

The **GSE** REPORT™

Contents of GSE Report™

“Once more I find myself forced into the unfortunate position of having to respond to what can only adequately be described as an orchestrated and audacious attack by Fannie Mae and Freddie Mac upon a respected federal government institution [CBO] and its highest-ranking official. And once more I must kindly but forcefully request that Fannie and Freddie refrain from public conduct unbecoming, unfortunate, and beneath us all.” – Congressman Richard Baker (R-LA) press statement, 5/18/01

“I have not seen the [CBO] study but if the news reports are accurate what was once a ‘spongy conduit’ for increasing homeownership has become a revenue pipeline for Fannie and Freddie’s shareholders. We’re concerned that in the past five years the GSEs’ federal subsidy has increased significantly and that Fannie and Freddie’s stockholders and employees continue to receive more than one-third of that subsidy. We now have two CBO reports that indicate this is an inefficient system that needs to be reviewed by the Congress and the GSE regulators.” – FM Watch Executive Director Mike House (*FM Watch press release*, 5/17/01)

Major Events

- Draft CBO study finds that Fannie & Freddie received a substantial increase in federal subsidies since the 1996 CBO study ([p. 3](#))
 - The draft CBO study finds that Fannie & Freddie received \$10.6 billion in subsidies from the federal government last year, an increase of more than 75% from five years earlier
 - The draft CBO study finds that the two companies pass about 63 percent of the subsidy on to home buyers in the form of lower mortgage prices but retain more than a third of the subsidy (37%) for their shareholders and employees
 - The final CBO study will be released at a May 23 House Financial Services Capital Markets Subcommittee hearing
 - Fannie & Freddie & Wall Street analysts blast the study
 - Cong. Richard Baker (R-LA) says his patience is “wearing thin” from Fannie & Freddie’s “unprofessionalism over the subsidy report.” – Cong. Baker accuses Fannie & Freddie of launching “an orchestrated and audacious attack” on the CBO study before it is even released
 - Cong. Baker will hold a follow-up Subcommittee hearing to hear Fannie & Freddie’s views on the CBO study and to hear the views of Wall Street analysts so the analysts can account for: (1) how they obtained copies of the draft study before Congress did; (2) “what the nature of their relationship with Fannie and Freddie is;” and, (3) “what would motivate them to ‘cheerlead’ in this manner.”
- Federal Reserve Bank of Chicago discusses GSEs at its annual conference May 9-11 ([p. 8](#))
 - Federal Reserve Board Governor Laurence Meyer says it’s “reasonable to be concerned” about the large size of Fannie & Freddie and whether the GSEs pose systemic risk to the economy. Meyer said rather than looking at systemic risk, he would look at “resource allocation that comes from the subsidy that is inherent in GSEs and how it is growing over time.”
 - Cong. Richard Baker (R-LA) plans May 23 hearing to discuss results of an updated CBO study that estimates the federal subsidies Fannie & Freddie receive from their GSE status (see earlier story in this *GSE Report*)
 - Former Treasury Assistant Secretary, Richard Carnell, finds that federal sponsorship of Fannie & Freddie, with its perceived implicit backing, tends to impart a *greater* net subsidy than explicit federal deposit insurance
 - Wayne Passmore (Federal Reserve) and Roger Sparks (Mills College) find that under some conditions, GSE mortgage securitization does not lower mortgage rates for consumers
 - Thomas Stanton, Johns Hopkins University, finds that Fannie & Freddie have become too big and too politically powerful for the government or Congress to adequately supervise. “We are sharing a canoe with a bear that is doubling in size every five years,” he said.

- Bert Ely, Ely and Company, contends that there are only two options for dealing with the housing GSEs: (1) contain them or limit their growth; or (2) fully privatize them. Ely notes, however, that a containment strategy is almost “unworkable” and that full privatization of the GSEs is the only solution.
- Senate Banking Committee’s Housing Subcommittee holds May 8 oversight hearing to review the effectiveness of OFHEO as Fannie & Freddie’s safety and soundness regulator ([p. 14](#))
 - OFHEO Director Armando Falcon expects that the long-awaited risk-based capital proposal for Fannie & Freddie will be published sometime this summer after an “unacceptable” five-year delay
 - Housing Subcommittee Chairman Wayne Allard (R-CO) says the Subcommittee may periodically conduct more oversight hearings on the GSEs
 - Senate Banking Committee Chairman Phil Gramm (R-TX) says that the Bush Administration is “moving” toward a position on the GSEs
 - Senator Chuck Hagel (R-NE) says he is concerned about whether Fannie & Freddie have “an unfair advantage”
 - Free Congress Foundation praises Senator Allard for holding the hearing
- Shadow Financial Regulatory Committee (independent panel of financial services experts) praises Cong. Richard Baker (R-LA) for his “courage” in taking on the GSEs, but does not believe the Fed is the appropriate regulator for the GSEs ([p. 20](#))
 - Cong. Richard Baker’s bill would abolish Fannie & Freddie’s current safety and soundness regulator (OFHEO) and make the Federal Reserve Board the regulator of Fannie & Freddie
 - The Committee noted that Cong. Baker’s bill does not provide enough guidance for regulators on what the activities of Fannie & Freddie should be
 - The Committee found that “contrary to the claims of the housing GSEs,” Fannie & Freddie’s new subordinated debt offerings “do not cultivate market discipline or constitute an effective increase in their capital”
 - Absent full privatization of the housing GSEs, the Committee supports “credible limits on the scope of the GSEs’ activities, the vesting of enhanced regulatory authority over them in the US Treasury, and the creation of a credible minimum subordinated debt requirement” to “substantially strengthen market and regulatory discipline and limit the risks posed to taxpayers.”

Major Events

Draft CBO study finds that Fannie & Freddie received a substantial increase in federal subsidies since the 1996 CBO study

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Fannie & Freddie & Wall Street analysts blast the study

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Cong. Baker will hold a follow-up Subcommittee hearing to hear Fannie & Freddie’s views on the CBO study and to hear the views of Wall Street analysts so the analysts can account for: (1) how they obtained copies of the draft study before Congress did; (2) “what the nature of their relationship with Fannie and Freddie is;” and, (3) “what would motivate them to ‘cheerlead’ in this manner.”

- An upcoming 2001 CBO study is likely to report that Fannie and Freddie received a substantial increase in federal subsidies since the 1996 CBO study. The press reported that a draft copy of the CBO study found that Fannie and Freddie received \$10.6 billion in subsidies from the federal government last year, an increase of more than 75% from five years earlier. The draft study also found that the two companies pass about 63 percent of the subsidy on to home buyers in the form of lower mortgage prices but retain more than a third of the subsidy (37%) for shareholders and employees. By calculating the FHLBanks’ subsidies, the draft CBO study reported that the housing GSEs combined (Fannie, Freddie, and the FHLBanks) received \$13.6 billion in subsidies last year (Fannie received \$6.1 billion; Freddie received \$4.5 billion; FHLBanks received \$3 billion). The 1996 study did not calculate the FHLBanks’ subsidies. The draft CBO study also found that the percentage of benefits going to shareholders remained the same, although the total size of the subsidy doubled from \$5.4 billion because of increased mortgage financing activities. The final 2001 CBO study will be released at Cong. Richard Baker’s (R-LA) May 23 House Financial Services Capital Markets Subcommittee hearing. (*Wall Street Journal*, Patrick Barta, Nicholas Kulish and Jacob Schlesinger, 5/17/01; *Washington Post*, Kathleen Day, 5/17/01; *National Mortgage News Daily*, 5/17/01)

Capital Markets Subcommittee Chairman Richard Baker’s comments on the CBO study

- Speaking at a May 11 Federal Reserve Bank of Chicago Conference, Congressman Baker said he plans to hold a May 23 hearing to discuss the results of the final CBO study. Cong. Baker confirmed that CBO Director Dan Crippen would release the final subsidy study at the hearing. Crippen will be the only witness at Cong. Baker’s hearing. Cong. Baker indicated that he would

hold an additional hearing at which officials from Fannie and Freddie will testify about the CBO study.

