premiums gives each insurance fund a claim on the capital and earnings of all banks insured by that fund—and in effect creates a network of indirect *cross-guarantees* among FDIC-insured banks. Thus each member of the Bank Insurance Fund is liable for ensuring that the FDIC can protect insured depositors at every other BIF member bank. As long as the fund can replenish its reserves, its existence precludes any loss to the taxpayers.

No similar cross-guarantees reduce the government's risk-exposure to Fannie and Freddie. The two GSEs pay no insurance premiums and have no insurance fund. The two GSEs do not even cross-guarantee each other. If one GSE were to fail, the survivor would have no responsibility to pay the failed GSE's creditors.

4. Special Deals Instead of General Rules. To a much larger degree than banks, Fannie and Freddie reap the benefits of special, company-specific laws and avoid the discipline of generic law. Instead of operating under laws applicable to thousands of businesses, the two GSEs often get to operate under statutes designed for them alone.

5. Protection from Effective Competition Subsidizes GSE Shareholders. Federal and state regulators routinely issue bank charters to qualified applicants. Once chartered, a bank can typically engage in a wide range of activities statewide and even nationwide. Gone are the days when each bank charter required special legislation. Gone are the days when regulators would grant charters sparingly so as to limit competition with existing banks. Entry into banking is relatively easy, and banking law affords banks little protection against competition. Thus if banks receive a net federal subsidy, they should generally face enough competition to force them to pass the subsidy through to their customers.

Fannie and Freddie, by contrast, enjoy significant protection against competition. Their government sponsorship reduces their borrowing costs and increases the value of their guarantees to such an extent that no fully private firm can compete against them effectively. And only Congress can charter a competing GSE. By impeding competition with Fannie and Freddie, these constraints on entry increase the potential for the two GSEs' government benefits to end up in the hands of their shareholders rather than their customers.

*6. **Free Ride.*** Banks must normally pay for deposit insurance. They must also comply with an array of restrictions and requirements not applicable to businesses generally. But Fannie and Freddie pay no fee for their government sponsorship. They make no payments to an insurance fund or affordable housing fund. They need not provide public benefits that impose significant costs on their shareholders. HUD's affordable housing goals are so weak that Fannie and Freddie can meet them without doing more for affordable housing than banks do. I believe that the two GSEs would have a profit motive to do their affordable housing business in any event, even without a government subsidy.[16]

Considering the great value of the benefits Fannie and Freddie receive from the government, they should be doing *far* more to increase home ownership at the margin (e.g., by the lower middle class, the working poor, or members of certain minority groups).

SYSTEMIC RISK

Fannie and Freddie are often characterized as "too big to fail"—meaning that if they were in danger of default, the government would have to rescue them lest their failure unleash "systemic risk" that would gravely damage the nation's financial system and economy.

Discussions of systemic risk (whether in the GSE or the bank context) often have a tone of inevitability. But systemic risk is not a force of nature like earthquakes, hurricanes, and tornados. It results from human decisions: for example, decisions by market participants and government officials about how to structure the financial system,

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[16] Fannie and Freddie have provided no detailed disclosure of the profitability of their affordable housing programs. When the Treasury asked them for such information in 1996 for use in a Congressionally mandated study, Fannie and Freddie responded very differently. Freddie replied that it "purchases most single-family and multifamily mortgages in support of affordable housing through its standard mortgage purchase programs and under the same credit standards as its other mortgage purchases." One can reasonably infer that affordable housing goals did not impose significant costs on Freddie's shareholders: if "most" affordable housing loans met Freddie's usual credit standards, then they presumably also provided something approximating a normal return.

Fannie called the information proprietary and refused to provide it unless the Treasury signed a written agreement constraining the Treasury from making public use of the information, which would have defeated the purpose of obtaining the information. One can reasonably infer that Fannie withheld the information because it indicated that Fannie's affordable housing programs were quite profitable.

Toward the end of this statement, I suggest three questions to shed light on the profitability of Fannie and Freddie's affordable housing activities—and thus on the GSEs' incentives to continue those activities even without government sponsorship ("Questions for Fannie and Freddie," questions 7-9).

what risks to take, and how to respond to problems. If investors expect the government to protect them from the full pain of downside scenarios, they will tend to take greater risks than they otherwise would have. Thus "too big to fail" and "systemic risk" are to a large extent *circular*: they have their roots in prevailing expectations, and they easily become self-fulfilling prophecies. Insofar as investors expect the government to rescue troubled GSEs, market discipline on GSEs will weaken, which will tend to increase the risk that the GSEs ultimately will get into financial trouble.

If a GSE's troubles coincide with a broader financial crisis, government officials will face additional pressures to rescue the GSE. For if during the crisis those officials seriously upset established expectations, they may create contagious uncertainty about the government's willingness to meet other expectations. A crisis is thus a particularly inopportune time for attempting to reeducate market participants about the scope of the government's undertakings. So if the government tacitly accepts "too big to fail" expectations during good times, it may find itself constrained during a crisis to rescue a GSE against its better judgment.

But the circularity of systemic risk also has a positive side: if the government acts in a timely way, it can correct "too big to fail" expectations. Congress did just that in the FDIC Improvement Act of 1991 ("FDICIA") by curtailing the practice of treating FDIC-insured banks as "too big to fail."[17] FDICIA's "least-cost resolution" rule allows the FDIC to protect a failed bank's uninsured depositors and nondeposit creditors only if doing so is the "least costly to the deposit insurance fund of all possible methods" for meeting the FDIC's obligation to insured depositors. 12 U.S.C. § 1823(c)(4). The rule has a narrow systemic-risk exception, which has never been used.[18] Before FDICIA, the FDIC was spending extra money from the deposit insurance fund to protect uninsured

[17] In context of a failed FDIC-insured bank, "too big to fail" treatment involves spending extra money from the deposit insurance fund to protect deposits above the $100,000 limit on deposit insurance coverage. It may also involve extra spending to protect nondeposit creditors.

[18] The systemic-risk exception becomes an option only if recommended to the secretary of the Treasury by two-thirds majorities of both the Federal Reserve Board and the FDIC's Board of Directors. The secretary can make the exception only if the secretary determines, "in consultation with the President," that least-cost resolution of a given institution "would have serious adverse effects on economic conditions or financial stability." The secretary must document the determination. The General Accounting Office must review and report on the exception, including the potential for it to diminish market discipline and encourage unsound risk-taking. To recoup the additional cost of deviating from least-cost resolution, the FDIC must levy a special assessment on insured depository institutions. Id. § 1823(c)(4)(G). Congress designed these rules to promote accountability and make the process sufficiently unpleasant that systemic-risk exceptions would be made rarely (if at all) and never lightly.

depositors at banks as small as $500 million in total assets. But less than one year later, when an $8.8 billion bank group in a swing state failed on the eve of the 1992 Presidential election, the FDIC did *not* protect uninsured depositors.[19] Financial markets took this action in stride. By giving clear and timely notice of the new policy, Congress had succeeded in changing market participants' expectations.

OPPORTUNITIES FOR IMMEDIATE ADMINISTRATIVE ACTION

Regulators can and should act now to improve the regulation of Fannie and Freddie.

First, bank regulators should use their existing data-gathering authority to obtain accurate data on FDIC-insured banks' holdings of GSE securities. They should correct call-report forms so as to distinguish between GSEs and true government agencies like Ginnie Mae.

Second, if FDIC-insured banks do have problematic concentrations of risk in GSE securities, bank regulators should take corrective action now, again using their existing authority. Although 12 U.S.C. § 24(Seventh) exempts GSE securities from its statutory 10-percent-of-capital limit on holding securities of one issuer; it does not impair other regulators' authority to act against problematic concentrations of credit risk (e.g., through rulemaking in the spirit of section 305(b)(1)(A)(ii) of FDICIA, which calls for risk-based capital standards to "take adequate account of . . . concentration of credit risk"), or through enforcement action under 12 U.S.C. § 1818).

Third, the SEC should prohibit mutual funds whose portfolios consist in large part of GSE securities from mislabeling themselves as "Government" or "U.S. Treasury" funds.

Fourth, the Fed should review the adequacy of its current safeguards on so-called "daylight overdrafts" by GSEs.

Fifth, HUD should tighten its scrutiny of the GSEs' housing mission, using both its authority to review activity-expansion and its general rulemaking authority.

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[19] The First City Banks of Texas failed on October 30, 1992. Uninsured depositors ultimately suffered no loss—but only because the bank's assets ended up being worth more than its liabilities.

In the Presidential election four days later, President Bush received 40.6% of the vote in Texas, Governor Clinton 37.1%, and H. Ross Perot 22.0%.

QUESTIONS FOR FANNIE AND FREDDIE

Over the years, Fannie and Freddie have had remarkable success in dodging inconvenient questions about their relationship with the federal government and about their affordable housing programs, such as the following:

1. If the federal government does not subsidize Fannie and Freddie, why exactly do Fannie and Freddie object to giving up their various ties to the government?

2. Do capital market participants *err* in perceiving the federal government as implicitly backing Fannie and Freddie?

3. Do *you* believe that the federal government in any way implicitly backs Fannie and Freddie?

4. If Fannie and Freddie were to default on their obligations, would the federal government have any *moral obligation* to assure that Fannie and Freddie's creditors got paid?

5. If Fannie or Freddie were to get into serious financial trouble, would anything prevent the government from letting that GSE's creditors incur a loss?

6. What, if anything, would be wrong with Congress enacting legislation making clear that Fannie and Freddie must confine their activities to the secondary mortgage market?

7. Of all loans purchased by Fannie and Freddie, what percentage consists of affordable housing loans that provide more flexible underwriting standards (e.g., that allow borrowers to have higher debt or income ratios or make lower down payments; for brevity, "special affordable housing loans")?

8. Of all loans purchased by Fannie and Freddie that count toward the Department of Housing and Urban Development's affordable housing goals, what percentage consists of special affordable housing loans?

9. Of all loans purchased by Fannie and Freddie, how does the profitability (i.e., overall rate of return) of special affordable housing loans compare with the profitability of other loans that count toward HUD's affordable housing goals and with the profitability of loans that do not count toward those goals?

Mr. Chairman, I recommend that you ask Fannie and Freddie to answer questions 1 through 6 fully, clearly, and unequivocally. I also recommend that you ask the General Accounting Office to study questions 7 through 9 for the period from January 1, 1993, to the present.

CONCLUSION

Mr. Chairman, you have taken on an admirable but unenviable challenge: seeking to fix problems before the crisis hits or the scandal breaks. Your bill would make significant improvements in the regulation of Fannie and Freddie. More broadly, the bill and this hearing are important in continuing to focus the spotlight on the GSEs, their valuable government benefits, and the question whether they give the American people a return commensurate with those benefits.

TESTIMONY
OF
THE NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND
GOVERNMENT-SPONSORED ENTERPRISES
OF THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES

PRESENTED
BY
MARTIN EDWARDS, JR.
PRESIDENT-ELECT, NATIONAL ASSOCIATION OF REALTORS®

JULY 11, 2000

TESTIMONY OF THE NATIONAL ASSOCIATION OF REALTORS®

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Introduction

Mr. Chairman, Congressman Kanjorski, members of the Subcommittee I am Martin Edwards, President – Elect of the National Association of REALTORS®. I am a REALTOR® from Memphis, Tennessee, and will become the president of the NATIONAL ASSOCIATION OF REALTORS® next year. I am a partner in Wilkinson & Snowden, Inc., a commercial and industrial real estate firm.

As members of the Subcommittee know® the National Association of REALTORS® 780,000 members are involved in all aspects of the residential and commercial real estate industry. One of the REALTORS® principal goals is that America's homeownership opportunities expand and that our housing finance system remains strong, vibrant and responsive to demand. I am pleased to present the Association's views on H.R. 1409, the "Secondary Mortgage Market Enterprises Regulatory Improvement Act."

The National Association of REALTORS® is concerned that H.R.1409 taken as a whole is significantly at odds with the legislation Congress adopted in 1992 amending the GSEs' charters and laying out the current regulatory framework. When Congress adopted the Secondary Mortgage Market Enhancement Act of 1992, it reaffirmed the role that Fannie Mae and Freddie Mac should play as government-sponsored enterprises facilitating the expansion of the nation's residential secondary mortgage market and expanding American homeownership opportunities. The 1992 Act not only sharpened the mission and public purpose of the enterprises, it established the Office of Federal Housing Enterprise Oversight (OFHEO) to regulate the GSEs' financial operations and risk management. In the same legislation, Congress mandated affordable housing targets for Fannie Mae and Freddie Mac that formally charged the enterprises with the responsibility of promoting homeownership for families with incomes generally below the gross national median household income, which was $40,816 in 1999 according to the most recent data.

The 1992 Act reaffirmed that Fannie Mae and Freddie Mac as unique American financial institutions. All observers acknowledge that as government-sponsored enterprises, Fannie Mae and Freddie Mac are well-capitalized and well-managed corporations. Because of the two enterprises' activities, today's homeownership costs are lower and access to mortgage credit -- even for borrowers with blemished credit -- is easier and more equitable. Much of what Fannie Mae and Freddie Mac are doing in the current mortgage finance environment relates to lowering the costs of homeownership. The two enterprises are working to lower the two largest barriers to homeownership in this country -- the mortgage loan down payment and costs associated with closing the mortgage transaction. REALTORS® applaud and support these activities.

REALTORS® and the GSEs

REALTORS® and homebuyers rely on the GSEs to provide liquidity in the mortgage marketplace. That is the essence of why Congress created these enterprises. In the nearly thirty years that Fannie Mae and Freddie Mac have existed they have fulfilled their congressionally chartered mission in good economic times and in less prosperous economic times.

Creating homeownership opportunities at affordable costs to more Americans is the cornerstone of the National Association of REALTORS® business and public policy objectives. REALTORS® believe that Congress created Fannie Mae and Freddie Mac for that purpose and the enterprises consistently demonstrate their commitment to home ownership and housing affordability.

REALTORS® know from painful experience that booming mortgage lending and real estate cycles inevitably turn downward. Fannie Mae and Freddie Mac, unlike primary market lenders, remain in markets during these downturns. REALTORS® also support the federal ties and subsidies that flow to the GSEs because of their federal charters. In exchange, the GSEs fulfill their charter obligations -- they do what Congress, homebuyers, and most lenders want.

Despite REALTORS® general support for the GSEs, we do have our criticism of Fannie Mae and Freddie Mac. REALTORS® do not support Fannie Mae's and Freddie Mac's efforts to expand their foreclosed property disposition activities to include bidding on third party foreclosed properties. In addressing our concerns, REALTORS® did not seek legislation to hobble the enterprises, nor was there a concerted public effort to eliminate their activities. REALTORS® raised our concerns about the GSEs' third-party REO activities directly with the enterprises and both companies agreed not to expand their third-party REO activities.

We strongly disagreed when the GSEs opposed increasing the FHA mortgage limits. It is likely that we will not agree in the future on this issue.

More recently, there has been growing concern among some REALTORS® about the need to revise the conforming loan limits. As home prices and economic conditions converge to diminish housing affordability in a growing number of real estate markets on the West Coast, in some fast growing Mountain States, and along the Eastern seaboard. REALTORS®, believe that there are very solid reasons for selective loan limit increases to match the 'high cost area' limit currently in effect in Alaska, Hawaii and the Virgin Islands. These 'high cost areas' enjoy a conforming loan limit that is 50 percent higher than the standard conforming loan limit of $275,000.

