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

Testimony by

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to the

Subcommittee on Financial Management, the Budget, and International Security

of the

Senate Committee on Governmental Affairs

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by Bert Ely

I -- Introduction

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

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

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

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

II -- The Fannie/Freddie Problem Today

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

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

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

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

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

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

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

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

The second GSE rescue occurred nine years later when Congress broadened the assessment base for deposit insurance premiums levied to pay $800 million annually of interest on bonds issued by the Financing Corporation, or FICO. FICO was a special purpose

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corporation Congress created in 1987, in the Competitive Equality Banking Act, to finance the early stages of the cleanup of the S&L debacle. FICO issued $8.17 of bonds between 1987 and 1989, with interest on them to be paid from a special deposit insurance assessment on S&L deposits. By 1996, shrinking deposits in a contracting S&L industry fueled concerns that FICO would default on its interest payments, which were not explicitly guaranteed by the federal government. Congress eliminated that default threat, in the 1997 omnibus appropriations legislation, by broadening the FICO assessment base to include deposits in commercial and savings banks insured by the FDIC's Bank Insurance Fund.

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

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

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

A -- Freddie Mac's serious accounting problems

Freddie has been undergoing a slow strip-tease since January 22 of this year, when it announced that it was being forced by its new outside auditors, PriceWaterhouseCoopers (PwC), to restate its financial statements for 2000 and 2001 prior to issuing audited financial statements for 2002.[iii] The news from Freddie has gotten only worse since then, culminating in the June 4 termination of three top officers, including Freddie's long-time CEO, Leland Brendsal, and its long-time chief operating officer, David Glenn.

Since June 4, Freddie has disclosed the breadth of the reaudit now underway, which encompasses several hundred thousand transactions reaching back into the 1990s[iv] and the July 11 news report that Freddie will not complete its registration under the 1934 SEC Act[v] until mid-2004, two years after Freddie volunteered to register with the SEC under that act.[vi] I am puzzled, and troubled, that it will take Freddie nine months, or more, to complete its registration with the SEC after it issues restated financial statements through 2002, which it has claimed it will do by September 30 of this year. Perhaps Freddie's management is setting us up for a further delay in the issuance of its restated financial statements.

This witness's accounting and financial experience, gained over almost four decades, has been that the initial bad news about a company's financial problems is rarely the last bad news. Instead, the strip-tease usually continues, as probers dig deeper and deeper into the

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bowels of a company's accounting. I am absolutely shocked, and appalled, by the depth and scope of Freddie's accounting problems, as they have been revealed to date, most recently in testimony last Thursday to the Senate Banking Committee by Armando Falcon,[vii] the outgoing director of the Office of Federal Housing Enterprise Oversight (OFHEO). OFHEO is an independent agency within the Department of Housing and Urban Development (HUD).

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

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

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

B -- Inadequate financial disclosures by both companies

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

While Fannie boosts, and once upon a time Freddie boosted, about their compliance with GAAP, the breadth of their financial and operational disclosures, and their voluntary registration with the SEC (but only under the 1934 Act), it is not enough for these two companies to match the financial and operational disclosures of genuine private-sector firms.

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Instead, as GSEs which pose enormous systemic and taxpayer risks, Fannie and Freddie should provide much more detailed and timely disclosures about their activities and financial condition. In particular, Fannie should commit, as Freddie has done, to issue a quarterly "fair value" financial statement, as prescribed under Financial Accounting Standards (FAS) No. 107. Presently, FAS 107 disclosures have to be provided only annually, in a footnote to audited financial statements. It was unfortunate that Tim Howard, Fannie's chief financial officer, would not commit Fannie to quarterly FAS 107 disclosure statements during a July 15, 2003, conference call with stock analysts and investors.

