CBO TESTIMONY

Statement of
Douglas Holtz-Eakin
Director

Aligning the Costs and Benefits of the Housing Government-Sponsored Enterprises

before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

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CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
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Chairman Shelby, Senator Sarbanes, and Members of the Committee, I am pleased to have this opportunity to discuss proposed policies to improve the balance of federal costs and benefits from the operations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. I will emphasize the following points in my statement:

- The provisions of law that investors interpret as a federal guarantee of the obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are no longer necessary to support a well-functioning housing market. Therefore, those entities could gradually be relieved of the responsibilities and benefits of their current status as government-sponsored enterprises (GSEs) and required to operate as fully private organizations—which would reduce their risks and costs to the federal government.

- The Congressional Budget Office (CBO) estimates that those housing GSEs received about $23 billion of federal subsidies in 2003, of which $13.6 billion was passed through to borrowers as reduced rates in the mortgage markets. Inasmuch as Fannie Mae and Freddie Mac lag behind the market in serving low-income borrowers, a disproportionately small share of those benefits went to those borrowers.

- The large mortgage portfolios held by Fannie Mae and Freddie Mac are not necessary for the secondary mortgage market to operate efficiently; those enterprises' issuance of mortgage-backed securities (MBSs) can accomplish that outcome. In fact, their holdings in portfolios are the source of much of their risks and federal subsidies and most of their accounting difficulties. If the housing GSEs' investment portfolios were reduced through statute, regulation, or the adoption of investment portfolio fees, federal subsidies would lessen, with little change in benefits.

- Restricting the size of the GSEs' portfolios is a direct means of attempting to reduce systemic risk, which is the potential for an event at one institution to trigger turmoil in the market that can spread through the financial system and ultimately adversely affect the performance of the U.S. economy.

- To the extent that the entities retain their GSE status, giving regulators the ability to adjust capital standards so that they are appropriate for the exposure to interest rate, credit, and operations risks is critical to limiting federal costs from the GSEs' operations.

- Advancing home ownership beyond the level that results from rising income and competitive market forces will require the government to target its current subsidies more effectively.

Introduction

From a policy perspective, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks have two shortcomings that are largely the result of their statutory design. First, those GSEs, whose obligations are perceived by investors to be federally guaranteed, present risks and costs to taxpayers. Second, the housing GSEs are an inefficient way to achieve the government's goals for home ownership.

The principal benefit conferred on a privately owned financial intermediary by GSE status is a reduced cost of funds compared with that for other financial firms of similar credit quality. That advantage accrues to the GSE as a result of provisions in law that investors interpret as a federal guarantee of GSEs' debt obligations. CBO has estimated that, in 2003, the implied guarantee and related benefits conveyed an annual subsidy to the housing GSEs in excess of $23 billion. For 1995 to 2000, CBO also estimated that the GSEs reduced interest rates on the mortgages that they financed by 20 to 25 basis points (100 basis points is 1 percentage point). More recent estimates by Federal Reserve Board staff suggest that the savings could now be lower. By comparison, the Federal Reserve Bank of Minneapolis has estimated that reductions of 200 basis points would be required to raise home ownership rates by just 0.5 percent.

To their credit, the enterprises have achieved their original objectives of promoting the development of a secondary mortgage market (Fannie Mae and Freddie Mac) and of ensuring housing finance lenders' reliable access to capital markets (Federal Home Loan Banks). In more recent years, the Congress and various administrations have attempted to shift the focus of the GSEs to increasing home ownership by low-income families.

For Fannie Mae and Freddie Mac, that effort has largely consisted of the establishment of so-called affordable-housing goals. Yet Fannie Mae and Freddie Mac continue to finance a smaller proportion of mortgages for low- and moderate-income families than are served by the market as a whole. They also lag behind the market in serving first-time home buyers, especially minority first-time home buyers, according to the Department of Housing and Urban Development (HUD). Indeed, HUD's latest affordable-housing goals direct the enterprises to match the performance of the market in serving low- and moderate-income families by 2008.

