Statement of
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On
H.R. 3703
For
Roundtable Discussion on H.R. 3703
Subcommittee on Capital Markets
House Banking Committee
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Mr. Chairman and member of the Subcommittee:

H.R. 3703 is a milestone in Congressional efforts to gain control of the Government Sponsored Enterprises, and more generally the liabilities they create for the United States Government. The political courage and stamina that was required to introduce this bill and to continue to press it forward cannot be overstated, and Chairman Baker and those members of the Subcommittee who have expressed support for H.R. 3703 deserve the thanks of every citizen who is interested in sound government.

Nevertheless, H.R. 3703 is a very modest proposal, that can only be seen as an interim step in the necessary process of dismantling the GSEs and eliminating both their threat to the taxpayers and to the private financial sector of our economy.

Before commenting on the specific elements of H.R. 3703, I would like to summarize my views on why the GSEs—and Fannie Mae and Freddie Mac in particular—pose a serious problem for both the public and private sectors.

The GSE form—at least as it is embodied in Fannie Mae and Freddie Mac—contains an inherent contradiction. It is a shareholder-owned company, with the fiduciary obligation to maximize profits, and a government-chartered and empowered agency with a public mission. It should be obvious that it cannot achieve both objectives. If it maximizes profits, it will fail to perform its government mission to its full potential. If it performs its government mission fully, it will fail to maximize profits.

These consequences are fully clear when we look at Fannie Mae and Freddie Mac. In 1996, the Congressional Budget Office found that these two companies had received subsidies in 1995 of approximately $6.5 billion, but that only about two-thirds of this subsidy was actually delivered to the mortgage markets. The remainder was retained for the benefit of their shareholders and managements.

This is exactly what one would expect from this hybrid form. If Fannie and Freddie were fully performing their government mission, their entire subsidy would have gone to the mortgage markets. The fact that they retained a portion for themselves reflects their obligation to their shareholders and the incentives of their managements to increase their own compensation.

This has direct consequences in the real world. Since 1992, Fannie and Freddie have had an obligation to assist in financing affordable and low income housing. Obviously, doing so would be costly, and would thus reduce their profitability. Studies now show that their performance in financing low income housing—especially in minority areas—is far worse than that of ordinary banks. In other words, despite the fact that Fannie and Freddie receive subsidies to perform a government mission—in this case support of low income housing—their need for and incentives to retain a high level of profitability is an obstacle to their performance.

But that is not the full extent of the problem. Because of their unique structure, Fannie and Freddie are able to determine the size of their own subsidies. There is no effective restriction on their issuance of debt, and since every bond or note they issue reflects the subsidy they receive, they can increase their subsidy whenever they want without a vote of Congress. Although their subsidy was estimated at $6.5 billion in 1995, it is now probably something in the range of $10 billion, and it will grow larger as they continue to borrow money in the capital markets and increase the size of their portfolios.

Because they are not on-budget, Congress and the Administration have no effective control over the growth of Fannie and Freddie, and hence over the risks they create for the taxpayers.

Thus we have a vicious and dangerous cycle: Fannie and Freddie must grow in order to maintain their profitability and hence their high stock prices, but there is no countervailing check on their growth—no effective competition, no required government approvals, and no fear in the financial markets that there is any risk associated with financing this growth. Moreover, their fiduciary obligations to their shareholders require them to exploit their subsidy to the fullest extent possible. These are agencies that are—in the fullest sense of the phrase—out of control.

Today, they are financially healthy and pose no immediate risks to the taxpayers. This is because our economy and our housing markets are strong. However, even if these favorable conditions were to continue indefinitely, history tells us that no company is fully isolated from market forces. This is especially true of Fannie and Freddie, because they are growing so fast that they will soon run out of high quality mortgages to buy.