C -- Insufficient disclosure comparability between Fannie and Freddie

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

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

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

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

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

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The stress test, as applied to date, has been based on a static analysis. That is, the test assumes that the GSE will not purchase any new mortgages during the "stress period," other than those is already has committed to purchase (12 U.S.C. '4611(a)(3)(A)). In effect, the GSE will be assumed to be operating in a wind-down or "run-off" mode. That is a highly unrealistic assumption that ignores the impact on the housing marketplace if Fannie or Freddie suddenly stopped purchasing mortgages or committing to do so. Assuming the GSE would continue purchasing mortgages would have the effect of increasing its capital requirement under the stress test. The OFHEO Director may, after conducting the appropriate studies, run the stress test based on the assumption that the GSE will continue to purchase mortgages (12 U.S.C. '4611(a)(3)(B)). However, OFHEO has delayed the implementation of that testing procedure.

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

IV -- The Underlying Problems Caused by GSE Status

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

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

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

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

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

B -- America suffers from an inefficient housing finance system

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

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

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

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

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

GSEs lower the cost of debt capital for those who can borrow from a GSE or whose debt is secured by a GSE loan guarantee. This lower cost tilts capital flows towards those sectors of the economy favored under the GSE authorizing legislation, notably housing and to a much lesser extent, financially stronger segments of agriculture and rural America. Given that there is a finite amount of savings during any time period, this tilt toward GSE-favored borrowing tilts debt capital away from other sectors of the economy, notably the productive sector; i.e., non-farm businesses. Little wonder then, that middle-class and upper-middle-class America live in larger and larger homes amidst a growing urban sprawl. These outcomes were not intended when the GSEs were created. Therefore, the desirability of these outcomes should be subject to a political debate, for the first time.

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

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

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

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

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

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

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

Reports issued by the Congressional Budget Office (CBO) in 1997 and 2002 quantified the extreme inefficiency of Fannie and Freddie in delivering a housing finance subsidy. Approximately 40% of the subsidy was consumed by Fannie and Freddie, in terms of higher profits for their stockholders and higher compensation for their executives. The retained portion of the subsidy largely explains the substantial above-market rates of return Fannie and Freddie consistently earn on their equity capital.

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

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

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

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

Fannie and Freddie widely advertise that they promote home ownership and have played a significant role, if not the dominate role, in raising the home-ownership percentage, a political goal that possibly ranks even higher than mom and apple pie. That is a highly dubious assertion as much of the Fannie/Freddie subsidy flows to middle-class homebuyers who have

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ample means to purchase a home without a financing subsidy (in part because they have sufficient funds for a down payment).

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

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

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

A -- Full SEC registration by Fannie and Freddie

Reps. Chris Shays and Edward Markey have introduced H.R. 2022 to bring Fannie and Freddie under the full scope of all SEC laws and regulations, and specifically the 1933 Act, governing the registration of securities offered for sale to the public, and the 1939 Trust Indenture Act. This is a simple and easily executed reform, as evidenced by the fact that H.R. 2022 is merely a seven-page bill. Among other objections, Fannie and Freddie oppose paying SEC registration fees. However, a provision added to this year's version of Shays-Markey would hold their SEC assessments to a reasonable amount. Despite Fannie's and Freddie's vigorous protests, this is a straight-forward and obvious reform, particularly in light of Freddie's extremely serious accounting problems. Interestingly, Farmer Mac is required to register with the SEC.

B -- Restructuring GSE regulation

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

Rep. Ed Royce will soon introduce a bill that would merge OFHEO with the Federal Housing Finance Board (FHFB) in a new office within Treasury. This is a sensible

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approach that should be enhanced by also merging the Farm Credit Administration (FCA) into this new agency. The FCA regulates the FCS and Farmer Mac. The new agency would then regulate the five active and continuing GSEs, a concept Federal Reserve Chairman Alan Greenspan endorsed last Wednesday.[xii]

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

C -- Increase OFHEO's budget and powers

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

D -- Eliminating state income tax exemptions

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

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

Repealing the so-called Treasury line of credit that the stockholder-owned GSEs have at the Treasury would be symbolic for Fannie and Freddie; it would have a more substantive effect on Farmer Mac. The Secretary of the Treasury has statutory authorization, at his discretion, to purchase up to $2.25 billion each of Fannie's and Freddie's debt, at a market rate of interest. This authority is granted, respectively, under 12 U.S.C. '1719(c) and 12 U.S.C. '1455(c). The maximum amount of the notes Treasury is authorized to purchase equaled .25% of Fannie's outstanding debt on June 30, 2003, and .36% of Freddie's outstanding debt at September 30, 2002 (more recent debt data is not available). Clearly, the funding Treasury could provide to either Fannie or Freddie is minuscule relative to their outstanding debt and liquidity needs.