The Federal Home Loan Banks contribute to the housing goals more directly by paying the larger of $100 million or 10 percent of net earnings annually, as required by law, to an Affordable Housing Program. The program, which the banks administer, provides subsidized loans—some at no interest—to promote housing assistance to low-income families and individuals. In recent years, the

Federal Home Loan Banks' annual contributions to that program have been about $200 million.

In general, the structure, activities, and governance of the housing GSEs are not well-suited to the objective of increasing home ownership rates. Fannie Mae and Freddie Mac are for-profit entities that operate in the secondary, or resale, market for home mortgages. Their operations affect the overall supply of mortgage financing and, thus, the prices of and interest rates on conforming mortgages (which have an original principal of no more than a ceiling that currently is $359,650 for a single-family property). Similarly, the Federal Home Loan Banks are primarily wholesale lenders to their member institutions. All act to increase the flow of funds to retail lenders.

Effectively advancing the policy goal of increasing home ownership beyond the rates that would emerge from rising family income and competitive financial market forces will require more targeted use of current subsidies, such as increased assistance for down payments by low-income and first-time borrowers. The Affordable Housing Program of the Federal Home Loan Banks could be a useful model for a more targeted approach. But if the housing GSEs are to be significant low-cost contributors to the goal of increasing home ownership, the Congress will need to fundamentally modify existing policies toward the GSEs.

A number of policy alternatives, short of privatization, are available to improve the balance of public costs and benefits of the housing GSEs and to progress toward current policy goals for Fannie Mae and Freddie Mac. Those alternatives include measures to reduce the housing GSEs' risks and to focus the energies of GSE management more effectively on increasing low-income families' opportunities to own a home.

Improving Control of the Housing GSEs' Risks

Fannie Mae and Freddie Mac engage in two lines of business: portfolio investments and mortgage-backed securities. In the first, those GSEs buy and hold mortgages (and mortgage-backed securities and other fixed-income securities), which they finance by issuing their own debt in the capital markets. They thus expect to earn interest on the investments in excess of the rate paid on debt. In the second, the GSEs pool individual mortgages and then sell to investors guaranteed claims (MBSs) to the contractual cash flows from those mortgages. For that service, the enterprises charge fees that they expect to cover the cost of defaults on mortgages and earn a return on investment. Both lines of business have grown significantly. Outstanding MBSs grew from about $600 billion in 1990 to $2.3 trillion in 2004, while total debt (including obligations of the Federal Home Loan Banks) leaped from less than $300 billion to $2.5 trillion over

Table 1.

The Housing GSEs' Outstanding Mortgage-Backed Securities and Debt, Year-End 1985-2004

(Billions of dollars)

	Fannie Mae		Freddie Mac		FHLBs'	Total	Total
	MBSs[a]	Debt	MBSs[a]	Debt	Debt	MBSs[a]	Debt
1985	55	94	100	13	74	155	181
1986	96	94	169	15	90	265	199
1987	136	97	213	20	116	349	233
1988	170	105	226	27	137	396	269
1989	217	116	273	26	137	490	279
1990	288	123	316	31	118	604	272
1991	355	134	359	30	108	714	272
1992	424	166	408	30	115	832	311
1993	471	201	439	50	139	910	390
1994	486	257	461	93	200	947	550
1995	513	299	459	120	231	972	650
1996	548	331	473	157	251	1,021	739
1997	579	370	476	173	304	1,055	847
1998	637	460	478	287	377	1,115	1,124
1999	679	548	538	361	525	1,217	1,434
2000	707	643	576	427	592	1,283	1,662
2001	859	763	653	578	621	1,512	1,962
2002	1,029	851	749	666	674	1,778	2,191
2003	1,300	962	773	740	741	2,073	2,443
2004	1,403	945	852	732	816[b]	2,255	2,493

Source: Congressional Budget Office based on data from the Department of Housing and Urban Development's Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board. The 2004 numbers are based on data from Fannie Mae and Freddie Mac.