- In the spring of 2000, Cong. Baker requested that CBO update its 1996 GSE subsidy study (relying on 1995 data), after receiving a letter from Federal Reserve Board Chairman Alan Greenspan. **In a May 19, 2000 letter to Congressman Baker, Chairman Greenspan noted the GSEs' subsidies come "at the expense of other federal or private sector initiatives and hence are ultimately financed by households, either through taxes or through the reduced accumulation of wealth." Greenspan thought it was appropriate for Congress to examine the subsidies enjoyed by the GSEs.** Chairman Greenspan further noted that the 1995 Congressional Budget Office (CBO) study found that the annual subsidies provided to the GSEs were worth \$6.5 billion, of which the GSEs' shareholders kept \$2.1 billion, rather than being passed through to homebuyers. Greenspan further noted that the data used in the CBO study is now five years old, "suggesting that a request to CBO for an update would be in order."
- **Regardless of the size of the subsidy, Cong. Baker said he would use the CBO study and hearings on government subsidies enjoyed by the GSEs to weigh the benefits of the programs against the risks they pose to the broader economy.** Cong. Baker stated, "Whatever the actual figure may be...after we recover from the shock over the size of the number, we more keenly consider what the true ramifications are and what we should look for."
- Among other things, Congressman Baker said he would seek to determine:
 - "precisely who is benefiting from the subsidy and by what percentage"; (Congressman Baker noted that Chairman Greenspan pointed out last year that "these organizations alter the housing finance markets only to the degree that they pass through to homebuyers part of their government subsidy.")
 - "what if any relationship there is between the subsidy and potential systemic risk"; (Chairman Greenspan emphasized last year that "if the subsidy enables Fannie and Freddie to hold less capital, then bondholders and taxpayers may be at greater risk if these government-sponsored enterprises need financial assistance in the future.")
 - "what the American public is getting in return for the subsidy, and if, when placed on a balance, it is justified over and against the weight and possibility of risk and cost";
 - whether the GSEs meet their charter obligations? If so, at what cost?;
 - whether there are other means by which the GSEs' policy goals could be reached;
 - and, "if the subsidy is used for other purposes other than mission compliance, who gets it and how much do they take?"
- Congressman Baker concludes, "Rather than focus on the dollar value of the subsidy, I will be interested to learn how much has it grown, how fast, and the expectations for the future. I will want to examine how much of it flows to targeted recipients. And if there are reasons for concern, which result in distortions of the marketplace, the subcommittee will examine methodologies to direct the subsidy to those targeted by the mission, and minimize the flow of taxpayer benefits to others."

- The CBO was scheduled to release the updated study at the May Federal Reserve Bank of Chicago conference, however, the economists backed out of the conference because the CBO's report on the GSEs' subsidies had not yet been completed. (*American Banker*, Barbara Rehm, 5/15/01; *BNA Daily Report for Executives*, Michael Bologna, 5/14/01; *Dow Jones Newswire*, Jennifer Corbett Dooren, 5/2/01, 5/11/01; *Letter from Fed Chairman Alan Greenspan to Cong. Richard Baker*, 5/19/00; *National Mortgage News Daily*, 5/4/01; *Prepared remarks by Congressman Richard Baker at the 37th Annual Federal Reserve Bank of Chicago Conference on Bank Structure and Competition*, 5/11/01)

Capital Markets Subcommittee Ranking Member Paul Kanjorski's (D-PA) comments on the draft CBO study

- Congressman Kanjorski told *Reuters*, after speaking to the National Association of Realtors, "the numbers themselves aren't as significant as to see whether the subsidy is valuable and whether it's going to the consumer." Congressman Kanjorski was not convinced that Congressman Baker's GSE bill strengthening regulation of Fannie and Freddie is necessary. "The burden is on Mr. Baker to show what the problem is," he said. While Cong. Kanjorski welcomed further Congressional oversight of the GSEs, he opposed making the Federal Reserve Board the regulator of Fannie and Freddie. "I'm not a very strong supporter of the idea of putting more responsibility in the hands of the Federal Reserve," he said. "I think they have all they can handle now with monetary policy and we should look at other institutions to carry that burden." **At the same time, he said Congress should examine whether Fannie and Freddie are overstepping the bounds of the congressional mandates as they grow.** (*Reuters*, Mark Felsenthal, 5/17/01)

FM Watch comments about the draft CBO study

- **FM Watch Executive Director Mike House provided the following statement about the draft CBO study: "I have not seen the study but if the news reports are accurate what was once a 'spongy conduit' for increasing homeownership has become a revenue pipeline for Fannie and Freddie's shareholders. We're concerned that in the past five years the GSEs' federal subsidy has increased significantly and that Fannie and Freddie's stockholders and employees continue to receive more than one-third of that subsidy. We now have two CBO reports that indicate this is an inefficient system that needs to be reviewed by the Congress and the GSE regulators."** (*FM Watch press release*, 5/17/01)

Fannie & Freddie blast the draft study

- Freddie's Senior Vice President of Government Relations Mitch Delk called the CBO's findings "fatally flawed" and contends that the study overstates the funding advantages of the GSEs, but underestimates the benefits the GSEs bring into the market. In a letter to Congressman Baker, Delk stated, "the benefits Freddie Mac bring far outweigh the value we derive from our congressional charter." He noted that a study funded by Freddie estimated that Fannie and Freddie save families from \$8 billion to \$23 billion, and that the annual subsidy was \$7 billion at most. Delk also stated that the study was based on "erroneous assumptions and faulty analysis."
- Fannie spokeswoman Janice Daue, said the report "should be completely disqualified from serious consideration," and claimed that the draft report is "quite divorced from market reality." She noted, "It drastically underestimates the value that Fannie Mae and Freddie Mac provide to consumers. It has a number of flawed assumptions, changing any one of which would turn the results around." An unnamed Fannie spokeswoman said CBO's analysis is incomplete because – among other flaws – it did not take into account Federal income tax payments by the GSEs and compared their debt cost borrowings to banks with different credit ratings. Fannie's Senior Vice

President for Portfolio Strategy Peter Niculescu said one of the most troubling aspects with the CBO study “is how many assumptions there are – many of which are wrong. These numbers are inherently uncertain.” (*National Mortgage News Daily*, 5/17/01; *Wall Street Journal*, Patrick Barta, Nicholas Kulish, and Jacob Schlesinger, 5/17/01; *Washington Post*, Kathleen Day, 5/17/01; *Reuters*, Mark Felsenthal, 5/17/01; *American Banker*, Tommy Fernandez, 5/18/01)

Wall Street analysts blast the report

- Lehman Brothers analyst Bruce Harting describes the CBO study as “flawed.” He said the study’s figures would be significantly different if certain assumptions, such as credit rating and taxes paid, were corrected. He disputes the idea that Fannie and Freddie get government “subsidies” at all, noting that neither GSE receives money directly from the government. “They get a benefit from government sponsorship, not a subsidy,” he said. Salomon Smith Barney analyst Tom O’Donnell dismissed the study’s finding that the GSEs pass on only a portion of their subsidy to homebuyers and retain the rest. “Attracting talented people and compensating them well” is often necessary to ensure the success of a large company, he said. UBS Warburg analyst Gary Gordon doesn’t believe the CBO study will hold much weight in the market. “It is possible that this study, however flawed, could have some political traction. (But) we doubt it because it is technical in nature and open to serious dispute.” (*Dow Jones Newswire*, Janet Morrissey, 5/17/01)
- According to *Bloomberg*, “Wall Street analysts rallied to the mortgage companies’ side, issuing commentary in the morning to poke holes in the draft report.” *Bloomberg* reported that Merrill Lynch & Co., Prudential Securities, Lehman Brothers Inc. and UBS Warburg LLC were among the investment banks that defended the Number 1 and Number 2 issuers of corporate debt. (*Bloomberg News*, 5/17/01)