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

F -- Higher capital requirements for Fannie and Freddie

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

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

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

F -- Ending mission creep

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

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

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

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VI -- Longer Term Solutions to the GSE problem

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

A -- GSEs are anachronisms

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

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

As I have already noted, FM Policy Focus has taken the position that containing and restraining Fannie's and Freddie's growth will cure the Fannie/Freddie problem. I strongly disagree because FM Policy Focus's desire to curb Fannie and Freddie clashes violently with their desire to grow faster than the residential mortgage market so as to maintain their past rate of earnings growth, hopefully producing a steadily rising stock price. Given their enormous political clout, I believe Fannie and Freddie will succeed in repelling FM Policy Focus's containment initiatives.

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

The source of most of Fannie's and Freddie's earnings growth has come from rapid growth in their mortgage portfolios. This growth has largely occurred because Fannie and Freddie now buy back a substantial amount of the MBS they manufacture. In so doing, they assume interest-rate risk, which represents the primary risk, as well as systemic risk, facing the two companies today. The complex derivatives contracts they enter into almost entirely hedge interest-rate risk; relatively little credit risk is hedged through derivatives.

As many have noted, including the Congressional Research Service (CRS),[xvii] Fannie's and Freddie's MBS buy-back programs do not advance affordable housing goals or mortgage market liquidity one whit. The MBS buybacks serve just one purpose -- to boost earnings

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growth. Therefore, barring Fannie and Freddie from owning mortgages or MBS, beyond that which is need to facilitate ongoing securitization activities, would help mightily to reduce, if not eliminate the systemic risk these two copies pose. In effect, this action would turn both GSEs into institutions strikingly similar to the Freddie Mac of the 1970s.

D -- The merits of completely privatizing Fannie and Freddie

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

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

E -- The Ely privatization proposal for Fannie and Freddie

My forthcoming paper will lay out my Fannie/Freddie privatization proposal in great detail. Specifically, it will explain how the housing finance marketplace will be restructured, principally through market forces, so that the efficiencies of moving large blocks of debt capital to mortgage originators can be fully captured. It also will propose a housing finance tax credit, modeled on the Earned Income Tax Credit, that will go only to those home buyers on the cusp of homeownership and to existing homeowners experiencing temporary income declines. Finally, it will address all-important transition issues and privatization of the FHLBs.

VII -- Conclusion

Mr. Chairman and members of the committee, I have appreciated the opportunity to testify today on this extremely important issue. I look forward to your questions.

Endnotes

i. Ely, Bert, and Vicki Vanderhoff, "The Farm Credit System: Reckless Lender to Rural America." American Bankers Association, 1990.

ii. Wallison, Peter, and Bert Ely, "Nationalizing Mortgage Risk: The Growth of Fannie Mae and Freddie Mac," American Enterprise Institute, 2000, pp. 44-47.

iii. [cite Freddie news release]

iv. [cite Freddie news release]

v. [cite official name of the 1934 Act and state what it addresses and does not address]

vi. [cite Kopecki story]

vii. [citation for this testimony]

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

ix. 12 U.S.C. '4611-14.

x. Because of the time it takes (often two months, or more) to close on a mortgage refinance, the GSEs can start to adjust the liability side of their balance sheet before the asset side readjusts due to the mortgage refinance.

xi. [citation to be provided]

xii. [supply citation for Greenspan endorsement]

xiii. The FHLBs also are exempt from federal income taxes, but they pay some special assessments that roughly equal what they would pay in federal income taxes were they subject to that tax.

xiv. [Citation to be supplied]

xv. [citation to be supplied]

xvi. [citation to be supplied]

xvii. [citation to be supplied]

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