WASTE, FRAUD, ABUSE, AND MISMANAGEMENT

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BEFORE THE

TASK FORCE ON HOUSING AND INFRASTRUCTURE

OF THE

COMMITTEE ON THE BUDGET HOUSE OF REPRESENTATIVES

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Abuse of the National Transportation Safety Board's Rapidraft Payment System

THURSDAY, APRIL 13, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON HOUSING AND INFRASTRUCTURE,
Washington, DC.

The Task Force met, pursuant to call, at 10:15 a.m. in room 210, Cannon House Office Building, Hon. John Sununu (chairman of the Task Force) presiding.

Members present: Representatives Sununu, Knollenberg, Miller, Ryan, Toomey, Bentsen, Clement and Lucas.

Mr. SUNUNU. Good morning. Today's hearing is the first of the Housing and Infrastructure Task Force, one of six such panels recently established by the House Budget Committee. The overriding objective of these panels is to identify and review cases of mismanagement or misuse of Federal funds in an effort to better allocate resources, improve government operations and ultimately look out for the taxpayers' interests.

I do not view these issues that we are going to be addressing in these hearings as partisan, and it is not our objective to point fingers or place blame. Frankly, both the administration and the Congress share a responsibility to oversee these agencies. If problems occur, we need to work together to look for solutions.

I believe that success in the continuing efforts here will not be marked by a dramatic hearing or simplistic legislation that guarantees accountability but instead by painstaking review and evaluation of what works and, of course, what doesn't work in government.

Today's hearing is a modest step in this direction. In reviewing the problems associated with the Rapidraft check writing system within NTSB, I hope that this Task Force can address three specific areas:

First, we need to understand what basic flaws of the Rapidraft system led to very significant abuses, a significant number of drafts being processed for inappropriate uses. Second, we should consider the corrective action that has been taken by NTSB leadership and assess whether or not similar changes should be implemented in other Federal agencies that might still be relying on Rapidrafts or other similar third party systems. And, third, I believe we should consider whether extending legislation such as the Inspector General Act or the Chief Financial Officers Act to additional Federal agencies would help prevent similar problems from occurring in the future.

I believe that today's two witnesses and NTSB Chairman Jill Hall and Inspector General Ken Mead will help provide answers to these important questions.

Before we begin, however, I want to make a few personal observations about the NTSB itself. In my view and I believe the view of Congress and the American people, the NTSB is without peer in the performance of its core mission. The technical expertise and objectivity of its investigators helped to ensure the safety of travelers not just in the United States but throughout the world. And this is indeed a unique role. The NTSB provides an invaluable service to the country and has earned its reputation for integrity.

It should be emphasized that the problems we are going to discuss today relating to the Rapidraft system are unrelated to the core investigatory work of the NTSB. Moreover, it was the leadership within the NTSB itself that first identified the problems and requested that the Department of Transportation Inspector General work to begin an audit and make recommendations to the Board.

This could not have been an easy request for Mr. Hall and the Board to make. Moreover, implementing the changes to financial systems, which the NTSB has already begun, is a difficult task in any organization. Yet, throughout this process, the Board has continued to meet its critical responsibilities in an exemplary fashion. It is a fact that I believe is a great credit to Mr. Hall's personal leadership.

The objective of this hearing is not to assign blame or responsibility for a system that we know is flawed and that the current Board inherited and which had been in place for about 10 years. The Task Force's goal is not to second-guess the overall effort of Mr. Hall or Mr. Mead. To the contrary, Mr. Hall's initial problem identification and request should really serve as a model for others in similar positions.

Instead, I hope we will work to make the best possible use of the hard work already done by Mr. Hall and Mr. Mead and their respective staffs and apply the important lessons before us across all areas of the Federal Government.

It is my pleasure to yield at this time to Mr. Bentsen for an opening statement.

Mr. BENTSEN. I thank my chairman of the Task Force, Mr. Sununu, for yielding to me.

I want to thank or welcome both Chairman Hall and Inspector General Mead here today. We appreciate you testifying.

I can't help but say that—it's not Mr. Sununu's fault—but we probably should have had the FAA here today. Because, as we speak, the conference report on the budget resolution is coming up on the floor, and you have got members of the committee who are stuck here. But we do have important business before us today, and I know Mr. Sununu and I are eager to get over to the floor and do rhetorical battle with respect to the budget, as well as the other members are.

The Task Force is charged with holding oversight hearings on waste, fraud and abuse and reporting our findings and recommendations to the full House Budget Committee. I know of no one, Democrat or Republican, in the Congress who believes the

American people should tolerate any waste, fraud and abuse involving their hard-earned tax dollars.

In this our first oversight hearing we turn to the Rapidraft check writing program of the National Transportation Safety Board. With all due respect to Chairman Hall, the NTSB is not really on the Nation's radar screen except for those tragic times when there is a major accident. When there are tragedies in our skies like the Egyptair crash off the coast of Nantucket or the TWA flight 800 in New York, we look to the NTSB to investigate. I think I can safely say that there is a broad agreement by Members on both sides of the aisle that the NTSB is the world's premiere independent accident investigation agency.

I would like to start also by commending you, Chairman Hall, on your proactive stance with respect to financial inconsistencies that your agency unearthed at the NTSB.

From my reading of the materials supplied, in 1999, when your Office of Finance became aware of potential abuses of the Rapidraft system, you contacted the Inspector General, who did not have jurisdiction over your agency, and requested that he come in and conduct an audit. You then terminated the Rapidraft system and replaced it with a program universally used throughout the government. Shortly after, the Chief Financial Officer, who failed to properly audit payments under the system, was voluntarily separated from his position. All the while, you apprised the authorizing congressional committees of your activities. Moreover, I understand that you recently contracted with an outside firm to have them conduct a complete audit of the abandoned Rapidraft system that goes beyond the Inspector General's investigation.

Chairman Hall, I want to commend you and your agency for showing us how an agency can take the reins of responsibility and initiate reform that deters waste, fraud and abuse. I think this is something that you ought to be proud of and something that, at the conclusion of these hearings, Mr. Chairman and members, that we ought to hopefully hold out as a model for the Federal Government in standing up and addressing problems within an agency rather than not doing anything.

And, with that, I yield back the balance of my time.

Mr. SUNUNU. Thank you, Mr. Bentsen.

Mr. SUNUNU. At this time, it is my pleasure to welcome both of our witnesses. We will take testimony from each, Mr. Mead and Mr. Hall, and then allow members 5 minutes on alternating sides for comments and questions.

STATEMENTS OF KENNETH M. MEAD, INSPECTOR GENERAL, DEPARTMENT OF TRANSPORTATION; AND JAMES E. HALL, CHAIRMAN, NATIONAL TRANSPORTATION SAFETY BOARD

Mr. SUNUNU. Welcome, Mr. Mead. We're pleased to have you begin.

STATEMENT OF KENNETH M. MEAD

Mr. MEAD. Thank you, Mr. Chairman and members of the Task Force.

I want to at the very outset here reaffirm what you said in your opening remarks. The Department of Transportation Inspector

General does not have statutory audit or investigative jurisdiction over the National Transportation Safety Board. We did our work at the request of Chairman Hall, who called us promptly upon learning of some issues concerning this Rapidraft program; and he just as rapidly took action upon our recommendations. Indeed, even in advance of us issuing our formal recommendations, the chairman acted.

And that is not always the case. As you look about government, when you find recommendations from the Inspector General or GAO, you don't always see such expeditious implementation. So I just want to say I hold Chairman Hall in the highest personal and professional regard.

Now, beginning in 1984, NTSB contracted with a vendor to provide a line of credit for writing third-party checks, which in our testimony we will refer to as Rapidrafts. They are much like your own checks except they have NTSB's name on them. A primary purpose of these Rapidrafts was to eliminate extra paperwork and processing time required to issue Treasury checks. The vendor administered the Rapidraft program, including issuing blank checks and providing NTSB with monthly transaction statements and canceled checks.

Now our testimony is going to cover three areas: First, the established internal controls for this program were not working as intended, and clearly so; second, what our recommendations were and NTSB's response; and, finally, I think our findings illustrate the need for some type of institutional oversight of NTSB in the financial management area.

The Rapidraft system was in operation from 1984 through September 1999. It authorized some NTSB employees, 177 of the total complement of about 450 staff, to write Rapidrafts for accident and nonaccident investigation purposes.

During the past 3 fiscal years, NTSB issued 26,000 Rapidrafts totaling nearly $13 million. During the first 11 months of 1999 about $3.6 million in Rapidraft payments were made. This system was under the general management of NTSB's Chief Financial Officer, called a CFO for short. Its operation was governed by an NTSB order.

In late August 1999, after learning about incidents of possible abuse, Chairman Hall asked for our assistance in investigating and auditing the suspected abuse. We agreed to do so.

We performed the work under what is called a memorandum of understanding, which actually had been under discussion between NTSB and our office even before this abuse was uncovered. Chairman Hall told me that he wanted audit coverage just as a good financial management practice.

Well, our audit revealed that the Rapidraft system was seriously mismanaged. Of the 1,000 Rapidrafts paid during fiscal 1999 which we sampled, 902 of those, or over 90 percent, failed to comply with NTSB internal controls. Now what do I mean by that? There are seven specific deficiencies that I would like to note here.

First, 678 of the 1,000 Rapidrafts didn't contain a required explanation for the check. Now, without an explanation or supporting documentation, it is difficult to determine whether the disbursement is for a legitimate purpose. An example: in November, a

$2,150 Rapidraft was issued and negotiated with no payee and there was no explanation on the Rapidraft as to what the purpose of the check was.

Second deficiency: 222 of the 900 checks were paid without the required signature or authorization number. We found, for example, a $1,416 check that was paid—issued—but it bore no authorizing signature. It is like you cashing a check but not signing it.

A third deficiency: 22 Rapidrafts were issued in 1999 in excess of the $2,500 ceiling. For example, six ranging from $7,800 to $24,000 were issued for building renovations.

Fourth deficiency: as a matter of practice, paid Rapidrafts were not reconciled with supporting documentation by NTSB. In fact, when my staff retrieved the canceled Rapidrafts from NTSB, they were still in the same unopened envelopes that the vendor used to send them to NTSB. That compares to getting your bank statement, throwing it in a drawer and never looking to see whether the checks were yours or the charges appropriate.

Fifth: employees separating from NTSB weren't required to turn in their unused checks, and many did not. Moreover, the contractor was not notified, in turn, that 37 employees, 37 of the 177 users, had left the agency. The headquarter's employee who embezzled over $70,000 and who in fact worked for the Chief Financial Officer used Rapidrafts that were left behind by a former employee.

Sixth: employees could order blank Rapidrafts from the contractor without management approval or knowledge. Management didn't track how many Rapidrafts were issued to the employees, and they were not kept in secure locations.

And, finally, these checks were used to split purchases and circumvent Federal regulations. Splitting is the practice of using multiple checks to divide a single purchase to avoid competition. For example, one employee wrote three checks totalling $4,600 to the same vendor on one day for the same thing. And this lack of adherence to internal controls overall rendered the system susceptible to fraud, waste and abuse.

Our investigations disclosed that two employees had embezzled government funds using the Rapidraft system. The employees have resigned. Criminal prosecution has been initiated against both of them.

On April 4, one former employee was indicted by a Federal grand jury on seven felony counts.

On April 11, the other former employee, the one who worked under the Chief Financial Officer, was charged with a felony for embezzling nearly $74,000.

In November 1999, we apprised NTSB of our findings. We recommended that they discontinue the Rapidraft system, implement an approved payment program using credit cards and ensure that the Chief Financial Officer's Office developed and implemented comprehensive internal controls.

Chairman Hall told us that he had discontinued the Rapidraft Payment System. He adopted the governmentwide purchase credit card and travel credit card programs. He also appointed a new CFO. He has retained the services of a private sector audit firm to audit the financial management systems.

Now the NTSB, as your opening remarks indicated, is held in very high regard for its investigations. And, in this case, NTSB took prompt action to get help, and it took prompt corrective action, and they have committed to a meaningful course of corrective action on a broad front.

Now, it is necessary for Chairman Hall to seek outside assistance, because NTSB doesn't have an Inspector General or an equivalent institutional oversight mechanism. We feel that if they had been subject to some type of institutional oversight and follow-up of corrective action, it is likely that the problems uncovered in 1999 may have been avoided.

And just by way of illustration, I should say that, because of the experience at NTSB and our own prior audit work at FAA, the Department is terminating a similar program at FAA where similar weaknesses were found. And that wouldn't be possible if we weren't there to constantly monitor the situation. It just shows I think the value of continuing oversight. And that concludes my remarks.

Mr. SUNUNU. Thank you very much, Mr. Mead.

[The prepared statement of Mr. Mead follows:]

PREPARED STATEMENT OF HON. KENNETH M. MEAD, INSPECTOR GENERAL, U.S. DEPARTMENT OF TRANSPORTATION

Mr. Chairman and members of the Task Force, we appreciate the opportunity to discuss the National Transportation Safety Board's (NTSB) Rapidraft Payment System.

In 1984, NTSB contracted with a vendor to provide a line of credit for third-party check writing privileges. A primary purpose of these checks, referred to as Rapidrafts, was to eliminate the extra paperwork and processing time required to issue checks through the Treasury Department. The vendor served to administer the Rapidraft program, including issuing blank checks (drawn against the vendor's bank account), maintaining a list of authorized NTSB users, and providing NTSB with monthly transaction statements and canceled checks. NTSB renewed the firm's contract, most recently in 1996.

The Rapidraft Payment System—in operation from 1984 through September 1999—authorized some NTSB employees, including on-site accident investigators, to write Rapidrafts "for accident and nonaccident investigation costs." These Rapidrafts were limited to $2,500 per transaction. During the past three fiscal years (FY), 1997 through 1999, NTSB issued 26,097 Rapidrafts totaling $12.9 million. During the first 11 months of FY 1999, only $227,776 (6 percent) of the $3.6 million Rapidraft payments were associated with on-site accident investigations.

The Rapidraft Payment System was under the general management of NTSB's Chief Financial Officer (CFO). Its operation was governed by an NTSB Order prescribing the procedures and internal controls on use of Rapidrafts.

In late August 1999, after learning about incidents of possible abuse of the Rapidraft Payment System by one or more NTSB employees, NTSB Chairman Jim Hall requested our assistance in investigating the suspected abuse. In addition to rendering investigative services, we agreed to perform a broader audit of the Rapidraft Payment System. As NTSB is not within the scope of our investigative and audit authority, we performed the work under a mutually agreed to Memorandum of Understanding and Agreement.

In brief, our audit revealed that the Rapidraft Payment System was seriously mismanaged. Our review of 1,000 Rapidrafts paid during FY 1999 showed that 902, over 90 percent, were noncompliant with NTSB internal controls. Specific deficiencies we identified include the following:

- 678 Rapidrafts did not contain the required explanation for the check.
- 222 Rapidrafts were processed and paid without the required signature or authorization number.
- 22 Rapidrafts were issued in excess of the $2,500 limit. In the two prior fiscal years, more than 150 Rapidrafts exceeded $2,500, including eight Rapidrafts issued for $20,000 or more.

- As a matter of practice, paid Rapidrafts (forwarded by the contractor to NTSB, similar to a bank's return of canceled checks to a customer) were neither reviewed nor reconciled with supporting documentation by NTSB.
- The contractor was not notified that 37 of the 177 authorized users had left NTSB.
- Employees separating from NTSB employment were not required to turn in unused Rapidrafts and many did not.
- Employees ordered and received blank Rapidrafts from the contractor without management approval or knowledge.
- NTSB management did not track how many Rapidrafts were issued to employees.
- Rapidrafts were not kept in secure locations at NTSB.
- Rapidrafts were used to "split" purchases and circumvent Federal Acquisition Regulations and NTSB Orders. ("Splitting" is the practice of using multiple Rapidrafts to divide a single purchase—which exceeds the Government's $2,500 micropurchase ceiling—into a series of separate, smaller purchases in order to circumvent the ceiling.)

NTSB's lack of adherence to internal controls rendered the Rapidraft Payment System susceptible to fraud, waste and abuse, as evidenced by two known embezzlements which we investigated. Our investigations disclosed that two NTSB employees, one in a field office and one at Headquarters had separately embezzled Government funds using the Rapidraft System. The employees resigned before our investigation commenced in August 1999. Since then, our findings concerning each of those former employees have resulted in criminal prosecution by the Department of Justice.

Our investigation disclosed that a former employee was responsible for misappropriating in excess of $20,000. On April 4, 2000, she was indicted by a Federal grand jury in the Northern District of Georgia on seven felony counts of embezzlement. On April 11, 2000, the other former employee—who worked under NTSB's former CFO—was charged in a one-count felony Information by the U.S. Attorney's Office for the District of Columbia for embezzling approximately $74,000.

In early November 1999, we apprised NTSB of our audit and preliminary investigative findings, transmitting our formal audit report. Our audit report recommended that NTSB:

- Discontinue the Rapidraft Payment System.
- Implement approved payment programs, such as the Governmentwide commercial purchase card and a Federal payment processor for travel-related reimbursements.
- Ensure that the CFO's office develops and implements comprehensive internal controls for these programs.

In response to our recommendations, Chairman Hall notified us that he had discontinued the Rapidraft Payment System and NTSB adopted the Governmentwide purchase credit card program. Moreover, NTSB appointed a new CFO in January 2000 and has retained the services of a private sector audit firm to assist in identifying weaknesses and recommending procedures and resources for improved audit control. This outside audit firm will audit and examine internal control weaknesses in other financial systems, such as NTSB's travel program, accountability of property and internal controls, and electronic certifications. These programs and systems were beyond the scope of our review of the Rapidraft Payment System.

The NTSB is held in high regard for its expertise and role in assuring the safety of all modes of transportation. It is widely regarded as the preeminent investigative agency of its kind in the world. We note NTSB's prompt action in requesting assistance to identify the cause and extent of the problems with the Rapidraft program and appreciate its cooperation with our auditors and investigators. NTSB has committed to a meaningful course of corrective action on a broad front, promptly ending its use of Rapidrafts even before the completion of our audit, and must now follow through in its implementation of these actions.

To help the Task Force in its efforts, our testimony today addresses three areas related to the problems identified with the NTSB's Rapidraft program.

- First, the established internal controls were not operating as intended,
- Second, our recommendations to correct the problems identified and NTSB actions relative to those recommendations, and
- Finally, our findings in this matter illustrate the need for some type of institutional oversight within NTSB in order to provide the Chairman and the Board with independent reviews of NTSB's financial management programs and business operations. This capability presently does not exist.

In December 1997, we issued an audit report to the Federal Aviation Administration (FAA) regarding the closeout of its imprest fund, which included recommendations concerning third-party drafts. At that time, we recommended FAA limit its use of third-party drafts to exceptional circumstances. As a result of our work with the NTSB in this matter, we made follow-up inquiries about the continued use of third-party drafts in the Department of Transportation (DOT).

On March 30, 2000, DOT's Assistant Secretary for Budget and Programs issued a memorandum informing all DOT operating administrations that the use of third-party drafts will be discontinued by the end of Fiscal Year 2000. As originally designed, third-party draft programs once served a useful purpose by providing a payment mechanism for time-sensitive missions such as NTSB's. However, the Government's adoption of purchase and travel credit card programs has supplanted the need for third-party drafts.

INTERNAL CONTROLS WERE NOT OPERATING AS INTENDED

The Rapidraft Payment System was seriously mismanaged and subjected to embezzlement. During fiscal years (FY) 1997 through 1999, NTSB issued 26,097 Rapidrafts totaling $12.9 million. While intended "for accident and nonaccident investigation costs", Rapidrafts were predominately used to reimburse employees for non-accident related travel, pay tuition for training, make equipment purchases, and pay employees' salaries. Also, Rapidrafts were processed and paid when they exceeded the $2,500 limit, and employees "split" purchases to circumvent that limit and the Federal Acquisition Regulations.

The internal controls designed for the Rapidraft Payment System were not followed, resulting in numerous weaknesses that left the System inherently vulnerable to fraud, waste, and abuse. For example, Rapidraft stocks were not protected from unauthorized use, Rapidrafts were paid without the required signature or authorization number, and 37 of the 177 authorized users no longer worked for NTSB. Rapidrafts were also paid when the signatures of current and former employees were forged. The CFO's office did not review paid Rapidrafts or reconcile them with required supporting documentation to ensure payments were authorized and appropriate.

Our review of 1,000 Rapidrafts paid during FY 1999 showed that they frequently lacked supporting documentation. The lack of documentation precluded us from determining whether many of the payments were for legitimate NTSB purposes.

RAPIDRAFTS WERE USED IN VIOLATION OF NTSB POLICY

Contrary to NTSB policy, Rapidrafts were paid when they exceeded the $2,500 limit, and payments were split to circumvent acquisition regulations and the $2,500 limit. NTSB Order 1542 Section 5b(2) states "Rapidrafts are limited to a maximum of $2,500 per item/service." During FY 1999, the Rapidraft Payment System contractor processed 22 NTSB Rapidrafts that exceeded the $2,500 limit, including ones for $11,076 and $4,070. During a limited review of FY 1998 and FY 1997 Rapidrafts, we identified 107 and 49, respectively, that were processed for more than $2,500 including individual Rapidrafts as follows:

- $28,532 for hotel services;
- $24,461, $20,000, and $13,357 for building renovations (FY 1997);
- $16,404, $10,000, and $7,890 for building renovations (FY 1998); and
- $5,795 for telephone service.

Also, NTSB Order 1542 Section 5b(3) notes "A paid Rapidraft does not eliminate or mitigate . . . the prohibition against subdividing foreseeable purchases, merely to use simplified procedures." However, NTSB employees—including the former CFO—were "splitting" payments using multiple Rapidrafts to divide a purchase that exceeds the government's $2500 micropurchase ceiling into a series of separate, smaller purchases in order to circumvent the ceiling, a violation of Federal Acquisition Regulations and NTSB Order. For example, one employee wrote three Rapidrafts totaling $4,649 to the same payee on 1 day for computer equipment.

Internal controls were not sufficient to protect the System from fraud, waste, and abuse. Although some controls existed on paper, the controls were not followed. Also, NTSB staff were not trained in the proper use of Rapidrafts (NTSB Order 1542, Section 5a) or the penalties for misuse (NTSB Order 1542, Section 7a).

NTSB Order 1542 prescribes internal control procedures for Rapidrafts, including segregation of duties, limitations on use, requirements for supporting documentation, and guidance on safeguarding the Rapidrafts. For example, Section 6d states "If the Rapidrafts do not meet certain pre-established criteria, [the contractor] will reject them for payment. The amount may not exceed $2,500. The signature appearing on the Rapidraft must be an authorized employee, and the authorization number must match the one assigned to that employee."

However, the internal control procedures were not followed by NTSB and the contractor. Specific weaknesses OIG identified include:

• Rapidrafts were paid without the required signature or authorization number.

• Rapidrafts were paid without the required supporting documentation.

• The contractor was not notified that 37 of the 177 authorized users had left NTSB.

• Employees leaving NTSB were not required to turn in unused Rapidrafts and many did not.

• Employees ordered and received blank Rapidrafts from the contractor without management approval or knowledge.

• NTSB management did not track how many Rapidrafts were issued to employees.

• Rapidrafts were not kept in secure locations at NTSB.

• As a matter of practice, paid Rapidrafts (forwarded by the contractor to NTSB, similar to a bank's return of canceled checks to a customer) were neither reviewed nor reconciled by NTSB.

Our sample of 1,000 Rapidrafts from the 7,749 paid during the first 11 months of FY 1999 showed that 902 Rapidrafts (90 percent) were noncompliant with NTSB internal controls. For example, 678 Rapidrafts (68 percent) did not contain the required explanation of the purpose for the check. Also, 222 Rapidrafts (22 percent) were processed and paid even though they did not include the required authorization number. Additionally, 52 Rapidrafts contained more than one deficiency such as no signature on the check and no explanation of the purpose for the check. While the contractor should not have paid Rapidrafts without signatures or authorization numbers, NTSB officials did nothing to check the contractor's actions or processes.

Specific examples of Rapidrafts issued and transacted in violation of the usage procedures are as follows:

• In August 1998, a $1,416 Rapidraft bearing no authorizing signature was issued and subsequently negotiated.

• In November 1998, a $2,150 Rapidraft for which no payee was listed was issued and later negotiated.

Further, canceled Rapidrafts were not reviewed or reconciled with supporting documentation to verify that the payments were for legitimate products or services, and that the transacting employee was authorized to make the payment. Bundles of paid Rapidrafts from the contractor were stored unopened, and the CFO's office did not compare them against supporting documentation.

The CFO's office only compared a listing of check numbers and dollar amounts on the contractor's bill with check numbers and amounts entered into the accounting system by employees who issued the Rapidrafts. If there was a match, NTSB paid the bill without question. Reconciling Rapidrafts to the supporting documentation is an important control mechanism because it provides independent assurance that payments and purchases are authorized and appropriate.

CONTROL WEAKNESSES WERE PREVIOUSLY IDENTIFIED

Weaknesses in internal controls for the Rapidraft Payment System were identified on at least two previous occasions. A 1992 audit report by the General Services Administration's (GSA) Inspector General on NTSB's travel procedures and practices identified internal control weaknesses in the use of Rapidrafts. Also, staff began raising concerns to the NTSB CFO in early 1999 that internal controls were not being implemented.

The GSA Inspector General concluded that Rapidrafts were not properly safeguarded and were improperly used. Specifically, the GSA Inspector General's report noted that investigators or their supervisors were routinely issuing Rapidrafts for travel advance purposes even though they were not authorized to do so. The report also noted that subordinates issued Rapidrafts to their supervisors for travel purposes. The GSA Inspector General noted that these practices were of particular concern because they circumvented a fundamental control—separation of duties.

The then-Comptroller (former CFO) responded to the report outlining planned corrective actions to be taken, including issuing a memorandum to all employees on authorized uses and safeguarding of Rapidrafts. Based on our work, corrective actions were either never implemented or sustained because we identified the same weaknesses as the GSA Inspector General.

Also, in January 1999, CFO staff began raising concerns to the CFO that Rapidraft users were not complying with internal control requirements. Specifically, CFO staff noted that Rapidraft users were not submitting required supporting documentation for purchases and not entering required data into the accounting system. When these concerns were ultimately raised to and reviewed by senior managers outside of the CFO's office, instances of embezzlement were uncovered. Further, we found that in January 1999, NTSB personnel in the office of the CFO alerted the former CFO to irregularities involving the use of Rapidrafts by the former Headquarters employee who has since been charged with theft. Yet the CFO did not take timely or adequate action and, in the next 8 months, until the Headquarters employee resigned in August 1999, this employee embezzled approximately 34 Rapidrafts totaling $30,000. The CFO resigned effective November 29, 1999, after our investigation was commenced.

RAPIDRAFTS WERE EXPLOITED IN TWO KNOWN EMBEZZLEMENTS

In the end, the lack of adherence to internal controls subjected NTSB to separate known embezzlements by two employees. We investigated a former GS–7 employee in the Atlanta field office of the NTSB suspected of embezzling approximately $20,000. The employee resigned in July 1999. Investigation disclosed that between October 1998 and June 1999, the employee embezzled money from NTSB by writing Rapidrafts to employees of NTSB and then fraudulently endorsing the Rapidrafts to herself. The employee then deposited the Rapidrafts into a personal bank account. On April 4, 2000, the employee was indicted by a Federal grand jury in Atlanta, charged with seven counts of theft.

We also investigated a former GS–8 employee of the NTSB Headquarters staff who resigned in August 1999. On April 11, 2000, the former employee was charged in a one-count felony Information by the U.S. Attorney's Office for the District of Columbia for embezzling approximately $74,000 between September 1997 and August 1999, by fraudulently writing 97 Rapidrafts to herself using the signature authority of a former NTSB employee and then cashing the majority of these Rapidrafts at a local liquor store. The Headquarters employee knew that once cashed, the canceled Rapidrafts were not reviewed by NTSB for purposes of reconciliation.

IG RECOMMENDATIONS AND NTSB CORRECTIVE ACTION

On October 26, 1999, we met with Chairman Hall and senior NTSB staff to discuss our audit results and preliminary investigative findings. On November 8, 1999, we issued an audit report to the NTSB that recommended NTSB discontinue the use of the Rapidraft System and instead use the Governmentwide commercial purchase card program for its on-site investigative expenses and other purchases. We recommended that NTSB discontinue processing employee travel claims and instead use a Federal processor for reimbursement of travel claims to ensure that proper voucher examination is performed.

By letter dated November 5, 1999, we notified the NTSB of our preliminary investigative results. Subsequently, on March 21, 2000, we issued a final investigative report to the NTSB. Our investigative report supported the earlier recommendations of the audit and recommended that NTSB consider disciplinary action for employees as appropriate.

The NTSB generally concurred with our recommendations. By letter dated November 23, 1999, Chairman Hall responded that NTSB had discontinued the Rapidraft System and adopted the Governmentwide Citibank Purchase card Program in its place. The Chairman also reported that NTSB had commenced discussions with a private sector audit firm for assistance in identifying audit weaknesses and recommending procedures and resources for improved audit control. We were recently informed that such a contract has been executed and that an audit will begin in the near future.

On January 3, 2000, the NTSB appointed a new CFO. The new CFO was hired from the U.S. Treasury Department and has 35 years of Federal service in the field of financial management. We have met with the new CFO several times to review our audit and investigative results. He has identified and initiated specific actions necessary to implement our recommendations, but his efforts require the full support of the NTSB Board and senior staff if he is to succeed in reforming and improving the financial management of the NTSB.

NEED FOR INSTITUTIONAL OVERSIGHT WITHIN THE NTSB

To his credit, NTSB Chairman Hall promptly sought our assistance in this matter. It was necessary for the Chairman to seek outside assistance because the NTSB is without an Inspector General or an equivalent institutional oversight organization. The NTSB has historically relied on agreements with other Inspectors General or private sector firms for audit assistance. Outside oversight has included General Accounting Office audits and congressional oversight exercised through the authorizing and appropriations process.

There is no full-time oversight of NTSB. Our work with respect to the Rapidraft System was carried out in accordance with an August 31, 1999, Memorandum of Understanding (MOU) between our office and the NTSB. The MOU allows for our office to conduct investigations and audits at the request of the NTSB on a reimbursable basis. It does not provide authority for us to self-initiate audits or investigations as we do for the Department of Transportation, nor does it authorize, or create a responsibility for us to ascertain whether or not NTSB implemented the corrective actions discussed with us. As you are aware, such follow-up is critical to oversight. For example, as noted above, the GSA IG was not in a position to follow up on its 1992 audit results. If NTSB had been subject to some type of institutional oversight, it is possible that the 1992 audit would have resulted in real corrective action and the problems uncovered in 1999 may have been avoided.

Similarly, if the NTSB had an institutional oversight organization, the employees who reported irregularities to the CFO in January 1999 would have had an in-house channel to pursue when they did not see action on the part of the CFO in response to their reports of irregularities. At the Department of Transportation, we receive approximately 600 telephone calls, letters, and E-mail messages a year reporting suspected fraud, waste and abuse within the Department. Our fraud, waste and abuse Hotline offers employees confidentiality or the opportunity to provide information anonymously. Reports to our Hotline receive independent attention from our staff and are also shared with the Department management. For management, they serve as a useful source of information about programs and operations in the Department that, at a minimum, require management attention. The NTSB does not have a vehicle similar to our Hotline to ensure an independent review of suspected fraud, waste and abuse.

"The National Transportation Safety Board Amendments Act of 1999," (H.R.2910) was passed by the House on October 1, 1999. The legislation reauthorizes the NTSB and also contains provisions that address Inspector General oversight at the NTSB. The bill provides that the Inspector General at the Department of Transportation will carry out Inspector General responsibilities only with respect to the financial management and business operations of the NTSB. While we did not seek this additional responsibility, we concur that our audit and investigation concerning the NTSB's Rapidraft System strongly suggests that some type of institutional oversight is appropriate. The Senate is considering similar provisions as part of its reauthorization legislation for the NTSB.

Mr. Chairman, this concludes our testimony. I would be happy to answer any questions you may have.

Mr. SUNUNU. Welcome, Mr. Hall. We're pleased to hear your testimony.

STATEMENT OF JAMES E. HALL

Mr. HALL. Thank you very much, Mr. Chairman, Congressman Bentsen, members of the committee.

I was invited to appear before you today regarding the National Transportation Safety Board's request for an audit and investigation by the Department of Transportation's Inspector General regarding financial discrepancies found during an August 1999 document reconciliation in preparation for our end-of-year financial closeout. I have brought with me today our Managing Director, Dan Campbell; our General Counsel, Ron Battocchi; and our Chief Financial Officer, Mitch Levine, who will be available to be responsive to any questions the committee may have as well.

Before I begin, permit me, Mr. Chairman, to spend just a few moments on the NTSB and its mission. Since Congress created it as an independent agency in 1967, the Safety Board has served as the eyes and ears of the American people at more than 100,000 aviation accidents and thousands of surface transportation accidents. Over time, it has become one of the Board's premiere accident investigation agencies. In fact, it is only one of nine independent investigative organizations in the world.

Perhaps more importantly, as part of our investigations we make safety recommendations that we hope will prevent similar accidents from recurring. In its 33-year history, the Board has issued almost 11,000 recommendations in all transportation modes to more than 1,250 recipients. In 1990, we began compiling the "most wanted list" that highlights some of what we considered to be our most important but not yet implemented recommendations and covers concerns such as data recorders in all transport vehicles, aircraft icing, fuel tank flammability and human fatigue.

It is important to note that, because the Board does not have regulatory or enforcement powers, we rely on our reputation for impartiality and thoroughness to get our recommendations implemented. To date, more than 80 percent have been adopted. Many safety features currently incorporated into airplanes, automobiles, trains, pipelines and marine vessels have had their genesis in Safety Board recommendations; and over the years Board recommendations on ground proximity warning systems, windshear, crew resource management, railroad passenger safety, drunk driving, seat belts, child safety seats, graduated licensing and emergency response to hazardous material substances have been implemented. At an annual cost of less than 20 cents a citizen, the 400-member Safety Board I believe is one of the best investments this Congress makes.

My testimony submitted for the record details the series of events that led up to the August 1999 discovery. Today, I would like to focus on what actions have occurred since I requested Mr. Mead's assistance.

I would, however, like to emphasize several facts. NTSB staff discovered the discrepancies and notified me of the findings. Because I was concerned about this compromise to our agency's financial integrity and our reputation, I immediately requested the Department of Transportation Inspector General to perform an audit and criminal investigation to determine if our concerns were valid and whether there were any additional problems even though, as previously mentioned, the IG had no jurisdiction over the agency. The NTSB staff and leadership cooperated fully throughout the IG's audit and investigation. We were already taking corrective actions before the IG completed their work, and we kept our appropriating and authorizing committees fully informed throughout the investigation.

I asked the IG to look at three areas during their audit and investigation. Was there criminal conduct by any NTSB employee? Were there systemic problems with the Rapidraft program? And were there sufficient financial controls for small purchases?

Mr. Mead and his staff responded to my request quickly and very effectively. He sent a full team of auditors and investigators who devoted 3 months to the audit and 7 months to the investigation. The IG's audit did conclude that there were weaknesses in our internal controls and that existing controls were not followed.

The report made three recommendations: to discontinue the Rapidraft Payment System immediately; to implement an approved payment program to meet NTSB's needs; and, third, to ensure that the Chief Financial Officer's Office develops and implements comprehensive internal controls.

I terminated the Rapidraft system even before I received the IG's preliminary report in October 1999, based on an oral briefing from the Inspector General and his staff. Following that report, we took a series of additional actions. I placed the Chief Financial Officer on administrative leave. In January 2000, I hired a new Chief Financial Officer, Mr. Mitch Levine who is with us today, who has 35 years of Federal financial management service.

We are currently recruiting to fill vacancies in accounting operations and system accounting. We implemented governmentwide commercial credit card programs for travel expenses and small purchases. Travel vouchers and purchase card bills are now paid through the Treasury Department Disbursing Centers.

And we selected an independent audit firm, PriceWaterhouse-Coopers, which began work yesterday to develop a program for comprehensive financial integrity. As part of their audit, they will conduct a closeout review of the Rapidraft Payment System; document NTSB's financial management processes and systems; perform a baseline analysis of existing financial policies, procedures and systems; test internal controls; develop internal control recommendations; and assess our audit readiness.

We received the Inspector General's investigative report on March 21st. It did not find any additional criminal activity beyond that already found by the NTSB. It concluded that the two previously identified employees had embezzled about $95,000. Both employees have left the NTSB. I have been advised that one has been indicted by a grand jury and the other is pleading guilty for criminal acts involving embezzlement and that restitution to the American people will be sought.

Let me close, Mr. Chairman and members of this committee, by saying to you that I take this situation very seriously, and it is the most deeply troubling experience I have had in all my years of public service. It has unduly impugned the reputation of this agency and its dedicated employees.

This has been an especially difficult time for the Board's employees, and it has been a distraction from our mission. As you may know, while we have been managing this event, we have had to deal with both the Egyptair and Alaska Air investigations.

We are taking, Mr. Chairman, every action necessary to ensure that these deficiencies are rectified and procedures are put in place to ensure that they do not recur. I give my this committee my pledge that will be done.

Now, I fully support independent oversight of the Board's operations on a regular basis. In fact, that concerned me most when I became chairman of this agency, and I was trying to move in the that direction at the time these events occurred.

I want to publicly express my appreciation to Mr. Mead and his staff, and to thank them for assisting us in this task.

Mr. Chairman, I appreciate your attention and the attention and time the committee staff and you and the members have given me. That completes my statement.

Mr. SUNUNU. Thank you very much, Chairman Hall. I appreciate your statement and its candor and certainly want to invite Mr. Levine and Mr. Campbell to assist you as we go through the questioning process with any details that might be helpful.

[The prepared statement of Mr. Hall follows:]

PREPARED STATEMENT OF JIM HALL, CHAIRMAN, NATIONAL TRANSPORTATION SAFETY BOARD

Good morning, Chairman Sununu and Members of the Task Force. I was invited to appear before you today regarding an audit and an investigation that the National Transportation Safety Board (NTSB) requested from the Department of Transportation's Inspector General (IG). In August 1999, as the NTSB's staff was engaged in reconciling documents to close our books for the fiscal year, financial discrepancies were found and brought to my attention. I promptly called Inspector General Mead and asked for a full and independent investigation.

Before turning to the circumstances of that request, I would like to put the problems we discovered in our program for Rapidraft payments program in context. I became Chairman of NTSB in October 1994, and inherited a financial accounting system and organization that had been in place for many years and had not been modernized with automated information capabilities. Weaknesses in its utility for budgeting purposes were apparent, and after preparation of budgets for 1996, I asked senior managers at NTSB to rethink our finance and budget process to make recommendations to improve our performance. Staff reviewed the provisions of the Chief Financial Officer Act, which, although it does not apply by its own terms to a small agency such as NTSB, appeared to reflect a "best practice" approach to financial operations. As a consequence of this review, in February 1997, I requested the Department of Treasury's Financial Management Service (FMS) to do a top-to-bottom evaluation of the finance accounting system that had been in place at NTSB for more than a decade. The cost for this service was $55,000, not insignificant for NTSB, but we believed that modernization was critical.

NTSB received FMS's initial report in June 1997. The report found that the existing accounting system was insufficient to support modernized accounting practices. It recommended that we acquire a new accounting system. We contracted again with FMS for assistance in selection of such a system. This resulted in the purchase of an off-the-shelf, Joint-Financial-Management-Improvement-Program (JFMIP) compliant accounting program. The FMS report also recommended that we target October 1, 1998, as the date for changeover to a new system. We met that date, and began use of an entirely new, modern system for fiscal year 1999. Achieving this target placed a substantial workload on the accounting staff, but we believed it was a critical first step in permitting us to achieve a clean audit opinion on NTSB's financial statements. The goal of a clean audit was a key recommendation of FMS and is a central concept embodied in the Chief Financial Officer Act. I wholeheartedly agreed with this approach.

I concurrently elevated the organizational structure of the comptroller's function to independent office status, headed for the first time by a Senior Executive level official, also as recommended by the FMS report and the Chief Financial Officer Act. And we undertook intensive training of administrative staff in the program offices, in order to use the new accounting system to its full potential. We knew that the total process of modernization and information integration would take several years. However, by the middle of 1999, we were in the midst of a substantial revision in our financial processes, with the goal of meeting financial accounting practices at a level not yet, even today, required of us.

DISCOVERY OF EMBEZZLEMENT

From April 1989 until August 1999, Safety Board offices used what was for a time a governmentwide, GSA-approved Rapidraft payment system. Rapidraft is a service offered by a commercial vendor that enables a government employee to write checks to pay for goods and services. NTSB Board Order 46A, issued in October 1990, established the Rapidraft program for payment of small purchases, travel advances, travel expenses, training registration, and other services. Proper reconciliation of accounts within the program was a shared function between program offices and the financial specialists within what is now organized as the Office of Chief Financial Officer (CFO). In August 1999, during reviews to prepare for the fiscal year-end closeout, a highway safety program officer asked for assistance from the CFO office in reconciling records discrepancies concerning a particular Rapidraft payment. That meeting triggered further analysis, and the subsequent review identified suspect behavior on the part of two NTSB employees concerning possible embezzlement. Approximately $95,000 appeared to be at issue.

NTSB'S REQUEST TO IG FOR AUDIT AND INVESTIGATION

NTSB has traditionally used the services of outside, independent auditors to assess financial management issues. In this instance, I asked DOT IG if it would conduct an audit and a criminal inquiry. The IG does not have jurisdiction over the NTSB. However, NTSB has the authority to use the services of other Federal agencies and has used the services of other IGs in the past. We were in the process of finalizing a new voluntary audit agreement with the DOT IG when the discrepancies were uncovered. We believed that an IG, with the ability to simultaneously pursue a financial audit and a criminal investigation, was especially well suited to assist us. Consequently, we broadened the scope of our pending agreement to include criminal investigations and requested the DOT IG commence an immediate two-pronged review of the problem we had uncovered. Staff and management were instructed to cooperate fully with the work of the IG. NTSB (with DOT IG participation) briefed its Congressional authorizing and appropriating committees on the problems identified and the initiation of work by the DOT IG. The concerns shared with the Inspector General were:

- Was there criminal conduct by any NTSB employee? (criminal investigation)
- Were there systemic problems with the Rapidraft program? (audit)
- Are there sufficient financial controls for small purchases? (audit)

The IG completed its audit work and briefed top NTSB management on its results on October 26, 1999, and their final report was delivered on November 8, 1999. In addition, the IG periodically shared information on the progress of their criminal investigation, and delivered the results of that investigation on March 21, 2000.

IG AUDIT AND INVESTIGATION REPORT RECOMMENDATIONS

The IG's audit report concluded that there were weaknesses in internal controls, and that existing controls were not followed. The report made the following three recommendations:

1. Discontinue use of the Rapidraft Payment System immediately.
2. Implement an approved payment program to meet NTSB needs, specifically for:

- On-site investigative expenses, office supplies, computer equipment, tuition and training payments, and other similar expenses, NTSB should use the Governmentwide Commercial Purchase Card Program.
- And, travel-related reimbursements, NTSB should use the same organization that currently provides their payroll services (FAA) or another Federal processor.

3. Ensure that the CFO's office develops and implements comprehensive internal controls over these programs.

The IG investigative report concluded that there was criminal activity on the part of the two employees that were originally referred by the NTSB.[1] No other embezzlements were uncovered by the IG. Criminal enforcement is ongoing and restitution will be pursued. In addition, the report recommended administrative action be considered for certain irregularities concerning use of agency e-mail, and that NTSB ensure proper procedures for the acquisition of small purchases, the payment of performance bonuses only within the payroll process, and adherence to government regulations regarding the use of frequent flyer mileage upgrades.

NTSB ACTIONS TAKEN AND PLANNED

In September 1999, NTSB terminated the Rapidraft Payment System. After receiving the October 26 briefing on this subject, the then incumbent CFO was placed on administrative leave. In January 2000, a new CFO with 35 years of Federal financial management service was hired. Recruitments are underway to fill additional vacancies in accounting operations and system accounting. After the new CFO familiarized himself with the circumstances of DOT IG's work, a series of briefings were undertaken with NTSB's authorizing and appropriating committees of Congress concerning the results of the IG's work and our responses. The NTSB has initiated implementation of all the IG Audit Report's recommendations.

1. Rapidraft Payment System has been canceled.
2. Governmentwide commercial credit card programs have been implemented for travel expenses and small purchases. Travel vouchers and purchase card bills are being paid through Treasury Department Disbursing Centers.

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[1] Both employees identified by NTSB resigned from the agency prior to investigation by DOT IG and the Federal Bureau of Investigation.

3. An independent audit firm (PriceWaterhouseCoopers) has been selected to develop a program for comprehensive financial integrity.[2] PriceWaterhouseCoopers will perform the following tasks:

- Conduct a closeout review of the Rapidraft Payment System;
- Document NTSB's financial management processes and systems;
- Perform a baseline analysis of existing financial polices, procedures and systems;
- Test internal controls;
- Develop internal control recommendations; and
- Assess audit readiness.

As I noted, the IG's report on the investigation was received at the Board on March 21, 2000, and we are currently preparing an action plan that will address all stated recommendations. As a result of the IG's work, we understand that one of the two clerical employees originally referred to the IG by NTSB has been indicted, and the other is pleading guilty for criminal acts involving embezzlement.

I would like to close by indicating NTSB's appreciation for the work of Ken Mead and members of his staff. This has obviously been a difficult time for NTSB, but as an institution we strongly favor having the ability to resort to independent, expert assistance as a means of quality assurance and improved performance. We would like to thank the DOT IG for providing that service to us in this case. Mr. Chairman, that completes my statement and I will be happy to respond to questions.

Mr. SUNUNU. I would like to begin the questioning by discussing the 1997 Treasury FMS recommendations and the changes that were recommended as part of that process. And also I know there were some controls, control changes recommended as part of the Inspector General's audit. Could I ask you to talk about those changes? Specifically, has the new system for financial control been implemented, what elements are in place and working, and what elements are yet to be implemented?

Mr. HALL. I think the person with the most knowledge to respond to that is our CFO, Mr. Levine.

Mr. LEVINE. This is history, Mr. Chairman, so I am looking back at a time when I wasn't at the Board. The Board selected the new accounting system based on work done by the Center for Applied Financial Management, which is a Treasury entity that they brought in to look at their old financial system. They concluded that in order to comply with most of the government regulations dealing with financial management and the plethora of laws that have been enacted by the Congress, we needed to move to an integrated financial management system that was approved by the Joint Financial Management Improvement Program and certified by the General Services Administration.

NTSB selected a system with an assistance from the same consulting group from Treasury. A system was selected. The vendor is ICF Kaiser, it is called FINASST. That system recently was again recertified through independent testing by the Joint Financial Management Improvement Program as a system that complies with the core financial requirements that are set by JFMIP and GSA.

Mr. SUNUNU. If I may, you are not required, though, by law to comply with the Chief Financial Officer's Act, is that correct?

Mr. LEVINE. I have to defer to the Chief Counsel or the Managing Director on that.

Mr. HALL. No, we are not.

[2] A copy of the PriceWaterhouseCoopers proposal, and the Board's acceptance letter, were provided to the Committee. PriceWaterhouseCoopers began their audit activity on April 12, 2000, and we expect the review to take about 4 months.

Mr. SUNUNU. I don't believe that is the case.

So, to be clear, you are setting—as a set of compliance standards you are using the Joint Financial Management Improvement Program. Are you required to meet that standard by law or that is the one that you chose as a best practice model?

Mr. CAMPBELL. There are elements within it that we would be required to meet. We intend to meet all the elements, because we do see it as a best practice approach.

Mr. SUNUNU. And have all of the elements been implemented to date that enable you to meet those standards? And, if not, what system needs to be implemented to meet the standards you have established for yourselves?

Mr. LEVINE. The system is the accounting system of record, and was the accounting system of record for all of fiscal 1999. It is the system we are using to account for the fiscal year 2000 appropriation. It meets all the accounting standards. Where we find it lacking is we need to better improve the financial management information reporting capabilities of the system. I look at it as a powerful data warehouse, but somehow we don't have a key to opening all the doors.

Basically, we can do the obligation accounting, the expenditure accounting, all the things required to make Treasury reporting, but we do not have all the capabilities we need to provide information to the executives and the managers of the NTSB to manage their resources as effectively as they could.

Mr. SUNUNU. Have you set a time line for achieving those goals of providing the Board with executive financial management information?

Mr. LEVINE. This year we are working with our vendor to develop scripted management reports that we can put on the desktops of our managers so they can click on an icon and get the kind of management information they need.

We are working with the different managers and the administrative officers to determine what is needed. In other words, we are not just pushing it, we are trying to work with them as if they are customers, which they are.

Through the remainder of FY 2000 and into FY 2001, we plan to invest about $100,000 to $150,000 more for necessary system enhancements. We are also hiring an additional systems accountant to help us roll this out.

Mr. SUNUNU. Let me ask you specifically about the disbursement system that is, I hope, fully in place fully now to replace the Rapidraft system. You have gone to a commercial credit card system, is that correct, the governmentwide credit card system?

Mr. LEVINE. Yes, the Board, long before I got here, implemented both the Citibank travel card and the Citibank purchase card programs. We have issued more than 350 travel cards to our investigators and employees who travel. We have also issued over 100 purchase cards to our investigators and others with procurement responsibilities.

Mr. SUNUNU. Do you have documentation requirements that are more formal than what was used in the past? And are you performing—I should ask, how frequently are you performing reconciliation on those credit card accounts?

Mr. LEVINE. The personal travel cards are like your own personal card. When Chairman Hall or Dan Campbell travel, or whatever, the price of the airline ticket is put on the card through our approved travel agency. All travel expenses are placed on the card. When we return, we file a travel voucher. That travel voucher comes to the CFO organization and is reviewed and processed.

I am concerned because I don't believe the review is sufficient. One of the things that Ken Mead reported in his audit report was that we needed to look to a third-party processor. We are in negotiations with the Department of Veterans' Affairs to implement a travel voucher processing system where they will review and pay our vouchers and conduct post audits.

My intent is to also have DVA perform a post audit on a sample of FY 2000 vouchers.

Mr. SUNUNU. Mr. Mead, I want to ask you a couple of questions about the Rapidraft system in general before opening it up to Mr. Bentsen for questions. Could you talk a little bit about the degree to which the Rapidraft system was used in other departments within agencies within the Department of Transportation, the volume of Rapidrafts that were previously used by the FAA, for example, prior to canceling their program?

Mr. MEAD. Yes. The FAA this past year spent about $14 million using a like system.

Mr. SUNUNU. Conceptually, at least, the subcontractor—third-party subcontractor—was the same Gelco, and the contractual limitations, $2,500 maximum and authorization number requirements were similar, is that correct?

Mr. MEAD. Yes. But the fact is, we went in and audited the FAA system in 1997. Although we found no embezzlements, we did find weaknesses that were remarkably comparable to the ones that we found at NTSB, unauthorized signatures and so forth. And we recommended that—at the time, that FAA tighten up that program.

We could understand how there might be exigent circumstances or emergencies where you needed it. I don't think that they fully responded to the recommendations. As a result of the experience at NTSB and that prior audit work that program must be terminated.

The Volpe Center is in Massachusetts, the research center. They, too, were using the like system, as was the Federal Highway Administration.

Mr. SUNUNU. Now, there are 10 other Federal departments or agencies that are using a similar third-party payment system through the same subcontractor; and another six we have identified that are using a different third-party draft system. I understand that you don't know all of the limitations associated with each of the contracts, but I do want to ask you a general question which is, do you believe that the weaknesses you have identified in the nature of a third-party check writing system, in particular the system that was used through this subcontractor, do you think those weaknesses are likely to exist at other agencies—Department of Education, Department of Energy, Immigration? Do you think it is in the interest of the committee at least to raise your concerns about the weaknesses of the system with these other agencies?

Mr. MEAD. Yes, I would. I would be surprised if you didn't find weaknesses, at least to some degree. And here is why: When you just talk NTSB, which is a small agency cashing approximately 8,000 checks a year worth about $4 million, it is a very paper-intensive system. And when you have holes that turn up where there is no reconciliation, where checks are being paid and nobody is even signing the check, where there is no payee, where there is no purpose on the check, you have to have a very rigorous oversight system to make sure that a check writing program, is going to be airtight. And that is tough. In fact, that is why the Federal Government moved to credit cards. It is much tighter accounting system.

Mr. SUNUNU. Thank you.

One final question for Chairman Hall, and that is—and Mr. Levine as well—as you move through this credit card system, have you found that there is anything unique regarding the NTSB's critical mission that in certain cases might make the commercial or government credit card system impractical and do you think there may be situations in some of these other agencies that would somehow prevent them from ever implementing a government credit card system if they chose?

Mr. HALL. I am not aware of any. My answer would be no.

Mr. SUNUNU. Thank you.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Let me say, first of all, Mr. Mead, with respect to the chairman's most—his line of questioning there that, on its face, I think the credit card system clearly works better than a Rapidraft. And it is an antiquated type structure to use and does raise the potential, if not for abuse, the potential for sloppy recordkeeping, if nothing else.

I have yet in my experience in the private sector or the public sector found an expense reimbursement system that has been smooth and clean. I know in my old banking days we always wondered whether the company was carrying us or we were carrying the company. I am sure that is sometimes the case here as well.

That being said, obviously the system has some problems; and I do have a number of questions. Let me go to the chairman's last question, though.

Mr. Hall, I can see certainly in most cases where you are buying an airline ticket, charging a hotel room, that the credit card system works pretty well. In fact, in some cases you couldn't do it without a credit card. But are there instances that you could explain to us in the—where in the case of NTSB, which is a somewhat unique agency, where a credit card system might not work? I don't think we want to have Federal employees walking around with a pocketful of cash, but there are cases where you are on the ground that you have to have something a little more liquid than a credit card.

Mr. HALL. Well, I might ask Mr. Campbell to comment on this as well. He has more years of experience than I do in this area, Congressman.

In the aviation area, our investigators operate sort of the highway patrol of the skies. Every time there is a fatal aviation accident, we have an investigator there. They have to take charge of that wreckage. They have to be responsible for assisting with the wreckage removal, with the engine tear downs, other things that are routinely done as part of the investigation. Obviously, to be able to pay for those things is very important.

On major accident investigations, it is hard to anticipate in advance things that you may be called upon to do.

The credit card system, to my knowledge, so far has served us fairly well.

Mr. Levine wanted to comment. Somebody over was there was rustling.

Mr. LEVINE. Congressman Bentsen, the credit card contract permits the use of convenience checks to handle situations where credit cards are not accepted by a vendor.

Convenience checks are set up for unique situations. Let me give you some examples. Convenience checks are limited to investigators in charge at an investigation, and a handful of others.

NTSB often has to take custody of wreckage or equipment and often needs to buy services from the local economy. For example, the local police department may moonlight and be willing to provide protection of that material overnight. Last I heard, off-duty policemen don't take credit cards. The convenience check program is one way we can handle that.

It is also possible for our people to get cash advances from their travel card from an ATM machine. They can take these funds and then seek reimbursement through proper channels when they come back to their duty station.

So there are a few cases where the credit card just doesn't work, and the contract with Citibank which GSA negotiated for all of government does provide for that. We have limited the utilization of the convenience checks, and very few of them have been used. We have very bright people doing this work. They know how to get it done.

Mr. BENTSEN. Let me ask just a few other questions. With respect to the Financial Management Service Review in 1997, there were a number of recommendations in that report. Some included adding budget officers and staff, implementing new systems technology for management—for financial management. The agency didn't follow through on all those. Were there budgetary reasons related to that? In the scheme of your agency that you all go from one emergency to the next emergency?

Mr. HALL. The last 10 years almost any mode of transportation in the United States doubled. As a result, there has been a tremendous impact on the work of our agency and the number of employees we need to accomplish our mission at a time when everyone else in Washington is basically downsizing.

I have requested every year I have been chairman more people in my budget. And our committees of Congress normally, usually over the objection of the Office of Management and Budget, have assisted us in getting more people. In retrospect, we took most of those additional people and placed them in investigative positions in order to accomplish the mission. And I did not, at the same time, put enough people in our accounting and budget office to perform the mission of the additional amount of money that we were using.

We will have additional employees in the new fiscal year. Many times, I find those employees are tied by OMB or Congress to specific slots. I have difficulty getting money to fund accountants. I am going to take the first people we get and be sure that we have enough people to be responsible stewards of the money we are given.

So that is a long answer of saying I think, yes, we have had some difficulties in being able to accomplish everything that we wanted to do because of manpower limitations.

Mr. MEAD. My I offer a perspective on that?

I think in this case, as in the case in many situations in government and private industry, the leadership and stewardship of the people you have in place is critical. And here, as is illustrated by the experience with the Rapidraft system, there were plenty of early warning signs given directly to the Chief Financial Officer. And they were not acted on. And I think with the new leadership in place, that you should see a strong improvement.

Mr. BENTSEN. This reminds me a little bit of graduate school. This is going to be a great case study some time.

Mr. Mead, two things. One is, as I understand it, H.R. 2910, the NTSB reauthorization that passed last year now does give you authority to look at NTSB?

Mr. MEAD. Yes, sir, on rather nonjudgmental financial management areas only. And I think it would be inappropriate to have the Inspector General for the Department of Transportation in a position to second guess programmatic judgments or investigative judgments of the NTSB. So, yes, that is in the bill. It has passed. It hasn't moved through the Senate yet, and we are prepared to do it if the Congress wants us to, but we don't want authority into the programmatic areas.

Mr. BENTSEN. So you want to limit it to the financial scope.

Mr. MEAD. Keep it clean, rules and regulations, internal controls that reasonable people can agree upon and you can empirically audit.

Mr. BENTSEN. That would solve that part of the problem in your testimony.

Mr. MEAD. Yes, it would.

Mr. BENTSEN. In your investigation and in the investigation that was carried out that Justice is now involved in with the two individuals that have been indicted, is the loss to the government, the taxpayers, the fraud or theft limited to the two payments, the $90,000? Did you find any overpayment of a contractor? Or was it a case of inefficient bookkeeping, recordkeeping, questionable use of using the Rapidraft Payment System for paying accounts that probably should have been paid out of another vouchering system? Or have you found a situation where there might be other, higher dollar misuse of funds?

And I know there is a difference of agreement with respect to Board orders in 1992 and 1995 as to what areas are covered, and we could get into that debate. But I guess my question is, bottom line, other than lax controls and using the Rapidraft system for vouchers that other systems should have been used for, did you find other cases where Acme Trucking Corp. was paid more money than it should have been paid or anything like that?

Mr. MEAD. We do not know of any embezzlements other than the one that we have reported to you. I would be surprised if there were not other instances of abuse of this system, but they would be very difficult to track down. Why? Well, when nobody signs the check and it is paid or there is no purpose and no documentation underlying it, it is difficult to tell what the purpose was for or whether it was for a legitimate expense.

I think the fair answer to your question is that the vast majority of these checks were probably written by upstanding people for legitimate purposes. Where there were weaknesses was in internal controls and so forth, and sloppiness. But I can't vouch that we have uncovered all the abuse in this program.

Mr. BENTSEN. I assume the PriceWaterhouseCoopers audit should show some of that.

You raised one issue that I hadn't thought about, and my time is up, but the way this system works is there is a contractor who is the bank account holder on behalf of the agency, and the check is written and passed through them. But they cleared checks without a signature?

Mr. MEAD. Yes, sir. Do you see this package here? When we went to NTSB when Chairman Hall said come on in here and investigate and audit, we said, let's see the checks. And my auditors picked up unopened packages of checks that had been sent to NTSB's Chief Financial Officer unopened, bundles of them. Well, under the contract——

Mr. BENTSEN. Canceled checks.

Mr. MEAD. Oh, yes. These are all paid, and it was never opened by anybody, so there was never any reconciliation done. And under the terms of the contract with the vendor, at least our reading of it, NTSB had 45 days to tell them don't pay this check. But since there was no reconciliation or review, that just wasn't done. And now the 45-day period that NTSB did have to assert a claim has expired.

Mr. SUNUNU. If Mr. Bentsen would—thank you, Mr. Bentsen.

So that point—we have a check here that is displayed on our far right that gets to the point that you raise, which is a check that was cleared by the third-party contractor and it has no authorizing signature on it whatsoever. And there is a 45-day period where there might be a response but clearly there were significant problems with both internal controls not performing reconciliation but with the controls and the process used by the third-party contractors.

I would like to ask unanimous consent that all members be allowed to revise and extend their remarks and also ask unanimous consent that we include in the record a list of other departments or agencies that are using this third-party contractor. Without objection.

[The information referred to follows:]

LIST OF FEDERAL DEPARTMENTS OR AGENCIES THAT GELCO PROVIDES THIRD-PARTY DRAFT SERVICES TO

African Development Foundation
U.S. Department of Treasury—Bureau of Engraving & Printing
Federal Aviation Administration
Immigration & Naturalization Service
Internal Revenue Service
U.S. Department of Treasury

U.S. Mint
Office of Thrift Supervision
Federal Highway Administration
Internal Revenue Service—Southeast
U.S. Department of Energy
U.S. Department of Energy—Oak Ridge
U.S. Department of Education
U.S. Department of Transportation—Volpe

Mr. SUNUNU. I recognize Mr. Miller for 5 minutes.

Mr. MILLER. Rapidrafts, often in the private sector known as voucher systems, meet accountability standards when they are used properly and they are reviewed properly, so I don't want to get the focus off the Rapidraft, saying that is the problem. That is not the problem. But when you have checks written to Myriad Investments and the intent of those checks, as you said, Mr. Mead, are supposed to be used for accident and nonaccident purposes. A flag should have come up to somebody that you don't pay it.

When a check comes to Gelco with no signature, the fact is it should not have been paid. When a check comes to Gelco—and please put one of the ones up that exceed $2,500—exceeding $2,500, the fact is the check should not be paid. Period.

Now, there is not any question that there was some corruption internally. But I don't think there is any doubt that there is incompetence on the part of Gelco if you look what has happened and transpired. If you go to the Gelco contract, it is very specific. Gelco Payment System and the National Transportation Board agree to notify each other immediately of any misuse of the Rapidraft authorization—Rapidraft orders.

Now a certain amount of those were done. Many were not, based on the investigation.

Also, Gelco's payment system assumes responsibility for the face value of Rapidraft orders which fail to properly screen or be rejected. And if you look at their daily draft processing and standard violation systems, these checks did not comply with the criteria necessary to process those checks.

Travel cards are going to be no better than Rapidrafts if oversight does not occur. I have done dozens of loans when I was in the building industry with lending institutions that we used voucher systems or Rapidrafts, and they work if done properly, without a doubt.

And I don't want to get off the focus of Rapidrafts, saying that is our problem here and we are going to stop using Rapidrafts and when we stop using Rapidrafts the problems go away. That is not true. And there are certain Rapidrafts or vouchers or payments that are going to continue into the future that are going to be made to vendors, am I not correct? Nobody in their right mind is going to use their travel card to pay those. So they are still going to be paid.

And that is where the problem lies. And the shift to using a travel card does not deal with the problem.

Gelco did not do their job. They were incompetent. And there was corruption on the part of staff, without a doubt. And we don't know how widespread that corruption was, and we don't know how widespread this is here. So you have a checks and balances system.

In fact, Al Gore praised this system in one of his statements, saying this is how we reinvent government. We have taken care of it because we installed the checks and balance system that, if used properly, works.

And in your testimony—Mr. Mead, you stated, contrary to NTSB policy, drafts were paid when they exceeded the $2,500 limits. It was printed on the check that these Rapidrafts should not exceed that amount. Why did Gelco honor these checks?

Mr. MEAD. I can't respond to that.

Mr. MILLER. That is what I thought.

Mr. MEAD. The $2,500 is an NTSB order, and it was in the agreement with the contractor. But employees internal to NTSB wrote letters to Gelco saying for these employees, honor the checks over $2,500 all the way up to, in one case, $20,000. In another case, under the contract with the contractor, NTSB committed to notify the contractor whenever somebody left and was no longer an authorized user. They did not do so. Then employees internal to NTSB would sign somebody else's name who had been an authorized user. Gelco pays the check. So——

Mr. MILLER. The largest checks that were cashed were to J.D. Rainbolt Contractors—one for $7,500 one for $16,000, one for $20,000, one for $5,000, one for $26,000, one for $13,000—were by a former employee, not even employed at the time when he wrote them. I mean, it is more than Rapidrafts. It is internal incompetence on the part of the government and on the part of the agency that is supposed to be supervising the payment of these.

It says clearly $2,500. And if you put one of the checks up, that shows $2,500 crossed off by the person signing the check, and it was paid.

I guess I have a question. Is Gelco being held accountable for paying these? Are they being prosecuted right now? Can anybody answer that?

Mr. MEAD. No, not to my knowledge.

Mr. MILLER. Why not? I have a contract right here signed by William Park, signed by—I can't read the other name—but one by Gelco, and one by part the government, that specifies what they are to do. It specifies accountability. It specifies the process to go through. This is not new. This has been known.

In fact, one thing that really bothers me is, when I go to the history of events—and this is for Mr. Hall. You became aware of this in August of last year. Yet on September 23 we did a markup of your authorization bill, and you came before us as a committee. You never mentioned it. And on September 30, the bill was passed on the House floor, and you never mentioned it. And yet you knew about this problem in August.

Now, trust me, we have always voted for this stuff. Based on statements made before us on May, 1999, that you never refuted when you found out they were incorrect, one is, I know nothing that has caused me any concern.

In addition, Mr. Keller notified—he was a financial officer. He was a problem. "Eighty percent of our budget is dedicated to the people, so there is not a whole lot of flexibility as far as abuse or fraud or whatever that can take place," was stated. And also the statement was made, “The most important job you have given me is responsibility for handling taxpayer's money.”

And, Mr. Hall, you gave me the courtesy of coming by my office yesterday, and you told me that you had notified everybody when you found out about this, and I took that at face value. I am not trying to criticize you. But when I look back, because I was responsible for voting for your authorization last year, you knew about it a month before we voice voted it out of committee. You never brought it up. And it went out unanimously on the floor. You never brought it up. Why not?

Mr. HALL. At the time that I learned of this, I notified Mr. Mead and attempted to follow every piece of advice Mr. Mead gave me, including when to advise our committees, because we were dealing with an ongoing criminal investigation. At the time that Mr. Mead said we should go and meet with committee staff and advise them of this matter, we did so. So that is the reason.

On the matter of those checks, I would like to have a chance to check those and respond for the record in terms of who signed those checks and their status at the time they were signed.

Mr. MILLER. I don't have time. We do have those checks. But I do have the sequence of events as they unfolded. We have to break.

Mr. SUNUNU. I appreciate it, Mr. Miller. We will allow Chairman Hall to make that response for the record.

[The information referred to follows:]

CHAIRMAN HALL'S RESPONSE FOR THE RECORD REGARDING “WHO SIGNED THOSE CHECKS AND THEIR STATUS AT THE TIME THEY WERE SIGNED”

The checks referred to that exceeded $2,500 were signed by Mr. Don Libera, currently the NTSB's Deputy Chief Financial Officer. At the time he signed the checks, he was the agency's Budget Officer. Mr. Libera had specific written authority from the Chief Financial Officer, which also was provided to Gelco, to write checks in excess of the $2,500 limit. Because all of the checks were preprinted with the “NTE $2,500 limit,” Mr. Libera crossed through this note and initialed the checks he wrote that exceeded this limit. All of the checks written over the $2,500 limit were to expedite payment for legitimate purposes and were paid to NTSB employees, primarily for travel-related expenses, or to vendors for supplies or services provided. It should be noted that when Gelco received a check over the $2,500 limit, they would usually call appropriate Safety Board CFO personnel to verify authorization to override the established system limit.

Mr. SUNUNU. At this time, I would like to yield to Mr. Clement and make members aware that at the conclusion of Mr. Clement's questioning we will recess for this vote on the rule and return back promptly, at which time Mr. Miller will take the Chair to complete questioning from the remaining members.

Mr. Clement.

Mr. CLEMENT. I don't think I am going to have enough time, but I will at least start anyway.

Mr. Chairman, as you know, I serve on the House Transportation and Infrastructure Committee, the jurisdictional and oversight congressional committee for NTSB. I am acutely aware of the tremendous significance of the National Transportation Safety Board.