Cong. Richard Baker (R-LA) says his patience is “wearing thin” from Fannie & Freddie’s “unprofessionalism over the subsidy report”

- **Cong. Baker released a statement in response to reports of attacks by Fannie, Freddie, and their supporters on the integrity of the CBO: "Once more I find myself forced into the unfortunate position of having to respond to what can only adequately be described as an orchestrated and audacious attack by Fannie Mae and Freddie Mac upon a respected federal government institution and its highest-ranking official. And once more I must kindly but forcefully request that Fannie and Freddie refrain from public conduct unbecoming, unfortunate, and beneath us all."**
- **"It is my understanding that in recent days, the Congressional Budget Office, and its Director, Mr. Dan Crippen, as a professional courtesy to Fannie and Freddie, released to them an advance, confidential draft copy of a report on the federal subsidies received by the housing government-sponsored enterprises (GSEs). It is also my understanding that this action was taken with the express purpose of affording Fannie and Freddie an opportunity to respond in private, and on the condition that the contents of the draft would not be made public."**
- **"In return for Mr. Crippen's courtesy, and in violation of this agreed-upon condition, Fannie and Freddie have instead embarked upon a full-scale assault, in public, on the draft report's findings, calling them, among other things, 'flawed' and 'divorced from market reality.' These public assaults began, mind you, before even members of Congress, for whom the report was produced, had a chance to view the draft, and before there could even be completed a final version of the report, which my own office has yet to receive."**

- **"On top of the insult to members of Congress contained in these preemptive strikes against the report's findings, Fannie and Freddie have gone so far as to accuse the Congressional Budget Office of using 'inappropriate methodology, inaccurate assumptions and faulty analysis.' How can I interpret these comments as anything but an additional insult to the professional integrity of Mr. Crippen himself? In fact, in response to eerily familiar critiques of the findings and methodology in a 1996 report, the CBO has gone to heroic efforts to approach this new study with a methodology in keeping with the most rigorous of accounting standards. And further, I know that the protracted length of time prior to this new report's release is due specifically to the great care and deliberateness with which the CBO engaged in an academic-style review process of the highest order."**
- **"Worse still, I now read in the news that Fannie and Freddie have apparently taken the additional unprofessional step of sharing with and eliciting responses on the report from certain market analysts. These analysts, for whatever reason, have made the strange choice of joining in the attack on the Congressional Budget Office and discrediting the report as well. Because I wish to give everyone a chance to participate in this important public policy discussion, I see no reason why I should not announce at this time a follow-up Subcommittee hearing on the subsidy at which to hear, in person, the views of these analysts. And, to begin with, have them account for how they came to view a confidential report before Congress could, what the nature of their relationship with Fannie and Freddie is, and what would motivate them to 'cheerlead' in this manner."**
- **Cong. Baker concludes, "I have been patient. I have said that I would move slowly on my bill, and indeed I have not yet held a single hearing on it. I have asked for professionalism from all concerned, and vowed myself not to fire unless fired upon. But my patience is wearing thin. Next week, it appears, the battle begins in earnest." (*Press statement by Cong. Richard Baker, 5/18/01*)**

Fannie & Freddie deny they leaked the draft CBO study

- **"Fannie Mae has not and did not leak any portion of the CBO study," said Fannie's Spokeswoman Janice Daue. "We responded to media inquiries from outlets who received the study from elsewhere." Freddie's Spokeswoman Sharon McHale said her company pledged not to release the report and responded to queries once it appeared clear the embargo had been violated. "Freddie Mac did not release the report," she said. (*Reuters, Mark Felsenthal, 5/18/01*)**

Federal Reserve Bank of Chicago discusses GSEs at its annual conference May 9-11

Federal Reserve Board Governor Laurence Meyer says it's "reasonable to be concerned" about the large size of Fannie & Freddie and whether the GSEs pose systemic risk to the economy. Meyer said rather than looking at systemic risk, he would look at "resource allocation that comes from the subsidy that is inherent in GSEs and how it is growing over time."

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Former Treasury Assistant Secretary, Richard Carnell, finds that federal sponsorship of Fannie & Freddie, with its perceived implicit backing, tends to impart a *greater* net subsidy than explicit federal deposit insurance

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Thomas Stanton, Johns Hopkins University, finds that Fannie & Freddie have become too big and too politically powerful for the government or Congress to adequately supervise. "We are sharing a canoe with a bear that is doubling in size every five years," he said.

Bert Ely, Ely and Company, contends that there are only two options for dealing with the housing GSEs: (1) contain them or limit their growth; or (2) fully privatize them. Ely notes, however, that a containment strategy is almost "unworkable" and that full privatization of the GSEs is the only solution.

- The Federal Reserve Bank of Chicago held its 37th Annual Conference on Bank Structure and Competition on May 9-11 in Chicago. The theme of the conference was the financial safety net given to financial institutions from the federal government: its role, benefits and costs. Numerous panelists discussed the GSEs at the conference.

Federal Reserve Board Governor Meyer's comments on the GSEs

- **Federal Reserve Board Governor Laurence Meyer was asked during the Question and Answer session of the conference on May 10 whether he was concerned about the increasing size of Fannie and Freddie's portfolio and whether the firms posed any risk to the overall economy if they were to fail. Meyer said it's "reasonable to be concerned" about the large size of Fannie and Freddie and whether the GSEs pose systemic risk to the economy. "Whenever large financial institutions become as large as that (Fannie and Freddie), it's reasonable that there ought to be a concern," he stated. "As I look at the issues that are really pressing today and to say what are we as public policy most worried about, I don't think right now my focus would be on the systemic risk part of the story, that I agree that's something that we have to consider." He said that rather than looking at systemic risk, he would look at "resource allocation that comes from the subsidy that is inherent in GSEs and how it is growing over time." Both systemic risk and subsidy issues should be part of the public policy debate, he noted. Meyer made no other comments about the GSEs and refused to comment on Congressman Richard Baker's GSE bill that would make the Federal Reserve**

Board the regulator of Fannie and Freddie. (*Dow Jones Newswires*, Jennifer Corbett Dooren, 5/10/01; *Reuters*, 5/10/01)

Federal Reserve Bank of Chicago President's comments on the GSEs

- **Chicago Federal Reserve President Michael Moskow listed federal oversight of the housing GSEs as among key issues facing the financial services industry. Key questions for banks, insurers and investors include how GSE oversight can best be managed, how big a subsidy the government provides Fannie and Freddie and other institutions that have federal support, and how much that government backing alters market behavior. “All of these issues will have a critical impact on the financial services industry,” he said.** (*Reuters*, 5/10/01)

Congressman Richard Baker's comments on the GSEs

- Congressman Baker said he plans to hold a May 23 hearing to discuss results of a final CBO study estimating the federal subsidies Fannie & Freddie receive from their GSE status (see earlier story in this *GSE Report*).

