Housing Enterprises: The Roles of Fannie Mae and Freddie Mac in the U.S. Housing Finance System

Mr. Chairman and Members of the Task Force:

We are pleased to be here today to discuss the roles of Fannie Mae and Freddie Mac in our nation's housing finance system. Congress created Fannie Mae and Freddie Mac (the enterprises), the two largest government sponsored enterprises (GSEs), to promote home ownership in the United States. The enterprises fulfill their housing mission by borrowing funds or issuing mortgage-backed securities (MBS) and using the proceeds to purchase home mortgages from banks, thrifts, and other financial institutions. Financial institutions, in turn, may use the proceeds from their mortgage sales to the enterprises to fund additional mortgage loans, thereby helping to ensure a stable supply of mortgage credit across the nation. Financial institution mortgage lending is commonly referred to as the "primary residential mortgage market," while the enterprises' mortgage purchase activities are commonly referred to as the "secondary residential mortgage market."

Most analysts agree that the enterprises' activities have successfully lowered mortgage costs and increased home ownership in the United States. However, these benefits must be weighed against the potential costs associated with the federal government's implied sponsorship of the enterprises, which had combined debt and MBS liabilities of over $2 trillion at the end of 1999. In particular, the federal government could potentially decide to provide financial assistance to the enterprises in an emergency situation.

In recent years, we have issued several reports that assess the enterprises' roles in the housing finance system and federal oversight of their activities. My testimony today will briefly discuss the following important topics covered in these reports:

- the benefits and costs of the enterprises' housing finance activities,
- federal efforts to ensure the enterprises' safety and soundness, and
- federal efforts to ensure that the enterprises promote home ownership opportunities for all Americans.

The Benefits and Costs of the Enterprises' Housing Finance Activities

The enterprises are hybrid organizations that contain elements of both private- and public-sector organizations. Like many private companies, the enterprises issue equity and debt instruments to the investing public. The enterprises have also developed compensation packages that reward top executives for increasing shareholder value. On the other hand, the enterprises' close relationship with the federal government and their federal charters provide them with several important advantages over

private-sector companies. The most important of these benefits is an indirect one--the perception in the financial markets that the government would not allow the enterprises to fail, which allows them to borrow and issue MBS to finance mortgage purchases at relatively lower cost than private firms. The enterprises' federal charters also exempt them from paying state and local income taxes and some of the fees charged by the Securities and Exchange Commission for securities and debt issuances. The charters also provide each enterprise with a $2.25 billion conditional line of credit with the Treasury Department.

In a May 1996 report, we estimated that the total annual value of these benefits to the enterprises ranged from $2.2 billion to $8.3 billion on a before-tax basis and $1.6 billion to $5.9 billion on an after-tax basis.[1] To some extent, the enterprises pass these savings on to home buyers in the form of lower mortgage interest rates. Although it is not possible to calculate these savings precisely, we estimate that in 1995 the enterprises' mortgage purchase activities resulted in savings of about a quarter of a percentage point annually on a typical $100,000 mortgage. This translated into savings of about $10 to $25 per month on such a $100,000 mortgage, or about $3 billion to $7 billion annually for the approximately $2 trillion in mortgages that the GSEs were eligible to purchase and that were outstanding at the time.[2] Most analysts also agree that the enterprises' activities, such as their imposition of greater standardization on mortgage products and processes, have also facilitated the development of an efficient, nationwide mortgage finance system.

However, federal sponsorship of the enterprises' activities as GSEs also creates significant risks and costs. First, the potential exists that U.S. taxpayers would end up paying for a portion of the enterprises' debt and MBS obligations, which stood at over $2 trillion at the end of 1999. In fact, Fannie Mae experienced significant financial difficulties because of a sharp rise in interest rates between 1981 and 1984, resulting in losses of $277 million. To help Fannie Mae overcome these problems, the federal government provided limited tax relief and relaxed the enterprise's capital requirements. Congress also showed its willingness to assist GSEs that experience financial difficulty in 1987 when it authorized up to $4 billion to

[1] Housing Enterprises: Potential Impacts of Severing Government Sponsorship (GAO/GGD-96-120, May 13, 1996).

[2] The enterprises' charters restrict them from purchasing mortgages above a set dollar amount, known as the conforming loan limit. The conforming loan limit depends upon how many housing units are financed by a single residential mortgage loan. The conforming loan limit is currently set at $252,700. The charters also require the enterprises to meet certain underwriting standards for mortgage loan purchases.

help the Farm Credit System, another GSE, overcome a farm crisis and the resulting increase in loan defaults. Second, opportunity costs can also be generated when the perceived backing of a GSE by the federal government diverts funds from other financial institutions that may otherwise be able to provide more efficient services to the public. Third, opportunity costs can also be generated if a GSE enters into activities that are outside its statutory mission.