We raise these issues to make this point: The current regulatory structure facilitates REALTORS® working with GSEs to address housing and homeownership problems. The proposed regulatory scheme introduces considerable uncertainty into the process.

Issues Raised by the Secondary Mortgage Market Enterprises Regulatory Improvement Act

H.R. 1409 proposes to make the Federal Reserve Board the regulator for Fannie Mae and Freddie Mac. The bill transfers safety and soundness regulation from the Office of Federal Housing Enterprises Oversight (OFHEO) and moving mission and new program and product regulation from the Department of Housing and Urban Development (HUD). The Board will have new authority to govern GSE activities. Its supervisory powers would parallel those that the Federal Reserve and other bank regulators already have over financial institutions. Unlike last year's GSE regulatory reform bill, the Federal Home Loan Banks and the Federal Housing Finance Board are unaffected by the bill.

The bill proposes prompt corrective action and enforcement similar to those for banks. However, the bill is extremely ambitious, going beyond the GSE regulatory structure. The bill raises questions about the mission, operations and activities of Fannie Mae and Freddie Mac that would be particularly troublesome for REALTORS® if enacted.

First, the Federal Home Loan Bank System, the nation's third housing-related GSE is excluded from the bill's scope. Significant disparities among the housing-related GSEs could likely result regarding capital, regulation, and activities.

Second, it is unclear whether the Federal Reserve Board is willing to take on the task of regulating Fannie Mae and Freddie Mac. Chairman Baker acknowledged that he had not consulted with the Board regarding the prospect of taking regulatory authority for these GSEs in addition to regulating bank holding companies and financial holding companies, as required by the Gramm-Leach-Bliley Act.

We would note that the Board has no experience regulating housing and real estate-related entities. Neither the Board nor its regional banks are experienced in regulating housing and real estate. As the nation's central bank, the Federal Reserve Board has historically held a negative view of the special status that the housing finance enterprises benefit from as a matter of public policy.

There is pending a major expansion of regulatory responsibilities for the Federal Reserve under the Gramm-Leach-Bliley Act through a proposed regulation to allow financial services holding companies sell and manage real estate. Governor Laurence Meyer recently affirmed the controversial nature of this proposed regulation.

A critical concern for REALTORS® regarding the Federal Reserve as the prospective GSE regulator is this: As the nation's central banker the Board could potentially have a conflict of interest regulating Fannie Mae and Freddie Mac. The Federal Reserve Board controls the nation's money supply and is the regulator for money center banks and financial services holding companies. REALTORS® are concerned, for example, that the Federal Reserve Board would not be unbiased in deciding whether to increase the GSEs' conforming loan limits when bank holding companies and financial holding companies that have huge stakes in mortgage lending subsidiaries would prefer that loan limits not increase. Arguably it is in the banks' interest to see conforming loan limits lowered or frozen.

Third, paradoxically the proposal to assure the prudent regulation of the GSEs seems to disregard a principal lesson that the nation learned during the savings and loan crisis of the 1980s. The old Federal Home Loan Bank Board regulated savings and loan associations and administered the S&L deposit insurance fund. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) institutionalized the principle of "constructive friction," effectively creating tension between mission and safety and soundness regulation in financial regulation. Admittedly the regulatory issue is not exactly the same. However, the proposal could create situations where the Board could well find itself making regulatory decisions that might favor one regulated industry over another.

Fourth, the bill goes beyond improving GSE regulation. The bill proposes to address issues associated with mission. It raises the public policy issues associated with the GSEs' federal charter to support the secondary mortgage market, and how conforming loan limits are established and revised. H.R. 1409 proposes limiting the Treasury Department's authority to purchase GSE obligations to provide liquidity to the mortgage markets in addition to removing the GSEs' exemption from Securities Exchange Commission registration. These provisions attack the premise for the GSEs' creation and existence and should be addressed separately.

For these reasons, the National Association of REALTORS® cannot support the bill in its entirety. However, REALTORS® do not take issue with the need for a strong and credible GSE regulatory structure. Congress came to the current regulatory structure after nearly two years of review and debate. The proposed focus on a single regulator as opposed to the current regulatory scheme is rooted in the difficulties that led to abolishing the Federal Home Loan Bank Board and separating mission regulation and safety and soundness regulation for thrifts in the wake of the savings and loan debacle of the 1980s. Congress deemed it prudent to separate mission and purpose from safety and soundness to avoid the regulatory and political conflicts that contributed to the savings and loan industry crisis.

The GSE safety and soundness and risk management concerns have not gone unaddressed. Last year the GSEs committed to Chairman Baker to institute new financial management and disclosure commitments intended to strengthen capital adequacy, transparency and market discipline. Recent oversight hearings in this Subcommittee about the GSEs' commitments to more disclosure and transparency regarding the risk management confirm that the GSEs are holding up their end of the bargain.

REALTORS® are concerned that GSE regulatory reform could well be the stalking horse for eliminating Fannie Mae and Freddie Mac as significant facilitators of housing finance. This does not mean that REALTORS® believe that regulatory scrutiny of Fannie Mae and Freddie Mac is unnecessary or could not be improved. Congress has oversight authority that it is clearly exercising. The bill, however, is extremely ambitious and like its predecessor may only serve as an impediment to focused discussion about regulating Fannie Mae and Freddie Mac.

Financial Marketplace, Competition and Innovation

What then are the issues that are really driving this debate?

Fundamental forces are transforming the U.S. housing finance system. There are implications for the primary and secondary mortgage markets, the capital markets, the financial system, homebuyers, Congress, and the GSEs' regulators. Traditional mortgage lenders and mortgage lending relationships are changing and creating significant uncertainty among industry competitors. The largest financial institutions are positioning to take advantage of the sweeping changes in the nation's banking laws. Their goal is to concentrate financial services mortgage financing in the hands of a few financial conglomerates that are emerging in the wake of new banking and financial laws.

Several of these financial conglomerates, once based in mortgage lending, consider themselves in competition with Fannie Mae and Freddie Mac. These financial services providers actively work to impede the GSEs' growth and innovation in the marketplace. These financial institutions are the same entities that petitioned the Federal Reserve Board and the Secretary of the Treasury to permit them to sell and manage real estate less than two years after sweeping banking and financial services reform legislation, the Gramm-Leach-Bliley Act, went into effect.

These lenders lament not having the financial advantages that Congress granted to the GSEs and advocate containing them. These financial companies are willing to argue that Fannie Mae and Freddie Mac have an unfair advantage because of their federal charter ties. Yet these same mortgage companies' parent banking companies have their own federal subsidies that come in the form of deposit insurance and other benefits that derive from the nation's banking and financial system safety net.

Fannie Mae and Freddie Mac were created to do what no fully private company could or was willing to attempt. Fannie Mae and Freddie Mac stabilize the residential secondary mortgage market. The GSEs have federally mandated goals that require investment in housing for low- and moderate-income families. These are families whose incomes are at or below area median incomes in specified geographic areas and other underserved markets. The price that Congress extracted from the GSEs for the federal charter and other benefits was to limit these enterprises to a single line of business. REALTORS® wonder if the lamenting financial institutions would give up their other lines of business to do solely what Fannie Mae and Freddie Mac do within the constraints of their federal charter.

Today's mortgage marketplace is extremely competitive and rapidly changing. Improvements in technology are largely driving the primary and secondary mortgage markets.

REALTORS® are working with the GSEs to forge partnerships to use technology to speed the real estate transaction, lower origination and settlement costs, and open markets to creditworthy borrowers. Many of these potential homeowners were shut out by traditional underwriting and credit risk assessment practices.

Need for GSE Regulatory Reform

REALTORS® believe that Congressional oversight is an important mechanism for scrutinizing Fannie Mae and Freddie Mac. The current regulatory framework adopted in the 1992 Act is fundamentally sound, though it may need to be fine-tuned. Vigorous regulation of the GSEs does not require radical changes, such as empowering the Federal Reserve Board to spread its regulatory clout into housing and real estate. Even the Federal Reserve Board has its limits and its own share of controversy associated with the prospect of regulating financial holding companies selling and managing real estate as a "financial activity" under the Gramm-Leach-Bliley Act.

GSE regulatory reform should not significantly alter the critical roles that Fannie Mae and Freddie Mac play as investors in home ownership. GSE regulatory reform should not result in a structure that effectively hamstrings the GSEs and leaves them vulnerable to cumbersome or burdensome oversight that stifles competition in the marketplace, reduces their effectiveness as mortgage investors, or makes them vulnerable the megabanks attempts to control financial markets and limit consumer financial choices and homeownership opportunity.

Congressional oversight of the GSEs' performance and a measured deliberate review of their mission are important undertakings. Congress created the housing enterprises to accomplish specific and, at the time, nearly revolutionary housing policy objectives. The current federal relationship with the GSEs is more than 20 years old and the residential secondary mortgage market is mature and efficient. The federal ties and charter issues are legitimate concerns for public debate and congressional review. It is appropriate for the Subcommittee to ask if the GSEs should have a new or continued role in the housing finance system. But it is our view that this review should occur against a background of what the GSEs currently do to promote homeownership and further refine the nation's housing finance system that is the envy of every country abroad.

REALTORS® believe that the public policy decision that created Fannie Mae and Freddie Mac and established these companies as government-sponsored housing enterprises continues to be relevant and necessary. The residential secondary mortgage market works to the benefit of the mortgage lending industry, homeowners, and the nation's housing policy.

Conclusion

When Congress created Fannie Mae and Freddie Mac it set in motion a commonly shared public policy regarding American homeownership. The residential secondary market has evolved into a highly efficient, flexible system that is based on the premise that federally sponsored enterprises should be the engines that facilitate homeownership. Under changing economic conditions, the residential mortgage lending industry evolved to satisfy the needs of the market.

Congress created the GSEs and empowered them to become critical intermediaries in the flow of consistent, affordable housing finance through the mortgage delivery system, and *de facto* regulators of the terms under which most mortgages are made.

Developments in the secondary mortgage market played critical roles in the advancement of mortgage liquidity and the reshaping of the nation's mortgage finance system. First, it forced the conformance of most underwriting, documentation and other essential terms of mortgage lending to the standards set by Fannie Mae and Freddie Mac. Conventional market mortgage pricing is directly tied to the capital markets, which reduced the volatility of mortgage rates and makes funding sources more reliable.

Second, Fannie Mae and Freddie Mac created new housing investment products and facilitated a broader investor base for mortgages. Cash flows from a single pool of fixed rate mortgages could be structured in a variety of ways to suit investor needs regarding maturities and call protection. Finally, the technological tools needed for the development of these new securities, primarily computers and software that could perform a complex array of underwriting, pooling, structuring and pricing analyses, brought mortgage finance to a new level of sophistication.

The economic success and the function the GSEs serve have generally been unquestioned. Homeownership rates pushed past the 67 percent mark last year due in significant part to the activities of the GSEs. The appropriateness of government fulfilling this market function, however, continues to invite periodic attempts at controls and limitations.

The challenge is to devise reasonable rules of operation that maintain fiscal integrity without unduly hindering the operation of the enterprises and the national mortgage markets. REALTORS® urge that this Subcommittee not undertake dramatic reforms for Fannie Mae and Freddie Mac such as those contemplated in H.R. 1409.

REALTORS® urge this Subcommittee to consider these questions before embarking on sweeping changes affecting the GSEs. What would housing finance be like without the GSEs? Would this nation be as well housed? Would as many families have access to the American Dream? Would housing be as strong a sector of the economy as it is today?

The GSEs' mortgage product innovations facilitate lenders and others committed to expanding homeownership. NAR, in partnership with five minority real estate professional associations, has just embarked on a major program to achieve parity for white and minority home ownership rates. NAR's Home Ownership for People Everywhere awards -- the HOPE Awards -- will recognize unsung heroes across the country that help to break down the barriers to minority homeownership. As we go forward, we want to be sure that the mortgage market remains accessible to minorities. Two of the very strongest voices for minority homeownership have been Freddie Mac and Fannie Mae.

Mr. Chairman, we believe that the current regulatory structure best serves the interests of the nation. We believe that the secondary mortgage market works to the benefit of the mortgage lending industry, homeowners, and the nation's housing policy. Fannie Mae and Freddie Mac activities deepen housing markets, reduce transaction costs, streamline the process, empower mortgage credit consumers, and integrate new products and financing options into the residential real estate transaction. REALTORS® believe that this nation would not be nearly as well housed and that we could not achieve our current homeownership rates without Fannie Mae and Freddie Mac backed by the federal charter and mission.

PREPARED STATEMENT

of

James C. Miller III

before the

Subcommittee on Capital Markets, Insurance,

and Government Sponsored Enterprises

of the

Committee on Financial Services

U.S. House of Representatives

July 11, 2001

Mr. Chairman, Congressman Kanjorski, and other Members of the committee: thank you for convening this panel and for inviting me to participate. As you probably know, I served as Director of the Office of Management and Budget from 1985 to 1988, and as Chairman of the Federal Trade Commission from 1981 to 1985. Now, in addition to the responsibilities outlined in the first attachment to this statement, I serve as a consultant to Freddie Mac. These remarks and the views I express today are my own, however.

In my experience, decisions made by government affecting market-based enterprises tend to be more challenging than those made by those same enterprises. Often the decision rules in government are unclear (just who makes the decisions and how they are made), frequently the information on which decisions are based is insufficient, and the incentives for those in authority to make the correct decisions tend to be weak. This suggests caution in changing institutional arrangements that work reasonably well. I do not mean to imply that "if it ain't broke, don't fix it," as that slogan is typically the refuge of interests that have little on their side of the argument. But I do urge careful consideration of all facets of current programs (as well as alternatives) before making changes that might jeopardize fundamentally the way they work and the benefits they generate for the consuming public.

I understand that two issues are before the committee this afternoon. First, the recent Congressional Budget Office (CBO) report relating to alleged subsidies to the Goverment-Sponsored Enterprises (GSEs) Freddie Mac and Fannie Mae. Second, your bill, Mr. Chairman, entitled the "Secondary Mortgage Market Enterprises Regulatory Improvement Act." Please let me summarize my views on these two matters.

<u>Summary</u>

CBO's 1996 and 2001 reports on the GSEs are both flawed, because the model on which the analysis is based is unrealistic and otherwise inapplicable. To CBO, the GSEs engage in a zero-sum game. The federal government, bestows a "subsidy" on the GSEs, which they, in turn, distribute to home owners, minus a fee. CBO estimates the total "subsidy" and subtracts its estimate of the total benefits to home owners; the remainder is the portion of the "subsidy" that accrues to the GSEs.

That approach is wrong. The GSE operation is not a zero-sum game. The GSEs create more value for consumers than their funding advantage, however measured. The reason is that within the existing financial structure, the introduction and development of the GSEs has had far-reaching, positive consequences. By pooling risks and by increasing competition in the market for mortgages, they have reduced mortgage rates across the board. By innovating, they have increased the availability of mortgages and have reduced the paperwork involved in obtaining a mortgage. Because CBO's model excludes these and other effects, CBO unrealistically concludes the present institutional arrangement shortchanges consumers.