Richard Carnell, Fordham University School of Law, and former Treasury Assistant Secretary for Financial Institutions

- **Carnell recounted Fannie and Freddie's recent attempts to depict federally insured depository institutions as GSEs, and then outlined six structural reasons why—contrary to what one might expect—federal sponsorship of Fannie and Freddie, with its perceived implicit backing, currently tends to impart a *greater* net subsidy than explicit federal deposit insurance.**
 1. Unlike deposit insurance, the government's perceived implicit backing of GSEs has no dollar ceiling and applies to all of a GSE's liabilities.
 2. No credible, workable receivership mechanism exists for Fannie and Freddie—an omission reinforcing the privileged position of the two firms' creditors.
 3. Whereas the members of each federal deposit insurance fund indirectly cross-guarantee each other, and thereby reduce risk to the government, no similar cross-guarantees reduce the government's risk-exposure to Fannie and Freddie.
 4. To a much larger degree than depository institutions, Fannie and Freddie reap the benefits of special, company-specific laws and avoid the discipline of generic law.
 5. Fannie and Freddie enjoy significant protection against competition. Their government sponsorship reduces their borrowing costs and increases the value of their guarantees—to such an extent that fully private firms have difficulty competing with them. GSE charters are, moreover, available only by Act of Congress. By impeding competition, these constraints on entry increase the potential for Fannie and Freddie's government benefits to end up in the hands of their shareholders rather than their customers.
 6. The government does not require Fannie and Freddie to pay any explicit fee for their government sponsorship or to provide public benefits that impose significant costs on their shareholders. (*“Federal Deposit Insurance Versus Federal Sponsorship of Fannie Mae and Freddie Mac: The Structure of a Subsidy”*, Richard Scott Carnell, 5/11/01)

Wayne Passmore, Federal Reserve and Roger Sparks, Mills College

- **A paper by Passmore and Sparks found that, under some conditions, mortgage securitization (GSE and non-GSE) does not lower mortgage rates for consumers.** Passmore presented slides at the conference that compared Fannie and Freddie's return on equity with that of the largest thrifts, noting that the GSEs' return on equity has consistently remained above that of the top 50

thrift holding companies. **Comparing the GSEs' capital to assets with the top 50 thrift holding companies, Passmore also demonstrated that the GSEs hold far less capital relative to assets than the top 50 thrift holding companies.** In the long-run, Passmore and Sparks found that GSE growth prospects are uncertain due to: (1) consolidation among large mortgage originators; (2) the need to purchase and hold most of the increase in the stock of conventional mortgage debt; and (3) expansion into new business lines generates political opposition.

- **Passmore and Sparks' study found that the standard method of estimating the effects of GSEs on mortgage rates by comparing the spread between the jumbo and conforming mortgage rates has "serious conceptual difficulties."** The study found that the observed spread between jumbos and conforming loans could be generated by differences in borrower characteristics, by the GSE cost advantage, or by jumbo market fragmentation, or by all three. Their theory suggests an alternative and complementary approach to determining if the GSEs lower mortgage rates is to look at who holds the riskiest conforming mortgages. (The paper and conclusions are those of Passmore and Sparks and do not indicate concurrence by other members of the research staff, by the Board of Governors, or by the Federal Reserve Banks.) (*The Simple Microeconomics of Government-Sponsored Enterprises*, Wayne Passmore and Roger Sparks, 5/01)

Thomas Stanton, Johns Hopkins University

- **Stanton stated that Fannie and Freddie had become too big and too politically powerful for the government or Congress to adequately supervise. "We are sharing a canoe with a bear that is doubling in size every five years," he said. He said OFHEO (Fannie and Freddie's current safety and soundness regulator) cannot effectively regulate the GSEs because it doesn't have effective bank supervisory powers and it has a limited budget. The government and OFHEO are incapable of supervising the GSEs because: (1) the government subsidy allows GSEs to expand and increase their risk-taking without facing the market discipline that constrains other companies; (2) the GSEs have both the incentive and ability to influence or dominate the political process; and (3) the unusual legal structure of GSEs involves complexities that policymakers may not fully understand. His paper contends that "all of these factors make government supervision of the largest GSEs difficult, if not impossible, and also make it difficult for the government to devise an exit strategy."**
- **Stanton noted that the implicit government guarantee, coupled with a desire to grow, has resulted in Fannie and Freddie moving into higher-risk activities. Stanton said Fannie and Freddie's combined \$2.3 trillion in debt obligations and outstanding mortgage-backed securities puts taxpayers at risk if the GSEs were to fail because of the implied backing of the federal government. Further, the political dominance of Fannie and Freddie on Capitol Hill also keeps the federal government from becoming an effective regulator. "Given the continuing inability of the federal government to supervise the largest GSEs, an exit strategy becomes necessary," said Stanton. "The government will need to take advantage of windows of opportunity to push GSEs into giving up federal sponsorship."** (*Dow Jones Newswires*, Jennifer Corbett Dooren, 5/10/01; *Reuters*, Mark Felsenthal, 5/10/01; *"Government Sponsored Enterprises (GSEs): Why is Effective Government Supervision Hard to Achieve"*, Thomas Stanton, 5/10/01)

Bert Ely, President, Ely & Company, Inc.

- Ely contends Fannie, Freddie, and the FHLBanks were first created to meet a perceived market failure that in fact was caused by public policy failures and provide a secondary market for mortgages. In addition, the FHLBanks were created to funnel wholesale funding to retail lenders.

Ely notes that “the creation of each housing GSE effectively slapped a bandage over a public policy failure rather than providing a genuine solution to the underlying public policy cause of that problem. However, the evolution of the financial markets...has eliminated the need for these bandages, which is why the three housing GSEs will not deliver net benefits to the economy in future years and why it is appropriate to consider privatization of these GSEs.” The GSEs impose numerous costs on the economy, and particularly on the housing sector including: (1) distorting competition; (2) distorting capital allocation within the economy through subsidized interest rates (overhousing the upper middle class); and (3) providing an inefficient subsidy delivery vehicle (CBO’s 1996 report found that Fannie retained \$1 of subsidy for every \$2 they delivered).

- Ely also notes that Fannie and Freddie are crowding out technological innovation. Ely writes, “Fannie and Freddie increasingly dominate mortgage origination software as they steadily build software platforms that will encompass all aspects to a highly automated mortgage origination process. While this may seem quite appealing from an efficiency perspective, the dominance of this duopsony could stifle technological innovation within those elements of the mortgage marketplace the two GSEs dominate. In effect, their dominance raises significant barriers to entry into many aspects of the mortgage origination process.”
- Ely contends that there are only two options for dealing with the housing GSEs: (1) contain them or limit their growth; or (2) fully privatize the GSEs (stripping Fannie and Freddie of all of their GSE attributes and converting the FHLBanks into stockholder-owned corporations stripped of all GSE attributes). Ely notes, however, that a containment strategy is almost “unworkable” because Fannie and Freddie have no choice but to fight containment because slower growth would mean a reduced rate of earnings growth that would hurt their stock prices and executive compensation. Full privatization of the GSEs is the only solution. (“*GSEs as Instruments of Federal Policy: Public Benefits and Public Costs*,” Bert Ely, 5/11/01)

Fannie & Freddie’s safety and soundness regulator, OFHEO

- OFHEO Director Armando Falcon warned that Cong. Baker’s bill, which makes the Federal Reserve Board the regulator of Fannie and Freddie, could disrupt the government’s ability to regulate the GSEs’ financial soundness. “I am cautious about proposals that could disrupt safety and soundness regulation in an effort to address a separate set of mission-related issues,” he said. Falcon argues, “The heart of the issues currently surrounding the enterprises are mostly related to their activities and their charters, not their financial health,” he said. “The current regulatory system works,” he said. “OFHEO is, and will remain, a strong and effective regulator.” Concerns about the GSEs’ expansion into non-mission related activities, including home equity or mortgage insurance, should be addressed by HUD (Fannie and Freddie’s mission regulator), said Falcon.
- Falcon said OFHEO is doing its job and that the regulatory system works. He claims that Fannie and Freddie are currently safe and sound because they are operating under an effective regulator. “That is not just because they are well managed, but also because OFHEO is doing its job,” he said. (*Reuters*, Mark Felsenthal, 5/11/01; *National Mortgage News Daily*, 5/11/01; *Statement by OFHEO Director Armando Falcon at the Federal Reserve Bank of Chicago conference*, 5/11/01)