To help ensure that the enterprises conduct their business in a safe and sound manner and use their government-provided benefits to achieve a public purpose, in 1992 Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act (1992 Act). The 1992 Act established the Office of Federal Housing Enterprise Oversight (OFHEO) to ensure that the enterprises are adequately capitalized and operating safely. The 1992 Act also provided the Department of Housing and Urban Development (HUD) with additional regulatory authority to ensure that the enterprises fulfill their housing finance mission. As part of the 1992 Act, Congress concluded that the financial benefits that the enterprises derive from their government sponsorship involve a corresponding obligation to meet the mortgage credit needs of all potential home buyers, including those with low- and moderate-incomes. This regulatory scheme allows the enterprises to continue to have the same powers as private companies to conduct their day-to day-business.

In the remaining two sections of my testimony, I will discuss the status of OFHEO and HUD's efforts to fulfill their regulatory responsibilities under the 1992 Act.

OFHEO Monitors the Financial Safety of the Enterprises

The 1992 Act established OFHEO as an independent agency within HUD to monitor the enterprises' financial safety and soundness. Under the act, OFHEO is subject to the congressional appropriations process but the enterprises pay assessments to finance its activities. OFHEO's budget was about $16 million in fiscal year 1999. The act provided OFHEO with two essential responsibilities to carry out its safety and soundness mission: (1) establish capital standards for the enterprises and (2) establish an examination program.

As required by the 1992 Act, OFHEO has established minimum capital standards for the enterprises, which are capital ratios applied to certain on-balance-sheet and off-balance-sheet obligations. OFHEO has consistently classified the enterprises as in compliance with the minimum capital standards since they were established in 1993. The act also mandated that OFHEO develop a stress test to serve as the basis for more

sophisticated risk-based capital standards. The purpose of the stress test is to help manage taxpayer risks by simulating, in a computer model, situations where the enterprises are exposed to adverse credit and interest rate scenarios. The enterprises are required to hold sufficient capital to withstand these adverse conditions for 10 years, plus an additional 30 percent of the required capital to cover operations and management risk.

Although the 1992 Act directed OFHEO to complete the stress test and risk-based capital standards by December 1, 1994, OFHEO has not yet completed these tasks. In an October 1997 report, we identified several reasons for OFHEO's inability to comply with the deadline, including (1) the complexity of the task, (2) OFHEO's decision to develop a new stress test rather than adopt or modify existing stress tests, (3) OFHEO's initial difficulties in obtaining required financial data from the enterprises, and (4) greater than expected managerial and technical difficulties.[3] OFHEO has proposed a rule to implement the stress test and risk-based capital standards and expects to issue a final rule by the end of 2000.

OFHEO also has the authority to establish an examination program to monitor the enterprises' management and financial condition. Our 1997 report found that OFHEO had not been able to implement its plan to examine all relevant operations of the enterprises on a 2-year schedule. We attributed OFHEO's inability to meet the schedule to limited staff resources and the start-up challenges associated with examining the enterprises, which are extremely large and complex financial institutions. Since that time, OFHEO has revised its examination program and implemented an annual examination schedule. OFHEO's examination staff has generally found that the enterprises have been operated in a safe and sound manner.

HUD Has Responsibility for Overseeing the Enterprises' Fulfillment of Their Housing Mission

HUD has statutory authority to ensure that the enterprises fulfill their mission of promoting housing and home ownership opportunities for all Americans. In passing the 1992 Act, Congress concluded that HUD's regulatory framework had not been effective in ensuring that the enterprises' activities benefit low- and moderate-income Americans and those who live in underserved areas, such as central cities and rural communities (targeted groups). The 1992 Act required HUD to develop, implement, and enforce a comprehensive housing mission regulatory framework. Among other provisions, the 1992 Act directed HUD to set

[3] Federal Housing Enterprises: OFHEO Faces Challenges in Implementing a Comprehensive Oversight Program (GAO/GGD-98-6, Oct. 22, 1997).

housing goals, which require the enterprises to meet specified criteria each year for the purchase of mortgages serving targeted groups.

In 1995, HUD established a final rule for enterprises' housing goal mortgage purchases for the years 1996 through 1999. In a July 1998 report, we found that HUD generally adopted a conservative approach to setting the housing goals that placed a high priority on maintaining the enterprises' financial soundness.[4] For example, HUD and OFHEO conducted research during the rulemaking process that concluded that the proposed housing goals were modest and would not materially affect the enterprises' financial condition. According to HUD data, the enterprises met or exceeded the housing goals between 1996 and 1998.

In March of this year, HUD proposed a new rule setting housing goal requirements for the period 2000 through 2003. HUD's proposed housing goals are set higher than the goals set for the period 1996 through 1999. According to HUD, the enterprises' share of the affordable housing market remains below desired levels. For example, banks and other lenders continue to make relatively more mortgage loans in the primary market to targeted groups than the enterprises purchase in the secondary residential mortgage market. HUD believes that the proposed housing goals will provide strong incentives for the enterprises to more fully meet the housing needs of targeted groups. The comment period on the proposed rule ended in May 2000. HUD is currently reviewing comments and expects to issue a final rule by the end of 2000.