Under Chairman Hall's leadership, the NTSB has had to address some of the most challenging national transportation catastrophes on record. As a fellow Tennesseean, I will say I am especially proud of Chairman Hall's commitment to excellence and public service.

Like other members here, I strongly believe that every level of the Federal Government should be held accountable for its actions. On behalf of American taxpayers, Chairman Hall has worked to make improvements in the deficient financial accounting system that he inherited from the previous administration in 1994. He has indeed worked on behalf of taxpayers by reversing NTSB practices that were mismanaged.

Mr. Hall—Chairman Hall, it is my understanding that NTSB does not have an IG of its own. You contacted the Department of Transportation's IG to come in and do an audit of the Rapidraft check system, payment system. You have also contracted with PriceWaterhouseCoopers to do an outside audit as well. Do you feel that it would be beneficial to the NTSB to have an internal IG instead of having to rely on DOT's IG?

Mr. HALL. I certainly would have no objection to an internal Inspector General in our agency.

I was told when I first inquired about an IG that our agency was too small to have a full-time Inspector General. I consulted with a number of people on getting that advice. But I think it is imperative that our agency in the future have an annual audit of all of our financial activities, and we are moving to do that.

Mr. CLEMENT. Mr. Mead, do you have any comment about the question I asked?

Mr. MEAD. Just a point of perspective. When a problem comes up like this, you need a critical mass to be able to deploy. I think you can make a case for an internal IG. I think you can make a case for having a Cabinet-level IG with the critical mass that can come in.

Mr. Hall and I have a very good professional and personal relationship, and I think that helps a great deal. You would have a problem if—you have a case like this come up—there is no way that NTSB could responsibly have a permanent IG staff of 10 or 15 people. And that is the only perspective I would have. If you want us to do it, we will do it. But please don't give us any responsibilities that go into the programmatic area or the investigative area. Keep it down to the financial management.

Mr. CLEMENT. I may have another question or two when we come back.

Mr. SUNUNU. We have approximately 4 minutes left in the vote. If you would like to ask one of your questions and you can resume questioning when we return.

Mr. CLEMENT. I will wait.

Mr. SUNUNU. We will recess at this time. We will reconvene as soon as we return from the vote. Thank you, gentlemen.

[Recess.]

Mr. MILLER [presiding]. I would like to correct one misstatement that I made on the checks that were in the individual larger amounts, the individual was still employed. But the comment was more directly to the Rapidrafts were not to be used for this type of purpose at this amount. And that was the issue.

Mr. Toomey, do you have questions?

Mr. TOOMEY. Is Mr. Clement finished?

Mr. CLEMENT. I am through. And I appreciate what you just said, Mr. Chairman; and Mr. Hall may want to comment.

Mr. HALL. No, that is fine.

Mr. CLEMENT. Thank you.

Mr. TOOMEY. I will be brief, but I did want to just get actually maybe both Mr. Mead and Mr. Hall to react to some thoughts.

First of all, if we look at the case of the Rapidraft payments that the IG reviewed, there were 1,000. And I take it there is no reason to believe that that is not a representative sampling. And when we consider that 90 percent of these had some kind of noncompliance, one kind or another, it suggests, obviously, a routine lack of regard for the rules of compliance. And I wonder if it doesn't reveal to some degree almost a culture of disrespect for certainly the rules of the reimbursement, the whole Rapidraft system, and I wonder how much more pervasive that culture would be of disregarding rules which are really rather important.

Now, I take it that your investigation focused more on discovering individual and systemic misuse rather than focusing on whether there was criminal intent or fraud that went with that. But I was wondering, Mr. Mead, if you could clarify that for me a little bit.

Mr. MEAD. I will try, yes, sir.

Inspector General offices are divided into two parts. One side is a criminal investigative, looking at quasi-criminal administrative violations that get an individual in serious trouble. The other side of an IG operation is audit, program evaluation, financial audit where you look at the effectiveness of the programs.

And in a case like this, what we had was criminal misconduct, and we suspected that from the beginning. But once we got in there and saw the type of criminal misconduct and how it was allowed to occur, the latter—the unauthorized people signing checks, the no-known purpose on them, the no payees, going over the limits, things of that nature—we began to see that there was an underlying vulnerability to this whole program. That triggered the audit side of our office which led to the broader audit, sir.

Mr. TOOMEY. But as for those broader audits, we had a system that we know was extremely vulnerable to abuse. Obviously, if you don't need to sign checks, you don't even need to write a payee and yet the check will be cashed. And yet there are only two cases of fraud and embezzlement that have been pursued on a criminal level. With such a high degree of noncompliance it strikes me there must be a whole lot more flaws that occurred that we don't know about certainly beyond those two cases. And that is—you know, I have no direct evidence of that, just by the sort of—intuitively seems quite likely. So one of my questions is, what do we do about that? What can be done?

Mr. CAMPBELL. If I may respond to that, Congressman, that is the first order of business with our contract with PriceWaterhouseCoopers. We understood from the nature of the investigation that DOT IG did for us that they would not necessarily get to the universe of all the difficulties that they might see. And so the first order of business we have with the independent audit firm is to assess that problem for us and give us some advice on how to proceed. The agency has chosen to continue to pursue that issue.

Mr. TOOMEY. And specifically with respect to the checks that were cashed a year ago or 2 years ago with the old payments, are they still being investigated or is that the kind of thing where that is being given up and we are trying to prevent repeat offenses?

Mr. CAMPBELL. No, sir we are looking at the past.

Mr. TOOMEY. In the inspection that you did do, the auditing and investigation work that you did, was most of the noncompliance that was cited about the handling of the Rapidraft system itself and fault in that process? Could you also tell me about to what extent do you believe that these items that were being paid for were purchasing things that either were not intended to be—you addressed those which were not intended to be used by the Rapidraft system—but what about items that shouldn't be bought at all that were being purchased? Any more thoughts on that?

Mr. MEAD. Yes, there is clearly some instances of those where you don't really know what the payment was for. You see the check behind you to American Express. That is one where nobody signed. But even if it was signed, the question occurs, well, what about American Express? Why were you writing checks to American Express? What was it for? And there are a lot in that category. A large number.

Mr. CAMPBELL. If I could expand on that. The actual Gelco book that you write checks from has a check at the top and a series of additional documents that—additional parts of the document that need to be filled out. What we will attempt to do is take some of the difficult, the problematic checks and marry them back up with their underlying documents which themselves need to be accompanied by the obligating form.

The check is not actually permission to obligate money. The check is just a way of making the payment. Each check needs to be accompanied either by a training form, a travel voucher, a 4400 for purchases and so forth.

So there is an opportunity to go back and look at these checks and ask yourself, one, do we have the documents—of course, the ones we don't have the documents for would then by themselves be particularly suspicious. But if we have the documents you can review the document to give you some sense of what the underlying purchase was about and make a determination about whether it was for an authorized purpose or not. And that is our intention.

Mr. TOOMEY. So that is ongoing, that investigation.

Well, finally, just my last question for the Chairman, are you concerned that there may be within the Board a sort of culture of disrespect for internal rules and procedures, a sort of lax attitude that has been revealed by this whole discovery that might pervade both the institution and into other areas other than just the finances?

Mr. HALL. Congressman, I have a great deal of respect for all of my employees. Setting the culture of the agency is the responsibility of the management of the agency. I can assign that responsibility, but I must accept that accountability. In this case, the individual that was responsible was not enforcing the type of culture that should be in place.

We are going to, as Mr. Campbell said, look at each and all of these transactions. That is one of the things we have asked PriceWaterhouseCoopers to do. But, you know, my employee base there does an outstanding job, in my opinion, performing their mission.

And a part of their mission and part of their time was supposed to be given and needed to be more directed toward a proper accounting of these funds, and so we are going to put an emphasis on that. If we had a cultural problem, we are going to change that cultural problem.

I don't know how else to comment on it. I don't choose to be in this position. The employees in the agency work very hard in their job. It is the responsibility of management to lay down that culture and direction for them. In this area we have not been as successful as I would like. We have had this embarrassing situation, and I intend to do everything we can if there is a problem to be sure it is effectively addressed.

Mr. MEAD. I think, just from the observations of my own auditors and investigators, there was a culture of looseness at the top in the Chief Financial Officer's office. You didn't have an IG that every so often did visitations at the agency on a routine basis to make sure everything was honest. We found that, transcending the Rapidraft program, there were problems with the travel vouchers not being reviewed. The computer equipment frequently wasn't inventoried properly. The CFO should have made sure that employees got periodic ethics training. And these things just were not happening.

And I, too, know a number of NTSB employees and have the highest respect for them. But I do think you have to look at that CFO for a great deal of leadership. And I don't believe the Board, Mr. Hall or NTSB was being well served, sir.

Mr. TOOMEY. Thank you, Mr. Chairman. I yield the balance of my time.

Mr. MILLER. Chairman Hall, a couple of questions I need to ask you, just to clear up some confusion. Under Federal reg 31 CFR 208, which is under the management of the Federal Agency Disbursement Act—can you hear me?

Mr. HALL. I was having a little difficulty.

Mr. MILLER [continuing]. Which implements the Debt Collection Improvement Act of 1996, requires the authority of the Secretary of Treasury to grant waivers of all Federal payments made after January 1, 1999, when it must be made by electronic fund transfer. And 31 CFR 208 permits nonelectronic payment for national security interest, military operations, national disasters, law enforcement, amounts less than $25, certain payments in foreign countries or in emergencies or, "mission-critical circumstances that are of such an unusual and compelling urgency that the government would otherwise be seriously injured."

Based on that, under what circumstance did NTSB qualify for a waiver of 31 CFR 208 to continue using the Rapidrafts after January 1, 1999?

Mr. CAMPBELL. Congressman, I don't believe that NTSB qualified for a waiver under those provisions. And I don't believe that we had a waiver under those provisions. I think that the program for the Chief Financial Officer, who is, unfortunately, not here to answer this question, was to make a transition to the purchase card program and the travel card program which we have implemented now as of about September of 1999. And during the period between

January 1 and September, I have personally asked this question and——

Mr. MILLER. So you are confirming they should not even have been using Rapidrafts after January 1.

Mr. CAMPBELL. It is my understanding that we should have gone to electronic transfer.

Mr. MILLER. We need to ask this, because that issue has come up and we didn't have clarification. The confusion I had—there was an ongoing problem with a system that shouldn't even have been in existence.

Mr. CAMPBELL. There would have been a class of transactions which would have met the exemption standards, particularly those in the field where the actions are—making an electronic funds transfer at an accident scene may have been difficult, but there was another whole class of transactions which probably would not have met the waiver requirement.

Mr. MILLER. Probably the last question I can think of is—we ran out of colleagues here—is part of the Rapidraft Payment System NTSB maintained $350,000 in a non-interest-bearing account with Gelco Information Network Inc. Have you made any effort to get that money back at this time?

Mr. LEVINE. We are, right now, trying to get that money back. There are a couple of issues on float and miscellaneous charges that my people are trying to reconstruct, but they have been in contact with Gelco. That is money that was put in deposit, I believe, as far back as 1989. It is basically to cover the float. We have been in contact with them, and I have been assured that that is being expedited.

Mr. MILLER. Well, Mr. Hall, you have been very courteous and kind and forthright, and Mr. Mead, also. I appreciate the input.

We were told that other members are coming, but we are going to go check. We will not delay you any longer than you have to. Is there any final comment you would like to make?

Mr. HALL. No, sir.

Mr. MILLER. If somebody doesn't show up in the next 5 seconds, we will thank you graciously for being here today. Our comments were not an attack. I hope they were not taken as such. They were not meant to be.

Mr. Knollenberg, I have been informed, will be here within 60 seconds, so I will have to wax eloquently for the next 60 seconds.

This is probably not the best of times—with Egyptair, what is ongoing right now? We just had a hearing in Transportation on that issue. It is not the best of times to be here.

I know your focus is on issues very important to us, very important to commuters. I think you are doing an excellent job in that area. It is a shame that a situation like this has to occur. I know you are a man who probably takes this very personal because you are the top. It is not meant to be personal.

From our perspective, it is just an issue that was believed should have been discussed publicly, and it sounds like just the process we have taken has changed some other agencies from the direction they have gone in using these, trying to come up with more of an accountable system. It sounds like and it appears like the individual now you have put in charge of CFO is going to be a thumbson individual and he is going to make sure something like this never occurs in the future, and I am glad to see that.

But your agency does an excellent job, and this hearing is not in any way intended to impugn the quality of work you do. Because you do top-quality work. We are not—that is not the goal. It is more accountability. And I know that you have taken many steps to create accountability, and we thank you for that. And, again, I want to say there was nothing personal in the questions that had to be asked. I think we are all glad they probably were, and we can move forward when Mr. Knollenberg shows up to ask his final questions.

Mr. CLEMENT. Mr. Chairman how do you stay physically in shape and be mentally alert? That is what I would like——

Mr. MILLER. You keep me in line. I try very hard, sir.

Why don't we talk a break for just a minute or so for Mr. Knollenberg? We will adjourn the meeting after that.

[Recess.]

Mr. MILLER. We are going to reconvene the meeting.

Mr. Knollenberg has walked in. He has 20 seconds worth of questions left, because he has used up 40 minutes and 40 seconds already.

Mr. KNOLLENBERG. Well, I apologize for being late. Three places at the same time doesn't work.

Let me again welcome everybody, and I appreciate your being here. I am sure I might touch on a question that has been handled before, and if it has just mention that. Mr. Chairman, you obviously may want to reflect on that, too.

Simple question, and I will get right to the heart, it was how many Rapidrafts exceeded 5,000?

Mr. LEVINE. $5,000 or $2,500, sir?

Mr. KNOLLENBERG. I am sorry. Your question was what again?

Mr. MILLER. How many exceeded 2,500?

Mr. LEVINE. I sorted it——

Mr. KNOLLENBERG. I am asking how many exceeded 5,000.

Mr. LEVINE [continuing]. I have a list. And the only reason I asked for clarification, sir, is my list tells me we issued about 169 that were over $2,500. I will have to go back to that list and to get you an answer. If I could provide that for the record, I will.

Mr. MEAD. I have the answer here, so you won't have to do that. There were 70 Rapidrafts totalling $708,000 written for amounts between 5,000 and 28,000.

Mr. KNOLLENBERG. That is fine. What was the maximum Rapidraft limit authorized for any user?

Mr. MEAD. Under the Board order, the limit was $2,500.

Mr. KNOLLENBERG. Who were the persons primarily involved in writing the over-limit checks?

Mr. MEAD. Mr. Libera, who was a Deputy Chief Financial Officer, and Mr. Mills, who was an Accounting Officer. And I should note that administratively they wrote or their supervisors wrote to the vendor Gelco and said please authorize these people to write checks over $2,500. The NTSB Board never approved that.

Mr. KNOLLENBERG. Another quick question, for what purposes—and this is probably general, but what purposes were the checks written for and what was the total dollar value?

Mr. HALL. We have Mr. Libera here.

Mr. KNOLLENBERG. That question has been raised before. I am not trying to duplicate. If you can't do it quickly, would you do it for the record?

Mr. HALL. Be glad to do it for the record. Yes, sir.

[The information referred to follows:]

RAPIDRAFTS OVER $2500

[Fiscal Years 1997–1999]

No.	FY	Last Name	First Name	Cleared Date	Check Number	Amount	Pay to	Purpose
1	1997	Libera Jr	Donald P.	80697	020001231–9	$2,644.67	North American Van Lines	Invoice
2	1997	Libera Jr	Donald P.	81597	020001237–3	$4,703.21	Shane Lack	Travel Voucher
3	1997	Libera Jr	Donald P.	81897	020001236–4	$3,717.55	Robert Benzon	Travel Voucher
4	1997	Libera Jr	Donald P.	82697	020001245–4	$5,137.89	Robert Hilldrup	Travel Voucher
5	1997	Libera Jr	Donald P.	82997	020019002–4	$4,896.93	Ronald Schlede	Travel Voucher
6	1997	Libera Jr	Donald P.	90297	020019003–3	$3,807.48	Alfred Dickinson	Travel Voucher
7	1997	Libera Jr	Donald P.	90497	020001234–6	$3,560.19	Dennis Jones	Travel Voucher
8	1997	Libera Jr	Donald P.	90897	020019011–4	$8,709.96	Ronald Schlede	Travel Voucher
9	1997	Libera Jr	Donald P.	90897	020019008–7	$3,819.24	Ronald Wentworth	Travel Voucher
10	1997	Libera Jr	Donald P.	90897	020019006–9	$3,176.26	Cynthia Keegan	Travel Voucher
11	1997	Libera Jr	Donald P.	90997	020019005–1	$3,153.58	Deepak Joshi	Travel Voucher
12	1997	Libera Jr	Donald P.	91097	020001249–9	$10,729.59	Robert Francis	Travel Voucher
13	1997	Libera Jr	Donald P.	91097	020019007–8	$3,395.38	George Black	Travel Voucher
14	1997	Libera Jr	Donald P.	91097	020019009–6	$2,508.58	Gordon Hookey	Travel Voucher
15	1997	Libera Jr	Donald P.	91297	020019001–5	$3,930.20	Keith D. Holloway	Travel Voucher
16	1997	Libera Jr	Donald P.	91297	020019010–5	$2,689.92	Gregory J. Phillips	Travel Voucher
17	1997	Libera Jr	Donald P.	91597	020019014–1	$3,815.76	Paul Schlamm	Travel Voucher
18	1997	Libera Jr	Donald P.	91897	020019015–9	$2,950.35	Matthew M. Furman	Travel Voucher
19	1997	Libera Jr	Donald P.	92297	020019025–8	$2,852.08	James Skeen	Travel Voucher
20	1997	Libera Jr	Donald P.	92997	020019052–8	$10,162.68	Robert Benzon	Reimbursement
21	1997	Libera Jr	Donald P.	92997	020019018–6	$4,744.42	James R. Jeglum	Travel Voucher
22	1997	Libera Jr	Donald P.	92997	020019017–7	$2,890.73	Malcolm Brenner	Travel Voucher
23	1998	Libera Jr	Donald P.	10898	020019283–2	$3,166.52	Richard J. Wentworth	Travel Voucher
24	1998	Libera Jr	Donald P.	11498	020019282–3	$2,871.61	Matthew M. Furman	Travel Voucher
25	1998	Libera Jr	Donald P.	12198	020019286–8	$4,596.76	Linda A. Jones	Travel Voucher
26	1998	Libera Jr	Donald P.	12698	020019289–5	$6,106.39	Richard J. Wentworth	Travel Voucher–Prehearing Prep
27	1998	Libera Jr	Donald P.	12698	020019288–6	$6,045.76	Ronald Schlede	Travel Voucher–Prehearing Prep
28	1998	Libera Jr	Donald P.	12898	020019287–7	$5,194.33	John Goglia	Travel Voucher
29	1998	Libera Jr	Donald P.	20498	020019290–4	$3,509.67	Robert McGuire	Travel Voucher
30	1998	Libera Jr	Donald P.	20598	020019292–2	$6,183.51	Robert Hilldrup	Travel Voucher
31	1998	Libera Jr	Donald P.	20698	020019293–1	$5,442.72	Cynthia Keegan	Travel Voucher
32	1998	Libera Jr	Donald P.	20698	020019291–3	$4,897.93	Robert Francis	Travel Voucher
33	1998	Libera Jr	Donald P.	20998	020019295–8	$4,696.18	Jamie Finch	Travel Voucher
34	1998	Libera Jr	Donald P.	21798	020019296–7	$3,000.20	Robert Macintosh Jr.	Travel Voucher
35	1998	Libera Jr	Donald P.	22098	020019303–9	$6,513.41	Robert Macintosh Jr.	Travel Voucher–Silk Air
36	1998	Libera Jr	Donald P.	22398	020019302–1	$7,714.14	Greg Phillips	Travel Voucher
37	1998	Libera Jr	Donald P.	22398	020019299–4	$4,473.88	Malcolm Brenner	Travel Voucher
38	1998	Libera Jr	Donald P.	22498	020019301–2	$6,297.40	Scott Warren	Travel Voucher
39	1998	Libera Jr	Donald P.	22598	020019297–6	$2,938.00	Richard Parker	Travel Voucher
40	1998	Libera Jr	Donald P.	31098	020019309–3	$6,692.20	Barry Sweedler	Travel Voucher
41	1998	Libera Jr	Donald P.	31198	020019307–5	$3,411.66	Robert Francis	Travel Voucher

RAPIDRAFTS OVER $2500—Continued

[Fiscal Years 1997–1999]

No.	FY	Last Name	First Name	Cleared Date	Check Number	Amount	Pay to	Purpose
42	1998	Libera Jr	Donald P.	31198	020019306–6	$3,288.47	Deborah Smith	Travel Voucher
43	1998	Libera Jr	Donald P.	31298	020019308–4	$2,602.25	Denise Daniels	Travel Voucher
44	1998	Libera Jr	Donald P.	32598	020019312–9	$5,233.23	James Hall	Travel Voucher
45	1998	Libera Jr	Donald P.	32798	020019310–2	$4,403.19	Jerome Trachette	Travel Voucher
46	1998	Libera Jr	Donald P.	40198	020019311–1	$3,548.83	Paul Weston	Travel Voucher
47	1998	Libera Jr	Donald P.	40998	020019317–4	$5,326.21	Thomas Haueter	Travel Voucher
48	1998	Libera Jr	Donald P.	40998	020019314–7	$5,237.61	Deborah Smith	Travel Voucher
49	1998	Libera Jr	Donald P.	41398	020019319–2	$6,260.06	Robert Hilldrup	Travel Voucher
50	1998	Libera Jr	Donald P.	41398	020019316–5	$4,918.46	John Goglia	Travel Voucher
51	1998	Libera Jr	Donald P.	41498	020019320–1	$3,175.35	Thomas Conroy	Travel Voucher
52	1998	Libera Jr	Donald P.	41798	020019322–8	$4,655.14	Gregory A. Feith	Travel Voucher
53	1998	Libera Jr	Donald P.	42098	020019326–4	$9,157.86	Robert Francis	Travel Voucher
54	1998	Libera Jr	Donald P.	42798	020019321–9	$5,272.43	Evan Byrne	Travel Voucher
55	1998	Libera Jr	Donald P.	42898	020019329–1	$6,785.50	Scott Warren	Travel Voucher
56	1998	Libera Jr	Donald P.	42998	020019327–3	$4,387.70	James Pericola	Travel Voucher
57	1998	Libera Jr	Donald P.	43098	020019332–7	$6,881.87	James Hall	Travel Voucher
58	1998	Libera Jr	Donald P.	50898	020019331–8	$5,317.69	Gregory Salottolo	Travel Voucher
59	1998	Libera Jr	Donald P.	51398	020019335–4	$5,644.60	Robert Francis	Travel Voucher
60	1998	Libera Jr	Donald P.	51398	020019333–6	$3,395.27	Ronald Robinson	Travel Voucher
61	1998	Libera Jr	Donald P.	60998	020019337–2	$6,473.44	Gregory Feith	Travel Voucher
62	1998	Libera Jr	Donald P.	61598	020019340–8	$2,839.83	Robert Francis	Travel Voucher
63	1998	Libera Jr	Donald P.	62298	020019341–7	$5,000.00	Gregory Feith	Advance for Travel
64	1998	Libera Jr	Donald P.	62998	020019342–6	$3,597.08	Gordon Hookey	Travel Voucher
65	1998	Libera Jr	Donald P.	81398	020019345–3	$6,309.77	James Hall	Travel Voucher
66	1998	Libera Jr	Donald P.	100197	020019057–3	$8,816.11	Gary K. Abe	Travel Voucher
67	1998	Libera Jr	Donald P.	100297	020019059–1	$14,466.36	Gregory Feith	Travel Voucher
68	1998	Libera Jr	Donald P.	100397	020019058–2	$2,995.47	Gary K. Abe	Travel Voucher
69	1998	Libera Jr	Donald P.	100797	020019062–7	$3,156.32	American Express	Airfare RE
70	1998	Libera Jr	Donald P.	100797	020019064–5	$2,694.00	Rivy Cole	Travel Voucher
71	1998	Libera Jr	Donald P.	100897	020019063–6	$4,830.44	Peter Goelz	Reimbursement
72	1998	Libera Jr	Donald P.	100997	020019066–3	$6,476.75	Woodfield Suites	employee accomodations
73	1998	Libera Jr	Donald P.	101097	020019056–4	$4,089.87	Richard parker	Travel Voucher
74	1998	Libera Jr	Donald P.	101497	020019068–1	$2,822.63	Gregory Feith	Travel Voucher
75	1998	Libera Jr	Donald P.	102297	020019074–4	$4,089.87	Richard B. Parker	Travel Voucher
76	1998	Libera Jr	Donald P.	102497	020019252–6	$8,904.04	Lawrence D. Roman	Travel Voucher
77	1998	Libera Jr	Donald P.	102797	020019255–3	$2,709.00	Barry Sweedler	Travel Voucher
78	1998	Libera Jr	Donald P.	110697	020019258–9	$5,516.21	Robert m. Mac-intosh	Travel Voucher
79	1998	Libera Jr	Donald P.	110797	020019259–8	$3,269.50	Linda Jones	Travel Voucher
80	1998	Libera Jr	Donald P.	111297	020019260–7	$2,516.60	Richard J. Went-worth	Travel Voucher
81	1998	Libera Jr	Donald P.	111897	020019263–4	$5,386.47	Jim Hall	Travel Voucher
82	1998	Libera Jr	Donald P.	111897	020019261–6	$2,723.47	Gregory Phillips	Travel Voucher
83	1998	Libera Jr	Donald P.	112497	020019264–3	$5,176.33	Jamie Finch	Travel Voucher
84	1998	Libera Jr	Donald P.	120997	020019267–9	$3,577.05	Dennis Grossi	Travel Voucher
85	1998	Libera Jr	Donald P.	121997	020019273–3	$3,339.19	Jerome Frechette	Travel Voucher
86	1998	Libera Jr	Donald P.	122297	020019270–6	$2,821.60	Robert Francis	Travel Voucher
87	1998	Libera Jr	Donald P.	122397	020019272–4	$3,212.69	Paul Misenick	Travel Voucher
88	1998	Libera Jr	Donald P.	122697	020019280–5	$3,789.36	Ronald Schlede	Travel Voucher
89	1998	Libera Jr	Donald P.	122997	020019271–5	$2,699.65	Kenneth Egge	Travel Voucher
90	1998	Libera Jr	Donald P.	123197	020019278–7	$2,738.41	Deborah Smith	Travel Voucher
91	1999	Libera Jr	Donald P.	040899	030400001	$8,202.13	James E. Hall	Travel Voucher
92	1999	Libera Jr	Donald P.	112398	010030512	$2,799.47	Tom Conroy	Travel Reim-bursement
93	1998	Mills	William J.	81798	020033326–8	$4,070.00	James V. Roberts	Travel Voucher
94	1998	Mills	William J.	81798	020033327–7	$3,232.54	Michael T. Brown	Travel Voucher
95	1998	Mills	William J.	82898	020033328–6	$2,979.07	George Black	Travel Voucher
96	1998	Mills	William J.	90298	020033330–4	$3,003.80	Paul Alexander	Travel Voucher

RAPIDRAFTS OVER $2500—Continued

[Fiscal Years 1997–1999]

No.	FY	Last Name	First Name	Cleared Date	Check Number	Amount	Pay to	Purpose
97	1998	Mills	William J.	90998	020033331–3	$4,435.76	Paul Misenick	Travel Voucher
98	1998	Mills	William J.	91198	020033332–2	$2,780.02	Dennis L. Jones	Travel Voucher
99	1998	Mills	William J.	92298	020033337–6	$4,693.43	Alfred Dickinson	Travel Voucher
100	1999	Mills	William J.	020599	020033362	$6,474.24	Robert Francis	Travel Voucher
101	1999	Mills	William J.	031799	020033365	$2,980.77	Deepak Joshi	Travel Voucher
102	1999	Mills	William J.	100898	020033343	$3,902.65	Paul Misenick	Travel Voucher
103	1999	Mills	William J.	101398	020033350	$2,737.00	James Hall	Travel Voucher
104	1999	Mills	William J.	101498	020033345	$2,576.77	Ronald Schlede	Travel Voucher
105	1999	Mills	William J.	101998	020033347	$4,720.01	Robert Francis	Travel Voucher
106	1999	Mills	William J.	102298	020033351	$4,571.66	John Goglia	Travel Voucher
107	1999	Mills	William J.	102798	020033352	$3,025.17	Deepak Joshi	Travel Voucher
108	1999	Mills	William J.	111998	020033353	$2,783.64	James Hall	Travel Voucher
109	1999	Mills	William J.	112598	020033357	$2,934.07	Dave Tew	Travel Voucher
110	1999	Mills	William J.	112598	020033356	$3,381.28	Dave Tew	Travel Voucher
111	1999	Mills	William J.	120998	020033360	$3,962.12	Robert Francis	Travel Voucher
112	1999	Mills	William J.	121198	020033358	$2,530.54	Paul D. Weston	Travel Voucher
113	1999	Mills	William J.	122198	020033361	$2,583.54	James Hall	Travel Voucher
114	1999	Mills	William J.	073099	020033372	$3,154.17	James Hall	Travel Voucher
115	1997	Thomas	Laura J.	63097	020018153–7	$2,604.10	American Express	Airfare RE
	....			....	....	**$515,396.10**	**TOTAL TRAVEL REIMBURSEMENT**	**115 DRAFTS**
116	1996	Caldwell	Alice	100296	020005696–8	$2,772.00	Training 2000 MITAGS	Registration
117	1997	Libera Jr	Donald P.	71897	020001230–1	$14,907.13	Capital Hill Reporting	Invoice
118	1997	Libera Jr	Donald P.	80697	020001232–8	$23,412.29	Jacksonville Hilton and Towers	Invoice
119	1997	Libera Jr	Donald P.	81897	020001240–9	$17,000.00	John Davis	Attorney
120	1997	Libera Jr	Donald P.	81997	020001233–7	$19,723.77	Metrocall	pager bill
121	1997	Libera Jr	Donald P.	81997	020001239–1	$5,785.19	Tharpe Company	purchases
122	1997	Libera Jr	Donald P.	82097	020001238–2	$12,705.00	Dupage Airport Authority	Invoice
123	1997	Libera Jr	Donald P.	82097	020001241–8	$8,304.31	Proctor Electric	Invoice
124	1997	Libera Jr	Donald P.	82597	020001244–5	$11,267.20	Paul Schlamm	service
125	1997	Libera Jr	Donald P.	82797	020001242–7	$22,407.00	Tratech International	equipment
126	1997	Libera Jr	Donald P.	82797	020001243–6	$3,982.17	Nelson Marketing	Invoice
127	1997	Libera Jr	Donald P.	90297	020001247–2	$7,000.00	Office of Coroner, Washington Cty	HWY41
128	1997	Libera Jr	Donald P.	90897	020019004–2	$4,530.46	MicroWarehouse	purchase
129	1997	Libera Jr	Donald P.	90897	020001246–3	$4,500.00	Brave Audio visual, Inc.	Hearing
130	1997	Libera Jr	Donald P.	90997	020001248–1	$8,721.15	Embassy Suites Hotel	Hearing rooms/ Audiovisual equip
131	1997	Libera Jr	Donald P.	91097	020001250–8	$20,500.00	G.W. Hoch, Inc	Comm Ctr A/C
132	1997	Libera Jr	Donald P.	91097	020019012–3	$20,000.00	J.D. Rainbolt	PO–5th Fl renovation
133	1997	Libera Jr	Donald P.	91097	020019013–2	$4,272.00	Spirit Telecommunications	Rewire 5th Fl
134	1997	Libera Jr	Donald P.	91597	020019023–1	$13,359.20	KEV Corporation	6th floor renovations
135	1997	Libera Jr	Donald P.	91597	020019022–2	$7,000.00	System Safety Development	Accident Investigation Workshop

RAPIDRAFTS OVER $2500—Continued

[Fiscal Years 1997–1999]

No.	FY	Last Name	First Name	Cleared Date	Check Number	Amount	Pay to	Purpose
136	1997	Libera Jr	Donald P.	91797	020019021–3	$13,000.00	Boeing Commercial Airplane group	Modifications to B–727
137	1997	Libera Jr	Donald P.	91997	020019024–9	$20,000.00	J.D. Rainbolt	5th floor renovations
138	1997	Libera Jr	Donald P.	92297	020019051–9	$13,357.00	KEV Corporation	6th floor renovations
139	1997	Libera Jr	Donald P.	92997	020019053–7	$2,800.00	Spirit Telecommunications	RE Installation 5th&6th
140	1997	Libera Jr	Donald P.	93097	020019054–6	$2,918.16	GES Exposition Services	Oshkosh Exhibit
141	1998	Libera Jr	Donald P.	10798	020019281–4	$3,996.64	Phillip Humnicky	Photograph TWA 800 Hearing in Baltimore
142	1998	Libera Jr	Donald P.	10898	020019284–1	$3,875.00	Federal Construction contractors	Partition RM 6100 and paint
143	1998	Libera Jr	Donald P.	11498	020019285–9	$9,459.00	Mitech Data Systems	NEC Laptops
144	1998	Libera Jr	Donald P.	21198	020019294–9	$5,055.60	Southwestern Bell	Bill for TX Sept–Nov
145	1998	Libera Jr	Donald P.	22098	020019298–5	$9,375.00	Federal Construction Contract	PO
146	1998	Libera Jr	Donald P.	30998	020019304–8	$5,000.00	Donald H. Mershon,PHD	TWA 800
147	1998	Libera Jr	Donald P.	30998	020019305–7	$3,690.00	Ocngressional Quarterly, Inc	PO
148	1998	Libera Jr	Donald P.	42798	020019324–6	$2,900.00	DOD Joint Spectrum Center	Invoice
149	1998	Libera Jr	Donald P.	61198	020019338–1	$5,794.70	Southwestern Bell	Bill for TX office
150	1998	Libera Jr	Donald P.	61198	020019339–9	$2,678.70	Southwestern Bell	Bill for TX office April 98–May 98
151	1998	Libera Jr	Donald P.	90898	020019346–2	$11,510.00	J&H Marsh & McLennan, Inc	Travel Insurance
152	1998	Libera Jr	Donald P.	93097	020019054–6	$2,918.16	GES Exposition Services	Oshkosh Exhibit
153	1998	Libera Jr	Donald P.	100397	020019055–5	$2,800.00	General Testing Laboratories	AZ accident, Testing of school bus windows
154	1998	Libera Jr	Donald P.	100697	020019061–8	$17,400.00	Graduate School, USDA	Procurement Training
155	1998	Libera Jr	Donald P.	100697	020019065–4	$10,000.00	KEV Corporation	6th Floor renovation
156	1998	Libera Jr	Donald P.	101797	020019067–2	$24,461.00	J. D. Rainbolt	5th floor renovations
157	1998	Libera Jr	Donald P.	101797	020019071–7	$6,739.75	Campbell Carpet Service	Install carpet/ GAPAFA
158	1998	Libera Jr	Donald P.	101797	020019073–5	$3,730.75	Spirit Telecommunications	install video cable/GAPAFA
159	1998	Libera Jr	Donald P.	102097	020019072–6	$28,532.25	Loew's L'Enfant Plaza	Board Meeting
160	1998	Libera Jr	Donald P.	102297	020019075–3	$5,980.00	S.P.Bryant	Refinish furniture
161	1998	Libera Jr	Donald P.	102397	020019253–5	$5,657.18	Capital Hill Reporting, Inc	Invoice
162	1998	Libera Jr	Donald P.	102397	020019070–8	$3,278.50	Graebel Companies	contract movers/ supplies

RAPIDRAFTS OVER $2500—Continued

[Fiscal Years 1997–1999]

No.	FY	Last Name	First Name	Cleared Date	Check Number	Amount	Pay to	Purpose
163	1998	Libera Jr	Donald P.	102997	020019254–4	$3,912.86	Oceaneering International	TWA 800
164	1998	Libera Jr	Donald P.	110697	020019256–2	$12,000.00	KEV Corporation	6th Floor renovation
165	1998	Libera Jr	Donald P.	111097	020019262–5	$16,403.80	KEV Corporation	6th floor renovations
166	1998	Libera Jr	Donald P.	111097	020019257–1	$7,890.00	J.D. Rainbolt	5th renovations
167	1998	Libera Jr	Donald P.	112597	020019265–2	$3,495.00	George Washington University	J. Finch CED program
168	1998	Libera Jr	Donald P.	121897	020019276–9	$3,714.50	American Relocation	TWA 800 Hearing Invoice
169	1998	Libera Jr	Donald P.	122497	020019275–1	$3,910.00	American Relocation	Invoice
170	1998	Libera Jr	Donald P.	123197	020019279–6	$20,917.41	Miami Airport Hilton & Towers	Invoice
171	1999	Libera Jr	Donald P.	012799	020019350	$2,957.50	Susan T. Strahan, MD	Conduct Psych/ Employment Examination
172	1999	Libera Jr	Donald P.	100598	020019348	$11,076.00	Hyatt Regency Hotel	Speaker's Accomodations 26 Rooms
173	1999	Mills	William J.	101998	020033344	$3,013.26	Elizabeth Cotham	Kinko Cop. Symp98
174	1997	Fenwick	Angela C.	21897	020006368–2	$2,833.92	Digital Equipment Corp.	VAX Maintenance
175	1999	Patel	Seema	022699	020032545	$2,826.00	RSPA Mike Moroney Center	Training Tuition
	....			....	....	**$554,006.51**	**TOTAL PURCHASES**	**60 DRAFTS**
176	1999	Libera Jr	Donald P.	011999	020019349	$3,719.56	Donna M. Seipler	Advance payment for amounts due
177	1998	Libera Jr	Donald P.	93098	020019347–1	$4,000.00	William P. Fannon	Advance for salary
	....			....	....	**$7,719.56**	**TOTAL OTHER**	**1 DRAFT**
	....			....	....	**$1,077,122.17**	**TOTAL OVER $2500**	**177 DRAFTS**

Mr. KNOLLENBERG. How many instances of split invoices are you aware of?

Mr. MEAD. We are aware of two.

Mr. KNOLLENBERG. Two.

Mr. MEAD. Two instances where purchases over $2,500 were simply submitted to avoid the Federal regulations. There may be more, but these are the ones that turned up in our sample.

Mr. KNOLLENBERG. There were copies of all the checks that were made available. Five checks on one day to—there is five, I believe. They were made on the same day, as I remember. That is a little bit strange. Was that done obviously to conceal exceeding the 2,500 limit?

Mr. MEAD. Yes, well, what was happening here was you buy the same thing but to stay under the ceiling you simply write multiple checks that, added together, equal the purchase price.

Mr. KNOLLENBERG. One of these is Tratech. Another one, was it Skill—Skillcraft, I believe it was. I think there were five made in one day. That is kind of strange.

Mr. MEAD. One was for computers. I think the other was for training.

Mr. KNOLLENBERG. Mr. Chairman, how is my time here?

Mr. HALL. We will be glad for the record to get you whatever information the Board has on those five checks.

Mr. KNOLLENBERG. I appreciate that.

[The information referred to follows:]

RESPONSE FROM DIRECTOR HALL TO QUERY BY MR. KNOLLENBERG ABOUT SPECIFIC SPLIT INVOICES

There were a total of four Rapidrafts that were involved in two split purchases with Tratech that were reported by the Inspector General in their investigative report.

There were two rapidrafts issued on February 5, 1998, for $1,400 each to pay an invoice for $2,800 that was dated February 4, 1998.

There were two rapidrafts issued on July 7, 1999, for $2,047 and $2,338 respectively to pay for one facsimile machine purchased on June 9, 1999, and 3 computers purchased on June 29, 1999.

With regard to the question concerning Skillcraft, our research did not yield any information.

Mr. KNOLLENBERG. What I found too disturbing, and I am sure this has been talked about previously, but what were these expenditures for? In the indications of the copied checks, the photocopies, there is nothing there to say it was for carpet purchase or furniture refinishing or payroll advances. There wasn't a lot of disclosure. And I think that it becomes clear that there must have been suspicion that it was beyond the scope of the authority and for purposes other than what would normally be covered in the cost of business. Would you agree with that?

Mr. MEAD. Yes, in general, I would.

Mr. KNOLLENBERG. And I presume that these people that have been involved with some of the accounting are no longer on the job or are being oversighted in a fashion that would tell you that there won't be anymore of this?

Mr. MEAD. The former Chief Financial Officer who was incumbent during all times pertinent to this inquiry has resigned. Mr. Levine down at the end of the table is his successor. He has 35 years of experience. I have confidence that he is going to serve the Chairman, the Board and NTSB well.

Mr. KNOLLENBERG. Thank you.

Just very quickly I will close with this: How did these authorized users obtain the Rapidrafts? Were they just about?

Mr. MEAD. Actually, the interesting thing, you think they would have to go in to the Chief Financial Officer and get them, but under the procedures they had set up you could call up the contractor and say, send me some checks, and he would send some checks.

Mr. KNOLLENBERG. We didn't use that in my business. I guess I was missing something. But that sounds like a pretty good deal do me.

Well, I think that I will just close with the assurance that I am looking for is that those who had access in such an open fashion to these checks no longer have that access. Can we say that there is 100 percent security on that?

Mr. HALL. Yes, sir. And we are bringing in an independent auditor. I would in a moment's notice bring the IG back in if I thought there was any difficulty. Mr. Levine has his orders, and his orders are if there is anything improper in any way that has been going on in the past is to change it and change it immediately.

Mr. KNOLLENBERG. Any talk about having an IG inside?

Mr. HALL. We did have that conversation, sir, while you were out of the room, but we would be glad to respond depending on——

Mr. KNOLLENBERG. I think that concludes my questions.

Thank you, gentlemen; and thank you, Mr. Chairman.

Mr. MILLER. Mr. Ryan and Mr. Sununu are headed back. I know Mr. Ryan has a few questions, so why don't we take a break for a few minutes until they arrive.

[Recess.]

Mr. SUNUNU [presiding]. In the interest of time, I am going to reconvene the hearing at this time.

We have one additional member that would like to ask questions. I hope he arrives in a timely way. I am confident he will.

I do have a few additional follow-up questions, and then we will try to adjourn the hearing in a timely way, because I know all of you gentlemen have important work to do.

Mr. Mead, we talked a little bit about other agencies that are currently using third-party systems, some with Gelco, that was a subcontractor to NTSB, some with other third-party draft systems. And some discussion was made that perhaps it would be appropriate to audit some of those systems.

My question for you is, given the experience of your investigators and auditors with the Rapidraft system at NTSB, what kind of an audit—what kind of a scope of an audit might you suggest that the committee seek in other agencies or departments where we might have questions about the nature of the program?

For example, I am asking your recommendations with regard to time period. Is it best to look at a broad period, 2 or 3 years, at a top-level audit? Should we look in depth at a month in the documentation, in the internal controls? What kind of guidance might you give this Task Force in making sound recommendations for looking at this system in other agencies?

Mr. MEAD. Well certainly we have a methodology that we know what questions to ask. And we know what answers you might get.

I would suggest that if you were to ask other agencies to do such an audit, you would go back at least one year and ask for a description of the internal controls and whether they were in place, and we could actually itemize those for you. For example, do people sign the checks, what are they for, so forth and so on.

I would also go back and ask for trend lines, say, going back about 4 or 5 years, about program usage so you could see the aberrations, if there were sharp aberrations, in program usage.

I would also want to know about the management that was in place at all pertinent times for the program going back, say, 5 years. And I say 5 years because Congress passed a law in 1995 or 1996 that phased these programs out and said you should go to electronic fund transfers only in emergencies and so forth should you be using these third party drafts. So 1995 really marked a demarcation point. I would not go back before then.

Mr. SUNUNU. Thank you.

Mr. Hall, what kind of internal communication have you utilized in trying to make employees aware as appropriate of the results of this audit and the concerns regarding financial controls and are employees making a best effort to understand those controls but also to abide by them?

Mr. HALL. Mr. Levine has presently underway a training program for all Board employees.

Mr. LEVINE. Mr. Chairman, on March 2, almost 2 months after my arrival, we began training managers and employees. We have a power point presentation that I personally give, and I also include our labor-management relations specialist.

We go over the events, we discuss the audit, we review the findings, and we go over the two credit card programs. We explain the dos and don'ts, and we explain management responsibilities.

The first one I gave was to the office directors. All of them are getting management reports. There is no such thing as privacy when you use a government credit card.

We have explained to them how to use it, what to look for. We also involved the labor-management relations people because there are cases of delinquent debt. But it is not debt owed to the government. It is debt owed by our employees who on their travel card have incurred charges and are not paying bills timely. That has labor-management relations implications as well. I have also briefed the employees of several offices.

Mr. SUNUNU. If I may, you mentioned delinquent credit cards. Is that a problem right now within NTSB? Do you have an approximate number or percentage of the cards issued that may be delinquent at this time?

Mr. LEVINE. Less than 10 percent at the last look. It has gotten better, actually.

Mr. SUNUNU. I should ask for your definition of delinquency.

Mr. LEVINE. Per Citibank's terms, it means they are over 60 days delinquent in paying their bill.

Mr. HALL. One of the other things I am trying to do is get a new travel agency, Congressman. What happens is that we end up with people getting things put on their card by hotels or because they changed plans because of sudden travel, and then it takes forever to get these items reimbursed. I have asked Mr. Levine to be very aggressive in that area, and we will be glad to provide you information on the record on the total amount.

Mr. SUNUNU. Thank you.

[The information referred to follows:]

REVIEW OF CITIBANK REPORT ON NTSB'S CREDIT CARD DELINQUENCIES

Citibank has issued 367 travel credit cards to our employees. A review of the latest Citibank report on delinquencies indicates that we have a 7 percent delinquency rate. Approximately 75 percent of the delinquencies are just 1 month overdue. NTSB management officials are working with employees to get their accounts current.

Mr. SUNUNU. Mr. Levine, how many employees have received a power point presentation and how many do you intend to present it to? I know that not—every single employee might not be an appropriate.

Mr. LEVINE. I have made a presentation to the top management and the officer directors of every major mode. I have also made a presentation to three of the smaller offices, and I have presentations scheduled right now for three more. The regional directors for aviation are coming in this May, and I am scheduled to present to them as well. That is our biggest mode and that is where a lot of the travel occurs. To date, I can't put a percentage on it, sir, but by office I have had three of the seven major offices.

Mr. SUNUNU. Will you have all seven completed by June?

Mr. LEVINE. Yes sir. That is what the chairman wants, and that is what I am going to do.

Mr. SUNUNU. I highly encourage to you do your best.

Mr. LEVINE. Appreciate your encouragement.

Mr. HALL. We are trying to move expeditiously, Congressman. As you may know, we have nine regional offices, stretching from Anchorage to Miami and covering the United States. I won't ensure that our new CFO gets to each one of those by June, but we have a priority right now in trying to brief our headquarters offices.

Mr. SUNUNU. I understand. Perhaps you can follow up just for the record the detail of that schedule and just so that the Task Force has a sense of coverage. Because I think there is a great value, even if it is a presentation at a fairly high level, so that employees really understand what kind of an effort is being made and also they understand the value of the oversight that has been provided in this case by the Inspector General.

Mr. LEVINE. Can I add one point of clarification, Mr. Chairman, that you may not be aware of?

Citibank basically requires us to give very specific training on the purchase card and the use of it before that card is issued. And I have to say that NTSB—and this occurred before I arrived—made sure that all employees who received that card had to receive that training as well. So there was training in addition to what I have given.

Mr. MEAD. I would like to, in the interest of full disclosure in light of the conversation with Mr. Miller earlier and NTSB on this credit card delinquency point, this is not just an issue with NTSB. We are dealing with it at the Department of Transportation, too. We had roughly $3.6 million of delinquencies in the serious category a couple months ago; and the Assistant Secretary for Budget, the CFO, myself, the Deputy Secretary have all thought this is an area we need to pay attention to as well. Since February, we have had a marked reduction. We are down to $2.9 million, but we still have a ways to go. So NTSB is not in this swimming pool all alone.

Mr. SUNUNU. I appreciate that clarification, Mr. Mead.

Mr. Levine, I certainly believe this is a question best addressed to you. Can you tell me, before the system that you have in place now, and perhaps the system that was or was not in place previously, how did you track property and equipment, not just furniture but, most importantly, electronic equipment, computers and information systems themselves?

Mr. LEVINE. I am not sure I have a good answer here, so I need to look over to my managing director and check.

Mr. CAMPBELL. The reason Mr. Levine is hesitating is that the inventory system is not within his control, and marrying up the inventory system and the financial system is one of the projects that we have under way.

Mr. SUNUNU. Once the FMS recommendations are implemented, will the inventory control system be part of the Mr. Levine's jurisdiction?

Mr. CAMPBELL. It will be part of the same data base. The way that the property system works now, when property is brought into the building, it is identified as NTSB property and tagged as such as it is in an inventory system. What we do not presently have is a marrying between the acquisition document and the inventory document.

Mr. SUNUNU. I believe Mr. Levine gave a rough time line for completing the implementation of the goals set out by the FMS review and some of the additional goals of the Inspector General's recommendations of perhaps completing by the end of this year. My question for Chairman Hall is, given that time line, when do you expect to and when have you set a goal for having a clean audit completed?

Mr. HALL. I would hope we could have a clean audit at the end of fiscal year 2001. That is my goal. I want to do everything I can so that my successor at this agency doesn't experience the same situation I have. I think the best way to do that is to be sure that this agency annually can produce a clean audit. And now I have given Mr. Levine all these responsibilities, and I have got to get him some more people to help him perform his responsibilities.

Mr. CAMPBELL. If I might, Mr. Chairman, one of the issues that we have asked PriceWaterhouseCoopers to look at is the degree of readiness that we have for such an audit and to tell us what it is that we would necessarily have to do. Depending upon what they come back with in terms of readiness or the lack thereof, we will probably pick the earliest possible target date. If it could be this year, it is this year; if it is next year, it is next year.

But we have to have an independent auditor come to us and say these are the deficiencies and these are the needs within your existing system that will produce such a possibility. As I mentioned once before, the first order of business was to relook at the Gelco Rapidraft issue in terms of whether there is any continuing liability there; and the second order of business is to put us on the path for a clean audit.

Mr. SUNUNU. Thank you.

Mr. HALL. I know you read my testimony. That was where I was trying to head with the Treasury in 1997, 1998, because at that time I was told we couldn't get a clean audit without redoing our financial house. I am committed to that, and I hope it will happen very soon.

Mr. SUNUNU. Mr. Mead, the various responsive or the various remedial actions that NTSB has undertaken and outlined, are they responsive to the recommendations in your report? And I mean that in two ways.

One, of course, specifically, are you comfortable with what they have outlined and set for goals to respond to the results of your audit? More generally, are there any areas that are of concern for you that it would be difficult for them to achieve the goals of your report even if those remedial actions are implemented? In other words, are there objectives or problems that you see that—areas where we will need continued oversight in any agency? In other words, it is not just necessarily a problem with their inventory management system or reconciliation process, but they are just, in your opinion, going to continue to be problem areas?

Mr. MEAD. I would have to say that the termination of the Rapidraft program, the hiring of PriceWaterhouse, the installation of a new CFO and the broad front of actions that have been articulated as planned are responsive and should take care of the problem.

Now, there is a lot planned, and so the key is going to be in their implementation. You know, earlier—I think you were in the hearing room—Congressman Miller said, well, it is not just the Rapidraft that is the problem, it is a deeper issue. And he is right. Because if we don't deal with some of these other internal control issues such as reconciling payments you could have a recurrence of this sort of thing with credit cards. So I think their ship is headed in entirely the right direction. The key is going to lie in the implementation. And you are absolutely right. This is the type of situation you can find at almost any agency.

Mr. SUNUNU. Thank you.

Finally, I believe, as a result of this, it would be in our best interest to have you audit the system as it exists or was used in FAA and at the Volpe Center within the Department of Transportation. And I anticipate that we will be making a formal—as a full committee—formal recommendation to you to do just that.

Again, I appreciate all of your time.

I want to yield to Mr. Ryan for his question period, and then we will adjourn forthwith. Mr. Ryan.

Mr. RYAN. Thank you, Mr. Chairman. I would like to ask unanimous consent that my opening statement be included in the record.

Mr. SUNUNU. Without objection.

Mr. RYAN. Thank you.

[The prepared statement of Mr. Ryan follows:]

PREPARED STATEMENT OF HON. PAUL RYAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

Mr. Chairman, I am perplexed by the apparent financial mismanagement that has occurred over the last 18 years at the National Transportation Safety Board (NTSB). As I had the chance to read the Inspector General's report last night, I was shocked to find some of the ways that our tax dollars are being spent.

In 1982, the NTSB set up the Rapidraft Payment System to provide investigators with a mechanism to pay authorized expenses associated with on-site investigations. This system allowed NTSB investigators to write checks, up to a $2,500 limit, for items such as tow trucks and crane rentals. The NTSB's Chief Financial Officer was put in charge of the system.

In 1999, the NTSB's Rapidraft Payment System came under investigation by the Inspector General of the Department of Transportation. The results of the Inspector General's report were startling. By the Inspector General's account, the Rapidraft Payment System was turned into the CFO's personal playground at the taxpayers expense. In a random sample of one thousand FY99 Rapidrafts, the Inspector General found 902 noncompliant drafts. That's over 90 percent of the drafts, with many of these checks exceeding the $2,500 limit. Worse yet, the audit found that only 5 percent of the $3.6 million in allocated funds were used in on-site accident investigations. The results of the audit found that Rapidrafts were being used for such noncompliant expenses as:

- $731,000 for nonaccident related travel.
- $410,000 for tuition for training.
- $286,000 for nonaccident related equipment office supplies.
- More than 100 checks cashed at one DC liquor store.

• And the list goes on from there.

In 1992, a similar audit of the RPS was conducted by the General Services Administration. The GSA audit found that 92 percent of the Rapidrafts issued in the first 9 months of Fiscal Year 1991 were improperly used. The NTSB took no appropriate actions at or since that time.

All though the 1992 audit found significant weaknesses in the system's internal controls, they were not corrected. The Rapidraft Payment System may just as well have been called the Rapiddraft Profligate System. The Inspector General found that 37 of the 177 authorized investigators that were approved to write these checks no longer work for the NTSB. Checks were paid without signatures, authorization numbers or explanations. The CFO did not reconcile these checks to ensure payments were authorized.

Mr. Chairman, I think that any American citizen would find this kind of abuse offensive. Americans work hard for their money. As it is tax season, we are all reminded of the large portion that we pay in taxes every year. The average financial tax burden that the government imposes on an individual today is 33.5 percent of their income. In 1999, Americans worked from January 1st until May 3rd to pay off their taxes. That's over 4 months that Americans work just to pay their taxes.

Through the Inspector General's report of the NTSB, we are finding today that Americans worked hard to give entertainment money to NTSB workers. Americans worked hard to assign blank checks to former NTSB workers with no accountability. Americans have worked hard to provide computer upgrades to top NTSB officials to download questionable material. This is simply unacceptable.

How does such a system become so poorly managed? Why weren't these obvious problems fixed after the 1992 audit? What other government agencies are using this Rapidraft Payment System? How many tax dollars are being wasted in these agencies because of improper oversight of the RPS? These are all questions that I hope are answered today.

I do appreciate Inspector Meade and Chairman Hall for being here and testifying today. I also commend Chairman Hall for his willingness to request that Inspector General Meade audit the NTSB when he saw deficiencies in the system. I understand that an audit by the Inspector General was a voluntary move by Chairman Hall in response to widespread abuse of the financial accounting system.

Mr. Chairman, it has come to my attention that the Department of Transportation has recently called for the end of the RPS system—not only for the NTSB, but for all related DOT agencies. I am disappointed that it took a Congressional hearing to end the eighteen years of fraud and abuse. Government agencies like the NTSB should be implementing new payment programs that meet its needs with appropriate controls built in. It's time for an end to these kind of slush funds.

Weeding through government waste and abuse is serious business. For a government employee to waste taxpayers time is reprehensible, but for that employee to waste taxpayer's money is criminal. My staff and I take the responsibility of working for the American taxpayer very seriously. We work hard not to abuse the awesome power to which we have been entrusted. I expect nothing less from the NTSB, or any other government agency, than to hold them to that same standard.

Mr. RYAN. Mr. Hall, I would like to go back to the 1992 GSA audit. In 1992, the General Services Administration found serious deficiencies in the management of the Rapidraft Payment System, including a lack of supporting documentation, that Rapidrafts were issued without proper authorization and that travel advances made with Rapidrafts were sometimes used for nontravel purposes and used to circumvent proper payroll procedures. In fact, the GSA found that as many as 92 percent of the Rapidrafts issued for travel purposes were not in compliance with NTSB internal controls.

In response, the NTSB Comptroller identified specific solutions for correcting those deficiencies that the NTSB intended to implement.

This was 1992. I know you weren't there then, and I know the people are new. But GSA did an audit in 1992. Why did it take so long for you to take action? What happened in 1992 that NTSB didn't do anything to follow up on that audit and why was that the case?

Mr. HALL. Congressman, I want to be responsive to you and to this committee on all questions, but I must tell you, in all honesty, that I was not aware of that audit. My predecessor did not inform me of that. I was not aware of that audit until this whole matter came up in this year.

Mr. RYAN. Who on your staff would have been aware of the audit?

Mr. HALL. Mr. Keller, who is the individual that is no longer with us. I am sure there are other individuals. We could get that information for the record, but I don't know.

The office at that time was structured differently, sir. We had an Office of Administration, and the Accounting Office was under the Office of Administration. The Accounting Office reported to the head of that office, who then reported to the managing director, who reported to the chairman.

My concern, when I read the statute in Congress, was I was accountable. But there were three people in between me and the individual that was responsible for the proper accounting of the money. That was when I couldn't get good numbers. The second and third year I was there, I tried to move toward a reform of the system.

[The information referred to follows:]

RESPONSE FROM DIRECTOR HALL TO QUERIES BY MR. RYAN ABOUT 1992 DEFICIENCIES

In 1992, GSA performed an audit for NTSB to evaluate the adequacy of administrative procedures and practices for travel at the agency. The audit found that: (1) travel advance documents were signed by officials with appropriate authority; (2) expense claims were within Federal limits; (3) required receipts were attached; (4) amounts claimed were accurate; and (5) travel vouchers were appropriately authorized and timely.

However, the audit found problems with travel advance accounts (NTSB no longer uses a travel advance system and has not for some time), including a failure by NTSB to undertake periodic reviews of travel accounts balances. The audit also found that investigators had written rapiddrafts to cover travel expenses, though investigator authority was limited to on-scene purchases. Rapiddrafts for travel reimbursements were to be written only by NTSB designated imprest fund cashiers. Additionally, it was found that rapiddraft booklets were not always adequately secured or locked up. No fraud, waste, or theft was in any way intimated. Distribution of the GSA audit report indicates that three copies were delivered to the then Chairman of the agency, since departed.

At the time of the report, financial management was undertaken by a division of the Office of Administration, which in turn reported to the Managing Director, a non-career appointee, who reported to the Chairman. As a practical matter, the Deputy Managing Director would have had day-to-day supervisory responsibility for the Office of Administration. None of these individuals are currently with NTSB. According to a memorandum dated November 16, 1992, the Chief of the Financial Management Division proposed to his immediate supervisor several remedial actions, apparently acceptable to the Director of the Office of Administration. Whether any of these actions were reported further up the management structure, I am unable to say.

Factually speaking, NTSB did move away from the travel advance system that was the principal issue of criticism, and I am unaware of any present issue with investigators having subsequently written rapiddrafts to cover travel expenses. It would appear that the chief deficiencies stated in the 1992 audit resolved themselves, whether as a result of precautionary actions or simple changes in circumstances, again I cannot say with any certainty.

I would add that NTSB has undergone an extensive administration reorganization that should help to prevent any repetition. All purely administrative functions now report directly to Managing Director. (The titles of Deputy Managing Director and Managing Director are now Managing Director and Executive Director, respectively.) Financial management has been removed from administration altogether, and, in accord with the principles of the Chief Financial Officer Act, a freestanding office reporting directly to the Chairman has been established. We did not hesitate to implement the recommendations of the DOT IG coming from the recent audit, and I am confident that NTSB follow-through will be exemplary.

Mr. MEAD. Here is something that I think—illuminating on that. After the General Services Administration filed its report back then, it was the IG from GSA, the incumbent, the fellow that was the chief financial officer who was then called the comptroller, same person, he wrote a memo and in it he said that he was going to write another memo reminding everybody not to do these things.

Mr. RYAN. Was the content of that memo notifying employees about NTSB Order 46A and 1542?

Mr. MEAD. Yes, sir. And so—but we have been unable to establish whether in fact that was actually done. And, moreover, it has been our experience, and I am sure yours, that just issuing memoranda really doesn't do the trick.

Mr. RYAN. So the GSA audit was conducted in 1992. They said 92 percent of the Rapidrafts were for out-of-compliance check writing. And then the comptroller at that time, which is also the CFO, you are saying, may or may not have issued a memo to the staff reminding them of how to comply with the Rapidraft system. Is that the gist of what you are saying?

Mr. MEAD. He did write to his boss saying he was going to do these things. But we do not know whether in fact he actually did.

Mr. RYAN. Are you looking at—your audit was a 3-year audit, from fiscal year 1997 through 1999. Have you looked at pre-fiscal year 1997 checks?

Mr. MEAD. No, sir.

Mr. RYAN. Do you have them?

Mr. MEAD. No.

Mr. RYAN. Do you know how much money has been appropriated within the agency to the Rapidraft system? Just the macro numbers of what had been appropriated to the Rapidraft system from 1992 to 1997? Because I know you know what money was deposited into Rapidraft system for fiscal year 1997, 1998, 1999. What about 1992 to 1997?

Mr. MEAD. No, I don't know. All I can say is that the 1997, 1998, 1999 patterns are similar. I do not know if the trend existed before that time.

Mr. RYAN. Mr. Hall, do you have access to the data that would show us how much money was ultimately passed through the Rapidraft system from 1992 to 1997?

Mr. HALL. We would be glad to try and obtain that for the record, Congressman.

Mr. RYAN. If you could, that would be helpful.

[The information referred to follows:]

TOTAL DOLLARS PAID THROUGH THE RAPIDRAFT SYSTEM AND THE NUMBER OF CHECKS WRITTEN

[Fiscal year]

Fiscal year	Dollar value	Number of Rapidrafts written
1992	$1,202,580.57	5,937
1993	$2,677,364.18	7,929
1994	$1,398,778.13	6,718
1995	$2,407,865.42	7,685
1996	$2,824,574.71	7,696

TOTAL DOLLARS PAID THROUGH THE RAPIDRAFT SYSTEM AND THE NUMBER OF CHECKS WRITTEN—Continued

[Fiscal year]

Fiscal year	Dollar value	Number of Rapidrafts written
1997	$4,277,124.64	8,836
Total	$14,788,287.65	44,801

Mr. RYAN. Mr. Mead, at your entire Department of Transportation Inspector General—I came late, so I know these questions may have been exhausted already—but it is my understanding that yesterday the Department of Transportation ceased all Rapidraft procedures as of yesterday, is that correct?

Mr. MEAD. Yes, sir. This subject did come up before. And based on the NTSB experience, our own audit of FAA previously, that Departmentwide instruction was issued yesterday that, as of May 10, they will no longer be used in the Department. The reason for the 30 days, I hasten to add, is because we have air traffic control facilities in the field we want to make sure that they have credit cards and they don't say, well, thanks for leaving us hanging.

Mr. RYAN. How many Rapidraft systems were in place within the entire Department as of yesterday?

Mr. MEAD. I believe that there were two, FAA and the Volpe Center in Boston. The Federal Highway Administration I believe had discontinued it. I will correct that for the record if I am wrong. FAA had been spending, I think, about $15 million this past year; the Federal Highway Administration, $80,000; the Volpe Center, about 80 or 90,000. I think 40,000 checks at FAA.

Mr. RYAN. Forty thousand at the FAA.

Mr. MEAD. In 1999.

Mr. RYAN. What is the total dollar amount?

Mr. MEAD. About $15 million.

Mr. RYAN. That is, again, the total budget? You are auditing that right now?

Mr. MEAD. No, but we soon will be.

Mr. RYAN. I hope we look at other areas within the entire Federal structure where Rapidraft systems are employed. I think that is something that is a challenge for the committee here.

I want to go back to in 1992. What is the procedure that occurs when another government agency like the GSA audits a program—what is the procedure that is in place today to make sure that those audits are actually recognized, that those audits are responded to, that the audits are acknowledged? What happens? I am just curious as to what happens when those audits come to you.

Mr. MEAD. Within the Department of Transportation over which we have jurisdiction, there is a requirement that they respond. In this case, where we didn't have the jurisdiction over NTSB, there is no requirement for follow through; and in the GSA case the GSA never follows up. In this case, there is follow up I think largely because of the relationship between the NTSB and us. But it is not a legal requirement, if you will.

Mr. RYAN. So in your opinion—and I don't want to paraphrase for you, but this was discovered in 1992, these inherent flaws: room for embezzlement, over-the-limit expenditures, and noncompliant expenditures were known in 1992.

Mr. Hall, when you found out, you put an end to it just this last year. Why do you think it took so long to find this out? And what went wrong in 1992? Is it simply that they went to one individual, which was at that time the CFO, who just let it die by the wayside? Then it cropped back up in 1999? Or what do you think, Mr. Mead, was the cause for that?

Mr. Hall, please feel free to answer as well.

Mr. HALL. Congressman, in fairness to the people, I don't know. Because I wasn't there, I don't know what they did. I don't want to respond to a question when I truly do not know the answer.

Mr. MEAD. What happens when we travel, we put it on a credit card. In order to get paid back, we have to fill out a form that says where we traveled, how much we spent. It has to be approved, goes into the system. The Department of the Treasury eventually cuts an electronic transfer to our personal bank account. And there is also a general audit made.

That is, obviously, a more difficult procedure to get money from the U.S. Government than a procedure where you simply write a check to yourself and cash it. And if you have a system in place where you don't even have to sign the check or you don't have to put down the purpose, it is more expeditious. But I think we all know that we can't have a system like that in place in government and public service. So it is easier.

Mr. RYAN. This question may have been asked as well, but I would like to hear from you Mr. Hall, as part of the Rapidraft Payment System NTSB maintained a $350,000 in a noninterest-bearing account with Gelco. What efforts have NTSB undertaken to retrieve the $350,000 deposit since the Rapidraft system was stopped?

Mr. HALL. That matter was covered, and that question responded to. I will be glad to have Mr. Levine respond again.

Mr. RYAN. If you could respond.

Mr. LEVINE. I became aware of the deposit about a month and a half into my tenure. I directed my people to go after Gelco. There are some issues dealing with float charges and outstanding charges. We intend to get that money very shortly.

Mr. RYAN. Thank you.

That is all, Mr. Chairman.

Mr. SUNUNU. Thank you very much, Mr. Ryan.

I want to thank all of our witnesses today for their time and for their candor. Should the Task Force have any additional requests for information, I want you to know that we will be mindful of the burden that is on you now with the work that you do every day. And, again, I appreciate the information that you provided that I believe has already made a difference in putting important focus on the way we disburse money in departments and agencies across the Federal Government; and for that you are to be congratulated.

Thank you, all.

The Task Force is adjourned.

[Whereupon, at 12:40 p.m., the Task Force was adjourned.]

Lack of Income Verification in HUD-Assisted Housing: The Need to Eliminate Overpayments

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THURSDAY, MAY 25, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON HOUSING AND INFRASTRUCTURE,
Washington, DC.

The Task Force met, pursuant to call, at 10:05 a.m. in room 210, Cannon House Office Building, Hon. John Sununu (chairman of the Task Force) presiding.

Mr. SUNUNU. Good morning. I would like to start by thanking Congressman Bentsen and all the members of the Task Force for participating in this hearing and supporting the oversight hearings for which we are responsible in both housing and infrastructure. But also I would like to recognize and thank the Special Agents that are here today, Raymond Carolan and Emil Schuster of the U.S. Department of Housing's IG Office; Deputy Secretary Saul Ramirez, who has testified here before on behalf of the Department of Housing and Urban Development; and Ms. Sheila Crowley of the National Low Income Housing Coalition.

I know you all have busy schedules. I appreciate your taking the time out to testify.

Since its inception, the Section 8 housing assistance program has helped millions of American families find affordable housing. Through the Section 8 voucher and certificate programs, HUD provides rental subsidies which help over 1.4 million households in the United States.