Robert Van Order, Freddie’s Chief Economist

- During the question and answer period on May 10, Freddie’s Chief Economist Robert Van Order defended the GSEs’ large portfolio holdings, claiming that holdings backed by single-family mortgages “aren’t very risky.” (*Dow Jones Newswires*, Jennifer Corbett Dooren, 5/10/01) Van

Order also defended the GSEs' government benefits at the conference, saying banks receive a subsidy in the form of federally backed deposit insurance. (*Reuters*, 5/10/01)

Tim Howard, Executive Vice President and Chief Financial Officer, Fannie Mae

- Howard acknowledged that the firm receives federal benefits, but disputed the notion of a subsidy. Howard said that what some people refer to as a federal subsidy of Fannie and Freddie, would more accurately be termed a "benefit." "Fannie Mae does not receive one penny of public funds," he stated. "To the contrary, last year our federal tax liability was \$1.6 billion," he added. Howard criticized the 1996 CBO study, saying Fannie earned its revenues by taking risks and by being efficient. "Free-market pricing and competition causes any benefits from our charters to be pushed through to the consumer," he said.
- Howard claimed that true subsidies are tangible and Fannie's government benefits are not. He claimed that if the government revoked the benefits it accords the GSEs, it would not recover any funds. In response to criticisms that Fannie's purchasing of whole mortgages and mortgage-backed securities for its portfolio is not mission-related, Howard notes that Fannie has been in the portfolio business since it was chartered in 1938 and that it did not issue its first MBS until 1981. Howard claims that many investors prefer investing in Fannie's bullet debt and callable debt to avoid the prepayment and cash flow uncertainty of Fannie's mortgage-backed securities. "Without Fannie Mae's and Freddie Mac's portfolio activities, only investors willing to hold MBS directly would be involved in the setting of mortgage yields, and as a consequence conforming mortgage rates would be considerably higher than they are now."
- Howard also stated that the while their government charters provide them with benefits, Fannie and Freddie are not the only entities that receive government advantages. For example, he said, banks benefit from federal deposit insurance, which Howard claims gives them a demonstrable advantage in funding the short-term adjustable rate mortgage and second mortgage assets that match their liability. Howard also noted that "so-called 'private' mortgage insurance is in fact mandated by Fannie Mae's and Freddie Mac's charters. Were it not for this federal benefit, the mortgage insurance industry would not exist in its present form." (*Dow Jones Newswire*, Jennifer Corbett Dooren, 5/11/01; *Reuters*, Mark Felsenthal, 5/11/01; "Fannie Mae's Benefits to Homebuyers: The Business Perspective," Timothy Howard, 5/11/01)

Alden Toevs, Manhattan Consulting Group

- Toevs claimed that the CBO's 1996 study findings that Fannie & Freddie receive \$6.5 billion in annual federal subsidies and passed on only \$4.4 billion to homeowners (the remaining \$2.1 billion going to Fannie & Freddie's shareholders and management) were overstated. He claimed that the funding benefits were overstated, the revenues of Fannie from its mortgage-backed securities business were overstated, and that the reduced borrowing rate found by the CBO applied to too few mortgages. Toevs argued that the GSEs' actions in the conforming markets also benefits the subprime and jumbo markets. Toevs argued that these benefits were not calculated into the CBO study. Instead, according to Toevs' calculations, the benefits of GSE sponsorship was \$1.9 billion in 1995 and \$2.9 billion in 1999. He calculated that Fannie passed through \$6.9 billion in benefits to borrowers in 1995 and \$9.8 billion in 1999. (*Reuters*, Mark Felsenthal, 5/10/01)
- A questioner at the conference noted that Fannie paid Manhattan Consulting Group to do the study and that the study was a proprietary study using Fannie's own internal numbers that cannot be replicated by anyone else because Fannie has refused to allow the data to be examined publicly. The questioner noted that Toevs' study measures the indirect benefits that the GSEs have in the

non-conforming market, yet does not measure the indirect costs to the economy as a whole or the cost to other companies from the GSEs' benefits. The questioner suggested that if these indirect benefits were taken into account, Toevs' calculation of GSE benefits to homeowners would be lower.

Ken Guenther, President and Chief Elective Officer, Independent Community Bankers of America

- Guenther noted that community banks currently have a positive relationship with the GSEs. However, any moves by the GSEs into originating mortgages or bypassing lenders and going straight to brokers could change this positive attitude. Guenther opposes proposals to make the Federal Reserve Board the regulator of Fannie and Freddie. He contends that regulation of the GSEs shouldn't rest with an agency that conducts financial monetary policy. In his opinion, the Fed will pay a high price should they regulate the GSEs. He also noted that FHLBank advances were important to community banks. (*Oral Remarks at Federal Reserve Bank of Chicago Conference, 5/10/01*) On the same panel, Thomas Stanton with Johns Hopkins University remarked to Guenther that the GSEs were "too-big-to-fail," a criticism that Guenther launched against large banks and that the GSEs were currently using technology to inconspicuously move into the primary market. Stanton said Guenther would find it difficult to draw a line between the primary and secondary market. (*Oral Remarks at Federal Reserve Bank of Chicago Conference, 5/10/01*)

Dusan Stojanovic, Mark Vaughan, Timothy Yeager (Federal Reserve Bank of St. Louis)

- Vaughan presented the findings from the Stojanovic/Vaughan/Yeager paper at the conference. Although all the authors are from the Federal Reserve Bank of St. Louis, the views expressed in the paper do not reflect official positions of the Federal Reserve Bank of St. Louis, the Board of Governors, or the Federal Reserve System. The authors found that the increasing reliance of commercial banks, particularly community banks, on FHLBank funding is a potential threat to safety and soundness because access to advances undermines market discipline, and the FDIC cannot raise premiums sufficiently to deter risk-taking. The study suggests that FHLBank members exhibit somewhat riskier profiles than nonmembers and that risk does increase dependence on advances. The differences, while statistically significant, do not appear to be economically large. ("*Do Federal Home Loan Bank Membership and Advances Lead to Bank Risk-Taking?*," Dusan Stojanovic, Mark Vaughan, Timothy Yeager, 4/30/01)

Senate Banking Committee's Housing Subcommittee holds May 8 oversight hearing to review the effectiveness of OFHEO as Fannie & Freddie's safety and soundness regulator

OFHEO Director Armando Falcon expects that the long-awaited risk-based capital proposal for Fannie & Freddie will be published sometime this summer after an "unacceptable" five-year delay

Housing Subcommittee Chairman Wayne Allard (R-CO) says the Subcommittee may periodically conduct more oversight hearings on the GSEs

Senate Banking Committee Chairman Phil Gramm (R-TX) says that the Bush Administration is "moving" toward a position on the GSEs

Senator Chuck Hagel (R-NE) says he is concerned about whether Fannie & Freddie have "an unfair advantage"

Free Congress Foundation praises Senator Allard for holding the hearing

- The Senate Banking Committee's Housing Subcommittee held a May 8 oversight hearing to review the effectiveness of OFHEO as Fannie and Freddie's safety and soundness regulator. The first panel was OFHEO Director Armando Falcon. The second panel was Fannie's Chairman Franklin Raines and Freddie's Chairman Leland Brendsel.
- Housing Subcommittee Chairman Wayne Allard (R-CO) chaired the hearing. No other Republicans attended the hearing. On the Democrat side, the following Members attended: Ranking Member Jack Reed (D-RI), Thomas Carper (D-DE), Debbie Stabenow (D-MI), and Jon Corzine (D-NJ).