To the contrary, in work commissioned by Freddie Mac and included here as the second attachment, Dr. James Pearce and I conclude that the present institutional arrangement confers benefits on home owners ranging from $8.4 billion to $23.5 billion annually, and that the GSEs are benefitted between $2.3 billion and $7.0 billion (funding advantage only).[1] Note that the lowest estimate of benefits to consumers exceeds the highest estimate of benefit to the GSEs.

On the matter of the proposed legislation, H.R.1409, my overwhelming reaction is that what you are proposing is a regulatory regime that goes far beyond safety and soundness (and "mission") into detailed constraints on the economic organization and operation of the GSEs. Surely we have learned over

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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.

the years that economic regulation is a bad idea. No matter how well-intentioned the legislation and no matter how public-spirited and informed the regulators, the results are inferior to market-based decisionmaking, where producers respond to the demands of consumers.

I do not take issue with a need for safety and soundness regulation for the GSEs. (Neither do they.) Nor do I take issue with the notion that in exchange for their charters the GSEs should focus on the goal of increasing home ownership. But surely those goals can be assured by less intrusive means.

The CBO Reports

Last fall, Freddie Mac asked James Pearce and me to evaluate the report CBO issued in 1996 and to make our own independent assessment of the benefits derived by consumers and the GSEs under the present institutional arrangement. Our report, published in January, concluded that the 1996 report systematically underestimated consumer benefits and systematically overestimated the benefits derived by the GSEs.

Briefly, CBO overestimated the funding advantage to the GSEs for two major reasons. First, it treated all Freddie Mac and Fannie Mae debt as long-term debt, ignoring the lower funding advantages on short-term debt. Second, CBO made errors in the way it measured the funding advantage on long-term debt and mortgage-backed securities.

CBO underestimated the benefits to consumers because its myopic, zero-sum model excluded the secondary effects of CBO on the mortgage market: the competitive effects on other mortgage providers, the innovations introduced by the GSEs, the efficiencies they bring to the marketplace, and so forth.

We then provided our own estimates of the benefits generated by the present institutional arrangement. We were careful to provide a range of estimates, recognizing that the available data sources are not all compatible, that there are different ways of approaching each issue, and that reasonable researchers might differ on the appropriate methodology in some instances.

As indicated above, we concluded that the benefits conveyed to consumers by the present institutional arrangement are far greater than the funding advantage derived by the GSEs.

James Pearce and I were also asked by Freddie Mac to comment on the draft of the 2001 report which CBO made available on a confidential basis and whose confidence we rigidly observed. A copy of our comments, released on May 18, 2001, is provided here at the third attachment.[2]

Frankly, we were pleased to see that CBO had corrected certain of the technical errors we had pointed out in our evaluation of the earlier (1996) report, especially the difference in funding advantage on long-term and short-term debt. In fact, that correction alone would have led the 1996 report to conclude that all of the "subsidy" was passed on to consumers; there was no "spongy conduit."

But in its new report, CBO introduced certain other errors that compounded the difficulty. For example, CBO baselines its estimate of the GSEs' funding advantage by comparing GSE costs with the costs incurred by a group of financial institutions that include some that are rated A-, whereas both GSEs have been rated AA-; this inflates CBO's estimate of the funding advantage. Or another example: while recognizing the lower funding advantage of short-term debt, CBO "adjusts" short-term debt in such a way as to lower the proportion of short-term debt, thereby increasing the estimate of funding advantage.

In its more recent report, CBO also adopts a new "capitalized subsidy" accounting methodology to replace the "subsidy-flow" calculations used in its earlier report. This new approach, which we believe is inappropriate, significantly increases CBO's estimate of the "subsidy;" in fact, only with this new methodology can CBO show annual subsidies in the $10 billion range.

But both CBO studies rest on the faulty premise that the GSE operation is zero-sum; that the GSEs are mere conduits for "subsidy." The methodology adopted opens the analysts to the anomaly that should their estimate of the benefits to consumers exceed their estimate of the funding advantage, they would be forced to conclude that the GSEs were receiving a "negative subsidy" – clearly an untenable position, but a situation which nonetheless could obtain from reasonable re-estimates.

How can an institutional arrangement result in benefits greater than the alleged subsidy? Consider for a moment the institutional innovation of property rights. Suppose in some area of commerce property rights were not recognized and/or enforced. Surely, commerce would not flourish. But legislation to

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[2]James E. Pearce and James C. Miller III, "Response to CBO's Draft Report: Federal Subsidies and the Housing GSEs," May 18, 2001.

recognize and enforce property rights would generate manifold benefits – to consumers and producers as well. Would it be appropriate to term the initiation and enforcement of property rights in this instance a "subsidy?" In a similar fashion, legislation over the years establishing and perfecting the GSEs has generated huge benefits to consumers and producers that is not appropriately measured by the GSEs' funding advantage. The legislation has enabled these two firms to engage in activities that would not have been replicated otherwise and to generate benefits to consumers not otherwise available.

H.R.1409

Again, the assurance of safety and soundness of the GSEs is not a question. The capital strength of the GSEs (as reflected in their extremely high, AA- ratings) is a major reason they have the funding advantage analysts point to as a measure of their "subsidy." Moreover, last fall the GSEs took steps voluntarily to establish criteria with respect to capital requirements and transparency. The question is just how best to assure appropriate safety and soundness standards, and how best to assure that the GSEs focus on their mission to promote home ownership.

I am not thoroughly versed on the details of the current regulatory regime affecting the GSEs. But I have had a good deal of experience in regulation generally. Not surprisingly, then, my real concern with H.R.1409, is that its approach envisions the Federal Reserve Board's (Board's) becoming an "economic czar" over the GSEs' operations. The history of such "economic regulation" is replete with failure, whether of the transportation variety (for example, the old Interstate Commerce Commission) or of financial services (for example, maximum interest rates on savings deposits). I suspect the same fate – harm to ultimate consumers – would result here.

For example, under H.R. 1409 the GSEs would not be allowed to commence any new activities without Board approval, and then only if the Board concludes that such activity is lawful, that it can be conducted in a safe and sound manner, and that the new activity is in the public interest. That sounds like the old "public convenience and necessity" regulation to me. Moreover, the Board's permission would be required for the GSEs to make acquisitions and issue new products. The Board, in certain circumstances, could also restrict the GSEs' growth in assets, make management changes, cap executive pay, and remove directors. In short, the Board – the Federal Reserve Board – would become the "czar" of the GSEs.

Conclusion

The present arrangement for the financial institutions (including the GSEs), while not perfect, has its strengths. While this doesn't mean reforms are out of order, it does suggest caution in making fundamental changes – especially changes based on the flawed study produced by CBO.

CBO's assessment of the GSEs is premised on a myopic, unrealistic model that assumes the GSEs are mere transmission vehicles for "subsidy." That approach ignores the role of the GSEs in lowering mortgage costs through innovation and imposing competitive discipline on other mortgage institutions. Our assessment of the evidence is that the present institutional arrangement benefits consumers between $8.4 billion and $23.5 billion annually. We also conclude that the GSEs receive annual benefits ranging from $2.3 billion and $7.0 billion.

The present nexus between the federal government and the financial institutions is a fact of life. Perhaps in a more perfect world – if we had it to do all over again – there would be far less interaction between government and financial institutions. But given that there is this connection, that this arrangement almost surely will continue, and that by most estimates financial institutions involved in making or facilitating home mortgages other than the GSEs receive a similar measure of federal sponsorship (or "subsidy"), it is my view that the market can be most efficiently accommodated by continuing the present institutional arrangement.

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]

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[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

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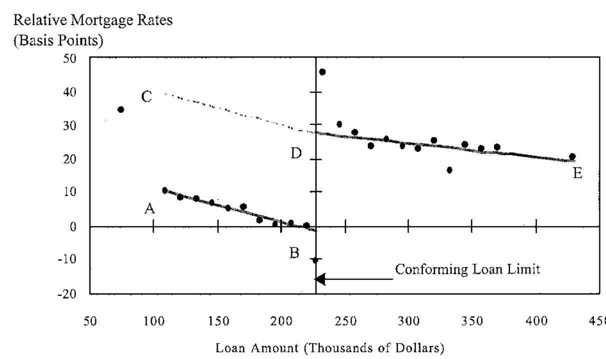
[6] In practice, the amount financed is measured as the (annual average) balance outstanding of mortgages in portfolio or pooled into MBS.

[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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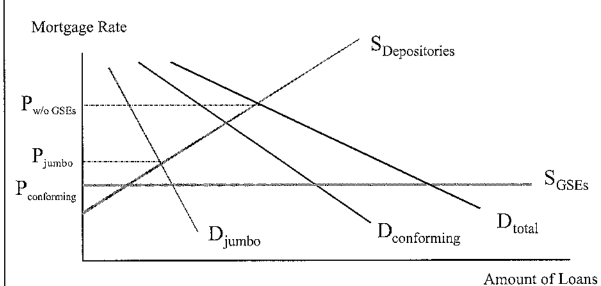
[8] The exhibit plots relative mortgage interest rates for fixed-rate loans in the Monthly Interest Rate Survey ("MIRS") after adjusting for origination week, lender type, new versus existing home, and loan-to-value intervals. The points plotted are averages computed over intervals with width of \$12,500. 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



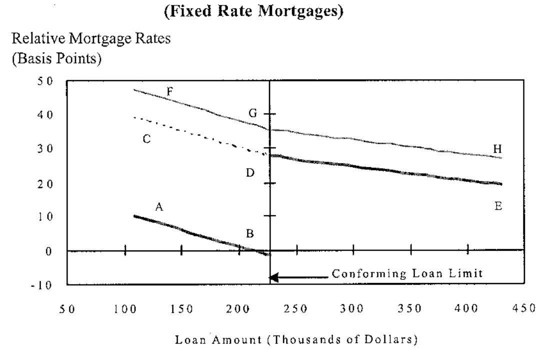
A theoretical argument for this point is illustrated in Exhibit 2. In this graph, the mortgage interest rate in the absence of Freddie Mac and Fannie Mae is found at the intersection of the depository supply curve ($S_{Depositories}$) and the total mortgage demand curve (D_{total}). When supply from 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.

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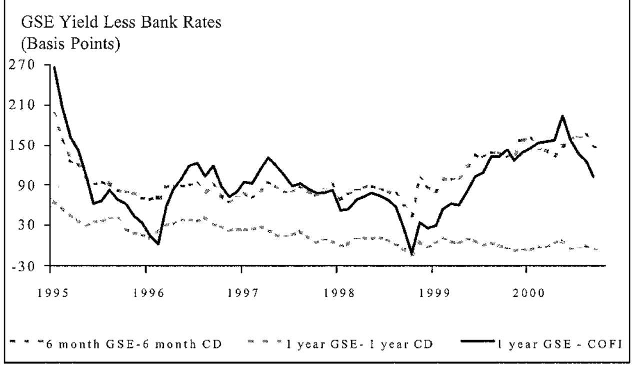
[10] The yield spreads are 6-month GSE debt less the 6-month CD yield, one-year GSE debt less the one-year CD yield, and one-year GSE debt less the 11th FHLB district COFI.

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

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[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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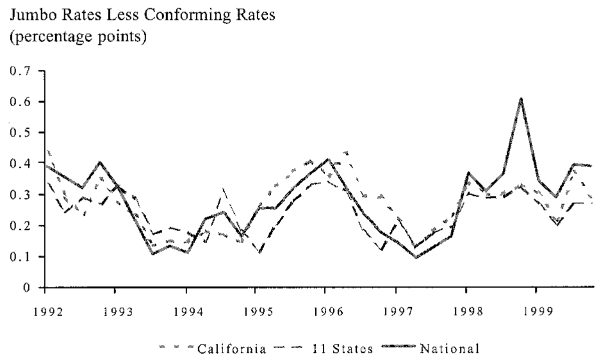
[18] The data used for the national series for jumbo rates come from HSH Associates (1992-1998), and Banxquote (1999), and for conforming rates from the Primary Mortgage Market Survey (Freddie Mac). This series is not risk-adjusted.

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.

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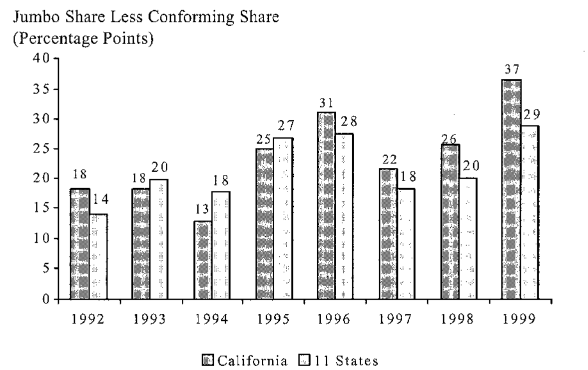
[20] Nothaft and Wang (1992). Also, in their concluding section, Hendershott and Shilling (1989), estimate that a 30-basis -point conforming loan differential would reduce the conforming ARM share by 10 percentage points in 1987 and 11 basis points in 1988.

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) CFRM: Indirect (3 + 4) ARM: (5)	 29 – 33 35 – 65 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) FRM Indirect (3 + 4 + 6) Conforming ARM (5 + 6) Jumb o (4)	 34-38 40-70 10 5
TOTAL BENEFITS ($billions)		**Partial Direct**** **Full Direct** **Full Indirect**	**$ 8.4 - $ 9.7** **$11.7 - $13.0** **$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

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[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).

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[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

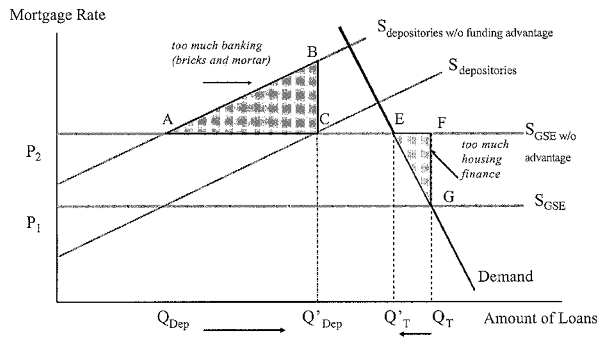

Exhibit 12 indicates that Freddie Mac and Fannie Mae provide an efficient allocation of resources from a "second best" perspective. Elimination of Freddie Mac and Fannie Mae's funding advantage would provide an efficiency improvement (triangle EFG) in that some of the excess housing finance would be 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.

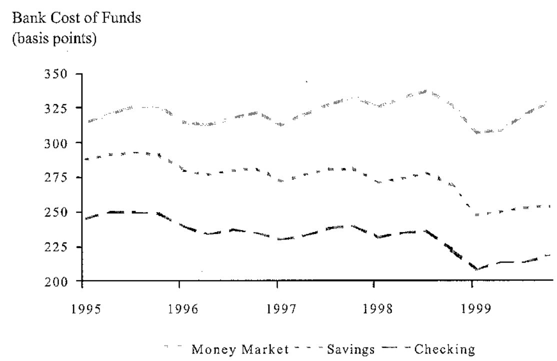
Exhibit 13
Bank Cost of Funds Are Below GSE Yields

Bank Cost of Funds less GSE Yields:

6 month CDs:	-103 bps
One year CDs:	-16 bps
11th 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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May 18, 2001

RESPONSE TO CBO's DRAFT REPORT: FEDERAL SUBSIDIES AND HOUSING GSEs[1]

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The Congressional Budget Office (CBO) has released a draft of its forthcoming study on Freddie Mac, Fannie Mae, and the Federal Home Loan Bank System. The forthcoming study updates a 1996 CBO study[4] of the benefits Freddie Mac and Fannie Mae receive through their ties to the government and the benefits these corporations provide to families. Since the 1996 study was released, Freddie Mac, Fannie Mae, and other analysts have criticized the CBO's methodology and conclusions. We presented a number of criticisms of the 1996 study in a document released in January of this year[5].