In a study I did with Bert Ely for the American Enterprise Institute, we concluded that by 2003 Fannie and Freddie would own or be bearing the risk of over 90 percent of all conventional conforming mortgages, and almost half of *all* mortgages in the United States. Since they must grow in order to remain profitable, this trend will continue. At some point, in theory, they will hold all mortgages, which will make them something like $8 trillion in size.

Aside from the fact that this amounts to a nationalization of the mortgage markets without a vote of Congress, the trouble with this is that holding *all* mortgages entails a great deal more risk than holding the high quality mortgages that Fannie and Freddie have historically financed, and because of their implicit backing by the government this will be a risk for the taxpayers. Just like the S&L debacle, Fannie and Freddie now and in the future will represent the classic case of privatizing the profits but socializing the risk. Their managements and shareholders are benefiting now from government support, but if these companies ever stop growing, or assume too much risk, or if interest rates spike, their losses will belong to the taxpayers.

But there is more. The fact that they can acquire all of the mortgages in the United States if they want points to their threat to the private sector. It should be obvious that Fannie and Freddie are not going to sit idly by and let themselves run out of mortgages to buy. They are going to seek new assets to acquire, and hence new businesses to enter. We are seeing this now with their purchase of their own mortgage-backed securities. Holding these allows them to earn more profit by taking more risk. When they were only guaranteeing mortgage backed securities, they were taking only credit risk; the holders of the MBSs were taking the interest rate risk. By buying back their own MBSs, they can also take interest rate risk, and hence earn more profit. It is not clear, as this Subcommittee has heard, how buying back MBSs helps homebuyers, but it sure helps the GSEs' profitability.

Other things that seem to be on their agenda are entering the business of mortgage origination, financing home improvements, and offering lines of credit to consumers through home equity loans. It may also be possible for them to enter the commercial mortgage markets and perhaps at some point commercial lending. If they are able to do these things, it will extend their lives considerably, and make it possible for them to exploit their implicit subsidy even more fully. Without some form of control—given their incentives—there is no end in sight.

The mortgage markets are clearly in danger of being nationalized today; if Fannie and Freddie are not restrained, other sectors of the financial economy could similarly become risks of the federal government instead of risks of private sector shareholders. It is no exaggeration to say that this is a threat to the private sector to the same degree as it is a threat to the taxpayers.

This brings me to H.R. 3703. Given what I have said above, the key features of this legislation from my point of view are those sections that address the source of the GSEs' subsidy and their ability to exploit this subsidy through unlimited issuance of debt and through competition with nonsubsidized companies.

The source of the subsidy is addresses to some degree in Section 136, which would repeal the Treasury lines of credit. This section has gotten a lot of attention in the media and by Fannie and Freddie. Everyone agrees the lines of credit are too small to be anything but symbolic. If they were to be eliminated it would reflect a weakening of the links between the government and Fannie and Freddie that would cause the financial markets to doubt the extent of government support.

Section 136 is one of the reasons I think the bill is modest. If the intention of Section 136 was to send this signal, it does not go far enough. The lines of credit are only one of many links between the government and the GSEs that the market relies on to support its view that Fannie and Freddie enjoy government backing. Other links are the following:

- The President appoints five members of their boards of directors
- They are exempt from state and local taxes
- They are exempt from registration with the SEC
- Their securities are eligible for open market transactions by the Federal Reserve Board
- Their securities may be used as collateral for government deposits in banks
- The Secretary of the Treasury has authority to approve their issuance of debt securities

If the line of credit is only symbolic, and if there is reason to terminate it as a symbol, then all these connections should also be terminated. In fact, if this were to occur, most of the rest of the bill would not be necessary. In the absence of government backing, market discipline would require the GSEs to maintain higher levels of capital, and would control their growth. They would no longer be able to enter any market with assurance that they could dominate it. At this point, of course, Fannie and Freddie would want to be rid of the restrictions in their government charters, and would seek the privatization that is the ultimate solution to the problems they pose.