The subsidies are reserved only for very low-income tenants and are based on the amount of income the tenant earns. Typically, the tenant pays the rent capped at 30 percent of income, and HUD pays the remaining rental cost of the apartment.

Obviously, determining a tenant's true income level is essential for the programs to operate not just efficiently, but fairly as well, because as we all know, the waiting list for these positions can be quite long.

Unfortunately, there has been a long-standing problem at the Department of Housing and Urban Development in assuring that subsidy payments are made in the right amount to those eligible low-income tenants.

Both the GAO and the HUD Inspector General's Office have determined that the systems in place "do not provide reasonable assurance that subsidies paid under the programs are valid and correctly calculated, considering tenant incomes and contract rents."

Since 1996, the HUD Inspector General has reported that HUD's housing subsidy programs do experience improper payments when beneficiaries' income status changes and they do not notify housing authorities to adjust their benefits.

HUD itself has estimated that approximately $935 million in excessive payments have been made in its Section 8 housing program for 1998. Had this $935 million been used to assist low-income tenants, it is estimated that approximately 150,000 families could have been assisted with their housing needs. So this is not simply a budgetary problem, but it is also a fairness problem.

We want to make sure within HUD that resources are made available to assist those that need help. Again, the waiting lists for many of these programs are quite long.

In 1999, HUD developed an approach to use a large-scale computer-matching income verification process that would compare IRS and Social Security information and identify tenants who had underreported their income. In the first quarter of the year 2000, HUD used its new matching methodology to identify approximately 280,000 tenant households with income discrepancies. HUD then prepared letters to inform tenants of their responsibility to disclose their proper income and tax data to the Public Housing Authority, as well as notifications to the housing authorities themselves.

Although the Department had originally planned to mail notification letters to all of these tenants with income discrepancies, it was decided to engage in a pilot program in Washington, DC. In February, about 900 letters were sent to tenants, which were not received well. As a result, the program was temporarily suspended.

Our goal today is to attempt to shed light on the nature of the problems that were encountered early on with the 1995 problem, understand what efforts the Department of Housing and Urban Development has made to solve the problems, and try to better understand the scope of the problem that the Inspector General's Office has been evaluating.

We will hear testimony from the Office of Inspector General, explaining their understanding of the problem and talking about several real-world examples of how and why overpayments are made.

In addition, we will hear testimony from the controller at HUD, who has responsibility for monitoring these finances, and hear about what steps HUD has taken to bring in the concerns of tenants and try to shed additional light on the tenants' perspective in these attempts to reduce the significant level of overpayments.

I would like to recognize Congressman Bentsen for any remarks he might have.

[The prepared statement of Mr. Sununu follows:]

PREPARED STATEMENT OF HON. JOHN E. SUNUNU, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW HAMPSHIRE

Good morning. I'd like to start by thanking Congressman Bentsen and all the members of the Task Force for being here this morning. I'd also like to recognize and thank Special Agents Raymond Carolan and Emil Schuster of the U.S. Department of Housing and Urban Development's Office of Inspector General, Deputy Secretary Saul Ramirez, U.S. Department of Housing and Urban Development, and Ms. Sheila Crowley of the National Low Income Housing Coalition. I appreciate your taking the time out of your schedules to be here this morning.

Since its inception the Section 8 housing assistance program has helped millions of American families to find affordable housing. Through the Section 8 voucher and certificate programs HUD provides rental subsidies which help over 1.4 million households in the United States. These subsidies are reserved only for very low-income tenants and are based on the amount of income the tenant makes. Typically, the tenant pays a rent capped at 30 percent of income, and HUD pays the remaining rental cost of the apartment.

Clearly, determining a tenant's true income level is essential for the programs to operate properly and fairly. Unfortunately, there has been a longstanding problem at the Department of Housing in assuring that subsidy payments are made in the right amount to eligible low income tenants. Both the General Accounting Office and the HUD Inspector General's Office have determined that the systems in place now do not "provide reasonable assurance" that "subsidies paid under these programs are valid and correctly calculated considering tenant incomes and contract rents." Since 1996, the HUD IG has reported that HUD's housing subsidy programs experience improper payments when beneficiaries income status changes and they do not notify housing authorities to adjust their benefits. In fact, HUD itself has estimated that $935 million in excessive payments have been made in its Section 8 Housing program for 1998. Had this $935 million been used to assist eligible low income tenants, it is estimated that an additional 150,000 families could have been helped.

In 1999 HUD developed an approach to use a large-scale Computer Matching Income Verification Process to compare IRS and Social Security information and identify tenants who had under-reported their income. In the first quarter of 2000, HUD used its new matching methodology to identify 280,000 tenant households with income discrepancies. HUD then prepared letters to inform tenants of their responsibility to disclose their proper income and tax data to their Public Housing Authorities, as well as notifications to the PHA's themselves. Although the Department had originally planned to issue notification letters to all tenants with income discrepancies, it was decided instead to use the Washington, DC, Housing Authority as a preliminary test area. In February 2000, letters were sent to approximately 900 tenants. It is my understanding that these letters were received rather negatively, and as a result the Department has halted its income verification program.

The purpose of this hearing will be to attempt to shed light on the nature of the problems in the income verification program, and the effort of the Department to solve these problems. The Task Force will hear testimony from two investigators from the HUD Inspector General Office explaining their understanding of the problem and relating real world examples of how and why the overpayments are made. In addition, we will hear testimony from the Controller at HUD who has responsibility for monitoring the finances at HUD. Finally, we will hear what steps HUD has taken and plans to take in the future, along with testimony from an advocate for tenants to bring light to their perspective on recent attempts to bring down these overpayments.

I would now like to recognize Congressman Bentsen for any opening remarks he may have.

Mr. BENTSEN. Thank you, Chairman Sununu. I want to thank our panelists for being here, both the individuals from the IG's Office, as well as my fellow Texan, the Deputy Secretary, who, prior to becoming Deputy Secretary of HUD, had real power as the county judge of Webb County, Texas, and gave that up to come here to Washington; and also Ms. Sheila Crowley from the National Low Income Housing Coalition.

Let me say, this Task Force of the Committee on the Budget is charged with investigating areas where there is either fraud, waste, or abuse in government programs. I think that there is strong bipartisan support among all members of the committee, as well as all Members of the House, that fraud and abuse in government programs with taxpayers' money should not be tolerated.

That being said, I think we also—and as a member of the Committee on Banking and Financial Services, which has jurisdiction over HUD, we also must not lose sight of the fact that we do have a low-income housing crisis in America; that as strong as our economy has been, we still have tens of thousands, or more, Americans who are on waiting lists trying to get into assisted homes, assisted living, including in my district in the greater Houston area. It is something that we should be focused on.

Additionally, as we have found through hearings on the Committee on Banking and Financial Services, while there is great concern, and I have great concern with respect to overpayments, we also have concerns about underpayments.

This is a broad problem and a complicated program that has probably been somewhat more complicated with the passage of H.R. 2 a couple of years ago, which I was involved in drafting with Mr. Lazio and Mr. Frank and others, that changed some of the income rules and targeting rules and others in the Section 8 program. So HUD is going through a transition with respect to that.

Finally, I am eager to hear not only about the findings of the IGs and the methodology and how we might address this, but also about the income verification program that HUD has instituted, both in terms of HUD, as to how that is going; but also from the IG, your perspective on that as well, and how that might be made even better, given that it appears to be the first time this is even done.

Finally, I think we must not lose sight of the fact that the clientele that we are talking about here are among the poorest of Americans, that there are many who are struggling their way up the rungs of the ladder; and we must be cautious in our diligence to root out fraud and abuse not to lose sight of the fact that many of these individuals may not share the technical expertise that those of us in the Washington realm do—and we should be cautious in that regard.

Mr. Chairman, thank you for holding this hearing. I look forward to participating in it. I yield back the balance of my time.

Mr. SUNUNU. Thank you, Mr. Bentsen.

I would like to begin with the testimony from the Office of Inspector General, and once we have completed that testimony, I would ask that you gentlemen literally just slide down to one side of the table so we can have all of the testimony presented from Ms. Crowley and Mr. Ramirez before we get to questions.

Then if the four of you can participate in the question-and-answer session, we will have questions from both me and Mr. Bentsen, but hopefully in a somewhat informal way; and you should feel free during that question period to make any points that you think are relevant, even if the questions are not necessarily directed to you, because our interest is in presenting as much information here as we can in what is, unfortunately, a short amount of time.

Mr. Schuster, I would appreciate your testimony. I yield to you for whatever time you might need.

STATEMENT OF EMIL J. SCHUSTER, SPECIAL AGENT IN CHARGE, SOUTHEAST/CARIBBEAN FIELD OFFICE OF THE HUD INSPECTOR GENERAL

Mr. SCHUSTER. Thank you. Good morning.

Chairman Sununu and Congressman Bentsen, I appreciate the opportunity to be here before you this morning to provide a little bit of insight on what the Office of Investigations for the Office of Inspector General of HUD does as far as tenant fraud.

I ask that my full written statement be included in the record.

Mr. SUNUNU. Without objection.

Mr. SCHUSTER. My knowledge of this issue is based on the 9½ years I have been in charge of the HUD Office of Inspector General, Office of Investigations Southeast/Caribbean District in Atlanta, Georgia.

We, like many in the IG community, have limited resources. Because of that, it is essential to set strict priorities in their use. These priorities are affected in large measure by the prosecutorial guidelines set by the various U.S. Attorneys.

There is generally a minimum dollar threshold on fraud charges in each judicial district. For example, it might be $10,000, or it could be as high in some districts as $100,000. In addition, each district might have their own set of priorities, so the priorities in, for example, Miami may be far different than in Memphis, Tennessee.

Nonetheless, there are deviations from these minimums when circumstances are so heinous that criminal prosecution is called for. Because of these limitations, our investigations leading to the prosecution of tenant fraud in the Southeast District have averaged approximately only five per year.

To further clarify our addressing of tenant fraud, I would like to use an interview question I pose to recent college graduates who are applying for Special Agent positions.

I explain to the person that a complaint is received and that a Section 8 tenant, identified as Mary Doe, is defrauding HUD by not disclosing income she is receiving from a part-time job. You conduct an investigation and find the following: Mary Doe has been working part-time at McDonald's for the past year. She has three elementary schoolchildren.

From the interviews, it appears that she is simply trying to earn some extra money to buy new school clothes, shoes, et cetera, for her children. She has not disclosed this additional income, and thereby has defrauded HUD out of $1,000 this past year.

How do we handle this?

The answer I look for is that this is not a prosecutable criminal case. Rather, this is the type of situation that we would refer back to the Housing Authority and/or the HUD program staff, recommending that they take some type of appropriate administrative action.

The purpose of this question is to show that not every fraudulent act warrants criminal prosecution. Judgment is needed, especially with limited resources.

Now, having identified the type of case that would generally not be pursued, I would like to describe several specific cases where we have undertaken investigations, alone or with other law enforcement agencies, that have led to successful prosecutions. We will often work with the Department of Health and Human Services IG, or Secret Service, or any of the various other IGs in looking at fraud.

Example number one is Nashville, TN, an IRS employee we prosecuted for falsifying her income in order to obtain Section 8 benefits. She failed to report her income she earned as an IRS employee. Her fraud resulted in a loss to HUD of over $15,000.

Example number two, Memphis, TN. A Memphis Housing Authority employee conspired with the Shelby County Corrections Officer to create a fictitious Section 8 landlord and place the property into the Section 8 program. The corrections officer became the tenant, receiving the Section 8 assistance. The officer would then receive the Section 8 checks and forge the fictitious owner's signature, and they would split the money. They took in about $11,000 of HUD funds.

In Campbellsville, KY, during a Safe Home operation—and this is our operation for violent crime in public and assisted housing; primarily we deal a lot with drug cases—we were investigating a situation with two people selling drugs in the Housing Authority developments.

During the investigation, we discovered that one of the individuals was a Section 8 landlord who was renting to another individual, who was another person who was selling drugs. During the search warrant, we found that the landlord was living actually in the residence with the tenant.

Now, this only amounted to fraud of just $1,070, but the Assistant United States Attorney [AUSA] decided to include this in the prosecution with the drug counts because of the heinousness of this situation.

In Atlanta, GA, the defendant created false birth certificates in order to obtain four different Section 8 subsidized apartments under fictitious names in Tennessee and Georgia. In addition, she received food stamps and welfare in each of the units. The loss to the government was over $15,000. This was one of the situations where we worked with the Department of Agriculture IG and the HHS IG.

Then in Broward County, FL, 35 individuals were prosecuted for fraudulently obtaining over $300,000 in Section 8 subsidies. The tenants were Nigerians, or spouses of Nigerians, who were in this country illegally or whose status had expired. The defendants were able to create false employers and have their verification of income forms sent to the post office boxes that they owned or were owned by Nigerian-owned businesses.

Twelve of the defendants were employees of the Florida Department of Human Rehabilitation Services, HRS, which is a basic State entity which handles welfare payments in the State of Florida.

Another side to this is, these people were making in the area of $35,000 to $40,000 per year as salary from the State of Florida. In addition, they were also receiving food stamps, AFDC, and educational grants that they were not entitled to receive.

There are certain common threads that run through these prosecutable-type cases. A subject who is a city, State, or Federal employee will spark the interest of an Assistant United States Attorney. A subject who is defrauding other government programs, like food stamps or AFDC, likewise is seen as a good target. Another good subject would be a drug dealer, obviously.

Of course, there are some whose actions are so flagrant that a jury would not hesitate to convict: for example, a subject who owns several rental houses, yet still claims Section 8 assistance.

Another important aspect of this case is the deterrent value prosecution will bring. For example, if there is some notoriety attached to the case, the media will run a story which has a positive impact on making an applicant think twice about lying. These are all things that we consider before opening an investigation.

We continue to receive allegations from a number of sources, and as I said, undertake approximately five investigations per year. Over the 9-plus years I have been in Atlanta, I have seen the same type of allegations occur and recur, understating income or failing to report jobs for the purpose of receiving a subsidized unit or a larger subsidy from HUD.

As both resources and prosecutorial appeal exist, we investigate the most egregious cases. Any remaining allegations are referred to the Housing Authority and/or HUD program staff for administrative action, as appropriate.

Mr. Chairman, that concludes my remarks. I would be happy to answer any questions following the testimony.

Mr. SUNUNU. Thank you very much, Mr. Schuster.

[The prepared statement of Mr. Schuster follows:]

PREPARED STATEMENT OF EMIL J. SCHUSTER, SPECIAL AGENT IN CHARGE, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, OFFICE OF THE INSPECTOR GENERAL, SOUTHEAST/CARIBBEAN DISTRICT

Chairman Sununu and members of the Housing and Infrastructure Task Force, I appreciate the opportunity to appear before you today to provide insight on the investigation of tenant fraud as it relates to the Department of Housing and Urban Development, Office of Inspector General. I ask that my full written statement be included in the record.

My knowledge of this issue is based on the 9½ years I have been the Special Agent in Charge of the HUD Office of Inspector General, Office of Investigations Southeast/Caribbean District in Atlanta, GA. We, like many in the IG community, have limited resources. Because of that it is essential to set strict priorities on their use.

These priorities are affected in large measure by the Prosecutorial guidelines set by the various U.S. Attorneys. There is generally a minimum dollar threshold on fraud schemes for each judicial district. It may range from $10,000 to as much as $100,000. In addition, jurisdictions have different priorities—Miami's are not the same as Memphis. Nonetheless, there are deviations from these minimums when circumstances are so heinous that criminal prosecution is called for. Because of these limitations our investigations leading to the prosecution of tenant fraud in the Southeast District has averaged approximately five cases per year.

To further clarify our addressing of tenant fraud, I would like to use an interview question I pose to recent college graduates who are applying for Special Agent positions in our office. I explain to the person that a complaint is received and that a Section 8 tenant identified as Mary Doe is defrauding HUD by not disclosing income that she is receiving from a part time job. You conduct an investigation and find the following: Mary Doe has been working part time at McDonalds for the past year. She has three elementary school children. From interviews it appears she is simply trying to earn some extra money to buy new school clothes, shoes, etc., for her children. She has not disclosed this additional income and thereby has defrauded HUD out of $1,000.00 this past year. How do you handle this? The answer that I look for is that this is not a prosecutable criminal case. Rather this is the type of situation that we refer back to the Housing Authority and/or HUD program office recommending that they take appropriate action.

The purpose of this question is to show that not every fraudulent act warrants criminal prosecution. Judgment is needed, especially with limited resources.

Now having identified the type case that would generally not be pursued, I would like to describe several specific cases where we have undertaken investigations, alone or with other law enforcement agencies, that have led to successful prosecutions. The reasons, I believe, are quite evident.

Nashville, TN—Evelyn Haggen Hodgins an IRS employee, was prosecuted for falsifying her income in order to obtain Section 8 rental assistance. Ms. Hodgins had failed to report the income she earned from the IRS. Her fraud resulted in a loss to HUD of over $15,000.

Memphis, TN—A Memphis Housing Authority employee Donna Dillihunt, conspired with a Shelby County Corrections Officer Pamela Allen to create a fictitious Section 8 landlord and place a property in the Section 8 program. The Corrections Officer became the tenant receiving the Section 8 assistance. The officer would receive the Section 8 checks and forge the fictitious owner's signature. The two defendants received over $11,000 in HUD funds.

Campbellsville, KY—During a Safe Home Operation evidence was obtained that Kelly Lee Shipp and Patricia May Wooley were selling drugs in the Campbellsville Public Housing Developments. During the investigation it was discovered that Mr. Shipp was a Section 8 landlord who was renting to Ms. Wooley. Mr. Shipp had moved in with Ms. Wooley after he had certified that he did not reside there. The loss to HUD was only $1,070. But due to the other criminal activities of the pair, the fraud charge was included in their prosecution.

Atlanta, GA—The defendant Marylin Arinzee, created false birth certificates in order to obtain four different Section 8 subsidized apartments under fictitious names in Tennessee and Georgia. In addition, she received food stamps and welfare at each of the units. The loss to the Government was over $15,000.

Broward County, FL—Thirty Five individuals were prosecuted for fraudulently obtaining over $300,000 in Section 8 subsidies. The tenants were Nigerians or the spouses of Nigerians, who were in this country illegally or whose status had expired. The Defendants were able to create false employers and have their Verification of Income forms sent to post office boxes that they owned or were owned by Nigerian owned businesses. Twelve of the Defendants were employees of the Florida Department of Human Rehabilitation Services (HRS). HRS is the State Agency that administers welfare payments in Florida. In addition, the defendants also received food stamps, AFDC, and educational grants that they were not entitled to receive.

There are certain common threads that run through these prosecutable type cases. A subject who is a City, State, or Federal employee will spark the interest of an Assistant United States Attorney. A subject who is defrauding other Government programs like food stamps or AFDC likewise is seen as a good target. Another good subject would be a drug dealer. And, of course, there are some whose actions are so flagrant that a jury would not hesitate to convict. For example, a subject who owns several rental houses yet still claims Section 8 assistance. Another important aspect of these cases is the deterrent value prosecution will bring. For example if there is some notoriety attached to the case the media will run a story which has a positive impact on making an applicant think twice about lying. These are all things that we consider before opening an investigation.

We continue to receive allegations from a number of sources and as I said undertake approximately five investigations per year. Over the 9 plus years I have been in Atlanta I have seen the same type of allegations occur and recur—understating income or failing to report jobs for the purpose of receiving a subsidized unit or a larger subsidy from HUD. As both resources and prosecutorial appeal exist, we investigate the most egregious cases. Any remaining allegations are referred to the Housing Authority and/or HUD program staff for administrative action, as appropriate.

Mr. Chairman, that concludes my remarks, and I would be happy to answer any questions you may have.

Mr. SUNUNU. Mr. Carolan.

STATEMENT OF RAYMOND A. CAROLAN, SPECIAL AGENT IN CHARGE, NEW ENGLAND OFFICE OF THE HUD INSPECTOR GENERAL

Mr. CAROLAN. Good morning, Mr. Chairman, Mr. Bentsen, and members of the committee. I am pleased to appear before you today and highlight a few examples of our work in the subsidy fraud area.

I would ask that my comments be entered into the record.

Mr. SUNUNU. Without objection.

Mr. CAROLAN. Mr. Chairman, I am a career Office of Inspector General employee. I have been with the Office of Inspector General for 28 years. I have been the Special Agent in charge of the New England District for the last 18 years. I believe that my district, New England, was the first to present subsidy fraud cases for prosecution to the United States attorney in the mid-1970's.

The investigation of these cases today is basically the same as it was then. The cases usually fall into four major categories: a tenant's failure to report income or assets; a tenant's failure to accurately report total family composition, which usually results in an underreporting of income; conspiracy between tenants and management; and conspiracy involving subsidized tenants and property owners.

Today, I would like to present especially egregious examples of subsidy fraud stemming primarily from the last two categories, the conspiracy ones.

My first example involves a 262-unit fully subsidized cooperative housing complex in the Charlestown section of the City of Boston. In cooperative housing, a tenant board of directors oversees all aspects of the property management. In this case, tenants were also employed by the management company at the site office to administer the annual income recertifications and to oversee all of the daily operations.

Our investigation revealed widespread fraud and conspiracy between some of the tenants and the management office employees. It also included the board members. The widespread fraud at this complex required the cooperation of the office staff, members of the board, in order to perpetuate the scheme.

The investigation indicated that employment verifications that were supposed to be independent were false and forged. Tenants and management staff conspired to report half of actual income and conspired to hide the occupancy of employed family members. There was a pattern of this. They also conspired to falsify family composition in order to qualify for larger unit sizes.

An example: Section 8 tenants Barbara and Michael failed to report total family income, resulting in overpayments of approximately $14,000. Michael was related to a project manager. The Section 8 forms failed to accurately reflect Michael's total income generated from his employment at a hospital, and failed to reflect any income generated by Barbara, the spouse, through her employment at the same hospital.

The Section 8 forms for 1988 reflected the total family income as $9,000, when, in actuality, in 1988 income for the gross wages for the entire family was over $57,000.

In addition, the Section 8 forms incorrectly listed their family composition as consisting of Michael, Barbara, and their son, Cory. When asked by our agents who Cory was, Barbara indicated that Cory was her dog, that she has no children. She could not explain how her dog appeared on the Section 8 forms as her child.

Listing a child on the Section 8 forms would entitle the Section 8 tenants to a deduction which is formulated into the total rent calculation. In addition, the bedroom size allocated to a Section 8 tenant family is based upon total family composition. In this case, the family qualified for a two-bedroom apartment. There were a lot of these cases at this particular site, where families were overhoused as a result of falsification of family composition.

Once these schemes were crafted, the employment verification forms were falsified and formed in order to fit each scheme. There was a pattern of this particular type of fraudulent activity at varying levels for many of the tenants at this complex.

When we attempted to verify the accuracy of their employment forms, the employees reported that the income information was inaccurate and that the signatures were all forged. The investigation involved the use of Federal grand juries and Federal search warrants.

Twenty-two tenants at the site, including four board members, were federally indicted for false statements, conspiracies, and other related charges. All defendants either pled or were found guilty in 1993. Monetary losses representing subsidy overpayments related to these indictments were approximately $245,000.

Following our investigation, the management company was required to repay HUD over $366,000, and was removed. A new management company was required to recertify all residents at this complex. This company's recertification process resulted in a $400,000 annual reduction in Section 8 subsidies the next year.

My second example involves a conspiracy between a property owner and a subsidized tenant. This case was not prosecuted due to evidence and statute of limitations issues. It is, however, I believe a good example of this type of scheme.

Our investigation indicated that a property owner transferred ownership of a single-family property to a straw buyer just prior to the application to the Public Housing Authority for participation in the Section 8 program. What he did was reversed his role from a property owner to a tenant.

From 1981 to 1995, subsidy was paid to the straw buyer in the amount of over $74,000. The scheme was disclosed when IRS began to investigate the straw buyer for failure to report rental income from the property to the IRS. What happened was the IRS received a 1099 from the Housing Authority disclosing rental income to that straw buyer.

In response to the IRS, the straw buyer stated that her ownership of the subsidized property was "in name only," that the rental income reflected on the form 1099 "was arranged" without her knowledge and was sent in—these payments were sent by the Housing Authority, the Public Housing Authority, to a post office box rented in her name without her knowledge.

Furthermore, she stated that the subsidy checks were also cashed without her knowledge or her endorsement on the checks. An administrative process to recoup this overpaid subsidy is ongoing.

So even though this case was not prosecuted for various reasons, the administrative process is ongoing, and I heard recently that what this straw buyer is doing is turning the deed back to the Housing Authority for that property, so the Housing Authority will be the owner, in an attempt to recoup the $74,000.

Some other examples that parallel income issues. An investigation was initiated to determine whether Jose and Rose, public housing tenants in Manchester, NH, failed to report their income. This was a joint investigation with the Social Security Administration Office of Inspector General.

The only income claimed on their public housing applications was Social Security and SSI, disability benefits. Both Rosa and Jose worked at a variety of jobs during the period of overpayment, which was July, 1995, to November, 1996. None of this income was reported on the applications.

Jose was indicted on December 9, 1998, on four counts of making false statements, three to HUD and one to the Social Security Administration, and two counts of misusing Social Security numbers. Jose pled guilty. A Federal judge sentenced him on June 30, 1999, to time served, which was 6 months. He got 3 years probation and an assessment of $200, and was ordered to make repayments in the form of restitution in the amount of $25,000.

In another case, this particular Section 8 tenant received Section 8 assistance in Lynn and Lexington, MA, from January 1987 until August 1998. During the period, they only claimed benefits received from Aid to Families with Dependent Children. They also held occasional part-time jobs.

Penny, using another name and another Social Security number of a deceased uncle, worked at a computer company from December, 1989, to July 1989, and did not report this income. On September 13, 1999, a criminal complaint was filed in U.S. District Court in Massachusetts, charging Penny with violating 18 U.S.C. 641, conversion of government funds.

On January 5, 2000, Penny waived her right to indictment and pled guilty to one count, information. The Federal district judge sentenced Penny to 6 months' confinement in a halfway house, 2 years' probation, a $100 special assessment, and $37,000 in restitution to the Federal Government.

Mr. Chairman, that concludes my remarks. I would be pleased to answer any questions you may have following the other witnesses's testimony.

Mr. SUNUNU. Thank you very much, Mr. Carolan.

[The prepared statement of Mr. Carolan follows:]

PREPARED STATEMENT OF RAYMOND A. CAROLAN, SPECIAL AGENT IN CHARGE, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, OFFICE OF THE INSPECTOR GENERAL, NEW ENGLAND DISTRICT

Mr. Chairman and members of the committee. I am pleased to appear before you today to highlight a few examples of our work in the subsidy fraud area. I am a career Office of the Inspector General employee with over 28 years of service. I have been the Special Agent in Charge of the New England District for the last 18 years.

I believe that my District was the first to present subsidy fraud cases for prosecution to the United States Attorney in the mid 1970's. The investigation of these cases today is basically the same as it was then. The cases usually fall into four major categories:

- Tenants failure to report income and/or assets.
- Tenants failure to accurately report total family composition resulting in understated total family income.
- Conspiracy between tenants and management.
- Conspiracy involving a subsidized tenant and a property owner.

Today I would like to present especially egregious examples of subsidy fraud stemming primarily from the last two categories.

CONSPIRACY BETWEEN TENANTS AND MANAGEMENT

My first example involves a 262 unit, fully subsidized. cooperative housing complex in the Charlestown section of the City of Boston. In cooperative housing, a tenant Board of Directors oversees all aspects of the property management. In this case, tenants were also employed by the management company at the site office to administer the annual income recertifications and to supervise daily operations.

Our investigation revealed widespread fraud and conspiracy between the tenants and the management office employees.

The widespread fraud at this complex required the cooperation of the office staff and members of the tenant Board of Directors in order to perpetuate the scheme. The investigation indicated that employment verifications that were supposed to be independent were falsified and forged.

Tenants and management staff conspired to report half of actual income and conspired to "hide" the occupancy of employed family members. They also conspired to falsify family composition in order to qualify for larger unit sizes:

Section 8 tenants, Barbara and Michael failed to report total family income resulting in an overpayment of $14,506. Michael was related to a project manager. The Section 8 forms failed to accurately reflect Michael's total income generated from employment at a hospital and failed to reflect any income generated by Barbara through her employment at the same hospital. The Section 8 forms for 1988 reflected the total family income as $9,073, when in actuality, the 1988 income for gross wages was $57,785.92. In addition, the Section 8 forms incorrectly listed their family composition as consisting of Michael, Barbara and their son, Cory. When asked by the agents who Cory was, Barbara indicated that Cory was her dog, that she has no children. She could not explain how her dog appeared on the Section 8 forms as her child. Listing a child on the Section 8 forms entitles the Section 8 tenants to a deduction which is formulated into their total tenant rent payment calculation. In addition, the bedroom size allotted to a Section 8 family is based upon total family composition. In this case, the family qualified for a two bedroom apartment.

Once the schemes were crafted, the employment verification forms were falsified and forged in the management office in order to fit each scheme. There was a pattern of this particular type of fraudulent activity at varying levels for many of the tenants at the complex.

When we attempted to verify the accuracy of the forms, the employers reported that the income information was inaccurate and that the signatures were forged. The investigation involved the use of the Federal Grand Jury and Federal Search Warrants. Twenty two tenants, including four board members, were federally indicted for false statements, conspiracy and other related charges. All defendants either plead or were found guilty in 1993. Monetary losses representing subsidy overpayments, related to the indictments, were approximately $245,000.

Following the OIG investigation, the management company was required to repay HUD over $366,000 and was removed by HUD. A new management company was required to recertify all residents. This company's recertification process resulted in a $400,000 annual reduction in Section 8 subsidies.

CONSPIRACY BETWEEN TENANT AND PROPERTY OWNER

My second example involves a conspiracy between a property owner and a subsidized tenant. This case was not prosecuted due to evidence and statute of limitations issues. It is however a good example of this type of scheme.

Our investigation indicated that a property owner transferred ownership of his single family property to a straw buyer just prior to the application to the public housing authority (PHA) for participation in the Section 8 program.

From 1981—1995 subsidy was paid to the straw buyer in the amount of $74,508. The scheme was disclosed when the IRS began to investigate the straw buyer for failure to report rental income from the property to the IRS. The IRS had received a Form 1099 from the PHA disclosing payment of this rental income to the straw buyer.

In a response to the IRS, the straw buyer stated that her ownership of the subsidized property was "in name only"; that the rental income reflected on the Form 1099 was "arranged" without her knowledge and was sent by the PHA to a post office box rented in her name without her knowledge. Furthermore she stated that the subsidy checks were cashed without her knowledge or endorsement. An administrative process to recoup the overpaid subsidy is ongoing.

OTHER EXAMPLES

An investigation was initiated to determine whether Jose and Rosa, Public Housing Tenants, Manchester, NH, failed to report their income. This was a joint investigation with the Social Security Administration, Office of Inspector General. The only income claimed on their public housing applications was SS/SSI. Both Rosa and Jose worked at a variety of jobs during the period of overpayment, July 1, 1995 to November 26, 1996, and none of this income was reported on their public housing applications.

Jose was indicted on December 9, 1998 on four counts of making false statements (18 USC 1001; 3 related to SSA and 1 to HUD) and two counts of misusing Social

Security numbers (42 USC 408, SSA violation). Jose plead guilty to counts 1 (18USC1001 re: SSA) and 4 (18USC1001 re: HUD) and the other four counts were dismissed. A Federal judge sentenced him on June 30, 1999 to time served (6 months), 3 years probation, an assessment of $200, and restitution of $25,906.33 ($18,650.33 to SSA and $7,256 to HUD)

Penelope, a/k/a Penny, received Section 8 assistance in Lynn and Lexington, MA, from January 1987 until August 1998 and during that period of time Penny only claimed benefits received from Aid to Families with Dependent Children and/or an occasional part time job. Penny, using another name and a SSN of her deceased uncle, worked at a computer company from December 1989 until July 1998 and did not report this income on her Section 8 applications.

On September 13, 1999 a Criminal Complaint was filed in U.S. District Court, District of Massachusetts charging Penny with violating 18USC641, Conversion of Government Funds. On January 5, 2000 Penny waived her right to indictment and plead guilty to a one count Information charging her with violating 18USC641. On April 10, 2000 a U.S.

District Judge sentenced Penny to 6 months confinement in a halfway house, 2 years probation, $100 special assessment, and $37,709 in restitution.

Mr. Chairman, that concludes my remarks, and I would be pleased to answer any questions you may have.

Mr. SUNUNU. At this time, I would like to ask Ms. Crowley and Mr. Ramirez to please have a seat at the witness table.

Mr. Bentsen.

Mr. BENTSEN. Mr. Chairman, I misspoke. Secretary Ramirez was the mayor of Laredo, not the county judge of Webb County. I apologize for that. I have found, as you have probably found, that the mayor of a city is the most powerful individual you can meet. So I want to make sure I got that right.

Mr. RAMIREZ. That is OK.

Mr. SUNUNU. I appreciate Mr. Ramirez' sacrifice, giving up that power for a little bit of public service, and obviously serving the needs of those looking for decent, affordable housing.

At this time, I would be happy to yield to Mr. Ramirez for his testimony for any time that he may require.

STATEMENT OF SAUL N. RAMIREZ, JR., DEPUTY SECRETARY, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. RAMIREZ. Thank you very much, Mr. Chairman, and Ranking Member Bentsen, as well as other members of the committee. I would like to submit my written testimony and its exhibits for the record, and provide you with just a summary of the key points of my testimony to move on to the question-and-answer period, if I may, Mr. Chairman.

First, let me say that it is historic for us at the Department to be able to deal with an issue such as tenant income verification. Let me just clear up a point. It is not just Section 8 that we are talking about when we are talking about tenant income verification; that we are actually talking about 4.5 million families that include residents of public housing, as well, and not just Section 8 subsidized housing.

What we have done is, we have a tool for assisting the Department in furthering our goal of targeting rental assistance only to eligible families and ensuring that each family pays the correct amount of rent. But we cannot act alone; both tenants and our partners who provide the housing have a direct responsibility for correcting and actually correctly determining the rental assistance, and HUD's new income verification program does not alter those roles.

The complexities associated with providing eligible individuals with the correct level of rental assistance are numerous. Legislation over the last couple of years has given different POAs, or private owners and agents, such as Housing Authorities, different types of wide discretion, or discretion in the delivery of rental assistance and recovery of excess rental assistance.

The differences include varied recertification policies, exclusion of specific income from rent determination calculations, the establishment of ceiling rents, and the adoption of diverse recovery policies.

Until now, the Department's past efforts to enhance the effectiveness of POAs, efforts to ensure that low-income eligible families receive the correct level of rental assistance, have been limited. However, the Department is now implementing a large-scale computer-matching income verification program to dramatically enhance the information our partners need to fulfill their income verification responsibilities.

HUD has matched tenant-reported income with Federal tax information, and has identified approximately 230,000 tenants who have underreported income. At this very moment, letters are being sent to these tenants and notifications are being sent to the POAs. HUD has worked with the tenant groups, as well as industry groups, to obtain the highest level of support for this initiative.

Also, in the interests of fairness to all parties, the Department is also addressing the overreporting of income, and will be mailing letters as part of this initiative in the near future to tenants who might not have received all the assistance to which they were entitled.

HUD's new large-scale computer-matching program achieves the delicate balance between the needs of tenants, including tenants' rights to privacy and due process, the responsibilities and work loads of our private owners and agents that are partners out there, and the ultimate goal of allocating scarce resources to eligible tenants at correct levels of rental assistance.

For several years, staff from OIG have conducted a sample of 1,000 households to estimate excess rental assistance. These estimates have ranged from—anywhere between $417 million and $935 million.

There are many reasons why this excess rental assistance cannot be fully recovered by HUD. Perhaps many tenants who have underreported their income will leave once they are identified, before any back rents can be collected. Recovery costs can be excessive and often fall way short of any rental assistance that could be received. Administrative costs paid by the POAs associated with tracking recoveries reduce the amount of any potential to us in the long run.

Moreover, when a tenant vacates after underreporting of income is identified, the tenant typically is replaced by another eligible family requiring assistance. And, of course, we endorse the goal of targeting rental assistance only to eligible families. However, we must point out that in cases like this, when an eligible family replaces an ineligible family, the net amount of rental assistance may not decline and may even increase. This is one reason why our program focuses on setting current rents correctly to prevent future abuses before they happen, when it is much more difficult for us to actually go out and collect after the abuses have occurred.

Through the use of our large-scale computer-matching income verification process, HUD is providing our partners, the private owners and agents, with an additional tool to help identify tenants responsible for program abuses.

In this first year of large-scale computer-matching income verification, HUD is seeking to establish a baseline by which to measure the private owners' and agents' income verification efficiency and effectiveness at the level at which the tenant program abuses can be better detected and better deterred.

With that, I would like to conclude by saying that our efforts to further enhance our abilities to create a more on-time system of verifying could probably be strengthened by seeking a stronger partnership with the Department of Health and Human Services quarterly new-hire reports, so that both the POAs and HUD can better track incomes, but that would certainly take some help on your part with additional legislation.

That concludes my summary of my written testimony, Mr. Chairman. I am prepared to answer any questions when we are done.

Mr. SUNUNU. Thank you very much, Mr. Ramirez.

[The prepared statement of Mr. Ramirez follows:]

PREPARED STATEMENT OF SAUL N. RAMIREZ, DEPUTY SECRETARY, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Thank you for allowing us this opportunity to testify on the Department's computer matching income verification efforts. For the first time in the history of public housing, we have a tool for assisting the department in furthering its goal of targeting rental assistance only to eligible families and ensuring that each family pays the correct amount of rent.

The Department acknowledges that more could be done to assure only eligible low income tenants receive HUD rental assistance and to assure that all tenants pay their fair share of rent as required by statute. We are aware—indeed we have estimated—the size of possible under-reporting of income. And, we are moving to do more by implementing an income verification program under the authorities given us by the Congress.

We are confident that our computer matching income verification efforts will improve the targeting of our scarce rental subsidy dollars, make the administration of these programs more fair, and bring in additional resources to offset the cost of reaching more of the 5.4 million low-income families who have severe housing needs.

The complexities associated with providing eligible individuals with the correct level of rental assistance are numerous. First, we cannot act alone in this area. As you know, HUD has no direct relationship with the tenants who benefit from our programs. Rather, both tenants and our partners who provide the housing each have a direct responsibility for correctly determining the rental assistance. Tenants must accurately and completely report their income to their housing managers—the Public Housing Authorities and private owners, and agents who administer our rental assistance programs. In turn, the housing providers have ultimate responsibility for verifying tenant incomes and setting the rents correctly. Our new computer matching tool is designed to dramatically improve the information our partners need to fulfill their income verification responsibilities.

In addition, comparing IRS or Social Security data with the income reported by tenants is not a straightforward calculation. Great care must be taken in drawing conclusions from the matching process because there are many reasons that IRS data, for example, might indicate that an improper underpayment is occurring when, in fact, it is not. Legislation over the years has given different housing providers wide discretion or varying directions in how they set rents, calculate tenant contributions and go about recovering excess rental assistance. These differences include exclusion of specific types of income from rent determination calculations and the establishment of rent ceilings that do not go up with increases in household income. Recent legislation has added additional variables in the form of longer intervals between recertifications for tenants under some of the Department's programs which means that increases in a tenant's income may not be captured in a timely manner by the recertification process.

Frankly, until now the Department's past efforts to enhance the effectiveness of POAs' (Private Owner or Agent) efforts to ensure that low income-eligible families receive the correct level of rental assistance have been limited. Beginning in the mid-1980's and continuing until 1992, the Department performed several narrow matches of tenant-reported income with tenant income supplied by State wage agencies and the Office of Personnel Management to identify under-reported income and excess rental assistance. The Omnibus Budget Reconciliation Act of 1993 allowed the Department to expand its computer matching efforts to include Federal tax information provided by the Internal Revenue Service and the Social Security Administration. There are a number of laws and other requirements to adequately safe guard the privacy of this sensitive data, for example Section 6103 of the Internal Revenue Code (IRC) and the Computer Matching and Privacy Protection Act of 1988. HUD and its partners have worked diligently on these issues and continue to work on ensuring that this sensitive data remains protected. The Department used that new authority to complete computer matching initiatives focused on individual POAs and on sampling the universe of subsidized tenants to estimate overpaid rental assistance. This sampling was conducted by HUD's Office of the Inspector General with the goal of quantifying under-reported income for financial statement purposes.

The Department is now implementing a large-scale computer matching income verification program. HUD has matched tenant-report income with Federal tax information and has identified approximately 230,000 tenants who under-reported income at some fairly large thresholds levels set by the Department for this initial effort. At this very moment, letters are being sent to those tenants and notifications are being sent to all our housing authorities and landlords requesting that tenants resolve the potential discrepancies we have identified through our income-matching program. The letters to the housing providers do not disclose any income data regarding tenants, but only advise the housing provider to recertify the income of these particular tenants.

HUD has worked diligently with tenant and industry groups to obtain the highest level of support for this initiative. For example, we conducted two training sessions for our partners and stakeholders, soon to be followed by a third. We developed an online guide to help our housing providers in processing and resolving income discrepancies, and we established two call centers to handle both housing provider and tenant inquiries. We are also including a fact sheet on the income verification program with all mis-match letters that are being sent to tenants.

In the interest of fairness to all parties, the Department is also addressing over-reporting of income and will soon be mailing letters as part of this initiative in the near future to tenants who might not have received all of the assistance to which they were entitled.

This large-scale computer matching program achieves the delicate balance between the needs of tenants, including tenants' rights to privacy and due process, the responsibilities and workload of housing providers, the responsibility to assure fairness among all tenants by assuring that each pays his/her proper amount as require by statute, and the ultimate goal of allocating scarce resources to eligible tenants at correct levels of rental assistance. HUD is undertaking these efforts because of statutory requirements and because it is the right thing to do. It is important to recognize, however, that this income verification efforts is primarily designed to improve voluntary compliance by providing reasonable assurance that tenants pay the proper amount in the future. We do not expect a large windfall from collections of past underpayments, Indeed, we ask POAs to be work with tenants on an prudent payment plan as appropriate that does not overwhelm their finances.

For many years now, the Department's financial statement has reflected an estimate that tenant underpayments total some $900 million. I think it is important to advise the Committee that this number is a gross estimate of underpayments and not a net amount that could be collected through tenant income verification efforts. For several years, staff conducted a sample of 1,000 households to estimate excess rental assistance. These estimates were developed under specific parameters and assumptions with numerous qualifying statements and have a wide statistical range $417 million and $935 million. It is extremely important to note that these are estimates of total excess rental assistance if all tenants reported income on a retrospective basis. It is not a total of recoverable excess rental assistance. Nor are they estimates of achievable departmental savings.

There are many reasons excess rental assistance cannot be fully recovered by HUD. First of all, our experience with a pilot income verification program indicates that approximately 30 percent of tenants who have under-reported their income will leave once they are identified before any back rents or future higher rents can be collected. In accordance with recent statutory changes, these tenants will be replaced by eligble households who are predominately very low-income households with the end result probably being little or no significant increased returns to the housing provider. Indeed, in such instances, the rents being paid to the provider for that unit may decrease. Our experience also suggests that even where a tenant agrees to pay off back rent owed, the average length of the agreed-upon payment plan is between 5 and 7 years. Given these circumstances, we do not expect big dollar returns to result from back rent collections under the income verification effort.

Second, while HUD has advised housing providers to pursue cases of blatant fraud, the recovery costs for the run-of-the-mill tenant underpayment can be excessive, and often far exceed any rental assistance that could be recovered. These include direct costs associated with verifying excess rental assistance and recovering funds through the legal system and administrative costs associated tracking recoveries. Businesses associated with debt collection have often cited 20 percent as a reasonable estimate of debt recovery, and recent experience with tenant income verification efforts around the country have been consistent with this benchmark. For example, in a recent computer matching initiative, the Dallas Housing Authority identified 95 tenants who received excess rental assistance totaling $350,000. The housing authority was able to establish repayment agreements with only 17 of these tenants. The repayment agreements totaled $80,000, or about 20 percent. The $900 million figure makes no attempt to calculate these costs of collection.

For all of these reasons—tenant move-outs, high administrative costs, the administrative payments to our partners—the amount of "excess" assistance paid to tenants cannot be easily recaptured by HUD. We believe that more is gained by looking forward than back. In the case of the Dallas Housing Authority, the agency terminated rental assistance to 42 of the 95 tenants who under-reported their incomes—freeing up units for eligible families. Through the use of large-scale computer matching income verification, HUD is providing housing providers with an additional tool to help identify tenants responsible for program abuses. In this first year of large-scale computer matching income verification, HUD is seeking to establish a baseline by which to measure housing provider's income verification effectiveness and the level of tenant program abuses. This information will allow HUD to effectively target its future enforcement and monitoring efforts to those areas where the problem is most acute.

HUD continues to work to improve its income verification program. The Department needs your support to better serve the needs of those eligible to receive rental assistance.

Mr. SUNUNU. Ms. Crowley, welcome. Thank you for being here. I am pleased to yield to you, for testimony, whatever time you might need.

Ms. CROWLEY. Thank you.

STATEMENT OF SHEILA CROWLEY, PRESIDENT, NATIONAL LOW–INCOME HOUSING COALITION

Mr. Sununu, Mr. Bentsen, I am very pleased to be here. I would like to submit my written testimony and attachments for the Record.

Mr. SUNUNU. Without objection.

Ms. CROWLEY. I am Sheila Crowley, the President of the National Low Income Housing Coalition. We are a membership organization. We represent individuals and organizations around the country that are committed to ending the affordable housing crisis and assuring decent housing and healthy neighborhoods for everyone.

Our members include nonprofit housing providers, homeless service providers, fair housing groups, State and local housing coalitions, public housing agencies, private developers and private owners, housing researchers, local and State government agencies, faith-based organizations, and residents and their organizations.

So on behalf of all our members, thank you for the opportunity to offer our perspective on the income verification issue and how it fits into the broader picture of housing affordability and the Federal response to the affordable housing crisis.

We have worked closely over the last 2 months with our partner resident organizations and HUD officials to shape the implementation of the income verification program in a manner that will achieve the objective of assuring that scarce housing assistance is used to help as many eligible families and individuals as possible, while preventing unwarranted panic and housing destabilization for thousands of public and assisted housing residents who have done nothing wrong.

Everyone, all of us, agree that people who fraudulently misreport their income in order to accrue more Federal benefits than that to which they are entitled should not be allowed to get away with it. As someone who is acutely aware of the severe limits of housing choices for poor Americans, I make no excuses for people who deliberately deprive others of badly needed housing assistance.

However, we believe that a substantial percent of the discrepancy between the rent certifications and the tax returns that have been identified in the IG's report have occurred for one of a number of legal and legitimate reasons or as the result of honest mistakes, or are rooted in errors made by Housing Authorities or private owners.

It is wrong to jump to the conclusion that lots of poor people are ripping off the system. The list of possible explanations for so-called "false positives," that is, leaseholders with legitimate discrepancies, is extensive. Mr. Ramirez has reviewed some of those.

Indeed, Congress has authorized many explanations for this discrepancy in order to reduce the disincentives for work that have been a problem in Federal housing programs. Further, if there are inaccuracies in how a tenant's share of rent is calculated that results in overpayment by the Federal Government, there are also many cases where residents are making overpayments.

As I understand it, the amount of resident overpayment has not yet been determined, so a true picture of what the overpayment problem is will emerge once both the false positives and the tenant overpayment are factored into the equation.

The concern of residents and their advocacy partners was that HUD's initial plan for implementation of the income verification program had the effect of accusing many innocent people of wrongdoing and then requiring them to prove otherwise. While there are some lingering concerns, I am happy to report that it is very accurate that HUD leadership has been very responsive to the issues raised by residents, and the income verification program has undergone significant improvements as a result.

The negotiations have necessarily slowed down the program, but we believe that taking the time to do it right is the right thing to do.

We want to solve the income discrepancy problem and eliminate the income discrepancy issue as an argument that has been raised against increased funding for housing assistance. Solving the problem in a way that causes precipitous harm to low-income residents for no valid reason is counterproductive and simply wrong.

It is equally wrong for Congress to use this income discrepancy analysis as justification for failing to address serious housing affordability problems. So I want to put this problem into perspective.

The widely accepted standard in the housing industry is that housing should cost no more than 30 percent of household income. Our analysis shows that in 1997 10.8 million very low-income households, that is, households with incomes at less than 50 percent of the area median, paid over half of their income for their housing. This is nearly 11 percent of all households in the United States. That includes 8.4 million renters and 2.4 million homeowners.

A more vivid illustration of the depth and breadth of the housing affordability crisis is our analysis of housing costs in comparison to wages in every jurisdiction in the country. We can say with assurance that nowhere in the country can a full-time minimum-wage worker afford the fair market rent for a two-bedroom rental unit. Nowhere.

The housing wage which we calculate, that is, the hourly wage one needs on a full-time basis to afford basic rental housing, ranges from $8.02 in West Virginia to $17.10 in Hawaii. In the Manchester, New Hampshire, metropolitan statistical area, for example, 44 percent of renter households cannot afford the two-bedroom fair market rent, and the housing wage is $13.20 an hour. One hundred and 2 hours of minimum wage work a week is required to afford the fair market rent in the Manchester SMA.

In the Houston SMA, 40 percent of the renters cannot afford the fair market rent. The housing wage is $11.56 an hour, and one must work 90 hours at the minimum wage in order to afford the fair market rent.

I have attached to my written testimony analysis of the housing costs and income gaps in the States that are represented by all the members of the Task Force for your review. The numbers are stark, but what does it mean to be a low-income family and have a severe housing cost burden?

One or more of the following happens: The family pays a precariously high percentage of its income for its housing, and then must scrimp on other necessities, like food or medicine; or adults in the family work two or three or more low-wage jobs and have precious little time left over to devote to family and parenting duties; or they are forced into substandard or overcrowded housing, paying rent to unscrupulous landlords who can take advantage of the severe housing shortage that poor people experience; or they simply cannot pay the rent, are threatened with eviction, gain poor credit records, and in some cases, spiral down into homelessness.

We are increasingly aware that the high rate of mobility among poor families, driven in large part by staying on the move to stay a step ahead of the eviction server, contributes to poor school performance by children who drift from one school to another and just never catch up. In the age of standardized tests as the primary indicator of academic achievement, these kids do not have a chance at success.

We all tacitly understand the centrality of stable housing in our ability to do our jobs and raise our families. If we ponder even for a moment how we would cope if maintaining our housing was a daily struggle, we could easily understand the human dimensions of the affordable housing crisis.

We know that receipt of Federal housing assistance contributes to housing stability for formerly homeless families and is associated with success at moving from welfare to work. It is a good investment in American families.

Federal expenditures on low-income housing are woefully inadequate in the face of this challenge, and when examined in comparison—and this is an analysis the National Low Income Housing Coalition has done for some time—when we examine this in comparison to Federal expenditures to subsidize the housing of middle- and upper-income households, the lack of investment in low-income housing becomes more apparent.

In 1997, assisted housing outlays were $26 billion, while housing tax expenditures, mostly mortgage interest deductions and property tax deductions, were $97 billion. In constant 2000 dollars, the tax expenditure level will go to $123 billion by 2005. It is going to take much more than fine tuning the existing low-income housing programs, which we must continue to do, to seriously make a dent in this program.

The good news is that we know how to solve the affordable housing crisis. It is not rocket science. We have a thriving, mission-driven, community-based, nonprofit housing sector that is only increasing in its capacity to provide safe, decent, and affordable housing. We believe strongly that the resources exist to intervene at the scale needed to make a difference. What we need now is creative and visionary leadership.

Thank you for your consideration of my remarks. I will be happy to answer any questions.

Mr. SUNUNU. Thank you very much, Ms. Crowley.

[The prepared statement of Ms. Crowley follows:]

PREPARED STATEMENT OF SHEILA CROWLEY, PRESIDENT, NATIONAL LOW-INCOME HOUSING COALITION

Mr. Sununu and Mr. Bentsen, I am Sheila Crowley, President of the National Low Income Housing Coalition. I would like to submit my written testimony and attachments for the record.

The National Low Income Housing Coalition is a membership organization representing individuals and organizations that are committed to ending the affordable housing crisis in America and to assuring decent housing in healthy neighborhoods for everyone. Our members include non-profit housing providers, homeless service providers, fair housing organizations, state and local housing coalitions, public housing agencies, private developers and property owners, housing researchers, local and state government agencies, faith-based organizations, and residents of public and assisted housing and their organizations. On behalf of our membership, I thank you for the opportunity to offer our perspective on the income verification issue and how it fits into the broader picture of housing affordability and the Federal response to the affordable housing crisis.

We have worked closely over the last 2 months with our partner resident organizations and HUD officials to shape the implementation of the income verification program in a manner that will achieve the objective of assuring that scarce housing assistance is used to help as many eligible families and individuals as possible, while preventing unwarranted panic and housing destabilization for thousands of public and assisted housing residents who have done nothing wrong.

Everyone agrees that people who fraudulently misreport their income in order to accrue more Federal subsidy than that to which they are entitled should not be allowed to get away with it. As someone who is acutely aware of the severe limits of housing choices of very poor Americans, I make no excuses for people who deliberate deprive others of badly needed housing assistance.

However, we believe that a substantial percent of the discrepancy between rent certifications and tax returns that is identified in the Inspector General's report has occurred for one of a number of legal and legitimate reasons or is the result of honest mistakes or is rooted in errors on the part of housing authorities or property owners. It is wrong to jump to the conclusion that poor people are ripping off the system. The list of possible explanations for so-called "false positives," that is, leaseholders with legitimate discrepancies, is extensive. Indeed, Congress has authorized many explanations for the discrepancy to reduce the disincentives for work that have been a problem in Federal housing policy. Further, if there are inaccuracies in how tenant share of rent is calculated that results in overpayment by the Federal Government, there also are cases where residents are making overpayments. As I understand it, that amount has not yet been determined. A truer picture of the Federal overpayment problem will emerge once both the "false positives" and tenant overpayments are factored into the equation.

The concern of residents and their advocacy partners was that HUD's initial plan for implementation of the Income Verification Program had the effect of accusing many innocent people of wrongdoing and then requiring them to prove otherwise. While there are some lingering concerns, it is accurate to say that HUD leadership has been responsive to issues raised by residents and the income verification program has undergone significant improvements as a result. The negotiations have slowed down the program, but we believe that taking the time to do it right is the right thing to do and is well worth the effort.

We want to solve the income discrepancy problem and eliminate the income discrepancy issue as an argument against increased housing funding. But solving the problem in a way that causes precipitous harm to low income residents for no valid reason is counterproductive and simply wrong. It is equally wrong for Congress to use this income discrepancy analysis as justification for failing to seriously address the affordable housing crisis of low income Americans. Let's put this problem into perspective.

The widely accepted standard in the housing industry is that housing should cost no more than 30 percent of household income. Our analysis shows that in 1997, 10.8 million very low income households (that is, households with income less than 50 percent of the area median) paid over half of their income for their housing. This is over 11 percent of all households in the United States and includes 6.4 million renter households and 4.4 million homeowners.

A more vivid illustration of the depth and breadth of the affordable housing crisis is our analysis of housing costs in comparison to wages in every jurisdiction in the country. We can say with assurance that nowhere in the country can a full time minimum wage worker afford the Fair Market Rent for a two bedroom rental unit. The housing wage, that is, the hourly wage one needs on a full time basis to afford basic rental housing, ranges from $8.02 in West Virginia to $17.01 in Hawaii. In the Manchester, NH, Metropolitan Statistical Area, 44 percent of the renter households cannot afford the two bedroom Fair Market Rent and the housing wage is $13.02. One hundred and 1 hours of minimum wage work a week is required to afford the Fair Market Rent. In the Houston, TX, MSA, 40 percent of renters cannot afford the Fair Market Rent, the housing wage is $11.56, and one must work 90 hours a week at minimum wage to afford a basic rental unit. I have attached to my written testimony analysis of the housing costs and income gap for the states of each of the members of the Task Force. I also have provided a copy of the complete jurisdiction by jurisdiction analysis for your use.

The numbers are stark. But what does it mean to be a low income family and have a severe housing cost burden? One or more of the following happens. The family pays a precariously high percentage of its income for its housing and must scrimp on other necessities like food and medicine. Or the adults in the family work two, three, or more low wage jobs and have precious little time left over to devote to family and parenting responsibilities. Or they are forced into substandard or overcrowded housing, paying rent to unscrupulous landlords who can take advantage of the severe housing shortage affordable for the poor. Or they simply cannot pay the rent and are threatened with eviction, gain poor credit records, and in some cases, spiral down into homelessness.

We are increasingly aware that the high rate of mobility among poor families, driven in large part by staying on the move to stay a step ahead of the eviction server, contributes to poor school performance by children who drift from one school to another and never catch up. In the age of standardized tests as the primary indicator of academic achievement, these kids do not have a chance at success. We all tacitly understand the centrality of stable housing in our ability to do our jobs and raise our families. If we ponder even for a moment how we would cope if maintaining our housing was a daily struggle, we can easily understand the human dimensions of the affordable housing crisis.

We know that receipt of Federal housing assistance contributes to housing stability for formerly homeless families and is associated with success at moving from welfare to work. It is a good investment in American families.

Federal expenditures on low income housing are woefully inadequate in the face of this challenge. And when examined in comparison to Federal expenditures to subsidize the housing of middle and upper income households, the lack of investment in low income housing becomes even clearer. In 1997, assisted housing outlays were $26 billion, while housing tax expenditures (mortgage interest and property tax deductions) were $97 billion. In constant 2000 dollars, the tax expenditure level will go to $123 billion by 2005.

It will take much more than fine-tuning existing low income housing programs, which we must continue to do, to seriously make a dent in this problem. The good news is that we know how to do solve the affordable housing crisis. We have a thriving mission-driven, community-based, non-profit housing sector that is continually increasing its capacity to provide safe, decent, and affordable housing. We believe strongly that the resources in our country to intervene at the scale needed to make a difference. What we need now is the creative and visionary leadership to make it happen.

Thank for your consideration of my remarks.

Mr. SUNUNU. I would like to begin the questioning now, touching on a few of the points that you raised with Mr. Ramirez.

First, you raised, I think, a very important concern about false positives, about trying to approach the verification process carefully.

There is no question when you have the number of letters that are going out, the number of discrepancies in income reporting that we have, there are going to be some legitimate reasons that both of you touched on in your testimony for the problem.

I think we can minimize those issues by putting in place a reasonable threshold for income discrepancy. We are not talking about a difference of $100 or $500 or even $1,000, as I understand it, in the income that is reported. It is at a higher threshold than that.

Mr. Ramirez, can you review for instance what those thresholds are?

Mr. RAMIREZ. Yes. We have actually two thresholds. One is for the multifamily Section 8 subsidized housing, which is a $4,000 threshold. Then we have an $8,000 threshold for public housing.

Mr. SUNUNU. For annual income?

Mr. RAMIREZ. Yes, sir, annual income.

Mr. SUNUNU. In your testimony on March 8, you suggested that there were, I think, 260,000 letters that were about to go out. In your testimony today, you mentioned 230,000 letters. It is a difference of about 10 percent. I just want to be clear for the record; how many letters are being mailed out today?

Mr. RAMIREZ. We have two family incomes, so the number has shrunk in matching up addresses and individuals in those incomes. We anticipate that that will be the case in a bigger mailing that will take place after working with the different industry groups, as it relates to the overpayments that will be discovered as we run the analysis, as well as the notification to all residents that are currently receiving some sort of subsidy that—in their verification recertification process, we are advising them, in the same form that we have advised by way of information and handout attached to these letters, what kind of income they need to take with them as they get recertified for the following year, sir.

Mr. SUNUNU. In your testimony, you said those letters are being sent as we speak. How many letters are being sent out this week?

Mr. RAMIREZ. I couldn't tell you exactly how many this week. It is a massive mailing of 230,000.

Mr. SUNUNU. When is the goal for having completed the entire mailing?

Mr. RAMIREZ. We should be done mailing all of these letters within the next 2 weeks or so, sir.

Mr. SUNUNU. Two weeks? That is the initial——

Mr. RAMIREZ. This is the initial match of discrepancies for underreporting income as it relates to the entire population.

Mr. SUNUNU. That is a total of 230,000 notifications?

Mr. RAMIREZ. Approximately, yes, sir.

Mr. SUNUNU. You talked about the concern of those that may be overreporting income, and therefore—and Ms. Crowley touched on that, as well. You didn't give an estimate of the number of cases of overreporting.

Has a similar IRS match been done to try to quantify the number?

Mr. RAMIREZ. Yes. We are currently working on that match. But let me, if I may, Mr. Chairman, just bring some perspective to where we are and where we were.

We have over the last several years depended on the Inspector General's review of a random sample of 1,000 residents. We have now gone to matching the entire population that is receiving some sort of benefit from public housing or subsidized housing.

We have worked very hard to reduce the false positive percentage on the underreporting process, and we feel comfortable in saying that we are running at about 20 percent in comparison to perhaps up to maybe as much as 50 percent in the old sampling method; and we are currently calibrating the false positives based on the thresholds that we have for the overpayment.

We run a similar risk in estimating an overpayment, if we are not careful, in first getting these false positives, as small a number as it can be, because you can imagine someone receiving a letter saying, you have something due you, and they go in and they then find out that they don't have anything due them as a result of us advising them that they have overpaid.

So we are in the process of doing that. We have gone through two runs of getting it. The number has reduced from about 55 percent to about 30 right now. We are not comfortable yet with where we are on the false positives. We are running the systems to see if we can further reduce that.

We are also working with the different industry groups to get together with them in the near future on these notifications and to report out to them.

Mr. SUNUNU. Ms. Crowley, I don't want to put you on the spot, but in the March testimony, Mr. Ramirez talked about trying to touch base with industry groups and tenant groups.

My question is, to what extent have you or your members participated in discussions with HUD, and what more do you think that HUD can do to make sure that the process they are undertaking is fair?

Ms. CROWLEY. I would say that our interactions with HUD officials have been extensive. My experience was that it did take getting it to the attention of the very highest levels to get us heard, but once that happened, then we were heard loud and clear. So there have been a series of meetings and discussions about that.

There are, as I said, lingering concerns. It is not 100 percent resolved. There are—my concern, my more than concern at this point, is about how it is going to play out at the local level and how we are going to assure that what it is that we have agreed to at this level actually happens there.

That is the tricky part, because if everything unfolds the way we have been told it will, then it should happen in a fair kind of way. But we are talking about the behavior of a large number of different people who are going to get communications through several layers, and there is always the danger of distorted communication.

So we will be very alert to how it is happening on the ground with our members and be prepared to advocate at that level as well.

Mr. SUNUNU. We don't need to take Mr. Ramirez to task for not including you?

Ms. CROWLEY. No.

Mr. SUNUNU. Good.

A few final questions about the scope of the problem, because there are two large issues here. One is the financial issue, which is estimating the size of the underpayments. That is important because the demand for the services are high.

You gave a very stark picture of that, Ms. Crowley. If we take the estimate of $935 million that has been presented to the Task Force by HUD and the Inspector General's Office, that does translate into 150,000 or so certificates, new certificates, which is even more than is being requested by the administration this year. So it is a significant number.

If I can finish, the other side of the problem is that if there is a case of someone who is ineligible receiving housing, then that means someone is on the waiting list, obviously, who is in need that would otherwise qualify for a slot. Of course, it is worth emphasizing that the vast majority of all of the tenants here are completely honest, law-abiding, and deserving of the services.

Even if you take the full figure of $935 million—I think you used the total figure of 26 million for low-income housing—but just at the Federal level, if you look at a figure of 15½ million for the certificate program, it is well under 10 percent. It is probably—that is roughly 7 percent. So at the absolute worst, 93 or 94 percent of the people in this are not even matched, so there is not an issue there.

So there are two sides to the problem. The specific question I have Mr. Ramirez, is the gross figure of $935 million—you gave an estimate of $400 million to $935 million—that is an annual loss; is that correct?

Mr. RAMIREZ. Well, that is the estimate that comes out of the methodology that was recommended to us to employ in partnership with the Inspector General, sampling only 1,000 of—after taking dual incomes, of about 4½ million families. So it is a broad estimate or a big estimate——

Mr. SUNUNU. Based on a sample of 1,000?

Mr. RAMIREZ. Yes.

The other thing is, because of some of the reasons I cited as to the difficulty in recapturing these funds, as a result of folks moving away and other activities, that the more realistic estimate that OMB has come out with in the budget we believe is closer to accurate, which is about $80 million. That is taking into consideration not just the turnaround that may occur, but also remember that there is that category of overpayments.

It is very preliminary for me to make any real estimate on that, but based even on a 50 percent false positive, the number is quite substantial on the overpayment side, as well.

So our goal in the end, Mr. Chairman, is to try to get folks qualified at the front end to avoid the back-end discrepancies that could lead to any sort of waste, fraud, and abuse that we know is occurring, as was highlighted by the Office of Inspector General.

Mr. SUNUNU. Ms. Crowley.

Ms. CROWLEY. I do not pretend to understand all the intricacies of these numbers, but my understanding—and Mr. Ramirez, correct me if I'm wrong—is that the 935 million is the first cut at the analysis, and it is before all the false positives have been cleaned out.

So once—as I said, to get to the true overpayment, you have to screen out all the false positives and you have to do the overpayment, and then you will get to what that real number is. So it is going to be something substantially less than that.

So the 230,000 letters that are going out, the total of that does not get up to $935 million because that analysis was based on sort of a gross analysis at that point.

Mr. RAMIREZ. Yes.

Ms. CROWLEY. So that has to be further refined to get at some understanding of what the true number is.

Mr. SUNUNU. Thank you.

Mr. RAMIREZ. May I just say—real quick, just to say that what we have done is that this year, for the first time ever, we will have an accurate baseline of what that number really is, instead of these estimates that are based on a small population of a greater population.

Mr. SUNUNU. That is the importance of keeping to your time line with regard to the issuance of the first 230,000?

Mr. RAMIREZ. Yes. On that one, working with the industry, because that is also an important piece of correspondence that needs to go out, we would anticipate that we could finish up our work on that letter and what we need to refine in our estimates to get that letter out on the overpayment side by June 30, Mr. Chairman.

Mr. SUNUNU. Thank you.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. Mr. Chairman, let me talk a little bit about the methodology, and then I want to talk a little bit about the broader program.

Again, in the methodology, this is based upon a—the $935 million figure is based upon a random sample of 1,000 households, so it is a sampling-type issue which has questions of accuracy, and then is extrapolated out against the entire program; but false positives and overpayments by tenants are not netted out, so it is still a rather nebulous figure that is out there.

The 230,000 notices that you are sending out, that is not net false positives?

Mr. RAMIREZ. It is—we have 90 days after they get sent out. We anticipate there may be as high as 20 percent false positives on the 230,000. That is just based on local policy for exemptions of certain incomes. Again, because of the way the law is now structured, there is a great deal of discretion that is given at the local level.

The difference between the old methodology and what we are employing now is that there is a complete match of income and Social Security, and based on that and the tiers we have established, we have narrowed down that universe to just 230,000 where there are these discrepancies.

Mr. BENTSEN. Can the IG's Office tell me, in these cases that have been going on for some time—this is a 60-year-old program, in effect, and a lot of your cases go back to the early 1980's, and have gone on for periods of time, unacceptable periods of time. In the IG's study, if you could speak to that, is there a preponderance of underpayment by tenants in the high-dollar range or the low-dollar range, and is it $10 and $20 a month, just outright fraud, or several thousand dollars?

Secondly, is there a preponderance of individual tenant abuse through PHAs, or is it with respect to third-party private-sector operators?

Mr. SCHUSTER. Sir, basically, as criminal investigators in our little world, we are just dealing with what we would call prosecutable criminal cases, so we would not get into the whole universe. We could not answer that.

Mr. BENTSEN. On that issue, Mr. Chairman, I will submit for the record from the IG's Office—I would be interested to know where the mean is and where they come down.

Let me ask this. From an investigator standpoint, the way I understand this, reading through this, Congress in 1993 adopted a law allowing, in the famous Omnibus Budget Reconciliation Act of 1993—one of the many things that did not get talked about in the 1994 elections was a change in the law that allowed for the use of IRS data for income verification and match; I believe that is correct.

From the IG's perspective and investigators' perspective, do you believe this new income verification will be a sufficient tool in trying to root out either outright fraud or just inadvertent underreporting of income?

