STATEMENT OF

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

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

OF THE
UNITED STATES SENATE
COMMITTEE ON GOVERNMENTAL AFFAIRS

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

JULY 21, 2003

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

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

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

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

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

Our position rests on the belief that the market forces of competition and innovation are the best disciplines for all enterprises, including GSEs. We also recognize that, due to the special privileges conferred in GSE charters, only a GSE has the ability to compete with another GSE in the business of funding long-term mortgages.

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

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

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

We see three possible outcomes to this public policy debate:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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