In summary:

1. OFHEO Director Armando Falcon expects that the long-awaited risk-based capital proposal for Fannie and Freddie will be published sometime this summer after what he called an "unacceptable" five-year delay. OFHEO has submitted the rule to the OMB. Once it is cleared, the rule will be subject to a 30-day Congressional review and then published in the *Federal Register*. After publication, the GSEs will have one year to comply.
2. Falcon believes that Fannie and Freddie are currently in good financial health. OFHEO is not concerned about the GSEs' growing amount of debt.
3. After the hearing, a spokesman for Senator Allard said the Senator would follow up on the status of the risk-based capital proposal at the OMB and would call more hearings if necessary to assess the progress made in implementing OFHEO's risk-based capital proposal. (*BNA Daily Report for Executives*, Adam Wasch, 5/9/01) At the close of the hearing, Senator Allard said that the committee may periodically conduct more oversight hearings. Asked after the hearing whether he expects to move legislation tightening controls on Fannie and Freddie, Senator Allard replied, "I don't see a need." (*Bloomberg News*, 5/9/01) He also stated after the hearing, "I've got no interest in using these hearings as a basis for legislation." Senator Allard is concerned about the GSEs' use of derivatives to hedge risk, noting that derivatives could add risk. (*Reuters*, Mark Felsenthal, 5/8/01)

4. **Although Senator Gramm did not attend the hearing, he told reporters at the Capitol on May 8 that he has the GSE issue under active consideration but has not yet made any decision on how or whether to proceed. “I’ve talked to almost anybody in authority on that subject,” including White House staff. He said that the Bush Administration is “moving” toward a position on the GSEs. (Reuters, Mark Felsenthal, 5/8/01; CQ Daily Monitor, 5/9/01)**

5. Many of the Democratic Members were supportive of the GSEs and encouraged the GSEs to increase their presence in the subprime market in an effort to combat predatory lending. In Senator Stabenow’s opening statement, she encouraged the GSEs to increase their role in the subprime market and argued that aggressive GSE involvement in this market would play a role in combating predatory lending. She noted that it would be even contrary to the GSEs’ mission if they did not get involved. She concluded that now was not the time to radically change the regulation of the GSEs. Senator Sarbanes was pleased that the hearing was a general Congressional oversight hearing and did not focus on a bill. He did not think any new legislation was needed in this area – what was needed was proper oversight. He has been told that Fannie and Freddie are as closely examined as insured depository institutions.

6. **Although Senator Chuck Hagel (R-NE) did not attend the hearing, he told Reuters on May 8 that he is concerned about whether Fannie and Freddie have “an unfair advantage.” Senator Hagel who is a member of the Housing Subcommittee said he did not intend to introduce legislation of his own on the issue. (Reuters, Mark Felsenthal, 5/8/01)**

Panel I:

OFHEO Director Armando Falcon

OFHEO Director Armando Falcon

- Fannie and Freddie “are currently in good financial health, are well-managed, and have exceeded minimum capital requirements every quarter the requirements have been in place”
- OFHEO is meeting the mission that Congress gave them. Fannie and Freddie: (1) are subject to examinations; (2) must meet quarterly minimum capital requirements; (3) will soon be subject to a risk-based capital stress test; and (4) can be held accountable if found lacking in any of these areas.
- Recognized that OFHEO is long overdue on implementing a risk-based capital rule for Fannie and Freddie. OFHEO has submitted the rule to the OMB. Once it is cleared, the rule will be published in the *Federal Register* and the GSEs “will be subject to the most sophisticated regulatory capital standard of any financial institution in the world.”

Questions & Answers

Risk-Based Capital Proposal

- Senator Allard noted that the Director of OFHEO testified before his Committee in 1996 that the risk-based capital proposal for Fannie and Freddie would be completed at the end of 1996. Senator Allard asked Falcon why the risk-based capital proposal was so late.
- Falcon admitted that OFHEO has not met Congress’ timetable for implementing the risk-based capital proposal. He agreed with Senator Allard that it has been an “unacceptable” delay. He

noted that completing the risk-based capital proposal was not a task that could be completed within the 18 months allotted in the statute, but he agrees that the delay has been too long. The rule is currently under review at the OMB. After it is cleared, there will be a 60-day Congressional review period. He estimates that the rule will be published in the *Federal Register* this summer. By statute, OFHEO cannot enforce the rule until a year after its publication.

- Senator Reed questioned why the internal model approach under Basle (which allows companies to use their own internal stress test models) was not used when creating the risk-based capital standard for Fannie and Freddie. Falcon noted that under Basle, it would not be feasible to create one stress test for all the thousands of different types of financial institutions with such diverse portfolios, while OFHEO can create one stress test model for two similar institutions.
- Senator Reed noted that the statutory requirement under the risk-based capital proposal has a very high multiple reserve, yet the GSEs have low losses. He questioned whether this reserve was too high or too low. He also questioned whether the historic loss scenario contained in the statute was a valid approach. Falcon stated that the stress test is a very conservative test but thinks it's sufficient for the GSEs. Falcon said that as a whole, OFHEO has a strong conservative regulatory regime for the GSEs and thinks the statute was appropriate.

GSEs' growing debt issuance

- Senator Corzine questioned whether OFHEO was concerned about the growing debt on the balance sheets of Fannie and Freddie.
- Falcon said OFHEO is comfortable with Fannie and Freddie's ability to manage the risks associated with their rapidly growing debt obligations. "As of today, we are comfortable that they are prudently managing the risk associated with that growth." Falcon also noted that OFHEO is conducting a systemic risk study on GSE debt (should be completed by year-end), focusing on their ability to manage obligations in the face of external shocks that might come from the capital markets. (*National Mortgage News Daily*, 5/8/01)

GSEs' use of derivatives

- Senator Allard inquired as to the amount of derivatives held by the GSEs. Falcon did not have the figure, but promised to get the figure to the Subcommittee.
- Senator Allard questioned what risks are posed by the GSEs' use of derivatives. Falcon noted that the GSEs use derivatives to manage risk (hedging) and that they don't use derivatives for speculative purposes. He noted that derivatives are an important part of mitigating interest rate risk. Senator Allard said that was an important point because many institutions use derivatives to manage risk but once institutions get into the speculative area, it raises concerns with the Subcommittee.

Does OFHEO have adequate resources?

- Senator Allard asked Falcon whether OFHEO had the appropriate resources to regulate Fannie and Freddie. Falcon said OFHEO needs better and more consistent funding. He noted that the Administration's proposed FY 2002 budget increases OFHEO's budget by 22%. Falcon also argued that OFHEO should be removed from the annual appropriations process so that it can control its budget and more quickly increase resources when needed. [Although OFHEO's budget is subject to Congressional approval, OFHEO is not funded with taxpayer money. OFHEO assesses Fannie and Freddie, but unlike other financial regulators, is subject to the appropriations process. Other federal financial regulators simply collect their fees directly from the banks and thrifts they supervise. Speaking at a recent Fed conference, Cong. Baker noted that if Fannie and Freddie were regulated by the OCC, the assessment for regulatory purposes would be \$67 million. At the same time, OFHEO currently labors under a budget of \$21 million.]