The 1992 Act also defined HUD's general regulatory authority over the enterprises and its new mortgage program approval authority.[5] HUD has the general regulatory authority to ensure that the enterprises' activities are consistent with their housing mission. HUD also has the authority to review new mortgage programs proposed by the enterprises to ensure that the programs are consistent with the enterprises' charters and not contrary to the public interest. In our view, Congress correctly recognized, in passing the 1992 Act, that the enterprises—given their hybrid structure—face a natural tension between maximizing profitability for their shareholders and fulfilling their housing mission.

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[4] Federal Housing Enterprises: HUD's Mission Oversight Needs to Be Strengthened (GAO/GGD-98-173, July 28, 1998).

[5] 12 U.S.C. § 4541-2. The 1992 Act defines a "new program" as being significantly different from mortgage programs that have been approved or that represent an expansion, in terms of the dollar volume or number of mortgages or securities involved, of programs previously approved.

In a March 1998 report, we provided an example of this natural tension and HUD's critical responsibility to exercise its general regulatory authority in a way that ensures that the enterprises fulfill their housing mission.[6] We pointed out that the enterprises have incentives to use the funding advantage associated with their government sponsorship to make nonmortgage investments—such as corporate bond purchases—that may result in arbitrage profits.[7] Our report recognized that some nonmortgage investments, particularly short-term investments, can contribute to mission achievement by facilitating liquidity in the secondary market for residential mortgages. However, our report concluded that the relationship between long-term nonmortgage investments and the enterprises' housing mission is not entirely clear.

Our March 1998 report found that HUD did not act promptly to ensure that the enterprises' nonmortgage investments were consistent with their housing mission. In fact, HUD did not exercise its general regulatory authority provided in the 1992 Act until 1997, when a public controversy erupted over Freddie Mac's investment in long-term Philip Morris corporate bonds. In 1997, HUD initiated a rulemaking process designed to develop criteria that would help ensure that the enterprises' nonmortgage investments are consistent with their housing mission and federal charters. We recommended that HUD promptly implement this rulemaking process, and HUD agreed to do so. However, HUD has not yet developed criteria for overseeing the enterprises' nonmortgage investments.

The enterprises have also engaged in other complex financial activities whose relation to their housing mission is not entirely clear. For example, in our March 1998 report, we pointed out that HUD approved a new mortgage program by Fannie Mae that would involve Fannie Mae in purchasing cash value life insurance, which is essentially a nonmortgage investment.[8] HUD officials told us that they lacked expertise in cash value life insurance when they approved the Fannie Mae program.

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[6] Government-Sponsored Enterprises: Federal Oversight Needed for Nonmortgage Investments (GAO/GGD-98-48, Mar. 11, 1998).

[7] We defined the term "arbitrage" to mean that the enterprises use their funding advantage from government sponsorship to raise funds for making certain nonmortgage investments. Our definition of arbitrage is similar to the definition of an arbitrage bond defined in reference to federal income tax exemption for interest on state and local bonds in the U.S. tax code.

[8] The program was called the Mortgage Protection Plan (MPP). Under MPP, Fannie Mae would purchase a cash value life insurance on a first-time home buyer after the selected borrower's residential mortgage was purchased by Fannie Mae and the borrower agreed to such coverage. MPP was designed to protect Fannie Mae and the borrower against default caused by the borrower's death. Fannie Mae did not go ahead with MPP because of tax law changes.

More recently, the enterprises' involvement in other activities—such as automated underwriting—have raised questions as to whether they are attempting to move beyond the secondary mortgage market into areas traditionally served by private lenders in the primary mortgage market. Some lenders believe that the enterprises' automated systems standardize the mortgage loan process to such an extent that the lenders' role in mortgage lending is minimized.

Conclusions

In summary, Congress provided Fannie Mae and Freddie Mac with substantial financial benefits so that they can fulfill their housing finance mission. There is widespread agreement that the enterprises' secondary mortgage market activities have lowered the cost of home ownership for millions of Americans. However, perceived federal sponsorship of the enterprises' activities as GSEs also involves significant risks and costs. In passing the 1992 Act, Congress created a regulatory structure with the potential to help ensure that the enterprises, in their attempts as private corporations to create shareholder value, would do so by focusing on and fulfilling their public missions without exposing U.S. taxpayers to undue risk.

In their oversight roles, OFHEO and HUD face a difficult challenge in ensuring that the enterprises meet their housing responsibilities in a safe and sound manner, while simultaneously being afforded sufficient latitude to manage their day-to-day business needs and meet their shareholder obligations. The enterprises are large, sophisticated financial institutions. Beyond various nonmortgage investments, the enterprises have become engaged in complex financial activities that may serve multiple purposes. Therefore, it is difficult to assess the financial risks of many of their activities as well as the relationship between their activities and mission achievement. Nonetheless, the making of such assessments by the enterprises' regulators and Congress is imperative to ensure that the interests of U.S. taxpayers are protected.

Mr. Chairman, this concludes my statement. My colleagues and I would be pleased to respond to any questions that you or other members of the Task Force may have.

Contact and Acknowledgements

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