Note: FHLBs = Federal Home Loan Banks.

a. MBSs = mortgage-backed securities; excludes holdings of the enterprise's own MBSs held in its portfolio.

b. As of June 30, 2004, data from the Federal Home Loan Banks' Office of Finance.

the same period (see Table 1). Such explosive growth exposes Fannie Mae and Freddie Mac to risks of losses, which are generally of three types: interest rate risk, credit risk, and operations risk.

The Federal Home Loan Banks are primarily in the business of borrowing in the capital markets and lending to member institutions, including banks, thrifts, credit unions, and insurance companies. The risks inherent in that activity may be somewhat less than those assumed by Fannie Mae and Freddie Mac, partly because loans to members, called advances, are highly collateralized—such that no home loan bank has ever experienced a credit loss on an advance. In recent years, some of the banks have also begun to acquire mortgage investment portfolios from members; aggregate holdings of such mortgage-related instruments are now in excess of $100 billion. As discussed below, the credit risk on the mortgages is retained by the members, but the interest rate risk is assumed by the banks, some of whom have experienced difficulties in managing it.

Interest Rate Risk

Interest rate risk is the potential for losses by a holder of mortgages, mortgage-backed securities, and other credit instruments from changes in market interest rates. For Fannie Mae and Freddie Mac, that risk arises primarily in connection with portfolio investments in mortgages and MBSs, which the enterprises finance with issues of debt securities whose maturities differ from those of the portfolio assets. For example, if the GSEs issue debt securities with a maturity of one year to finance fixed-rate 15- or 30-year mortgage investments, the GSEs face a risk from a rise in market interest rates. That is, when rates move up, the GSEs face higher borrowing costs when they roll over their maturing short-term debt, but the return on their mortgage portfolio will be fixed until the mortgages are paid off. That risk is enhanced by the tendency, observed in an environment of rising interest rates, for the effective maturity of mortgages to increase as borrowers extend the life of their loans that have below-market interest rates. Similarly, when rates fall, more borrowers prepay their mortgages and leave the GSEs with high-cost debt outstanding. In 2004, Fannie Mae's and Freddie Mac's investments, or retained mortgage portfolios, were about 40 percent of their outstanding debt and MBSs (see Table 2).

Fannie Mae and Freddie Mac offset much of the interest rate risk in their investment portfolios by issuing callable long-term debt (which matches the cash flows on mortgage debt), conducting interest rate swaps (which can effectively match maturities on assets and debts), and pursuing other hedges. But they do not shift all of that risk to others; doing so would be costly and less profitable. Importantly, those GSEs determine the amount of interest rate risk that they will retain. The Federal Home Loan Banks are also exposed to some interest rate risk, through both their advances and their mortgage portfolio holdings.

Credit Risk

Credit risk is the exposure to losses from the failure of borrowers to meet their obligations to pay as specified in the mortgage or other credit contract. In fact, default losses as a percentage of mortgages held or securitized by Fannie Mae and Freddie Mac have been quite modest in recent years, on the order of one to five basis points per year. The low loss rates have resulted largely from the

Table 2.

The Housing GSEs' Mortgage Portfolios Expressed as a Share of Their Outstanding Debt and Mortgage-Backed Securities, Year-End 1990 and 2004

	Fannie Mae's Retained Mortgage Portfolio as a Share of Debt and MBSs[a]	Freddie Mac's Retained Mortgage Portfolio as a Share of Debt and MBSs[a]	Federal Home Loan Banks' Net Mortgage Loans as a Share of Debt[b]	GSEs' Total Assets (Billions of dollars)
1990	27.7	6.2	n.a.	339.4
1991	25.9	6.9	n.a.	348.6
1992	26.5	7.7	n.a.	402.6
1993	28.3	11.4	n.a.	479.8
1994	29.7	13.2	n.a.	617.8
1995	31.1	18.6	n.a.	726.5
1996	32.6	21.9	n.a.	816.9
1997	33.4	25.4	0	939.9
1998	37.9	33.4	0.3	1,240.5
1999	42.6	35.9	0.4	1,345.2
2000	45.0	38.4	2.7	1,788.2
2001	43.5	41.1	4.4	2,138.1
2002	42.4	41.9	9.0	2,403.3
2003	39.9	42.5	15.3	2,635.8
2004	38.5	42.0	14.2[c]	2,709.5[d]

Source: Congressional Budget Office based on data from the Department of Housing and Urban Development's Office of Federal Housing Enterprise Oversight, the Federal Home Loan Banks' Office of Finance, Fannie Mae, and Freddie Mac.