- Senator Allard noted that there are proposals to make the Fed or the Treasury the regulator of Fannie and Freddie, and asked Falcon for his recommendations to strengthen OFHEO. Falcon noted that OFHEO submitted legislative recommendations to the House Banking Committee last year to enhance OFHEO's ability to do its job, such as removing OFHEO from the appropriations process, clarifying OFHEO's regulatory enforcement and other authorities, and providing OFHEO with independent litigation authority, similar to that enjoyed by all other federal financial regulators.

Panel II:
Fannie Chairman Franklin Raines
Freddie Chairman Leland Brendsel

Fannie Chairman Franklin Raines

- Fannie is the largest source of funding for the underserved.
- Fannie does not receive a penny of public funding.
- Fannie gives investors two options to invest in housing (either through investing in Fannie's MBS or its debt securities) to lower costs for consumers. Raines' written testimony noted that when Fannie guarantees the credit risk on its MBS, the potential market of investors for mortgages expands greatly. The vast majority of institutional investors do not purchase individual mortgage loans because they are unwilling to take the credit risk on such loans. Instead, they purchase MBS enabling them to avoid the credit risk but still receive compensation (in terms of higher yields) for taking prepayment risk if interest rates fall. When Fannie purchases mortgages for its investment portfolio, it is also greatly expanding the range of investors. Fannie funds those purchases with a mix of four types of debt: short-term debt, long-term bullet, callable and subordinated debt. These debt securities appeal to investors who are unwilling to accept the prepayment risks that comes with MBS, but want a yield higher than that on Treasuries.
- Fannie's debt securities draw investors to the US mortgage market who would not otherwise invest in mortgages. "Without Fannie Mae debt in the market...these investors would turn to other instruments. The result would be lower demand for less capital available to the US mortgage market and higher mortgage rates for US homeowners."
- Raines' written testimony noted that Fannie's ability to issue debt across the yield curve, combined with its expertise in matching the durations of its debt liabilities with those of its long-term fixed-rate mortgage assets, has allowed Fannie to build a specialization in managing the risk on long-term fixed-rate mortgages that consumers prefer. In contrast, banks and thrifts specialize in the short-term adjustable-rate and home equity loans that match the short-term federally insured deposits that make up half of their liabilities. "This reflects the advantage in short-term funding that depositories have over Fannie Mae and Freddie Mac by virtue of their access to low-cost deposits insured by the federal government and advances from their own government-sponsored enterprise, the Federal Home Loan Bank System."
- Fannie's six voluntary risk-management commitments provide investors and policymakers more information about Fannie's risk exposure than they can get from any other financial institution.
- Fannie specializes in 30-year fixed-rate mortgages with the option imbedded to refinance (95% of the single-family loans they finance fall under this category).
- The US has the best housing finance system in the world but we must do more. The homeownership rate in America stands at a record 67.5%, but the gap between whites and minorities is huge.

Freddie Chairman Leland Brendsel

- Freddie is among the strongest and best capitalized financial institution in the world.
- Freddie entered into six voluntary risk-management commitments last year, with Fannie following them. Under these commitments, the GSEs provide more information to the marketplace and investors than any company in the world.
- There is never a shortage of money to finance homes. When other markets face disruptions, there is no disruption in the markets they serve.
- Families enjoy the lowest rates. Freddie's activities lower mortgage interest rates on all conforming mortgage loans, not just the ones they purchase. He compared the rates for jumbos and the conforming markets.
- America's families choose from a broad array of mortgage products, including the 30-year fixed-rate mortgage with a low down payment. In other countries, this is not available.
- Freddie has been at the forefront of innovation in the market, including the development of its automated underwriting system, which allows the smallest lenders to compete.
- Freddie protects Americans from predatory loans. Predatory problems do not happen in their segment of their market. Freddie only purchases loans from reputable lenders.
- Freddie brings strength to the housing market and the economy. Freddie has helped the US reach its highest rate of homeownership.
- Freddie brings tremendous benefits to the nation. They far outweigh any benefits Freddie derives from its Congressional charter.

Questions & Answers

Does OFHEO have adequate resources?

- Senator Allard asked Raines and Brendsel to rate the effectiveness of OFHEO as a regulator and whether OFHEO had adequate resources.
- Raines said that OFHEO can stand up to any scrutiny or comparison with other financial regulators. He noted OFHEO has 13 examiners dedicated to Fannie alone (which has one type of business in one country), which he claimed is the same number of examiners banking regulators have dedicated to Citibank, which operates in 13 countries. The risk-based capital proposal has taken too long, which has not been a benefit to OFHEO or the GSEs. He wished it had taken less time.
- Brendsel said there are many things that OFHEO has done well. They have done an excellent job in their examination and review of the GSEs. The risk-based capital rule has been tardy and he hopes that it is finalized soon. He believes that OFHEO has enough resources to conduct their regulatory activity, particularly since they are regulating only two companies with one line of business.

Subprime lending

- Brendsel noted that the company was expanding into more parts of the subprime market. He noted that the company had no boundaries except the boundaries within its charter.
- Senator Sarbanes asked what the GSEs were doing to help alleviate the differential of the homeownership rates between whites and minorities. Raines stated that subprime lenders had done a good job penetrating the subprime market, but that this credit has come at a cost. Many consumers are wary of mainstream lenders so Fannie is working on a program with housing groups to raise their confidence with mainstream lenders. Brendsel said as part of their efforts, they would build more alliances with organizations that would help them penetrate the underserved and

subprime markets and bring in more qualified lenders to combat predatory lending. Senator Sarbanes said he hopes that the GSEs will help to provide more liquidity to reputable subprime lenders because all lenders are being tainted by the actions of a few.

Purchasing of MBS for their portfolios and use of derivatives

- Senator Allard noted that Fannie and Freddie have increased the direct purchasing of mortgages from lenders and purchasing of MBS for their portfolios and questioned the GSEs as to whether this was riskier than simply guaranteeing the loans.
- Brendsel said that purchasing loans was not riskier than their guarantee business. “That line of business is not riskier than the guarantee business.” (*Reuters*, Mark Felsenthal, 5/8/01) Freddie does not just take the risks on loans and simply put them on their balance sheet but uses intermediaries (such as mortgage insurance and callable debt) to restrict the risks to other investors. Both activities are ways to attract the broadest range of investors. Raines said that Fannie’s original business was buying mortgages and holding them while the practice of selling mortgages as mortgage-backed securities came later.
- In terms of derivatives, Raines said they use derivatives because the consumer demand for the 30-year fixed-rate mortgage product is greater than investors want to finance. Raines claimed that Fannie only purchases mortgages that investors don’t want. Therefore, he argued, Fannie must issue debt to fund their purchasing in order to meet the consumer demand for the 30-year mortgage. Investors are then given another option to invest in housing by investing in their debt (not just their MBS).