Mr. SCHUSTER. Once again, I don't know, as a Special Agent, whether I am equipped to answer that particular question. I think it would give you maybe an idea. But once again, dealing with our resources and our priorities and what the U.S. Attorney's offices are, in a sense dictating to us, we probably would not get into those specific areas unless we had proper resources.

Mr. BENTSEN. Mr. Carolan.

Mr. CAROLAN. I would say that it is very helpful, and some of the things that we talked about around the table, in some of the testimony, as long as this information is timely, where it is not old information, as long as it is accurate, apples to apples, and as long as we are all sensitive to the individual circumstances, the case-by-case family——

Mr. SUNUNU. If the gentleman would yield for a moment——

Mr. BENTSEN. Yes.

Mr. SUNUNU. Specifically, would an income matching program, as we are beginning to implement here, would that have assisted you in the Charlestown case? Would that have uncovered the income discrepancies that were prevalent in that case?

Mr. CAROLAN. I would assume that it may have pointed to a pattern, multiple cases at a particular site, which would have led us to look at something other than individual tenant fraud; that there had to be something there that was a common denominator. So I think, like I said, it would be helpful.

We have to remember, most of the cases we look at are the egregious ones. They are multiple years of underreporting of income, resulting in multiple years of overpayments, usually. They have to meet the test of the prosecutor.

We also look at ability to make restitution.

Mr. BENTSEN. Just a couple more questions. Let me ask, let me look at this from a broader perspective in the income verification.

As I understand how the Section 8 assisted housing program works, and has for the last long period of time, it has somewhat devolved from the Federal Government to local partners which—we actually expanded their authority through H.R. 2, or whatever the public law is now, back in 1998, and third-party contractors to the government who operate project-based housing and the Section 8 assistance is made to those entities.

They are required to verify the income and have that approved by a third party, and that is what the Federal Government has relied on in the past, for the last 60 years, I guess.

The income verification program, if I understand it, which is the first of its kind in HUD, came out of the 1993 act. It effectively is designed to try and match W–2, W–3 data of every tenant of record in the program against the data that is provided by the PHA, that they collect, or the third-party Acme Project-Based Housing Corps, whatever third party, to see whether that matches up.

So this will be the first time ever that HUD is basically looking over the shoulder of your clients in the field; is that correct?

Mr. RAMIREZ. It is correct on the income verification side.

But let me say, it is one more component of our overall 20-20 management reform. We have always taken the other side of oversight seriously, as well, and have reshaped the way we go about inspecting the Housing Authorities and the project-based owners for housing quality standards, for financial stability, for tenant satisfaction, and for management, as well, through our real estate assessment system and center.

So, yes, it is the first time we have ever done that, and it is a baseline that we are establishing so that Congress then can have a more accurate account of underpayment, overpayment, and the real number that is out there, and to assist you in providing the funding that we need to provide affordable housing.

Mr. BENTSEN. To the IG's, and then I will finish up, and I am going to apologize, because I am going to have to leave after that;

there is another meeting I was supposed to start chairing 15 minutes ago.

In your history of 28 years—and I don't know how long, Mr. Schuster, you have been there—is this a problem that you have seen throughout your career with HUD in the Section 8 public housing; or is this a problem that has just sort of started to occur in recent years?

Second of all—and you may not know the answer to this—but how would you compare the potential loss to the program in this with the old FHA coinsurance program that was designed to create affordable housing, multifamily housing, primarily in the late 1970's, but also in the 1980's? I assume you all dealt with some of those issues, as well.

Mr. SCHUSTER. I will start off first by saying, you know, is there a history of it? As long as I have been a criminal investigator, which is over 30 years, there have been people who have been out to defraud the system. So I have always—I have never had to worry about work. I have always had a lot of work. This has been continually.

I worked with ATF, I worked with Health and Human Services IG, and for the last 11 years I have worked for HUD IG. There has been—there has been a problem. There are people who are out to defraud the program.

As I said, we are dealing with a small number of people who are really ripping off the system. That is the only way to say it. There is no doubt that this is not by accident. They have a plan; they are conspiring to do this.

Mr. BENTSEN. This is not just an innocent, "I didn't report—I didn't realize that my minimum wage went up and I was getting more money," or something?

Mr. SCHUSTER. Right. This is not an accident. That is why in my statement I wanted to point out that there are situations where people are not trying to rip off the system, they are trying to do for family, or whatever. They might be actually, in a sense, defrauding the system, but it is not something that, you know, we would be concerned about in our particular responsibilities.

So I think, yes, there have always been problems. To what extent, we have no way of knowing. We don't get into that. Probably our audit side of the House has made more studies of that and may be more able to respond.

Mr. BENTSEN. Thank you.

Mr. Carolan.

Mr. CAROLAN. I would agree. We presented the first cases in my district, in the district of Massachusetts, in the 1970's, so I believe the problem is there and continues to be there.

But again, we look at the most egregious cases. We have a lot of criteria where we test them, like ability to make restitution, multiple years of the problem with one individual or family. So there are a lot of ways we screen out those that do not meet the standards, and refer them back to the HUD program people or to the providers for administrative recovery, to look at it and see whether they can recover.

As far as the second part of your question, the insurance programs, back to the 236 program and other programs, the same type of things were happening. We had falsification. As my associate said, there are people out there that are going to beat the system, and will find a way to try to beat the matching and everything else. I think it did exist back in some of those programs, also.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. SUNUNU. Thank you, Mr. Bentsen.

Mr. Miller.

Mr. MILLER. Thank you, Mr. Chairman.

Deputy Secretary Ramirez, we discussed preventing waste, fraud, and abuse from happening in the future. You briefly said how the law is now structured.

Mr. RAMIREZ. Yes.

Mr. MILLER. That raised a question.

Is there anything Congress can do to help you?

Mr. RAMIREZ. Yes, sir. We believe that to bring the accuracy of the system to an even more on-time basis—again, to bring a little perspective to the situation—the 1,000 number sampling that came out of this population of 4.5 million is based the same as we base our current verification process, which is prior year returns. So a year has gone by before we can actually match up and see if there was any discrepancy in what was certified and what income was actually reported.

If we were to be able to get legislative relief to work in greater cooperation with HHS, and in particular, for the 941 quarterly reports on new hires, that would help enhance the ability of the private owners or operators, as well as agents and our agency, to be more on time in capturing any discrepancies in recertification and underreporting.

Mr. MILLER. Has anybody asked for that legislative relief to date?

Mr. RAMIREZ. Consider it asked, sir.

Mr. MILLER. OK. I would like to follow up after the hearing with you on that.

Mr. RAMIREZ. We will be——

Mr. MILLER. If that has not occurred and there is something we can do to help you, we need to do that.

You basically talked about the DC pilot program and the new verification program we will be using in the future.

Can you give me just a brief overview of the difference, if you have not already done that? I know I missed part of the hearing.

Mr. RAMIREZ. The difference between the pilot and what we are doing now?

Mr. MILLER. The DC pilot program and the new verification program you are going to be using now.

Mr. RAMIREZ. What we have done—the biggest difference is that the letter, as Ms. Crowley mentioned earlier, what was sent in our pilot to the District of Columbia residents was a little more menacing then it needed to be. It was pretty bureaucratic, and had not really been vetted at the highest levels to be able to be a little more descriptive and clear in the objective of sending this letter and, also, in outlining the facts as to the type of incomes that qualified, did not qualify, what kind of rights tenants had in pursuing their—any remedial action they felt they needed to take.

I would like to acknowledge the great work and cooperation that we got, not just from Ms. Crowley, but, as well, other industry groups both on the private owners' side, the agents' side, through the Housing Authorities, and the tenants, which I thought was somewhat historic, to be able to get all these groups together around a table for the first time.

This was the issue that brought it. We have worked together since then. We will continue.

We now have a couple of issues that we need to resolve together, and now that we have gotten into a rhythm of exchanging documentation and corrections in language and whatnot, we need to clear up the correspondence that is going out to the agents and operators, advising them of what they need to do as a result of people receiving—the tenants having received these letters for over- or underpayments.

We have the letter for overpayment that we will be working on, and then a bigger mailing that will just lay out what qualifies, what does not qualify, and remedies that a tenant can pursue that will be going out.

Again, let me reiterate for the record that our notices—the way the mail works, and everything else, for underpayments, June 30, we are hoping to work with the industry to have the overpayment discussion done by that time as well, to get those letters out and proceed accordingly, and be able to come back with a more defined—because there is a 90-day period; sometime by December 1 this process should be concluded for this first cycle.

Mr. MILLER. Knowing that you could never eliminate all the waste, fraud, and abuse that might exist within any system, based on what you are proposing—and you are moving forward now—do you believe the next time you come before Congress, you will have fairly much resolved this problem?

Mr. RAMIREZ. We will have the baseline and an accurate number, gross number, of what we believe would be underreporting on the part of tenants.

We need to then, at that point, factor, as we believe is correct, the probability of being able to recapture those funds, and up to what level, without it becoming overly costly for this collection.

Finally, let me say that what we will have been able to accomplish, which is our goal in this process, is to be able to have eligible residents that are sitting on waiting lists, that have doubled over the last year and a half, into these units, and ineligible residents out of those units; and we feel that in that regard we will be able to meet that particular area of our mission.

I cannot say that we will be meeting our mission as completely as we should. There were some very accurate figures brought out by Ms. Crowley as to the real need that is out there. There are additional resources we would need to be able to create affordable housing opportunities.

Mr. MILLER. As a type of an aside, are you involved in any way with down-payment assistance with nonprofits?

Mr. RAMIREZ. Yes, sir.

Mr. MILLER. One problem we have noticed in the last few years, and I don't know why it is—I have dealt with a couple. Some I have looked at and I shake my head; some are doing a good job, but it seems like there is vague and ambiguous language that HUD keeps putting out. I have written letters to try to get this resolved. We have been effective in every instance.

It seems like there is a problem with HUD about putting out vague language, whether certain nonprofits' loans are going to be approved in the future, with no data to say that they are not going to be, no scheduled hearings to say there is going to be an overview. I am wondering why that continues to happen. It is becoming a problem.

There are some out there that are providing down-payment assistance for groups that are not using any government funds and are very successful. It seems like they are repeatedly being impacted in some fashion by HUD. It does not make any sense to me.

Mr. RAMIREZ. There are two issues there that you have touched on, Congressman.

The first issue is that when we put out a regulation to create the facilitation of the delivery of whatever programs we have, or activities that we have jurisdiction over, we purposely try to make sure that this regulation is as flexible and as open as possible to create as much local flexibility as possible. That may be interpreted as ambiguity, perhaps, in some instances.

We believe that it is better for us to refine it than to come out with something that is—that will, in essence, lock communities and not-for-profits into doing things a certain way, and we have learned that the cookie-cutter approach does not work.

The other side of the equation is that we do have some very successful not-for-profits that do not use any government funds that provide down-payment assistance to low- and moderate-income families for home ownership.

Our concern there, and we are working with the different groups, is that there are—there is a negative equity that is built as a result of what is brought in at the front end of these loans that, in essence, creates a bigger burden through the life of a loan for these low- and moderate-income families.

Mr. MILLER. Through inflated appraisals or such?

Mr. RAMIREZ. Correct.

So what we have been doing is, we have been talking to both the ones that are effective in doing this and have worked to monitor their activity to make sure that this does not occur, as well as those that are quite lax in dealing with it.

We have to step in and make sure that in the end what we are doing is that we are truly creating the opportunity for a family to realize the American dream and not end up living the American nightmare.

Mr. MILLER. One thing—and I think it is really important, because we have gone over this, I have done this too many times in the last year with nonprofits—that HUD should be a little more sensitive.

There are some that there is absolutely no—even suggestion that they are inflating appraisals, they are dealing with approved lenders who are providing quality appraisals; and yet some of the language comes out that implies that at a future date this specific nonprofit might not be an approved HUD agent to deal with those types of loans.

I would ask that you try to create more sensitivity. I understand that you try to deal with the problem, but in some cases, a problem is being created where there is none. I have not tried to be an advocate of any one specific group, but when we come back and approach HUD, we find no reason at all that they should be using language like that, and they change it. It just causes some problems and hurts some people who have tried to take advantage of these down-payment assistance programs, because their loan has not been recorded or has been delayed for some reason. It should not have been.

If you can just do that, I will appreciate it.

Mr. RAMIREZ. Yes, sir. We will get back to you with a response.

Mr. SUNUNU. Mr. Clement.

Mr. CLEMENT. Thank you, Mr. Chairman, Mr. Secretary, and the panel. It is a pleasure to have you here today.

Let me ask you this question, first. What percentage of households eligible for Federal rental subsidies actually get help?

Ms. CROWLEY. It is about one-third. That is the number that is most frequently cited; that if you defined the eligibility under what the law allows now and then you look at how many are actually getting assistance, it is about one-third.

There are other ways of looking at the number. Our number is, as I said, 10.8 million households with a severe housing cost burden who are low-income people. That includes both homeowners and renters. HUD's analysis is that the worst-case housing needs is 5.4 million households. Those are renters who receive no assistance and have a variety of housing problems.

Mr. CLEMENT. Of course, we all, Democrats and Republicans, want to stop waste and fraud. We should do everything we can to stop Federal payments to families who are not eligible.

If you assume that a $935 million overestimate is accurate, and every penny went to eligible families, how many more families would be covered?

Mr. RAMIREZ. About 150,000. But we don't agree with that assumption, Congressman.

Mr. CLEMENT. I wish you would expand on that.

Mr. RAMIREZ. As we went into this subject earlier in our testimony and in earlier questioning, the $935 million figure that is out there is based on a small sampling of—I hate to sound repetitive, but just to be able to clear things up, in the past, what we have done is that we would take a sampling of 1,000 residents in a total population of about 4.5 million. Then from there, the methodology that was employed would extrapolate to that number that you see up there.

What we are doing now is that we have actually matched up these households through tax returns, Social Security benefits that are paid, and their residency, and set thresholds as to whether they are underreporting or not. We have gotten down to the point of refining that, and have identified, in that universe of about 4.5 million, 230,000 households that have technically underreported.

I need to add that within that number, because of the broad discretion that has been provided to local Housing Authorities and operators, that they do have discretion as to what they would allow or disallow as eligible income. So we are going to be going through that process of getting down to the final number.

The other circumstance that we run into is that there are situations where people overpay in the program. We are currently matching up income and payments that get to a number that would reflect, as closely as possible, those amounts that are being overpaid, to advise those residents as well that they need to go in and clear up those overpayments, so they can actually be getting what they are entitled to.

The $935 million number that is out there is a number that is—that is, we believe, quite inaccurate in reflecting a true picture of what actually exists in the overpayment category.

Once we have—because this year is a baseline year, Congressman, for establishing that number, that baseline then is also impacted by certain situations, again allowable exceptions plus collection difficulties that occur, to get to a real number of actual recovery of any overpayments that are out there.

Our goal in the end, by establishing this system, is to be able to better qualify at the inception the residents, number one; and number two, that when we do find these discrepancies, and someone is living in a unit that is not qualified to live in that unit, that that unit then be vacated by that individual, or that family, and that it now be occupied by someone that is eligible.

Mr. BENTSEN. Mr. Secretary, there is no doubt in your mind there is a huge unmet need that exists?

Mr. RAMIREZ. I would further add that even after getting to this number, we would not be making a dent in the need.

It was earlier stated that we have over 11 million American families out there that—or close to 11 million that are out there that are suffering conditions of housing where they are paying more than 50 percent of their income in rent. So it is an unacceptable condition that exists.

Even with the current request that the President has proposed of 120,000 additional vouchers, it is a baby step in trying to resolve this problem, but a step that we feel is absolutely necessary, because it is an escalating problem.

Mr. CLEMENT. Mr. Secretary, these numbers up here on this chart, you don't really accept those numbers as true or accurate numbers?

Mr. RAMIREZ. That is correct. We accept those as rough estimates based on the methodology that has been employed in partnership with the figure of the Department of Housing and Urban Development to come up with a number that needs to be included in our financial statements.

Mr. CLEMENT. All right. Thank you.

Mr. SUNUNU. Thank you very much, Mr. Clement.

I have just a few final questions.

Mr. Ramirez, has the Department shared the match list of the 230,000 tenants that have a significant underreporting of income with the Inspector General's Office in order to try to identify patterns that might exist there that would be worthy of their investigation?

Mr. RAMIREZ. No, sir. It is premature for us to share that list with anybody, first off, because it has not gone through the cycle of it being exempted or not.

Secondly, it is—the private operators and agents, such as the Housing Authorities, it is up to them to assume the principal responsibility in rectifying any differences in underreporting.

So the principal obligation of having this reported to the Inspectors General throughout the country that serve the Department would be based, more than likely, on referrals from the Housing Authorities, agents, or private owners, sir.

Mr. SUNUNU. As this process moves forward, however, is it your intention to share information that HUD might develop regarding patterns in income underreporting, or egregious cases of income underreporting, to the Office of Inspector General?

Mr. RAMIREZ. We are prepared to share information that would not violate the Privacy Act and the method in which we were able to collect this information, and certainly we are not going to be the ones initially to make the call as to whether there is fraud or not occurring.

Inspectors General, as has been my experience through the years that I have been with the Department now—they have the run of the room. If they so wish to come in and audit these numbers, they are certainly welcome to.

Mr. SUNUNU. There is nothing that would prevent them statutorily from reviewing the income underreporting information that you might generate?

Mr. RAMIREZ. That would be a question that I would suggest be posed to the inspectors.

Mr. SUNUNU. Mr. Carolan, is there anything that would prevent you from reviewing information to identify patterns or egregious cases of underreporting that might be worthy of investigation?

Mr. CAROLAN. I don't believe there would be any barrier.

Mr. SUNUNU. Thank you.

A final question: Mr. Ramirez, we have talked a lot about this process, which I think is important. Mr. Clement mentioned the value of determining whether or not $935 million is recoverable, identifying what is recoverable. Ms. Crowley talked about looking at income overreporting as well.

These are all issues, though, at the end of the process, where we are trying to verify after the fact and match actual income to what was initially reported.

What has been done to deal with the front end of the process, to improve the internal control systems of HUD so that the Housing Authorities can better determine tenant income up front when they first apply, or when they are recertified?

Mr. RAMIREZ. One of the things, because of the discretion that is written into the law to create greater flexibility at the State level and local level, there have been some States that have been proactive in trying to get more on-time information as it relates to wages. So there are State wage reports that now go to Housing Authorities, but it is on a State-by-State basis. That is the only way it could be done.

Mr. SUNUNU. How many States do that?

Mr. RAMIREZ. I think there are three—we are actually using two right now. Two.

Mr. SUNUNU. Is that something that you are encouraging States to do?

Mr. RAMIREZ. Absolutely, sir. But that is, again, at their discretion.

Mr. SUNUNU. Thank you very much.

Thank you to all the witnesses for your testimony today. This is a significant problem, both in terms of the finances, but also in terms of the fairness of the program.

It is important that these programs are viewed by both the public that does not benefit from the program and those that are in need, that they are fair, in order to ensure the credibility of HUD that has a number of other programs that it uses to reach out to communities with, and the credibility of the Federal Government that is trying to oversee these and other programs efficiently and effectively.

Your testimony has helped us a great deal here today. Thank you for your time.

The committee is adjourned.

[Whereupon, at 11:41 a.m., the Task Force was adjourned.]

Government Failure in Disposing of Obsolete Ships

FRIDAY, JUNE 9, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON HOUSING AND INFRASTRUCTURE,
Washington, DC.

The Task Force met, pursuant to call, at 10:10 a.m. in room 210, Cannon House Office Building, Hon. John E. Sununu (chairman of the Task Force) presiding.

Chairman SUNUNU. Good morning and welcome to the witnesses. I want to thank Ken Bentsen and all the committee members for participating in the hearing today.

Today we welcome three witnesses to testify on the problems and the failure governmentwide in disposing of obsolete ships. Our witnesses today are Thomas Howard, Deputy Assistant Inspector General for the Department of Transportation; John Graykowski of the Maritime Administration; and Vice Admiral James Amerault, Deputy Chief of Naval Operations for Logistics. I understand all of you have busy schedules and I appreciate your taking the time today.

The Merchant Ship Sales Act of 1946 created the National Defense Reserve Fleet to provide merchant and nonmilitary vessels to meet shipping requirements during national emergencies. The Maritime Administration, MARAD, administers this fleet, and they are responsible for disposing of obsolete vessels of 1,500 gross tons or more. DOD provides funding to maintain the fleet, and right now there are 114 vessels that have been designated for disposal because most of them are no longer operational and they do pose problems that are both financial and environmental.

Unfortunately, we have a situation that is beginning to develop into a crisis. Over the last 5 years, in a number of ways, the government has restricted the ability of MARAD to engage in this task. There are current restrictions on MARAD to use its own funds to pay for the scrapping of these vessels. There have in the past been restrictions on utilizing foreign scrap yards, and there is a problem with the domestic supply of available scrap yards to handle the disposal of these obsolete vessels.

The vessels are maintained at three locations: James River Reserve Fleet in Virginia; Beaumont Reserve Fleet in Texas; and the Suisun Bay Reserve Fleet in California. During 1999 the cost to maintain this disposable fleet exceeded 4.2 million and there was an additional $1 million that we will have Mr. Graykowski talk about in some more detail for emergency repair.

This is really no direct fault of MARAD. These are old vessels, in some cases decades old. They have hazardous materials in some cases on them. They can leak oil and I think this environmental issue has really been undiscussed, at least unquantified. That is one of the issues I hope we can touch on today to better understand the potential environmental threat, the cost of that environmental threat, and the threat it poses not just on the river itself or the bay where these boats are being held but on local economy, shipping, and local navigation safety.

The estimates to deal with this problem in its entirety range from $500 million to over $2 billion. That is a significant amount of money. It is an enormous range of costs and I think that is simply an indication of how little we really understand both the short-term and long-term costs of dealing with these problems.

Since 1995 MARAD has only scrapped 7 vessels. Several were sold to contractors in 1999, but a number of the vessels were never removed and remain moored with the MARAD fleet. Progress has clearly dropped off in the past 10 years; but at the same time the longer we wait, the larger this problem becomes. The problem grows because over the next year over a dozen additional vessels are scheduled to come into the MARAD fleet.

Now, between 1987 and 1994, MARAD disposed of 130 vessels, most of which were exported to China, India, Mexico and Taiwan. Problems with the world price of scrap metal has also hindered efforts by MARAD to scrap the vessels because when scrap metal prices are depressed, there is less likelihood that either a foreign or a domestic scrap yard is going to be willing to pay to take the vessel off MARAD's hands. Current legislative restrictions exist, as I said earlier, that prevent MARAD from engaging in contracts to pay for the scrapping of these vessels and as a result the problem grows.

I think it is a problem that is getting worse. The estimate is that there would be as many as 155 vessels waiting for disposal by the end of 2001. The administration response to date, in addition to imposing a moratorium that lasted for some time and significantly delayed the scrapping process, was to move the date that we required these ships to be disposed of back 5 years or at least to request a movement in that date. While I understand that this reflects a recognition of the slow pace of progress in this area, I don't think that moving the date that we require all these vessels to be scrapped in and of itself is going to really address the problem. Delaying when we have a known environmental crisis before us really is no solution.

I am very interested to hear what our real options are for dealing with this problem. I don't think waiting is acceptable. I think and I hope Mr. Graykowski from MARAD will be candid and even creative in perhaps looking beyond some of the existing financial restraints or political restraints and talking through with this subcommittee, with this Task Force, what some of the potential options might be. And I am sure that members on both sides of the Task Force recognize that this is a problem that may actually cost money in the short term in order to save money in the long term, and certainly it warrants our closest attention.

We don't have a good handle on the costs and the potential risks associated with this, with these obsolete vessels, but I hope at the end of this hearing today we will have a much clearer picture of the options ahead of us.

[The prepared statement of Mr. Sununu follows:]

PREPARED STATEMENT OF HON. JOHN E. SUNUNU, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW HAMPSHIRE

I would like to start by thanking Congressman Bentsen and all the members of the Task Force for being here this morning. I would also like to thank and recognize Mr. Thomas J. Howard, Deputy Assistant Inspector General, Department of Transportation, Mr. John E. Graykowski, Deputy Administrator of the Maritime Administration (MARAD), and Vice Admiral James F. Amerault, Deputy Chief of Naval Operations for Logistics. I appreciate your taking time out of your busy schedules to be here with us.

The Merchant Ship Sales Act of 1946 created the National Defense Reserve Fleet (NDRF), which would provide merchant and nonmilitary vessels to meet shipping requirements during national emergencies. The Maritime Administration (MARAD) administers the fleet and is charged with the responsibility of disposing of vessels of 1,500 gross tons or more. The Department of Defense (DOD) provides funding to maintain the fleet. At this time, 114 vessels have been designated for disposal because many of them are no longer operational and pose serious problems both financial and environmental. It is my hope that we can explore here today the extent of the problems with scrapping these ships and discuss the possible solutions. Furthermore, I would like to know what we in Congress can do to help move this potentially costly situation forward or at least closer toward a comprehensive resolution.

These 114 NDRF vessels are maintained at three locations: the James River Reserve Fleet in Virginia; the Beaumont Reserve Fleet in Texas; and the Suisun Bay Reserve Fleet in California. During fiscal year 1999, the cost to maintain 110 vessels awaiting disposal exceeded $4.2 million, and an additional $1 million was spent on an emergency repair. The estimates to do away with this problem range from $500 million to $2 billion. The yearly costs to maintain an NDRF ship averages $20,000. If some of these ships are not disposed of soon, they may sink, causing serious environmental problems. Repairing and drydocking these vessels could be very expensive and may cost as much as $900,000 per vessel. Environmental cleanup and remediation could be even more expensive to address, and appears to be very hard to estimate, which is a large concern in my mind.

Since 1995, MARAD has only scrapped 7 vessels. Several vessels were sold to contractors in 1999, but the vessels were never removed and remain moored with the MARAD fleet. Progress in scrapping vessels has clearly dropped off in the past 10 years. The longer we wait the larger and more costly the problem becomes.

Typically, a ship scrapping company buys the rights to scrap a government ship and later sells the salvaged metal to recyclers. Remediation of hazardous materials takes place before and during the dismantling process. If a vessel is taken apart improperly, a ship scrapping operation can pollute the land and water surrounding the scrapping site and risk the health and safety of the scrapping operation's employees.

Exporting these ships is not an option at present. In 1994, the Environmental Protection Agency (EPA) prohibited the Navy and MARAD from exporting vessels after determining that the export of government ships for scrapping was prohibited by the Toxic Substances Control Act. In fact, MARAD has not sold a vessel to overseas markets for scrapping since 1994. MARAD disposed of 130 vessels between 1987 and 1994, of which 128 were exported to China, India, Mexico, and Taiwan. In September 1998, the Clinton administration placed a moratorium on overseas scrapping due to concerns about environmental and worker health and safety. The moratorium expired October 1, 1999. Currently, the administration requires MARAD to request approval from the EPA to sell vessels overseas to markets that are capable of scrapping in an environmental complaint manner.

It is apparent that this problem cannot continue to go unresolved. The Department of Transportation Inspector General's office indicated in its audit report of March 10, 2000, that the number of obsolete vessels could be as high as 155 by the end of fiscal year 2001. We can surely all agree that this situation is getting worse and something must be done soon.

I am interested to hear what plans are currently being made and developed to deal with these issues. I am hopeful that MARAD and the Navy can coordinate their efforts to bring about a solution. Solutions may range from allowing overseas scrapping of these vessels, creating a domestic scrapping industry in the United States to handle the workload, or to simply spend the money necessary to dispose of every obsolete vessel.

The bottom line is that the U.S. Government does not have a good understanding of the potential long-term cost of scrapping these ships or the environmental impact resulting from a ship-related accident. I look forward to hearing the thoughts of our panel members. I would like to recognize Congressman Bentsen for any opening comments he may have.

Chairman SUNUNU. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman, and I thank the members of the panel for testifying today. As the Chairman pointed out, this Task Force is charged with holding oversight hearings on waste, fraud, and abuse and reporting our findings and recommendations to the full House Budget Committee.

In this, our third oversight committee hearing, we turn to disposal of obsolete vessels in the National Defense Reserve Fleet by the Maritime Administration, MARAD program. I have a dual interest in this, the one which you all are doing; but, I also might add, representing the district which includes a great deal of watershed in the port of Houston and the ship channel.

I have had my own experience in trying to remove abandoned barges from the San Jacinto River, which the Coast Guard was kind enough to do with a little nudging from Congress. And, Mr. Chairman, we did find that in many cases, the cost of removal and decontamination exceeds the scrap value greatly and ends up being a net loss situation.

I am particularly interested in hearing about the Navy's pilot project for scrapping obsolete vessels and whether it can be used as a model for MARAD. While I am interested in learning the magnitude of the inventory excess problem, I am primarily concerned about how MARAD plans to economically scrap these vessels while complying with safety and environmental standards. I understand the issue is the relative feasibility of scrapping these vessels in the United States and overseas.

I might mention that our colleague, Mr. DeFazio of Oregon, has introduced a bill, H.R. 4189, which would establish a pilot program for the Department of Transportation to carry out the vessel scrapping and processing program in the United States. At his request, Mr. Chairman, I would ask unanimous consent at the appropriate time that his statement regarding his bill in this matter be included in the record.

Chairman SUNUNU. Without objection. And I would ask also unanimous consent that all members be given 5 days to submit written statements for the record.

[The information referred to follows:]

PREPARED STATEMENT OF HON. PETER A. DEFAZIO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Thank you very much for the opportunity to testify on the issue of how to dispose of the U.S. Government's obsolete ships. As the ranking Democrat on the House Transportation and Infrastructure Committee's Subcommittee on Coast Guard and Maritime Transportation, I am keenly interested in resolving this problem. I have introduced legislation, H.R.4189, to address the issue and the Subcommittee has held two hearings on this subject.

As you know, the U.S. used to send its surplus vessels for scrapping at overseas facilities, under terrible conditions. Public outrage over the U.S. sending its toxic legacies overseas, led the Administration to halt this practice several years ago. Since that time, virtually no ships have been scrapped. Why? Because the U.S. Maritime Administration (MARAD) is statutorily obligated to sell these ships, and cannot, under current law, provide funds for their disposal here in the United States. No U.S. shipyard can possibly scrap these ships in an environmentally responsible and safe manner. So, these ships remain rotting at anchor in U.S. harbors.

The government's current options are to again send its vessels to overseas shipyards where third world workers toil in unspeakable conditions, or leave them in U.S. harbors where they risk sinking and polluting our waters.

Instead of lamenting over this dilemma, Congress should take the initiative to change MARAD's statute and allow the agency to provide funding for shipyards in the United States to scrap ships. These ships are the responsibility of the U.S. Government and we should take responsibility the environmental hazards and safety risks posed by these vessels.

It is time to admit that it will cost money to take care of our toxic legacy. I have introduced legislation to do just that. My bill, H.R.4189, authorizes funding for a ship scrapping pilot program at MARAD, to pay qualifying shipyards to scrap its obsolete vessels.

I hope that as a result of this hearing, more Members of Congress and the public will be aware of this problem and work to enact legislation to solve it.

Mr. BENTSEN. I thank the Chairman and with that, I will yield back the balance of my time and look forward to hearing the testimony today.

Chairman SUNUNU. Thank you very much Mr. Bentsen.

I would like to begin our testimony with Mr. Howard from the Inspector General's office and then provide time for Mr. Graykowski to talk about his perception of the problem and thoughts on ways to deal with the problem. And then we will hear from Vice Admiral Amerault about the Navy pilot program which I know has met with some success, and even more important, I hope has yielded a good deal of information about the process, the costs, and the technical and financial obstructions to dealing with this problem.

Mr. Howard, welcome, and we are pleased to hear your testimony.

STATEMENTS OF THOMAS J. HOWARD, DEPUTY ASSISTANT INSPECTOR GENERAL FOR MARITIME AND DEPARTMENTAL PROGRAMS, U.S. DEPARTMENT OF TRANSPORTATION; JOHN E. GRAYKOWSKI, ACTING MARITIME ADMINISTRATOR, U.S. DEPARTMENT OF TRANSPORTATION; AND VICE ADM. JAMES F. AMERAULT, DEPUTY CHIEF OF NAVAL OPERATIONS LOGISTICS

STATEMENT OF THOMAS J. HOWARD

Mr. HOWARD. Thank you, Mr. Chairman, members of the Task Force. I ask that my statement be submitted for the record and I will summarize my remarks.

Chairman SUNUNU. Without objection.

Mr. HOWARD. My statement is based on our March 10th report on MARAD's ship-scrapping program. The Office of Inspector General has identified MARAD's ship-scrapping program as one of the 12 most pressing management issues in the Department of Transportation. The Department, the administration, and the Congress face a challenge in determining how to dispose of MARAD's fleet of old, environmentally dangerous ships in a timely manner.

The current approach of selling ships for domestic scrapping is not working. MARAD will not be able to meet the legislative mandate to dispose of its ships by September 30, 2001. It also will not be able to gain meaningful financial returns from these ships.

As you mentioned, Mr. Chairman, MARAD maintains its ships in the water in three locations. The picture being displayed shows a few of the ships in Suisun Bay. The one in the foreground is the *Mission Santa Ynez,* which is 56 years old and has been awaiting disposal for 25 years. Environmental dangers associated with these old, deteriorating ships are increasing daily. The so-called worst-condition ships average 50 years old and have been awaiting disposal for 22 years.

These photos show actual conditions on 3 of the 40 worst-condition ships. The ships contain hazardous materials such as PCBs, asbestos, lead-based paint, and fuel oil. Some have deteriorated to the point where a hammer can penetrate their hulls. If the oil from these ships was to leak into the water, immediate and potentially expensive Federal and State action would be required.

MARAD currently has 114 obsolete ships awaiting disposal. As shown in the chart being displayed now, this number has grown from 66 just 3 years ago. It is expected to reach 155 by the end of fiscal year 2001.

As shown in the next chart, only 7 ships have been scrapped since 1995. This represents a significant change from 1991 through 1994 when 80 ships were scrapped overseas. In addition, recent sales to domestic scrappers have only yielded between $10 and $105 per ship. This is down from an average price of $433,000 per ship during the early nineties.

MARAD's inability to reduce the backlog of ships awaiting disposal is attributable to a couple of factors: the loss of overseas sales, current limited domestic scrapping capacity and the Navy's pilot program.

Since 1994 MARAD has been relying on the domestic ship-scrapping market but its capacity is currently limited. Only four companies have passed MARAD's technical compliance reviews to scrap ships. Although MARAD sold 22 ships to these domestic scrappers since 1995, 13 are still moored in MARAD's fleet. Recent contractor delays in picking up ships and a default by one contractor raise a question as to whether the ships will be removed from the fleet.

The Department of the Navy experienced a similar inability to sell its obsolete combatant ships in the domestic market. In 1998 Congress authorized and appropriated funding for a pilot project allowing the Navy to pay domestic contractors to scrap ships. Last year the Navy awarded contracts amounting to $13.3 million for the scrapping of 4 ships. The contractor that defaulted on MARAD is scrapping a ship under the Navy pilot program. MARAD is coordinating with the Navy on its initiatives and is pursuing alternative disposal methods, but due to capacity limitations, no one of those alternatives has the potential of significantly reducing the backlog in a timely manner.

In our March report we recommended that the Maritime Administrator take several actions:

First, seek legislative approval to obtain an extension on the disposal mandate and eliminate the requirement to gain financial returns on vessel sales.

Second, continue to pursue programs to improve scrapping sales and identify alternative disposal methods.

Third, develop a proposal seeking authority and funding to pay domestic contractors to scrap ships, targeting the 40 worst-condition ships for priority disposal.

In its authorization request for fiscal year 2001, MARAD proposed a 5-year extension to develop and begin implementing a plan to dispose of these ships. We do not believe it is acceptable to begin disposal within 5 years, considering the condition of some of the ships, the environmental risk, and the cost to maintain them. In our opinion, the legislation should require MARAD to develop a disposal plan and substantially dispose of these ships within 5 years. Further, MARAD's plan needs to identify viable disposal methods, set milestones, and target the worst-condition ships for priority disposal.

This concludes my remarks. I will be happy to answer questions.

Chairman SUNUNU. Thank you Mr. Howard.

[The prepared statement of Thomas Howard follows:]

PREPARED STATEMENT OF THOMAS J. HOWARD, DEPUTY ASSISTANT INSPECTOR GENERAL FOR MARITIME AND DEPARTMENTAL PROGRAMS, U.S. DEPARTMENT OF TRANSPORTATION

Mr. Chairman and members of the Task Force, we appreciate the opportunity to be here today to discuss the Maritime Administration's (MARAD) program for scrapping obsolete vessels. We have identified this program as 1 of the 12 most pressing management issues in the Department of Transportation. The Department, the Administration, and the Congress face a challenge in determining how to dispose of MARAD's Fleet of old, environmentally dangerous vessels in a timely manner.

The current approach of selling obsolete vessels for domestic scrapping is not working. There is limited capacity in the domestic scrapping market and the Navy is paying contractors to scrap its obsolete warships while MARAD is asking contractors to pay to scrap its vessels. Further, MARAD has been constrained from selling vessels overseas for scrapping, although this had been a key market in the past.

MARAD will not meet the legislative mandate to dispose of its obsolete vessels by the end of fiscal year (FY) 2001 in a manner that will yield financial benefits. MARAD will need relief from those requirements. MARAD will also need authorization and funding for a program to pay for the disposal of obsolete vessels if it is to have the potential to significantly reduce the Fleet.

MARAD is pursuing a number of alternatives for disposing of its obsolete vessels, but because of capacity limitations, no one has the potential to significantly reduce the backlog of vessels in a timely manner. MARAD needs to develop a plan and take prompt action to dispose of all of its obsolete vessels.

Our statement is based on our March 10, 2000 report on the scrapping program. We will discuss three issues today:

- The environmental threats posed by MARAD's growing backlog of obsolete vessels;
- Key factors contributing to MARAD's inability to scrap vessels domestically; and
- The need for prompt implementation of a plan that prioritizes disposal of the "worst condition" vessels and identifies methods and milestones for disposing of all obsolete vessels in the Fleet.

GROWING BACKLOG OF OBSOLETE VESSELS IS A THREAT TO THE ENVIRONMENT

MARAD currently has 114 obsolete vessels awaiting disposal. This number has grown from 66 vessels 3 years ago. Moreover, the inventory of obsolete vessels awaiting disposal is continuing to increase, and is expected to reach 155 by the end of FY 2001.

MARAD maintains its vessels in the water at three locations—the James River in Virginia; Beaumont, Texas; and Suisun Bay, California. Environmental dangers associated with these old, deteriorating ships are increasing daily. The so-called "worst condition" vessels are about 50 years old and have been awaiting disposal for 22 years on average.

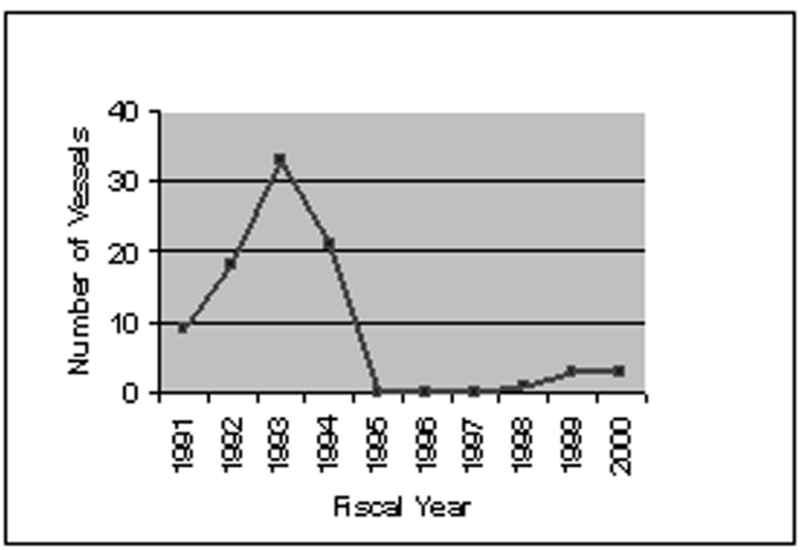
VESSELS AWAITING DISPOSAL AT SUISUN BAY RESERVE FLEET

These vessels contain hazardous materials such as polychlorinated biphenyls (PCBs), asbestos, lead-based paint and fuel oil. Some vessels have deteriorated to the point where a hammer can penetrate their hulls. If the oil from these vessels were to enter the water, immediate and potentially very expensive Federal and State action would be required. For example, MARAD spent $1.3 million on a costly environmental cleanup because one of the "worst condition" vessels deteriorated to a point where oil leaked into the water.

MARAD'S INABILITY TO SCRAP VESSELS IS ATTRIBUTABLE TO SEVERAL KEY FACTORS

Since 1995, only seven vessels have been scrapped. This represents a significant change from 1991 through 1994 when 80 ships were sold overseas at an average price of $433,000 per vessel. Recent sales to domestic scrappers have only yielded between $10 and $105 per vessel.

MARAD VESSELS SCRAPPED



MARAD stopped selling vessels overseas for scrapping in 1994 due to Environmental Protection Agency (EPA) restrictions. In September 1998, the Administration placed a moratorium on all sales of vessels for scrapping overseas that remained in force through October 1, 1999. MARAD has continued to refrain from exporting obsolete vessels because of concerns about the environment and worker safety.

Since 1994, MARAD has been relying on the domestic ship scrapping market, but its capacity is limited. Only four companies have passed MARAD's technical compliance review to scrap vessels. Although MARAD sold 22 vessels to these domestic scrappers since 1995, 13 of the vessels are still in MARAD's Fleet. Recent contractor delays and a contractor default raise a question as to whether these vessels will be removed by contractors from the Fleet.

The Department of the Navy experienced a similar inability to sell its combatant vessels for domestic scrapping. In 1998, Congress authorized and appropriated funding for a pilot project allowing the Navy to pay domestic contractors to scrap vessels. On September 29, 1999, the Navy awarded four contracts amounting to $13.3 million for the scrapping of four vessels.

MARAD cannot compete with the Navy pilot program in the limited domestic market because, by law, MARAD is prohibited from paying for scrapping services. The contractor that defaulted on MARAD, is scrapping a Navy ship under the pilot program.

MARAD NEEDS A PLAN AND PROMPT ACTION

To Dispose Of its Obsolete Vessels

While MARAD has been pursuing alternative ways to dispose of vessels, it is constrained by the legislative requirement to maximize financial returns. Also, the alternatives MARAD is pursuing have capacity limitations and, therefore, no single option has the potential to significantly reduce the backlog of vessels in a timely manner. These alternatives include: coordinating with the Navy and a west coast company on a proposal for a potential scrapping site; participating in interagency work groups to look for innovative ways to improve the ship scrapping process; and requesting approval from EPA to sell vessels to overseas markets.

The National Maritime Heritage Act of 1994 requires MARAD to dispose of its obsolete vessels by the end of FY 2001, which is an extension from 1999, the original deadline. MARAD does not have a plan to dispose of these vessels.

We recently recommended that the Maritime Administrator:

1. Seek legislative approval to obtain an extension on the disposal mandate and eliminate the requirement to gain financial returns on vessel sales;
2. Develop a proposal seeking authority and funding to pay domestic contractors to scrap vessels, and target the "worst condition" vessels for priority disposal; and
3. Continue to pursue programs to improve scrapping sales and identify alternative disposal methods for its obsolete vessels.

In its authorization request for FY 2001, MARAD proposed a 5-year extension "to develop and begin implementing a plan to dispose of these vessels." We do not believe it is acceptable to begin disposal within 5 years considering the condition of some of the vessels, the environmental risks, and the costs to maintain them. In our opinion, the legislation should require MARAD to develop a disposal plan and substantially dispose of these vessels within 5 years. Further, MARAD needs to identify viable disposal methods, set milestones, and target the "worst condition" vessels for priority disposal.

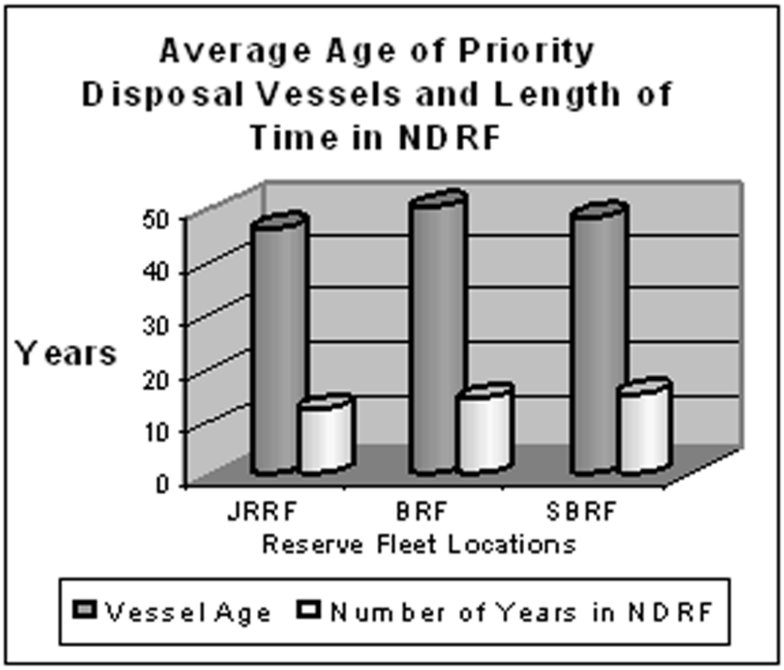
BACKGROUND

The Merchant Ship Sales Act of 1946 created the National Defense Reserve Fleet (NDRF), a Government-owned and administered Fleet of inactive, but potentially useful, merchant and non-military vessels to meet shipping requirements during National emergencies. MARAD administers the Fleet, and the Department of Defense provides the funding to maintain the Fleet. The Federal Property and Administrative Services Act gave MARAD responsibility for disposing of all Federal Government merchant-type vessels of 1,500 gross tons or more. The National Maritime Heritage Act of 1994 required MARAD to dispose of obsolete vessels in the Fleet by September 30, 1999, in a manner that maximizes financial return to the United States, but the Act was amended to extend the original disposal date by 2 years, from 1999 to 2001.

As of April 30, 2000, 114 obsolete vessels were designated for disposal because the majority of them are no longer operational. MARAD maintains the inactive vessels in the water at the following locations:

- James River Reserve Fleet (JRRF) at Ft. Eustis, Virginia (61 vessels);
- Beaumont Reserve Fleet (BRF) in Beaumont, Texas (9 vessels); and
- Suisun Bay Reserve Fleet (SBRF) in Benecia, California (42 vessels).

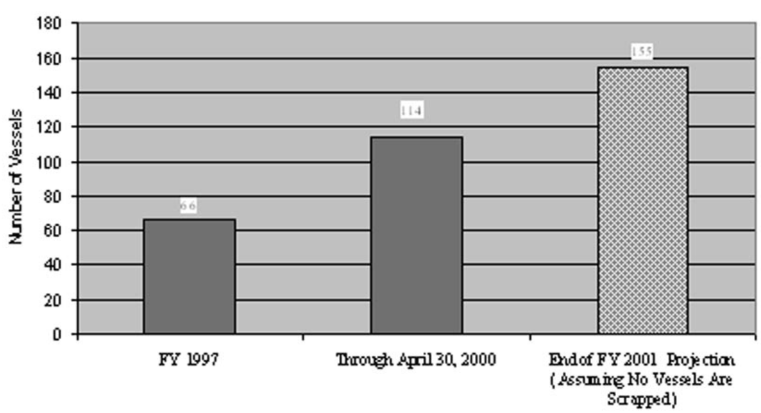
The Coast Guard holds two vessels in Mobile, Alabama for fire fighting training. As shown in the following chart, the average age of the 114 obsolete vessels is 48 years. These vessels have been in the Fleet for an average of 15 years.



THE NUMBER OF OBSOLETE VESSELS AWAITING DISPOSAL IS INCREASING

The number of obsolete vessels has almost doubled since 1997. MARAD expects its inventory of obsolete vessels awaiting disposal will increase to 155 vessels by the end of FY 2001, as shown in the following chart.

VESSELS AWAITING DISPOSAL

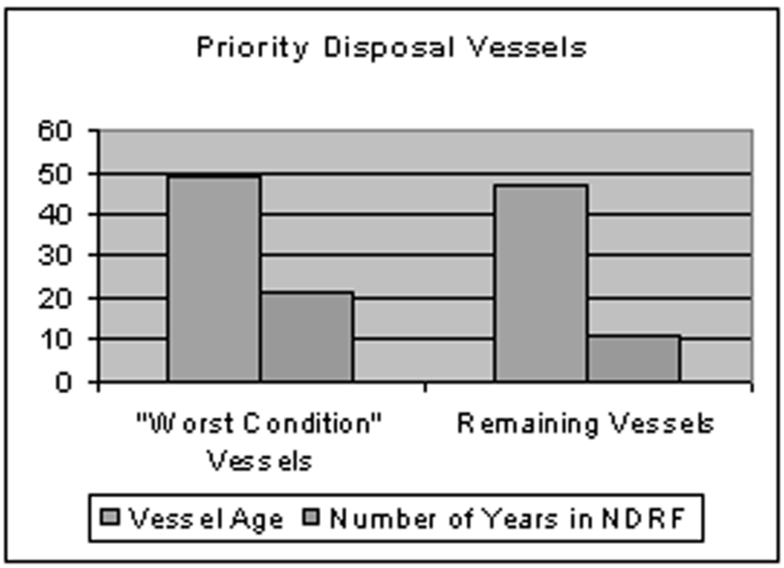


This projected increase is due to additional vessel transfers from the Navy, downgrades of other NDRF vessels to obsolete status, and the inability to sell ships for scrap. Of the 155 vessels, 132 will be targeted for scrapping. The remaining 23 vessels will be targeted for disposal through the fish reef program, use by a State or Federal agency, or held for useful parts and equipment. However, some of these vessels may be transferred into the scrapping category in future years if they cannot be disposed of through other means.

OBSOLETE VESSELS POSE ENVIRONMENTAL RISKS

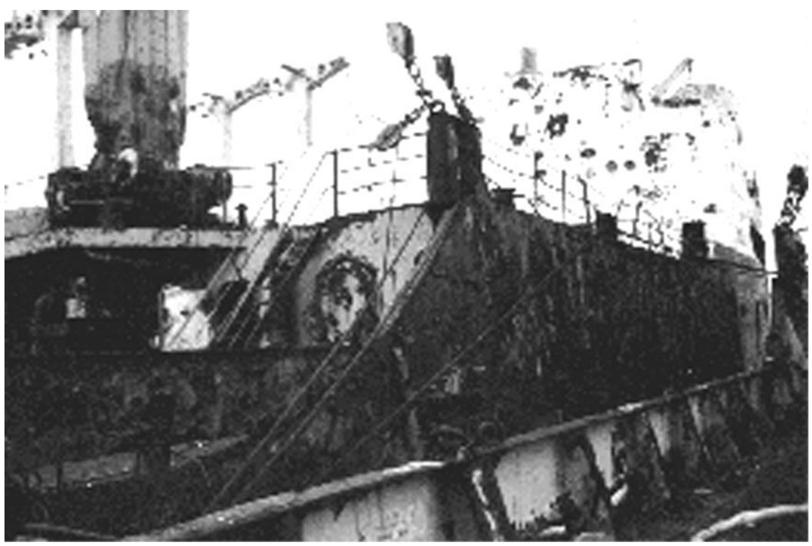
The 114 obsolete vessels currently awaiting disposal pose environmental risks because they are deteriorating, contain hazardous materials, and contain oil that could leak into the water. These vessels are literally rotting and disintegrating as they await disposal. Some vessels have deteriorated to a point where a hammer can penetrate their hulls. They contain hazardous substances such as asbestos and solid and liquid polychlorinated biphenyls (PCBs). If the oil from these vessels were to enter the water, immediate and potentially very expensive Federal and state action would be required.

In 1999, MARAD identified the 40 "worst condition" vessels. These vessels were classified as "worst condition" due to their severe deterioration and threat to the environment. As of April 30, 2000, 3 of the 40 had been moved out of the Fleet to domestic scrappers. As shown in the following chart, the "worst condition" vessels are older and have been in the Fleet longer than the other vessels awaiting disposal.



The "worst condition" vessels are in particularly bad condition, and may require additional or special maintenance. Our inspection of 11 of the original 40 "worst condition" vessels revealed corrosion, thinning, and rusting of the hull; asbestos hanging from pipes below deck; lead-based paint easily peeled from the ship; solid PCBs (in cabling); and in some instances, remnants of liquid PCBs in electrical equipment.

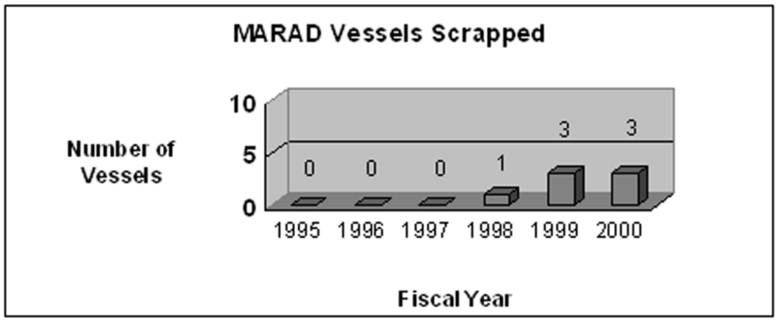
DETERIORATING VESSEL AT JAMES RIVER RESERVE FLEET



Costs to maintain these vessels will likely increase due to their deteriorating condition, leaks, and the need for additional time-sensitive maintenance. For example, MARAD spent $1.3 million to maintain 1 of the 40 “worst condition” vessels over the past 2 years. This vessel is over 35 years old, contains hazardous substances including asbestos, and has deteriorated to the point where oil leaked into the water requiring costly environmental clean-up. MARAD has applied over 20 patches to leaks, removed hazardous materials, deployed containment booms, and pumped oil out of the vessel. The vessel is disintegrating to a point where it will not be seaworthy much longer. Monitoring efforts for this vessel are ongoing.

PROGRESS IN SCRAPPING VESSELS IS LIMITED

Although MARAD has sold 22 vessels since 1995, only 7 have been scrapped. Two other vessels have been towed to scrapping sites. The remaining 13 vessels sold are still moored in MARAD's Fleet, requiring continued maintenance at U.S. Government expense.



Between 1991 and 1994, MARAD sold 80 vessels overseas for scrapping at an average price of $433,000 per vessel. During the past year, vessel sales yielded between $10 and $105 per vessel. On October 25, 1999, MARAD sold three vessels for $10 per vessel. The most recent sale was for two vessels at $105 per vessel on December 21, 1999.

LOSS OF OVERSEAS MARKETS CONTRIBUTED TO THE DECLINE IN SCRAPPING

MARAD suspended the sale of vessels to overseas scrappers in 1994 because the EPA prohibited the export of Government-owned ships containing PCBs. In September 1998, an Administration moratorium halted all sales of Government-owned vessels for scrapping overseas. The moratorium expired on October 1, 1999, but MARAD has refrained from exporting vessels overseas for scrapping.

Based on a 1997 agreement between MARAD and EPA, MARAD is required to request EPA's approval to sell vessels to overseas contractors that can scrap them in an environmentally compliant manner. The agreement requires MARAD to ensure that all liquid PCBs in transformers, capacitors, hydraulic and heat transfer fluids and that all "readily removable" solid PCBs are removed prior to exporting these vessels. This agreement also requires EPA to notify countries of import that they will be receiving vessels and that these vessels may contain PCBs. To date, MARAD has not requested EPA approval to sell any of its vessels awaiting disposal to overseas scrappers. However, on April 14, 2000, the Maritime Administrator sent a letter to the EPA requesting its assistance on developing an option for exporting vessels for scrapping and implementation of the 1997 EPA/MARAD agreement.

LIMITED DOMESTIC CAPACITY HAMPERS PROGRESS IN SCRAPPING

Since 1995 MARAD has been relying on the domestic market, but capacity in the domestic market is limited. In the 1970's, there were 30 U.S. contractors in the ship scrapping industry. Over the past 19 months, however, only four companies have bid on MARAD's scrapping contracts and passed MARAD's technical compliance review to scrap vessels. These four companies can only handle approximately one to five vessels at a time, depending on the size of the scrap yard and the dimensions of the vessel. For example, one company could only scrap two or three vessels per year. According to industry sources, it takes approximately 4 to 6 months to completely scrap a MARAD vessel.

Additional companies are not attracted to this industry because of the low profits currently available. Scrap steel prices in the United States are low and contractors must comply with environmental regulations. Most of the domestic scrapping company officials we contacted indicated that the profit from scrapping vessels is not worth the effort. At a minimum, contractors in this business must pay for the towing costs and provide $150,000 as a performance bond to secure a vessel after a contract has been awarded. Contractors receive no return on a vessel until scrap metal and the equipment removed from the vessel are sold.

Even when it has been able to sell vessels, MARAD has encountered problems with domestic contractors. In 1999, MARAD sold 17 vessels to 3 ship scrapping companies located in Brownsville, Texas. At the time of our review, we found that only two companies were actively scrapping ships, and only one of these companies was currently scrapping a MARAD ship. MARAD has granted a number of extensions to contractors, and in one instance, MARAD had to resell vessels because of contractor default. During our review, we also found that another company had not taken possession of any vessels because of an ongoing dispute with the Port of Brownsville regarding contamination of its scrapping site. It has since taken possession of its vessels.

NAVY PILOT PROJECT POSES COMPETITION FOR MARAD

The Department of the Navy experienced a similar inability to sell its combatant vessels for domestic scrapping. In 1998, Congress authorized and appropriated funding for a Navy pilot project for the disposal of obsolete warships. The Navy and MARAD are coordinating efforts to improve ship scrapping programs, as recommended by the Interagency Panel on Ship Scrapping and the General Accounting Office. The Navy agreed to share its findings from the pilot project with MARAD.

On September 29, 1999, the Navy awarded four cost-plus contracts totaling $13.3 million for the scrapping of four vessels under its new Pilot Ship Disposal Project. This pilot project departs from the sales contracting process by providing for cost plus incentive fees for scrapping the first vessels. It guarantees profitability by providing for the cost of scrapping the vessels and gives the contractor the opportunity to earn incentive fees, which encourages and rewards superior contractor performance. If the contractors are successful in scrapping the first 4 vessels, they will be given the opportunity to scrap more vessels, potentially leading to the disposal of 66 warships.

One of these contractors was also under contract with MARAD to scrap its vessels. The company completed scrapping four MARAD vessels during 1998 and 1999; however, it defaulted on a contract for another five MARAD vessels in August 1999.

MARAD cannot compete with the Navy's pilot project while it is required by law to maximize financial return on its vessels. If MARAD were authorized to implement such a project, it could cost as much as $515 million to dispose of the obsolete vessels that MARAD expects to have by the end of FY 2001.

ALTERNATIVES OFFER POTENTIAL BUT HAVE LIMITATIONS

While MARAD has been pursuing ways to improve scrapping sales, its ability to explore creative solutions for disposing of vessels is constrained by the requirement to maximize financial returns. Also, the alternatives MARAD is pursuing have capacity limitations, so no one single option has the potential to significantly reduce the backlog of vessels awaiting disposal in a timely manner. We have identified additional alternatives that MARAD has not pursued that may have the potential to contribute to the goal of disposing of obsolete vessels.

Programs to improve scrapping sales and alternatives MARAD is pursuing include: coordination with the Navy and a west coast company on a proposal for a potential scrapping site; participation in interagency work groups to look for innovative ways to improve the ship scrapping process and establish consistent procedures; donation of vessels designated for disposal for uses such as museums and the fish reef program, given legislative or executive approval; and coordination with the Navy on its program to sink vessels in deep water after hazardous materials are removed.

MARAD may be able to explore alternatives that have the potential to assist in disposing of some of its vessels such as: selling vessels to other countries for non-military uses, given legislative approval and approval from the EPA to sell vessels to overseas markets that are capable of scrapping them in an environmentally compliant manner.

According to MARAD, selling vessels overseas for non-military uses would require a change in the law that only allows MARAD to sell vessels for disposal or non-transportation use. However, legislation was passed in 1996 for four vessels to be sold on a competitive basis for operational use. One vessel was sold in 1999 and bids on two vessels are currently under review. The fourth vessel requires an EPA approval, which MARAD requested April 1999.

On April 14, 2000, MARAD sent a memorandum to EPA requesting its assistance in facilitating an export option for scrapping based on the 1997 EPA/MARAD agreement. MARAD also said it would contact the EPA staff to discuss recommendations made by the Interagency Panel on Ship Scrapping.

DISPOSAL PLAN AND PROMPT ACTION ARE NEEDED

The National Maritime Heritage Act of 1994 requires MARAD to dispose of its obsolete vessels by the end of FY 2001, which is an extension from 1999, the original deadline. MARAD does not have a plan to dispose of these vessels.

In our March 10, 2000 audit report, MA–2000–067[1], we recommended that the Maritime Administrator:

1. Seek legislative approval to extend the 2001 mandate to dispose of obsolete vessels and to eliminate the requirement that MARAD maximize financial returns on the sale of its obsolete vessels.
2. Continue to pursue programs to improve scrapping sales and identify alternative disposal methods that can contribute to the goal of reducing the number of obsolete vessels awaiting disposal, to include working with the Navy on the results of its studies on the environmental impact of sunken vessels.
3. Develop a proposal for submission to Congress seeking approval and funding for a project to pay contractors for vessel scrapping. The proposal should include a plan to target the "worst condition" vessels first, identify funding and staffing requirements, and provide milestone dates to dispose of all obsolete vessels.

MARAD concurred with our recommendations. In its FY 2001 authorization request, MARAD proposed a "five year extension [in the deadline that] will provide MARAD with additional time to develop and begin implementing a plan to dispose of these vessels." Considering the condition of some of the vessels, the environmental risks, and the costs to maintain them, we find the MARAD proposal unacceptable. MARAD must develop and implement a disposal plan for its obsolete vessels once legislative approval is obtained for an extension.

As a part of its disposal plan, MARAD must state specific milestones and steps it will take to scrap its obsolete vessels within the next 5 years. The plan must state how MARAD proposes to dispose of these vessels taking into consideration all the available options. MARAD must identify viable disposal methods, and target the "worst condition" vessels for priority disposal.

Mr. Chairman, this concludes our statement. I would be pleased to answer any questions.

Chairman SUNUNU. Mr. Graykowski.

STATEMENT OF JOHN E. GRAYKOWSKI

Mr. GRAYKOWSKI. Thank you, Mr. Chairman. And thank you, members of the Task Force, for the opportunity today to appear before you to talk about what we consider to be a serious and a growing problem with national significance.

By way of background, I am John Graykowski and I am currently the Acting Administrator of the Maritime Administration, which is a modal administration within the Department of Transportation. MARAD is a small Federal agency with a large portfolio of responsibilities generally focused on the promotion, enhancement, and strengthening of the U.S. maritime industries, consisting of vessel owners, maritime labor, our shipyards and our ports.

MARAD performs these duties in direct support of U.S. national and economic security objectives, one of which is to maintain a commercial sealift capability and shipyard capacity to be made available to the Department of Defense in times of war, national emergency, or under Presidential directive. In effect, MARAD serves as a bridge between the national defense apparatus of the country and the commercial maritime assets which are critical to support national needs.

I note the attendance today of one of our major partners in our effort to support the United States maritime industry, Vice Admiral Amerault, who will, I am certain, concur that our current defense posture relies heavily on the commercial maritime industry to maintain its readiness and response capabilities.

[1] Report on the Program for Scrapping Obsolete Vessels, MARAD, March 10, 2000.

Mr. Chairman and Members of the Task Force, it is precisely this partnership with the Department of Defense that has created the situation we have today, where a civilian agency, MARAD, has control and title to a large fleet of obsolete ships around the country.

I have submitted written testimony and I will thus simply summarize a few points:

One, the problem is ours, the Federal Government's problem. It is our responsibility to fix it. No matter how hard one might try to look at it differently, these are government ships, they are stored and maintained by the government and required by law to be disposed of properly by the government.

Secondly, the problem will not go away on its own. Indeed this problem grows larger with each passing day, both in terms of the increasing number of ships that need to be scrapped and in the simple and inescapable fact that like all of us, ships get old, steel wastes, and structural integrity degrades. We simply cannot ignore it. We can't pretend it doesn't exist and we can't simply persist in holding our collective breaths each time there is a storm near one of these fleets or in the calm of the night that something, quote, "bad" might happen.

We are paying considerable amounts of money now, as the Chairman noted, and that amount of expenditure will continue to grow. For example, we spent around $3 million last year just to take care of this fleet. We anticipate spending perhaps five times that in the next couple of years unless we resume scrapping operations.

As the Chairman referred to and wanted me to speak to, last year with that ship right there, the *Export Challenger* which is some 40 years old, we and the taxpayers spent $1.3 million to pump out some oil, to fix it up and return it to site in the James River where she sits today. And this, Mr. Chairman, and all of you, as all of us who are responsible for managing the taxpayers' resources, it is very hard to justify that type of expenditure but it is not going to stop with the *Export Challenger*.

We are going to begin, and it is no secret to Admiral Amerault or anybody familiar with this program, we are going to begin dry docking these ships, ships such as the *Export Challenger*. Their average age is 48 years old. That is older than me, I think it is older than the Chairman and older than others here, at the cost of $900,000 apiece minimum, because we don't know what it is going to take once they are in the dry dock to fix them up.

We will have 155 ships under our control at MARAD by the end of 2001. Anyone here can do the math and see that it will cost this country hundreds of millions of dollars in the next decade. And what do we end up with? Exactly what we have today—155 ships sitting in the James River, Beaumont, Texas, and Suisun Bay—unless we resume scrapping.

How we got here has been chronicled in my written testimony. Admiral Amerault will speak to it. Tom Howard just spoke to it. I am not going to repeat it. I will say, however, that there have been a series of decisions taken within our government that have resulted in the current impasse, decisions that were well founded in intention and desire but which did not address the fundamental and again inescapable fact that something has to be done with these vessels.

In a sense, I think that we have substituted in the last 7 years an appearance of action on this problem for real action while the infinite patience of time continues to take its toll on our vessels. But I would caution all of us against leveling recriminations against any of the agencies or people who have been involved in this matter, since that would, I believe, undermine our common purpose and desire to eliminate these ships as fast as possible and in the most responsible fashion we can.

Mr. Chairman and members of the Task Force, my agency MARAD is forbidden by law to do anything other than sell these ships. We did it for quite a number of years and very successfully and yielded a lot of money that was used to offset our need for appropriations. But because of this situation, MARAD has not taken any of the actions that might be necessary to inventory the fleet for both the hazardous materials that might exist and to estimate possible recoveries from the sale of metals from the ships. To do that would require a huge amount of money and a devotion of staff resources that we simply don't have at this time.

However, let me stress, if the statutory mandate is changed, and MARAD is given the authority to pay for scrap vessels domestically, MARAD is fully prepared, equipped and, I would submit emphatically, the right agency for the job. We are already charged by DOD for these, to take care of these vessels and to keep the ready reserve force ready to fight, and we do that in an outstanding fashion. We know these vessels, we know the shipyards that might be willing to participate in a program, and indeed we have a very strong and vibrant relationship with those shipyards that is in all senses a commercial partnership by virtue of the other programs MARAD implements. Thus I am confident that if directed by Congress, we, MARAD could establish a program that yields the best value to the government. We have proved that elsewhere and I am confident we would do it here.

Finally, Mr. Chairman, members of the Task Force, we all need to remove the extensive mystery about ship disposal—and I mentioned this to you yesterday—the mystery which leads to imposing regulations and treating this situation different from disposal situations elsewhere.

A ship is nothing more in a sense than a building. It differs because it floats, but it is a building. Fifty years ago, just as buildings were made using materials such as asbestos and PCBs, so are ships. But the problems are the same, the challenge is identical, and the technical responses to that need to be much different, whether it is a ship or a building. We have those resources, we have that capability, and we have the ability to take care of the problem.

I thank you for your interest, look forward to working with you, and again this is a long overdue opportunity.

Chairman SUNUNU. Thank you very much Mr. Graykowski.

[The prepared statement of John Graykowski follows:]

PREPARED STATEMENT OF JOHN E. GRAYKOWSKI, ACTING MARITIME ADMINISTRATOR, U.S. DEPARTMENT OF TRANSPORTATION

Good morning Mr. Chairman and Members of the Task Force. I welcome the opportunity to be here today to discuss an issue of great importance to the Maritime Administration (MARAD)—the disposal of obsolete government vessels. As you know, the Federal Property and Administrative Procedures Act of 1949 designates MARAD as the Government's disposal agent for merchant type vessels of 1,500 gross tons or more. Thus, in addition to MARAD's own National Defense Reserve Fleet (NDRF) obligations, the agency has taken title to over 40 merchant type Navy ships for disposal in the last 2 years.

