August 25, 2000

The Honorable Richard Baker
Chairman
House Subcommittee on Capital Markets,
Securities, and Government Sponsored Enterprises
434 Cannon House Office Building
Washington, DC 20515

Sent via Facsimile (202) 225-7313 and (202) 225-6518

Dear Chairman Baker:

In response to your invitation for written comments on H.R. 3703, “The Housing Finance Regulatory Improvement Act,” I am pleased to submit the views of my company, Household International. We appreciate the opportunity to participate in the public discussion of this extremely important issue. We look forward to working with you, as well as Ranking Member Kanjorski and the other members of the Subcommittee, as you go forward with the “GSE Roundtable Summit” and beyond.

Household International, Inc. ("Household"), through its subsidiaries, is one of the largest consumer lenders in the country. Two of Household’s lending subsidiaries include Household Financial Services (“HFS”) – a leading participant of the subprime secondary market and mortgage originator through subsidiaries like Decision One Mortgage – and Household Bank, f.s.b., a member of the Chicago Federal Home Loan Bank System. In addition, we have several nationally-chartered banks and a variety of state-licensed lenders. Since 1878, Household Finance Corporation (“HFC”), Household's largest business, has been making loans to a traditionally underserved “middle market” of consumers. Currently, HFC along with its affiliate, Beneficial Corporation ("Beneficial"), operates over 1400 loan offices in 46 states, where it serves 3.5 million loan customers.

As with the rest of the housing finance industry, we have followed with great interest the series of five hearings on H.R. 3703 held in your Subcommittee since you, and Chairman Leach, introduced the legislation on February 29 of this year. You are to be commended for introducing this forward looking (yet not without controversy) bill and in the hearings for raising a number of issues from potential systematic risk, transparency, leverage ratios and mission focus.

We agree completely with your efforts, at the height of economic prosperity, to take a look at the regulatory structure of two of the largest financial institutions (Fannie Mae and Freddie Mac) in the country. Both Fannie Mae and Freddie Mac are well-managed but their sheer size, dominance of the secondary marketplace and growth of non-mission related activities warrant the legislative scrutiny H.R. 3703 has provided.

Our specific comments on the bill are outlined below on a section-by-section basis:

Sec. 101. The current regulatory structure provides no effective control over the housing GSEs. The GSEs are exempt from state and local taxes and from filing with the SEC. This provides a competitive advantage over the private sector and contributes to the lack of control over the housing GSEs. By combining the two separate regulators (OFHEO and the FHFB) of the housing GSEs, H.R. 3703 creates a more effective governmental regulatory oversight. We feel this move would create no disruption to the delivery of services and liquidity, yet would consolidate and strengthen the regulators' ability to protect against any potential systematic risk. However, we firmly believe that placing the new combined Housing Finance Oversight Board (HFOB) as an independent agency of the U.S. Treasury Department would provide even stronger oversight for the HFOB. As such, HFOB needs the power the bank regulators have to tailor risk-based capital rules to the GSEs' actual risk. Finally, in lieu of such a change, some form of Federal Reserve supervision – or a Governor of the Federal Reserve as a designee to the HFOB Board – would still be an improvement from the current structure of H.R. 3703.

Section 103. This section requiring public disclosure of information is very important. For example, Fannie Mae and Freddie Mac were able to carve out an exception to the comprehensive new privacy regulations for all financial institutions passed by Congress last year.

Section 110. Another problem with the current regulatory structure for the housing GSEs is that it provides no effective control over their new ventures. Any new program by the housing GSEs should be required to conform to strict mission and prudential standards before it can be allowed to begin. We would note that Congress last year required financial holding companies to provide the Federal Reserve with prior notice before beginning new ventures. Subjecting the GSEs to an appropriate review of their new ventures will only benefit the market as a whole. Banks have been required for years to give their regulators notices or file applications for new ventures. Even with these requirements, the U.S. financial system is by far the most innovative in the world, as the wide range of new products constantly being brought on-stream demonstrates. Our nation's record 67% homeownership rate is a tribute to the innovation of the private sector and its increased ability to service the subprime market.

The need for effective supervision of GSE new programs is made clear by the enterprises' recent efforts to push their charters to the breaking point. The enterprises have shown little concern for their statutory mission in many of their new programs. For example, Fannie Mae and Freddie Mac have become increasingly active purchasers of home equity and subprime loans. Such loans, while possibly within the technical boundaries of the GSE charters, do nothing to promote home ownership. Today, home equity loans finance a wide range of consumer spending and debt consolidation.