If these ties are not cut, however, the rest of H.R. 3703 becomes relevant and necessary. In this connection, Section 110—which would give the new regulatory body authority to approve new activities—becomes very important. This provision is vital. Since it appears to be based on the Federal Reserve's authority to approve new activities for bank holding companies, objections based on the idea that it would hamstring the GSEs are without merit.

Since 1970, the Fed has had the authority to determine whether new activities proposed by bank holding companies were "closely related to banking." Last year, as the Subcommittee knows, this standard was broadened so that it now includes all "financial activities." I am not one who believes that bank holding companies should be so restricted—since they raise their money without government support in the capital markets—but the fact that the Fed has had this authority for 30 years without any noticeable problem for bank holding companies demonstrates that it is a workable way to control the expansion of activities beyond the boundaries Congress has in mind.

Sections 131 and 133 provide, respectively, for an annual review of the GSEs by rating agencies and the authority of the GSEs' new supervisor to establish a risk-based capital requirement that it considers necessary. Both these provisions are salutary, but I'm afraid they don't go far enough to address the lack of real control over Fannie and Freddie.

The fundamental problem, as I see it, is that Congress has no on-going basis for examining the GSEs, controlling their growth, or assessing whether they are worth the subsidies they receive. If a private sector rating agency concludes that either of Fannie or Freddie should be downgraded, then what? It's unlikely that the market will react adversely, since it is relying on government support as its ultimate basis for buying the GSEs' securities, and the fact that they are weakening financially is unlikely to worry investors who see them as government-backed entities. Their supervisor might react, but one of the lessons of the S&L crisis is that regulators respond to Congress, and if Congress does not want them to come down hard on the regulated industry they will not do so.

Imagine the scenario: the economy is weakening and homeowners are defaulting on their mortgages. As a result, Fannie and Freddie are downgraded by Moody's. The new Housing Finance Oversight Board steps in as a result of the downgrade to insist that Fannie and Freddie stop taking on new assets. As a result, the housing market falls apart completely, the economy gets worse, and there are more defaults. Does anyone believe that Congress will allow the Oversight Board to do this? The same thing is true if the Board decides that Fannie and Freddie need more risk-based capital as a result of a weakening in the housing market.

Similarly, while the establishment of a supervisory body that is independent of HUD, large enough to supervise all the GSEs, and financed outside the appropriations process is a real and important advance, I think the Subcommittee should consider the model suggested by locating the Office of the Comptroller of the Currency and the Office of Thrift Supervision in the Treasury Department, headed by single administrators. These officials—speaking with the authority of the President—are frequently able to act more independently than collegial bodies such as a board.

However, giving the Treasury a voice on the Oversight Board is an excellent idea, since the policy problems posed by the GSEs—and particularly Fannie and Freddie—are not housing problems but problems for our financial system as a whole.

Ultimately, Fannie and Freddie create more serious problems of control than are likely to be addressed by the bill. Assuming that full privatization cannot be achieved, the following steps are necessary in my view to deal with these problems:

- The GSEs should be charged a guarantee fee to compensate the government for its risks in backing their liabilities; the fees could be used to establish an insurance fund out of which the GSEs' creditors will be paid if they default.

- Debt issuance by the GSEs should be treated as a budget item, so that every year their growth through the issuance of debt will be weighed against the use of the government's resources for other purposes.

- The GSEs should be treated like other government agencies—i.e., (i) covered by the Anti-Lobbying Act, which would prohibit them from using their subsidies to do grass-roots lobbying of Congress, (ii) prohibited from organizing fundraisers, and (iii) prohibited from making soft money contributions to political parties.

Thus, I view H.R. 3703 as a very important—indeed a groundbreaking—piece of legislation. If it were adopted in its current form it would go a significant distance toward gaining control of Fannie Mae and Freddie Mac. But we should not think that, if the bill is indeed passed in its current form, it will address all the policy problems these hybrid bodies create.