Currently, there are 114 vessels slated for scrapping moored at the James River Reserve Fleet in Ft. Eustis, Virginia; Beaumont Reserve Fleet in Beaumont, Texas; and Suisun Bay Reserve Fleet in Benecia, California. This number is expected to grow to 155 by the end of Fiscal Year 2001 if additional vessels are not disposed of. MARAD is committed to finding an appropriate means of scrapping these vessels safely, economically and in an environmentally sound manner.

Under the National Maritime Heritage Act of 1994, MARAD is required to dispose of obsolete NDRF vessels by September 30, 2001, in a manner that maximizes financial return to the United States. Fifty percent of the amounts received from scrapping are to be used by the Maritime Administrator for the acquisition, maintenance, repair, reconditioning or improvement of NDRF vessels. Twenty-five percent is to be used for expenses incurred by the State or Federal maritime academies for facility and training ship maintenance, repair, modernization and the purchase of simulators and fuel; the remaining 25 percent is to be made available to the Secretary of Interior for maritime heritage grants.

Historically, MARAD's primary means of disposing of obsolete vessels has been to sell them for scrapping. From 1987 to 1994, MARAD sold approximately 130 obsolete vessels for scrapping overseas. During that period the agency received an average of $108 per ton for those ships.[1] Since an average ship in the NDRF weighs approximately 6,000 tons, the gross returns for scrapping such a ship overseas have been about $600,000.

Since 1995, MARAD has not scrapped any vessels overseas due to concerns raised by the Environmental Protection Agency (EPA) about the export of hazardous substances. Specifically, the EPA advised MARAD of its position that the export of a Government ship for scrapping was the equivalent of distributing in commerce regulated quantities of Polychlorinated Biphenyls (PCBs) under the Toxic Substances Control Act (TSCA). In November 1995, EPA issued a discretionary enforcement letter to MARAD allowing the export of two ships for scrapping once all PCBs had been removed. That procedure was unworkable since the removal of all PCBs could have compromised the watertight integrity of the ships.

In 1997, MARAD and the EPA signed an agreement allowing foreign ship disposal after removal of liquid PCBs and readily removable solid PCBs. Prior to implementation of the export agreement, however, the Department of Defense formed an Interagency Panel on Ship Scrapping to review the process for scrapping Government vessels. Thus, in January 1998, MARAD agreed to continue to refrain from selling any vessels for scrapping abroad until the Panel had completed its review. Additionally, in the fall of 1998, an executive memorandum requested that MARAD and the Department of Defense observe a moratorium until October 1, 1999, on the export of obsolete vessels to be scrapped, to ensure that the Panel's recommendations were fully considered. MARAD complied with this request.

The Interagency Panel, composed of representatives from DOD, the EPA, the Occupational Safety and Health Administration (OSHA), the Department of State, the Department of Justice, the U.S. Coast Guard and MARAD reviewed the process and procedures for scrapping ships. The Panel made recommendations regarding economic soundness and environmental and worker safety. It also concluded that all options for ship scrapping, including overseas scrapping, should remain open.

With regard to exports, the Panel made a number of recommendations—such as expansion of the notification process to importing countries regarding the presence of hazardous materials, and the requirement for bidders to submit a technical compliance plan—which could be incorporated into the process relatively quickly. Nevertheless, developing meaningful technical assistance, and determining how to enforce contractual requirements and monitor contractual performance overseas could take significant time and resources to implement.

[1] All references to tonnage in this statement are to lightship displacement tonnage. Lightship displacement tonnage refers to the actual weight of the ship.

Since 1996, MARAD has been exploring the domestic ship scrapping market. The agency has revised its solicitation process for domestic sales, incorporating environmental and safety issues as part of the award. A bidder is required to submit a technical compliance plan including environmental, worker health and safety, business, and operational plans that describe the bidder's knowledge and ability to address the problems inherent in ship scrapping. Following a review of the bidder's technical compliance plan, its compliance history and a site visit, MARAD awards vessels to qualified bidders on the basis of price. During the scrapping process, MARAD also conducts both announced and unannounced visits to the scrapping site to monitor the contractor's compliance with the sales contract.

Unfortunately, the capacity of the domestic market for buying and scrapping obsolete MARAD ships is limited, and the drop in the price of scrap steel has eroded the profitability of existing scrappers. Moreover, only four bidders have satisfied the requirements of MARAD's technical review since 1997, and only 9 of the 22 ships sold domestically during that time have been removed from the fleet sites. Three of these vessels were sold for $10.00 each. One sales contract for five vessels was terminated last year because the purchaser did not take possession of the vessels. We are likely to continue facing a backlog given the number of ships waiting to be scrapped.

You may be aware that about 40 NDRF vessels are in extremely poor condition. Time is critical in this effort. The cost to the Department of Defense of maintaining each NDRF vessel is approximately $20,000 per year. However, as obsolete vessels in the NDRF continue to deteriorate, the costs of upkeep will rise. For example, the *Export Challenger*, a vessel in the James River Virginia Reserve Fleet, experienced a relatively minor release of oil in 1998. Due to the deteriorated condition of the hull, the remainder of the oil aboard needed to be removed. The combined cost of clean up and removal of oil from the vessel was $1.3 million. The cost of dry-docking a vessel in order to prevent it from sinking is estimated to be about $900,000 per ship. MARAD expects to begin dry-docking 16 obsolete vessels in poor condition per year beginning in fiscal year 2002 in order to avoid environmental problems. In the meantime, these ships are monitored closely by MARAD to prevent sinking or a hazardous discharge.

We are fully committed to working with Congress to find a swift and appropriate solution for scrapping obsolete NDRF vessels. MARAD's authorization proposal for fiscal year 2001 contains a provision that would extend the deadline for the disposal of obsolete NDRF vessels from 2001 to 2006. During this period, MARAD intends to develop and implement a program to scrap these vessels safely, economically and in an environmentally sound manner.

In addition, Maritime Administrator Clyde J. Hart, Jr. recently wrote to Carol Browner, Administrator of the EPA, seeking to explore the possibility of resuming exports in a manner consistent with the prior agreement negotiated between EPA and MARAD. Although we have not yet received a response to our inquiry, we do not believe that this option has been foreclosed.

Mr. Chairman and Members of the Task Force, we appreciate the concern that you have shown in this area and want to assure you that we are working diligently to resolve the matter as soon as possible. This concludes my statement. I would be happy to answer any questions you may have.

Chairman SUNUNU. Admiral.

STATEMENT OF VICE ADM. JAMES F. AMERAULT

Vice Adm. AMERAULT. Good morning, Mr. Chairman, and distinguished members of the Task Force. I am very pleased to appear before you today to discuss the Navy's approach to reducing our own inventory of excess ships. With your permission, I would like to submit my prepared statement for the record but take a few minutes here to give you a shortened summary version.

Chairman SUNUNU. Without objection.

Vice Adm. AMERAULT. Thank you sir. The Navy's Inactive Fleet has 57 ships designated for scrapping. The decision to scrap a Navy ship is made only after carefully evaluating all other options, and these include several such as retention as a mobilization asset, sale to allied Nations under the foreign military sales program, use as a war memorial or historical museum, use for training, or use as a weapons development asset.

The Navy's primary interest is to dispose of all of our excess ships in a manner that is environmentally sound, economically neutral, and worthy of the proud service that these ships have performed for this Nation.

Historically, the scrapping rights to our ships have been sold to domestic shipbreakers, very much like what has gone on in the MARAD fleet. More recently, environmental concerns, worker safety, and changing economic conditions have impacted the methods and locations available to scrap our ships. Up until the mid-1990's, domestic shipbreakers were willing to pay for the rights to scrap Navy ships because the value of metal and other equipment in the ships offset their costs and provided a profit. This, of course, matched our goals and reinforced our expectation that Navy ships could be scrapped at no cost to the Navy. However, since 1996 eight scrapping contracts have defaulted, causing the Navy to expend over $12 million to return 28 ships to a safe storage condition. So within Navy we faced a dilemma: A backlog of ships to be scrapped was growing but there was no domestic market in which scrapping could be accomplished at no cost.

Consequently, we began in 1997 to work with EPA to determine the conditions under which scrapping might be accomplished overseas. In 1998 increased interest by the Congress and the public resulted in both the Vice Presidential and Secretary of the Navy moratorium on overseas scrapping. At the same time, the Under Secretary of Defense for Acquisition and Technology created an interagency panel to explore the problems and solutions to disposing of excess Navy and MARAD ships. The panel recommended that the Navy conduct a pilot program to determine the conditions under which domestic scrapping could be made feasible.

Consistent with this recommendation the Navy developed a ship disposal project with a pilot phase that was designed to qualify and quantify the technical scope and costs associated with ship scrapping. That pilot phase is currently underway. The goals of this project are:

1. To document all processes, costs, revenues and hazardous materials generation while demonstrating an environmentally sound and cost-effective method for dismantling ships;

2. To minimize the Navy's net cost of ship disposal by realizing a fiscal return on scrap metal and other equipment sales; and

3. Develop a viable domestic capability to scrap additional ships from the Navy's inventory after the pilot phase is completed.

A significant feature of the ship disposal project is that the Navy, not the shipbreaker, assumes the risks associated with the vagaries of the scrap metal market and equipment resale. The shipbreaker's profit is set in terms of the contract. Proceeds generated by the sale of scrap metals in excess equipment are then credited against the cost of the contract.

It is by decoupling this volatile scrap market from the contractor's profit or loss that a contractor can establish a stable economic model within which scrapping processes can be optimized, and hopefully that is our solution to defaulting contracts.

In September 1999 we awarded four indefinite delivery/ indefinite quantity contracts for the pilot phase. The initial task order under each of these contract is to dispose of one ship—and all ships, by the way, all four are exactly the same type and model of ship—to dispose of one ship under a cost plus incentive fee structure. Progress to date has been satisfactory. The data concerning the processes utilized and the cost revenue stream is being collected but has not yet been completely evaluated. The last of the four ships should be completely dismantled and all materials recycled in the fall of this year.

It became obvious to us during the initial performance of these task orders that much of the contract cost was attributable to process start-up of an infrastructure facilitation required for the dismantling process to provide further insight into the true cost of shipbreaking. Two additional task orders were awarded under the pilot phase on May 24th of this year under a fixed price incentive structure.

Task order awards after the pilot phase will be made following careful examination of the data collected and dependent upon the availability of Navy funding.

The Navy has also worked with MARAD on the ship disposal problem for several years. Through group participation in several joint agency working groups, we have shared our technical and process information. We will continue our open dialogue and provide the ship disposal project data when it is completely available to MARAD.

In summary, the Navy is committed to dismantling our excess ships in a way that is environmentally sound, publicly acceptable, and advantageous to the Navy and the government. The ship disposal project assists in accomplishing these goals while providing empirical data on the processes and costs associated with domestic ship scrapping in an environmentally safe way.

Mr. Chairman and member of the Task Force, this concludes my remarks. Thank you for your interest in the program. I would be happy to answer questions that you may have.

Chairman SUNUNU. Thank you, Admiral.

[The prepared statement of Vice Adm. James Amerault follows:]

PREPARED STATEMENT OF VICE ADM. JAMES F. AMERAULT, DEPUTY CHIEF OF NAVAL OPERATIONS (LOGISTICS)

Mr. Chairman and distinguished members of the panel, thank you for the opportunity to appear before you to discuss the Navy's approach to reducing our inventory of excess ships and how we are working with the Maritime Administration on this problem. We sincerely appreciate your interest in our program and processes.

Before going further, I would like to note for the committee that I have not included in my testimony any discussion of our process for disposing of nuclear powered warships. This is because that work is accomplished exclusively in our public shipyards and is subject to requirements more stringent than those necessary to dispose of non-nuclear powered ships.

I also wish to point out that Navy warships may present a more complex dismantling challenge than traditional merchant ships due to two facts. First, our warships are constructed to maintain mission capability despite battle damage; and second, they have a high density in terms of equipment and compartments.

The Navy's interest is to dispose of our excess ships in a manner that is environmentally sound, economically neutral and worthy of the proud service they have performed for this nation.

Let me now briefly explain the process we use to determine the manner in which we dispose of our conventionally powered ships. After a careful evaluation, the Chief of Naval Operations may declare a ship to be "excess" to the current operational needs of the Navy. The next step is to determine if the ship is required as a Mobilization Asset. If the ship is needed, it is placed in a state of preservation such that it can be reactivated and returned to active service.

If the ship is not needed as a Mobilization Asset, then it is made available for sale or lease to an allied Navy under the Foreign Military Sale/Lease program.

If the ship is not a candidate for lease, it is stricken from the Naval Vessel Register and may then be designated for transfer to a nonprofit organization for display as a historical memorial or museum. The requirements and mechanics of these transfers are governed by statute.

If not designated as a potential historical museum or memorial, the ship may be made available for Navy fleet weapons training or developmental testing of weapon systems. If used in this manner, the ship is usually sunk as a result of the training or testing. Therefore, prior to conducting the training or testing the ship is prepared in accordance with requirements set forth by the Environmental Protection Agency.

The ship may also be held as a logistics support asset to fill requests by active ships for parts or equipment that are no longer manufactured or stocked.

If the ship is not disposed of or held for any of the aforementioned purposes and it is a merchant type ship, then it must be transferred to the Maritime Administration (MARAD) in accordance with Federal Property and Administrative Services Act of 1949. Navy ships transferred to MARAD supplement the National Defense Reserve Fleet.

If it is not practical to use the ship in any of the ways I have mentioned, then the ship is designated for scrapping.

Ships that are declared to be in excess and are awaiting final disposition enter the Navy's Inactive Fleet. Today the Navy Inactive Fleet has 144 ships in its inventory, 28 of which are being prepared for transfer to MARAD, and 57 of which are designated for scrapping. The average age of the ships waiting scrapping is approximately 37 years and they have been out of active Navy service for an average of 7 years.

The traditional method the Navy used to scrap conventionally powered ships was to engage the Defense Reutilization and Marketing Service (DRMS) as a Government sales agent to sell the scrapping rights to a domestic shipbreaker. Proceeds from the sale of these rights were deposited with the United States Treasury, not the Navy. The shipbreaker's profitability was solely a function of his costs and the price of scrap metals on the open market.

No matter where the shipbreaking is accomplished, the "Title" to the ship remains with the Navy until the ship is deemed by the Navy to no longer be a ship. This generally occurs when the hull is no longer floatable. I think it is important to note that while the Navy holds the title it is the Navy that is presumed to be responsible for the disposition of the ship, even if the shipbreaker defaults on the contract.

Until 1996, DRMS awarded scrapping rights principally to the highest bidder. As scrap metal prices began fluctuating in the mid-nineties, these shipbreakers experienced fiscal difficulties leading in many instances to contract defaults.

In 1996, seeking to address the problem of contract defaults, DRMS initiated changes to improve the selection process for scrapping contractors. A two-step process was instituted that included an evaluation of the contractor's technical plans followed by an invitation to bid. Oversight at the contractor's facility was increased.

Under the old sales to the highest bidder process, eight scrapping sales contracts were defaulted and five sales contracts were completed between 1996 and 1999. The Navy has expended approximately $12 million since 1996 to return 28 of the ships from the eight defaulted contracts to a safe storage condition. Under the new two-step sales process, only two contracts have been awarded. One contract has been satisfactorily completed and contract default procedures have been initiated on the second contract. The contractor being defaulted has informed DRMS that it does not intend to pick up the eight remaining ships under this two step sales contract because the company will lose money.

Since the domestic scrapping industry was not meeting the needs of the Navy, the Navy entered into an agreement with the Environmental Protection Agency (EPA) in 1997 that identified the conditions under which EPA would exercise enforcement discretion against the Navy for exporting vessels that may contain regulated levels of PCBs for disposal.

At about that same time, Congress and the media increased their interest in both the environmental and safety concerns associated with ship scrapping. Overseas scrapping came under scrutiny; and some foreign scrappers were identified as not adhering to procedures that protected the environment and their workforce, especially when compared to the standards required in the United States. In response, on 19 December 1997, the Secretary of the Navy (SECNAV) suspended all initiatives to explore overseas ship scrapping. In addition, congressional hearings on ship scrapping were conducted in March 1998 and June 1998.

As a result of public and congressional interest, the Under Secretary of Defense (Acquisition and Technology) established the Interagency Ship Scrapping Panel on 24 December 1997. The panel was charged to review Navy and MARAD scrapping programs and investigate ways to ensure that Navy ships are scrapped in an environmentally sound, economically feasible and occupationally safe manner.

The panel issued its report in April 1998. One of its recommendations was that the Navy carry out a pilot project to quantify the scope and costs associated with ship scrapping in private industry. This pilot project would also serve as a vehicle for gathering information to improve the ship scrapping process.

On 23 September 1998, Vice President Gore requested both Navy and MARAD to observe a moratorium on efforts to award contracts or transfer vessels for scrapping overseas. This moratorium expired on 2 October 1999; however, Navy continues to operate under the previously mentioned SECNAV suspension.

Consistent with the panel's recommendation, the Navy initiated the Ship Disposal Project (SDP) in 1999 with three goals in mind. These are:

1. Document all processes, costs, revenues, and hazardous material generation while demonstrating an environmentally sound and cost effective method for dismantling ships;
2. Minimize the Navy's net cost of ship disposal by realizing a fiscal return on scrap metal and equipment sales; and
3. Develop a viable domestic capability to scrap additional ships from the Navy's inventory after a pilot phase is completed.

The Ship Disposal Project is structured in two parts. The first part, referred to as the "pilot," is underway and is intended to gain insight into the process and costs of scrapping warships. Navy will gather all revenue and expense data, document quantities and locations of hazardous waste that are generated during the scrapping process, and develop cost models for future decision making. The domestic shipbreaker is required to maximize the value (within a specified time period) of the recyclable equipment and scrap metal and sell these items as an offset to the Navy costs incurred under the contract. Part Two of our Ship Disposal Project is to award additional ships to one or more of these same shipbreakers as funds are available.

A significant feature of our Ship Disposal Project is that the Navy, not the shipbreaker, assumes the risk associated with vagaries of the scrap metal market and equipment resale. The shipbreaker's profit is set in the terms of the contract (i.e., cost contract or fixed price contract). Any proceeds realized from the sale of scrap metal or equipment are used to offset Navy contract costs. With this decoupling mechanism in place the contractor can establish a profitable economic model to optimize scrapping processes. The contractor is paid for the services he provides. The SDP also features a performance incentive for effective environmental and safety programs.

The Navy's Supervisor of Shipbuilding, Conversion, and Repair (SUPSHIP) performs oversight and contract administration for the SDP. This allows the contractors to benefit from the Navy's ship repair experience and further facilitates the exchange of information between the Navy and the contractor.

Prior to a ship arriving at a contractor's facility for scrapping, the Navy accomplishes some environmental remediation of the vessel. Nearly all hazardous waste and some other hazardous materials are removed from the ship. The Navy also performs limited sampling on each vessel to identify the existence and location of other hazardous materials.

On 29 September 1999, Navy awarded four Indefinite Delivery/Indefinite Quantity (IDIQ) contracts under Phase One of the Ship Disposal Project (i.e., the pilot phase). The initial task order under each of these contracts is to dispose of one ship under a Cost Plus Incentive Fee structure. Progress to date by the four domestic contractors has been satisfactory. Data concerning the processes utilized and cost/revenue stream are being collected but have not yet been evaluated. The last of the four originally awarded ships should be completely dismantled and all materials recycled in the fall of this year.

Two additional task orders were awarded under the pilot portion of the SDP to provide the Navy with further insight into shipbreaker's start-up costs. These additional task orders were offered under a Fixed Price Incentive structure to provide additional encouragement to reduce dismantling costs.

Decisions concerning Phase Two task order awards will be made after careful evaluation of the data collected during the pilot phase and are dependent on the availability of funding.

The Navy has worked with MARAD on the ship disposal problem for several years. Through participation in several joint agency working groups, we have shared our technical and process information. We will continue our open dialogue and provide the Ship Disposal Project data when it is available.

In summary, our Ship Disposal Project is pursuing the goal of dismantling our excess ships in a manner that is environmentally friendly, publicly acceptable, and advantageous to the Navy. The backlog of ships awaiting disposal presents an increasing burden on the Navy's resources and could present an environmental concern as they continue to age. We are committed to eliminating our backlog and avoiding any environmental risks. The Ship Disposal Project assists in accomplishing these goals while providing empirical data on the processes and costs associated with domestic ship scrapping. In addition, we continue to look for and study other disposal methods that may contribute to further reducing our backlog and our costs.

Mr. Chairman and members of the Committee, I thank you for your interest in our program and the opportunity to tell you about the Navy's ship disposal goals and programs. I will be pleased to respond to any questions.

Chairman SUNUNU. Let me begin the questioning with Mr. Graykowski. I think you have touched on this in your remarks but I want to be clear as to exactly what the problem is. Why hasn't MARAD at least put together a plan for disposing of obsolete vessels during the period where you have received an extension on disposal, a temporary one, from 1999 to 2001? What has kept you at least from putting together a strategic plan outlining how this might be accomplished?

Mr. GRAYKOWSKI. Well, as I mentioned in my opening statement, Mr. Chairman, first and foremost, we don't have any authority beyond selling the ships at a cost which generates a positive cash flow to the government and we have endeavored to do that. We have had a number of offerings of ships which you know have been taken at low prices and the ships never get picked up. We had one instance of contractor default.

So in one sense we have been sort of struggling to take the program into a domestic context. In 1993 we had run an export program for years generating tremendous amounts of money. We didn't have that much familiarity with domestic scrapping and there were constraints which, frankly, resulted in a lot of conflicting signals, I think, among various agencies as to how we were going to solve this problem. So MARAD tried to respond that way. We have never really explored or had the opportunity to explore with the Navy with respect to a pilot project but I don't think it is fair to say——

Chairman SUNUNU. Do you have any legislative mandate to develop such a plan?

Mr. GRAYKOWSKI. No, we do not have a legislative mandate to develop any plans.

Chairman SUNUNU. Do you think it is, despite the fact that you don't have a plan in place now, do you think that we really can afford to wait 5 years before we begin the disposal process? I was struck by the request by the administration to move that date back 5 years and that the disposal process would have been required to begin then. That would seem to be far too much time, given the condition of the vessels. Would you agree with that?

Mr. GRAYKOWSKI. I think that the perception that was created by the legislation was that we were going to somehow take all 5 years, and then at the end of 60 months we are going to sort of start doing what we came up with to do; and I think that a fairer assessment is give us a reasonable amount of time. We could have, I think, done what we did several years ago, which was asked for 2 years, knowing that that was unrealistic, from our perspective. The 60 months was an outside date.

I don't think in our hearts and minds at MARAD it was going to take that long or be that long and, quite frankly, looking at the development of the interest level within the Congress, both House and Senate, I think it is going to be overtaken by events. I am confident there is going to be some action and directives from the Congress which will both shorten the time and increase the pace of activity.

Chairman SUNUNU. I would tend to agree and very much hope that it is overtaken by proactive events rather than defensive events. And to that point, could you talk a little bit more about the problems associated with the *Challenger*? Was it a single leak, a single fracture, or a series of problems? And again, could you summarize the total cost associated with that one vessel?

Mr. GRAYKOWSKI. I will do that, Mr. Chairman, and I will also—I would like to submit a better answer for the record.

All of these ships, or many of them, have pockets of oil, I mean, for want of a better term. In some cases there are 1,000 barrels and in other cases 20 barrels. But we have surveyed 40 ships and I think I came up with a ballpark figure of some 40,000 barrels of oil that are scattered around the country, which would cause a problem in anybody's district, anybody's river.

On the *Challenger* there were small leaks and the Coast Guard notified us, as I recall, and I may be wrong on this, that this was a problem. And we had to boom it by putting containment booms around her, and were sort of—"directed" is too strong a word—encouraged and supported by the Coast Guard to sort of remediate the potential for additional oil to leak and this is oil deep in tanks. The ships are just laid up in some cases.

Chairman SUNUNU. Are you unable to pump it?

Mr. GRAYKOWSKI. Yeah. You have got to see it to believe it. In some cases, this is bunker oil, if any of you are familiar with the thick, heavy, sludgy stuff which over the years hardens into tar-like road tar. So just the process of peeling open the tanks and heating up the oil, if you will, to the point where you can pump is extensive and a very arduous process. So that is what we went through on her, to the cost of $1.3 million.

Chairman SUNUNU. All of the effort was done while it was still on the water?

Mr. GRAYKOWSKI. Yes, sir. She still remains there, and indeed we spent some more money down at the James River when Hurricane Floyd came through and we were very concerned. That was the reference I made there, additional funds we didn't anticipate having to spend.

Chairman SUNUNU. How many of the vessels, approximately, of the 40 worst-condition vessels are at or near the condition of the *Export Challenger*?

Mr. GRAYKOWSKI. We have triaged it or identified sort of a priority list and we have got sort of—not a new term—but the "dirty dozen." There are 12 ships that really, Mr. Chairman, are—*Export Challenger*, she is our poster child, but she has a lot of siblings. And so I say there are 12 that really are approaching the condition of the *Export Challenger*.

Chairman SUNUNU. Was it ever in danger of sinking?

Mr. GRAYKOWSKI. I don't think so. I mean, I don't want to impart—it is a tough question to answer.

Chairman SUNUNU. I don't know if that is an encouraging answer or discouraging answer from my perspective.

Mr. GRAYKOWSKI. I could say none of them sunk yet. No, we monitor them carefully, we do the best we can, and I don't think they are in danger of imminent sinking and hulling, absent sort of major storm and waves and conditions that don't exist today. These are calm waters. Congressman Bentsen, I think if he is familiar with where Beaumont sits, is a very well protected area. Over time will they sink? I think it is unavoidable, yes, but not imminent. I would like that message to be there.

Chairman SUNUNU. Has any effort been made to quantify what the potential costs would be of a catastrophic accident, either a sinking or a serious hull rupture of one of these vessels?

Mr. GRAYKOWSKI. I am getting no encouragement from the folks behind me. My bench is weak here. Well, to quantify the costs, fine; what kind of accident, we would have to remediate whatever leakage problem or environmental damage that occurs. And frankly as a lawyer, I have always looked at it as I have got the ultimate strict liability here. I am a generator under EPA, under TSCA, under CERCLA, under Fish and Wildlife and Migratory Birds; there are a whole number of acts out there. And the Federal Government is the ultimate deep pocket, so quantification depends on the extent of damage to a certain extent, but the checkbook is going to be open for a long time.

Chairman SUNUNU. OK. What kinds of marine wildlife are there in the James River, and was there any damage to the ecosystem or the wildlife with the *Export Challenger* accident?

Mr. GRAYKOWSKI. The answer is an emphatic no. There was no damage. We contained very limited minor leaks. We have got a containment boom pretty much around the fleet now in terms of where that is. There are State certified oyster beds. I understand there are a couple of wildlife refuges. Indeed we have ospreys building nests on our ships, and certain times of the year we can't go near them. They are wildlife habitat wetlands which we have got to protect as best we can.

Chairman SUNUNU. Your predecessor, Mr. Hart, wrote at least twice to the EPA requesting a meeting with the Administrator to resolve the issues that are preventing the timely scrapping of government vessels. Has there been any response from Ms. Brown or the EPA today?

Mr. GRAYKOWSKI. Mr. Chairman, there hasn't. I think that recently Deputy Administrator Bonnie Green, who testified in front of Congressman Gilchrest, has written the Administrator of the EPA, and I intend on writing her today to tell her once again that we have testified and we need to work in an interagency fashion.

To date, no sir, there has not been a response.

Chairman SUNUNU. Has the EPA put together guidelines for you or for the Navy, that you are aware of, for the disposing of obsolete vessels?

Mr. GRAYKOWSKI. We have got a memorandum of understanding, if you will, or agreement with EPA on certain conditions that have to be conformed with before we can scrap a ship, so that is in place. However, there are still some of the guidelines—I was just getting to that. While we have this memorandum, the particulars in terms of the regulations, for instance PCBs, and that the guidelines that we would employ to scrap and to monitor are not in place, sir.

Chairman SUNUNU. Would you explain that in a little more detail? What do you mean, the guidelines aren't in place?

Mr. GRAYKOWSKI. I think that EPA, and I am going to have to elaborate for the record if I could, EPA, we have got this memorandum of understanding, but it lacks sort of—that says we are going to cooperate, and here's the basic structure of that: Before MARAD scraps a ship, you have to clean out all the PCBs, for example, but in terms of the exact procedures and the quantities that would be allowed or not, they are still under development at EPA.

Chairman SUNUNU. I am confused. Does the memorandum, does the agreement that you signed, lay out what you need to do before you can move forward with a scrapping—is that valid or invalid? Either those are the guidelines you need to follow or the EPA has changed their minds and is walking away from this agreement and saying we are going to come up with different guidelines.

Mr. HOWARD. Mr. Chairman, may I speak to the agreement?

Chairman SUNUNU. Please.

Mr. HOWARD. The agreement contains three conditions: one, that all liquid PCBs be removed; that solid PCBs be removed to the extent possible; and that the country that is accepting the vessel be notified that the PCBs were on board and attempts were made to remove them. That is what the agreement covers.

Chairman SUNUNU. Those sound like reasonable guidelines.

Mr. HOWARD. MARAD received authority in 1997 or 1998 to sell two ships under those guidelines. When they attempted to put together a plan that complied with the guidelines they found that once they had removed the PCBs, that the ship wouldn't be seaworthy and it wouldn't be able to be towed to the foreign country that was willing to purchase it.

Mr. GRAYKOWSKI. So we are still waiting for final guidance, if you will, out of EPA to avoid this conundrum.

Chairman SUNUNU. I understand. So you are looking for a little additional guidance so that you won't have to destroy the seaworthiness of the vessel in an effort to scrap it efficiently and economically.

Mr. GRAYKOWSKI. Yes, sir; and I don't know what the status of the guidelines are at this point in time.

Chairman SUNUNU. Has MARAD or anyone else evaluated EPA's environmental concerns to determine whether they are supportable on an environmental or economic basis?

Mr. GRAYKOWSKI. The short answer would be no. I guess it would be very difficult for the Maritime Administration to second guess the Environmental Protection Agency on a determination of environmental——

Chairman SUNUNU. I understand that is not your expertise, but there has been no other outside or independent evaluation.

Mr. GRAYKOWSKI. No. We are sort of leaning—we as a country by approaching it this way are way ahead of, if you will, the rest of the world. Scrapping practices vary worldwide, and what we are trying to impose as standards and that the Admiral has worked with, for example, is where I believe sincerely the world is going to end up. But it is going to be several years before it gets there, but we will be the first to get there.

Chairman SUNUNU. Thank you very much. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. I have a few questions. First of all, I am familiar with the Beaumont area, even though I am in Houston. But let me tell you, when a hurricane comes up the Gulf Coast, and a lot of times they head toward an island in the Beaumont area, you can be in that protected part of the Sabine River and still get some pretty good surf over there. In my district back in 1994, as well as just last year, when you get either a storm or a hurricane or heavy rainstorm, you move the current on that river and you can lose control of operating ships.

Plus we had in 1994 a situation with these abandoned barges, some that were beached, that got moved off the beach, off the banks, and smashed into the I-10 bridge, was involved in part setting off an explosion in a pipeline.

So even though you are in a protected water area, the force of nature can sometimes change it, and that is something that we have to be concerned about, particularly in—at least I am most familiar with the Texas areas. And I do understand the environmental hazard related to these with, again, my own experience in going through it with these barges and most of the working ships in the Texas area.

Again, though, it is—and I know you have been having this discussion with Mr. Sununu about this—but it is my understanding that EPA has said that you could—if MARAD would remove the hazardous waste, be it PCB or whatever, then you could direct the vessel for scrapping. And I guess what you are saying is in some cases the vessel becomes unseaworthy and you can't do it. Why not salvage the vessel on site? I mean, we do that. I don't, but the organizations along the Houston ship channel do that from time to time, where they just do an onsite salvaging instead of trying to tow something in and take it apart.

Mr. GRAYKOWSKI. Well, number one—and probably you don't have to go farther than number one—we don't have the money for it, Mr. Bentsen.

Number two, the EPA agreement—let me correct myself if I could, please. And the Admiral was kind enough to tell me this. It pertained to exports, OK and it is very dicey at this point in time politically as well as I think practically, if you will, to be exporting these ships. And so while we have turned our attentions domestically as I have indicated——

Mr. BENTSEN. Can I say that, for a second, on EPA, on the exports, they were opposing the export of the ships because of PCB content?

Mr. GRAYKOWSKI. Primarily; and other what they consider to be toxic waste, they viewed it as——

Mr. BENTSEN. It is an interesting notion, and I only add that because I have had a small battle with the EPA over the last several years changing what has been the position for the last 15 years to allow for the export of PCBs for disposal and incineration abroad, which we believe violates the TSCA act, although EPA seems to believe that it doesn't. EPA has taken the position that they would like to export PCBs to Mexico and Latin America and other countries where they can be disposed of. Some would argue that this is because the volume of American PCBs is declining and there continues to be industry demand.

So it sounds to me like EPA may have a—the left hand may not know what the right hand is doing at the EPA. I would encourage you all to go back and talk to them.

Now they are under court order precluding them from doing that, from the California circuit, the West Coast circuit and we have tried to block them from doing that through the defense bill in the past. Again, EPA has taken this position that in some cases, at least, you would export PCBs for incineration.

Mr. GRAYKOWSKI. I am incredulous, frankly. This is news to me because when I leaf through, this is the agreement that I signed with EPA in 1997, it specifically links PCBs, the vessels and TSCA and the prohibition against introducing PCBs into international commerce and that is what ground the exporting to a halt.

Mr. BENTSEN. Maybe instead of offering up the ship for scrap metal you should have offered it up for PCB consideration. I would encourage you to revisit that, and that is in the courts, I think the 9th Circuit.

Let me ask you this. The chairman mentioned that the range of cost for addressing this problem would be between half a billion to $2 million. Why is there that amount of fluctuation or band in the cost? Is it because you don't know necessarily what you have out there until you get into the ship?

Mr. GRAYKOWSKI. We have not inventoried, and I told the chairman this yesterday, we have not really conducted the inventory necessary to say we have 5 pounds or 5,000 pounds of PCBs, I don't know, liquid versus solid. My impression is that most of the liquids have been removed except those transformers and capacitors that are buried in the bowels of the ship. We don't know approximately how much we can get off of the ship. I think the admiral can speak to the fact that—it is a net outlay when you pay to have someone scrap it, but there is a return that we would anticipate having a similar experience with.

Vice Adm. AMERAULT. Assuming you will ask about this anyway, but our program is based on the fact that we are paying someone to scrap the ships. Heretofore that was very difficult to do because they would default, there being no longer a viable market for the scrap material which used to finance the whole venture. So what we do is we reduce their risk of making nothing by paying their workforce and facilitization and other costs, by paying the cost of doing business, if you will, just the labor and so forth.

Any materials that come off the ships that then can be sold in the scrap market are, by contract, used to net the total cost in our favor.

Now, we don't know exactly how well that is going to do and I think it is going to depend on some things, one being facilitization that is taking place up front, and we have paid for that in the four pilots, the four yards that we have used as pilot program participants. Part of what we pay for is the facilitization to be able to handle the environmental and the other things. Once that is done, then you have learning curve, which can reduce the cost of their operation, and you have of course the value of that material. As you get a good steady throughput and the learning curve comes into play, their costs will go down and you will have a volume of material that you can sell for scrap. And the net, if things were to work out, might, and I say might because we don't have the final information and we don't have this—we don't know how scalable this is, but it could be that the net cost of this whole thing equals the cost of living up to the EPA agreements of taking out the PCBs and making the ships environmentally safe for export. So that is our hope.

Then you would have at least two processes that you could look at and compare. I would think that we would want to try to export a few ships so we could test that hypothesis to see if doing it domestically with a net value, if you will, approach, that we have done in this pilot program is indeed better or if you can still beat it overseas even if you pay the up front environmental costs.

Mr. BENTSEN. It seems to me there would be a couple of factors between domestically and overseas, the laboratory input and the capacity, but also there are some transportation costs associated as well. I am sure that these ships are not cheap to move around.

Vice Adm. AMERAULT. There is a cost of getting them there. That could work in our favor domestically.

Mr. BENTSEN. There are two bills, one being Mr. DeFazio's bill, and I would be interested in your comments on that. I don't know if MARAD has taken a position on that.

The other, in the Senate, the chairman of the Senate Commerce Committee, Senator McCain, has introduced a bill which gives DOT the authority to scrap 39 foreign vessels under terms determined by the agency. Is this an effective way to deal with the problem or do you have a position on that bill?

Mr. GRAYKOWSKI. No, we have not taken a position on any of the legislation. There are four bills in total. We don't have an administration position on any of the bills introduced.

Mr. SUNUNU. If I could interject there, Mr. Howard, those two alternatives, correct me if I'm wrong, were part of the recommendations that you made, one, to release the restriction on these exports, and, two, to authorize MARAD or get rid of the restriction on MARAD from being able to pay to scrap, and that is what Mr. DeFazio's bill does. He includes an authorization amount but of course in order to do that he needs to eliminate that restriction?

Mr. HOWARD. Yes, sir, that is consistent with what we recommended.

Mr. BENTSEN. It seems to me that this is a situation that there isn't going to be much of a market for and we just need to get a handle on this and how much it is going to cost and deal with it because again I realize these ships are docked and they are in somewhat secure waters most of the time, but I guarantee you there will be another storm that will come up high island and there will be more water in Suisun and Beaumont and everywhere else you have these and it is going to become a problem. It would be worthwhile for us to get a handle on this now and address this and figure out a way to do it. This is not unlike a Superfund situation or any other hazardous waste disposal, we just have to deal with it.

Mr. GRAYKOWSKI. Mr. Bentsen, I didn't mean to imply in my statement that the calm waters are always calm. Hurricane Floyd caused us some sleepless nights. The first report indicated that some of the nests had not broken but they were drifting apart, had hurricane Floyd been stronger and hit differently, our lives would have been differently. These ships cannot withstand heavy water.

Number two, I might take issue with you. I do see a potential for this country. There are 10,000 commercial ships operating around the world. If indeed we set the standard as we have consistently through the years on environmental matters and the rest of the world does catch up and I would point to the Basel Convention, which is part of the U.N. Process, if you will, moving toward declaring obsolete ships as a hazardous waste, the country of the Netherlands, which is a major world shipowner, there was one conference, they are pushing for another one, Norway has been talking about incorporating scrapping into the life cycle cost of the vessel, imputing to owners this notion that you are going to have to pay to scrap.

I would pose to you if we put a program together now with these government ships, quite possibly we are in a position to take advantage of it in a commercial sense when the rest of the world says, oh, my gosh, we are going to have to.

Mr. BENTSEN. That is a legitimate point. I had a discussion last week with some people in the maritime industry in Houston, where there is a discussion going on both in Texas and I think somewhat through the international maritime organization regarding emissions controls. Houston, of course has a serious ozone problem. One idea—and part of the contribution of that comes from the ships that go up and down the Houston ship channel. We can't impose a Houston emissions control policy on ships calling on our port because they will go somewhere else. There probably needs to be a national standard, but it is difficult to impose a national standard with respect to WTO and other international agreements that we have, and perhaps it needs to go through the International Maritime Organization. I do appreciate that.

However, surely you have some ships that are decaying to the point where we may not be able to wait for an international convention to—you know, necessarily get an agreement. We may be talking something more prospective than retroactive.

Mr. GRAYKOWSKI. The imminence is undeniable. I think long term there are benefits to be gained by sort of creating this new industry just as we have seen in other environmental recovery operations. Right now, Mr. Bentsen, we have to do something with, as I said, these 12 or the 40. I mean there are other benefits. We have not really looked at it in a broad perspective. If we attack it, we ought to attack it in a comprehensive fashion. We are dying for people to work in basic shipbuilding industries and trades. The shipyards are essential to the national defense. This is the type of program that can help support them different than building brand new ships. We have a source of labor to keep people coming in because this is another problem that has not been looked at.

Mr. BENTSEN. I agree with that. In order to get there, it may be something that has to be subsidized initially. The chairman doesn't always like to hear that word, but I think he understands as well this may be a situation where the need is great to deal with this problem, and I understand the need and the idea of maintaining shipyard operations. You might be able to match the two. Perhaps in the long run you are right. As in other environmental services which we have seen grow in waste disposal, this may be applicable also.

Mr. GRAYKOWSKI. Yards that I have talked with this about comment that there is a crossover point. If we guarantee a certain feedstock at some point, however many ships, the economies become such that it becomes a positive situation for the company or in this case the joint venture between government and industry. You are running so many ships, ostensibly you get the efficiencies down and the yields up in terms of the metals. And the projections that I have seen show a definite crossover point from subsidy to a revenue generating or certainly a wash situation referred to by the admiral. Until we start it, we are not going to know and we right now don't know much other than our ships are getting old and the problem is getting bigger.

Mr. BENTSEN. Thank you.

Mr. SUNUNU. Thank you.

Ms. Hooley.

Ms. HOOLEY. I am sorry that I missed your testimony but I have the written statements.

Having gone through your information, Mr. Graykowski, do you think we have the capacity to dismantle the ships today in a domestic market?

Mr. GRAYKOWSKI. Nope.

Ms. HOOLEY. You do not?

Mr. GRAYKOWSKI. No.

Ms. HOOLEY. Let me ask the vice admiral if we have enough capacity in domestic market to dismantle the ships?

Vice Adm. AMERAULT. I don't think now. It could possibly be generated but again as Mr. Graykowski said, I think one of the problems in trying to get it generated is what will be the throughput so that when it is capitalized there will be a continuous throughput to pay off that capitalization. So if we were to generate it, it would either have to be subsidized, or there would have to be some feeling that in an economic or business model, that there will be throughput to keep it going.

Ms. HOOLEY. When you say that we don't have the capacity, that has nothing to do with that we may have to pay to get this dismantled, it is simply that there are not enough shipbuilders or facilities?

Vice Adm. AMERAULT. There are people in the ship maintenance business and shipbuilding business and public yards.

Ms. HOOLEY. Which have the capability?

Vice Adm. AMERAULT. Yes. This is not rocket science. You need basically a berm or a dry dock or some sort of containment and metal workers and the new part of it is the environmental sense or the ability to deal with the environmental issues.

Ms. HOOLEY. Don't you think on the domestic side that we have much greater ability to deal with the environmental issues?

Mr. GRAYKOWSKI. Yes, ma'am. I was trying to get at that. I think export ought to be looked at as almost a last resort option. We will have 155 ships by the end of fiscal year 2001 and the Navy has——

Vice Adm. AMERAULT. We have 57 that are in excess category that will be disposed of in some way or another, and an additional 28 of which we will turn over to MARAD, so we will add to their problem.

Mr. GRAYKOWSKI. Exporting is almost giving up on the notion that we can do it better. I believe we can do it better here in America. Our standards are higher, but we have proven that is a better way to go. We have yards that are interested. When I say there is not the capacity, today there is not. People are not bidding on our ships because they have to pay us.

Ms. HOOLEY. As long as they have to pay you, they can't afford to do it?

Mr. GRAYKOWSKI. If we turn it around, I am confident that we can put a program together and there will be sufficient people to do it. But we need to do 12 to 15 ships a year, not onesies and twosies.

Ms. HOOLEY. Right now does MARAD have to maximize the economic value of the ships, and is that a problem?

Mr. GRAYKOWSKI. Absolutely. I mean, we went from selling ships in 1993 or so at $108 a ton which netted us several hundred thousand dollars, netted to the government, so we didn't have to ask for appropriations to the last bid we had accepted was $10 a ship for the whole ship that people paid us and even those contracts ran into problems.

Ms. HOOLEY. Most of those were foreign; is that right? The bids?

Mr. GRAYKOWSKI. No, the $10 ship bid was domestic.

Ms. HOOLEY. OK. OK. How much does it cost for you to store these ships? Wouldn't we be better off to pay somebody to dismantle them than storing them?

Mr. GRAYKOWSKI. Well, I have the statutory problem which precludes that. Intuitively, logically, and as a taxpayer, absolutely; but the money that we are spending to care take, which was $3 million last year, isn't enough to address the problem in a substantive and dramatic fashion. We would still have to increase the amount of money. The admiral spent a lot of money last year just on four ships. But we—you missed the part of the testimony regarding the dry dock. We are projecting that it is going to cost us $900,000 per ship times 155, and that is sort of a benchmark level of expenditure to just take it into the garage, if you use the analogies of a car. That is every single ship. That is a nonavoidable cost. We are going to spend that irrespective of a scrapping problem or not, but if we have a scrapping problem, we don't have to do it, we can devote the money to scrapping and we will have to do that with fewer ships. That is a function of time.

But your point remains. We are spending the money now and we are going to spend more and more money and end up exactly where we are today with ships sitting in the James River and elsewhere.

Ms. HOOLEY. Didn't the Navy have a pilot project and what happened with that?

Vice Adm. AMERAULT. Yes, ma'am. We still have the pilot program underway.

Ms. HOOLEY. It has been going what, a couple of years?

Vice Adm. AMERAULT. We had a 1999 contract for four ships. We have some money in 2000 that we are applying to two other ships, four contractors. So that ship breaking is underway. All four contractors are working on ships. All four ships are frigates. So if you look at this as a pilot or experiment, the control variable is the same. We had some money in 2000 which we asked for bids to continue. The best value bids were taken up on two of the contractors. So we basically are scrapping two more. We will learn a little more with those two.

What we are hoping to do is find out some data with regard to what are the costs of facilitizing a yard to take care of the environmental aspects of this and other things that they might need to create an efficient ship breaking process that is environmentally safe, by paying for their labor, and then finding out how much the value is in a typical ship in terms of the scrap material and scrap metals. Copper alloys, aluminum, steel, these are all in abundance. That would then net against the cost, and we would like to find out what the net value is and then subtract the initial facilitization, and then we would have some data to say if you create a steady stream and apply a learning curve. Maybe that net cost could go down over time and approach zero, or at least we would know what it would be and we can compare it to exactly the costs that are you talking about. If we do spend money on these ships in both the reserve fleet and in our own reserve fleet or in active fleet to keep them from sinking and having these environmental disasters, and in fact if eventually there is a cost of dry docking at a lot of money, considerable cost, it could be that your present value one-time costs are cheaper than your annualized costs of keeping all of that going.

So I think that is where you are going and that is what the project is all about to some degree. It is not the same kind of ships in their reserve fleet but there should be lessons——

Ms. HOOLEY. But MARAD cannot do a pilot project?

Vice Adm. AMERAULT. They are still enjoined to produce a scrap ship at no cost to the government. It is impossible for them to do that under statute. We are giving them all of the information that we find, or will, and there will be some—I don't know how scalable this is. There are lessons to be learned.

Ms. HOOLEY. Mr. Graykowski, Peter DeFazio from Oregon has introduced a piece of legislation that would allow you to do that. Are you supporting that?

Mr. GRAYKOWSKI. No, we have not taken a position as the administration on that legislation. But I am aware of it and following it with great interest.

Ms. HOOLEY. Why haven't you taken a position? It would seem to me that here is an opportunity for you to do a pilot project, to try this out. You are spending a ton of money keeping the ships, you know. Tell me why.

Mr. HOWARD. If I might comment on that, ma'am, Mr. DeFazio's bill is consistent with the recommendation that we made in our March 10 report. We recommended that the Maritime Administration develop a proposal for a pilot program and seek legislation and funding for that program. In order to do that, the Maritime Administration has to work that proposal through the Department of Transportation and through the Office of Management and Budget. What they told us in response to our report is that they would work that in next year's authorization bill.

Mr. SUNUNU. Ms. Hooley, recognizing that it wouldn't be good form, to say the least, for Mr. Graykowski to lobby for or against any single piece of legislation, I think it probably does bear emphasizing Mr. DeFazio's bill would be consistent with the goal of helping to build a domestic capability to do this work.

Ms. HOOLEY. Thank you. I am sorry that I put you on the spot.

Mr. GRAYKOWSKI. No, I am not on the spot. Look at—when I say——

Ms. HOOLEY. It just seems to me that it seems stupid. I don't know any other way to put it. It seems stupid that we don't develop our own program in this country based on some of the information that was in your testimony not only to keep our shipyards going and the workers there and trained workers, but it is costing us so much money to store these ships right now and we could be dismantling them in an environmentally sound way and put people to work, and we need to do that in this country. I am hoping that that can be something that we can look at this year, frankly, to begin at least if nothing else a pilot project on figuring out how do we do this the best way possible.

Thank you, Mr. Chairman.

Mr. SUNUNU. Thank you very much.

Let me take some time to ask one final round of questions and begin with the issue of subsidies, foreign or domestic. Mr. Graykowski, your predecessor Mr. Hart attended an international ship scrapping conference in the Netherlands last year, you are probably aware of that. One of the issues they discussed was providing international assistance to improve the working conditions or environmental conditions at ship breaking facilities in third world countries.

My first question, is the U.S. Government to your understanding considering providing any type of assistance to foreign countries or foreign ship breaking facilities?

Mr. GRAYKOWSKI. I am unaware of any efforts. We are not aware of anything at MARAD.

Mr. SUNUNU. Is that something that MARAD would support or oppose?

Mr. GRAYKOWSKI. Hmm. I am trying to be diplomatic here because we are talking about international things.

It strikes me if there is going to be a decision made to subsidize foreign companies and we are not willing as a country to spend the same tax dollars on a domestic program, that that might be hard to sustain politically in the body in which you serve and others serve. That is a gut reaction.

Mr. SUNUNU. EPA's moratorium on exporting vessels, was it based solely on the hazardous materials issue or was it also based on concerns for environmental and labor standards abroad?

Mr. GRAYKOWSKI. Yeah. I am just confirming that.

The moratorium, so-called, we are sort of confusing a number of different events. EPA was concerned about TSCA, as I discussed with Mr. Bentsen, and in 1993–1994 began to look at ships covered by TSCA and, therefore, restricting its exports. The moratorium was imposed by the administration, by Vice President Gore, to enable this DOD interagency panel to come up with a solution. So in a sense one may have fed into another, and the moratorium was extended until October 1999.

Mr. SUNUNU. Has the government done anything to express concerns, to discuss guidelines or objectives with any foreign ship breaking facilities since these discussions and the panel was convened and the memorandum of understanding was signed?

Mr. GRAYKOWSKI. I know we have maintained contacts. We had relationships with foreign scrapping facilities because we had dealt with them in the past, but let me give you an update in terms of our conversations with them.

Mr. SUNUNU. Has MARAD inspected any overseas facilities since 1994?

Mr. GRAYKOWSKI. No, we have not.

The notion of us imposing our standards on other countries around the world is difficult.

Mr. SUNUNU. Without question. Mr. Bentsen touched on those points, and the imposition of any number of requirements would be a violation of the regulations or the guidelines that we agree to abide by as part of the WTO.

Mr. GRAYKOWSKI. Furthermore, any requirements that we levy on the exports of our ships would require—would raise the cost to the scrap and lower the yield to the government, thereby making our ships less competitive with others.

Mr. SUNUNU. Are there any limits on the use of foreign scrap yards that are imposed on privately owned U.S. vessels?

Mr. GRAYKOWSKI. No, sir.

Mr. SUNUNU. None at all?

Mr. GRAYKOWSKI. They can take a ship any time, any way up to these foreign scrap yards and sell it without restriction.

Mr. SUNUNU. At this point under the memorandum of understanding that has been signed with the EPA, given those guidelines, you have the ability to utilize those breaking yards as well?

Mr. GRAYKOWSKI. Well, you mean under the EPA agreement? Theoretically if we clean up all of the PCBs, we are in that loop, but we have to make the ship unstable.

Mr. SUNUNU. The remaining issue is seaworthiness.

Mr. GRAYKOWSKI. You have to tell the country formally as the United States, we are going to send you a ship that might contain stuff, PCBs and other stuff, which in a political context is hard for a country to say no problem because every country has an environmental movement or green party, however you want to characterize it.

Mr. SUNUNU. It doesn't seem to me that the notification that a vessel going to a breaking yard might contain lead paint or PCBs or residual asbestos would surprise anyone in this country or abroad.

Mr. GRAYKOWSKI. Actually, I think our experience—actually, Mr. Chairman, we did run into a problem in India, which is 50 percent of the world market in scrapping. Because of that we are notifying you, Mexico is another outlet that—you know, I suppose in a lot of ways people don't know what they don't want to know, if you will. So private people take the ships and run them up on the beach and life goes on. But formal notification to the government, we are sending stuff that might be bad for you, do you mind?

Mr. SUNUNU. I am confident that your technical presentation could be a little more detailed on that.

Let me ask about the growth of the fleet. Do you have the option to object to or reject any additions to the reserve fleet?

Mr. GRAYKOWSKI. There are no additions. We don't have the money.

Oh, no. We have to take them under contract.

Mr. SUNUNU. Why have you never included funds in your budget request to cover the costs of domestic scrapping?

Mr. GRAYKOWSKI. Because we do not have the statutory authority to do anything other than sell them.

Mr. SUNUNU. That has never been part of the budget request either? You have never requested a repeal of that statutory limitation?

Mr. GRAYKOWSKI. No, because we had this DOD interagency panel. So we saw the panel in place and so there was no impetus to develop that legislative position.

Mr. SUNUNU. Admiral, could you run through the costs of the pilot program? You talked about the initial vessels, the two that were done using 2000 money. What have been the gross costs of the contracts that were let, the number of ships for each, and then the amount of scrap credits that have come?

Vice Adm. AMERAULT. I don't have the scrap credit yet, but I can tell you what we have paid so far. There have been four contractors and thus four contracts. Metro Machine Corporation in Philadelphia and Chester, PA, we paid $3.5 million for the initial phase, that is for one ship. That includes some facilitization, as I mentioned, the cost of labor, and we have yet to get a full accounting of the sales, and thus the net costs.

Mr. SUNUNU. So that is $3.5 million gross. Then anything they get through the sale of scrap will be credited against that. Do you split it 50/50?

Vice Adm. AMERAULT. No, sir, it always comes to us because again the insurance for them is that their costs will be borne. We are taking the risk, and that is what we are paying for.

Mr. SUNUNU. These are aluminum hull?

Vice Adm. AMERAULT. These are steel hull with aluminum superstructure.

Mr. SUNUNU. So the scrap value is a little higher?

Vice Adm. AMERAULT. I can't say with authority. Aluminum is one of the more saleable commodities, however. And I think warships tend to have more copper. There are other things that are good about those in a sense; however you determine goodness, I guess.

Baltimore Marine Industries, the cost is $4 million. The variance in this is mostly facilitization, what they were prepared and able to do to start with.

Again when we come out of this, we will have four facilitized contractors.

International Shipbreaking in Brownsville, Texas, $2.7 million. They are fully facilitized. This is a contractor that once defaulted on I think MARAD as well as us. And the reason that they are working out now is again, we have removed the risk. The reason that they defaulted was they bought the ship from us expecting to make money and didn't. So that puts them back in the business in a sense.

Ship Dismantling and Recycling, which is a consortium working in San Francisco, that is $3.9 million. So the ones that have to be facilitized are roughly about the same amount.

Mr. SUNUNU. Which were the two that were let with 2000?

Vice Adm. AMERAULT. We added a ship to Metro Machine and we added a ship to Ship Dismantling and Recycling.

Mr. SUNUNU. What were the incremental costs for adding each of those?

Vice Adm. AMERAULT. $2.7 million and $3.2 million. Again, that doesn't have the cost reduction that will come.

Mr. SUNUNU. The 2.7 was let to whom?

Vice Adm. AMERAULT. Metro Machine, and the other was 3.2. That is to Ship Dismantling and Recycling, which is a joint venture——

Mr. SUNUNU. That is six ships that have been placed?

Vice Adm. AMERAULT. Four contractors. Two of them have two ships.

Mr. SUNUNU. In the case of Metro Machine, the difference between the 2.7 and the 3.5 represents the start-up costs and the facilitization costs?

Vice Adm. AMERAULT. It will be that, yes, sir. And what we will find out is again how much this will all be reduced because none of these figures have the reduction for the sale of scrap.

Mr. SUNUNU. Did Metro Machine complete the scrapping of the first vessel?

Vice Adm. AMERAULT. They are almost done.

Mr. SUNUNU. But you don't have the cost figures?

Vice Adm. AMERAULT. Not yet, but that is part of the deliverable on the contract.

Mr. SUNUNU. To what detail will those cost figures be provided?

Vice Adm. AMERAULT. I think to great detail. It will almost have to be a CPA like accounting because it is contractual. I don't think that we will get it until some of these sales——

Mr. SUNUNU. There is a joke in here about whether or not DOD's books meet FASB standards, but——

Vice Adm. AMERAULT. Yes, I have been involved in that previously.

Mr. SUNUNU. Will all of that cost information be shared with MARAD?

Vice Adm. AMERAULT. It is open. Since I have been in this job, I have tried to engage MARAD in this problem. So I feel like a partner. I don't particularly want to have the Navy bear the cost of the problem they have.

Mr. SUNUNU. There are obviously economies of scale in the numbers that we are dealing with here. To the extent that there is cooperation or a long-term solution to the problem with MARAD, it is going to help both groups.

Are there any issues or concerns that you have, Mr. Graykowski, with regard to information sharing, either administrative problems or legislative problems, that somehow inhibit you from getting information that you think might be helpful?

Mr. GRAYKOWSKI. No. You are too modest. I told the admiral that. When he took over, he was the first person who really took ahold of this, not only on behalf of the Navy, but reached out to MARAD.

I don't see any impediments. We all have the same problem here, and I think we all want a solution.

Mr. SUNUNU. Admiral, do you have even a rough estimate for the scrap credit?

Vice Adm. AMERAULT. Let me just say that it is encouraging.

Mr. SUNUNU. Give me a range.

Vice Adm. AMERAULT. Any figures I had seen were rough and I don't want to pin them down to anything.

Mr. SUNUNU. Give me a wild range?

Vice Adm. AMERAULT. Well, it could be that say—say a million dollars a ship. $800,000 to a million dollars.

Mr. SUNUNU. If I were you testifying to me, I probably would have said something like well, between $200,000 to a million five.

Vice Adm. AMERAULT. That is my answer.

Mr. SUNUNU. If we have the opportunity, we will correct the record.

Vice Adm. AMERAULT. The reason is that I would be hesitant to create a program based on that figure would not be in either ours or your best interests.

Mr. SUNUNU. I understand. If we look at the gross numbers, it is 1,300 a ton to scrap the ships and that is an enormous figure at 10 times the scrap value. There seems to be a disconnect, so I would expect the credits to be significant in just trying to gauge where we might be at the end of this process.

Vice Adm. AMERAULT. I think the other thing is that this is a one-time venture, too. I think again their costs will come down and that probably affects it almost more than the price of the market.

Mr. SUNUNU. How much of their costs are driven by EPA mandated directives and environmental concerns?

Vice Adm. AMERAULT. I would say that is the second most significant thing. Labor is the most, and then the environmental concerns.

Mr. SUNUNU. Thank you.

The Navy received $284 million in fiscal year 2000 for environmental restoration. What is that funding directed for and why would the Navy need a new program for disposal of vessels if it could utilize that funding for this program?

Vice Adm. AMERAULT. Sir, the environmental remediation Navy is the appropriation or the line item, and it is for remediation. So I would say in our case, our ships that are scrappable, if you will, are not yet needing remediation. So I would have to find out whether those funds—we have appropriation lawyers, would tell us whether we can spend those funds on this.

Also in terms of the MARAD fleet, it is not just a Navy fleet. I am not so sure we would be spending our ERN funds on their fleet.

If we—and I think part of the answer might be in what Mr. Graykowski mentioned in terms of this has not yet—or these ships have not yet been declared as environmental hazards. So environmental restoration Navy is for declared environmental hazards.

Mr. SUNUNU. Who makes that declaration?

Vice Adm. AMERAULT. I am not sure.

Mr. GRAYKOWSKI. We have to find out what the scope of the ERN program is. I am guessing that it is SECNAV, but I don't know.

Mr. SUNUNU. If you would provide any clarification for the record, I would appreciate it.

Vice Adm. AMERAULT. We have not had difficulty in paying for the scrapping of ships that need to be scrapped. We are not running into an environmental problem with the ships that are in our Navy controlled inactive fleet.

Mr. SUNUNU. Would the Navy consider holding onto those vessels that are scheduled to be transferred to MARAD in order to dispose of them through the pilot project?

Vice Adm. AMERAULT. We are enjoined by statute to transfer them.

Mr. SUNUNU. Mr. Graykowski, putting aside political constraints and financial constraints, what do you think would be an ideal path forward for your agency?

Mr. GRAYKOWSKI. Give me a moment to sort of bask in this new found freedom that you have sort of given me.

Mr. SUNUNU. Believe me, it is very temporary.

Mr. GRAYKOWSKI. You don't know how temporary. I have to go back to my office.

The answer is obvious. You have picked up on it and you know it. Your colleagues have as well. We need, A, to have the statutory constraints lifted. We have to recognize reality and pay people.

B, I think we can set up a real partnership with the shipbuilding industry and create a ship breaking industry which focuses on breaking them in an efficient and economically and environmentally responsible way, and that is going to take money. I think we should start with, as the Navy has done with a pilot program, although I would suggest perhaps a bit more ambitious, and guarantee to a yard we will give you 12 ships. I have 40 to work with and so we could give them to 2 or 3 different yards. We can say here is the results, it is going to work or not.

I suggest that we hold off on exporting until we have a chance to get a program up and running, and I think we could do that in fairly short order if we have got the money and if the statute changes.

Mr. SUNUNU. What other alternatives are there for dealing with this that we haven't discussed? I will also editorialize by emphasizing that it seems to me that there is a problem where we probably want to take multiple approaches, where there is no single solution that is going to be ideal or best for every single vessel that we are talking about. There is the—I think the need to deal with the 40 vessels that are in the most serious condition and I think with the memorandum of understanding in place, foreign breaking yards ought to be an alternative. I think there is the very promising prospects of the Navy's pilot program and I think we need to continue to have discussions about the statutory requirement that hinders you, whether or not that means that we authorize a 12-ship or 40-ship pilot or we simply get rid of the requirement and allow you to use your annual maintenance budget more creatively.

But outside of those alternatives that we have discussed, are there any other opportunities that you see as strong alternatives for disposing of these ships?

Mr. GRAYKOWSKI. I am really racking my brain here. Because of the criticality of the problem, we have to focus. We cannot chase different options. To me we are going to export it or do it here. If we need to do it here we need to come up with a decision tree and come up with money. Limited capability and you have to ship everything out of the ship. Other than that, I mean knowing the ships as I do, I don't see anything other than getting them out of the water and cut up and disposed of as soon as possible. That is scrapping, either domestic or foreign.

Mr. SUNUNU. Thank you very much. Thank you, gentlemen. We are adjourned.

[Whereupon, at 11:46 a.m., the Task Force was adjourned.]

Implications of Debt Held by Housing-Related Government-Sponsored Enterprises

TUESDAY, JULY 25, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON HOUSING AND INFRASTRUCTURE,
Washington, DC.

The Task Force met, pursuant to call, at 10 a.m. in room 210, Cannon House Office Building, Hon. John Sununu (chairman of the Task Force) presiding.

Members present: Representatives Sununu, Bentsen, Miller, Smith, Ryan, Toomey, Hoekstra, Minge, and Clayton.

Chairman SUNUNU. Good morning. The purpose of today's hearing is to discuss recent trends in the issuance and accumulation of mortgage-backed securities at government-sponsored enterprises and other financial institutions.

As the internal portfolio is held by the GSEs continues to grow, a number of questions have been raised by Federal regulators, Members of Congress and others regarding the change in the risk profiles and the ability of GSEs and others to appropriately manage these risks.

This hearing will focus on the economic implications of this GSE debt, but, most important, it is meant to provide information. We intend to shed light on the nature of these portfolios, their size and their economic implications, rather than engage in extended policy debate over potential legislative prescriptions.

These questions are made even more timely by the current trends in the growth of the Federal budget surpluses and the projected pace of debt retirement over the next 3 years. Today, the GSEs play a central role not only in the housing finance market, but also in the global debt markets.

According to the Treasury Department, the GSEs' debt of $1.4 trillion is roughly the size of the municipal bond market and more than half of the outstanding amount of privately held Treasury debt.

Given that the Treasury Department forecasts that GSEs may well double over the next four to 5 years, it will likely surpass the level of privately held, marketable Treasury debt by 2004.

GSE debt also represents a significant portion of the assets of the banking system. Federally-insured deposit institutions hold around one-fifth of all GSE debt. Naturally, the strength, the safety, the soundness of this GSE debt is going to have an impact on financial institutions around the country.

Today, our budget Task Force will hear from witnesses who will describe the structure of GSE held debt in mortgage-backed portfolios, the nature of the financial risks involved in GSE debt and mortgage-backed securities, and the degree to which interest rate risk, credit risk, prepayment risk and other risks exist under different economic scenarios.

I think it is essential for policy-makers to better understand the nature of these risks and their relative sizes and the strategies for managing these risks before making assumptions or commitments regarding policy initiatives.

The housing GSEs continue to operate very successfully in today's marketplace. They are literally the backbone of America's residential mortgage system that is the most liquid and competitive in the world.

Moreover, GSE regulators in the most recent reports have offered clear opinions supporting the safety and soundness of the GSEs. However, these institutions are enormous and complex entities and we should understand the impact that an economic downturn might have on the GSEs themselves and the holders of their securities.

In the 1980's, Congress learned a difficult lesson when the American taxpayers were called upon to provide a financial backstop for the savings and loan industry. Despite the fact that GSE debt securities clearly disclose that they are not guaranteed by the United States, some analysts and investors do believe that GSE debt is implicitly backed by the Federal Government's moral obligation to support these important institutions.

Our goal is to better understand this potential liability as investors look toward GSE debt as a potential benchmark security.

The markets will ultimately decide whether or not to confer such a benchmark status, but as policymakers we will determine whether such a status is based upon safety and soundness alone or precipitated by Federal regulation, sponsorship or subsidy.

I look forward to the testimony of our witnesses and am pleased to yield to Representative Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. I thank you for calling this hearing. As the members of the panel know, this Task Force is charged with holding oversight hearings on waste, fraud, and abuse and reporting our findings and recommendations to the full House Budget Committee.

This is our fourth oversight hearing and in this hearing we turn to the economic implications of debt held by government-sponsored enterprises. This is an issue which, as I think members of the panel know and I would imagine the rather large audience we have today for this task farce knows, has been a subject of numerous hearings before the House Banking Committee Subcommittee on Capital Markets, of which I am a member. I appreciate those who are testifying today.

I think in talking with the chairman this is an interesting subject which we are embarking upon. It is one that we should look at more from, I think, an academic perspective rather than whether or not GSEs in and of themselves are a good or bad thing.

I think the focus ought to be on the question of GSE debt, in particular, the issuance of GSE corporate debt, the issuance of GSE conduit debt in the form of mortgage-backed securities and the repurchase of such conduit debt and whether or not that constitutes either a secondary market function, taking advantage of an arbitrage function or both.

I look forward, Mr. Chairman, to the testimony of our panel and the ability to question them on their expertise of this subject. I would say that this is a subject, the question of the GSEs themselves is a subject that will go on for quite some time.

Let me just close in saying this. The GSEs have without doubt contributed tremendously to a very stable housing market in the United States, along with the Federal Housing Administration. We know this has been of great benefit. It is something that was jump started by the Congress and the Federal Government.

The question before us on the House Banking Committee at least at this point is to what extent is a continued Federal involvement still necessary, have the GSEs grown too large and rather than aid the market now distort the market and is the answer to curtail the activities of the GSEs.

I am not sure that is the right question that is being asked or is the answer to unleash the GSEs and have the Federal Government get out of the business all together.

I am not sure that is the answer that those who are asking the question want. So this is an issue that is going to be around for a couple of years and I think, Mr. Chairman, that you are on point in having this hearing.

I yield back the balance of my time.

Chairman SUNUNU. Thank you, Mr. Bentsen.

Our witnesses today on our first panel are Barbara Miles of the Congressional Research Service, Thomas McCool of the GAO, and Bert Ely of Ely & Company.