Among the most troublesome recent ventures into which Fannie Mae and Freddie Mac have launched themselves are new programs that replace the bona fide third-party mortgage insurance <u>mandated in the GSE charters with risky self-insurance</u>. Under these new programs, Fannie Mae and Freddie Mac have replaced the levels of third-party coverage mandated for mortgages with loan-to-value ratios above 80% with a variety of alternative structures. Common to all of them is a large layer of self-insurance paid for by the borrower through a higher interest rate when the mortgage is initiated. Such loans not only undermine the GSEs' charters, but also put consumers into loans that are not subject to the mortgage insurance cancellation rights mandated by Congress in 1998. As a result, such loans often cost consumers more over the life of the loan than products readily and affordably available in the marketplace.

In the past few years, members of the private sector have seen more and more new "product" and "activities" that do not offer a tangible benefit to promoting home ownership. In exchange for the numerous benefits afforded GSE status, asking these financial behemoths to stick to their mission, as Section 110 does, is simply common sense. As Treasury Undersecretary Gensler said before your Subcommittee on March 22, "(l)imiting the non-mission investments of the housing GSEs could also increase their focus on mission-related activities. Such an action could enhance accountability for the GSEs' benefits, and improve market competition."

Section 136. H.R. 3703 repeals the housing GSEs' conditional line of credit with the Treasury which is <u>no longer necessary or desirable</u>. Congress first authorized the Secretary of the Treasury to lend to the housing GSEs decades ago. The dollar amounts of these lines of credit are now a mere fraction of the GSEs' actual borrowings. For example, since its line of credit was established at its current level in 1957, Fannie Mae's mortgage holdings have increased 320 times in size. Each of the GSEs has gone from being a small, relatively unknown borrower in the capital markets to being among the largest debt issuers in the world. Any function the lines perform at this point is purely symbolic. Repeal of the line of credit would be consistent with the congressional requirement that all GSE securities carry a disclaimer that they are not obligations of the U.S. government. The implied subsidy is worth many billions per year to the GSEs although only part of the government subsidy passes through to home buyers and the rest of the benefits go to the GSE shareholders. Thus, as part of a package of reforms, we totally support repeal of the line of credit.

Section 141. One of the most important hearings the Capital Markets Subcommittee held this year received testimony from Treasury Under Secretary Gary Gensler. On March 22, Mr. Gensler stated that based upon recent trends and growth forecasts, GSE debt is forecast to surpass privately held marketable Treasury debt in the next three years.

To understand the scope of the challenge posed by GSE debt, it is important to focus on GSE leverage. Congress learned the critical importance of capital to financial institutions when it was forced to allocate hundreds of billions to rescue the savings-and-loan industry in the 1980s. As a result, strict capital standards were imposed in law and by regulation to ensure that shareholder capital is at risk when an explicit or implicit government guarantee is provided.

The GSEs operate at far higher leverage ratios than permitted either by rule or in the marketplace for insured and uninsured financial institutions. Treasury Under Secretary Gensler further testified in March that Fannie Mae and Freddie Mac have roughly $32 of debt for each dollar of capital while the Federal Home Loan banks have roughly $19 in debt per dollar of capital. In contrast, large banks had about $11.50 of debt and thrifts had $12.50 in debt for every dollar of capital. Thus, Fannie Mae and Freddie Mac are now <u>leveraged almost three times higher than the nation's largest banks</u>. In fact, their leverage ratios have far more in common with speculative hedge funds than with other regulated financial institutions.

A review of the GSE balance sheets makes it clear that the huge debt and massive leverage are not being used to support their mission. Both Fannie Mae and Freddie Mac now hold on their own books approximately thirty percent of the total amount of their own mortgage-backed securities issued to investors. These MBS already represent home loans made to borrowers and securitized in accordance with the GSEs' mission. Their repurchase contributes little to the creation of new home-ownership opportunities. Instead, it appears to be no more than an arbitrage operation in which the GSEs use their government benefits to support huge investment portfolios.

GSE debt operations and the purposes for which this debt is raised present public policy questions that go far beyond their immediate impact on housing. As they expand their debt, the housing GSEs will rely ever more heavily on their implicit government guaranty. The role of the housing GSEs as debt issuers with implied government guaranties and their plans to achieve benchmark status thus require a thorough government review. To this end, Household supports the House Budget Committee's ongoing review of GSE debt operations and looks forward to continued review by the Banking Committee as well as the active participation of the Treasury Department and the Federal Reserve Board.

In conclusion, Household appreciates the opportunity to comment on H.R. 3703 and we look forward to participating in the Summit on September 6 in Washington. Please do not hesitate to contact me at 847-564-6442, Loren Morris at 847-564-6097 or our Government Relations office at 202-466-3561, if you have any questions regarding our views. We hope you will view us as a private sector resource as you continue your important work in the Banking Committee.

Best regards,

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Managing Director