We are pleased that in its draft report the CBO reflects favorably on some of the comments on its previous assessment of the nexus between the federal government and the housing GSEs. For example, we (and others) noted that in its 1996 report CBO overestimated the funding advantage to Freddie Mac and Fannie Mae in a number of respects. Among those was its treatment of all Freddie Mac/Fannie Mae debt as long-term, ignoring the lower funding advantage on short-term debt (Pearce-Miller, pp. 5 and 27). The draft accepts this point (p. 52). We also criticized the use of separate estimates of the funding advantage on callable and noncallable debt. CBO now accepts the proposition that the funding advantage on long-term debt should be estimated from spreads on noncallable debt only (p. 25). These modifications are potentially important. If CBO had used the updated report's methodology about appropriate debt spreads in its 1996 report, it would have found that Freddie Mac and Fannie Mae passed through all of the benefits of sponsorship to homeowners.

Unfortunately, even though CBO accepted some valid criticisms of its previous work, its analysis still contains errors. For example, in estimating the funding advantage on long-term debt, CBO included spreads on debt with credit ratings that are lower than the AA- "risk to the government" credit rating held by Freddie Mac and Fannie Mae. This error is a departure from the 1996 report, which based the estimated debt funding advantage on GSE-AA spreads. Moreover, CBO continues to make many of the same mistakes we pointed out earlier, and in the application of principles they often interpret the evidence incorrectly or adopt the wrong bases for their estimates. Consequently, we believe that relying on this report will lead to bad policy with respect to mortgage markets.

Our concerns with the draft report fall into three basic categories. First, with respect to the adoption of principles and the application of those principles to available data, we believe CBO makes numerous mistakes, the overall effect of which is to inflate estimates of the alleged subsidies to the GSEs and to deflate estimates of benefits to consumers. We deal with such issues in the first section of this response.

Second, while we found the revised accounting methodology (replacing what the draft report calls "subsidy-flow" calculations with "capitalized subsidy" calculations) of interest, we believe that its application here is inappropriate and misleading. The new methodology also inflates the report's estimates of benefits accruing to the GSEs.

Third, we believe the "model" used by CBO to address the issue of benefits is totally incorrect. In CBO's world, the federal government hands over to the GSEs certain benefits, which the GSEs then distribute to intended beneficiaries (consumers of mortgages), minus a significant service charge. CBO concludes that Freddie Mac and Fannie Mae hold back one dollar for every two dollars they pass on. This formulation is much too narrow and unrealistic, for it ignores the efficiencies generated by the GSEs and the effects of the GSEs in making the mortgage market more cost-effective. As we pointed out in our earlier work (pp. 30 - 35), the correct way to analyze the role of the GSEs is to include the whole panoply of effects brought about by the unique institutional environment created by the current GSE-government nexus.

A concluding section summarizes our response and indicates what useful inferences might be drawn from the draft report.

Technical Deficiencies in Principles and Their Application

As a threshold matter, there is little justification for *assuming* that all the difference between Freddie Mac and Fannie Mae costs on the one hand, and those of "comparable" institutions on the other, is due to advantages conferred on the two corporations by statute. Could Freddie Mac and Fannie Mae be particularly efficient in what they do? Could there be economies of scale or scope that lead to cost advantages beyond those conferred by the charter? If so, would none of these characteristics remain with the corporations if federal sponsorship were withdrawn? Because the draft report treats all of Freddie Mac's and Fannie Mae's competitive strengths as derived from their charters, its methodology imparts an upward bias on the advantages conveyed by the GSE-government nexus.

An example of this phenomenon is the contribution of the liquidity of Freddie Mac and Fannie Mae debt and mortgage-backed securities to the overall funding advantage. Freddie and Fannie have large volumes of debt and MBS outstanding. This volume adds to the securities' liquidity, a characteristic that raises their value in the marketplace. GSE status is responsible for some of the issuance volume of Freddie Mac and Fannie Mae securities, but Freddie and

Fannie would continue to be large issuers if they were fully privatized. Thus, debt of fully private firms who are also large issuers of securities should be given relatively high weight in comparisons used to estimate the funding advantage attributable to the GSEs' charters.

We note that the draft report concludes that the major "source" of the funding advantage is the "perception" of a government guarantee on GSE debt that "appears to outweigh the explicit disavowal of responsibility in every prospectus for GSE securities" (p. 19). But GSE markets are "made" by sophisticated market participants who know very well there is no legal obligation of the U.S. government to back GSE debt. Market participants might believe it likely the federal government would step in should there be a catastrophic failure, but the same argument would apply to other major financial institutions. Indeed, the argument might apply to Freddie Mac and Fannie Mae even if the charter were removed.

Although the draft report accepts our criticism of the 1996 report for treating all debt as long-term debt, it bases its estimates on "effective" short-term debt, which is significantly smaller than recorded short-term debt (pp. 27-28). There is an element of truth to this argument, and in some circumstances effective short-term debt is the appropriate measure. Under the "subsidy flow" approach of the 1996 report, the actual short-term debt outstanding is appropriate. The CBO's justification of its choice (footnote 27 on page 28) is flawed in that it assumes that GSEs maximize their funding advantage rather than shareholder value.

In estimating the borrowing advantages of the GSEs, the CBO report compares GSE long-term debt costs with debt issues rated A or AA (pp. 6 and 22-23). Indeed, some of the debt is rated as low as A-minus, a full three rating categories below AA-minus. There is little justification for comparing GSE costs with costs of A-rated institutions. Private institutions such as Standard and Poor's rate Freddie Mac and Fannie Mae on a stand-alone basis as AA-. Standard and Poor's rated both firms AA- in 1997, and they reaffirmed these ratings in February 2001. Inclusion of firms with single A and A-minus ratings in establishing the GSE rate differential inflates the estimated GSE funding advantage by 10 to 20 basis points, depending on how the analysis is done.

Similarly, the CBO understates the benefits to mortgage borrowers in a manner similar to the treatment of this subject in the 1996 report. The draft report uses the jumbo-conforming spread as the measure of Freddie Mac's and Fannie Mae's effect on interest rates. For reasons explained in our January report, we believe the draft report's assumption of a 25 basis-point benefit on conforming mortgages (p. 42; based on the jumbo-rate differential) is considerably on the low side (Pearce-Miller, pp. 27-30).

In all its conclusions, the draft report is much too willing to supply point estimates. For reasons explained in our previous comments (for example, p. 18), for many of the issues addressed in the draft report there is no one apparent "best" number to utilize. Therefore, expressing estimates of this sort as ranges provides a more appropriate sense of the limits of available data. To do otherwise would convey a sense of precision that is not justified. While we note the draft report's incorporation of sensitivity analysis, it alone does not convey to the reader the inherent imprecision of the task being addressed.

The report seeks to estimate the advantages derived by the GSEs from their particular regulatory environment. Although noting that Freddie Mac and Fannie Mae are subject to extensive federal regulation (albeit regulation that is different from other financial institutions), the report makes no attempt to quantify the effects of those differences. In particular, while noting that the GSEs must meet certain social goals, such as increased home ownership by citizens with low incomes (p. 16), in omitting such "costs" to the GSEs the draft report inflates the estimate of benefits stemming from the GSE-government nexus.

Because the draft report assumes that all benefits that do not go to mortgage borrowers are retained by the housing GSEs (p. 39), any overestimation of gross benefits or underestimate of benefits to borrowers imparts an upward bias to the estimate of benefits derived by the GSEs.

Finally, we note with concern the use, and potential for misuse, of certain emotive terms in the draft report. The CBO uses the term "subsidies" in the title and throughout the text. Most readers would presume the term to connote a direct outlay of funds from the federal treasury. This, of course, is not the case and presumably not what is intended. But confusion over that matter will persist unless clarified, preferably by using a more descriptive term, such as "benefits" or "funding advantage." The draft report also tosses around provocative terms such as "tacitly colluding duopolists" (p. 39) and "market power" (p. 40) without any clarification. This terminology could lead to unsubstantiated claims and detract from the integrity of the work.

Inappropriateness of the Accounting Methodology

In the draft report, CBO adopts a "capitalized subsidy" accounting methodology, to replace the "subsidy-flow" calculations used in its 1996 report (p. 29). Although the draft report does not describe all of the sources and assumptions, it is clear that the approach is to capitalize the entire stream of benefits to mortgage borrowers and to the GSEs upon execution of the loan transaction. Thus, CBO assumes an average life of loans, including both new loans and loan turnovers, and calculates the present value of the stream of benefits. Not surprisingly, this method yields much higher gross benefit estimates than the previous methodology, which simply applied the benefit differential to the current stock of securities and loans outstanding.

CBO justifies its decision to change methodology on its conclusion that the approach utilized in its 1996 report "is inconsistent with how costs for explicit guarantees are recognized in the federal budget and in federal financial statements prepared according to generally accepted accounting principles (GAAP)" (p. 30). There is much to say for having decision makers understand the full impact of irreversible decisions (public as well as private). Indeed, one of us (Miller) has been at the forefront of arguing for changes such as those incorporated in the Credit Reform Act of 1990. This is not the same kettle of fish, however.

First, the benefits conveyed to mortgage borrowers and the GSEs are not in the form of a(n explicit) guarantee. The GSEs themselves provide the guarantee. It might be appropriate for them to account for guarantees on their books in present-value terms, but that is not the same as requiring the benefits to be capitalized each year.

Second, there is the matter of the common-sense understanding of the way benefits work. Under the CBO (revised) methodology, a mortgage borrower who had benefited from lower loan rates received a one-time "shot" of benefits when the loan was made, *but benefits not one iota each succeeding year.* Clearly, neither mortgage borrowers nor GSEs conceptualize the benefits of the GSE-government nexus in those terms.

Third, using the earlier "subsidy-flow" approach avoids anomalies. For example, under the CBO's "capitalized subsidy," any time a GSE experienced a marked contraction in portfolio, its subsidy could go "negative." Or, when its portfolio expanded a modest proportion, the estimated subsidy would increase dramatically. The decision to vary some parameters from year to year while keeping others fixed may contribute to these fluctuations. For example, loan and security activity varies from year to year, while discount rates, spreads, and average lives of mortgages do not. We are not taking issue with the specific calculations (some of which are not outlined in sufficient detail for us to make an informed judgement) or the desirability in appropriate circumstances of expressing streams of benefits and costs in present value terms, we believe the "capitalized subsidy" approach utilized in the draft report is inapplicable to the task at hand.

Inappropriateness of Zero-Sum, Pass-through Model

The major failing of the draft report has to do with the model it assumes to be appropriate. The establishment of the housing GSEs precipitated a number of changes in housing markets that are not captured by the model CBO utilizes. The draft CBO report assumes that private institutions in the mortgage market would provide all the services that Freddie Mac and Fannie Mae currently provide if Congress were to withdraw federal sponsorship from these two corporations. The only difference that homeowners would notice would be a 22 basis-point increase in interest rates. This ignores the added liquidity that Freddie Mac and Fannie Mae bring to the mortgage market and the much higher availability of fixed-rate loans in the conforming market than the jumbo market.

What CBO is saying, in effect, is that the federal government gives the GSEs "subsidy," which they are supposed to pass on to consumers (mortgage borrowers). It's a closed, zero-sum model. The GSEs never create value, they are merely conduits for the "subsidy." This, of course, runs altogether counter to the original rationale of the GSEs - to increase liquidity in mortgage markets and thereby lower costs and increase mortgage availability.

The CBO model presumes that any difference between an independent estimate of benefits bestowed by the federal government and an independent estimate of benefits flowing to consumers is a measure of the benefits flowing to, and retained by, the GSEs. What if, as we could reasonably construct, the estimate for consumer benefits exceeded the estimate for gross benefits from the federal government? Would we then have to conclude that the GSEs were subsidizing consumers?

The more appropriate approach is to count all of the impacts - positive and negative - associated with the current institutional arrangement. To do otherwise causes CBO to miss some of the more salient features of the current mortgage market[6]. For example, under our approach, GSE activity reduces interest on conforming mortgages they don't securitize and on non-conforming mortgages - a source of considerable benefits to consumers. CBO's model excludes such considerations and therefore underestimates consumer benefits[7].

Finally, because of its myopic model, CBO fails to recognize that to the extent that ("subsidized") mortgages may draw funds from and increase interest costs elsewhere in the economy, such effects will be minimized by retaining the current institutional arrangement (Pearce-Miller, pp. 33-34).

Concluding Remarks

Although CBO's draft report incorporates important improvements in methodology and data, it is flawed, perhaps fatally, by the misapplication of principles, by the adoption of an inappropriate accounting methodology, and by a stubborn adherence to a closed, myopic model of the benefit generation and transmission process. In almost every case, the deficiencies lead to an inflation of the benefits flowing to the housing GSEs and a deflation of the benefits received by consumers.

But there is some common ground. In our report published earlier this year, we concluded that benefits to Freddie Mac and Fannie Mae ranged from $2.3 billion to $7.0 billion for 2000 (Pearce-Miller, p. 1). Compare now Table B-1 in CBO's draft report with respect to 2000: taking the annual subsidy, adjusting for new technical assumptions and subsidy rates, and excluding the value of tax and regulatory exemptions and the FHLB subsidy (for consistency purposes) yields a comparable CBO (2000) estimate of $7.7 billion, which is just outside our range. The figure can be brought within our range by accepting some technical modifications to the procedure used to estimate the spread on long-term debt[8].

The truly significant differences pertain to estimates of benefits to consumers. Our report concluded those benefits ranged from $8.4 billion to $23.5 billion per year. The draft report concludes that benefits to consumers total only $7.0 billion per year (p. 1), some $1.4 billion less than the lower end of our range of estimates. What causes this discrepancy? By and large it is CBO's refusal to look beyond its myopic "flow-through" model. In the agency's view, benefits are received by the housing GSEs and some portions are passed on to consumers. This short-sightedness causes CBO not only to miss some of the most dynamic aspects of the mortgage market but to undercount benefits consumers all across America are realizing each and every day.

Footnotes:

[1]Congressional Budget Office, "Federal Subsidies and Housing GSEs," draft dated April 25, 2001.

[2]Welch Consulting; 111 University Drive, East; Suite 205; College Station, Texas 77840.

[3]Law and Economics Consulting Group; 1600 M Street, N.W.; Suite 700; Washington, DC 20036.

[4]Congressional Budget Office, "Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac," 1996.

[5]James E. Pearce and James C. Miller III, "Freddie Mac and Fannie Mae: Their Funding Advantage and Benefits to Consumers," Freddie Mac, January 9, 2001. CBO's draft report specifically acknowledges taking such comments into account, although it states that "disagreements remain on several fundamental issues" (p. 9).