We would like to try to keep our testimony to 5 minutes, and once we have taken testimony from each of the panelists, we will have questions from the members.

Ms. Miles, we will begin with you. Welcome, and thank you for being here.

STATEMENTS OF BARBARA MILES, SPECIALIST IN FINANCIAL INSTITUTIONS, GOVERNMENT AND FINANCE DIVISION, CONGRESSIONAL RESEARCH SERVICE; THOMAS J. McCOOL, DIRECTOR, FINANCIAL INSTITUTION & MARKET ISSUES, GENERAL GOVERNMENT DIVISION, GENERAL ACCOUNTING OFFICE; AND BERT ELY, PRESIDENT, ELY & COMPANY, INC.

STATEMENT OF BARBARA MILES

Ms. MILES. Good morning. Mr. Chairman and members of the committee, I am Barbara Miles, a specialist in financial institutions in the Congressional Research Service of the Library of Congress. Thank you for inviting me to appear this morning to discuss the housing-related government-sponsored enterprises and the implications that their activities may pose for the economy and the Federal budget.

At the end of the first of quarter of this year, the three housing GSEs—Fannie Mae, Freddie Mac and the Federal Home Loan

Banks—had outstanding debt of $1.47 trillion. For comparison, publicly held marketable Treasury debt was about $2.7 trillion.

The current and projected declines in the publicly held debt of the U.S. Government imply that at current growth rates, GSE debt could surpass Treasury debt as early as 2003.

When Fannie Mae and Freddie Mac's outstanding guarantees of mortgage-backed securities are added in, the GSE presence in capital markets is very nearly equal to the size of the Treasury market today.

Both the absolute size of the debt and its rapid growth have raised questions and concerns about the risks that the GSEs' activities pose for the economy and for the government. In this regard, I will discuss briefly two fundamental questions.

The first is what is the Federal Government's responsibility to and for the housing GSEs?

And, second, what are the specific risks that these companies' activities pose?

GSEs are a special class of financial institutions in our economy. They are government in that they serve as instruments of public policy for influencing credit allocation in our economy—in this case, into the housing sector. Their sponsorship means that they have congressional charters that assign them narrow lending powers, but that also grant them exemptions and privileges that lower their costs, in part by implying a guarantee that is formally denied. That they are enterprises means that they operate as private sector institutions for the benefit of their owners.

The public policy purpose of the housing GSEs is reasonably clear. They all provide liquidity to mortgage markets by lending to primary lenders or by buying and selling mortgages in a secondary market that crosses geographic and institutional boundaries that for many years characterized our banking system.

The charter benefits of sponsorship are significant. They are arrayed in the table that I attached to my written testimony.

Some of the benefits are clear subsidies, exemption from State and local income taxes, for example. Others accord preferential treatment, granting GSEs securities agency status. The main value resides, however, not in the individual benefits but in the nature of the charter itself. Even though there is no explicit Federal backing, the benefits and public policy importance of the mission denoted by the charters leads market participants to infer that the GSEs would not be allowed to fail such that creditors would lose their money.

This is the implied guarantee. It effectively lowers funding costs for the GSEs and lowers the capital requirements below those of other private companies in otherwise similar financial conditions.

The risks that the GSE operations pose fall into two categories.

The normal business risks experienced by any intermediary in mortgage markets include interest rate risk, credit risk, a variety of business and market risks. All of these risks can be managed. They cannot be made to disappear, but they can be managed by a prudent company and by all accounts they are being managed well.

Ordinarily, the private market can be expected to exercise discipline over any excessive risk taking, but the market discipline is weakened by the implied guarantees in the case of the GSEs. As a result, all three GSEs have safety and soundness regulators to examine and to test the companies and control for those excessive risks.

The Office of Federal Housing Enterprise Oversight is responsible for safety and soundness regulation of Fannie Mae and Freddie Mac, while HUD oversees their mission, and the Federal Housing Finance Board has responsibility for the Home Loan Banks. Both OFHEO and FHFB have proposed risk based capital standards, although they are not yet in effect.

OFHEO, HUD and the FHFB are, in an important way, the last line of defense against the larger risks to the economy. And those greater risk to the financial system and the economy are systemic risks and a kind of systematic risk.

Systemic risk is the likelihood that a failure of a GSE would cause widespread failures of other financial institutions and result in severe damage to the financial system. In this case, it is partly a direct result of the charter provision that allows depository institutions to hold GSE securities without the normal limits that would be imposed on banks by their safety and soundness regulators.

According to the Treasury, banks currently hold GSE debt that is equivalent to one-third of bank capital and many banks have sufficient holdings that a GSE failure could wipe out their capital. A failure of a GSE under these circumstances could create a domino effect and seriously strain the deposit insurance funds.

Systematic risk is risk that cannot be controlled by diversification. It is the problem of having all your eggs in one basket, but there is only one basket. Portfolio theory holds that diversification makes for better management of risk, but by law GSEs can only diversify so far. Ultimately, they build and grow on a single sector of the economy—and actually only a large part of that sector—and that sector therefore poses systematic risks for the companies. Beyond some point, they cannot continue to grow in their current path without "breaking out" of their assigned market.

For the government, this same risk is one of having an entire sector of the economy more or less identified with the GSEs. So long as the GSEs have their benefits fully operating, the sector becomes dependent upon the companies and cannot diversify away from them. If, on the other hand, GSEs are allowed into other sectors, they are better diversified, but the economy is not.

The growth in GSE debt has also led to consideration of GSE debt as the "risk-free" benchmark for pricing in securities markets. But for a benchmark asset to function properly, it should reflect risks that are inherent to the economy overall. These clearly do not. Yet because of their inferred safety, the private sector could turn to them and, as a result, there could be pressures on the GSEs other than their announced growth plans and, as a result, also on their regulators to allow them to expand their missions further to fill that kind of benchmark role.

This completes my prepared statement and I would be pleased to answer any questions you may have.

[The prepared statement of Barbara Miles follows:]

PREPARED STATEMENT OF BARBARA MILES, SPECIALIST IN FINANCIAL INSTITUTIONS, GOVERNMENT AND FINANCE DIVISION, CONGRESSIONAL RESEARCH SERVICE

Mr. Chairman and members of the committee, I am Barbara Miles, Specialist in Financial Institutions in the Congressional Research Service of the Library of Congress. Thank you for inviting me to appear before you to discuss the housing-related government-sponsored enterprises (GSEs)[1] and the implications their activities may pose for the economy and the Federal budget.

At the end of the first quarter of this year, the three housing GSEs—Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System—had outstanding debt totaling $1.47 trillion.[2] For comparison, publicly held, marketable Treasury debt was about $2.7 trillion.[3] The current and projected declines in the publicly held debt of the U.S. government imply that, at current growth rates of about 20 to 25 percent per year, GSE debt could surpass Treasury debt outstanding by 2003. When Fannie Mae and Freddie Mac's outstanding guarantees of mortgage-backed securities (MBS), $1.21 trillion (net of the $508 billion of MBS the GSEs have repurchased), are added in, the GSE presence in capital markets is very nearly equal to the size of the Treasury market.

Both the absolute size of the GSE debt, and its rapid growth have raised concerns about the risks the GSE's activities pose for the economy and the U.S. Government. In this regard, I will discuss two fundamental questions:

First, what is the Federal Government's responsibility to and for the housing GSEs?

Second, what are the specific risks that these companies' activities pose?

WHAT ARE GSES AND WHY DO WE HAVE THEM?

The answer to the first question is tied up in what GSEs are, why we have them, how they are perceived by investors and why. GSEs are a special class of financial institutions in our economy. They are government in that they serve as instruments of public policy for influencing credit allocation in the economy—in this case into the housing sector or, more accurately, into mortgage finance. Their sponsorship means that they have congressional charters that assign them narrow lending powers, but also grant special exemptions and privileges that lower their costs, in part by implying a guarantee that is formally denied. That they are enterprises means that they operate as private sector institutions for the benefit of their owners.

Public Policy Purpose. The initial government purpose of the three housing GSEs is reasonably clear. The 12 regional Federal Home Loan Banks were chartered in 1934 as a collective GSE in order to provide liquidity to savings and loan associations so that they could continue lending for home mortgages, or at least not be forced by depositor withdrawals to call in mortgage loans already made. There was only very limited private sector ability to take the risks associated with assisting thrifts facing liquidity problems; and nothing, short of the commercial banks' Federal Reserve or the Federal Government itself, could fill the financing gaps on a scale sufficient to deal with the widespread problems of the 1930's. The Banks were chartered to be owned by the S&Ls themselves, and given a series of benefits that lowered their costs. In turn, the Banks made low-cost loans (called "advances") to the S&Ls on the strength of their mortgage lending, and turned a profit for their member-owners in doing so.

Fannie Mae and Freddie Mac were both started to assist in providing liquidity to lenders by developing a secondary mortgage market. A series of problems—including Federal and state laws restricting depository institutions—impeded nationwide flows of mortgage funds and made tapping the resources of general capital markets difficult. As a result, funds did not flow in a normal market response from areas with high savings or from investments with low returns into the regions and mortgages where rates and yield were higher. Fannie Mae, originally a government agency in 1938, but rechartered as a GSE in 1968, and Freddie Mac in 1970, were to help solve these problems by doing what the primary lenders could not do: act as national intermediaries to first, move funds across the country by borrowing where funds were cheap to invest in mortgages where rates were high, and second,

[1] There are five GSEs in our financial system. Two operate in farm credit markets—the Farm Credit System and "Farmer Mac." A sixth GSE, Sallie Mae, provides student loans and is currently in the process of converting to a fully private company.

[2] Sources: quarterly statements of Fannie Mae, Freddie Mac and the Office of Finance of the Federal Home Loan Banks.

[3] This excludes non-marketable debt which, by definition, does not trade in capital markets and is, therefore, not an indicator of market size.

develop appropriate securities to tap into non-traditional investment sources. Both actions made mortgages funds more uniformly available.

The charter benefits. The benefits that have been granted to the GSEs are significant and valuable. (See Table, attached.) Some of the benefits directly and explicitly lower the costs of operation of the GSEs below those of any other private-sector company. Exemption from State and local income taxes, for example, was worth about $490 million to Fannie Mae and Freddie Mac last year.[4] The SEC registration exemption, according to the U.S. Treasury, was worth another approximately $280 million. CBO estimates that, were all five GSEs required to register, the Federal budget would gain $313 million in 2001, and about $1.5 billion for 2001-2005.

Other benefits accord GSE debt preferential treatment, including the eligibility for unlimited investment by depository institutions—circumventing the normal safety and soundness limits on loans to a single borrower—and the eligibility of their debt and MBS as collateral for public deposits. Still others simply provide links that signal that these companies are more "important" than "normal" corporations as a matter of public policy.

Implied Guarantee. The charter value resides not simply in the sum of the individual preferences but in the nature of the charter itself. Even though there is no explicit government backing, because of the benefits and because of the public policy importance of the GSE mission as demonstrated by their special charters, market participants infer that the Federal Government would not allow the GSEs to fail such that creditors would lose their money.[5] This is usually referred to as the "implied guarantee," and it effectively lowers funding costs for the GSEs below those of other private companies in similar financial condition. A series of studies since 1990 have generally put the funding advantage at about 30 basis points (or 0.3 percentage point) below what is available to triple-A companies and about 40 basis points below double-A companies. While there appears to have been some narrowing of this advantage in the past few months, the advantage is still significant.

The implied guarantee also allows for high leverage on the part of GSEs. That is, less capital is needed to assure investors of safety for any given level of assets. Relatively low financial capital allows a higher rate of return for the company so that there is an incentive toward toward maintaining minimum levels consistent with investor comfort and low borrowing costs. Capital provides a kind of cushion against losses for investors. But the implied guarantee replaces, to some extent, the normal market discipline that would take into account the actual risks of the business operations of the company.

Market power. By most accounts, the problems that gave rise to creation of the housing GSEs have been corrected.[6] Correction is generally measured in terms of the degree to which housing finance is integrated with general capital markets. Mortgage rates are effectively uniform across the country, and mortgage markets tap funds in the rest of the capital market with relative ease. Further, many sources of liquidity are now available to primary mortgage lenders, although they would generally be more expensive than the terms available from the GSEs. The charters continue, however, and now contribute to considerable market power.

Because their costs are lower than for non-favored companies, many private sector observers are particularly concerned that GSEs can reap greater-than-competitive profits, even while undercutting pricing of potential competitors. They need only price their products a little below what fully private companies would have to charge. And GSEs control the value of their charters, because increasing business volume increases the extent of the benefits conferred by the charter, while increasing risk adds to the depth of the gains. In short, the special charters confer benefits on the GSEs that increase in value as a company's business volume and risk increase. This arguably provides incentives not only to dominate the assigned market but also to seek ways to continue to grow even after the market to which the GSEs

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[4] This assumes a state tax average of about 8 percent and cooperation under the state tax compacts. See Zimmerman, Dennis. Unfunded Mandates and State Taxation of the Income of Fannie Mae, Freddie Mac, and Sallie Mae: Implications for D.C. Finances. CRS Report 95-952 E.

[5] All GSEs are required to inform investors that their securities do not carry full-faith-and-credit guarantees. Yet the statutory equivalence of GSE and Federal debt for a variety of purposes reassures investors that the government in some way stands behind the debt. Investors are probably correct in their assessments: when the Farm Credit System was in trouble in the late 1980's, it was rescued so that no investors lost.

[6] Jud, G. Donald. Regional Differences in Mortgage Rates: An Updated Examination. Journal of Housing Economics, June 1991. Hendershott, Patrick, and Robert Van Order. Integration of Mortgage and Capital Markets and the Accumulation of Residential Capital. Regional Science and Urban Economics, May 1989.

are constrained by charter is saturated. This, in turn, gives rise to new risks for the government.

THE RISKS OF GSE OPERATIONS

The risks that GSE operations pose fall into two separate categories: the normal business risks of the GSEs' operations, and the larger risks to the financial system and the economy.

Normal business risks. Normal risks are those that would be experienced by any intermediary in mortgage markets and include the following.

- Interest rate risk: that changes in interest rates will result in a loss of economic value.
- Credit risk: that borrowers will default on (not repay) loans or other obligations.
- Business risk: that factors beyond a firm's control could result in unanticipated loss of earnings, or capital.
- Management risk: losses arising from decisions made (or not made) by managers.

Ordinarily, the private market can be expected to maintain discipline over risk-taking by assessing the riskiness of a company's operations and acting in accordance with what it sees. If leverage were high enough (capital were low enough), for example, to raise concerns about insolvency, creditors would demand prompt payment or attempt to accelerate principal repayment where possible, and new credit would become costly. This market-imposed discipline means that a company has every reason, so long as it is solvent, to control its own risk-taking in order to avoid the costs that would be imposed by creditors. GSEs, like other companies, have an incentive to maintain their shareholder value.

In the case of GSEs, however, the market discipline is weaker because of the implied government-backing. Creditors, so long as they continue to infer that GSE debt is near-equivalent to Treasury debt, will allow greater risk and countenance lower capital. GSEs can borrow at preferential rates in good times, and in bad times. While this is supposed to be a strength, it is also a problem if matters get out of hand because once capital is lost, the GSE may have reason to take greater risks in the pursuit of rewards large enough to work itself back out of difficulty.

A case of not-well handled interest rate risk did create severe problems for Fannie Mae. The secular rise in interest rates that occurred in the 1970's and the sharp rise in 1979 presented major problems for all mortgage lenders who had basically lent for long-term mortgages at fixed rates while financing at shorter term rates. Fannie Mae was such a lender at that time and its high leverage exacerbated its problems. The spread between interest rates on mortgages and the rates required on new debt turned negative. At the same time, fewer mortgages were being prepaid as home buyers either assumed the mortgages of the sellers, or homeowners simply did not move, both reactions to high interest rates that prolonged the expected life of loans held by Fannie Mae and prolonged their losses. According to a 1986 study by HUD (then the sole regulator for Fannie Mae), the GSE was insolvent on a mark-to-market basis every year from 1978 through 1984. The worst year was 1981 when estimated net worth fell to minus $11 billion and the corporation actually booked losses. Ultimately, Fannie Mae was allowed to grow its way out of difficulty, although it required regulatory forbearance, some tax adjustments, and declining interest rates to return to health after 1985.

All three housing GSEs have safety and soundness regulators who are specifically charged with examination and testing to keep these risks in check. The Federal Housing Finance Board oversees the Banks. The Office of Federal Housing Enterprise Oversight (OFHEO) oversees Fannie Mae and Freddie Mac for safety and soundness, while HUD has responsibility for mission oversight. Both the FHFB and OFHEO have proposed risk-based capital standards that are intended to test the GSEs for excessive interest rate and credit risk and would require capital holdings accordingly. If the tests work as intended and are timely, it should be possible for regulators to require sufficient capital at all times to avoid a repeat of the 1980's experience. Those tests are not yet in effect.

Repurchase of mortgage backed securities. The repurchase of their own MBS by the GSEs can be thought of as a case of repatriating interest rate risk. When mortgages are securitized and sold, the GSE retains the credit risk on the loans, but sells to investors the interest rate risk. MBS are less profitable than portfolio holdings as a result. Repurchase restores profits along with risk. Fannie Mae and Freddie Mac are the largest holders and purchasers of their own MBS, holding nearly 30 percent of their own issuances and in some recent periods repurchasing a volume equal to or greater than what they issued.

While it is clear that this increases shareholder value, it is difficult to understand what, if anything, it does for mortgage markets. In order to repurchase the securities, the GSEs must issue new debt. Given that U.S. capital markets are highly integrated, mainstream economic theory holds that there should be no lasting change in yields required by the market on either the debt or the MBS. As a result there should be no benefit to pass through to housing markets.[7]

Larger Risks. The larger risks to the financial system and the economy are systemic risk and systematic risk.

Systemic risk. Systemic risk is the likelihood that a failure of one institution would cause widespread failures of other institutions and result in severe damage to the financial system. In the case of the GSEs, the potential for systemic risk is a direct result of the charter provision that allows depository institutions to hold their debt and MBS without limit. Normally, depositories are restricted to no more than 15 percent of capital in loans to a single borrower. According to the Treasury, banks held over $210 billion in GSE debt 1 year ago, which constituted one-third of bank capital, and over $355 billion in MBS. These holdings have raised concern among banking regulators. A failure of a GSE could create a domino effect if it resulted in the sudden loss of capital at banks and thrift institutions, and could strain the deposit insurance funds were the situation unanticipated or severe enough.

Systematic risk. Systematic risk is basically that risk that cannot be controlled by diversification. This kind of risk brings to mind the old adage about the dangers of putting all your eggs in one basket: it is generally a very risky thing to do. In the case of the GSEs, there are two sides to the risk: first, portfolio theory holds that diversification makes for better management of risk. But by law, the GSEs can only diversify so far. Ultimately, they build and grow on a single sector of the economy, one that because of their dominance and ability to increase dominance, poses systematic risks for the companies. They cannot diversify away from residential mortgages without a change in mission. Beyond some point, they cannot continue to grow without "breaking out" of their assigned market. One recent study estimates that by 2003, Fannie Mae and Freddie Mac will have to control (retain or guarantee) better than 90 percent of all outstanding conventional/conforming mortgage loans, and essentially all of new loans originated.[8]

On the other side, if the GSEs take over the housing sector, the government runs systematic risk with respect to the housing sector. So long as the agencies have their benefits fully operating, the sector becomes dependent upon these companies and cannot diversify away from them. If the GSEs are allowed into other sectors, they are better diversified, but the economy is not.

Recall now the data on Treasury and GSE debt. The growth in GSE debt, combined with the projected declines in Treasury debt, has led to consideration of GSE debt as the "risk-free" benchmark for pricing debt in securities markets. Indeed, the GSEs have been positioning themselves to fill such a function by regular issuances of debt in a manner that creates an alternative to the Treasury yield curve. The possibility that the Federal Reserve might use GSE securities for conducting monetary policy has also arisen. But a major economic drawback of using GSE securities—or the securities of any other corporation—is that for the benchmark asset to function properly, it should reflect only risks inherent to the economy overall. GSE securities, on the other hand, include risks specific to their corporations, in this case housing sector risks, which are very different than risks to the overall economy. Yet, because of their inferred safety, the private sector could use them as a benchmark anyway. Thus, the problem arises again that the GSEs may have cause to expand their missions to fill the benchmark role.

The point behind creating GSEs is to increase efficiency by improving the allocation of credit in the economy. But the risk to the economy from introducing what is effectively a subsidized entity into a new market is that current competition will be displaced and economic inefficiency increased.

That completes my prepared statement, Mr. Chairman. I will be pleased to respond to any questions you may have.

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[7] The exception would be if GSE debt and MBS were not good substitutes for one another, i.e., the products were not well integrated in capital markets.

[8] Wallison, Peter J. and Bert Ely. Nationalizing Mortgage Risk: The Growth of Fannie Mae and Freddie Mac. AEI Studies on Financial Market Deregulation, 2000.

TABLE 1.—GOVERNMENT–SPONSORED ENTERPRISE LINKS TO THE FEDERAL GOVERNMENT

Feature	Federal National Mortgage Association	Federal Home Loan Mortgage Corporation	Federal Home Loan Banks	Farm Credit System	Federal Agricultural Mortgage Corporation	Student Loan Marketing Association
Chartered by Act of Congress	Yes	Yes	Yes	Yes	Yes	Yes
Form of Ownership	Publicly held	Publicly held	Cooperative	Cooperative	Cooperative and publicly held	Publicly held
President or Presidential Appointees Name Some Board Members	Yes (5/18)	Yes (5/18)	Yes (6/14)[1]	No	Yes (5/15)	Yes (7/21)
Treasury Lending Authorized	$2.25 billion	$2.25 billion	$4.0 billion	No[2]	$1.5 billion[3]	$1.0 billion
Treasury Approval of Debt Issuance	Yes	Yes	Yes	No	No	Yes
Securities Eligible for Federal Reserve Open Market Purchases	Yes	Yes	Yes	Yes	N/A	Yes
Use of Federal Reserve as Fiscal Agent	Yes	Yes	Yes	Yes	Yes	Yes
Debt Eligible to Collateralize Public Deposits (All U.S. Government; Most State and Local)	Yes	Yes	Yes	Yes	Yes	Yes
Exempt from SEC Registration (1933 Act)	Yes	Yes	Yes	Yes	No	Yes
Government Securities for Purposes of the SecuritiesExchange Act of 1934	Yes	Yes	Yes	Yes	No	Yes
Securities Eligible for Unlimited Investment by NationalBanks and State Bank FR Member	Yes	Yes	Yes	Yes	Yes	Yes
Securities Eligible for Unlimited Investment by Thrifts Regulated by FDIC or OTS	Yes	Yes	Yes	Yes	Yes	Yes
Exemption of Corporate Earnings from Federal Income Tax	No	No	Yes	Yes[4]	No	No
Exemption of Corporate Earnings from State and LocalIncome Tax	Yes	Yes	Yes	Yes	No	Yes
Exemption of Interest Paid from State Income Tax	No	No	Yes	Yes	No	Yes
Subject to GAO Audit	Yes[5]	Yes[5]	Yes	No	Yes	No
Federal Regulator	HUD/OFHEO[6]	HUD/OFHEO[6]	FHFB[7]	FCA[8]	FCA	ED

[1] Each bank.
[2] Treasury is authorized to guarantee up to $4 billion of Financial Assistance Corporation bonds.
[3] Upon required certification from FAMC, borrowing from Treasury authorized to make payments under guarantee.
[4] Federal Land Banks, Farm Credit Banks and Financial Assistance Corporation.
[5] Mortgage transactions may be subject to GAO audit under rules that may be prescribed by the Comptroller General.
[6] HUD regulates mission and program; the Office of Federal Housing Enterprise Oversight regulates safety and soundness.
[7] Federal Housing Finance Board.
[8] The Farm Credit System Assistance Board also has certain powers with respect to the Financial Assistance Corporation and the System institutions needing financial assistance.

Source: Statutes and regulations pertaining to the GSEs as compiled in Report of the Secretary of the Treasury on Government Sponsored Enterprises, May 1990, updated by CRS.

Chairman SUNUNU. Thank you very much.
Mr. McCool.

STATEMENT OF THOMAS J. McCOOL

Mr. MCCOOL. Thank you, Mr. Chairman.

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 to promote home ownership in the United States. The enterprises fulfill their mission by borrowing funds or issuing mortgage-backed securities 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.

Most analysts agree that the enterprise's 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, in particular, the cost of any financial assistance the Federal Government might decide to provide in an emergency situation.

In recent years, GAO has issued several reports that assess the enterprises' role in the housing finance system and Federal oversight of their activities. My testimony today will briefly discuss topics covered in these reports, including the benefits and costs of the enterprises' housing finance activities, Federal efforts to ensure the enterprises' safety and soundness and Federal efforts to ensure the enterprises promote home ownership opportunities for all Americans.

Now, I will shorten my discussion of the benefits, since Barbara has already gone through some of the benefits that the GSEs obtain.

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. Again, the most important of these benefits is the perception in the financial markets that the government would not allow the enterprises to fail, which allows the enterprises to borrow and issue MBS to finance mortgage purchases at relatively lower cost than fully private firms.

These and other benefits, again, which have been discussed already, are to some extent passed on to home buyers in the form of lower mortgage interest rates.

In our report on privatization, which we issued in 1996, we gave an example of a reduction in mortgage interest rates for a $100,000 mortgage would add up to about $10 to $25 a month. So again, there are substantial benefits passed on to homeowners.

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.

Second, opportunity costs are generated when the perceived backing of the 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 of 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.

This act established the Office of Federal Housing Enterprise Oversight, OFHEO, to ensure that the enterprises are adequately capitalized and operating safely and provide the Department of Housing and Urban Development with additional regulatory authority to ensure that the enterprises fulfill their housing finance mission.

The 1992 act established OFHEO as an independent agency within HUD to monitor the enterprises' financial safety and soundness. The act provided OFHEO with two essential responsibilities to carry out its mission: first, to establish capital standards for the enterprises and, second, to establish an examination program.

As required by the 1992 act, OFHEO established minimum capital standards for the enterprises, which are capital ratios applied to certain on balance and off balance sheet obligations.

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 situations where the enterprises are exposed to adverse credit and interest rate scenarios.

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 conditions. At the time of our 1997 report, 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 statutory authority to ensure that the enterprises fulfill their mission of promoting housing and home ownership opportunity for all Americans. The 1992 act required HUD to development, implement and enforce a comprehensive housing mission regulatory framework. This included setting housing goals which required the enterprises to meet specified criteria each year for the purchase of mortgages serving targeted groups.

In our work, we found that HUD generally adopted a conservative approach to setting the housing goals that placed a high priority on maintaining the enterprises' safety and soundness.

In March of this year, HUD proposed a new rule setting housing goal requirements for the period 2000 through 2003 which are higher than the previous goals. 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. 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 to ensure that the enterprises' activities are consistent with their housing mission and its new mortgage program approval authority to review new mortgage programs proposed by the enterprises to ensure the programs are consistent with the enterprises' charters and not contrary to the public interest.

In giving HUD this mission oversight authority, Congress correctly recognized that the enterprises face a natural tension between maximizing profitability for their shareholders and fulfilling their housing mission. For example, we have pointed out that the enterprises have incentives to use the funding advantage associated with their government sponsorship to make non-mortgage investments, some of which may result in arbitrage profits.

While our reports found that HUD had not acted promptly to ensure that the enterprises' non-mortgage investments were consistent with their housing mission, in 1997, HUD initiated a rulemaking process designed to develop criteria that would help ensure that the enterprises' non-mortgage investments are consistent with their housing mission and Federal charters. However, HUD has yet to develop criteria for overseeing the enterprises' non-mortgage investments.

Enterprises have also engaged in other complex financial activities whose relation to their housing mission is not always clear. We reported on HUD's approval of a new mortgage program by Fannie Mae that would have involved Fannie Mae purchasing cash value life insurance. More recently, the enterprises' involvement in other activities 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.

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 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 the enterprises would focus on and fulfill their public mission 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.

As large sophisticated institutions, the enterprises have become engaged in complex financial activities that may serve multiple purposes. 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. I will be happy to answer any questions.

[The prepared statement of Thomas J. McCool follows:]

PREPARED STATEMENT OF THOMAS J. MCCOOL, DIRECTOR, FINANCIAL INSTITUTIONS AND MARKETS ISSUES, GENERAL GOVERNMENT DIVISION

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 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 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.

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.

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.

ENDNOTES

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.

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

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.

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 arbi-

trage 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.

Chairman SUNUNU. Thank you, Mr. McCool.

Mr. Ely.

STATEMENT OF BERT ELY

Mr. ELY. Mr. Chairman and members of the Task Force, I am pleased to testify this morning on the economic implications of debt issued by government-sponsored enterprises, or GSEs. I request permission to submit additional material to the committee for inclusion in the record of this hearing.

Also, I am testifying today on my own behalf. The statements I will make and the opinions I will offer are mine alone and do not necessarily reflect those of any client.

I will begin by addressing the issue of the systemic risks posed by the GSEs and specifically Fannie Mae and Freddie Mac. Within that context, I will then discuss the amount of GSE obligations federally-insured banks and thrifts hold relative to their capital. GSE obligations include mortgage-backed securities the GSEs have guaranteed as well as the debt they have issued. I will close by offering a recommendation.

Systemic risk arises when the failure of a large financial institution threatens the stability of the financial markets. While the failure of a small institution would not threaten financial stability, the failure of a large institution could. Hence, size matters.

Because stable financial markets are essential to the smooth functioning of the economy overall, systemic risk must be treated extremely seriously. Systemic risk also can arise when a large financial institution begins to suffer funding problems. That is, it experiences difficulty and high costs in rolling over its debt because the financial market fears that the institution might be sliding toward insolvency.

That situation arose in the fall of 1998 when a large, highly leveraged hedge fund, Long-Term Capital Management, experienced a funding problem. Although LTCM apparently never was actually insolvent on a mark-to-market basis, there were grave doubts about its solvency in the aftermath of the Russian debt market default in the summer of 1998.

Due only to the intervention of the New York Fed, Long-Term Capital Management was able to keep rolling over its debt in sufficient quantities to enable it to shrink itself in an orderly manner.

Had LTCM been forced to sell its assets at fire sale prices in order to pay its maturing debts, chaos would have reigned in the financial markets. Those fire sale prices would have caused tremendous mark-to-market losses for other financial firms, possibly rendering some of them insolvent. A cascade of losses could have wracked global economic havoc.

I mention LTCM because as big as it was, its outstanding debt at the time of its troubles was less than one-seventh of the amount of debt Fannie and Freddie combined had outstanding at the end of last year. Adding in their MBS, the total outstanding obligations of Fannie and Freddie at the end of 1999, $2.125 trillion, was 17 times LTCM's obligations when it crashed. Unquestionably, Fannie and Freddie pose serious systemic risks. Clearly, they are too-big-to-fail institutions.

The fact that Fannie and Freddie are GSEs makes it nearly certain that the Federal Government will rescue them should they experience financial problems. History bears out this statement. In 1988, Congress threw a $4 billion life ring to the much smaller Farm Credit System, even though it was solvent on a book value basis, after yields on FCS debt over longer Treasuries went above 100 basis points, signalling that new FCS debt might become virtually unmarketable.

In 1996, Congress averted a possible default on FICO bonds by extending the FICO interest bond assessment from S&Ls to all federally-insured depository institutions. And, of course, Congress coughed up approximately $160 billion drawn from various sources to ensure that the Federal deposit insurance commitment would be met for all failed S&Ls.

Much has been made in hearings held earlier this year by the Capital Markets Subcommittee of the House Banking Committee that a statutorily required stress test will prevent Fannie or Freddie from reaching insolvency. Although OFHEO has strived valiantly to implement this stress test, the test will not prevent either Fannie or Freddie from creating systemic risk.

This is a most important point that Representative Richard Baker, chairman of the Capital Markets Subcommittee, made in a hearing last Thursday. This is the case because any meaningful deterioration in the financial condition of either Fannie or Freddie, even if neither is insolvent, will create funding problems for both GSEs since they are, for all practical purposes, Siamese twins.

According to a recent American Banker article, over two-thirds of federally-insured banks and thrifts hold more GSE debt and MBS, relative to their capital, than would be permissible for them to hold if GSE obligations were held to the same loan-to-one borrower and investment-per-company rules that apply to credit extensions by banks and thrifts to genuinely private organizations.

Due to data limitations, it is not possible to identify the specific GSEs for which banks and thrifts have exceeded the credit limits applicable to private entities. However, given their enormous size relative to the other GSEs, most banks and thrifts are overexposed to Fannie and Freddie obligations.

This overexposure has undoubtedly created solvency concerns about banks and thrifts heavily invested in GSE debt and MBS should Fannie or Freddie get into trouble. This is the case because if funding problems drove down the market value of GSE debt, that drop would cause capital reductions in banks and thrifts that would trigger regulatory sanctions that in turn would force banks and thrifts to reduce their lending to consumers and businesses. The resulting credit crunch could easily cause a recession, which would magnify the downward spiral.

If banks and thrifts continue to hold a proportionate share of the total amount of Fannie and Freddie obligations, then Fannie's and

Freddie's continued growth will increase the systemic risk they pose to America's banks and thrifts.

Ironically, the growing presence of Fannie and Freddie obligations on bank and thrift balance sheets further increases the likelihood that the Federal Government will rescue the GSEs should they experience funding problems because of the adverse effects that those problems would have on federally-insured depository institutions.

Although the reforms Congress enacted in the early 1990's have essentially eliminated the taxpayer risk posed by Federal deposit insurance, Congress would still understandably be concerned about the credit crunch effects of Fannie and Freddie's funding problems.

While GSE obligations owned by banks and thrifts should be subject to the same loan and investment limitations applicable to the obligations of private sector firms, forcing banks and thrifts to trim their Fannie and Freddie obligations would merely shift systemic risk elsewhere in the financial system, not eliminate it. In any event, the GSE exception to these limitations should be of less concern to Congress than the enormous and increasing size of these two undercapitalized GSEs.

Until such time as Fannie and Freddie can be transformed into genuinely private sector firms by eliminating their special privileges, Congress must ensure that a reliable mechanism is in place to rescue Fannie or Freddie should one of them stumble financially. Because there are innumerable reasons why they might stumble, some of which lie outside the U.S. financial system, it would be pointless to try to prevent an external event. Instead, if needed, a rescue mission should be executed as quickly and smoothly as possible.

It would be foolhardy to rely upon "market discipline" to prevent a stumble because the exercise of market discipline could collapse the financial markets. We got a whiff of that potential effect in the aftermath of Treasury Under Secretary Gary Gensler's testimony in March before the Capital Markets Subcommittee when yields on Fannie and Freddie debt shot up at the mere suggestion that they are not government-backed institutions.

The two existing rescue mechanisms are grossly inadequate. First, Fannie's and Freddie's Treasury lines of credit, at $2.25 billion for each institution, pale in light of the total amount of their outstanding debt in MBS. Fannie's line of credit is less than .2 percent of its outstanding obligations. The comparable figure for Freddie is about 2.5 percent, or in effect one-four-hundredth of its outstanding obligations.

Second, if Congress were out of session and the Treasury lines of credit had been fully drawn down, then presumably the Fed could lend to Fannie and Freddie or buy their securities. But to do so, the Fed would have to sell a like amount of Treasury securities. Massive sales of Treasury debt could be highly disruptive to the financial markets.

Key, therefore, to dealing with a Fannie or Freddie funding crisis would be congressional enactment of a line of credit comparable to the life ring Congress tossed to the Farm Credit System in 1988 that the Treasury Department could draw upon to keep the financial markets funding Fannie and Freddie even if these GSEs were experiencing financial difficulties.

That action would give Congress time resolve their problems in a manner that would minimize the cost of any rescue. As distasteful as this recommendation may seem, going forward with the present limited rescue resources is playing Russian roulette with the U.S. economy.

Mr. Chairman and members of the Task Force, I thank you for your time, and I welcome your questions.

[The prepared statement and other submitted materials of Bert Ely follows:]

PREPARED STATEMENT OF BERT ELY, ELY & CO., INC.

ECONOMIC IMPLICATIONS OF DEBT ISSUED BY GOVERNMENT-SPONSORED ENTERPRISES

Mr. Chairman and members of the Task Force on Housing and Infrastructure, I am pleased to testify this morning on the economic implications of debt issued by government-sponsored enterprises, or GSEs. I request permission to submit additional material to the Committee for inclusion in the record of this hearing, specifically a monograph I co-authored recently, titled "Nationalizing Mortgage Risk: The Growth of Fannie Mae and Freddie Mac." Also, I am testifying today in my own behalf. The statements I will make and the opinions I will offer are my alone and do not necessarily reflect those of any client.

I will begin by addressing the issue of the systemic risk posed by the GSEs, and specifically Fannie Mae and Freddie Mac. Within that context, I will then discuss the amount of GSE obligations federally insured banks and thrifts hold relative to their capital. GSE obligations include mortgage-backed securities, or MBS, the GSEs have guaranteed as well as the debt they have issued. I will close by offering a recommendation.

SYSTEMIC RISK

Systemic risk arises when the failure of a large financial institution, due to its actual or apparent insolvency, threatens the stability of the financial markets. While the failure of a small institution would not threaten financial stability, the failure of a large institution could. Hence, size matters. Because stable financial markets are essential to the smooth functioning of the economy overall, systemic risk must be treated extremely seriously.

Systemic risk also can arise when a large financial institution begins to suffer funding problems; that is, it experiences difficulty and high cost in rolling over its debt because of financial market fears that the institution might be sliding toward insolvency. That situation arose in the fall of 1998 when a large, highly leveraged hedge fund, Long Term Capital Management, or LTCM, experienced a funding problem. Although LTCM apparently never was actually insolvent, on a mark-to-market basis, there were grave doubts about its solvency in the aftermath of the Russian debt default in the summer of 1998.

Due only to the intervention of the Federal Reserve Bank of New York, LTCM was able to keep rolling over its debt in sufficient quantities to enable it to shrink itself in an orderly manner. Had LTCM been forced to sell its assets at fire-sale prices, in order to pay its maturing debt, chaos would have reigned in the financial markets. Those fire-sale prices would have caused tremendous mark-to-market losses for other financial firms, possibly rendering some of them insolvent. A cascade of losses could have wracked global economic havoc.

I mention LTCM because as big as it was, its outstanding debt at the time of its troubles was less than one-seventh of the amount of debt Fannie and Freddie combined had outstanding at the end of last year. Adding in their MBS, the total outstanding obligations of Fannie and Freddie at the end of 1999, $2.125 trillion, was 17 times LTCM's obligations when it crashed. Unquestionably, Fannie and Freddie pose serious systemic risks. Clearly, they are too-big-to-fail financial institutions.

The fact that Fannie and Freddie are GSEs makes it nearly certain that the Federal Government will rescue them should they experience financial problems. History bears out this statement. In January 1988, Congress threw a $4 billion life ring to the much smaller Farm Credit System, or FCS, even though it was solvent on a book-value basis, after yields on FCS debt over longer term Treasuries went above 100 basis points, signalling that new FCS debt might become virtually unmarketable. In September 1996, Congress averted a possible default on the so-called FICO bonds by extending the FICO bond interest assessment from savings-and-loans, or S&Ls, to all federally insured depository institutions. And of course, starting in 1989, Congress coughed up approximately $160 billion, drawn from various sources, to ensure that the Federal deposit insurance commitment would be met for all failed S&Ls.

Much has been made in hearings held earlier this year by the Capital Markets Subcommittee of the House Banking Committee that a statutorily required stress test will prevent Fannie or Freddie from reaching insolvency. Although the Office of Federal Housing Enterprise Oversight, or OFHEO, has strived valiantly to implement this stress test, the test will not prevent either Fannie or Freddie from creating systemic risk. This is a most important point that Rep. Richard Baker, Chairman of the Capital Markets Subcommittee, made in a hearing last Thursday. This is the case because any meaningful deterioration in the financial condition of either Fannie or Freddie, even if neither is insolvent, will create funding problems for both GSEs since they are, for all practical purposes, Siamese twins.

INVESTMENTS BY BANKS AND THRIFTS IN GSE OBLIGATIONS

According to a recent (April 14, 2000) American Banker article, over two-thirds of federally insured banks and thrifts hold more GSE debt and MBS, relative to their capital, than would be permissible for them to hold if GSEs obligations were held to the same loan-to-one-borrower and investment-per-company rules that apply to credit extensions by banks and thrifts to genuinely private organizations. Due to data limitations, it is not possible to identify the specific GSEs for which banks and thrifts have exceeded the credit limits applicable to private entities. However, given their enormous size, relative to the other GSEs, most banks and thrifts are most overexposed to Fannie and Freddie obligations.

This overexposure has understandably created solvency concerns about banks and thrifts heavily invested in GSE debt and MBS should Fannie or Freddie get into trouble. This is the case because if funding problems drove down the market value of GSE debt, that drop would cause capital reductions in banks and thrifts that would trigger regulatory sanctions that, in turn, would force banks and thrifts to reduce their lending to consumers and businesses. The resulting credit crunch could easily cause a recession, which would magnify the downward spiral. If banks and thrifts continue to hold a proportionate share of the total amount of Fannie and Freddie obligations, then Fannie's and Freddie's continued growth will increase the systemic risk they pose to America's banks and thrifts.

Ironically, the growing presence of Fannie and Freddie obligations on bank and thrift balance sheets further increases the likelihood that the Federal Government will rescue the GSEs should they experience funding problems because of the adverse effect those problems would have on federally insured depository institutions. Although reforms Congress enacted in the early 1990's have essentially eliminated the taxpayer risk posed by Federal deposit insurance, as I explain in a paper titled "Banks Do Not Receive a Federal Safety Net Subsidy," Congress would still understandably be concerned about the credit-crunch effects of Fannie's and Freddie's funding problems.

While GSE obligations owned by banks and thrifts should be subject to the same loan and investment limitations applicable to the obligations of private-sector firms, forcing banks and thrifts to trim their Fannie and Freddie obligations would merely shift systemic risk elsewhere in the financial system, not eliminate it. In any event, the GSE exception to these limitations should be of less concern to Congress than the enormous and ever increasing size of the two undercapitalized GSEs.

WHAT TO DO ABOUT THE SYSTEMIC RISKS FANNIE AND FREDDIE POSE

Until such time as Fannie and Freddie can be transformed into genuinely private-sector firms by eliminating their special privileges, Congress must ensure that a reliable mechanism is in place to rescue Fannie and Freddie should one of them stumble financially. Because there are innumerable reasons why they might stumble, some of which lie outside the U.S. financial system, it would be pointless to try to prevent an external event. Instead, if needed, a rescue mission should be executed as quickly and smoothly as possible.

It would be foolhardy to rely upon "market discipline" to prevent a stumble because the exercise of market discipline could collapse the financial markets. We got a whiff of that potential effect in the aftermath of Treasury Under Secretary Gary Gensler's testimony in March before the Capital Markets Subcommittee when yields on Fannie and Freddie debt shot up at the mere suggestion that they are not government-backed institutions.

The two existing rescue mechanisms are grossly inadequate. First, Fannie's and Freddie's Treasury lines of credit, at $2.25 billion for each institution, pale in light of the total amount of their outstanding debt and MBS. Fannie's line of credit is less than .2 percent of its outstanding obligations; the comparable figure for Freddie is about .25 percent. Second, if Congress were out of session and the Treasury lines of credit had been fully drawn, then presumably the Fed could lend to Fannie and Freddie or buy their securities, but to do so, the Fed would have to sell a like amount of Treasury securities. Massive sales of Treasury debt could be highly disruptive to the financial markets.

Key, therefore, to dealing with a Fannie or Freddie funding crisis would be congressional enactment of a line of credit, comparable to the life ring Congress tossed to the Farm Credit System in 1988, that the Treasury Department could draw upon to keep the financial markets funding Fannie and Freddie even if these GSEs were experiencing financial difficulties. That action would give Congress time to resolve their problems in a manner that would minimize the cost of any rescue. As distasteful as this recommendation may seem, going forward with the present limited rescue resources is playing Russian roulette with the U.S. economy.

Mr. Chairman and members of the Task Force, I thank you for your time. I welcome your questions.

ELY & COMPANY, INC.,
FINANCIAL INSTITUTIONS AND MONETARY POLICY CONSULTING,
Alexandria, VA, July 29, 2000.

Hon. EVA M. CLAYTON,
U.S. House of Representatives, Washington, DC.

DEAR MS. CLAYTON: I am writing to clarify an answer I gave to a question you posed to me at the Budget Committee's Housing and Infrastructure Task Force hearing on Tuesday about the GSEs. I stated something to the effect that I do not believe that the lower interest rates Fannie Mae and Freddie Mac provide are necessarily beneficial to housing finance. However, I am not an advocate of high mortgage interest rates. Instead, I fear that the interest rate subsidy Fannie and Freddie deliver may actually harm housing affordability if that subsidy gets overcapitalized in housing prices. Let me explain.

At present interest rate levels, a .25 percent reduction in the rate on a 30-year fixed-rate mortgage enables a borrower to finance a mortgage approximately 2.4 percent larger than the borrower could finance without that interest rate reduction; a .375 percent rate reduction will finance an approximately 3.6 percent larger mortgage. While that may seem desirable, if the existence of the Fannie/Freddie subsidy causes housing prices to rise by more than 2.4 percent to 3.6 percent, then it is the seller of a house, rather than the buyer, who receives the benefit of the mortgage subsidy. My research suggests that at times, and perhaps much of the time, Fannie and Freddie's interest rate subsidy has been overcapitalized in housing prices, thus making it more difficult for moderate income people to buy a home. In my opinion, a more much effective and lower cost housing finance subsidy would target the subsidy to just those homebuyers on the cusp of home ownership.

I would welcome the opportunity to meet with you to discuss in greater depth the issues you raised at the hearing.

Very truly yours,

BERT ELY.

NATIONALIZING MORTGAGE RISK: THE GROWTH OF FANNIE MAE AND FREDDIE MAC

Peter J. Wallison and Bert Ely

1. INTRODUCTION

Fannie Mae and Freddie Mac are today the largest financial institutions in the United States. Many economic studies, including one by the Congressional Budget Office (CBO), have concluded that these government-sponsored enterprises (GSEs) receive an implicit government subsidy arising out of the statutory benefits they retained at the time they were "privatized" (Fannie in 1970, Freddie in the 1980's). In 1996, the CBO estimated the value of that subsidy at $6.5 billion for the previous year, and the subsidy has grown substantially larger since then.

According to the CBO, only a portion of that subsidy is actually passed along to the mortgage markets.[1] The balance, almost a third, is retained for the share-holders and managements of the two companies, accounting for more than 40 percent of their 1995 profits (which ranked them among the most profitable publicly held companies in the United States).

The lower interest rates that Fannie and Freddie can command because of their government backing permit them to out-compete any private-sector rival and to dominate any market they are permitted to enter. Although their charters are supposed to limit their activities preventing them from competing with companies that must raise their funds without government backing the vagueness of the charters and the political power of Fannie and Freddie have enabled them to expand with few constraints. That they can and do make soft-money political contributions, hire legions of lobbyists, and employ people with close ties to Congress as top management further ensures their insulation from scrutiny.

Meanwhile, their dominance of the residential mortgage markets grows ever greater. Reasonable projections based on statements by Franklin Raines, the chairman of Fannie Mae, suggest that, by the end of 2003, the two companies will have assumed the risk associated with almost half of all the residential mortgages in the United States. That means that the taxpayers, who ultimately stand behind the obligations of these two companies, will have unwittingly become responsible for almost $3 trillion of residential mortgage risk that should be on the books of private sector firms.

An important decision point lies immediately ahead. As shown in this analysis, in 4 years, Fannie and Freddie will have either acquired for their portfolios or guaranteed more than 91 percent of all the conventional/conforming mortgages in the United States. Those are the high-quality loans on middle-class homes that have until now been virtually the only mortgages the GSEs would purchase. As they grow beyond their traditional market segment, Fannie and Freddie will have to purchase increasing amounts of lower-quality loans and hold more of those loans in portfolio, increasing their risks. If they fully hedge those risks, their extraordinary profitability will decline.

The question is whether Fannie and Freddie will (1) slow their growth to reduce the risks they take on; (2) continue their growth at the rate Franklin Raines predicted, but accept reduced profitability by hedging those risks; or (3) continue the growth in both those assets and risks in order to achieve high profitability. The evidence is that they are pursuing the third course.

To be sure, there is nothing wrong with growth, risk, or profitability. But the growth of the GSEs—aided as it is by government support—creates enormous risks for taxpayers only a decade after the savings and loan bailout, and it threatens to drive a whole sector of the private financial community out of the residential mortgage market. Those factors raise serious policy issues. The purpose of this study is to examine the implications of that growth for the mortgage market, for those who compete with Fannie and Freddie, and for the nation's taxpayers.

Chapter 2 provides background on the GSEs and the mortgage markets. It outlines the statutory links to the Federal Government that have led the financial markets to conclude that Fannie and Freddie will not be allowed to fail, describes the mortgage market in the United States, and summarizes both the functions and growth of the GSEs.

Chapter 3 contains detailed information on the structure of the residential mortgage market today, the growth of Fannie and Freddie's share of that market since 1995, and (if the forecasts of Fannie's chairman are correct) the share they will hold together and separately at the end of 2003. It shows that the GSEs' total risk including both the mortgages they will own and those they have guaranteed will in-

[1] In its 1996 report, Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac, CBO concluded that the GSEs reduced interest rates in the conventional/conforming market by passing along about two-thirds of the implicit subsidy they received from the government, while retaining the balance for themselves. CBO estimated that subsidy as $6.5 billion in 1995, a figure that was derived by estimating the GSEs' funding cost savings as a result of their implicit government backing. Prior assessments of the GSEs' credit quality had concluded that, without government backing, Fannie and Freddie would have private-sector credit ratings in the Aa range. That permited CBO to estimate the savings attributable to the government's implicit credit enhancement by computing the difference between the costs the GSEs would have faced without government backing and the costs they actually paid. That savings was estimated at about 50 basis points for each dollar of funds acquired. CBO then noted that the difference between interest rates in the jumbo market and those in the conventional/conforming market amounted to approximately 35 basis points, and concluded that the GSEs were retaining about 15 basis points, or about one-third of their implicit subsidy.

crease from somewhat more than a third of the market today to almost half of a much larger market 4 years hence.

The growth of Fannie and Freddie in relation to the growth of the conventional/conforming sector of the market is examined in chapter 4. It shows that, beginning in 1998, they were already acquiring more net mortgage assets in each year than the total net principal amount of the conventional/conforming loans made in that year. The data presented in chapter 4 also show that, by the end of 1998, Fannie and Freddie were holding in portfolio or had guaranteed more than 73 percent of all conventional/conforming mortgages, and that figure could reach almost 92 percent by 2003.

The implications of that growth are addressed in chapter 5, which discusses the possibility that to make up for the absence of sufficient conventional/conforming mortgages—Fannie and Freddie will have to drive deeper into the subprime markets, taking more risk and displacing more of the genuine private-sector lenders who have traditionally made these loans. The chapter also discusses other financial services that Fannie and Freddie might be preparing to offer if their charters are not more strictly interpreted.

Chapter 6 continues the analysis of the implications of GSE growth, focusing on the risks to taxpayers that will be associated with the nationalization of almost half the residential mortgage market by 2003. The chapter points out that Fannie and Freddie have a choice—to hedge the greater risks they will be taking and reduce their profitability, or to maintain their level of profit growth by taking greater risk. It suggests that the incentives of management and the pressures of the financial markets will push the two GSEs toward greater risk-taking.

The study's conclusion notes that there is an inherent conflict between the GSEs' status as private, profit-making companies and the government mission they are expected to perform. There is ample evidence that their government mission is no longer necessary, and that they are using the subsidy they receive primarily to enhance their profitability and to dominate their market. Even if that were not true, the risks they are creating for taxpayers and the threat they represent to non-subsidized private-sector competitors would argue strongly for more strictly confining them to limited areas of activity, eliminating their links to the government, or taking steps toward recapturing their subsidy through a complete privatization.

2. BACKGROUND

The Federal National Mortgage Association (popularly known as Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are two government-chartered and government-sponsored corporations that have been assigned the statutory mission of improving liquidity in the middle-class residential mortgage markets by buying and selling residential mortgages.

Fannie Mae and Freddie Mac carry on their functions in two ways—by purchasing and holding mortgages originated by mortgage lenders, and by placing their guarantee on securities (mortgage-backed securities, or MBSs) that represent an interest in pools of mortgages they have assembled. Whether they are holding mortgage loans or MBSs in their portfolio or are guaranteeing MBSs that are then sold to investors, they are assuming the credit risk associated with those loans.

Although initially established to enhance liquidity in the mortgage markets, it is doubtful that Fannie and Freddie are necessary for that purpose today. Many private organizations are now capable of purchasing mortgages from originators and selling them—either directly or through securitization—into the capital markets. However, Fannie and Freddie now argue that they perform their public mission by reducing interest rates on the mortgages they are permitted to buy, and thus help homebuyers to obtain lower-cost financing. That claim is dubious; economists believe that the lower rates attributable to the GSEs' subsidized borrowing are simply capitalized into the cost of the homes, thus benefiting developers and home sellers rather than buyers.

Fannie and Freddie were originally government agencies but were "privatized" when they were permitted to sell shares to the public. Today, both companies are among the largest and most profitable financial institutions in the world, with their securities listed on the New York Stock Exchange.

The unusual thing about their privatization, however, is that Fannie and Freddie continue to retain a large number of connections to the government, as well as various privileges and immunities that no genuinely private company can claim:

- The president appoints up to five members (a minority) of their boards of directors.
- The secretary of the Treasury is authorized to invest up to $2.25 billion in their securities, and to approve their issuance of debt.

• They are exempt from state and local income taxes and from the requirement to register their securities with the Securities and Exchange Commission.

• Their debt securities are eligible for open-market transactions by the Federal Reserve Board and for investment by insured banks.

• Their debt securities are eligible collateral for the Federal Government's deposits of tax revenues in banks.

• Their securities require only a 20 percent risk weighting (versus 100 percent for the securities and debt of private companies) under the Basel risk-based capital standards applicable to banks.

Those extraordinary advantages have convinced the capital markets that the Federal Government will never allow Fannie and Freddie to fail. Thus, they are able to sell their debt securities at interest rates that are consistently better than any AAA-rated corporation in the world and just slightly above the rate paid by the Treasury itself. Moreover, that favored position allows them to operate with capital levels that are much lower than those of other financial intermediaries, since the capital markets are not concerned that those low capital levels will ever mean losses to the holders of their debt or their MBSs.

THE MARKET IN WHICH THE GSES OPERATE

The residential mortgage market is composed of a number of segments—government-guaranteed Veterans Administration (VA) and Federal Housing Administration (FHA) loans; multifamily housing loans; middle-class mortgages (known as conventional/conforming mortgages, the basic loans that Fannie Mae and Freddie Mac purchase or guarantee); subprime loans (loans with credit deficiencies); home equity loans; and so-called jumbo loans, which exceed the size limit on conventional/conforming loans.

According to Federal Reserve data, FHA and VA loans constitute about 11 percent of the total market. Although similarly authoritative numbers are difficult to obtain for jumbo loans, most observers agree that those mortgages constitute another 15 percent of the market. Fannie and Freddie cannot compete for most FHA and VA loans, since those are purchased and marketed by the Government National Mortgage Association (known as Ginnie Mae), an on-budget government agency that obtains its funds at Treasury rates and thus can offer lower rates than can Fannie and Freddie.[2] Nor can Fannie and Freddie compete for jumbo mortgages, which have initial loan amounts above $252,700, the limit on the size of the loans Fannie and Freddie can purchase in the year 2000.[3]

That leaves 74 percent of the total residential market in which Fannie and Freddie can invest. Of that portion, most are conventional/conforming loans; the balance are subprime, home equity, and multifamily housing loans.

In the past, the GSEs purchased almost exclusively conventional/conforming loans, because those are the best credits available in the middle-class market. But increasingly in recent years—as they have foreseen that their need for assets will outstrip the conventional/conforming market—the GSEs have entered the market for subprime, home equity, and multifamily housing loans. Those assets are riskier middle-class credits, since they represent loans to borrowers with impaired credit (subprime loans), subordinated debt (home equity loans), and rental housing (multifamily).

GSE GROWTH

In a statement to a September 1999 financial conference, Franklin Raines predicted that by the end of 2003 Fannie Mae will have 28 percent of the U.S. residential mortgage market, and that its profitability will have doubled. Raines's forecast implies an 11.3 percent annual rate of growth in risk and a 15 percent annual rate of growth in profitability during 1999 and over the following 4 years.[4]

[2] Although Ginnie Mae can borrow at a lower rate than Fannie and Freddie, the GSEs have been able, from time to time, to offer a lower mortgage rate to many subprime borrowers eligible for FHA and VA loans. That may be a consequence of the fact that Fannie and Freddie's MBSs have greater liquidity than Ginnie Mae's, and perhaps shorter duration. It may also be attributable to better underwriting skills at Fannie and Freddie, which might leave Ginnie with higher credit losses. It remains to be seen whether Fannie and Freddie will be able to maintain a permanent beachhead in the FHA/VA market.

[3] The limit, which is keyed to housing prices, was $240,000 in 1999.

[4] Not to be outdone, in a November 1999 statement to securities analysts, Leland Brendsel, the chairman of Freddie Mac, also predicted a mid-teens growth in profitability, without specifying the period over which that would occur.

The Raines statement provides a valuable benchmark for assessing both the steps that Fannie Mae must take to achieve that goal and the shape of the residential mortgage market in 2003, if the goal has then been achieved.

At the end of 1999, the residential mortgage market—that is, all outstanding residential mortgage loans in the United States—had an aggregate book value of just over $5 trillion. In 1998 and 1999, that market grew strongly—by more than 8 percent each year. But its long-term growth rate has been about 6 percent. If we make the conservative assumption that the residential mortgage market will grow at that rate for the next 4 years, it will have a total value of about $6.4 trillion in the year 2003.

Thus, when its chairman predicts that Fannie Mae will have 28 percent of the residential mortgage market in 2003, he is saying that it will in that year have assumed the risk of mortgage loans with an aggregate value of more than $1.8 trillion. At that size, Fannie Mae may or may not be the largest financial institution in the world—depending on the size of future mergers among the world's largest banks—but it will unquestionably be the largest S&L the world has ever seen.

And in second place will be Freddie Mac, which in 1999 was about two-thirds the size of Fannie. If we assume that that relative size differential will continue through 2003, then Freddie Mac will hold in portfolio, or will have guaranteed, mortgages with an aggregate value of more than $1.2 trillion, a growth rate of 11.4 percent between 1998 and 2003.

Together, then, the GSEs in 2003 will be bearing the risk associated with more than $3 trillion in residential mortgages, or almost 48 percent of all home mortgages in the United States. The balance of the market—barely more than half—will be left to the thousands of private, non-subsidized lenders who have traditionally provided mortgage finance in the United States.

Those extraordinary facts have a number of equally startling corollaries:

- Since the U.S. government stands behind the obligations of the GSEs, the nation's taxpayers—rather than the shareholders of private sector mortgage lenders—will ultimately bear the risks associated with almost half of all the residential mortgage debt outstanding in the United States.
- If the total residential mortgage market is growing at 6 percent a year, and Fannie and Freddie are growing, respectively, at 11.3 percent and 11.4 percent a year, then the GSEs cannot achieve their growth goals solely within their traditional segment of the residential mortgage market. They will have to strike out into other areas.
- The current private-sector sources of mortgage finance will be forced to consolidate and will gradually be squeezed out of the residential market; in effect, half of that sector of the economy will have been nationalized.
- Just as ominously, achieving a 15 percent annual rate of profit growth will require that Fannie and Freddie take on and retain more financial risk—in a process reminiscent of the S&L industry's ultimately fatal effort to achieve high levels of profitability only fifteen years ago.

3. MARKET SHARES

Table 3–1 shows the growth of the residential mortgage markets since 1995. The data for the size of the FHA/VA market (line 3), multifamily mortgages (line 5), and the mortgage market as a whole (line 6), during the years 1995 through 1998, are taken from reports published by the Federal Reserve Board. Information on the size of the jumbo market (line 1) and the conventional/conforming market (line 2) was derived from industry sources. Other one-to-four-family mortgages (line 4), a residual figure, consists primarily of subprime and home equity loans. For the purpose of this study, those loans and multifamily loans (loans for apartment buildings) have been combined into a category called "all other."

ASSUMPTIONS AND DATA

The projections for 1999 through 2003 are based on our judgment that the very strong residential real estate market during 1998 and 1999 will return gradually over the next 4 years to its historical pattern. Thus, although the market grew by 9.3 percent in 1998, we project that it will have grown by about 8 percent when all the data on 1999 are in, by 7 percent in 2000, and by 6 percent in each of the 3 years thereafter.

Historically, total residential real estate mortgage debt has grown slightly faster than nominal gross domestic product (GDP). In that context, residential mortgage debt's extraordinary growth in 1998 cannot be expected to continue. If we assume that the market will gradually return to its historic growth pattern in relation to

GDP, that would reinforce the projection of a gradual return to a 6 percent growth rate beginning in 2001.

TABLE 3–1.—SIZE OF THE RESIDENTIAL MORTGAGE MARKET, PAST, PRESENT, AND PROJECTED, 1995–2003

[Dollars, in millions]

	History (year-end)				Projection (year-end)					Annual growth rate: 1995–1998 (%)	Annual growth rate: 1998–2003 (%)	Growth rate difference
	1995	1996	1997	1998	1999	2000	2001	2002	2003			
Composition of outstanding mortgage market:												
1. Jumbo mortgages	568,008	602,069	639,797	699,485	755,444	808,325	856,825	908,234	962,728	7.2	6.6	–0.6
2. Conventional/conforming	1,969,096	2,087,172	2,217,961	2,424,882	2,618,873	2,802,194	2,970,326	3,148,545	3,337,458	7.2	6.6	–0.6
3. FHA/VA mortgages	466,620	497,684	525,000	524,354	546,377	566,456	584,300	602,705	621,690	4.0	3.5	–0.5
4. Other 1- 4-family mortgages	505,997	532,085	572,096	673,732	747,556	818,051	883,279	952,928	1,027,281	10.0	8.8	–1.2
5. Multifamily: all kinds	277,002	294,783	310,456	340,782	368,045	393,808	417,436	442,482	469,031	7.2	6.6	–0.6
6. Total residential mortgages	3,786,723	4,013,793	4,265,310	4,663,235	5,036,294	5,388,834	5,712,164	6,054,894	6,418,188	7.2	6.6	–0.6
7. Annual growth rate (%)	4.3	6.0	6.3	9.3	8.0	7.0	6.0	6.0	6.0			

Sources: For all tables, historic data sources are as follows: Federal Reserve Bulletin, December 1999; periodic financial reports issued by Fannie Mae and Freddie Mac; and industry nestimates. Projected data are the projections of Peter J. Wallison and Bert Ely.

The division of the market into four subcategories—jumbo, conventional/conforming, FHA/VA, and all other (subprime, home equity, and multifamily loans)—is necessarily somewhat arbitrary. There are no official or government estimates of the size of key market segments; apart from FHA/VA and multifamily mortgages, there are no formally recognized and defined subcategories into which the market has been divided for purposes of official reporting.

Although official figures are lacking, there is a wide variety of unofficial market breakdowns.[5] The data we have received from market sources, however, indicate that jumbo loans account for about 15 percent of the market and FHA-VA loans for about 11 percent. Accordingly, conventional/conforming plus all other loans—the loans in which Fannie and Freddie can invest—account for about 74 percent.[6]

FANNIE AND FREDDIE MARKET SHARES

Table 3–2 contains data on the respective market shares of Fannie and Freddie. The information on their shares between 1995 and 1998 was derived by comparing the information in their financial statements to known market totals. For the years after 1998, we assumed a growth rate in market shares that would permit Fannie Mae to reach the 28 percent market share projected by Franklin Raines for the year 2003. We then assumed that Freddie's growth rate would be such as to maintain its market share in relation to Fannie. That means that Fannie, which had grown at a rate of 11.2 percent annually between 1995 and 1998 (line 11), would have to grow at a slightly greater rate, 11.3 percent, from 1999 through 2003, and that Freddie would have to increase its growth rate from 9 percent to 11.4 percent (line 17).

[5] In a recent statement, Fannie chairman Franklin Raines divided the residential mortgage market into seven subcategories: conventional/conforming (49 percent), FHA/VA (11 percent), jumbo (19 percent), subprime (6 percent), home equity loans (6 percent), seller-financed (2 percent), and multifamily (7 percent).

[6] If Mr. Raines is correct that the jumbo market is 19 percent of the total, that would indicate that Fannie and Freddie have an even larger percentage of the total eligible market.

TABLE 3–2.—FANNIE MAE AND FREDDIE MAC MARKET SHARES, PAST, PRESENT, AND PROJECTED, 1995–2003

[Dollars, in millions]

	History (year-end)				Projection (year-end)					Annual growth rate: 1995–1998 (%)	Annual growth rate: 1998–2003 (%)	Growth rate difference
	1995	1996	1997	1998	1999	2000	2001	2002	2003			
Fannie/Freddie retained portfolios, total mortgages outstanding:												
Fannie Mae:												
8. Retained portfolio:	252,868	286,527	316,592	415,434	528,811	635,882	754,006	877,960	1,020,492	18.0	19.7	1.7
9. Total residential (%)	6.7	7.1	7.4	8.9	10.5	11.8	13.2	14.5	15.9			
10. Conventional/conforming & all other (%)	9.2	9.8	10.2	12.1	14.2	15.8	17.7	19.3	21.1			
11. Retained + guaranteed:	766,098	834,700	895,730	1,052,577	1,208,711	1,347,209	1,485,163	1,634,821	1,797,093	11.2	11.3	0.1
12. Total residential (%)	20.2	20.8	20.9	22.5	24.0	25.0	26.0	27.0	28.0			
13. Conventional/conforming & all other (%)	27.8	28.6	28.9	30.6	32.4	33.6	34.8	36.0	37.2			
Freddie Mac:												
14. Retained portfolio:	107,706	137,826	164,543	255,670	337,432	420,329	506,383	605,489	712,419	33.4	22.7	–10.7
15. Total residential (%)	2.8	3.4	3.8	5.5	6.7	7.8	8.9	10.0	11.1			
16. Conventional/conforming & all other (%)	3.9	4.7	5.3	7.4	9.0	10.5	11.9	13.3	14.7			
17. Retained + guaranteed:	566,751	610,891	640,528	734,021	846,097	943,046	1,039,614	1,144,375	1,257,965	9.0	11.4	2.4
18. Total residential (%)	15.0	15.2	15.0	15.7	16.8	17.5	18.2	18.9	19.6			
19. Conventional/conforming & all other (%)	20.6	21.0	20.7	21.3	22.7	23.5	24.3	25.2	26.0			
Fannie + Freddie:												
20. Retained portfolio:	360,574	424,353	481,135	671,104	866,243	1,056,212	1,262,388	1,483,449	1,732,911	23.0	20.9	–2.1
21. Total residential (%)	9.5	10.6	11.2	14.3	17.2	19.6	22.1	24.5	27.0			
22. Conventional/conforming & all other (%)	13.1	14.6	15.5	19.5	23.2	26.3	29.6	32.6	35.9			
23. Retained + guaranteed:	1,332,849	1,445,591	1,536,258	1,786,598	2,054,808	2,290,255	2,524,777	2,779,196	3,055,057	10.3	11.3	1.1
24. Total residential (%)	35.2	35.9	35.9	38.2	40.8	42.5	44.2	45.9	47.6			
25. Conventional/conforming & all other (%)	48.4	49.6	49.5	51.9	55.0	57.1	59.1	61.2	63.2			
26. Conventional/conforming only (%)	67.7	69.3	69.3	73.7	78.5	81.7	85.0	88.3	91.5			

Table 3–2 displays market share data in two ways: (1) the respective mortgage portfolios of Fannie and Freddie as a percentage of the market as a whole, and (2) those mortgage portfolios plus the principal amount of the mortgage-backed securities that Fannie and Freddie have guaranteed—again, as a percentage of the market as a whole. We show those data separately for two reasons.

First, while there is no significant difference between the credit risk of guaranteeing MBSs and the risk of holding whole mortgages, there is a substantial difference in profitability. Fannie and Freddie earn considerably more from retaining mortgages in their portfolios than from receiving guarantee fees on MBSs. That is because they assume an additional risk—interest-rate risk—when they retain mortgages. Accordingly, as Fannie strives to meet Franklin Raines's forecast of 15 percent annual profitability growth, we would expect to see greater proportional growth in its mortgage portfolio than in its guarantees of MBSs.[7] That differential is reflected in our projections.