Note: n.a. = not applicable.

a. MBSs = mortgage-backed securities (excludes an enterprise's own MBSs held in its portfolio).

b. The Federal Home Loan Banks started their mortgage loan programs in 1997 with $37 million in loans.

c. As of June 30, 2004.

d. Fannie Mae has not yet reported its year-end assets; as of June 30, 2004, the enterprise held $989.3 billion in assets. That figure, however, may be revised once Fannie Mae completes its accounting restatement.

general upward trend in house prices and the statutory requirements for Fannie Mae and Freddie Mac to deal in prime credit quality mortgages that have loan-to-value ratios of no more than 80 percent or that include private mortgage insurance for the amount over 80 percent.

Nonetheless, both enterprises are at risk of losses when the market price of the collateral (the mortgaged house) declines below the unpaid loan balance and accrued interest. So if a loan goes into default and cannot be restored to current status, the mortgage holder can foreclose on the collateral and sell the house; if the proceeds of the sale fail to cover the amount owed, the mortgage holder or guarantor loses the difference. That risk can exist for every loan that the enterprises hold or securitize with a credit guarantee and can cause losses for them, even as the overall national or regional average price of houses rises. Although Fannie Mae and Freddie Mac have adopted a variety of measures to minimize losses from credit defaults, they retain a substantial amount of credit risk, which they do not attempt to hedge. At the home loan banks, credit risk is reduced by the level of collateral required on advances and by the fact that the members retain the credit risk on the mortgages sold to the banks.

Operations Risk

Operations risk refers to a firm's exposure to failures of internal systems and controls, such as the severe accounting weakness and failures uncovered at the housing GSEs. The pervasive and broad nature of operations risk means that it can affect almost any aspect of the firm. It includes fraud, theft, mismanagement, and failures of information systems. It is generally addressed by devoting internal and external examiners, including auditors and regulators, to oversee and investigate the integrity of existing safeguards.

Policy Alternatives

In general, alternatives available to the Congress to improve the cost-benefit performance of the GSEs include policies to restrict the size of their investment portfolios, to require more disclosure, to require the registration of securities, to increase capital requirements, to allow regulators to promptly take over a troubled GSE in order to stop future losses as its capital is exhausted, and to target GSEs' resources more narrowly on the task of achieving federal housing goals.

Restricting the Size of the Investment Portfolios

Policies to restrict the size of the investment portfolios held by Fannie Mae and Freddie Mac, either by statute or regulation, are supported by findings that the portfolios are:

- Far larger than needed to support the mission of ensuring a liquid secondary market for conforming mortgages or to promote affordable-housing goals, and

- A major source of interest rate, operations, and systemic risks.

As large issuers of debt securities that are traded as government "agency" securities and as holders of risky investment portfolios, Fannie Mae and Freddie Mac constitute an unquantifiable and unique source of risk to the stability of the financial system and the economy—or "systemic" risk.

The law allows federally insured banks and thrifts to invest in those GSEs' debt securities in unlimited quantities. According to estimates by the Office of Federal Housing Enterprise Oversight (OFHEO), the safety and soundness regulator of Fannie Mae and Freddie Mac, at year-end 2001, over 30 percent of commercial banks with over $1 billion in assets were holding Fannie Mae or Freddie Mac debt equal to more than 10 percent of their capital. In fact, more than 10 percent of such banks were holding Fannie Mae debt in excess of 50 percent of their capital. And smaller banks' holdings of GSEs' debt securities represent a significantly larger share of their capital. Thus, an event that created doubt about Fannie Mae's or Freddie Mac's ability to service debt could have a cascading effect on the institutions holding their securities, the U.S. credit system, and the economy.