[6]CBO (pp. 48-49) misrepresents the approach we recommend by suggesting that if we calculated that the GSEs passed on more than a dollar for each dollar they held back, the current system would pass some sort of benefit-cost test. But that is mixing their model with ours. In our model, the benefits to the GSEs are independent of the benefits to consumers. The current institutional arrangement allows both to benefit substantially. It is a positive-sum arrangement.

[7]CBO also alleges that these effects net out, since the rate concessions by other financial institutions are a "cost" to them (p. 50). This ignores the role of competition in providing a spur to cost-cutting and innovation.

[8]The draft uses a long-term debt spread of 47 basis points. Analysis by Pearce shows that removing an ad hoc restriction-deleting quarters with a single banking sector issuance-in the consultants' procedure yields a spread of 37 basis points. This calculation uses the same data as the CBO consultants, and it uses the same universe of comparator firms, including those rated A and A-. If the long-term debt spread were 37 basis points, the top end of the CBO range using the 1996 methodology would be within the Pearce-Miller range of $2.3 to $7.0 billion.

Testimony of
Leslie K. Paige
Vice President
Citizens Against Government Waste
Before the House Subcommittee on Financial Services
July 11, 2001

Mr. Chairman, members of the committee, thank you for the opportunity to testify today. In particular, I would like to thank you, Mr. Chairman, for your tenacity and commitment to protecting the interest of taxpayers with regard to the nation's housing government-sponsored enterprises (GSEs). My name is Leslie Paige. I am a vice-president of Citizens Against Government Waste (CAGW), a nonpartisan, nonprofit organization with more than one million members and supporters nationwide dedicated to eliminating waste, fraud and abuse in government.

CAGW is a member of the Homeowners Education Coalition (HomeEC), an ad hoc coalition of taxpayer groups, including National Taxpayer's Union, the Competitive Enterprise Institute, 60 Plus, the Free Congress Foundation, CapitolWatch, the Small Business Survival Committee, and the American Association of Small Property Owners. Collectively, the members of HomeEC represent millions of taxpayers and have decades of experience in advocating for taxpayers and seeking a smaller, more efficient government.

HomeEC's mission is to raise questions with our respective members, the media and the general public about the nation's largest housing GSEs, and to stimulate an ongoing, public review of their activities and the impact those activities have on taxpayers and the economy as a whole.

Mr. Chairman, today's hearing, like the hearings you convened last year and earlier this year, have provided our groups with the rare opportunity to have some input into the ongoing debate over what reforms, if any, Congress should enact with regard to the housing GSEs, particularly the two largest, Fannie Mae and Freddie Mac.

Recent newspaper stories in authoritative publications have reported that the nation's housing GSEs have once again conclusively beaten back any attempts to reform them. However, to paraphrase Mark Twain, we believe that reports of the demise of this important process have been greatly exaggerated.

Last year, during the GSE roundtable discussion you convened, Mr. Chairman, one of your panelists, Mr. Fred Khedouri, a financial manager at Bear Stearns stated that "the markets are in the business of gauging expectations and perception...so perception is the most central variable here." The only folks who benefit from the perception that the reform effort is dead are Fannie Mae, Freddie Mac and the Federal Home Loan Banks. Maintaining the status quo qualifies as a win for the GSEs and a loss for taxpayers. We believe that Congress is actually at the very beginning of the process and we're proud to be part of it.

There are indeed voices in Congress, on Wall Street, in the media and in some sectors of the home mortgage market who say that the GSEs are extremely profitable, and supremely well-managed, that these hearings are much ado about nothing, that the GSEs should be left to their own devices, and that critics should just stop talking about them. CAGW and the members of HomeEC strongly disagree.

The time to address the concerns of taxpayers regarding the GSEs is not at some future date when they might be facing a financial crisis. Basically, been there, done that. We experienced exactly that type of scenario in the 1980s with the Savings & Loan debacle, which cost taxpayers hundreds of millions of dollars. In the "Origins and Causes of the S & L Debacle: A Blueprint for Reform," the Commission on Financial Institution Reform, Recovery, and Enforcement concluded that "Congress transformed the S & Ls into agents of national housing policy and that Government regulation sheltered the S & Ls from competition...." That sounds uncomfortably familiar to us.

In the final analysis, that bailout happened because the government created an oversubsidized environment and because politicians and policymakers were ill-prepared to deal with the unforeseen consequences of its actions.

We are seeing it now, as Congress rushes belatedly to address the financial plight of another mammoth quasi-government agency, the United States Postal Service.

Congress' fiduciary responsibility to taxpayers extends far beyond today's prosperity and the issue of whether a vigorous public debate will somehow impinge on the profitability of two quasi-government agencies. This public dialogue is laying the groundwork for the enactment of future reforms that will shield taxpayers from unwanted liabilities, without harming homeowners, the private sector, or the overall economy.

CAGW has had the issue of government-sponsored enterprises on its radar since the early 1980s. This organization was created 16 years ago after Peter Grace presented to President Ronald Reagan 2,478 findings and recommendations of the Grace Commission (formally known as the President's Private Sector Survey on Cost Control). These recommendations provided a blueprint for a more efficient, effective and smaller government.

The Grace Commission recognized the special advantages that Fannie Mae and Freddie Mac had and described the leverage these benefits conferred. The commission understood then, as many of you do today, that the GSEs' "agency" status assures them access to credit at a preferential rate. The commission concluded that the implication of federal support ensured that "even without full faith and credit, the government would rescue an agency in trouble. This appears to be important in increasing the credit limits of an agency, even though less creditworthy agencies pay interest rates above more creditworthy agencies."

Presciently, the Grace Commission stated then that the special advantages enjoyed by Fannie Mae and Freddie Mac would distort the market, an observation more recently made by Federal Reserve Chairman Alan Greenspan. The GSEs act as "a powerful disincentive for well-capitalized private sector entities to compete in the mortgage market." The commission also stated that there was no reason for Fannie Mae and Freddie Mac not to pay state and local taxes, and outlined a potential transition to a fully private status for all government sponsored enterprises, "without threatening their ability to perform their historic mission."

The Grace Commission further noted that the concern over what was then a substantial and burgeoning federal debt had not carried over to comparable increases in agency debt. That lack of concern was related to the fact that farming and home building, two "powerful constituencies," were primary beneficiaries of the GSEs, "making them a difficult target for any activity that gives the appearance of a reduction in Government support."

The Grace Commission summed up why it is important for Congress to convene hearings such as these and to continue oversight of the GSEs. "The Government does not control agency growth because it is private; but the agencies depend upon Federal sponsorship (i.e., being treated as part of the Government) for their growth. This contradiction has extremely important consequences, now and for the future."

There are numerous areas of concern with regard to the GSEs, but these concerns are all of a piece and they revolve around one central problem, in our opinion, and that is the special benefits the GSEs receive, the most important of these being the perception that the GSEs are backed by the taxpayers.

With the release of the CBO update, it is no longer tenable to argue that there are no federal subsidies and there is no implied government guarantee, yet the GSEs continue to try and the effort is tying them in rhetorical knots.

Last September, during the GSE Roundtable, a Freddie Mac representative emphatically stated that the GSEs receive no taxpayer subsidies. Later in the discussion, the same GSE spokesperson opined that the "non-existent" federal subsidy that his company does not receive was not "unique" and that the financial sector was replete with subsidies. Later still, a representative of Fannie Mae said that the "nonexistent" subsidy that his company did not receive was worth much less than the Congressional Budget Office claimed and furthermore, the benefits that Fannie Mae confers on homeowners far outweigh the value of this "nonexistent" subsidy.

It is an awkward situation to be in, reminiscent of the old fable about the Emperor and his nonexistent new clothes. In fact, there are subsidies and their value is measurable and substantial, whether you embrace the study done by Jim Miller and James Pearce, or the CBO analysis, as HomeEC does, it is worth multiple billions of dollars. Since 37 percent of their $10.6 billion annual subsidy is soaked up by the GSEs themselves, it is clear that they have converted their congressionally-conferred benefits into a highly-efficient profit-delivery system. In fact, private Wall Street ratings agencies, such as Standard & Poor's, calculate these government-conferred benefits when rating the GSEs. This year, S & P gave Fannie Mae and Freddie Mac AA- "risk to government" rating (we think it would be more accurate to call it "risk to taxpayers"), but this rating still assumes that the GSEs will have unlimited access to the debt markets during times of financial crisis, simply because they are government-sponsored enterprises, regardless of their true financial status.

There are good reasons for the investment community to believe that government would bail out the GSEs, in spite of official disclaimers to the contrary. Actions speak louder than words. The federal government has in fact stepped in to bail out another GSE in the recent past -- the Farm Credit system. Fannie Mae experienced serious financial instability in the 1980s. Congress can no longer simply accept the GSEs' reassurances that they are superior money managers and therefore their activities pose "zero" risk to taxpayers. Reality is finally sinking in...the GSEs have become "too big to fail," in a financial squeeze, the taxpayers would be on the hook and the risks are significant. As such, their financial activities merit serious scrutiny by Congress.

Aside from the very real issue of subsidies and implied taxpayer backing, if Congress needs more reasons to begin a reform process of the GSEs, members need only look at the newspapers every day because they are peppered with stories about the GSEs and their new financial activities every day.

There is the explosive debt issue. As of March 31st of 2001, Fannie Mae and Freddie Mac together either owned or guaranteed $2.4 trillion in mortgages and mortgage-backed securities. By 2003, these two entities will have more debt and guarantees outstanding than U.S. Treasury debt held by the public. Fannie Mae announced last year that it was prepared to begin issuing unlimited amounts of debt.

The CBO report addresses an even more important issue, aside from their calculation of the value of the GSEs' subsidies. What the CBO is pointing out, and what taxpayers need to more clearly understand, is that these mortgage giants now control 71 percent of the conventional conforming mortgage market. This dominance, were it occurring among two purely private corporations, would certainly raise eyebrows at the U.S. Department of Justice's Anti-Trust Division.

According to a recent analysis by Peter Wallison and Bert Ely for the American Enterprise Institute (which I have attached to my testimony), Fannie Mae and Freddie Mac will own or guarantee 91 percent of the conventional conforming mortgage market within three years at their current growth rate. Federal Reserve Chairman Alan Greenspan has worried aloud about the market distortions this growth is already causing. At what point do we wake up and realize that our entire home mortgage system has been nationalized and that because we failed to restrain GSE growth, curtail their non-mortgage related activities, and protect taxpayers when we had the chance, we have shifted enormous risks onto them, risks that should really be borne by the private sector?

In addition to the sheer volume of the debt the GSEs are accruing, there is the composition of that debt. The GSEs are repurchasing more and more of their own mortgage-backed securities. Today 34 percent of all Fannie Mae-guaranteed MBS are held by Fannie Mae and the comparable percentage for Freddie Mac is 31 percent. This growth in the repurchase of MBS far surpasses the percentages in the private sector. This practice defeats the original purpose of the secondary mortgage market, which is to allow the free market to distribute mortgage risk among many private investors. Barbara Miles of the Congressional Research Service described the repurchasing of MBS as the "repatriation of debt," and failed to see any mission-related purpose for the practice. The repurchase of

MBS is driven by the GSEs' true agenda, the quest for excessive profits derived from their government subsidies.

The repurchase of MBS is not the only change in the nature of the GSEs' business enterprises. In order to realize the sort of massive profits they have become accustomed to, and to make good on their promises to investors to maintain the double-digit growth in earnings, Fannie Mae and Freddie Mac are marauding into areas which are outside their charters, which are unrelated to helping lower and middle income people achieve homeownership, and which are already served by a highly competitive and vibrant market.

For example, the GSEs are purchasing home equity loans, insisting that it is well within their charter to help homeowners extract value from their single most valuable asset. However, 70 percent of all home equity loans are used for consumer purchases or debt consolidation and there are thousands of financial institutions, large and small, ready to provide that service. It is a huge stretch to contend that this practice puts people into homes.

There have been recent revelations that Fannie Mae and Freddie Mac have begun peddling securities at the retail level to individual investors with as little as $1,000 to invest. These investments are packaged to mimic callable certificates of deposit, an activity is in direct competition with small regional banks. To quote the vice chairman of the Community Bankers Association of New York, this move is "an overt example of mission creep that creates a more difficult entity for the government to control...Not only are they building a customer base to sell future products to, they are creating a population of political constituents."

Earlier this year, Freddie Mac invested several million dollars in LendingTree.com, an e-commerce mortgage brokerage startup which was in financial trouble and needed help. Why LendingTree.com and not some other similar company? As we understand it, The Department of Housing and Urban Development has not made a ruling on the permissibility of this sort of investment and is waiting for more information from Freddie Mac. The larger point is that picking winners and losers in the volatile world of e-commerce is not the role of a federally-chartered GSE, armed with the implied backing of the taxpayer.

Fannie Mae has agreed to purchase loans from the home improvement giant Home Depot, loans which will used for remodeling or consumer purchases. Congress should be demanding an explanation of how this kind of financial activity gets low-income people into affordable housing.

There are serious indications that Fannie Mae and Freddie Mac may seek an increase in their conforming loan limits, which, at $275,000, already constitute an entitlement for upper middle income homebuyers. This would put them directly into the jumbo mortgage market and in direct competition with private commercial lenders who already serve that niche. Congress should block any legislation or amendment which would raise the conforming loan limit.

In fact, CAGW and the other members of HomeEC believe that it is unconscionable for the GSEs to be buying consumer loans, trying to move into the jumbo home mortgage market and the sub-prime market, getting into retail investment banking, or dabbling in e-commerce at a time when several official and independent analyses show that they are lagging in their congressionally-chartered mission of catering to low and middle-income people trying to purchase a first home.

Mission creep by the GSEs is inevitable for several reasons. With the nation's home mortgage market maturing, the GSEs must diversify in order to maintain their 15 percent annual profit growth commitment to Wall Street investors. It will continue to be a nagging problem as long as there is no effective, authoritative regulatory structure in place to draw a bright line and enforce it. Mission creep must not be dismissed as the carping of a few self-interested industry groups. The encroachment of a government-sponsored entity into a competitive sector of the economy will cause the otherwise healthy players to leave the market and result in fewer choices for consumers and more risk for taxpayers.

In the opinion of CAGW and the other members of HomeEC, the Department of Housing and Urban Development is simply not up to supervising these two financial behemoths, with mortgage portfolios in the multi-trillions and whose activities have a systemic impact on the entire economy and banking system. HUD has a relatively small cadre of staffers to define and enforce mission-related goals and the Office of Federal Housing Enterprise Oversight is charged with ensuring the safety and soundness of their financial activities. Both of these regulatory offices are financially outgunned and lack enforcement tools.

There are no clearly defined parameters on what is or is not a secondary mortgage market activity, what sort of investments the GSEs should be permitted to engage in. They have been permitted to interpret their charters as an infinitely malleable set of loose guidelines where anything that makes a hefty profit is construed as furthering homeownership. The affordable housing mission has become nothing more than a politically-convenient fig leaf.