Indeed, just such a trend is visible between 1995 and 1998, when Fannie's mortgage portfolio grew by 18 percent (line 8), while its total risk (mortgages plus MBSs it had guaranteed) increased by only 11.2 percent (line 11). We believe that trend will continue and will become more pronounced from 1999 to 2003, with Fannie's portfolio of mortgages increasing by 19.7 percent on an annualized basis during that period.

We project a different trend for Freddie, which (starting at a much lower base than Fannie) grew its portfolio at the unsustainable rate of 33.4 percent annually between 1995 and 1998. Since we are assuming that for 1999 and the next 4 years Freddie will remain about two-thirds the size of Fannie, we are projecting that Freddie will reduce the rate of growth of its retained mortgage portfolio to 22.7 percent (line 14)—a rate that will still be higher than Fannie's but will bring Freddie in 2003 to a position at which its retained mortgage portfolio will be roughly 70 percent the size of Fannie's.

Second, making a distinction between mortgages retained in portfolio and mortgages guaranteed through MBSs reveals that Fannie and Freddie have only a limited range of options available to them. When Franklin Raines predicted that Fannie Mae would reach 28 percent of the total residential mortgage market in 2003 (line 12), he could have been referring to substantial growth in Fannie's issuance of MBSs, with much lower growth in the company's mortgage portfolio. However, when he forecast that Fannie would double its profitability during that period, he could only have been talking about a substantial increase in Fannie's mortgage portfolio, since only by enlarging that portfolio can a 28 percent market share be consistent with a 15 percent year-over-year rate of profit growth.

Fannie's options are further limited by the fact that the GSEs are permitted to purchase or guarantee only those mortgages with an initial principal amount that (in 2000) does not exceed $252,700. As noted above, that limitation essentially confines them to 74 percent of the total residential market, which for ease of reference we shall call the middle-class mortgage market. Accordingly, table 3–2 also shows the growth in the GSEs' risk (mortgages and MBSs) as a proportion of that market.

Those data indicate that by 2003, Fannie is likely to hold in its portfolio 21 percent of all mortgages in that segment (line 10), and it will have assumed the risk (through holding mortgages in its portfolio or guaranteeing MBSs) of 37 percent of that market (line 13). In that same year, Fannie and Freddie together will hold in their portfolios about 36 percent of all middle-class mortgages outstanding (line 22), and will bear the risk (through ownership of the underlying mortgages or guarantees of MBSs) of 63 percent of that entire market segment (line 25).

The numbers are even more dramatic if we consider only the conventional/conforming portion of the market. In that case, by the end of 1998, Fannie and Freddie had purchased and retained or guaranteed almost 74 percent of all the conventional/conforming mortgages outstanding (line 26). We project that by 2003 they will have

[7] Serious questions arise if Fannie and Freddie are now meeting their growth objectives by purchasing MBSs that are already outstanding in the market. If their purchases of MBSs are made in sufficient amounts to increase prices and decrease yields on outstanding MBSs, then Fannie and Freddie will be reducing the spread between their borrowing costs and the yield they receive on their MBS portfolios. That in itself will raise their risks. If their purchases do not substantially affect yields in the MBS market, however, it is questionable whether that activity has any salutary effect on mortgage rates for homebuyers. Unless they can show such an effect, Fannie and Freddie will be hard put to explain why that use of subsidized funds qualifies as anything more than a strategy to maintain their targeted earnings growth rate. Indeed, it seems unlikely that Fannie and Freddie's purchases will appreciably influence MBS market yields. If they reduce homebuyers' interest rates by only about 30 basis points when they transfer two-thirds of their annual subsidy directly into the mortgage markets, the indirect effect of their purchase of outstanding MBSs in the $3 trillion MBS market should be even smaller.

assumed the risk of virtually all these mortgages—91.5 percent. It is no wonder, then, that Fannie and Freddie are advertising their efforts to acquire loans in the subprime categories. They are making a virtue of necessity, since their growth requirements leave them no choice.

Thus, if Fannie remains on the growth path forecast by Franklin Raines and if Freddie keeps pace, by the end of 2003 they will hold in their portfolios more than one-third of all middle-class residential mortgages in the United States (line 22), and more than a quarter (line 21) of all residential mortgages of any kind. Moreover, if we include their guarantees of MBSs, these two companies will be bearing the credit and other risk that is associated with almost half of all the mortgages outstanding (line 24), almost two-thirds of all middle-class mortgages (line 25), and more than 91 percent of all conventional/conforming mortgages (line 26).

In chapter 4 of this study, as those percentages suggest, we show that Fannie and Freddie can meet their growth objectives in the years ahead only by purchasing the riskier loans in the subprime, home equity, and multifamily categories. There will simply not be a sufficient amount of the higher quality, conventional/conforming mortgages to meet their needs. So in addition to assuming a greater degree of risk simply through their growth over the next 4 years, the GSEs will also be increasing their overall risk by going more deeply into the lower-quality sectors of the market that until now have been served satisfactorily by non-subsidized lenders. We explore the nature and possible consequences of the GSEs' growing risk profiles in chapter 6 of this study.

Also, as the GSEs move into the lower-quality market sectors they have previously shunned, they will reduce the portfolio assets, revenues, and profits of thousands of mortgage lenders now active in that market. Although some might think that mortgage lenders will have a choice whether to sell the mortgages they originate to Fannie and Freddie, that is not really the case. Because the GSEs can offer lower government supported rates for the mortgages they are willing to buy, no lender can offer a competitive rate against another lender who is willing to sell the resulting loan to Fannie or Freddie. Their lower rates also permit Fannie and Freddie to skim the cream from the mortgage markets, leaving other lenders with riskier loans to weaker borrowers. That problem will become more severe as Fannie and Freddie drive deeper into the subprime market.

In other words, if Fannie and Freddie are permitted to continue their growth, even if they don't move outside the secondary mortgage market itself, they will gradually strangle the other participants in the mortgage markets. Those markets will become more concentrated and less diverse than any other financial market in the United States and, increasingly, an obligation of the Federal Government rather than of the private sector. The impact on competition of Fannie and Freddie's growth is discussed in detail in chapter 5 of this study.

4. GROWTH

Table 4–1 presents data on the year-to-year growth in the mortgage assets of Fannie Mae and Freddie Mac since 1995. The information for the years 1995 through 1998 is taken from their financial statements; the projections for the years 1999 through 2003 are derived from the assumptions that were used in chapter 3 to project their asset totals for those years.

The data show Fannie and Freddie's growth as a percentage of the growth of: (1) the entire residential mortgage market (line 29); (2) the conventional/conforming portion of the market (line 32); and (3) the conventional/conforming plus "all other" portion of the market (line 35).

By presenting the information in that way, we are able to show that, as Fannie and Freddie grow in the year ahead, they will have to drive deeper and deeper into the subprime loan categories in order to find the assets their growth requires. Clearly, Fannie and Freddie cannot continue to grow indefinitely by purchasing and guaranteeing conventional/conforming mortgages. If the conventional/conforming loan market grows at the same rate as the market as a whole in each of the next 4 years, conventional/conforming mortgages outstanding will increase by $720 billion. But to maintain their projected growth rates, Fannie and Freddie will have to increase their mortgage investments and guarantees by $1 trillion. At the end of 1998, they had retained in their portfolios or guaranteed 74 percent of those loans, and we project that by 2003 they will have retained or guaranteed almost 92 percent.

Thus, beginning in 1998, Fannie and Freddie together, to meet their combined growth goals, were required to add new assets at a rate that exceeded the growth in conventional/conforming mortgages that year. Line 30 of table 4–1 shows that in 1998, the total amount of conventional/conforming mortgage debt outstanding increased by $207 billion. But in that same year, Fannie and Freddie together added

$250 billion in new mortgage assets and guarantees to their balance sheets, so that their increase in mortgage credit risk was 121 percent of the net increase in the conventional/conforming market (line 32). By 2003, Fannie and Freddie's need for new assets will equal 146 percent of all net new conventional/conforming loans.

Accordingly, unless they can break into the jumbo market through a change in law, or out-compete Ginnie Mae for a substantial share of the FHA-VA market, the only recourse for Fannie and Freddie is the subprime market.

However, the subprime market, as its name implies, involves considerably greater credit risk than does the conventional/conforming market. By entering that market, Fannie and Freddie will be taking on more risk than they have in the past—risk that may be only partially compensated by the higher interest rates and guarantee fees those mortgages generally yield. We cover that issue more fully in chapter 6.

TABLE 4–1.—GROWTH IN RESIDENTIAL MORTGAGES: FANNIE MAE AND FREDDIE MAC VERSUS THE MORTGAGE TOTALS, PAST, PRESENT, AND PROJECTED, 1995–2003

[Dollars, in millions]

	History (year-end)				Projection (year-end)					Annual growth rate: 1995–1998 (%)	Annual growth rate: 1998–2003 (%)	Growth rate difference
	1995	1996	1997	1998	1999	2000	2001	2002	2003			
27. Annual growth in residential mortgage market—total	227,070	251,517	397,925	373,059	352,541	323,330	342,730	363,294	32.4	–1.8	–34.2	
28. Growth in GSE portion	112,742	90,667	250,340	268,210	235,447	234,522	254,420	275,861	49.0	2.0	–47.1	
29. GSE portion of total (%)	49.7	36.0	62.9	71.9	66.8	72.5	74.2	75.9				
30. Growth in conventional/conforming—total	118,076	130,789	206,921	193,991	183,321	168,132	178,220	188,913	32.4	–1.8	–34.2	
31. Growth in GSE portion	112,742	90,667	250,340	268,210	235,447	234,522	254,420	275,861	49.0	2.0	–47.1	
32. GSE portion of total (%)	95.5	69.3	121.0	138.3	128.4	139.5	142.8	146.0				
33. Growth in conventional/conforming & all other mortgages—total	161,945	186,473	338,882	295,077	279,580	256,987	272,915	289,814	44.7	–3.1	–47.7	
34. Growth in GSE portion	112,742	90,667	250,340	276,079	236,348	235,420	255,394	276,917	49.0	2.0	–47.0	
35. GSE portion of total (%)	69.6	48.6	73.9	93.6	84.5	91.6	93.6	95.5				
36. Nominal GDP—4th quarter	7,529,300	7,981,400	8,453,000	8,947,600	9,394,980	9,864,729	10,357,965	10,875,864	11,419,657	5.9	5.0	–0.9
37. GDP annual growth rate (%)	6.0	5.9	5.9	5.0	5.0	5.0	5.0	5.0				
38. Assumed growth rate after 1998 (%)	5.0											
39. Total mortgages outstanding/GDP (%)	50.3	50.3	50.5	52.1	53.6	54.6	55.1	55.7	56.2			
40. Change in mortgage/GDP ratio (%)	0.6	0.0	0.2	1.7	1.5	1.0	0.5	0.5	0.5			

5. THREAT TO PRIVATE-SECTOR COMPETITORS

Since Fannie and Freddie are growing faster than the mortgage market itself, their growth comes from taking market share, revenue, and profits from genuinely private-sector mortgage lenders. As shown earlier, to maintain the rate of profit growth on which their stock price depends, Fannie and Freddie must encroach further and further on the private sector. Although they had previously concentrated on the best and most creditworthy loans within the conventional/conforming sector—leaving to the banks, S&Ls, and other non-subsidized lenders the subprime, home equity, and multifamily loans that represent greater default risks—they are now compelled to wade into that market and begin to take market share from the companies that are already there.

The figures in table 3–2 illustrate quite well the problem that confronts Fannie and Freddie's private sector competitors. As shown by line 22, the GSEs' share of all residential mortgages (conventional/conforming and "all other") will grow from 19.5 percent at the end of 1998 to almost 36 percent at the end of 2003. That increase of 16.4 percentage points would equal approximately $800 billion, or 12.4 percent of the aggregate principal amount of all mortgages outstanding at the end of 2003. In other words, in 4 years, $800 billion in principal amount of mortgages—which would otherwise be in the portfolios of private-sector lenders now operating in those markets—will instead be in the portfolios of Fannie and Freddie. That will substantially reduce the mortgage supply for the lenders now in the market, and will force many of them to leave the mortgage lending business entirely.

In effect, the growth of Fannie and Freddie is leading to a steady nationalization of the residential mortgage markets in the United States, without any debate—or even apparent awareness—by Congress.

As shown by lines 29, 32, and 35 of table 4–1, Fannie and Freddie must take most of the growth in mortgages outstanding if they are to meet their market share, revenue, and earnings growth objectives. Since they cannot meet their needs for product solely out of the conventional/conforming mortgages that will come to market between 1999 and 2003, they must look elsewhere for product.

One easy target would be the jumbo market, which will become available if Congress can be induced to eliminate the ceiling on conventional/conforming mortgages. Opening the door for Fannie and Freddie to enter the jumbo mortgage market would, by 2003, give them access to almost $1 trillion of mortgages that are now off-limits.

Other mortgage markets beckon to Fannie and Freddie, including those to be accessed by dipping deeper into the subprime loan pool and assuming the higher credit risks associated with those loans; by expanding more aggressively into the financing of multifamily housing designed for renters, not homeowners; and by acquiring home equity loans in addition to first mortgages. But those can be merely stopgaps. Our projections extend only through 2003; if the growth of Fannie and Freddie continues beyond that year at the rate Frank Raines has forecast, they will at some point acquire all the available residential mortgage product in the United States. As the practical limits of the residential mortgage market are reached, one can easily envision Fannie and Freddie arguing that they should extend their skills and cost advantages into the commercial mortgage market. After all, many office building and shopping center owners would welcome the taxpayer subsidy Fannie and Freddie can deliver.

Fannie and Freddie's other opportunity for growth outside the residential mortgage market is to provide financial services generally, especially consumer credit services. Home equity loans, for example, provide a ready entry into consumer financial services. Once the GSEs hold a home equity loan, they have the opportunity to use it as a revolving loan fund with which Fannie and Freddie would be able to supply credit directly to the homeowner/borrower. Although in one sense that might be considered loan origination, such a determination would have to be made by the Department of Housing and Urban Development (HUD)—which in the past has shown little appetite for challenging Fannie and Freddie's expansion. If in fact that activity goes unchallenged by HUD, the GSEs could become very large sources of consumer credit, and through their implicit government subsidy they would be able to offer consumers better rates than banks and other consumer lenders.

Perhaps the greatest competitive threat, however, remains in the mortgage origination process. Although Fannie and Freddie vigorously deny that they have any intention to originate mortgages, pointing out that they lack the statutory authority to do so, what exactly constitutes origination of a mortgage is a matter of interpretation. If Fannie and Freddie were to open their automated underwriting facilities to direct borrower access over the Internet, it might be possible for them to provide the prospective homebuyer with a certification that his or her mortgage would qualify for purchase by Fannie or Freddie. At that point, the actual lender would have little to do except to perform the ministerial acts necessary to fund the loan and deliver it to one or another of the GSEs. The compensation for that role would, of course, be small.

In a November 1999 speech to securities analysts, Leland Brendsel, the chairman of Freddie Mac, referred in rather vague terms to major changes in the offing for the mortgage market:

I can safely predict that within a few short years, the mortgage industry will change dramatically. When the dust settles in the mortgage market, we will be left with an industry structure where investor funds flow to consumers with little drag from antiquated, inefficient processes. Consumers will be able to tap global capital markets at even lower cost than they can today.

And later in the same statement he was even more explicit. Citing the potential of technology "to streamline the entire mortgage process and eliminate inefficiency in the housing finance system," he continued:

Freddie Mac has brought tremendous efficiency to the mortgage market, but the industry still generates significant costs from redundant operations and expensive transfer of information through all the steps in the mortgage process. As technology wrings out remaining inefficiencies, Freddie Mac's role will be enhanced, as we deliver low-cost funds to consumers even faster and more effectively.

There can be little doubt that Mr. Brendsel was describing a mortgage industry in which, through technology, Freddie Mac would be dealing directly with borrowers and perhaps with consumers generally.

6. RISKS

It is impossible to understand the risks that Fannie and Freddie create for the government and taxpayers without understanding their similarities to the S&Ls that collapsed at the end of the 1980's. Like the S&Ls,

- their principal investments are home mortgages, long-term assets that can abruptly become short-term assets when a home is sold or refinanced;
- they can borrow at government-assisted rates that do not substantially increase as they take on more risk;
- they are unable to manage risk through asset diversification because virtually all their assets are home mortgages.

But Fannie and Freddie are like 1980's S&Ls in another significant way. Scholars reviewing the S&L collapse have shown that it came about in substantial part because the industry was seeking high profits in order to recover the capital depleted by losses during the high-interest-rate period at the beginning of the 1980's. To achieve that profitability, through a process ultimately called "gambling for resurrection," the S&Ls reached for greater and greater risk. Although the debt market usually requires much higher interest rates from companies that are taking on increased risk—if those companies can access the debt market at all—that was not true for the S&Ls. Because their deposits were backed by the government, weak and failing S&Ls were able to raise the necessary funds to keep on gambling—ultimately causing immense losses to the government and the taxpayers.

Of course, Fannie and Freddie are not weak companies, and they have no need to take risks to restore their capital. But they have strong—indeed, compelling—reasons to continue increasing their profitability. That circumstance creates the same incentives to take on risk that the managements of weak S&Ls confronted fifteen years ago.

The incentives are clear. Fannie and Freddie are public companies; their shares are listed on the New York Stock Exchange and are closely monitored by the investment community. The value that investors place on their stock at any given moment is not only a vote on their earnings growth prospects and the quality of their management, but also directly affects management's compensation. Like the managements of most large, publicly held companies, the managements of Fannie and Freddie are compensated in part through stock options, which in turn acquire increasing value only if the price of their stock increases.

That creates a strong incentive for the managements of the GSEs, like those of conventional private firms, to increase their profits and to impress investors with their potential for profit growth. For example, at the Merrill Lynch investor conference in September 1999, Fannie Mae chairman Franklin Raines projected that Fannie Mae would achieve annual earnings growth of 15 percent in 1999 and over the next 4 years. But profit growth at that rate is highly unusual. Fannie already boasts that it is one of only eight companies in the S&P 500 that can claim to have had a double-digit rate of earnings growth for twelve straight years. Continuing that growth in profitability—and indeed increasing it—would be extraordinary for any company in today's low-inflation environment.

We can only speculate why Mr. Raines would place such a burden on himself and his management. Possibly it is because he wants to be seen as a highly capable manager, or he feels an obligation to match the success of his predecessors. However, the fact that his compensation and that of the top managers at Fannie Mae are tied to increases in Fannie's stock price also provides a substantial incentive to impress the financial markets.

Once we look at Fannie and Freddie as gigantic S&Ls that are seeking an almost unprecedented rate of profitability growth, we can begin to see why they create risks for the government and the taxpayers that parallel the risks created by the S&Ls in the 1980's. Because of their government backing, they are essentially exempt from debt market discipline—just like the insured S&Ls of the 1980's.

The incentives may be different, but the objectives are the same—to increase profitability by issuing debt at a government-backed rate, while achieving higher profitability through taking on greater risk. In the 1980's, S&Ls tried to do that to replenish their capital; Fannie and Freddie are doing it to maintain the profit growth that sustains a growing market valuation of their stock.

To be sure, Congress has attempted to address the question of GSE risk, using the familiar device of a regulatory agency. In 1991, Congress established the Office of Federal Housing Enterprise Oversight (OFHEO), a regulatory agency charged with supervising the GSEs the way banking regulators supervise banks and S&Ls. Given the experience of the 1980's—not only with the S&Ls but with banks themselves—we should be skeptical about the effectiveness of regulators in controlling the risks of the companies they regulate.

For one thing, there is always the question of asymmetric information—the regulated company knows more than its supervisor about the risks it is taking on. For another, as demonstrated in the case of the S&L industry, the regulated companies frequently have more power to influence Congress than has the regulatory agency, and they are frequently successful in limiting the agency's resources. It is useful to recall that Congress repeatedly supported the S&L industry's efforts to avoid regulatory restriction on its activities. As it happens, in the case of OFHEO, that phenomenon was clearly demonstrated in 1999, when a Senate committee initially capped OFHEO's appropriation at the previous year's $16 million level—despite an administration request for a 20 percent increase. Although an increase to $19 million was ultimately voted, the special effort that was required sent a signal to OFHEO about how much congressional support it will receive if it seriously attempts to control Fannie and Freddie's behavior.

Even without those negative signals, there are good reasons to believe that OFHEO will not act to reduce the GSEs' risk-taking. For example, if Fannie or Freddie's capital ratios slipped too low, OFHEO could direct the troubled GSE to reduce its assets as part of a plan to strengthen its capital position. Shrinkage, however, implies that the GSE in question would sharply reduce its buying and guaranteeing of mortgages. It might even be required to sell assets. That would improve its capital ratios, but the cutback and asset sales could force an increase in mortgage interest rates and a sudden, sharp reduction in housing construction, with secondary effects throughout the economy.

The possibility that there might be severe macro-economic consequences as a result of an OFHEO regulatory action should raise both systemic—risk concerns about OFHEO's new capital regulations and doubts about the likelihood that they will ever be effectively applied. If OFHEO's capital regulations are believed to threaten severe macroeconomic consequences—and certainly Fannie and Freddie will not be shy about pointing that out—it is easily foreseeable that Congress will act to prevent the enforcement of the regulations. That example, not at all far-fetched, suggests how difficult it will be for OFHEO to be an effective source of discipline over Fannie and Freddie. And without OFHEO, there is effectively no means of controlling their risk-taking.

Nevertheless, OFHEO has proposed a regulation intended to control the riskiness of Fannie and Freddie—including a risk-based capital requirement that imposes capital penalties when risks are not adequately hedged. Undoubtedly, Fannie and Freddie will cite those regulations as a basis for quelling congressional concerns. The question, however, is whether it is reasonable to believe that Fannie and Freddie can achieve the extraordinary rates of growth they are projecting while keeping their risks within tolerable levels. If they do so, they will be unusual companies indeed.

The GSEs' sagging stock prices demonstrate that Wall Street is skeptical on that score. As shown on lines 52 and 55 of table 6–1, both GSEs have experienced a significant decline, per dollar of portfolio investment, since 1995. We project that that trend will continue through 2003. On January 12, 2000, Fannie's common stock closed 20 percent below its twelve-month high, while Freddie closed down a more troubling 28 percent for the same period. That development seems to be puzzling to Fannie Mae chairman Raines, who asked at the Merrill Lynch conference, "So why does the market trade Fannie Mae at a discount to the other companies with similar growth rates?"

There are two possible reasons.

First, some investors may have recognized that Fannie and Freddie are simply running out of room to grow by purchasing the high-quality conventional/conforming mortgages that have been their traditional assets, and that the cost of hedging the risks of lower-quality product may reduce their profitability.

Second, and more ominously, Fannie and Freddie's lagging stock prices may reflect a growing concern in the equity markets that the GSEs are not adequately hedging their risks, so that their future earnings may be hit by losses on the riskier mortgages they are purchasing or guaranteeing today.

In addition to their inherent lack of diversification, Fannie and Freddie face a number of other risks as guarantors of MBSs and as holders of large portfolios of mortgages and MBSs. Those risks include credit risk, interest-rate risk, counterparty risk, and spread-compression risk, all of which are discussed more fully below. As we will show, each of those risks can be reduced or hedged, but doing so is costly and will inevitably reduce Fannie and Freddie's profitability. To compensate for those costs—while trying to maintain and surpass their past levels of profitability—they must take on still more risk, always keeping one step ahead of their regulator.

Credit Risk. In common with all housing lenders, the GSEs have enjoyed a substantial decline in their credit losses in recent years. Fannie's pre-tax losses, per mortgage dollar owned or guaranteed, dropped from 5.3 basis points in 1996 to 2.9 basis points in 1998 (table 6–2, line 59); Freddie's pre-tax credit losses dropped from 10.5 basis points in 1996 to 5.1 basis points in 1998 (line 65).

But the housing market is historically volatile, and it regularly passes through boom and bust periods related to national economic conditions, interest rates, and other factors. Completely exogenous factors—an example might be a change in the tax system that alters the deductibility of mortgage interest in a significant way—could have seriously adverse effects, for which the participants have no effective way to prepare. It is important to keep in mind that Fannie and Freddie will be more exposed to the risks of the housing market than any lenders in history, since their already unprecedented market shares will—as discussed earlier in this study—grow even larger in the future.

TABLE 6–1.—FANNIE MAE AND FREDDIE MAC NET INCOME BY LINE OF BUSINESS, PAST, PRESENT, AND PROJECTED, 1995–2003

[Dollars, in millions]

	History (year-end)				Projection (year-end)					Annual growth rate: 1995–1998 (%)	Annual growth rate: 1998–2003 (%)	Growth rate difference
	1995	1996	1997	1998	1999	2000	2001	2002	2003			
Net income by line of business (basis points):												
Fannie Mae:												
41. Portfolio investment	1,369	1,694	1,894	1,878	2,219	2,621	2,988	3,346	3,702	11.1	14.5	3.4
42. Credit guarantee	1,003	1,031	1,162	1,540	1,583	1,661	1,770	1,872	1,973	15.4	5.1	–10.3
43. Total	2,372	2,725	3,056	3,418	3,802	4,282	4,758	5,218	5,675	12.9	10.7	–2.3
44. Federal tax rate (%)	28.0	29.5	29.3	25.9								
Freddie Mac:												
45. Portfolio investment	N.A.	785	892	1,021	1,305	1,591	1,857	2,116	2,372	14.0	18.4	4.3
46. Credit guarantee	N.A.	458	503	679	751	760	793	819	841	21.8	4.4	–17.4
47. Total	1,091	1,243	1,395	1,700	2,055	2,352	2,650	2,935	3,213	15.9	13.6	–2.4
48. Federal tax rate (%)	31.2	30.0	29.0	27.8								
Fannie + Freddie:												
49. Portfolio investment	N.A.	2,479	2,786	2,899	3,524	4,212	4,846	5,462	6,074	8.1	15.9	7.8
50. Credit guarantee	N.A.	1,489	1,665	2,219	2,333	2,422	2,563	2,691	2,814	22.1	4.9	–17.2
51. Total	3,463	3,968	4,451	5,118	5,857	6,634	7,409	8,153	8,888	13.9	11.7	–2.2
Net income per $ of business (basis points):												
Fannie Mae:												
52. Portfolio investment		62.8	62.8	51.3	47.0	45.0	43.0	41.0	39.0			
53. Credit guarantee [1]		13.3	14.0	16.9	14.0	13.0	12.5	12.0	11.5			
54. Total	34.0	35.3	35.1	33.6	33.5	33.6	33.4	33.1				
Freddie Mac:												
55. Portfolio investment		63.9	59.0	48.6	44.0	42.0	40.0	38.0	36.0			
56. Credit guarantee [1]		7.9	8.2	10.2	9.5	8.5	8.0	7.5	7.0			
57. Total		21.1	22.3	24.7	26.0	26.3	26.7	26.9	26.7			

[1] Assumes no credit risk on GSE/government-guaranteed debt held in portfolio.
N.A. = Not available.

Obviously, credit risk is closely related to conditions in the general economy. In recent years, a sustained economic expansion, soon to be the longest in U.S. history, has brought unemployment to record lows while boosting incomes. Both of those factors have led to a steady rise in housing prices. Rising prices in turn have given homeowners more equity in their homes, which protects mortgage lenders and guarantors, notably Fannie and Freddie. However, an economic down-turn could depress housing prices while causing a jump in mortgage delinquencies as the unemployment rate rises. Mortgage foreclosures would increase, substantially raising Fannie and Freddie's credit losses.

As Fannie and Freddie are also diving deeper into the pool of subprime mortgages, they will be in largely uncharted waters. Although Fannie and Freddie claim that technology has greatly increased their loan-underwriting capabilities, thereby lowering their risks in sub-prime lending, that assertion has not been tested by a recession. Further, because of lower down payments from more financially challenged borrowers on properties that may not hold their values well during an economic downturn, losses on subprime lending could be much higher than on higher-quality loans.

Unlike their deep knowledge of and databases on conventional/conforming loans, the GSEs' relative inexperience with the subprime market makes their judgments concerning the risks they are assuming much less sure. Thus, Fannie and Freddie face not only higher likely losses in subprime loans per dollar lent or guaranteed but also greater uncertainty as to how high those losses will be. To cover their risks in those cases, Fannie and Freddie have in the past relied in part on private mortgage insurance, but recently they have been exploring various devices that would enable them to assume more of the mortgage insurer's risk and thus keep more of the profit for themselves. That is consistent with their desire to increase their profits, but obviously it will also increase their risks of loss in the event of a market turndown.

TABLE 6–2.—CREDIT–RELATED EXPENSES FOR FANNIE MAE AND FREDDIE MAC, 1995–1998

	History (year-end)			
	1995	1996	1997	1998
Fannie Mae:				
58. Pre-tax credit-related expenses ($, in millions)		409	375	261
59. Pre-tax credit cost (B.P.)		5.3	4.5	2.9
60. Credit guaranty tax rate (%)		31.4	31.1	24.3
61. After-tax credit cost ($, in millions)		281	258	198
62. After-tax credit cost (B.P.)		3.6	3.1	2.2
63. Credit income before credit expense (B.P.)		16.9	17.1	19.1
Freddie Mac:				
64. Pre-tax credit-related expenses ($, in millions)		608	529	342
65. Pre-tax credit cost (B.P.)		10.5	8.6	5.1
66. Credit guaranty tax rate (%)		28.2	28.4	28.2
67. After-tax credit cost ($, in millions)		437	379	246
68. After-tax credit cost (B.P.)		7.5	6.2	3.7
69. Credit income before credit expense (B.P.)		15.4	14.4	13.9
70. Difference: line 63 1 line 69 (B.P.)		1.5	2.7	5.2
Fannie Mae ($, in millions)	22,200	29,200	43,200	83,600
% of total portfolio	8.8	10.2	13.6	20.1
Freddie Mac ($, in millions)	7,665	10,056	12,567	29,817
% of total portfolio	7.1	7.3	7.6	11.7

B.P. = Basis points. 1 B.P. = .01%.
Memoranda data—government/GSE securities in portfolio. They presumably have no credit risk.

Finally, Fannie is seeking substantial loan growth in the multifamily housing market, specifically to meet affordable housing goals. Multifamily mortgages can be much riskier than those for owner-occupied, single-family homes, as Freddie learned to its regret a few years ago, because tenant income is more vulnerable to economic downturns and rental property deterioration can be more severe than owner-occupied housing.

Credit-guarantee fees, per dollar of risk assumed, declined during 1999 for both Fannie and Freddie, reflecting lower credit costs as well as increased competition between them for the business of large mortgage originators. A decline in fees is probably only the visible portion of the competition between the GSEs for that business. It is likely that they are also placing their guarantees on MBSs that are backed by somewhat riskier pools of mortgages, for which they are also attempting to assume more of the risk previously taken by mortgage insurers. A sharp and largely unpredictable upswing in credit losses a few years hence could therefore result in substantial losses in their guarantee business.

Interest-Rate Risk. Fannie and Freddie's potential interest-rate risk is growing rapidly as they grow their mortgage portfolios. Those portfolios consist of both whole mortgages and MBSs. In just twenty-one months, from the end of 1997 to September 30, 1999, Fannie increased its mortgage investments by 59 percent, or $188 billion; Freddie's increase was 91 percent, or $150 billion.

Like the S&Ls before them, Fannie and Freddie are heavily dependent on short-term funding to finance the long-term, fixed-rate mortgages they own. That is the classic borrow-short-to-lend-long strategy that S&Ls pursued, with disastrous consequences, when interest rates skyrocketed in the early 1980's. On September 30, 1999, 41 percent of Fannie's debt matured within 1 year. Freddie was worse off on that date, with 51 percent of its debt due within 1 year. The two GSEs have tried to lessen their maturity mismatching through various devices, such as callable debt and interest-rate hedging. But such devices are costly, as discussed below, and their extensive use will reduce the GSEs' profitability.

Theoretically, Fannie and Freddie can minimize their interest-rate risk in two ways. First, they can "match fund" their mortgage portfolios. That is, they can sell debt that matches the maturity of their mortgage investments. Maturity matching is complicated, though, by mortgage prepayments, which are not as predictable as risk managers would like. Because the ease and cost of mortgage refinancing have come down in recent years, mortgage prepayments accelerate dramatically whenever longer-term interest rates decline even moderately.

Prepayments create a maturity mismatch because longer-term funding now exceeds longer-term assets. To some extent, Fannie and Freddie can neutralize maturity mismatching by issuing debt that can be called, or repaid, before maturity. But callable debt carries a higher interest rate than non-callable debt, so Fannie and Freddie pay a price for that form of interest-rate risk protection.

The reverse form of interest-rate risk occurs when interest rates rise. In that case, there is likely to be a sharp slowdown in home sales and mortgage refinancing, so that low-rate mortgages remain on the GSEs' books longer than anticipated and have to be supported with higher-rate liabilities. That can result in substantial losses or profit reduction and is exactly what happened to the S&L industry when interest rates spiked in the late 1970's and early 1980's.

Second, Fannie and Freddie have reduced their exposure to higher rates through the use of various financial derivatives, largely interest-rate swaps. That is, for a fee, the two GSEs shift some of their interest-rate risk to third parties. That practice enables them to increase their reliance on cheaper short-term funding. But derivatives can be costly, particularly when interest-rate volatility causes significant changes in the shape of the interest-rate yield curve.

Counterparty Risk. Hedging interest-rate risk through derivatives raises a separate risk—counterparty risk, which is essentially a form of credit risk. That is, will the counterparty be able to pay when called on to do so under a swap agreement or other form of derivative contract? Counterparty-risk assessment is not a simple process, though, particularly when the counterparty is another financial institution that has entered into many other financial contracts.

The increasing challenge Fannie and Freddie face as they grow larger is finding sufficient counterparty capacity among highly rated potential counterparties: that is, firms with AAA or AA credit ratings. At the end of 1998, 32 percent of Fannie's counterparty risk was with entities rated less than AA; 7 percent of its counterparty risk was with entities rated less than A. Freddie is less forthcoming about its counterparty risk, merely stating that at the end of 1998, its five largest counterparties, which accounted for 60 percent of its total counterparty exposure, were rated at least A+. Consequently, as Fannie and Freddie's risk-hedging needs grow, they may have to pay steadily higher fees for a given amount of protection while relying increasingly on less creditworthy counterparties.

Spread-Compression Risk. In terms of their desire to maintain their profitability, the most serious risk the two GSEs now confront is spread compression: that is, a narrowing of their interest margins. Spread compression has become quite evident at both companies, as reflected in the net income they earn on their portfolio investments per dollar of investment. In 1996, Fannie's net income (excluding the cost of credit risk) per dollar of portfolio investment was 62.8 basis points (table 6–1, line 52); for the first half of 1999, that profit margin had declined to 49.3 basis points. Freddie has experienced a similar reduction—its net income, per dollar of portfolio investment, declined from 63.9 basis points in 1996 (table 6–1, line 55) to 46.6 basis points during the first half of 1999. During the third quarter of 1999, Freddie's interest margin declined seven points from the second quarter, which suggests that its net income per dollar of portfolio investment declined again.

Spread compression is occurring for two reasons. First, as Fannie and Freddie continue to grow, their sheer size and the demands they impose on the financial markets will force up their cost of obtaining credit and interest-rate protection, per dollar of protection obtained. Second, Fannie and Freddie's purchases of mortgages and MBSs will drive up mortgage prices, thereby reducing mortgage yields, as their mortgage portfolio growth reaches and then exceeds the growth in those portions of the mortgage market where they can lawfully participate. That spread compression will negatively affect Fannie and Freddie's earnings growth and return on equity capital. For Fannie, those data will be found in table 6–1, line 43, and table 6–3, line 85; the comparable data for Freddie are in table 6–1, line 47, and table 6–3, line 100. Lower mortgage and MBS yields in the face of rising risk-protection costs will squeeze Fannie and Freddie's net interest margins. Unless they can trim their operating costs to fully offset that squeeze, which is unlikely, they will experience even less net income per dollar of portfolio investment. That decline will lower their return on equity capital and slow their earnings growth. In the face of that inevitable spread compression, Fannie and Freddie's managements will understandably be tempted to take greater risks—specifically, greater credit risk and increased interest-rate risk.

TABLE 6–3.—FANNIE MAE AND FREDDIE MAC CAPITAL REQUIREMENTS, PAST, PRESENT, AND PROJECTED, 1995–2003

[Dollars, in millions]

	History (year-end)				Projection (year-end)					Annual growth rate: 1995–1998 (%)	Annual growth rate: 1998–2003 (%)	Growth rate difference
	1995	1996	1997	1998	1999	2000	2001	2002	2003			
Fannie Mae:												
71. Core capital (OFHEO-defined)	10,959	12,773	13,793	15,465	18,668	22,109	25,811	29,456	33,602	12.2	16.8	4.6
72. Required minimum capital	10,451	11,466	12,703	15,334	18,168	21,359	24,811	28,456	32,602	13.6	16.3	2.7
73. Core-required minimum	508	1,307	1,090	131	500	750	1,000	1,000	1,000			
74. Mortgage portfolio (net)	252,588	286,259	316,316	415,223	528,811	635,882	754,006	877,960	1,020,492	18.0	19.7	1.7
75. Other assets	63,962	64,782	75,357	69,791	61,007	73,360	86,987	101,287	117,730	2.9	11.0	8.1
76. Total assets on B/S	316,550	351,041	391,673	485,014	589,818	709,242	840,993	979,247	1,138,222	15.3	18.6	3.3
77. Other assets/total assets (%)	20.2	18.5	19.2	14.4	10.3	10.3	10.3	10.3	10.3			
78. Calculated minimum capital: Assets on B/S (2.5%)	7,914	8,776	9,792	12,125	14,745	17,731	21,025	24,481	28,456	15.3	18.6	3.3
79. MBS, other off-B/S (.45%)	2,310	2,467	2,606	2,867	3,060	3,201	3,290	3,406	3,495	7.5	4.0	–3.4
80. Other capital requirement	228	223	305	342	363	427	496	569	652	14.5	13.8	–0.7
81. Other/total capital required (%)	2.2	1.9	2.4	2.2	2.0	2.0	2.0	2.0	2.0			
82. After-tax income for dividends, stock buybacks, other		911	2,036	1,746	599	841	1,056	1,573	1,529			
83. Net income (%)		33.4	66.6	51.1	15.7	19.6	22.2	30.1	26.9			
84. Dividend payout rate (%) [1]		31.5	30.9	30.9								
85. After-tax return on core capital, before preferred dividends (%)		23.0	23.0	23.4	22.3	21.0	19.9	18.9	18.0			
Freddie Mac:												
86. Core capital (OFHEO-defined)	5,829	6,743	7,376	10,715	12,229	14,728	17,248	20,019	23,062	22.5	16.6	–5.9
87. Required minimum capital	5,584	6,517	7,082	10,333	11,829	14,228	16,748	19,519	22,562	22.8	16.9	–5.9
88. Core-required minimum	245	226	294	382	400	500	500	500	500			
89. Mortgage portfolio (net)	107,424	137,520	164,250	255,348	337,432	420,329	508,383	605,489	712,419	33.5	22.8	–10.7
90. Other assets	29,757	36,346	30,347	66,073	37,492	46,703	56,487	67,277	79,158	30.5	3.7	–26.8
91. Total assets on B/S	137,181	173,866	194,597	321,421	374,924	467,632	564,870	672,766	791,577	32.8	19.8	–13.1
92. Other assets/total assets (%)	21.7	20.9	15.6	20.6	10.0	10.0	10.0	10.0	10.0			
93. Calculated minimum capital: Assets on B/S (2.5%)	3,430	4,347	4,865	8,036	9,373	11,676	14,122	16,819	19,789	32.8	19.8	–13.1
94. MBS, other off-B/S (.45%)	2,066	2,129	2,142	2,153	2,289	2,352	2,391	2,425	2,455	1.4	2.7	1.3
95. Other capital requirement	89	42	75	145	167	200	236	275	318	17.7	17.0	–0.7

96. Other/total capital required (%)	1.6	0.6	1.1	1.4	2.0	2.0	2.0	2.0	2.0
97. A-T income for dividends, stock buy-backs, other		329	762	(1,639)	542	(148)	131	164	170
98. Net income (%)		26.5	54.6	196.4	26.4	16.3	4.9	5.6	5.3
99. Dividend payout rate (%) [1]		26.0	26.5	26.3					
100. After-tax return on core capital, before preferred dividends (%)		19.8	19.8	18.8	17.9	17.4	16.6	15.8	14.9

[1] Common + preferred dividends as a percentage of net income.
B/S = balance sheet.

That temptation is troubling, given their extremely thin capital cushions. Under existing regulations, Fannie and Freddie must have, at a minimum, equity capital (common stock, permanent preferred stock, paid-in capital, and retained earnings) equal to 2.5 percent of on-balance-sheet assets plus .45 percent of outstanding MBS and other off-balance-sheet obligations. The on-balance-sheet capital ratio is one-half the leverage capital ratio equired for commercial banks considered to be well capitalized for regulatory purposes. Worse, as is clear from table 6–3, lines 73 and 88, Fannie and Freddie operate much closer to their minimum capital ratio requirement than is generally true for well-capitalized banks, which generally have risk-based capital of 10 percent. Therefore, increased risk-taking, which might not be immediately evident to regulators and stock market analysts, could set up either company—or both—for serious financial difficulties.

Systemic Risk. As Fannie and Freddie continue to grow, they will pose increased systemic risk to the U.S. financial markets. They had $866 billion of debt outstanding as of September 30, 1999. By the end of 2003, that amount will increase by almost $1 trillion, rising to $1.8 trillion (table 6–4, line 105). At that point, or shortly thereafter, the combined debt of the two GSEs may exceed the Treasury debt held by the general public—if budget surpluses continue to shrink the amount of Treasury debt outstanding.

Recently, Fannie and Freddie have been attempting to emphasize the similarity of their debt to Treasury securities, by mimicking Treasury's frequent, regular issuances of new debt. Indeed, at one point Fannie Mae's website contained the statement that its debt securities "will often provide investors with a spread pickup to the Treasury structure." In other words, investors can receive substantially the same security as Treasury debt with an interest-rate premium. If those marketing efforts are successful, actual losses at either of the GSEs—or a perception in the markets of a sudden increase in their riskiness—could result in a serious systemic problem for the economy as a whole.

TABLE 6–4.—FANNIE MAE AND FREDDIE MAC INTEREST-BEARING DEBT OUTSTANDING, PAST, PRESENT, AND PROJECTED, 1995–2003

[Dollars, in millions]

	History (year-end)				Projection (year-end)					Annual growth rate: 1995–1998 (%)	Annual growth rate: 1998–2003 (%)	Growth rate difference
	1995	1996	1997	1998	1999	2000	2001	2002	2003			
Fannie Mae:												
101 Interest-bearing debt O/S	299,174	331,270	369,774	460,291	560,327	673,780	798,943	930,285	1,081,311	15.4	18.6	3.2
102 O/S debt as percentage of total assets	94.5	94.4	94.4	94.9	95.0	95.0	95.0	95.0	95.0			
Freddie Mac:												
103 Interest-bearing debt O/S	119,328	156,491	172,321	287,234	337,432	420,329	508,383	605,489	712,419	34.0	19.9	–14.1
104 O/S debt as percentage of total assets	87.0	90.0	88.6	89.4	90.0	90.0	90.0	90.0	90.0			
105 Total O/S interest-bearing Fannie and Freddie debt	418,502	487,761	542,095	747,525	897,759	1,094,109	1,307,326	1,535,774	1,793,730	21.3	19.1	–2.2

O/S = outstanding.

Despite their efforts to present their securities as substitutes for Treasury securities, Fannie and Freddie are not the Treasury. Their securities are only implicitly backed by the U.S. government; they do not carry the full-faith-and-credit promise of the United States. Indeed, the GSEs' securities are by statute required to state that they are not obligations of the United States. They are able to obtain favorable financing because the markets do not believe—given the GSEs' many connections with the U.S. government—that they will be allowed to fail.

But it is important to understand that that condition still leaves some room for doubt. Ultimately the GSEs' ability to fund themselves in the financial markets depends on their ability to manage their risks as well as on conditions in the U.S. housing markets. The housing markets, in turn, are subject to risks—such as changes in the tax code—that cannot be anticipated. An adverse change in the GSEs' financial condition could lead to an increase in the yield spread of the GSEs' debt over Treasury debt. That could be a gradual rise, as the market worries about whether their implicit backing will turn into a bailout, or it could reflect a sudden shift in market perceptions. In the case of Farm Credit System (FCS) debt in 1987, a gradual rise was followed by a sudden tipping point, when the market fled to quality. In the case of the Farm Credit System, the yield spread over longer-term Treasuries went above 100 basis points, signaling that new FCS debt might become unmarketable.[8]

If a similar phenomenon should affect Fannie or Freddie's securities, the financial intermediaries that are currently holding that debt instead of Treasuries may find that they can sell only at substantial losses; the losses would then raise questions about their own financial stability, and a systemic crisis would arise. To be sure, Congress could resolve the crisis, but a great deal of damage would then have been done to the economy as the market fled to quality and credit sources dried up. The U.S. financial markets experienced that phenomenon during the fall of 1998, in the aftermath of the Russian debt crisis and the Long-Term Capital Management debacle.

Of course, the effect of a Fannie and Freddie crisis would be even more calamitous for the housing markets. If those GSEs were to face substantially higher interest costs in marketing their debt, the costs would be transmitted immediately to the housing market—slowing home purchases and new home construction dramatically. That in itself would have a severely adverse effect on the general health of the U.S. economy.

Fannie and Freddie can contain their risks, but at the cost of reduced profitability. There is no indication in their behavior thus far that they are willing to accept that result.

7. CONCLUSION

Fannie Mae and Freddie Mac are fast becoming a problem that can no longer be ignored. By 2003, they will have assumed the risk—either through ownership or guarantees—of almost one-half of all residential housing mortgages in the United States. In effect, the residential mortgage market will have been partially nationalized, with the taxpayers bearing a risk that should be borne by private stockholders and creditors.

Moreover, we project that in 2003, Fannie and Freddie will own or have guaranteed 91.5 percent of all conventional/conforming mortgages, justifying the concern of private mortgage lenders throughout the United States that they will gradually be squeezed out of their traditional markets, and that Fannie and Freddie are planning to extend their activities to some form of direct relationship with the public.

It seems clear that the problem here is the peculiar structure of Fannie and Freddie—profit-seeking companies that have been granted special status to pursue a public mission. Those objectives are contradictory. Whatever balance Congress initially thought could be achieved between them has been lost.

What are the benefits that Fannie Mae and Freddie Mac claim to provide, and are those benefits worth the cost in taxpayer risk and competition for non-subsidized mortgage lenders?

Although the GSEs do contribute to liquidity in the mortgage markets, they are no longer necessary for that purpose; private firms now routinely acquire and securitize portfolios of jumbo mortgages—which exceed the size that Fannie and Freddie may purchase—and those private firms could certainly do the same for conventional/conforming loans.

[8] Bert Ely and Vicki Vanderhoff, "The Farm Credit System: Reckless Lender to Rural America" (Alexandria, Va.: Ely & Company, Inc., November 1990).

Recognizing the validity of that argument, Fannie and Freddie now claim that their purpose is to reduce middle-class mortgage rates, and point to the fact that those rates are about 30 basis points lower than rates in the jumbo market. However, many economists have noted that that saving for homebuyers is an illusion: the lower interest rate is immediately capitalized into the cost of the home, so that the real benefit of the implicit subsidy goes to developers and home sellers rather than to the homebuyers whom congress presumably intended to assist.

Weighed against those highly conjectural benefits are the real taxpayer risks that Fannie and Freddie create, and the real danger that they will eventually evict private non-subsidized lenders from the residential mortgage market.

Policymakers have a number of appropriate potential responses: true privatization of Fannie and Freddie through cutting their links to the Federal Government; tighter statutory and regulatory restrictions on their efforts to expand their activities; limitations on their use of lobbyists, their political contributions, and their other efforts to manipulate the legislative process; free sale of identical GSE franchises, or the imposition of special taxes, affordable housing burdens, or other costs that would enable the government to recapture their implicit subsidy; forbidding the tying of management compensation to their stock price; and even returning them to their former status as on-budget Federal agencies.

Whatever the course ultimately adopted, it is important to recognize that options are foreclosed and solutions become more difficult as Fannie Mae and Freddie Mac continue their de facto nationalization of the residential mortgage market.

BANKS DO NOT RECEIVE A FEDERAL SAFETY NET SUBSIDY: A PAPER PREPARED FOR THE FINANCIAL SERVICES ROUNDTABLE BY BERT ELY, MAY 1999

For several years, the Federal Reserve, and its chairman, Alan Greenspan, have argued with extreme forcefulness that banks benefit from a substantial, but apparently unquantifiable taxpayer subsidy. Mr. Greenspan contends that in order to minimize the competitive distortions caused by this alleged subsidy, expanded powers for banking companies should be exercised only through non-bank affiliates of bank holding companies regulated by the Fed and barred for operating subsidiaries of national banks regulated by the Treasury Department's Office of the Comptroller of the Currency.

The Fed cannot quantify the amount of this alleged subsidy because there is, in fact, no such subsidy. Instead, a subsidy of at least $1.5 billion annually flows in the opposite direction, in the form of non-interest-bearing loans banks have been forced to make to the Federal Government through the Fed and the Federal Deposit Insurance Corporation.

What some contend is a Federal subsidy to banks in fact is not, for two reasons. First, deposit insurance delivers genuine economic value to banks due to its inherent risk-spreading nature which is common to all insurances. That is, deposit insurance protects deposits against bank failure because, through the premium charged for it, deposit insurance effectively spreads bank insolvency risk over a far broader equity capital base than just the capital of the bank holding those deposits. Deposit insurance therefore permits each insured bank to utilize expensive equity capital more efficiently than it otherwise could; that is, a bank with deposit insurance can operate with higher leverage than it could without it. The fact that the Federal Government currently operates the deposit insurance system does not negate this inherent value of deposit insurance. Non-bank firms must, of necessity, operate with lower leverage because they do not have insolvency protection for their creditors comparable to deposit insurance.

Second, taxpayers do not subsidize Federal deposit insurance because over the last decade Congress has made deposit insurance as risk-free as possible to taxpayers by creating mechanisms which impose all deposit insurance losses on the banking industry, even in circumstances far worse than the S&L crisis. Because of the reforms Congress enacted, deposit insurance is no longer simply a government guarantee, as it was during the S&L crisis—it has been transformed into a genuine insurance mechanism which can stand on its own without Federal backing. Ironically, these taxpayer safeguards have greatly magnified the highly undesirable cross-subsidy within deposit insurance which flows from sound, well-managed banks to poorly capitalized and badly run banks. Unfortunately, the existence of this cross-subsidy has been masked by Mr. Greenspan's false assertion that taxpayers subsidize Federal deposit insurance. Worse, his false assertion has inflicted significant and possibly lasting harm on the banking industry by making it more politically vulnerable to the imposition of yet more social welfare obligations beyond those which already burden it, but not its non-bank competition.

Interestingly, this analysis of the subsidy argument reveals that non-banks, and specifically securities firms, receive a significant taxpayer subsidy—free access to the Fed's discount window during times of economic duress. Arguably, permitting this access achieves a public good—systemic stability, but that good does not warrant a subsidy for securities firms any more than the public good of Federal deposit insurance would warrant a taxpayer subsidy for banks.

Although banks do not receive a taxpayer subsidy, the Fed's amazing success in propounding this fiction has raised the question of how best to contain the alleged subsidy. Careful analysis indicates that even if a subsidy existed, it would flow with equal ease to operating subsidiaries of banks and non-bank subsidiaries of holding companies. Therefore, whether there is a subsidy or not, there is no rationale for limiting the organizational flexibility of banks by requiring that certain activities be conducted only in non-bank subsidiaries of Fed-regulated holding companies. Mr. Greenspan's argument that the holding company structure better contains the fictional subsidy is entirely without merit.

INTRODUCTION

Contrary to frequent assertions by Federal Reserve Chairman Alan Greenspan, banks do not receive a so-called Federal "safety net subsidy," as this paper will demonstrate. Instead, banks pay all costs of banking's Federal safety net, including the Federal Government's cost of regulating banks. What is alleged to be a safety net subsidy, specifically that banks can operate with higher leverage than non-banks, in fact represents the consequence of the risk-spreading nature of deposit insurance. That is, banks can operate with higher leverage ratios than their non-bank competitors because banks participate in, and pay for the entire cost of, a risk-spreading mechanism that safely permits higher leverage.

This paper will first explain what a Federal safety net subsidy would be if banks did receive such a subsidy. It will then explain the structure of banking's Federal safety net to demonstrate that any taxpayer risk, and therefore any subsidy flowing from this safety net, is concentrated in Federal deposit insurance. The next portion of the paper will describe various actions Congress has taken over the last 10 years to eliminate taxpayer risk from deposit insurance by imposing all of that risk on the capital of the entire banking system. The paper will then explain how deposit insurance works as a risk-spreading mechanism so as to permit higher leverage for banks insured by the Federal Deposit Insurance Corporation (FDIC). At the same time, as the paper will demonstrate, the banking industry pays what amounts to a subsidy to the Federal Government of at least $1.5 billion annually. Unfortunately, as the paper will explain, Federal deposit insurance has created an unhealthy cross-subsidy within the banking industry which flows from healthy, well-managed banks to weak, poorly managed banks. At the same time, large non-bank financial firms receive an important Federal safety net subsidy in the form of free access to the Federal Reserve's discount window. Finally, the paper will conclude that while banks do not receive a Federal safety net subsidy, if there were one it would be equally well contained in a bank-operating subsidiary structure as in a holding company-affiliate structure.

Two other points regarding this paper are in order. First, the term "banks" refers, unless otherwise indicated, to all FDIC-insured institutions, including savings-and-loans and savings banks. However, the term does not encompass credit unions. Second, the paper assumes that the alleged Federal safety net subsidy ultimately is paid by taxpayers. It is highly unlikely that there is another source for such a subsidy.

WHAT A SAFETY NET SUBSIDY WOULD BE IF THERE WERE A SUBSIDY

The threshold question in the debate over whether or not banks receive a Federal safety net subsidy is what would constitute a taxpayer subsidy to banks if a subsidy actually existed. That is, how would banks actually reap that subsidy? There appear to be four ways in which a taxpayer subsidy could be transmitted to banks—direct payment of taxpayer funds to banks, using taxpayer funds to protect depositors and others from bank insolvency losses, using taxpayer funds to pay the cost of banking regulation, and higher interest rates on the Federal debt because of the contingent taxpayer liability posed by Federal deposit insurance. None of these potential sources of a Federal safety net subsidy exist, as will be discussed shortly. The absence of any subsidy is reinforced by the fact that the Fed has never quantified the dollar amount of this subsidy. As recently as April 28, 1999, when Mr. Greenspan contended that permitting operating subsidiaries to engage in non-bank activities as a principal would lead to "greater Federal subsidization" (Greenspan, 1999), he did not quantify the amount of that increased subsidy. Surely, if a subsidy existed, Fed economists could at least estimate its size.

DIRECT PAYMENT OF TAXPAYER FUNDS TO BANKS

The Federal Government does not directly subsidize banking activities by making explicit payments to banks. For example, the government does not pay banks to maintain branches in low-income communities nor does it subsidize banks operating in remote locations. Further, any services which the Federal Government purchases from banks are priced at competitive market rates.

USING TAXPAYER FUNDS TO PROTECT DEPOSITORS IN FAILED BANKS

Although the S&L crisis cost general taxpayers $125 billion,[1] steps Congress has taken since then, notably the 1991 enactment of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), have effectively eliminated the risk Federal deposit insurance poses to taxpayers. These protections are summarized below, starting on page 6, in the discussion of Federal deposit insurance.

USING TAXPAYER FUNDS TO PAY THE COST OF FEDERAL BANKING REGULATION

Federal banking regulation cost almost $1.7 billion in 1997;[2] figures are not yet available for 1998. The Office of the Comptroller of the Currency (OCC), the regulator of national banks, is supported entirely by examination and application fees paid by banks. The same is true for the Office of Thrift Supervision (OTS), the Federal regulator of thrift institutions (savings-and-loans and savings banks). As will be discussed further below, the expenses and insurance losses of the FDIC are fully covered by deposit insurance premium assessments and interest earned on the fund balance of the FDIC's two deposit insurance funds, the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). The expenses of the Federal Financial Institutions Examination Council, the regulators' coordinating body, are charged to the regulatory agencies.

At the Fed, the income value of non-interest-bearing reserves which banks maintain on deposit at the Fed was approximately $653 million in 1997,[3] or $136 million more than the cost of the Fed's supervision and regulation activities in 1997. As is widely recognized, the present reserve requirement on checkable deposits is simply a tax on those deposits. The Fed does not use these reserves to execute monetary policy since it long ago elected to instead be an interest-rate signaler (Ely, 1997a). Although reserve balances are declining because of bank sweep accounts (average reserve balances declined 11 percent in 1998), the income value of reserve accounts should continue to exceed the cost of Fed supervision and regulation for the foreseeable future. Any shortfall, though, at the Fed will be more than covered by the FDIC's net income, as noted below in the discussion, starting on page 12, of the banking industry's forced loan to the FDIC.

INCREASED COST OF FINANCING THE FEDERAL DEBT

Although it cannot be proven, it is highly unlikely that the Federal Government's contingent liability under Federal deposit insurance has raised the cost of financing the Federal debt, for two reasons. Arguably, any increase in this financing cost could be viewed as a subsidy to the banking industry. First, the Federal Government's debt has unambiguously been rated AAA for many years. In fact, Treasury securities, despite any contingent Federal deposit insurance liability, are widely viewed as the closest thing to risk-free debt that exists anywhere in the world. Therefore, it is difficult to imagine that Federal deposit insurance has raised yields on Treasury securities.

Second, as will be discussed below, starting on page 6, over the last decade Congress has made Federal deposit insurance essentially risk-free to Federal taxpayers. Any perceived cost advantage banks have in obtaining insured deposits therefore is a product of the soundness of banking's self-financed insurance safety net. Also, bank deposits appear to be a relatively cheap source of bank funding largely, if not entirely, because of the expense banks incur in gathering deposits through branch offices and in the substantial regulatory costs banks must pass through to their depositors.

THE STRUCTURE OF BANKING'S FEDERAL SAFETY NET

Banking's Federal safety net has three components—banks' ability to borrow at the Fed's discount window, the Fed's guarantee of payment finality on payments transmitted through the Fed, and Federal deposit insurance. As a practical matter, if banks receive a safety net subsidy, it comes only through Federal deposit insurance because the Fed operates the other two components of this safety net on a risk-free basis to itself and therefore to the taxpayer.

THE FED DISCOUNT WINDOW

The Fed discount window does not provide banks with a safety net subsidy although it does provide banks, and especially small rural banks, with a very slight funding subsidy comparable to the funding subsidy that the Federal Home Loan Banks deliver to their members. For the 1992-98 period, discount window loans outstanding averaged $208 million—$74 million for adjustment loans (used to meet reserve requirements and other short-term liquidity needs) and $134 million for seasonal loans to small agricultural banks; for 1998, the comparable numbers were $162 million, $67 million, and $95 million.[4] Given that the Fed's lending or discount rate for adjustment and seasonal loans is a below-market rate, this funding subsidy would equal approximately $2 million annually if a market rate was 1 percent higher and $4 million if it was 2 percent higher. Although indefensible, in the larger scheme of things, this is an extremely modest subsidy.

The Fed should not suffer any losses as a lender since it lends to banks only on a fully collateralized basis; acceptable collateral is specified in the Fed's Regulation A.[5] Further, because the Fed can be a very demanding lender, it can insist on substantial overcollateralization of its loans and can demand the posting of additional collateral should the posted collateral lose market value. Any losses the Fed did experience as a lender would be borne by taxpayers because these losses would reduce, dollar-for-dollar, the earnings the Fed sends back to the Treasury every year. Any loss the Fed experienced on its discount window lending would occur only because Fed officials failed to monitor the market value of the Fed's loan collateral in a timely manner. Also, under Sec. 142 of FDICIA, the Fed could be liable to the FDIC in a failed bank situation for any increased loss to the FDIC as a result of the Fed failing to demand payment of outstanding discount window loans within 5 days after the failed bank became "critically undercapitalized." However, such a loss should be a fairly easy bullet for the Fed to dodge.

Therefore, because of its essentially risk-free nature and the modest amount lent, the Fed's discount window does not gift a safety-net subsidy to the banking industry. Even its funding subsidy, a few million dollars per year at most, is extremely modest compared to the funding subsidies provided by the Federal Home Loan Banks.

THE FED'S PAYMENT SYSTEM

The Fed provides payment finality on interbank payments made through the Fed, thereby eliminating interbank credit risk for those banks which directly access the Fed's payment system. These interbank payments generally take the form of checks deposited in the Fed for collection from other banks, automated clearinghouse (ACH) payments, and Fedwire funds transfers. In effect, when the Fed grants payment finality to a bank for a payment the Fed has not yet collected from another bank, the Fed has assumed a credit risk on the bank upon which the payment was drawn while the payment is being processed through the Fed's payments system. However, this credit risk is extremely short-term, lasting just a few minutes to a few hours for any single payment. The Fed has recognized this payment system risk by establishing daylight overdraft limits; that is, a limit on the amount that a bank can be overdrawn at any point in time in its reserve or clearing account at the Fed. Further, the Fed can charge interest on intraday overdrafts; that interest effectively compensates the Fed for the intraday credit risk it assumes by providing payment finality at the time a payment is presented to it for collection.[6]

Operating in a real-time environment, the Fed can effectively eliminate its payment system risk in two ways. First, it can refuse to accept payment requests presented to it which are drawn on weak banks. Second, it can accept such payment requests only to the extent to which a weak bank has covered any intraday overdraft at the Fed by borrowing at the discount window on a fully collateralized basis. In other words, through proper, timely management, the Fed can eliminate its payment system risk and therefore any subsidy that direct access to the Fed's payment system would provide to the banking system. As a practical matter, the Fed has always operated its payment system on a risk-free basis, which means that the Fed has not subsidized the banking system in this manner.

Contrary to the Monetary Control Act of 1980, which bars the Fed from subsidizing the priced services (principally collecting checks, processing ACH payments, and executing Fedwire transfers) it offers to banks, the Fed in fact does subsidize these services by using a portion of its annual "pension cost credit" to lower its service prices. In 1997 (the most recent year for which figures are available), the Fed recognized a pension cost credit of $200.8 million.[7] While $138 million of this cost credit was turned over to the U.S. Treasury, the Fed retained approximately $62.8 million of this credit to subsidize its priced-services activities.[8] However, this subsidy is not a safety net subsidy. Instead, it represents a conscious effort by the Fed to use funds that would otherwise go to the U.S. Treasury to gain a competitive edge, through lower prices, over private-sector providers of payment services.[9] An amendment to S. 900, the financial services modernization bill passed by the Senate on May 6, 1999, will bar the Fed from using any portion of its pension cost credit to subsidize its priced services activities.

THE FEDERAL RESERVE PORTION OF THE SAFETY NET POSES NO TAXPAYER RISK

Clearly, Fed operations, and specifically its discount window lending and the operation of its payment system, are designed to operate on a risk-free, and therefore loss-free, basis. To the best of the author's knowledge, the Fed has never incurred a loss from a bank failure. The run on and subsequent failure of Continental Illinois in May 1984 best dramatizes the ability of the Fed to avoid losses in failed banks. Fed advances to Continental Illinois peaked at $7.6 billion in August 1984 (Continental Illinois Corporation, 1984, p. 2), yet the Fed did not lose a penny on that loan, or at least the Fed has never admitted to any such loss, yet the FDIC spent $1.1 billion [10] protecting depositors and other Continental creditors against any loss whatsoever. Clearly, losses incurred under banking's Federal safety net are focused on Federal deposit insurance and the FDIC.

FEDERAL DEPOSIT INSURANCE

Federal deposit insurance for banks, which is offered exclusively through the FDIC, represents the third component of banking's Federal safety net. Federal deposit insurance is a contingent liability of the Federal Government; as a practical matter, though, numerous safeguards Congress has enacted since the S&L crisis have eliminated any risk Federal deposit insurance might otherwise pose to taxpayers.

Federal deposit insurance creates the potential for a taxpayer subsidy only to the extent that the FDIC incurs losses in protecting depositors of failed banks. If banks never failed or always failed without losses to the BIF or SAIF, then there would be no losses to be subsidized. Banks do fail, though, even in good times, and sometimes with substantial losses. However, those losses will not be borne, or in effect be subsidized, by taxpayers if they instead are paid by healthy banks through deposit insurance premiums. Despite suffering $37.1 billion in losses from 1934 to 1997,[11] the BIF and its predecessor, the FDIC fund, have not received a single dollar of taxpayer assistance. Instead, all BIF/FDIC losses as well as FDIC operating expenses have been covered by deposit insurance assessments, which totaled $46.4 billion through the end of 1997,[12] and earnings of the BIF/FDIC fund. Even the Federal Government's initial $289 million capitalization of the FDIC was repaid in 1947 and 1948, with interest.[13] At the end of 1998, BIF had a fund balance (unaudited) of $29.6 billion (Federal Deposit Insurance Corporation, 1998a, p.17). SAIF, the successor to the Federal Savings and Loan Insurance Corporation (FSLIC), which has had a comparable experience since 1989, reached an unaudited fund balance of $9.8 billion at the end of 1998 (Federal Deposit Insurance Corporation, 1998a, p.17).

Stung by the S&L crisis, and its enormous cost to taxpayers, as well as by the commercial banking problems of the 1980's and early 1990's, Congress enacted numerous reforms which directly or indirectly have eliminated the taxpayer risk in Federal deposit insurance. These reforms were intended, and to date have performed, to minimize deposit insurance losses while ensuring that all such losses will be imposed to the maximum extent possible on banks which do not fail. By eliminating the taxpayer risk previously posed by Federal deposit insurance, Congress transformed Federal deposit insurance from a government guarantee program into a genuine insurance mechanism, albeit a mechanism with serious cross-subsidy problems discussed below in the section on mispriced deposit insurance premiums, which starts on page 13.

The seven principal reforms divide into two broad categories—minimizing deposit insurance losses and imposing all deposit insurance losses on bank capital.

MINIMIZING DEPOSIT INSURANCE LOSSES

Cross-guarantees among affiliated banks (1989) The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which launched the resolution of the S&L crisis and FSLIC's bankruptcy, included a "cross-guarantee" provision (Sec. 206, enacting 12 U.S.C. 1815(e)). This provision made all "commonly controlled" banks liable for the FDIC's share of an insolvency loss in any one of the commonly controlled institutions. That is, the FDIC experiences an actual loss in a failed bank only to the extent that it cannot recover its potential loss from affiliated banks of the failed bank. As a practical matter, the amount of this potential recovery is limited to the market value of the affiliated banks. Hence, for deposit insurance purposes, all banks in a multi-bank holding company or otherwise under common ownership or control are treated as if they were one bank for the purpose of absorbing at least some portion of the FDIC's share of a failed bank's insolvency loss. To some extent, the value of this provision to the FDIC has been diminished by interstate branching, which was authorized in 1994 (and is discussed on the next page). Nonetheless, it was an important first step which Congress took to minimize FDIC losses and remains an important loss-minimization tool for the FDIC.

Prompt regulatory action/least-cost resolution (1991) In many ways, prompt regulatory action (often referred to as prompt corrective action, or PCA) and least cost resolution (LCR), are the heart of FDICIA,[14] which Congress enacted on November 27, 1991. Together, PCA and LCR represent the most important tool the Federal Government has to minimize deposit insurance losses in banks which have sunk into insolvency. At the same time, they reflect a fundamental and understandable congressional distrust of the bank regulators in the aftermath of the S&L crisis and problems in the commercial banking industry. Briefly, regulations issued under the authority of PCA set trigger points in a bank's slide toward insolvency. These triggers are intended to force regulators to take timely corrective action in a failing situation or, barring a turnaround, to force the closure of a bank before it becomes insolvent. LCR is designed to minimize the FDIC's use of purchase-and-assumption transactions in failed bank situations because such transactions can protect the uninsured portion of deposits, which has the effect of raising the cost of a bank failure. Although not fully tested during a severe economic crisis, in theory PCA and LCR should minimize deposit insurance losses even during a crisis. A discussion of the workings of PCA and LCR lies beyond the scope of this paper.