Risk-Sharing with HUD

- In response to a question by Senator Thomas Carper (R-DE), Raines stated that he would like to work with HUD to structure a risk-sharing program to eliminate the competition between GSEs and Ginnie Mae. He noted that Fannie and Ginnie Mae used to be part of the same organization until 1968. “I think from that time there has been this sort of silly competition that has gone on as opposed to working in a partnership,” he stated. Raines noted that he has met with HUD Secretary Mel Martinez regarding establishing a risk-sharing program with HUD. Raines said Fannie has the technology, risk management, and product development skills, while HUD brings enormous capital to take on risk that would make the program successful. “I think if we put our resources together, our private capital with the government’s capital, we can serve more people without shifting risk onto HUD that HUD is not in the position to undertake,” said Raines. (*National Mortgage News*, 5/14/01; *Real Estate Finance Today*, Chris De Reza, 5/14/01)

(Sources: *Oral and Written Testimony from Senate Banking Committee’s Housing Subcommittee hearing (unless otherwise indicated)*, 5/8/01)

Free Congress Foundation praises Senator Allard for holding the hearing

- **J. Bradley Jansen, Deputy Director of the Free Congress Foundation’s Center for Technology Policy, applauded Senator Allard for holding an oversight hearing on the GSEs. Jansen called attention to the Free Congress Foundation’s opposition to the GSEs’ exemption from the privacy provisions of the Gramm-Leach-Bliley Act. “Given the recent allegations of senior Fannie officials bullying private sector competitors coupled with the fiasco of inundating some Congressmen with boxes of petitions lobbying for special treatment in the name of constituents who knew nothing about their names being used, we must question the wisdom of a late night, smoke-filled room agreement to give the GSEs a privacy free pass,” said Jansen. As a Congressional staffer at the time, Jansen personally surveyed many of the petitions received, but found that none of the petitioners knew their names had been used.**

“If the GSEs are so cavalier about our personal data, why should we give them a free pass on privacy,” Jansen asks. Jansen also urged Senator Allard to question the GSEs on efforts to entice homeowners into refinancing and assuming more debt. (Free Congress Foundation press release, 5/7/01)

Shadow Financial Regulatory Committee (independent panel of financial services experts) praises Cong. Richard Baker (R-LA) for his “courage” in taking on the GSEs, but does not believe the Fed is the appropriate regulator for the GSEs

Shadow Committee recommends Treasury Department should be the GSE regulator

Cong. Richard Baker’s bill would abolish Fannie & Freddie’s current safety and soundness regulator (OFHEO) and make the Federal Reserve Board the regulator of Fannie & Freddie

The Committee noted that Cong. Baker’s bill does not provide enough guidance for regulators on what the activities of Fannie & Freddie should be

The Committee found that “contrary to the claims of the housing GSEs,” Fannie & Freddie’s new subordinated debt offerings “do not cultivate market discipline or constitute an effective increase in their capital”

Absent full privatization of the housing GSEs, the Committee supports “credible limits on the scope of the GSEs’ activities, the vesting of enhanced regulatory authority over them in the US Treasury, and the creation of a credible minimum subordinated debt requirement” to “substantially strengthen market and regulatory discipline and limit the risks posed to taxpayers.”

- During a press briefing and luncheon on May 7, the Shadow Financial Regulatory Committee said Congressman Richard Baker’s GSE bill (HR 1409) has “significant shortcomings.” While they praised Congressman Baker for his “courage” in taking on the mammoth GSEs, the Committee felt that the bill should be revised to effectively address concerns that the GSEs’ growth could easily get out of hand or the GSEs could become financially volatile, requiring a taxpayer bailout. **Absent privatization of the housing GSEs, the Committee supports “credible limits on the scope of the GSEs’ activities, the vesting of enhanced regulatory authority over them in the US Treasury, and the creation of a credible minimum subordinated debt requirement” to “substantially strengthen market and regulatory discipline and limit the risks posed to taxpayers.”**
- The Committee said it does not believe that the Federal Reserve Board is an appropriate regulator for Fannie and Freddie, as proposed in Cong. Baker’s bill. “As an agency that values its independence, the Fed may not take on the difficult political fights that will be necessary to restrain Fannie and Freddie’s growth,” said the Committee in a written statement. Peter Wallison, a resident fellow of the American Enterprise Institute and a member of the Shadow Committee said that because of the political interests associated with the GSEs, such as the real estate lobby and the homebuilders lobby, “it will be extremely difficult for the Fed to interfere in a process like that and still maintain the very good relationships it wants on the Hill.” The central bank, he said, is “always afraid there will be legislation or some effort to restrict the Fed’s independence.” [Cong. Baker’s bill would abolish OFHEO and make the Federal Reserve Board the regulator of Fannie & Freddie. The bill abolishes OFHEO one year after the bill’s enactment, but transfers all OFHEO

employees and property to the Fed. The Fed would be responsible for oversight of safety and soundness and charter review. HUD would maintain authority over Fannie and Freddie's affordable housing goals.]

- The Committee instead suggests that the Treasury Department regulate the GSEs, since it has “expertise in the regulation of financial institutions (through its involvement in the Office of the Comptroller of the Currency and the Office of the Thrift Supervision), but also bears the principal risk of financial difficulties at Fannie and Freddie.”
- The Committee also noted that the bill does not provide enough guidance for regulators on what the activities of Fannie and Freddie should be. The Committee noted that Fannie and Freddie's current charters are so general, they have been allowed to expand their activities well beyond the secondary mortgage markets. “This represents a derogation of the original intentions of Congress,” said the statement. “It does little good for Chairman Baker's bill to provide authority for a regulatory agency to approve new activities by Fannie and Freddie without defining what the scope of their activities should be. The Baker bill should amend these GSE charters to make clear that they must devote their attentions solely to the secondary mortgage markets.” **Wallison of the Shadow Committee argued that the GSEs extensive charters are currently too broad and too open to interpretation. Meaningful regulation of Fannie and Freddie, including steps to keep them from engaging in businesses outside their charters, is impossible unless the charters are simplified.**
- The Committee also criticized one of the provisions of the GSEs' voluntary risk management agreement that Fannie and Freddie struck with Cong. Baker last October. Under the provision, Fannie and Freddie agreed to issue subordinated debt to foster more market discipline and increase their effective capital. **The Committee found, however, that “contrary to the claims of the housing GSEs, the new subordinated debt offerings do not cultivate market discipline or constitute an effective increase in their capital.” Charles Calomiris, a Columbia University finance professor and member of the Shadow Committee, called Fannie and Freddie's current subordinated debt program “a farce.”** He said that the agreement requires the GSEs to issue too little debt, which creates a price distorting “liquidity premium” and that the agreement creates so many safety nets that subordinated debt holders are not really at a risk of a loss. **Calomiris noted that there is no evidence that Fannie and Freddie's current subordinated debt programs will actually be subject to loss, and thereby achieve the goal of providing market discipline. Calomiris noted that because Fannie and Freddie are not governed by regulatory restraints that normally apply to financial institutions, a 2 percent subordinated debt issuance, as the Committee has recommended for banks, would not provide the same degree of market discipline for the GSEs.** Calomiris said the GSEs have agreed to build up and maintain a subordinated debt layer of financing equal to roughly 2% of on-balance sheet assets, which he argues should be closer to 10%. The Committee's statement reads: “[T]o ensure that direct market discipline provides an effective deterrent to imprudent risk taking by the GSEs, the minimum ratio of subordinated debt should be set at 10 percent of total assets (defined as the sum of assets held and guaranteed).”
- **The Shadow Committee continues to advocate full privatization of the housing GSEs. As an interim measure, however, the Committee believes imposing a minimum subordinated debt requirement on the GSEs if properly designed, “could substantially discipline these entities and reduce the contingent liabilities borne by taxpayers because of the potential for a costly bailout of the housing GSEs.”** (*American Banker*, Rob Garver, 5/8/01; *BNA Daily Report for*

Executives, Richard Cowden, 5/8/01; *Dow Jones Newswire*, Elizabeth Price, 5/7/01; *Real Estate Finance Today*, Chris De Reza, 5/14/01)

Members of the Shadow Financial Regulatory Committee include:

George G. Kaufman, Loyola University of Chicago
Robert E. Litan, Brookings Institution
George G. Benston, Emory University
Charles W. Calomiris, AEI and Columbia University
Franklin R. Edwards, Columbia University
Scott E. Harrington, University of South Carolina
Richard J. Herring, University of Pennsylvania
Paul M. Horvitz, University of Houston
Roberta Romana, Yale Law School
Hal S. Scott, Harvard Law School
Kenneth E. Scott, Stanford University
Peter Wallison, AEI

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