As long as the GSEs continue to enjoy $10.6 billion annually in government benefits; continue to absorb 37 percent of that windfall; continue to leverage their implied taxpayer guarantee to expand unimpeded into businesses beyond the scope of their charters, then Citizens Against Government Waste favors the imposition of a strong, independent, adequately-financed regulator with expertise in addressing systemic risk and armed with meaningful enforcement mechanisms to take action if necessary.

Having said that, Mr. Chairman, I must add that the groups in HomeEC are free market advocates. The optimum long-term reform we favor is the full privatization of all of the GSEs.

Fannie Mae and Freddie Mac have had great success securitizing home mortgages. Today, securitization is a firmly established financial practice. The activities of Fannie Mae and Freddie Mac do not exist in a vacuum. Their duty to stockholders, which dictates that they maximize profits, has run head on into their mission. The quest for profits is winning, at taxpayer expense. Thousands of private entities are standing by with sophisticated techniques to securitize a range of things. It is no longer necessary, nor advisable, to continue subsidizing a business, engaging in normal business practices, which could achieve success on its own.

The CBO study raises still more questions. HomeEC would respectfully like to suggest that CBO be asked to receive data from the GSEs in order to analyze several more relevant questions, on behalf of taxpayers, such as: what are the risks to taxpayers associated with the GSEs' decision to repurchase vast quantities of their own MBS?; what are the risks to the taxpayer of having two GSEs holding on their balance sheets more mortgage-related assets than the entire 1,600 member thrift industry; to what extent are the subsidies given to Fannie Mae and Freddie Mac capitalized into housing prices and therefore benefit sellers and home builders, rather than home buyers; to what extent are the GSE subsidies that do get passed on to consumers going to home buyers/sellers with high incomes, rather than those on the "cusp" of ownership; how exactly do Fannie Mae and Freddie Mac increase the rate of home ownership by purchasing refinanced mortgages and home equity loans; to what extent do factors other than the existence of Fannie Mae and Freddie Mac (such as changes in the tax laws) account for the relatively modest increase in the home ownership rate from 63.9 percent in 1985 to 66.8 percent in 1999; what exactly is the value of the GSEs' exemption from Title V (privacy) of the Gramm-Leach-Bliley Act?

Mr. Chairman, the groups in HomeEC are philosophically opposed to subsidy programs, whether they be implicit or explicit. History shows that subsidy programs breed inefficiency, waste and abuse and they often hang on long after their original mission has been accomplished, putting taxpayers at increased risk.

Even if you agree with the notion that homeownership is a greater societal good and that the federal government has an appropriate role in promoting it, the real question before this committee and the Congress is "Is this the most efficient way to help low income families get into their first homes?" The fact is, the GSEs subsidize is mortgage debt and, increasingly, consumer debt. They are the least efficient, least transparent, least accountable subsidy delivery system. And they have now become so ascendant in the financial markets that their activities have far-reaching effects throughout the entire national financial system and therefore into the pocketbooks of ordinary citizens. Increased oversight by Congress is absolutely obligatory.

On behalf of our one million members and supporters, we thank the committee for the opportunity to speak to you today and are available to answer any questions you might have.

Statement of

Edwin S. Rothschild
on behalf of FM Watch

Federal Subsidies and the Housing GSEs

before the

Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises

Committee on Financial Services
U.S. House of Representatives

July 11, 2001

Mr. Chairman, Members of the subcommittee, thank you for the opportunity to testify today. I especially would like to thank you, Mr. Chairman, for holding this and previous hearings on the performance of and potential taxpayer risks associated with the Government Sponsored Enterprises, Fannie Mae and Freddie Mac .

My name is Ed Rothschild. I am a principal at the consulting firm of PodestaMattoon and a consultant to FM Watch, a coalition of financial sector and housing related trade associations.

Since its inception FM Watch has supported efforts to expand affordable homeownership in America. When HUD proposed its new Affordable Housing Goals rule last year, FM Watch submitted comments that urged HUD to set higher goals for the GSEs. We commented that, "While the new goals are a step in the right direction, they are still modest and will not move the GSEs to lead the market in underserved communities."

FM Watch then decided to initiate a study on how the GSEs allocated their taxpayer subsidy. This decision followed research and reports by the General Accounting Office, the Urban Institute, HUD, the National Community Reinvestment Coalition, and many others concluding that the GSEs lagged rather than led the market in supporting affordable housing (as Congress intended), particularly for low- and moderate-income, African-American and Hispanic families. Initially, we had planned to base our analysis on the results of the Congressional Budget Office's 1996 report, but when you, Mr. Chairman, asked CBO to update that report, we decided to use the most current subsidy analysis.

Following the issuance of the new CBO report, "Federal Subsidies and the Housing GSEs," FM Watch published "Shuttered Dreams: How Fannie Mae and Freddie Mac Misspend the GSE Housing Subsidy." This study examines the distribution of the $10.6 billion subsidy, particularly as it relates to promoting affordable housing for low- and moderate-income borrowers.

In establishing the GSEs, Congress conferred specific benefits on them for a specific purpose – expanding and promoting home ownership, especially for low- and moderate income homebuyers and those in underserved communities. These benefits were not given to create government-subsidized entities that could dominate private markets. Rather, Congress expected the GSEs to perform a clear but constrained mission: to provide liquidity to the secondary mortgage market and to promote affordable housing. The essence of Congress' deal was clear: publicly granted powers were given for public purposes.

FM Watch's study demonstrates that the GSEs misspend their taxpayer-funded subsidy by continuing to allocate more to their stockholders than to helping put people into homes. This is going on even though the Department of Housing and Urban Development (HUD) forecasts continuing substantial unmet housing needs into the foreseeable future among minority and low-income families. Moreover, as the CBO, HUD, Treasury, and others have pointed out, the subsidy that does reach homebuyers is predominately spent to help wealthier borrowers – whose mortgages yield more lucrative returns – but disproportionately fails to serve low-income households and minorities, particularly African-Americans and Hispanics.

So long as there are unmet homebuying needs, the federally subsidized GSEs ought not to retain $3.9 billion or 37 percent of the housing subsidy. Public subsidies are a public trust. The GSEs should be required to focus on the mission that Congress mandated – to promote affordable housing for the benefit of low- and moderate-income families and the American taxpayer.

I would like to summarize the major findings of "Shuttered Dreams" to demonstrate how the GSEs are misspending the subsidy.

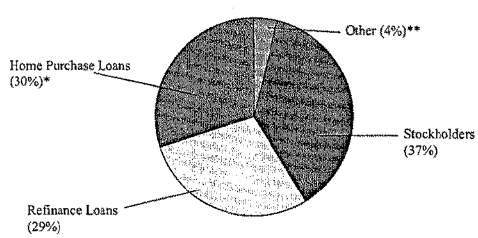
<u>Over one-third of the GSE subsidy never reaches the housing sector. It is retained by the GSEs for stockholder profits. Even more startling, less than one-third of the subsidy actually goes to helping people buy homes.</u>

- The CBO study concluded that the GSEs retained fully 37 percent ($3.9 billion) of the taxpayer-provided housing subsidy to benefit their stockholders. As Figure 1 shows, this is the largest single use of the taxpayer subsidy. It does nothing to promote homeownership, and only serves to enrich private GSE stockholders.

- An additional 29 percent ($3.1 billion) went to the GSEs' purchase of mortgages to refinance existing debt. This refinancing activity does not help Americans buy homes. *Thus, 66 percent of the subsidy goes either to GSE stockholders or refinancing activity – none of which actually helps American families buy homes.*

- Only 30 percent of the subsidy ($3.2 billion) was applied to purchasing the mortgages of single-family homebuyers. This should be the GSEs' core mission, yet less than one-third of the subsidy is spent for this purpose. Moreover, as discussed below, this part of the subsidy is disproportionately spent on purchasing more lucrative mortgages, rather than the mortgages of low- and moderate-income households (Figure 1).

Figure 1
GSEs Keep 37 Percent of the Housing Subsidy for their Stockholders



* Single-family, owner-occupied. **Multi-family, non-owner occupied single-family, and other loans.

CBO estimate of the GSEs' subsidy allocated according to 1999 HMDA Data. Conventional loans within the $240,000 conforming limit.

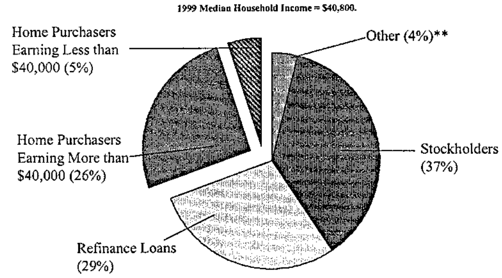
Only five percent of the subsidy is spent to create new homeownership opportunities for the bottom half of Americans by income.

- The bottom half of Americans by income receive a disproportionately small share of the GSE housing subsidy. In 1999, the median household income in the U.S. was $40,800. Single-family homebuyers who earned up to $40,000 received only 5 percent ($0.5 billion) of the subsidy (Figure 2). Clearly, GSE affordable housing efforts should be directed at this segment of the population, but the data shows only a paltry percentage goes to this important group of under-served Americans.

Figure 2

GSE Stockholders Receive Over Seven Times the Subsidy Going to Lower Income Home Purchasers*

1999 Median Household Income = $40,800.



*Single-family homebuyers earning less than $40,000. ** Multi-family, non-owner occupied single-family, and other loans. CBO estimate of the GSEs' subsidy allocated according to 1999 HMDA Data. Conventional loans within the $240,000 conforming limit. Percentages may not total 100 percent due to rounding.

- This contrasts sharply with GSE stockholders, who receive 37 percent of the subsidy. *Thus, GSE stockholders received over seven times more of the subsidy than the bottom half of Americans by income.*

- This also contrasts sharply with support for wealthier borrowers earning above the median household income, who receive 26 percent of the subsidy. Thus the top half of American homebuyers by income received five times the subsidy as the bottom half.

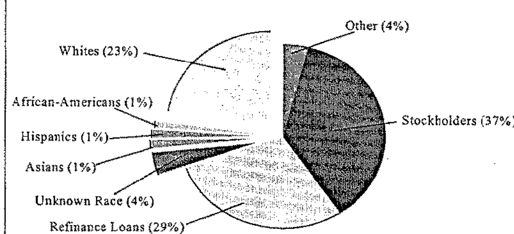
- Congress clearly intended that the GSEs lead the market when it comes to affordable housing, but the GSEs in fact *lag the market*, as both the Department of Housing and Urban Development (HUD) and the General Accounting Office have concluded. The data bears this out. Of all conventional, conforming loans made to borrowers with incomes below $20,000, the GSEs purchased only 26 percent by dollar volume, whereas the private market held or purchased 74 percent. But of these types of loans to borrowers with incomes above $100,000, the GSEs purchased 51 percent, while the private sector held or purchased 49 percent. In other words, GSE activity is more concentrated at higher income levels than the private market.

By a surprisingly significant margin, African-Americans and Hispanics receive a disproportionately small share of the subsidy, a complete reversal of Congressional intent.

- It is especially important that the GSEs use their government subsidy to serve both African-Americans and Hispanics. While the overall U.S. homeownership rate is at a record high of 67.7 percent, the homeownership rate for African-Americans is 47.3 percent and for Hispanics, 46.7 percent.[1] When Congress directed the GSEs to promote affordable housing, it certainly intended that these important groups would be served.

- Just the opposite is the case. Only two percent of the entire taxpayer-financed GSE housing subsidy went to African-Americans and Hispanics to purchase and live in their own homes (Figure 3).

Figure 3
Only Two Percent of the Housing Subsidy Helps African-Americans and Hispanics Buy Homes



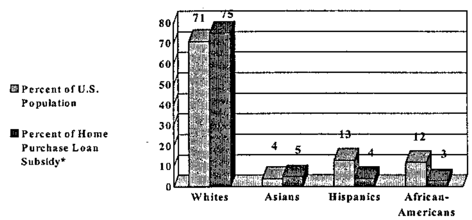
1999 HMDA Data. Conventional, single-family, owner-occupied home purchase loans within $240,000 conforming limit.

- The share of the subsidy used for single-family home purchases by African-Americans and Hispanics significantly lagged their share of the population. Figure 4 compares the allocation of the 30 percent portion of the total subsidy that actually went to promote homebuying. African-Americans constitute 12 percent

[1] Press Release, U.S. Department of Housing and Urban Development. October 27, 2000.

of the U.S. population, but received only three percent of the GSE housing subsidy supporting home purchases. Hispanics make up 13 percent of the population, but received only four percent of the subsidy (Figure 4).[2]

Figure 4
African-Americans' and Hispanics' Home Purchase Loan Subsidy Lags Their Share of the U.S. Population



* Compares the allocation of the 30 percent portion of the total subsidy that actually goes to promoting homebuying. CBO estimate of the GSEs' subsidy allocated according to 1999 HMDA Data. Conventional, single-family, owner-occupied home purchase loans within the $240,000 conforming limit. Includes only the subsidy supporting single-family, owner-occupied home purchase loans.

The GSEs Can and Should Do More

Clearly the GSEs have ample opportunity to do more to assist African-Americans and Hispanics. The GSEs only purchased 31 percent of the dollar volume of conventional, conforming mortgage loans made to African-Americans and 39 percent of those made to Hispanics, while purchasing 47 percent of those loans made to whites.[3]

FM Watch undertook this study because other organizations, among them, HUD, GAO, the Urban Institute, and the National Community Reinvestment Coalition, have issued reports which demonstrate that the GSEs to lag the market when it comes to supporting low- and moderate-income and African-American and Hispanic homebuyers. Our analysis demonstrates the same pattern of activity and Congress should step in.

For example, in December 2000 HUD reported that (the numbers cited below exclude subprime B and C loans),

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[2] The GSE Public Use Data Base supports the conclusions regarding the distribution of the subsidy among racial groups drawn from the HMDA data. African-Americans received $0.183 billion (3 percent) and Hispanics received $0.279 billion (4 percent) of the portion of the subsidy the GSEs pass through to borrowers, while whites received $4.8 billion or 72 percent. (See Appendix A.)

[3] The GSE Public Use Data shows a similar pattern. In dollar terms, the GSEs purchase 36 percent of loans made to African-Americans, 53 percent made to Hispanics, and 63 percent made to whites.

- In 1999, the share of the conventional conforming market that was composed of Special Affordable home purchase loans was 36 percent more than the corresponding share of Fannie Mae's purchases and 34 percent more than the corresponding share of Freddie Mac's purchases.

The GSEs similarly lag the market in the purchase of loans for African-American and Hispanic borrowers.

- In 1999, the share of the conventional conforming market that was composed of loans to African-Americans was 47 percent more than the corresponding share of Fannie Mae's purchases and 43 percent more than the corresponding share of Freddie Mac's purchases.

- In 1999, the share of the conventional conforming market that was composed of loans to Hispanics was 15 percent more than the corresponding share of Fannie Mae's purchases and 25 percent more than the corresponding share of Freddie Mac's purchases.

According to HUD, this performance, and the fact that the GSE purchases of loans for low-income and African-American borrowers typically have high down payments, has raised questions about the contribution of the GSEs to increasing homeownership for these borrowers.