Fannie Mae and Freddie Mac differ from large commercial banks in several respects that tend to magnify their potential as sources of systemic risk. Each issues far more in marketable debt securities than several of the largest U.S. banks combined. Further, because the GSEs' debt is perceived as guaranteed by the government, there is no effective market discipline for its issuance, as there is for others' debt. And regulated financial institutions can invest no more than 10 percent of their capital in the debt issued by a single bank.

Holders of GSE-guaranteed MBSs are not as tightly linked to the financial condition of the GSEs as debt holders are. Holders of the MBSs have claims to the underlying mortgage collateral that backs the securities as well as the guarantee of the GSEs.

Reducing the size of the GSEs' portfolios would reduce federal risks and costs probably without reducing market liquidity, which is not enhanced by the GSEs' large portfolios. Portfolio purchases are no more effective than purchases for securitization in reducing mortgage interest rates. Moreover, GSEs' purchases during periods of financial stress appear to have been in response to more profitable opportunities (such as wider interest rate spreads), but in doing so, the GSEs are displacing other investors who would have responded to those opportunities.

Although Fannie Mae's and Freddie Mac's investment portfolios currently provide a significant avenue for taking risks and earning profits, they are not the only means available. For example, if their investment portfolios were restricted, the GSEs could lower their underwriting standards and take on more credit risk—thus replacing both the risks and the opportunities for profits that existed before with new ones. The multiplicity of opportunities for increased risks and rewards means that restricting the risks to which enterprises expose the government will require vigilant oversight and supervision by the GSE regulator.

Another option would levy an earmarked fee on portfolio investments in order to generate income for low-income housing and provide an incentive for the housing GSEs to rely less on their retained portfolios. For example, imposing a fee of 10 basis points on the GSEs' average daily investment portfolios would raise $8.8 billion over five years. Proceeds from the fee would equal less than 20 percent of the portion of the federal subsidy not passed through in the form of reduced mortgage rates—that is, the portion retained by equity investors and other stakeholders of the housing GSEs.

Adopting Other Loss-Reduction Measures: More Disclosure, Registration, Increased Capital Requirements, and Prompt Closure

If Fannie Mae, Freddie Mac, and the Federal Home Loan Banks retain their status as GSEs—and the federal government retains the attendant exposure to risks—the Congress may wish to give the GSE regulator additional means to protect taxpayers.

Disclosure. At the most basic level, regulators must have sufficient information about the operations of the regulated entity to be able to assess the risks to the government. The Congress or OFHEO might require Fannie Mae to provide quarterly reports in the form of fair-value accounts. (Freddie Mac already does so.) Such accounts are useful to analysts because almost all balance-sheet entries are reported as either market valuations or, in their absence, fair values (estimates of the prices that the enterprises believe could be received in market transactions); that approach could provide a more current picture of the firms' economic position than do measures under generally accepted accounting principles, which mix historical cost and market valuations. Such disclosures made quarterly, instead of annually (as is the case now), could also prove valuable to regulators because Fannie Mae's fair-value measures of capital often are less than the values that OFHEO uses.

Registration. Some Members of Congress have proposed requiring the GSEs to register all of their securities with the Securities and Exchange Commission (SEC). OFHEO's recent disclosure that Fannie Mae had been cherry picking its mortgage portfolio—identifying and retaining the high-quality loans for its portfolio while selling the lower-quality ones without disclosing the reduced quality of those offered for sale—suggests that investors in MBSs could benefit from additional disclosures that might accompany SEC registration. Under one option, assessing SEC registration fees could also raise more than $1.2 billion over five years. Such a requirement would be unlikely to have a significant adverse effect on the GSEs or on the mortgage markets. If the fees were fully passed on to borrowers, the closing costs on a $300,000 mortgage in 2006 would increase by about $55.

