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

HEARING

before the

FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY SUBCOMMITTEE

of the

COMMITTEE ON GOVERNMENTAL AFFAIRS
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OVERSIGHT OF GOVERNMENT-SPONSORED ENTERPRISES: THE RISKS AND BENEFITS OF GSEs TO CONSUMERS

MONDAY, JULY 21, 2003

U.S. Senate,
Subcommittee on Financial Management,
the Budget, and International Security,
of the Committee on Governmental Affairs,
Washington, DC.

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

Present: Senator Fitzgerald.

OPENING STATEMENT OF SENATOR FITZGERALD

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

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

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

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

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

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

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

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

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

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

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

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

Mr. Pollock will be followed by Peter J. Wallison, Senior Fellow of the American Enterprise Institute and Co-Director of AEI's program on financial market deregulation. Prior to joining AEI in 1999, Mr. Wallison served as General Counsel of the U.S. Treasury Department and Counsel to President Ronald Reagan and was a partner with Gibson, Dunn and Crutcher.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Of the three, there is no doubt that Fannie Mae and Freddie Mac dominate the secondary mortgage market. Last year, 2002, they represented more than 80 percent of the conforming loan volume. If you look at the outstanding loans of conforming size, that is to say, eliminating jumbos and FHA loans and sub-prime, Fannie and Freddie together have at least a 67 percent market share of all the outstanding single-family conventional loans, as defined. That is a big share measured in any way. And on top of that, they have sustained a remarkable, extremely profitable record over many years, with rates of return on common equity year after year in the 25 percent range.

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

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

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

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

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

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

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

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

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

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

Mr. Wallison, thank you. You may proceed.

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

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

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

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

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

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

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

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

In any event, as shown by a Census Bureau study presented at an AEI conference in October, the monthly cost of owning a home is not the obstacle that prevents renters from buying homes. The obstacle is the down payment. Most renters do not have the down payment necessary to buy a home. Accordingly, the claim by Fannie and Freddie that they put people in homes by reducing interest rates is not true.

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

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

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

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

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

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

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

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

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

That concludes my testimony. Thank you.

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

TESTIMONY OF BERT ELY,\1\ ELY AND COMPANY, INC.

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

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

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

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

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

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

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

One reason we don't know what we don't know about Fannie and Freddie stems from their inadequate financial disclosures, specifically the risk associated with their interest rate derivatives. There is also a troubling lack of comparability in the disclosures of the two companies.

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

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

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

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

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

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

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

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

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

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

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

Giving OFHEO more money and power will not suffice. Repealing the GSE State income tax exemption is highly meritorious, but extremely difficult to accomplish politically. Repealing the GSE's Treasury line of credit would have symbolic value, but would be difficult to achieve.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Senator Fitzgerald. Thank you. Mr. House.

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

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

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

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

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

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

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

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

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

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

Therefore, FM Policy Focus recommends that Congress replace the existing ineffective regulatory regime with a strong single regulator in the Treasury with authority over safety and soundness and mission. This structure should have all the attributes cited by Chairman Greenspan in his testimony before the Senate Banking Committee just last week namely, expertise, regulatory authority, and power strong enough to keep the GSEs safe and sound.

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

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

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

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

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

TESTIMONY OF JAMES C. MILLER III,\1\ SENIOR FELLOW, HOOVER

INSTITUTION

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

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

Senator Fitzgerald. Without objection.

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

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

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

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

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

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

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

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

Well, what we did was hypothesize the thrift industry as being a single firm, as if it were a single firm, would it, in fact, meet this OFHEO risk-based capital standard?--and we applied it and guess what? In the case of the upward interest rate scenario, it failed after 7\1/2\ years. The industry failed the test. And, in fact, it would have needed $32 billion more in capital at the beginning of the period in order to survive the 10-year test period. It did pass the interest rate reduction scenario, but since it failed one part of the test, it failed it in total.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Senator Fitzgerald. Without objection.

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

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

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

Senator Fitzgerald. Without objection.