Given the direction from Congress at the time the GSEs were established, followed by the 1992 passage of the Federal Housing Enterprises Financial Safety and Soundness Act, and the 1992 affordable housing goals, we question why the GSEs are not using their taxpayer subsidy to purchase more affordable housing loans from these groups of homebuyers. The answer is that the GSEs have placed a greater priority on increasing profits at the expense of promoting low- and moderate-income housing. Affordable housing loans tend to be smaller, riskier and less profitable, so the GSEs have tended to purchase the larger, less risky loans which are made to wealthier borrowers.

This strategy has produced impressive returns for the GSEs. In 2000, the GSEs' return on equity was 25 percent versus 13 percent for Federally-insured depository institutions. But the GSE emphasis on profits has come at the expense of creating affordable housing opportunities for homebuyers.

The GSEs can do more to increase affordable housing, without reducing the subsidy to other borrowers. The GSEs argue they must choose between giving a few borrowers a large subsidy or giving many borrowers a small subsidy. This is a false choice. Allocation of the subsidy is only a zero sum game when Fannie Mae and Freddie Mac retain over a third of the taxpayer-financed subsidy to boost returns for their stockholders.

The $3.9 billion retained by the GSEs can and should be used to expand homeownership. Down payment grants or interest rate subsidies could be used to help more low-to-moderate income Americans buy their own homes. Or, changing HUD's Affordable Housing Goal definitions to bring them in line with CRA could channel more GSE activity to underserved areas. Currently, for example, there is a discrepancy between HUD's housing goal definitions and those for CRA that enables the GSEs to meet goals for underserved areas with loan purchases that would not qualify as underserved under CRA. Moreover, simply changing HUD's Affordable Housing Goal definition of low- and moderate-income to conform with the definitions of low- and moderate income under the Community Reinvestment Act could also shift more of the subsidy from GSE shareholders to truly low- and moderate income homebuyers.[4]

In closing, Mr. Chairman, we want to take note of a statement made last year by the Chairman of Fannie Mae to a conference of low-income housing advocates.

"We have made a decision that we do not believe that it is the best use of the kind of resources that we have in the secondary market for us to take the subsidy that the [private] bank says they are providing [to a low-income borrower] and to move that subsidy to Fannie Mae, because that's what essentially buying it at par means. Now if the bank wants to continue the subsidy, we'd be delighted to buy the loan. But for us to take over the subsidy that they've entered into is something we've decided we wouldn't do. But if the bank wants to continue the subsidy, they want to buy down the rate, continue that, we'd be delighted to buy the loan."

We strongly disagree with that statement. If the GSEs were to use more of their subsidy to do precisely what Fannie Mae's Chairman has stated his company *will not do*, many more families would be able to buy homes. The GSEs can – and should – do much more to promote affordable housing. The private sector would welcome their increased involvement and renewed commitment to redressing this pressing need. Finally, we believe Congress should be as vigilant in overseeing the expenditure of the taxpayer subsidy as they are in overseeing the expenditure of appropriations.

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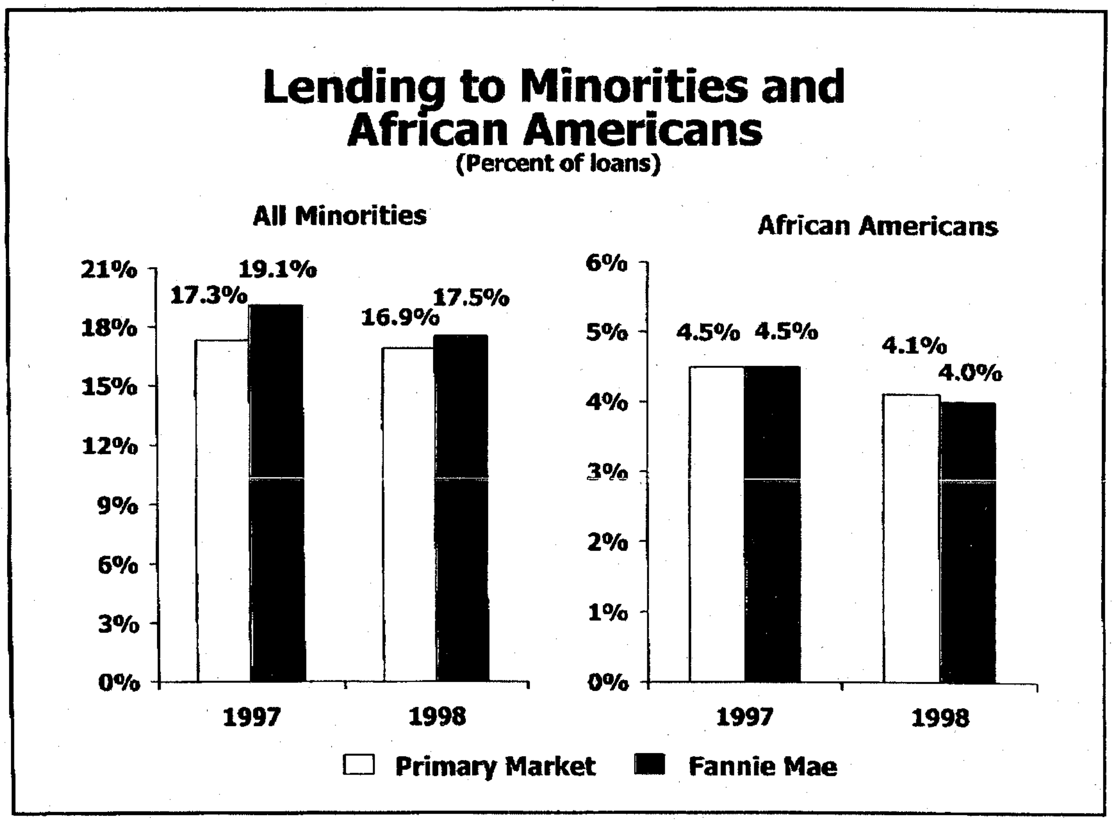
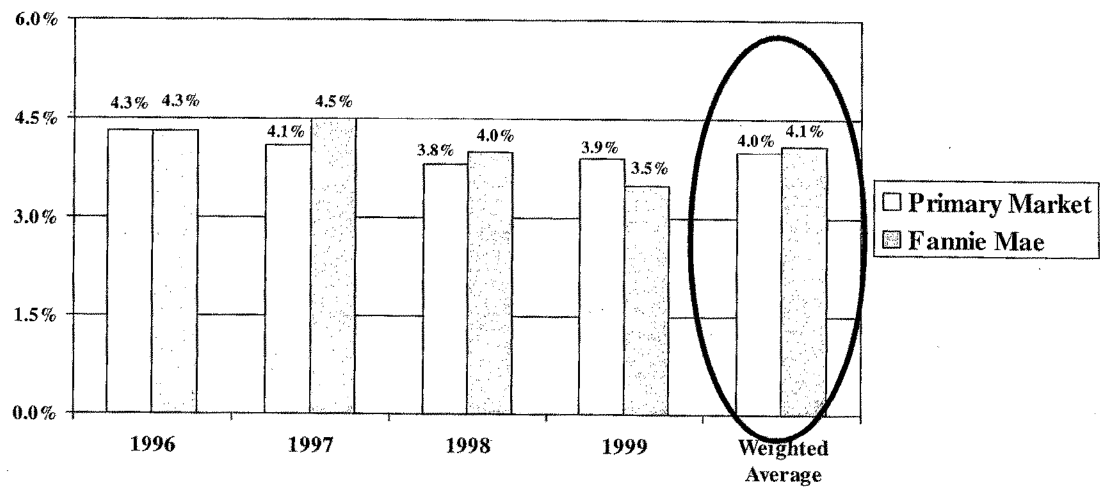
[4] For more detailed information on this issue, see Canfield & Associates, Inc.'s "Fannie Mae's and Freddie Mac's Affordable Housing Goals," an analysis of the important differences between CRA requirements for depository institutions and the GSEs' Affordable Housing Goals.

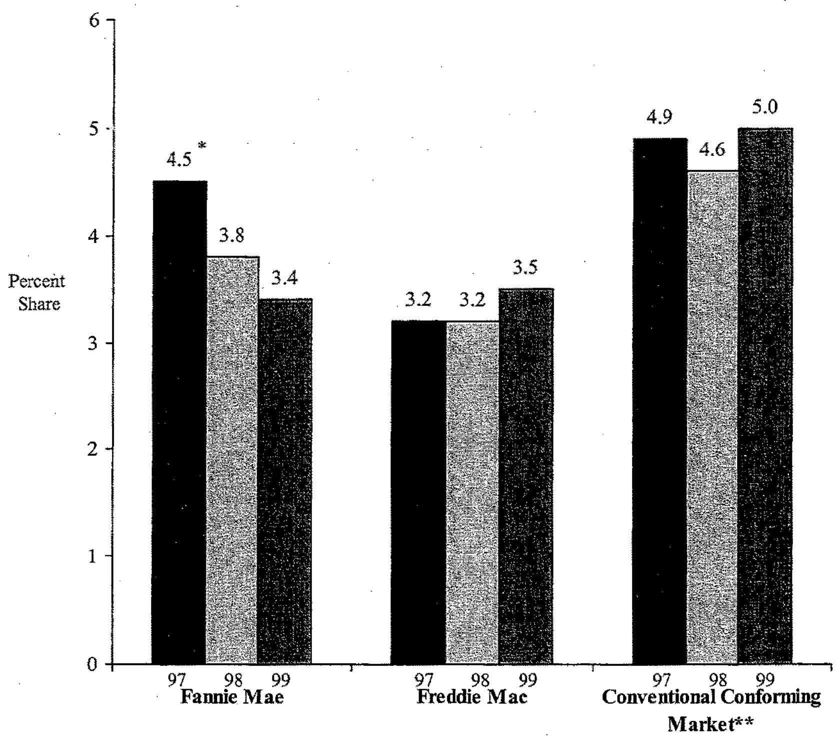

Lending to Minorities and African Americans
(Percent of loans)
All Minorities
21%
18%
15%
12%
9%
6%
3%
0%
17.3%
19.1%
16.9%
17.5%
1997
1998
African Americans
6%
5%
4%
3%
2%
1%
0%
4.5%
4.5%
4.1%
4.0%
1997
1998
Primary Market
Fannie Mae

Fannie Mae vs. the Market
African American Lending



Source: Fannie Mae FMIS data for owner-occupied, purchase money mortgages in MSAs. "Primary Market" is based on HMDA data for conventional conforming, owner-occupied, purchase money mortgages in MSAs — plus jumbo, subprime, and manufactured loans reported as "sold to" Fannie Mae or Freddie Mac. Market data is adjusted for estimated subprime volume not reflected in HUD-identified subprime lender volume.

Figure 6
The Share of GSE Purchases and Conventional Conforming Mortgages for African-American Borrowers, 1997-1999



Source: Table 5. Home purchase loans in metropolitan areas.

* Interpreted as follows: In 1997, 4.5 percent of Fannie Mae's aquisitions of single-family-owner home purchase mortgages in metropolitan areas were for African-American borrowers.

** "Conventional Conforming Market" excludes estimated B&C loans.

Statement of the
Council of FHLBanks
Regarding

"The Secondary Mortgage Market Enterprise
Regulatory Improvement Act"
(H.R. 1409)

Financial Services Subcommittee on
Capital Markets, Insurance, and
Government Sponsored Enterprises

U.S. House of Representatives

Washington, DC
July 11, 2001

The Council of Federal Home Loan Banks (FHLBanks) submits the following statement to the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises regarding "The Secondary Mortgage Market Enterprise Regulatory Improvement Act," (H.R. 1409) and the May 2001, CBO study titled "Federal Subsidies and the Housing GSEs."

"The Secondary Mortgage Market Enterprise Regulatory Improvement Act," (H.R. 1409)

This proposed legislation would, among other things, abolish the Office of Federal Housing Enterprise Oversight (OFHEO) and move safety and soundness regulation for Fannie Mae and Freddie Mac to the Federal Reserve Board. The FHLBanks would continue to be regulated separately by the Federal Housing Finance Board (FHFB) for both mission regulation and safety and soundness oversight.

We believe that, regardless of the path Congress chooses to take pertaining to Fannie Mae and Freddie Mac oversight, the current regulatory structure established for FHLBank System is quite appropriate given its unique mission and cooperative structure. There are at least four primary reasons why the FHLBank regulatory structure should remain as is and not be changed. They are:

1. The FHLBanks are unique, both in structure and operation, from Fannie Mae and Freddie Mac.

While Fannie and Freddie are publicly traded entities, the FHLBanks are organized in a cooperative structure in which our customers are our shareholders. This creates radically different business models. The FHLBanks and their members believe that combining the regulation of all housing GSEs could eventually lead to the weakening of the cooperative structure of the FHLBank System—much the way Freddie Mac went from a cooperative structure to a publicly traded model.

Furthermore, while our housing finance role continues to be of dominant importance, our statutory mission as defined in Gramm-Leach-Bliley includes supporting agriculture and small business lending for Community Financial Institutions. Fannie Mae and Freddie Mac, on the other hand, are focused on housing exclusively. While there is some overlap in mission among the two housing GSEs and the FHLBanks, vast structural and operational differences still separate these organizations.

2. The Gramm-Leach-Bliley Act (GLB Act) recently addressed concerns over the FHLBanks regulatory structure and strengthened the FHFB's enforcement authorities.

The Council recognizes and is appreciative of the extraordinary time and effort that the Chairman and Ranking Member of this Subcommittee put forth to enact the Federal Home Loan Bank System Modernization Act of 1999. That substantial and forward-thinking legislation has set the FHLBanks on a sound course for many years to come.

As you know, through Title VI of the GLB Act, Congress implemented GAO recommendations to strengthen the FHFB by creating a more arms-length relationship between the FHLBanks and their regulator. The GLB Act also added enforcement authority to the FHFB that mirrors the authorities of the OCC, FDIC and other financial regulators. Additional new regulatory legislation is simply unnecessary.

3. The FHLBanks are continuing to digest the numerous substantial changes mandated by the GLB Act.

The most significant of those changes requires the FHLBanks to incorporate a stringent new capital regime. The Federal Home Loan Bank System Modernization Act of 1999 created a more permanent capital base for the FHLBank System and required the FHLBanks to submit to a state-of-the-art, risk-based capital test, including a stress test. However, these changes did not create similar capital structures between the FHLBanks, Fannie Mae and Freddie Mac. On the contrary, the FHLBanks' risk-based capital requirements, the capital-to-assets ratios and capital structures remain very different and more stringent than that of the other GSEs — making the ability to seamlessly unify GSE regulation more difficult.

4. Why change something that works?

While it is appropriate and necessary for Congress to exercise its oversight responsibilities to ensure the safety and soundness of the FHLBanks, the current regulatory structure has been working well since its creation in 1989. For instance, the FHFB:

- has ample authority to regulate mission, as well as safety and soundness matters over the FHLBanks,
- has responded quickly and efficiently to all of the deadlines imposed by Congress in FIRREA and GLB Act, and

- does not go through the appropriations process (which has been a contentious point for OFHEO) and is funded directly by assessments from the FHLBanks.

Furthermore, the FHLBanks continue to obtain AAA/aaa ratings from both Moody's and Standard & Poor's. The FHLBanks have never experienced a credit loss during their 70-year history—even during the turbulent 1980s. This extremely strong record suggests that change is neither warranted, nor wise.