Capital Requirements. Currently, OFHEO has little authority to set or modify capital requirements. Yet to the extent that the GSEs retain the government's implicit guarantee, capital will be the government's primary line of defense against losses by the enterprises. That is, if losses occur, the enterprises' ability to cover them and sustain operations without federal assistance depends on the cushion of capital between their liabilities and assets. To protect the public from losses, financial regulators must have statutory flexibility to set and adjust minimum and risk-based capital standards.

Provisions for Receivership. A financial enterprise with a credible federal guarantee of its debts could continue to borrow and operate indefinitely even if it was insolvent. In those circumstances, management would have strong incentives to assume a riskier financial position in hopes of earning back the accumulated losses. Indeed, management would have no reason to limit risks because excess gains would accrue to the firm, while the losses would be left to the government guarantor. To avoid that type of moral hazard and the risk to which it exposes government, the regulator needs the authority to promptly place the enterprise into receivership, where the firm could be sold or taken over in an orderly manner that limited the cost to the government.

Targeting Subsidies

Under current policy, there is only a loose connection between the benefits provided by the housing GSEs and federal housing goals. That is, Fannie Mae and Freddie Mac provide benefits to borrowers in proportion to the size of their mortgage, subject to the cap on conforming mortgages. Thus, any subsidy that is passed through by Fannie Mae and Freddie Mac goes to home buyers in general, where it increases the demand for housing attributes such as structure and lot size, number of rooms, and other amenities. The subsidy also has some small positive effect in promoting first-time purchases by low-income families. The Federal Home Loan Banks' lending supports all activities of member banks, not just mortgages. Indeed, the general use of the federal subsidy by the banks may have offered justification for the Congress to create the Affordable Housing Program.

Numerous other options exist for targeting the current subsidies to increase home ownership by low-income families. One approach would be to increase direct assistance for down payments—which are often barriers to purchases—to low-income first-time home buyers. For example, in 2003, replacing the interest rate subsidy that the GSEs passed through to borrowers with down payment assistance could have provided 1 million targeted households with $13,600 each. According to the results of underwriting simulations reported by the Minneapolis Federal Reserve Bank, such assistance would dramatically increase the home ownership prospects of those renters. Another approach would be to restrict portfolio holdings to U.S. Treasury securities and mortgages for low-income buyers. Yet another would be for the government to pay interest supplements to holders (including, but not limited to, Fannie Mae and Freddie Mac) of mortgages provided to low-income first-time home buyers. Finally, the Congress could legislate a phased reduction in the conforming loan ceiling to focus Fannie Mae's and Freddie Mac's efforts more directly on the objective of increasing home ownership rates.

Related CBO Publications

Letter to the Honorable Richard C. Shelby regarding updated estimates of the subsidies to the housing GSEs, April 8, 2004

Testimony of Douglas Holtz-Eakin on Regulation of the Housing Government-Sponsored Enterprises, October 23, 2003 (Before the Committee on Banking, Housing, and Urban Affairs, United States Senate)

Effects of Repealing Fannie Mae's and Freddie Mac's SEC Exemptions, May 2003

Letter to the Honorable Paul S. Sarbanes regarding the new-business assumption in the risk-based capital rule for Fannie Mae and Freddie Mac, January 2003

Letter to the Honorable Richard H. Baker regarding CBO's May 2001 report on the housing GSEs, July 2001

Federal Subsidies and the Housing GSEs, May 2001

Testimony of Dan L. Crippen on Federal Subsidies for the Housing GSEs, May 2001 (Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Committee on Financial Services)

Interest Rate Differentials Between Jumbo and Conforming Mortgages, 1995-2000, May 2001

Remarks of June E. O'Neill before the Conference on Appraising Fannie Mae and Freddie Mac, May 1998

Testimony of June E. O'Neill on Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac, June 1996 (Before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the House Committee on Banking and Financial Services)

Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac, May 1996

The Federal Home Loan Banks in the Housing Finance System, July 1993

Controlling the Risks of Government-Sponsored Enterprises, April 1991

Government-Sponsored Enterprises and Their Implicit Federal Subsidy: The Case of Sallie Mae, December 1985

The Housing Finance System and Federal Policy: Recent Changes and Options for the Future, October 1983