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

Based on my research and that of multiple colleagues, Fannie Mae and Freddie Mac have contributed to the expansion of home ownership in America, providing affordable residential mortgages for households who otherwise would not have had the opportunity to become homeowners. Freddie Mac and Fannie Mae's efforts have helped to advance gains in overall home ownership rates, as well as in home ownership rates among minority and low-income households occurring over the past decade. This has been a phenomenal decade for home ownership which I do not believe would have been as strong without the role of the GSEs, a decade resulting in a record high home ownership rate of 68 percent in 2003.

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

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

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

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

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

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

Thank you, Mr. Chairman.

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

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

[Recess.]

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

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

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

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

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

But is that correct?

Mr. Pollock. That is correct.

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

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

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

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

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

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

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

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

Senator Fitzgerald. And from a lot of banks?

Mr. Harvey. From banks, as well.

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

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

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

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

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

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

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

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

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

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

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

Senator Fitzgerald. To the Farm Credit System?

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

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

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

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

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

Senator Fitzgerald. OK.

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

Senator Fitzgerald. Yes?

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

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

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

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

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

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

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

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

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

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

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

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

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

Senator Fitzgerald. Yes.

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

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

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

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

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

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

Senator Fitzgerald. For guaranteeing it?

Mr. Pollock. For guaranteeing it.

Senator Fitzgerald. You pay----

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

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

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

Mr. Pollock. We are, yes, sir.

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

Mr. Pollock. The Mortgage Partnership Finance Program is approximately $70 billion, a little----

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

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

Senator Fitzgerald. OK, and growing very rapidly.

Mr. Pollock. Yes.

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

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

Senator Fitzgerald. OK.

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

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

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

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

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

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

Mr. Pollock. In the 20s.

Senator Fitzgerald. So it has----

Mr. Pollock. It started off being 25----

Senator Fitzgerald. It has been coming down.

Mr. Pollock. Yes.

Senator Fitzgerald. OK.

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

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

Mr. Pollock. Even in this market.

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

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

Senator Fitzgerald. OK.

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

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

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

Senator Fitzgerald. Yes.

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

Senator Fitzgerald. Right.

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

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

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

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

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

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

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

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

Senator Fitzgerald. Mr. Miller.

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

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

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

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

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

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

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

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

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

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

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

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

Senator Fitzgerald. OK.

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

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

Senator Fitzgerald. Is that test----

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

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

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

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

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

Mr. Ely. That is correct.

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

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

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

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

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

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

Senator Fitzgerald. Yes.

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

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

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

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

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

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

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

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

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

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

Ms. Wachter. Absolutely.

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

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

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

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

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

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

Mr. Miller. Right. Right.

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

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

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

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

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

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

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

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

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

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

Senator Fitzgerald. Mr. House.

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

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

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

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

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

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

Senator Fitzgerald. So you are opposed to that.

Mr. House. In fact, I feel very----

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

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

So we are fine.

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

Senator Fitzgerald. Mr. Wallison.

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

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

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

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

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

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

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

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

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

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

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

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

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

Ms. Wachter. Yes.

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

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

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

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

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

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

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

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

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

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

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

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

Senator Fitzgerald. Yes, Mr. Pollock?

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

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

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

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

But that is a ``second-best'' argument.

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

Mr. Wallison. Actually, Mr. Chairman, if I can respond to that----

Senator Fitzgerald. OK.

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

Senator Fitzgerald. The margins of Fannie and Freddie, then, would get thinner and thinner----

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

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

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

Senator Fitzgerald. Yes.

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

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

Mr. Miller. I am not sure in which order to take these things. One reason----

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

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

Senator Fitzgerald. OK. [Laughter.]

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

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

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

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

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

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

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

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

Mr. House. But Mr. Chairman----

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

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

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

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

Senator Fitzgerald. Mr. Ely.

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

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

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

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

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

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

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

Alex and I have talked about this at length.

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

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

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

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

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

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

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

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

Senator Fitzgerald. Any final----

Mr. Miller. Could I just make a correction?

Senator Fitzgerald. Yes.

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

Senator Fitzgerald. Mr. Pollock.

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

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

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

I think as a general----

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

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

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

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

Senator Fitzgerald. OK.

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

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

Senator Fitzgerald. Thank you.

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

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

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

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

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

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

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

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

Senator Fitzgerald. Thank you. Dr. Wachter.

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

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

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

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

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

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

A P P E N D I X

[GRAPHICS NOT AVAILABLE IN TIFF FORMAT]

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