May 2001, CBO study: "Federal Subsidies and the Housing GSEs"

We would now like to turn very briefly to the May 2001, CBO study titled "Federal Subsidies and the Housing GSEs." In addition to noting that not one dollar of federal funds goes to FHLBanks, we would also like to make the following two points.

First, footnote 2 on page 16 of the CBO report ignores the changes promulgated in GLB Act. It states when referring to the FHLBanks that:

> "...the quality of capital is lowered by the right of member banks to redeem shares at par (the price they initially paid) in anticipation of financial trouble."

The GLB Act set up stringent requirements for a strong risk-based capital structure. One of the key statutory requirements is that no redemption of member stock is allowed if a FHLBank would fail any capital requirement.

Second, while the CBO study focused on housing, the study acknowledges that determining the benefit "... to the FHLBs is more complicated because their member banks engage in a variety of lending and other activities." Those other activities that community banks undertake include funding a communities' commercial trade, creating jobs, and making credit available to consumers. Nonetheless, whatever the benefit is, the study states the following on page 25:

> "The banks are cooperatively owned by retail financial institutions that have elected to become members of the FHLB System and are eligible to borrow from the FHLBs. Because members are both owners and customers of the FHLBs, it is likely that almost all of the benefit of GSE status is passed through to them, either in the form of concessions on advances or via dividends. Because retail lending is a highly competitive industry, members may be forced to pass most of the benefit through to their own customers."

Thus, even the study acknowledges that the benefit of lower credit cost created by the FHLBank System flows through its members and goes to American communities and consumers. We believe that is our purpose and that through our 8,000 member cooperative we really are a nation of local lenders that continues to provide the lifeblood of every community -- the availability of credit.

National Association of Home Builders

Statement for the Record

Regarding H.R. 1409,
"The Secondary Mortgage Market Regulatory Improvement Act "
Congressional Budget Office Study
"Federal Subsidies and the Housing GSEs"

Submitted to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises,
Committee on Financial Services

United States
House of Representatives

Washington, DC
July 11, 2001

The 203,000 members of the National Association of Home Builders (NAHB) appreciate the opportunity to submit our views on H.R. 1409, "The Secondary Mortgage Market Regulatory Improvement Act," and the May 2001 Congressional Budget Office (CBO) study, "Federal Subsidies and the Housing GSEs." Both of these are under consideration by the Subcommittee as part of its examination of possible changes to the regulatory structure for the housing-related government-sponsored enterprises (GSEs), specifically Fannie Mae and Freddie Mac.

Fannie Mae and Freddie Mac are extremely critical components of this nation's housing delivery system. That we have become the best housed nation in the world is due in large part to the contributions of these two companies. With the help of Fannie Mae and Freddie Mac, nearly two-thirds of the nation's households are homeowners. Much of this success is due to the public/private partnership established by Congress more than a half-century ago and to the reforms enacted in the Federal Housing Enterprises Safety and Soundness Act of 1992 (the GSE Act). This is not to say, however, that the current housing finance system is perfect. Indeed, several sectors of the housing market remain underserved by the present system. Until these gaps are filled, we cannot afford to be complacent. There is more work that the GSEs can and should be doing to expand homeownership opportunities to all Americans and to support the markets for affordable rental housing.

NAHB supports a strong and efficient regulatory system for Fannie Mae and Freddie Mac, one that balances safety and soundness concerns with mission fulfillment. We believe that the current GSE regulatory system meets these objectives. Nevertheless, Congress is right to periodically assess the current system and to examine changes to improve the system. In so doing, Congress should avoid enacting legislation that could impair the ability of Fannie Mae and Freddie Mac to perform their critical role in the housing finance system.

I. NAHB Comments on H.R. 1409

In the 106^{th} Congress, this Subcommittee considered H.R. 3703, "The Housing Finance Regulatory Improvement Act of 2000." H.R. 3703 proposed a two-track approach aimed at improving the regulation of the GSEs and changing their relationship to the federal government. The first track would have consolidated the regulation of all the housing GSEs, including the Federal Home Loan Bank System (FHLBS), into a new independent agency. The second track proposed a number of changes to the GSEs' charters with regard to GSE status. In testimony dated July 20, 2000, NAHB expressed concerns that several provisions of H.R. 3703, particularly those relating to the regulator's authority and changes to GSE status. We testified that enactment of such provisions, would disrupt the smooth operation of the US housing finance system by undermining the ability of the GSEs to provide liquidity and lower-cost financing, ultimately raising the cost of homeownership and rental housing.

H.R. 1409, introduced in this Congress, repeats the approach of H.R. 3703. With the exception that H.R. 1409 excludes the FHLBS, it is essentially the same as H.R. 3703. We are dismayed that the legislation ignores the extensive hearing record of the past year and the voluntary initiatives announced by Fannie Mae and Freddie Mac on October 19, 2000, regarding steps to strengthen market discipline, capital and liquidity. Indeed, H.R. 1409 has not resolved, and may have exacerbated, NAHB's concerns with the prior legislation. We will confine our comments on H.R. 1409 to three provisions in the bill: consolidation of regulatory oversight in the Federal Reserve; approval process for new activities; and, changes to GSE status. As discussed below, NAHB believes that enactment of these provisions could have significant consequences affecting the availability and cost of housing for America's homebuyers and renters.

Consolidation of Regulatory Oversight in the Fed

H.R. 1409 would consolidate the safety and soundness regulation of Fannie Mae and Freddie Mac by the Office of Federal Housing Enterprise Oversight (OFHEO) and the mission oversight by the Department of Housing and Urban Development (HUD) into the Federal Reserve Board. OFHEO would be abolished and HUD's general regulatory authority over the enterprises would be terminated. The Fed's principal duties with respect to Fannie Mae and Freddie Mac would be to ensure that the enterprises operate in a financially safe and sound manner, carry out their missions, and remain adequately capitalized. The Fed also would have general supervisory and regulatory authority over the enterprises. HUD would retain authority over affordable housing goals and Fair Housing Act responsibilities.

NAHB has several concerns regarding the proposed regulatory structure for Fannie Mae and Freddie Mac as set forth in H.R. 1409. First, we do not believe that consolidating the regulatory oversight of Fannie Mae and Freddie Mac into the Federal Reserve would improve regulatory efficiency. Prior to the 1992 GSE Act, all regulatory authority over Fannie Mae and Freddie Mac was vested in HUD. In the wake of the thrift crisis, Congress passed the 1992 GSE Act that created OFHEO as the safety and soundness regulator for the Enterprises and reaffirmed HUD as the program regulator. In so doing, Congress created a positive tension between the mission and safety and soundness oversight of these entities which has served the housing market extremely well. It has focused the GSEs on their affordable housing mission, while establishing rigorous safety and soundness requirements. Any effort to consolidate these regulatory functions would be a step backward and would not improve on the current regulatory structure.

H.R. 1409 would result in a reduced emphasis on Fannie Mae's and Freddie Mac's housing mission. Regulation of how the enterprises carry out their affordable housing mission would be transferred from HUD, an agency focused on serving housing needs, to the Fed, an independent agency focused on bank regulation with no expertise in housing policy. The Fed is not the appropriate regulator for Fannie Mae and Freddie Mac. Although the Fed certainly is the pre-eminent banking regulator, it lacks the housing focus necessary to oversee Fannie Mae's and Freddie Mac' housing mission. Indeed, Fed Chairman Alan Greenspan has argued that Fannie Mae and Freddie Mac have fulfilled their Congressional mandate, thus the GSE status of these companies is no longer needed and is an unnecessary diversion of resources into housing. We take exception with this view and have expressed our concerns to Chairman Greenspan.

Transferring regulatory authority to the Fed also could result in a delay in the publication of final risk-based capital regulations for Fannie Mae and Freddie Mac. Implementation of such capital standards should be the highest priority to ensure the safety and soundness of the enterprises. We note that OFHEO is close to publishing its final risk-based capital rule applicable to Fannie Mae and Freddie Mac. This rule promises to be the toughest and most sophisticated of capital regulations in the financial services industry. NAHB has submitted comments to OFHEO in support of such a capital structure and we commend OFHEO for its work thus far. It is important that any consideration of restructuring the GSE regulatory framework not interfere in the development of these rules.

Review of New Activities

Section 106 of H.R. 1409 requires the Fed to approve new GSE activities and review ongoing activities. Currently, HUD is required to review new programs for Fannie Mae and Freddie Mac to ensure they are consistent with these GSEs' Congressional charters and are in the public interest. Under H.R. 1409, Fed approval would be required before the enterprises could begin a new activity. The bill defines new activity as any activity that is significantly different from or an expansion of previously approved programs and activities. A new activity could be approved only if it is authorized by law, if the Fed determines it can be conducted in a safe and sound manner, and it is in the public interest. The bill directs the Fed to establish procedures for obtaining new activity approval.

NAHB strongly believes that the GSEs should always operate within their Congressional charters. We believe that the GSEs have effectively identified market needs and responded efficiently. This is particularly true in the affordable housing area where both GSEs have introduced products and services to expand homeownership opportunities for low-and moderate- (low/mod) income borrowers, renters and residents of areas underserved by the broader housing finance system. Technological innovations by the GSEs, such as their automated underwriting systems (AUS), also have contributed to their efforts to expand homeownership opportunities. In the affordable multifamily market, both GSEs have established forward commitment programs that support much-needed production of new units. Further, each has developed partnerships and alliances at the national and local levels to expand affordable housing opportunities. Several of NAHB's local Home Building Associations have worked with Fannie Mae and Freddie Mac on these partnerships.

NAHB is concerned that the prior approval process for new GSE activities envisioned in H.R. 1409 could adversely affect the ability of the GSEs to adopt programs such as these, preventing the companies from carrying out their housing missions. The prior approval language is so vague that any activity undertaken by Fannie Mae and Freddie Mac could be deemed "new" and require Fed approval through an undetermined process. We fear that the prior approval process could have a chilling effect on market innovation and impede the flow of new products and programs to meet new demands. Ultimately, we believe that this provision would hurt housing consumers.

Proposed Changes to GSE Status

Sections 109 and 110 of H.R. 1409 would change key federal privileges and legal exemptions provided to the enterprises in their federal charters. Section 109 of the bill would eliminate the exemption from SEC registration and reporting requirements. Section 110 would make use of the Treasury's line of credit with the GSEs -- the authority to purchase $2.25 billion of Freddie Mac and Fannie Mae securities – conditional upon a request from the Fed. Further, while the bill does not call for an outright repeal of the line of credit, as was proposed in H.R. 3703, other provisions direct the Treasury to study the GSE line of credit and the desirability of eliminating the line. These provisions effectively weaken Fannie Mae's and Freddie Mac's GSE status which provides the enterprises with their key benefit -- the ability to raise capital at rates that benefit homeowners and renters throughout the nation.

NAHB strongly opposes the withdrawal of any of the federal privileges and legal exemptions specified in the GSEs' charters, or any other actions that would dilute the GSE status of these institutions. There is nothing in the hearing record on H.R. 3703 that would support these provisions. Indeed, the consensus at the end of the hearing process was that the federal attributes in the GSEs' charters should not be repealed or modified. All of us are aware of what happened in the financial markets following the March 2000 hearing. These events are a clear demonstration of the importance of the financial market's perception of the GSEs and the potential for unintentional damage from possible changes to their GSE status. We urge Congress to carefully consider the consequences that changes to GSE agency status could have on the housing finance system and the cost of homeownership.

II. NAHB Comments on the CBO Study – "Federal Subsidies and the Housing GSEs"

The Congressional Budget Office (CBO) made at least two attempts to estimate the implicit "subsidy" captured by the housing government sponsored enterprises, once in 1996 and again in 2001. The CBO studies analyze a number of important elements in the operation of Fannie Mae and Freddie Mac (the Federal Home Loan Bank System is also analyzed but that is not the subject of this comment) in order to show that they retain some of the value of their federal preferences. The 2001 CBO study estimates that Fannie Mae and Freddie Mac received

$10.6 billion in federal subsidies in 2000, retaining about $3.9 billion (37 percent) and passing along $6.7 billion (63 percent) to mortgage borrowers in the form of lower mortgage rates.

While the analysis is complex and the estimation techniques are sophisticated, the underlying approach is very simple. CBO backs into the value of the federal preferences retained by Fannie Mae and Freddie Mac by estimating "wholesale" and "retail" advantages in mortgage borrowing and lending. The difference is assumed to be retained by the two corporations.

The "wholesale" advantage is calculated as the difference between comparable, private debt and Fannie Mae or Freddie Mac debt. The "retail" advantage is calculated as the difference between mortgage rates on conforming mortgages and non-conforming mortgages. Under this approach, CBO assumes that any difference in Fannie Mae's and Freddie Mac's cost of funds is due to their federal preferences. Likewise, any difference between conforming and non-conforming mortgage rates is the only portion of the preference passed to consumers. Neither of these assumptions is true and therefore the logic behind the CBO estimation procedures, however sophisticated, is flawed.

Fannie Mae and Freddie Mac borrow at lower rates than other private financial institutions because of their special federal status and because they are large, unique, and well run companies in competition with each other. The movement of funds from world capital markets to the US housing market is one of the most efficient and effective financial operations in the world. These two intermediaries have perfected the systems, procedures and pricing by experience and experimenting. Their debt is priced lower because of these efficiencies compared to other financial companies. They also deal exclusively in residential real estate mortgages, which have proven to be one of the safest long term investments. Other financial intermediaries have more diverse portfolios that make it difficult to compare directly. If Fannie Mae and Freddie Mac are unique and better than others at what they do, then the CBO approach attributes these efficiencies to federal preferences when they should be attributed to expertise, experience and uniqueness.

Fannie Mae and Freddie Mac are able to reduce mortgage rates because of their federal preferences. They are also required to focus a substantial amount of their business on priorities identified by HUD, including mortgages for low- and moderate-income home owners and rental apartments. Compelling Fannie Mae and Freddie Mac to perform these added functions is a direct consequence of their federal charter and preferences. But, lending to underserved markets is not the same as lending to the conventional, vanilla mortgage market and CBO does not account for this difference. In fact, by virtue of the CBO residual approach, the benefits accruing to low- and moderate income renters and owners is attributed to the corporation.

The CBO study develops and utilizes some sophisticated estimation techniques in order to arrive at their estimates of the differences between the GSEs and other financial institutions. Some of the assumptions made could be changed based on different views. However, these points become relatively moot when the calculations are used in a model that ignores two overarching issues – unique characteristics beyond the federal preferences and requirements to serve markets not served by the private marketplace.

Conclusion

NAHB has appreciated the opportunity to share our views on H.R. 1409 and the May 2001 CBO Study. We believe that the housing finance system works well due largely to the critical supports provided by the housing government-sponsored enterprises, Fannie Mae and Freddie Mac. NAHB opposes the withdrawal or modification of the federal privileges and legal exemptions specified in the GSEs' charters or any other actions that would dilute the financial market's perception of the GSE status of these institutions. We appreciate the Subcommittee's efforts to assess and seek improvements to the regulatory framework for the GSEs and we are interested in continuing to participate in this process as we move forward. Ultimately, NAHB believes that any regulatory regime for the GSEs must allow these institutions to fulfill their public missions to support the housing finance system in a safe and sound manner.

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