Depositor preference in failed banks (1993) Although enacted as part of the 1993 budget reconciliation bill as a spending reduction measure and with no debate whatsoever over its deposit insurance implications, the depositor preference provision of the Federal Deposit Insurance Act[15] serves as a potentially significant legal device for reducing FDIC losses in failed banks. Briefly, depositor preference gives both insured and uninsured deposits in domestic branches of a bank a liquidation preference over deposits in that bank's foreign offices as well as all other general, unsecured claims on that bank. Consequently, general unsecured claims which are not domestic deposits will absorb all of a failed bank's insolvency loss before the first dollar of loss will be borne by domestic deposits, and specifically by the FDIC as the insurer of the insured portion of domestic deposits. Depositor preference already is playing a role in reducing the FDIC's loss in the relative handful of banks which have failed in recent years.

Interstate banking and branching (1994) Although intended primarily to improve the operating efficiency and customer service of commercial banks, the Interstate Banking and Branching Efficiency Act of 1994 greatly improved the safety-and-soundness of the banking system by permitting large banks to operate regionally or nationally. The banking problems in Texas and other states during the 1980's as well as the banking crisis of 1930-33, during which time 9,000 mostly small, single office banks failed (Federal Deposit Insurance Corporation, 1983, table on p. 41) were greatly aggravated by state and national banking and branching restrictions and prohibitions. It is highly unlikely that even a future regional banking crisis, such as that which struck the Southwest in the mid-1980's or the New England banking crisis of the late 1980's and early 1990's, would be as severe, in terms of deposit insurance losses, as those crises were.

IMPOSING ALL DEPOSIT INSURANCE LOSSES ON BANKS

Recapitalizing the deposit insurance funds Sec. 104 of FDICIA established the framework for building the BIF to a "designated reserve ratio" (presently 1.25 percent of insured deposits) and maintaining that ratio. FIRREA, which created the BIF and SAIF, established similar requirements for the SAIF. Under the guise of the designated reserve ratio, the FDIC was able to levy a substantial tax on banks to build the BIF and SAIF to a 1.25 percent reserve ratio. Although not used solely to build the BIF to a 1.25 percent ratio, the FDIC levied $27.9 billion of premiums on BIF-insured institutions from 1990 to 1995 (Federal Deposit Insurance Corporation, 1997, p. 105). From 1991 to 1996, the FDIC levied $8.5 billion of premiums, including $5.2 billion in 1996, on SAIF-insured institutions to build that fund to a 1.25 percent ratio (Federal Deposit Insurance Corporation, 1997, p. 107). These huge assessments cannot be tapped to pay future deposit insurance losses, as is discussed in the next paragraph. Hence, they form a permanent investment base which generates the interest savings on financing the Federal debt that provides much of the special subsidy discussed below, starting on page 12, which flows from the banking industry to the Federal Government.

Unlimited FDIC assessment power Of particular importance to taxpayers, Sec. 103 of FDICIA gave the FDIC a blank check, through the authorization of emergency special assessments, on the capital of all of the institutions insured by a particular fund to quickly rebuild that fund to the designated reserve ratio should prior losses have driven that ratio below the designated minimum. This unlimited assessment power gives the FDIC the power to draw heavily on the capital of the banking industry to cover deposit insurance losses should cross-guarantees, PCA, LCR, and depositor preference fail to minimize those losses. To the extent that the FDIC has to draw upon its $30 billion line-of-credit at the U.S. Treasury to meet short-term liquidity needs, those interest-bearing borrowings will effectively be repaid from future FDIC assessments.[16] At December 31, 1998, the book value of the equity capital of all FDIC-insured institutions was $556.7 billion (Federal Deposit Insurance Corporation, 1998, p. 16), almost three times the amount of the insolvency losses suffered by Federal deposit insurance since the S&L crisis first erupted in the early 1980's.

Special "systemic risk" or too-big-to-fail assessments In addition to the emergency special assessment powers of FDICIA's Sec. 103, FDICIA's Sec. 141 codified the concept of too-big-to-fail (TBTF) and provided the means to pay for it. Specifically, this systemic risk provision (the so-called "systemic risk exception ") authorizes the Fed and FDIC, with the concurrence of the Secretary of the Treasury and the President, to declare a bank TBTF. The FDIC may then protect, if necessary, all the liabilities of that bank against loss in order to "avoid or mitigate" the "serious adverse effects on economic conditions or financial stability" if the bank were liquidated under FDICIA's LCR provisions. The systemic risk provision of FDICIA also authorizes the FDIC to levy one or more emergency special assessments on the other members of the insurance fund to which the failed TBTF bank belonged to cover the cost of protecting the failed institution's creditors. Because of this provision, healthy banks, not taxpayers, will bear the cost of protecting uninsured creditors of TBTF banks from any loss.

FEDERAL DEPOSIT INSURANCE PERMITS HIGHER LEVERAGE, WHICH IS NOT A SUBSIDY

Integral to the contention that banks receive a deposit insurance subsidy is the argument that this subsidy permits banks to operate with higher leverage than nonbank institutions. Kwast and Passmore (1997, pp. 16-27) present substantial evidence that non-banks, with the possible exception of large investment banks, operate with less leverage than banks. They close the discussion of their leverage contention by opining that "these differences [in leverage ratios] are quite likely due, in substantial part, to the fact that banks have direct access to the Federal safety net" (Kwast and Passmore, 1997, p. 27) without explaining the linkage between this direct access to the safety net, the subsidy the safety net allegedly provides, and the higher leverage banks enjoy. Interestingly, they ignore the fact that non-bank firms can access one important element of the safety net, the Federal Reserve discount window, as will be discussed below, starting on page 13. What is especially intriguing about the Kwast/Passmore paper is that it ignores an explanation as to why banks can safely operate with higher leverage—the insurance value of deposit insurance—that this author explained in the American Banker (Ely, 1997b) 3 months prior to the publication of the Kwast/Passmore paper.

ALL FORMS OF INSURANCE PERMIT HIGHER LEVERAGE

A central element in the subsidy debate is the indisputable fact that all forms of insurance permit an insured to operate with higher leverage than the insured could enjoy without insurance. That is, higher feasible leverage is an inherent byproduct of the risk-spreading nature of any form of insurance. This statement holds true for businesses, which banks are, as well as for individuals. In effect, insurance prevents the bankruptcy of businesses and individuals who have partially financed their assets with debt if their assets suffer an insurance-covered decline in value which exceeds the insured's net worth. Viewed from another perspective, insurance is a credit enhancement device an insured obtains in exchange for a fee called an insurance premium.

A simple example will illustrate this crucial point. An individual with a net worth of $100,000 purchases a home for $200,000 that is partially financed with a $160,000 mortgage. Having used $40,000 of her net worth to make a down payment on the house, she has $60,000 worth of other assets. Hence, she has total assets of $260,000 which have been financed by a $160,000 mortgage and her $100,000 of net worth. If her home then suffers a $150,000 uninsured fire loss, she will now have assets worth $110,000 and a negative net worth of $50,000 (assets of $110,000 minus the $160,000 mortgage). Personal bankruptcy will occur, which means the mortgage holder will incur a loss of at least $50,000. The risk of this type of loss is precisely why lenders insist that borrowers insure mortgaged assets for at least the amount of the mortgage. Consequently, a person who cannot obtain property insurance cannot leverage herself as highly as someone who can obtain such insurance. In effect, insurance exists not just to protect the net worth of the insured, but equally important to protect lenders against loan losses. In the context of this paper, a depositor is a lender to a bank.

Insurance works properly, from the perspective of ensuring insurer solvency, if the risks of loss it has assumed are diversified sufficiently; insurance premiums are priced properly so as to cover the insurer's losses, operating expenses, and profits (thereby deterring moral hazard on the part of insureds); and the insurer has enough net worth of its own to absorb extraordinarily high or unanticipated losses and pricing errors. In effect, insurance pools the risk of loss of many insureds in return for a premium. Consequently, by using insurance to shift the risk of a substantial loss to an unrelated party, an insured can own more assets than she otherwise could own since her net worth will not become negative if she suffers an insured loss. Put another way, an insurance contract is an option contract which give the insured an option on its insurer's net worth and loss reserves should the insured suffer an insured loss. An insurance premium therefore is the price of that option contract.

INSURANCE THEORY APPLIED TO DEPOSIT INSURANCE

This theory of insurance, which reflects the reality of insurance, is applicable to all types of financial institutions. The creditors of banks and insurance companies are, to some extent, protected by insurance mechanisms. The creditors of other types of financial firms, such as investment banks and finance companies, generally speaking do not enjoy similar insurance protection.[17] Therefore, all other things being equal, firms with insurance which protects their creditors against loss can operate with greater leverage than firms without that type of insurance. Claims on insurance companies are protected by state guaranty funds; a discussion of these funds lies beyond the scope of this paper. Instead, the balance of this paper will focus only on Federal deposit insurance and the protection it provides to bank creditors, specifically depositors.

Although deposit insurance is characterized as protecting depositors, or at least the first $100,000 of a depositor's balance in a bank, against loss, in actuality Federal deposit insurance works in a slightly different manner. A bank fails because it becomes insolvent; that is, it has a negative net worth because the book value of its liabilities exceeds the market value of its assets. A bank becomes insolvent, and therefore a failed bank, when asset losses and operating losses (current expenses exceed current income) consume any positive net worth it had. When the FDIC takes over a failed bank, it places it in a receivership. The FDIC then advances to the receivership sufficient funds to ensure that insured deposits are made whole, either through a direct payment to depositors or a transfer of the insured deposits to another bank. The FDIC then assumes, under the law of subrogation, a claim on the failed bank's receivership in proportion to the amount of insured deposits it protected to the total amount of domestic deposits. The payment the FDIC makes into the failed bank's receivership is functionally equivalent to the payment an insurance company makes to a homeowner who has suffered a fire loss or, if so specified in the insurance contract, to the holder of the mortgage on the home.

Insured deposits permit a bank to operate with higher leverage than it could without deposit insurance because deposit insurance shifts to other banks, through FDIC premium assessments, the bank's insolvency risk that otherwise would be borne by the insured deposits. Unlike a money market mutual fund, though, a bank cannot operate with infinite leverage, that is zero capital. Instead, it must hold some capital which effectively operates as an insurance deductible that provides some insolvency risk protection for the FDIC and therefore for other banks. The fact that most banks today are not paying explicit premiums to the FDIC does not negate the fact that they are paying for their FDIC insurance, as will be discussed below, starting on the next page. This insolvency risk protection potentially extends to all liabilities in banks that most likely are TBTF although the uncertainty as to which banks are TBTF (the so-called "constructive ambiguity" favored by regulators) undermines the credit-enhancing value of TBTF protection.

Like any insurance entity, the FDIC must have sufficiently dispersed risks in order to be a sound, viable insurance mechanism. The FDIC is a very viable insurer given that it insured 8,554 banking companies at the end of 1998 (Federal Deposit Insurance Corporation, 1998b, p. 62).[18] The fact that the FDIC operates two insurance funds, the BIF and the SAIF, does not threaten the FDIC's viability as an insurer since Congress intends to merge the two funds and in any event would quickly merge them if one of them began to suffer high losses.

The largest individual FDIC insurance risk, BankAmerica, accounted for just 5.9 percent ($163.5 billion) of the FDIC's insured deposits at September 30, 1998 (the latest date for which this data is available).[19] BankAmerica's insured deposits equaled just 29.6 percent of the total capital of FDIC-insured banks on that date ($163.5 billion/$556.7 billion). Given its size, the diversity of its assets, and its geographical spread, in the extremely unlikely event that BankAmerica should become insolvent, the FDIC's loss in resolving its subsidiary banks would be a tiny fraction of their insured deposits. For example, if BankAmerica incurred an insolvency loss equal to 5 percent of its liabilities, it would cost the FDIC $8.2 billion ($163.5 billion x .05) to protect BankAmerica's insured deposits against any loss; that amount equals just 1.5 percent of total bank capital ($8.2 billion/$556.7 billion). If BankAmerica were declared to be TBTF, which almost certainly would be the case, a loss equal to 5 percent of the total amount of liabilities to be protected might be as high as $27-$28 billion, or approximately 5 percent of total bank capital. While enormous (and reflective of massive regulatory failure), a loss of that magnitude nonetheless could be borne entirely by the banking system.

Creditors of a non-bank financial firm operating without creditor insurance do not have a third-party standing by to make them whole if the firm becomes insolvent. Therefore, creditors of such a firm can look only to the net worth of the firm itself to protect them against insolvency. Accordingly, without that third-party protection, creditors properly insist that an uninsured firm operate with less leverage. However, there is nothing to prevent non-bank financial firms from establishing insurance mechanisms comparable to deposit insurance if their managements desired to operate with higher leverage.

THE BANK SAFETY NET ACTUALLY SUBSIDIZES THE FEDERAL GOVERNMENT

Contrary to Mr. Greenspan's assertion that Federal deposit insurance provides banks with a Federal taxpayer safety net subsidy, the reverse is true—banks effectively provide a special subsidy to the Federal Government and hence to taxpayers. This subsidy takes three forms—two financial and one non-financial.

BANKS' LOW-INTEREST-RATE LOANS TO BIF AND SAIF

The Federal Deposit Insurance Act effectively bars BIF and SAIF from dropping below a designated reserve ratio, which the FDIC Board has set at 1.25 percent of insured deposits. That is, if the fund balance in the BIF or the SAIF drops below 1.25 percent of insured deposits, either because of deposit insurance losses or growth in the total amount of insured deposits, then the FDIC Board of Directors must adopt a recapitalization plan for that fund. Key to raising a fund above a 1.25 percent reserve ratio is levying higher deposit insurance premium assessments on the members of that fund. This recapitalization requirement effectively means that the entire fund balance below the 1.25 percent requirement is not available to absorb deposit insurance losses, except over the very short term. In effect, then, the required reserve balance in each fund represents what is tantamount to a forced, low-interest-rate loan from the banking industry to the Federal Government. Banks extended that loan to the Federal Government through the high deposit insurance assessments they paid in the early and mid-1990's that built the BIF and SAIF to their 1.25 percent reserve ratios. These premium payments constituted a permanent loan to the Federal Government because the FDIC is "on budget,"[20]

A portion of the interest on this loan, which accrues to the FDIC as income earned on its portfolio of Treasury securities, pays for FDIC losses and expenses in excess of its deposit insurance premium assessments and other sources of income from outside the Federal Government. The portion of its interest income the FDIC spends effectively constitutes interest banks earn on the forced loan. That interest, which banks never collect, in turn, is in lieu of making cash premium payments to the FDIC.

The unspent portion of the FDIC's interest income on its Treasury securities represents the net income value to the Federal Government of the banking industry's forced loan. Banks receive absolutely nothing in return for this foregone income. In 1997, this loan lowered the cost of financing the Federal debt by approximately $1.4 billion;[21] 1998 figures are not yet available. If Congress had put the FDIC on a pure pay-as-you-go financing basis, banks would not have had to pay heavy premium assessments to build the essentially untouchable portion of the BIF and SAIF fund balances. That portion, at the designated reserve ratio of 1.25 percent, reached $35.6 billion at the end of 1998.[22]

Arguably, the banking industry delivers another $800 million annually to Federal taxpayers in the form of the interest banks pay on the FICO bonds issued during the 1987-89 period to finance a limited disposal of failed S&Ls. This interest is paid entirely by a special assessment on bank and S&L deposits. Because the S&L crisis was rooted in numerous failed public policies reaching back to the 1930's (Ely and Vanderhoff, 1991), the case can be made that FICO bond interest should be paid from general taxpayer funds rather than with a special assessment on bank deposits.

BANKS' NON-INTEREST BEARING RESERVES

As noted on page 2, the income value of required reserves actually on deposit at the Fed exceeded the Fed's bank supervision expenses by $136 million in 1997. Given that banks probably hold more vault cash than they would if interest was paid on reserves on deposit at the Fed, the excess of the Fed's income on required reserves over Fed supervision and regulation expenses is somewhat higher. However, reserves on deposit at the Fed have been dropping due to sweep accounts, so the income value of these reserves has been declining and would disappear if the Fed opted to pay interest on reserves (contrary to popular belief, the Fed is not explicitly barred by law from paying interest on reserves).[23] The time may arrive when the Fed's supervision and regulation expenses will exceed the income value of required reserves. However, even if the Fed held no non-interest-bearing reserves, its supervision and regulation expenses would be substantially less than the interest savings the Federal Government enjoys by virtue of the forced loan the banking industry has made to the FDIC, and hence to the Federal Government.

NON-FINANCIAL SUBSIDIES

Because Congress views Federal deposit insurance as a great benefit to the banking industry, it has imposed social welfare obligations on banks that effectively save the Federal Government substantial sums. It lies beyond the scope of this paper to quantify those sums. The Community Reinvestment Act (CRA) is one obvious obligation. While there is great debate over whether banks make or lose money when meeting their CRA obligations, it is highly unlikely that CRA lending and service obligations earn the target rates of return that banks set for other products and services, especially when considering the substantial administrative costs banks incur in complying with the CRA. Other laws, such as the Bank Secrecy Act, which impose obligations on banks but not on other types of financial institutions, effectively represent a special tax on banks and therefore a subsidy to the government.

Adding it all up, the banking industry effectively provided a cash subsidy to the Federal Government of $1.5 billion in 1997 plus payment of FICO interest and an incalculable amount of social welfare services, specifically in the form of CRA lending.

FEDERAL DEPOSIT INSURANCE CREATES AN UNDESIRABLE CROSS-SUBSIDY WITHIN BANKING

While banks do not, contrary to Mr. Greenspan's assertion, receive a Federal safety net subsidy, Federal deposit insurance has created a highly undesirable cross-subsidy within the banking industry which flows from healthy, well-managed banks to weak, poorly managed banks. This cross-subsidy takes three forms—mispriced deposit insurance premiums, excessive capital requirements for low-risk assets and well-managed banks, and excessive regulatory compliance costs.

MISPRICED DEPOSIT INSURANCE PREMIUMS

Although it may seem odd to contend that healthy banks pay too much for their deposit insurance while weak banks pay too little given that almost 95 percent of the banks will pay no deposit insurance premium for the first half of 1999,[24] that in fact is the case, for this reason: The annual income foregone by banks on the deposit insurance premiums they paid to the FDIC to build the BIF and SAIF to a 1.25 percent reserve ratio, as discussed above, effectively is an implicit deposit insurance premium. Assuming banks could earn a 6 percent yield on this forced loan to the government, this foregone income is equivalent to almost a 6 basis point deposit insurance premium.[25] Hence, effective premiums for FDIC-insured deposits range from 6 basis points to 33 basis points since explicit premium rates presently range from zero to 27 basis points. In the author's opinion, based on his substantial research on the pricing of deposit insurance, this premium range is too narrow. The safest banks should pay no more than two basis points for insurance of all of their deposits while the riskiest banks should pay as much as 70-100 basis points.

The very serious problem caused by mispriced deposit insurance premiums is that they do not deter bad banking while also causing a misallocation of credit. Thus, the pernicious nature of mispriced deposit insurance reaches far beyond banks to the functioning of the entire economy, as became evident in the aftermath of the S&L crisis and the commercial banking difficulties of the 1980's and early 1990's. Unfortunately, the very real problem of the cross-subsidy within the banking industry caused by mispriced deposit insurance has been masked by the debate over whether or not banks, taken as a whole, receive a Federal safety net subsidy.

The FDIC itself has acknowledged the shortcomings of its premium rate structure. Earlier this year, it considered charging a higher premium rate to as many as 573 banks, almost all of which did not pay any premium in 1998. The premium increase would have been levied on banks with CAMELS ratings of 3, 4, or 5 for bank management or asset quality (Barancik, 1999a) However, in response to a strong negative reaction to this proposal, the FDIC quickly announced that it was backing off from its initial proposal, having "decided to revise and delay until next year a plan to make more institutions pay for deposit insurance" (Barancik, 1999b). This retreat by the FDIC does not negate the fact that deposit insurance premiums are underpriced for riskier banks. The FDIC's problem is that as a government monopoly it cannot properly price deposit insurance premiums because prices can be properly established only in private, competitive marketplaces where both buyers and sellers, or insureds and insurers, have a choice as to whom they do business with.

EXCESS CAPITAL REQUIREMENTS

Implicitly acknowledging that neither government banking regulation nor government pricing of deposit insurance will prevent unwise banking, Congress effectively mandated the Basle risk-based capital standards with regulations which tie prompt regulatory action, discussed above, to various measures of bank capital. Yet like FDIC insurance premiums, risk-based capital standards only very crudely reflect the actual riskiness of bank assets. This is particularly evident for loans to private-sector firms where no distinction in capital requirements is made between firms which are AAA-rated and those which have a junk bond status. Worse, capital ratios have been set high enough to minimize banking failures caused by a combination of inept management and regulatory failure,[26] which means that capital ratios are too high for well-managed banks. Undifferentiated capital requirements for private-sector credit risks, coupled with the inability of regulators to sufficiently differentiate good banking from bad in establishing risk-based deposit insurance premiums, are the principal reasons why banking has steadily lost market share as a channel of financial intermediation. In effect, regulatory inefficiencies have created substantial regulatory arbitrage opportunities which financial services entrepreneurs, utilizing electronic technology, have increasingly capitalized upon, at banking's expense.

EXCESS REGULATORY COMPLIANCE COSTS

Because of the regulatory shortcomings cited above and congressional distrust of the competency of the banking regulators, as FDICIA effectively proclaimed, Congress and the banking regulators have geared regulatory compliance burdens to the lowest common denominator in banking; that is, the poorly managed banks which are most likely to fail. This compliance burden is made worse by the inherent, one-size-must-fit-all nature of government banking regulation. This burden, which imposes higher operating costs on banks as well as regulatory straitjackets which impair the managerial flexibility of bank managers, further harms banking's competitiveness. All of these costs are borne by banks and are in no way subsidized by the Federal Government.

LARGE NON-BANK FINANCIAL FIRMS RECEIVE AN IMPLICIT SAFETY NET SUBSIDY

While banks pay for the entire cost of their Federal safety net, as demonstrated above, large non-bank financial firms do not pay for their Federal financial safety net, which is the ability to borrow at the Fed's discount window in "unusual and exigent circumstances."[27] Although the Fed has not lent in such circumstances for at least fifty years, it can lend to a large insurance company or investment banking firm facing severe liquidity problems. The importance of this standby lending authority for the Fed was evidenced by a little-noticed provision in FDICIA (Sec. 473, Emergency Liquidity) which effectively broadened the types of collateral which the Fed could accept in lending to non-bank firms to include marketable securities. This amendment reportedly was sparked by the liquidity problems some securities firms faced in the aftermath of the 1987 stock market crash. The report accompanying the Senate version of FDICIA made clear that this amendment to 12 U.S.C. Sec. 343 was intended to make it easier for the Fed to lend to temporarily illiquid investment banking firms.

Unpublished reports also indicate that there have been times, specifically in the mid-1970's and the late 1980's, when insurance companies suffering liquidity problems approached the Fed about borrowing at the discount window. According to these reports, the Fed did not lend to these insurers, but that does not mean the Fed could not have lent to them. That insurers occasionally face liquidity crises illustrates one of the great weaknesses of the state guaranty funds for insurers—the lack of an equivalent to the Fed's discount window.

Another close call for the Fed may have been Long Term Capital Management (LTCM). Although the New York Fed did lean on LTCM's principal creditors to provide additional liquidity to LTCM during its late-summer crisis last year, had that liquidity not been forthcoming, the Fed might have been forced to lend directly to LTCM in order to prevent a liquidity freeze-up in the global capital markets.

While the Fed theoretically would demand sufficient collateral when lending to a non-bank to protect itself against any loss, there is the danger that the Fed could not obtain enough collateral fast enough if the market value of the pledged securities was falling rapidly, as occurred during the 1987 stock market crash and again last summer following Russia's domestic debt default and LTCM's subsequent problems. This collateralization problem is compounded by the fact that most marketable securities of investment banking firms already have been pledged as collateral for the loans financing the purchase of those securities. In such a case, the Fed can only obtain a junior, and very thin, lien on such securities. Consequently, the Fed's risk of loss on discount window lending to non-bank firms may be much greater than it is on loans to banks which have substantial unobligated assets. Far worse in the case of non-bank firms, the Fed does not have an FDIC to look to for a bailout. As the Continental Illinois caper discussed on page 5 so clearly illustrates, the Fed can hide behind the FDIC when lending to a troubled bank. Sec. 142 of FDICIA further exaggerated this difference by limiting the length of time the Fed can lend to a troubled bank;[28] no comparable limit applies to non-bank discount window loans.

Non-bank financial firms which have legal access to the Fed's discount window do not have to pay a commitment fee in advance for that right of access nor has Congress established an after-the-fact mechanism, comparable to the FDIC's unlimited assessment powers, to assess surviving non-bank financial firms for any losses the Fed might incur in lending to non-bank firms. The absence of a commitment fee and assessment power effectively has gifted non-bank financial firms with a valuable Federal financial safety net subsidy that has been denied to banks through their forced participation in an unsubsidized Federal deposit insurance scheme. Arguably, a public good—systemic stability—flows from non-bank access to the discount window. However, that good does not warrant this subsidy any more than the public good of Federal deposit insurance would warrant a taxpayer subsidy for banks.

IF THERE WERE A BANK SAFETY NET SUBSIDY, THE OPERATING SUBSIDIARY STRUCTURE WOULD BE PREFERABLE TO THE HOLDING COMPANY STRUCTURE

As should be clear by this point, banks do not receive a Federal safety net subsidy financed by taxpayers. Consequently, it should be a moot question as to whether the "op-sub" or the "holding company" structure of a banking organization can better contain a safety net subsidy. Unfortunately, this is not a moot question because of the amazing success Mr. Greenspan has had in promoting the fiction that banks receive a safety net subsidy. Therefore, the balance of this paper will examine the containment issue.

ORGANIZATIONAL DIFFERENCES UNDERLYING THE OP-SUB DEBATE

The op-sub organizational structure is one in which a banking company conducts what have traditionally been viewed as non-bank activities in an operating subsidiary of the bank; hence, the term op-sub. Notable among these non-bank activities are securities and insurance underwriting and brokerage. An op-sub, because it is owned by, and therefore is capitalized by, its parent bank, is subject to the regulatory oversight of the bank's regulator. In effect, the op-sub's equity capital, and therefore its capacity to absorb losses, flows from the bank's owner or owners through the bank to the op-sub.

Under rules proposed by the OCC, for the purpose of measuring a national bank's compliance with its regulatory capital requirements, a bank's equity capital investment in an op-sub must be fully deducted from the bank's capital. This deduction will eliminate any double-counting of capital and therefore any "double-leveraging" whereby debt of the parent is counted as equity capital in a subsidiary. Some degree of double-leveraging is still evident in capital arrangements between bank holding companies and their subsidiary banks, but not to the extent it once was. Still, the OCC's proposed rule represents a more conservative approach to op-sub capitalization than now governs the capitalization of banks by Fed-regulated bank holding companies.

In the holding company structure, non-traditional activities, specifically securities and insurance underwriting, are conducted in a direct subsidiary of the bank holding company. Therefore, such a subsidiary is a side-by-side, non-bank affiliate of the bank. That is, the bank and its non-bank affiliate have a common parent, which is regulated by the Fed as a bank holding company. The capital invested in the non-bank affiliate comes from the holding company, possibly with some degree of double-leverage. This structural alternative is referred to as the non-bank affiliate structure.

In addition to its equity capital investment, a bank can engage in other types of financial transactions with an op-sub, specifically lending to it or buying assets from it. Likewise, a bank can engage in similar transactions with a non-bank affiliate. In the latter case, Sec. 23A and 23B of the Federal Reserve Act limit the financial dealings between a bank and its non-bank affiliates; the OCC has proposed to apply the same restrictions to dealings between a bank and its op-subs. Therefore, the op-sub debate focuses on equity capital issues and not on debt or other types of financial transactions.

GREENSPAN'S SAFETY NET SUBSIDY ASSERTION

Mr. Greenspan, with almost no support outside of the Fed, asserts that banks receive a safety net subsidy which banking companies can use to greater competitive advantage in the op-sub structure than in an affiliate structure. The fact that the OCC becomes the key banking regulator of a banking company opting for the op-sub structure while the Fed is the key banking regulator of a banking company electing the affiliate structure has no bearing, of course, on Mr. Greenspan's position in this debate.

There are two sequential pieces to Mr. Greenspan's safety net subsidy assertion. First, he contends that banks generate "subsidized equity capital." Apparently, based on a conversation the author had with a Fed economist familiar with Mr. Greenspan's thinking on this subject, subsidized equity capital represents the above-market rate of return banks earn on their equity capital by virtue of their safety-net access. There apparently are two sources for this additional rate of return.

The first source is that banks can lower their weighted average cost-of-funds by operating on a more highly leveraged basis than non-banks. This favorable cost-of-funds differential generates the additional return on equity that banks supposedly earn. It is true that banks can operate on a more highly leveraged basis than non-banks, but that advantage does not constitute a taxpayer subsidy. Instead, as was explained above, it represents the insurance value of any form of insurance. As noted above, if non-banks want to capture the risk-spreading benefit of insurance, they should create private insurance vehicles comparable to Federal deposit insurance. As the author has explained in numerous fora, the cross-guarantee concept can be utilized to privatize bank deposit insurance and can be broadened to insure the liabilities of non-bank firms.[29]

The second source of above-market returns that banks supposedly earn stems from the Federal Government's guarantee of the FDIC's insurance obligation. Because of this guarantee, Mr. Greenspan contends, interest rates on bank deposits do not reflect a sufficient FDIC insolvency risk premium; that is, depositors would demand higher interest rates if the FDIC's insurance obligations were not federally guaranteed. Presumably this absence of an FDIC risk premium extends to the non-deposit liabilities of TBTF banks implicitly protected under the FDICIA systemic risk exception discussed above. However, there is no need for such a risk premium because the congressional reforms discussed above, starting on page 6, have essentially eliminated the FDIC insolvency risk.

The author readily agrees that deposit insurance is mispriced on a bank-by-bank basis, and grievously so in some cases, but the FDIC's unlimited assessment powers, which underpin the substantial cross-subsidy in deposit insurance pricing discussed above, readily trump the effect of the bank-by-bank mispricing of Federal deposit insurance. That is, while some banks may benefit competitively for a time by being undercharged for their deposit insurance, eventually their sins will sink them, as we saw most recently in the BestBank failure.[30] Over time, though, the competitive damage of mispriced deposit insurance falls most heavily on the stronger banks which are hurt by the overpriced deposit insurance premiums they pay, excessive capital requirements, and the regulatory burdens discussed above. Hence, while mispriced deposit insurance and banking regulation adversely distort the financial marketplace, the net effect of these distortions is far more detrimental than helpful to well-managed banks.

The second sequential piece of the Greenspan assertion is that having once captured extraordinary profits, thereby creating subsidized equity capital, banks can then more easily downstream that subsidized capital into op-subs than it can funnel that capital up to the bank's parent holding company, which would then invest that capital in non-bank affiliates. However, that argument simply does not wash because it is just as easy, given the tax neutrality of moving earnings around within a banking company, for the management of the banking company to invest bank earnings downstream into an op-sub as it is to dividend bank earnings up to the holding company for reinvestment in a non-bank affiliate. This equality will be strengthened by the OCC's proposed rule to require that all capital a national bank invests in an op-sub be deducted from the bank's capital for regulatory purposes.[31]

OTHER ARGUMENTS FAVORING THE OP-SUB STRUCTURE

Other arguments favor the op-sub structure over the non-bank affiliate structure, including the inherently greater operating efficiency of op-subs. Also, op-subs will strengthen banks, if the 100 percent capital deduction rule is in place, while non-bank affiliates could harm affiliated banks, particularly if the corporate veil between a bank and a non-bank affiliate can be pierced if the affiliate becomes insolvent. These arguments lie beyond the scope of this paper. However, an article by Longstreth and Mattei (1997) does an excellent job of demonstrating the legal superiority of the op-sub structure.

CONCLUSION

The contention that banks receive, and therefore benefit competitively, from a Federal safety net subsidy, is simply false. There is no subsidy because banks are subject to FDIC assessments which will pay for the full cost of the banking industry's safety net even in circumstances far worse than the S&L crisis. Further, various reforms enacted by Congress over the last decade have so dramatically reduced the potential for such a crisis that the reoccurrence of a crisis of that magnitude would represent unconscionable regulatory failure, partly by the very agency which argues that banks enjoy a Federal safety net subsidy.

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ENDNOTES

1. Author’s calculation.

2. These costs, which totaled $1.692 billion, break down by agency as follows: Federal Reserve System—$517 million; Federal Deposit Insurance Corporation (including administrative costs of the deposit insurance funds)—$677 million; Office of the Comptroller of the Currency—$350 million; Office of Thrift Supervision—$148 million.

3. Reserves on deposit at the Fed in 1997 (excluding compensating balances for services provided by the Fed) averaged $10.792 billion (calculated from the monthly Federal Reserve Bulletin, Table A6). The average yield on the Fed’s securities portfolio in 1997 was estimated to be 6.05 percent (calculated from Board of Governors of the Federal Reserve System (1997), Statistical Tables 6 and 14). $10.792 billion x .0605 = $653 million.

4. Calculated from data published in the monthly Federal Reserve Bulletin, various issues, Table 1.12, “Reserves and Borrowings.”

5. Codified as 12 CFR 201.

6. It is not necessary for the Fed to include a cost-of-funds element in its intraday interest rate since it pays no interest to banks which accumulate positive intraday account balances at the Fed.

7. Board of Governors of the Federal Reserve System (1997), Pg. 288, Table 6, footnote 1.

8. Ibid., p. 264, footnote 2 to the financial statements for priced services provided by Federal Reserve banks.

9. The pension cost credit is describe more fully in a report by the author, titled “An Analysis of the Fed’s Priced Services Activities,” appended to testimony by Mr. Eric Roy, on behalf of the Association of Bank Couriers (Committee on Banking and Financial Services, 1997, pp. 249-250). This report also discusses other ways in which the Fed effectively utilizes taxpayer funds to subsidize the services which it provides to banks.

10. This estimate was obtained in a March 31, 1999, telephone call to the Division of Finance at the Federal Deposit Insurance Corporation.

11. Federal Deposit Insurance Corporation (1997), Table on Recoveries and Losses for All Cases, p. 104.

12. Ibid., Table of Income and Expenses, p. 105.

13. Federal Deposit Insurance Corporation (1980), p. 299, Table 127, Footnote 3.

14. Prompt Regulatory Action constitutes Subtitle D of Title I of FDICIA (Sec. 131-133) while Least-Cost Resolution follows in Subtitle E (Sec. 141-143).

15. Depositor preference was enacted as Sec. 3001 of Public Law 103-66 and is codified as 12 U.S.C. ?1821(d)(11).

16. This line of credit is authorized by 12 U.S.C. Sec. 1824(a). In addition, Sec. 1824(b) authorizes the FDIC to borrow from the Treasury Department’s Federal Financing Bank.

Sec. 1824(c) governs the repayment schedule for any such borrowings. Presumably, the interest rate on these borrowings will not be less than Treasury’s borrowing rate given that, in setting the interest rate on Treasury loans to the FDIC, the Secretary of the Treasury will take “into consideration current market yields on outstanding marketable obligations of the United States of comparable maturity.” This provision in Sec. 1824(a) should bar any taxpayer subsidy to banks through this borrowing channel. Given the capital strength of the banking industry today, this line of credit could safely be canceled.

17. One exception: the Securities Investor Protection Corporation (SIPC), which is a creature of the Federal Government. It protects the cash and securities account balances of customers of insolvent broker/dealers against fraud, up to statutorily specified limits.

18. Although there were 10,461 FDIC-insured banks at the end of 1998 (Federal Deposit Insurance Corporation, 1998b, p. 63), the cross-guarantee provision of FIRREA discussed on page 6 effectively consolidates the banking industry into a smaller number of institutions for deposit insurance purposes.

19. Calculated from call reports filed with the FDIC by BankAmerica's ten subsidiary depository institutions.

20. The FDIC is "on-budget" for this reason: for the purpose of calculating the Federal Government's revenues, spending, and therefore its annual surplus or deficit, the FDIC's revenues from outside the government, such as the premiums it collects, count as Federal revenues while its cash outlays count as Federal spending. It is this inclusion of the FDIC's revenues and spending in the government's financial statements which makes the FDIC an on-budget Federal agency. The interest the FDIC earns on its portfolio of Treasury securities does not count as Federal revenue because it is merely a bookkeeping transfer within the Federal Government, from the Treasury to the FDIC.

21. BIF and SAIF combined net income of $1.918 billion ($1.438 billion for BIF plus $480 million for the SAIF) for 1997 minus a non-cash reversal of prior years' loss provisions of $506 million equals $1.412 billion.

22. Total insured deposits of BIF and SAIF equaled $2.85 trillion at the end of 1998 (Federal Deposit Insurance Corporation, 1998a, p. 17). 1.25 percent of that amount equals $35.63 billion.

23. According to several observers on the scene at the time, in 1978, when interest rates were rising, the Fed proposed to pay interest on required reserves so as to arrest a decline in Fed membership as state-chartered banks dropped their Fed membership. Because the Federal Reserve Act does not specifically bar the Fed from paying interest on reserves, the Fed opined that it could pay that interest. However, members of the House and Senate Banking Committees strongly opposed this proposal, partly because payment of interest on reserves would have added substantially to the Federal budget deficit. The banking committees reportedly backed up their position with a legal opinion from the Congressional Research Service of the Library of Congress stating that the Fed did not have statutory authority to pay interest on reserves; the author has not yet located that document. Faced with this extremely negative congressional reaction, the Fed backed off from its proposal. Congress later solved the Fed's membership problem by mandating, in the Monetary Control Act of 1980, that all depository institutions maintain reserves at the Fed regardless of whether they belong to the Fed. Congress's views in 1978 were set forth in a June 5 letter to then Fed Chairman G. William Miller from Henry S. Reuss, then chairman of the House Banking Committee, and William Proxmire, then Chairman of the Senate Banking Committee, and in a June 28 letter from Reuss to Miller.

24. For the first semiannual assessment period in 1999, 95.0 percent of all BIF-insured institutions will not pay an insurance premium while that will be the case for 93.4 percent of all SAIF-insured institutions. Just eleven FDIC-insured institutions will pay the highest premium rate of 27 basis points (Federal Deposit Insurance Corporation, 1998a, p. 19).

25. FDIC-insured deposits equaled 74.7 percent of total domestic deposits at the end of 1998 ($2.85 trillion/$3.814 trillion), as calculated from Federal Deposit Insurance Corporation (1998a), pp. 4, 16, and 17. The FDIC earned approximately a 6 percent yield on its Treasury securities in 1997 (1998 data is not yet available), as calculated from Federal Deposit Insurance Corporation (1997), pp. 47, 48, 63, and 64. Assuming a minimum reserve ratio of 1.25 percent: .0125 x .06 x .747 = 5.6 basis points.

26. The shortcomings of government banking regulation are the real moral hazard in Federal deposit insurance (Ely, 1997c).

27. 12 U.S.C. Sec. 343, second paragraph. Unlike banks, which can borrow at the discount window of a Federal Reserve bank without prior approval by the Board of Governors of the Federal Reserve System, loans to non-bank firms require an affirmative vote of five members of the Board of Governors.

28. 12 U.S.C. 347b(b)(1), as amended by Sec. 142 of FDICIA, provides that "[e]xcept as provided in paragraph (2), no advances to any undercapitalized depository institution by any Federal Reserve bank under this section may be outstanding for more than 60 days in any 120-day period."

29. See for example, Petri and Ely (1995). Other articles and papers on the cross-guarantee concept are posted on the Ely & Company website at *http://www.ely-co.com.*

30. On July 23, 1998, the BestBank of Boulder, Colorado, failed with total assets of $314 million. The FDIC's estimated loss in BestBank, as of the end of 1998, was $171.6 million, or 55 percent of assets; that loss percentage may go higher. As

spelled out in a 74-page report issued by the FDIC's Inspector General (Federal Deposit Insurance Corporation, 1999), BestBank represents an extremely serious regulatory failure by the FDIC.

31. An amendment to H.R. 10, as reported by the House Banking Committee on March 11, 1999, would require that this capital deduction include all retained earnings in the op-sub.

Chairman SUNUNU. Thank you very much to each of our witnesses.

Let me begin with Ms. Miles.

Could you please talk in slightly more specific terms about the trends in the size of the portfolios held by the GSEs, both whole loans and their own mortgage-backed securities?

In relative terms, what has been the size of the increase over the past decade? Is it a new trend or are the portfolios they hold essentially the same size as they have held historically?

Your comments.

Ms. MILES. You have two separate trends going on. Historically, until about the middle 1980's, Fannie Mae was a portfolio holder and they did not start issuing mortgage-backed securities until about 1980 and they were not a significant size until a few years after that.

Freddie Mac, by contrast, started life as a mortgage-backed securities issuer and held very small portfolios. That started changing.

Chairman SUNUNU. Started changing when?

Ms. MILES. Again in the 1980's and significantly in the 1990's. At this point, I am going to have to check my memory here. I know Tom has some numbers in front of him. I believe that Freddie Mac is up to about—not quite one-third of its assets in the form of its portfolio or repurchased mortgage-backed securities and about two-thirds in mortgage-backed securities.

Chairman SUNUNU. Mr. McCool, did you want to offer some specifics?

Mr. MCCOOL. That is about what we have. For Freddie Mac, it is about one-third in portfolio and two-thirds as MBS outstanding and for Fannie Mae it is about 43 percent in portfolio.

Chairman SUNUNU. Let's stay focused on their portfolios, when you say 43 percent in portfolio.

Mr. MCCOOL. That means that they hold either as whole mortgages or as repurchased mortgage-backed securities about 43 percent of the total outstanding obligations are in their portfolio rather than as outstanding mortgage-backed securities that somebody else holds.

Chairman SUNUNU. And for Fannie Mae in particular, that amount would be approximately $550 billion currently? Is that right?

Mr. MCCOOL. Well, 522 at the end of 1999.

Chairman SUNUNU. You mentioned both whole loans and mortgage-backed securities. What are the differences in risks that the holder of those securities are exposed to? In other words, from the standpoint of systematic risk, interest rate risk, prepayment risk, is there any difference in whether or not the GSEs or any other financial institution chooses to hold whole loans versus mortgage-backed securities?

Ms. MILES. Would choose to hold them?

Chairman SUNUNU. Yes.

Ms. MILES. If you are holding them, you have all the risks. The advantage of mortgage-backed securities, when you sell them, you are selling mortgages off your books. You are retaining the credit risk, but you are pushing off onto someone else the interest rate risk.

One of the reasons they are less profitable than holding whole loans is that in the process of giving someone else the interest rate risk you also have to give them the profitability that attaches to that. But when you buy them back on your books, you are essentially repatriating all that risk.

Chairman SUNUNU. My question is: For the purposes of us assessing a change in the risk profile, should it matter to us whether Fannie Mae, say, previously held $100 billion in whole loans and today holds $100 billion in mortgage-backed securities? They are still taking the credit risk on both and because they choose to hold them, they are holding interest rate risk and prepayment risk, correct?

Mr. MCCOOL. Interest rate and prepayment risk. Right.

Mr. ELY. Mr. Chairman, if I could add to that, there is cause for concern because when they do take back the interest rate risk, particularly if they buy back mortgage-backed securities that they or someone else has previously issued, they take back the interest rate risk and they bring back the prepayment risk. This gets to what is, I think, of concern with regard to their balance sheets. That is, they become like the traditional S&L of the 1960's and 1970's, that is, they significantly maturity mismatch on their balance sheet in terms of how they fund themselves.

Now, they hedge a lot of that risk by buying interest rate swaps and other forms——

Chairman SUNUNU. If you could hold up there, believe me, I will get to hedging, but for the purposes of laying out information, I want to proceed with a little bit of order, whether it is order in my own mind only.

Mr. McCool, you talked a little bit about new product issuance and about HUD's proposed regulations regarding new products to make housing more available to lower income people.

Question one is how do new products that might be offered by the GSEs affect their risk profile and their credit risk profile in particular. And maybe comment regarding the 3 percent down payment product which is just one new product that has been in the news and been marketed pretty heavily.

Mr. MCCOOL. The effect on the risk profile would obviously depend on the product, but in cases where, you know, you are moving toward lower down payment products, then it would tend to increase the credit risk, to the extent it is not hedged.

Chairman SUNUNU. You also discussed investment in, I guess, non-mission-related vehicles, cash value life insurance and other investments. Why has there been a delay in issuing regulations regarding those investments?

Mr. MCCOOL. Well, you would have to ask HUD that. We have been sort of—we have recommended that HUD issue regulations to establish criteria, as I said, in our 1998 report and they did put out an advance notice and they did get some comment back but they have not actually gone forward with the regulations to set forth criteria.

Chairman SUNUNU. Is it your contention, as you addressed those issues in your testimony, that those investments in non-mission-related securities increases the risk profile of the GSEs?

Mr. MCCOOL. Well, actually, some of them might be quite safe and sound, let's put it that way. For example, some of the non-mortgage investments that Freddie Mac purchased were actually from a safety and soundness perspective probably pretty good, but they had nothing much to do with what Freddie Mac was in business from the GSE perspective.

So that is part of the issue, are they mission-related in the sense that the GSEs were given privileges to achieve a mission and the question is whether they are doing that. So they could be safe and sound and not mission-related, they could be both risky and non-mission related, I guess. We have not seen too many examples of that, but that is also feasible.

Chairman SUNUNU. Ms. Miles, Mr. Ely mentioned mismatch, the concern that long-term liabilities might be funded with short-term assets. Have you made any effort to quantify the degree to which the portfolios held by the GSEs are well matched and how do we as policy makers better understand whether or not there is an appropriate level of matching in these portfolios?

Ms. MILES. I have not attempted to do that recently. We have some horrendous examples from the past, including one that I gave you in my written testimony about what happened when Fannie Mae in the late 1970's and early 1980's was in fact our largest savings and loan association. They were not well matched at that point.

They did what every S&L did. They used the relatively short end of the yield curve in order to fund mortgages at the longer end and according to a study done by HUD in 1986, on a mark-to-market basis, they were insolvent every single year from 1978 through 1984 and only came out of trouble in 1985, generally because of regulatory forbearance.

Having said that, I do not think anyone sees anything quite like that now and the best people to ask that question are here today. I would ask OFHEO and also the Federal Housing Finance Board what those matches are.

Chairman SUNUNU. Mr. Ely, you raised the case of Long-Term Capital Management and I would like to address that a little bit, in a little bit more detail.

You mentioned that their debt was only one-seventh of the GSEs'. Does that include their exposure as a result of their trading on margin?

Mr. ELY. Yes, because this was a very highly leveraged institution. In effect, it largely financed its asset portfolio with, if you will, margin debt. It may not have been called that as such, but effectively it was very highly leveraged.

Chairman SUNUNU. But they do not actually hold their margin exposure on their books as debt, correct?

Mr. ELY. I have never seen their financial statements. I am not sure they have ever been published. But as I understand it, they owned assets, a variety of securities, that were financed with debt that was on their balance sheet. They also had some off balance sheet exposures, too. As I understand it——

Chairman SUNUNU. But this is a not insignificant point. They had debt obligations to a number of financial institutions that eventually came and were willing to roll over their debt in order to facilitate the orderly liquidation. And I assume that is the debt that you talk about being one-seventh the size of the GSE debt.

Mr. ELY. That is correct.

Chairman SUNUNU. It would seem to me that that would not include, however, their exposure to margin calls which a margin call does not necessarily require the entry of a debt or an obligation on your books. So it would seem to me that there is at least something of a difference here and there was an enormous exposure to margin calls in the case of Long-Term Capital Management that I hope, assuming that the non-mission related-investments are more or less focused, the GSEs are not exposed to. I do not know of any GSE being exposed to a margin call, do you?

Mr. ELY. I am not aware of that.

Chairman SUNUNU. Long-Term Capital Management, they also, I know, traded quite heavily in currencies and currency futures. That is obviously a very volatile market that GSEs are not really exposed to. Is that correct?

Mr. ELY. Except that they do raise funds in foreign markets, so whether or not any of that is in foreign currencies, I do not know, but they do sell their debt on a global basis so that the extent to which we worry about systemic risks, we have to think not only in terms of how U.S. investors are reacting, but also about foreign owners of their debt.

Chairman SUNUNU. If they were effective at managing their risk exposure, I assume they would just swap out of any exposure to foreign currencies, correct?

Mr. ELY. That is a reasonable assumption.

Chairman SUNUNU. In the same way that they would swap out of exposure to short-term rates if they wanted to balance their portfolio appropriately.

Mr. ELY. That is correct. But what that does is create counterparty risk, which is a form of credit risk. In other words, the underlying assumption in any kind of swap or derivative arrangement is the counterparty will be able to perform if and when called upon to do so. One of the things discussed in the report I co-authored on nationalizing mortgage risk is that the footnote disclosures by both Fannie and Freddie, in my opinion, do not provide enough insight into the counterparty risk that they have under all of their swap and derivative arrangements.

Chairman SUNUNU. What is riskier, holding a whole loan or holding a mortgage-backed security? To an individual, for example to me. Let's start with that.

Mr. ELY. It depends on who issues the mortgage-backed security. If the mortgage-backed security is issued by one of the GSEs, by Fannie or Freddie, then I would argue that that is less risky than holding a whole mortgage because of the implicit backing of the Federal Government.

Chairman SUNUNU. I mean, it says pretty clearly that it is not backed, so let's assume that to be the case.

What about for a financial institution? What is riskier for the bank in my hometown, Bedford or Manchester, New Hampshire, what would be riskier, holding a whole loan or holding a mortgage-backed security?

Mr. ELY. If you leave aside even the Federal guarantee, presumably it is riskier to hold a whole mortgage if the bank has a large concentration of mortgages it has originated locally because one of the benefits of mortgage-backed securities, whether they are issued by a GSE or privately, is that they provide geographical risk dispersion.

Chairman SUNUNU. Should we be concerned, and should we include in these discussions, then, the fact that the whole loans held by the bank and thrift industry still dwarf the number of mortgage-backed securities held by the bank and thrift industry, I think by a factor of two to one or three to one?

Mr. ELY. Well, again, that also is a function of what the capital levels are at the banks and thrifts. In other words, there may be risk in the form of a geographical concentration, but if the bank or thrift holds enough capital, then that can offset the risk. That is the tradeoff. And basically, banks and thrifts are held to a higher capital standard to reflect the fact that they have some degree of concentration of risk.

Although it is not widely used, there is an instrument, known as a credit derivative that represents another tool for trying to diversify geographical risk concentrations.

Chairman SUNUNU. Thank you.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Let me go back just for a second to this question of risk. It seems to me there are two types of risk related to a mortgage, whether it is in the form of a whole loan or mortgage-backed securities, and you all have said this, but just to clarify, there is credit risk related to the asset itself and there is interest rate risk. Both entities, both instruments, carry some form of that type of risk.

But I think we need to also consider the fact it is not—I do not think we can just say because Fannie and Freddie have the implicit guarantee of the Federal Government, which I totally concur with, that we also have to give some credit to underwriting standards, whether they be Fannie and Freddie's underwriting standards or the bank's underwriting standards or whoever's underwriting standards. So I think there are other factors that come into play as to what the risk is.

I also need to say, and I think the chairman was commenting on this, I realize we like to use Long-Term Capital Management as a comparison. I think that is a red herring.

And, Bert, you made this clear in your comments in response to the chairman, that the types of investments that LTCM was in, which I do not have objection with them doing that, are far different in most respects with the types of investments that the GSEs are in, just as the GSE investments are different in many respects to the types of asset investments on the part of banks, on the part of mutual funds, et cetera.

Now, the question is the concentration, which I think is where you make a bigger point and the question of is there too much concentration in the mortgage market on the part of the GSEs with a potential for systemic risk and how that flows back to the taxpayer.

Now, let me ask a couple of questions. One issue that we have sort of talked around which I think was sort of the initial focus of this hearing and that is what is the risk to the taxpayer compounded by the fact that the GSEs in addition to issuing corporate debt with which they use the proceeds to purchase whole loans and then the corpus of which is pledged against that corporate debt, is that risk compounded when the GSEs enter the secondary market and purchase back mortgage-backed securities which they issued?

And, second of all, how much of that purchase is for the purpose of supporting the primary market price of the securities itself that they are issuing and how much of it is, for lack of a better term, an arbitrage play because their ability to—because of both the price of the security in the market and the cost of their capital?

And if it is such a play, how much of that—and I am not going to ask you to quantify the difference today, but how much of that spread, if you will, enures back to the benefit, if any, to the homeowner in terms of lower mortgage costs? Or does it all go to the shareholder? Or do you know?

Mr. ELY. Well, to address a couple of points, in my opinion, you do not have to have Fannie and Freddie to maintain liquidity in the secondary market. That market is big enough that private sector firms, specifically broker dealers, could do that job.

In my opinion, the MBS buyback is to take advantage of arbitrage. It is an arbitrage play. Driving it, in my opinion, is that Fannie and Freddie have made a commitment to the financial markets, Fannie more strongly than Freddie, to grow their earnings at 15 percent a year, to double their earnings every 5 years.

The mortgage market is not growing that fast and so they have to figure out how to grow their revenues faster than the market is growing. A good way to do that is to buy back MBS, to get the interest rate spread, which is significantly greater for carrying interest rate risk than carrying credit risk.

Our assessment is that on a net profit basis, depending on which GSE you are looking at, they get about four to six times as much net profit, per mortgage dollar outstanding, if they assume the interest rate risk which they get by buying back the MBS. So ultimately their MBS buybacks are driven by the earnings growth commitment that they have made to Wall Street.

Now, in terms of where that benefit goes, that is something I have not assessed. It would be a good question to pose to CBO in the context of the study that they are doing to update their 1996 report on Fannie and Freddie. At that time, CBO made an estimate as to how much of the overall subsidy that Fannie and Freddie have flows through to homeowners and how much of it stays with stockholders and management.

Mr. BENTSEN. And I want to hear your comment, but I want to follow up with Bert here because we——

Is the reason, in your opinion, that Fannie and Freddie—let's say Fannie, is the commitment to the capital markets of the 15 percent annual return because the structure of the entity is such that the Federal Government wanted to jump start the secondary market and ease the ability to gain a mortgage and in effect leverage private capital, that the entities have to be able to raise private capital at a competitive rate of return and the fact that, criticism notwithstanding, the ability for the GSEs to expand into non-mortgage investments in any marked way, as opposed to a nominal sense, is limited by the fact that HUD oversees them and there may be legislation, et cetera, has this created sort of a Hobson's choice for us of whether we want to have—of the type of entity that we have here?

Is this part of our own creation, that they are forced to earn returns where they can in order to meet their mission and satisfy those who are putting capital into it?

Mr. ELY. Well, there are two issues here. First, in terms of the rate of return, they clearly are earning above-market rates of return on their equity capital. ROEs of 22 and 24 percent are earned on a steady basis, which are quite handsome compared to genuine private sector firms.

What is the motivation here is that it is the promise of such significant growth in earnings, that is 15 percent a year, doubling earnings every 5 years, that is key to driving up their stock price. That is what motivates Fannie and Freddie—not so much the striving for high ROE as it is the earnings growth rate.

And, again, the problem they face, and maybe it is their Hobson's choice, is that they have made a commitment to the financial markets to grow their earnings faster per year than the mortgage market as a whole is growing, which means they have to assume a larger and larger market share, if you will, of the total interest spread that exists in the mortgage market.

This is increasingly a dilemma for them. My sense is that the stock market is increasingly skeptical of their ability to maintain that earnings growth rate, which is again separate from the ROE question.

Mr. BENTSEN. But without sufficient capital, they are unable to purchase more mortgages in the secondary market at a rate competitive enough to meet the missions that Congress set out when they were created in the 1930's and in the 1960's. Is that correct?

Mr. ELY. Well, that is true, except that a lack of capital has not been a problem for them. At times, Fannie particularly has been buying back stock. Given what their stock prices have been, at least until very recently, they would certainly have no problem in issuing additional capital stock. So I do not think——

Mr. BENTSEN. So it is not that stock buyback—it is not necessarily a bad thing. I mean, we would expect in a corporation that has sufficient capital that it ought to support a stock price at a relatively good price through a buyback. I mean, that would be something—that would be considered a good corporate practice in most cases, right?

Mr. ELY. That is true, but a stock buyback suggests that a corporation has more capital than it needs rather than being short of capital, so I do not think that Fannie and Freddie have suffered from a lack of capital.

Mr. BENTSEN. Do you all have any comment?

Ms. Miles or Mr. McCool?

Mr. MCCOOL. Well, I think just getting to your question, I think it is fairly clear that holding mortgages in a portfolio, whether it be MBS or whole loans, is both more profitable and riskier than issuing MBS. I think that is true. What is done with the profits is something that is very difficult to know.

I think that the question about a Hobson's choice, in our work on mission regulation, we talk about it as the tension between increasing shareholder value and fulfilling the mission and I think it is fairly clear that that tension exists. That is why mission regulation is so important.

Ms. MILES. I think as far as the repurchase of mortgage-backed securities goes, it is difficult for me to understand what that is supposed to do for housing markets because if you believe that capital markets are well integrated, then what you are talking about is a GSE taking one form of its means of financing mortgages and simply substituting it for another form of financing mortgages. In other words, issuing general GSE debt in order to buy back mortgage-backed securities, which are the other way of financing them, and you should end up with a wash.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman SUNUNU. Thank you.

One brief point to clarify. A wash in terms of both interest cost and liquidity?

Ms. MILES. In terms of what it is that the GSE has actually done. I mean, if you finance the mortgages by buying them through GSE debt or if you finance them through selling mortgage-backed securities, those are both means of financing mortgages. And if you simply substitute one for the other while you change who is holding the risk, you still have the same amount of mortgage money sitting out there in the market.

Mr. BENTSEN. Mr. Chairman, if you will yield, that is true except for the ability, I think, to buy—if you are able to go back into the market and buy the MBS at a discount, at a deeper discount than the issuance price, the question is what do you do with the spread on the discount.

We know that MBSs fluctuate in price based upon interest rate changes which are obviously beyond the control of Fannie and Freddie, or I think they are, and the guy who is doing that is testifying over at the banking committee now, they are over there.

And the question comes back to, again, is taking advantage of that spread doing one of two things: is it supporting the initial issuance price of the future MBS or the current MBS and that may or may not be the case, although issuers do do that from time to time, support their product in the secondary market, both private and Fannie and Freddie, but the other is what are you doing with the spread and is the spread somehow affecting the price of the future issuance and thus the price of the mortgage to the consumer, which is the original mission.

Ms. MILES. Again, that depends on what you believe about the substitutability of these instruments.

Chairman SUNUNU. Thank you.

Mr. Hoekstra.

Mr. HOEKSTRA. I thank the chairman. I thank you for doing this hearing.

Ms. Miles, I would just like to go to some testimony on page 3 of your testimony and I want to get an elaboration or expansion of your comments at the bottom of the page where it talks about market power.

"By most accounts," and I am quoting, "By most accounts, the problems that gave rise to creation of the housing GSEs have been corrected. Correction is generally measured in terms of the degree."

So are you saying that the circumstances and conditions that gave rise to GSEs in this area are no longer out there, that the need no longer exists?

Ms. MILES. The academic studies that have been done on this would say yes, that is correct. The argument then becomes one of does the market failure reappear if you remove GSE status from the market and that is where most of the argument would be today.

Mr. HOEKSTRA. OK.

Mr. ELY. If I could add something to that?

Mr. HOEKSTRA. Yes.

Mr. ELY. We have a substantial amount of asset securitization in this country that has nothing to do with the GSEs, in the jumbo mortgage market, credit cards, and auto loans. The markets have learned how to securitize assets. If Fannie and Freddie went away, the markets would still be able to securitize mortgages.

Mr. HOEKSTRA. Thank you.

Ms. MILES. And if I could pick up on one thing there. I do not know of anyone who is actually advocating that Fannie and Freddie go away. I have heard a lot of advocacy that they simply graduate out of their GSE status, which is a different question.

Mr. HOEKSTRA. Right. And they graduate out of GSEs to move them away from the benefits that I think all three of you talked about in your testimony that they receive as being identified as a GSE.

And I would also assume if we moved them away from a GSE we would also perhaps move away some of the risk that is associated with the taxpayer. Would that be safe to say?

Mr. ELY. Yes.

Mr. HOEKSTRA. OK. Because I think where I then start getting some concerns, I think, again, Ms. Miles, on page 5 of your testimony, you talk about them repurchasing their mortgage-backed securities and it is toward the bottom of the page.

"While it is clear that this increases shareholder value, it is difficult to understand what, if anything, it does for mortgage markets."

So this really—what I see at least I think all three of you talking about in your testimony, you are seeing behavior out of these GSEs that is not associated with their primary mission, but is associated with their mission to their shareholders of meeting the commitments that they have made to their financial markets.

Is that what you are saying here on page 5?

Ms. MILES. That is correct. And one of the things to bear in mind is when we set up GSEs, I tried to make clear right up front, we set up something that has an inherent contradiction in it. Because while it has a public purpose and those charters are intended to be tools to take care of that public purpose, we also set them up as private enterprises with a fiduciary, a legal responsibility to their shareholders. There is a tension there.

Mr. HOEKSTRA. That is right.

And then, Mr. McCool, in your testimony on page 6, you are using the same type of examples. "We pointed out that the enterprises have incentives to use the funding advantage associated with their government sponsorship to make non-mortgage investments, such as corporate bond purchases, that may result in arbitrage profits."

Again, you conclude, "However, our report concluded that the relationship between long-term non-mortgage investments and the enterprise housing mission is not entirely clear."

So you are saying the same thing, that there is not—activity that the GSEs are engaged in may or may not be directly related to their primary mission.

Mr. MCCOOL. There are cases where that is very true. There are cases where non-mortgage investments are necessary to maintain liquidity and there are other cases, we suggest, where that relationship is not clear.

Mr. HOEKSTRA. And then at the bottom of page 6, you go on to talk about, "For example, in our March 1998 report, we pointed out that HUD approved a new mortgage program Fannie Mae that would involve Fannie Mae in purchasing cash value life insurance, which is essentially a non-mortgage investment. HUD officials told us that they lacked expertise in cash value life insurance when they approved the Fannie Mae program."

We are seeing these organizations move into an area where it may be higher risk to the taxpayer, it gets to be even higher risk if the people that have oversight over them do not understand the activities that they are engaging in. Is that what you are saying in this section?

Mr. MCCOOL. Well, part of the issue there was we thought it would have been prudent for HUD to talk to, in this case, Treasury, who actually does understand cash value life insurance and, in particular, the tax treatment thereof, which was one of the issues. But in this case, that discussion did not occur.

Mr. HOEKSTRA. Well, what you are saying is that for an organization whose debt approaches that of Treasury and in some form is overseen by HUD, HUD is approving activities and actions that it does not understand.

Mr. MCCOOL. In this particular case, I think that was true.

Mr. HOEKSTRA. Mr. Chairman, I have no more questions. Thank you.

Chairman SUNUNU. Thank you, Mr. Hoekstra.

Mrs. Clayton.

Mrs. CLAYTON. Thank you, Mr. Chairman. I also think this is a significant hearing. I would also ask if my opening statement may be a part of the record.

Chairman SUNUNU. Without objection.

[The prepared statement of Eva M. Clayton follows:]

PREPARED STATEMENT OF HON. EVA M. CLAYTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

Chairman Sununu, this is the latest in a series of hearings and other activity that have focused on this important subject.

On July 18, our colleague, Congressman Peter Hoekstra, issued a "Dear Colleague" calling for "A Healthy Debate on the Future of GSEs."

That call came on the heels of five hearings on GSEs that have been conducted in Congress, this session.

Those hearings centered around a Bill, H.R. 3703, that has been introduced by our colleague, Congressman Richard Baker.

Despite those hearings, it appears that we are still searching for the right thing to do in this situation—There is no emerging consensus.

I believe it is important and useful that Congress exercise its oversight authority, especially on a matter—housing—that affects all of our citizens.

Home ownership rates in the United States have reached historic levels.

One of the questions I hope this hearing will help answer is whether the role of the GSEs has substantially and significantly contributed to this desirable rise in home ownership?

And, if so, will the call for reform help or hurt this role?

No one likes debt.

But, another question I hope this hearing will answer is whether the debt of GSEs is something about which we should be concerned to the point of panic.

It is fair to say that, while comparison of GSE debt to Treasury debt is of some use, the comparison is not exact.

They are not the same.

Still another question I hope this hearing will help to answer is whether the GSEs, by their activities, are exposing our Government to unreasonable and unacceptable risk?

Not all risk is unreasonable and unacceptable.

A related question is whether the GSEs, through their debt, are adding to or contributing to the debt of the United States.

We have worked hard to eliminate the national debt, and we are on track to do just that by 2013, and activity that impedes that progress must be closely scrutinized.

What is the fundamental role of the GSEs, and can that role be better performed by some other entity?

Is the current arrangement with the GSEs in need of repair, restructuring, radical change?

And, finally, I hope this hearing will help us to answer the question, what is best for the consumer—- what is best for the American people?

Can we have home ownership, without debt?

Can we ensure that every citizen, regardless of their station in life, with hard work, determination and careful budgeting, has a chance to own a home, without the involvement of the GSEs?

While home ownership has reached historic levels in America, still, for many, it is out of reach.

Like home ownership generally, minority home ownership has grown.

Yet, despite that growth, home ownership among African- Americans today stands at just over 47 percent.

And home ownership among Hispanics stands at roughly the same amount.

Yet, the home ownership rate among whites is close to 75 percent.

Home ownership, Mr. Chairman, is the backbone of this Nation's way of life.

Whatever we do, we must promote that important goal.

Before we change anything, we must be clear as to whether what we have now is a benefit or a burden.

And, even if it is a burden, when weighed against the good it does, is it a necessary burden.

Under current law, Fannie Mae and Freddie Mac face strict supervision and examination by OFHEO, which has a staff of 95, whose full-time responsibility is to oversee these two entities.

Fannie Mae and Freddie Mac will argue that they employ sophisticated interest-rate and credit risk management strategies, strategies, they will say, which provide more than adequate protection.

Fannie Mae will argue that it is limited by charter to investing in residential mortgages only

They will point out that In the 1980's, most S & Ls failed because, through deregulation, they were allowed to invest in endeavors far beyond home mortgages.

Most of the S & Ls that stayed with their traditional mortgage business recovered, they say.

And, finally, Fannie Mae will argue that any increase in its debt does not in any way increase the indebtedness of the U.S. government.

Their obligations, they say, are not in any way backed by the full faith and credit of the United States Government.

In fact, they argue, the law requires that the front page of all their debt and mortgage-backed securities state that they "are not guaranteed by the United States and do not constitute a debt or obligation of the United States.

Indeed, I have heard nothing to this point to suggest that the GSEs are not doing a good job.

Moreover, I have seen no evidence that they are not well managed.

Indeed, for example, the OFHEO 2000 Report concludes, "At year- end 1999, Fannie Mae exceeded safety and soundness standards in all examination program areas.

Mr. Chairman, I believe first and foremost, we must maintain our ability to encourage home ownership opportunities in America—for everyone.

I look forward to the testimony of our witnesses.

Mrs. CLAYTON. I guess I want to pick up on Mr. Hoekstra's remarks. Let me just make a statement also.

I think we are indeed enjoying historical highs in terms of people enjoying the American way of home ownership, and I think that is a good thing. I think indeed people have calculated making debt no one likes but taking a risk and having access in their homes, they think that is a worthwhile activity. And so we are having historical highs right now where people are making the calculation, buying a home, and I certainly encourage that, but I think I would be remiss to suggest that the issue has been addressed sufficiently.

When you look at those historical highs, there is a disproportional benefit. Minorities are not increasing their homes at the same rate. Working middle class are now having stress. There is a recent article, I guess about 3 weeks ago, in the high tech areas where working people who are making 60 and $75,000 a year are finding it difficult to afford homes. So there is a constraint in the market.

I think we acknowledge great things are happening for many Americans, but to suggest that there is not a need for these entities that provide for an easy way for most Americans to get housing I think is inaccurate, so I want to challenge that.

And I do not know if you are saying that you feel that there is no longer any problem in the marketplace, I want to suggest there is a problem in the marketplace. Contrarily, I think because we are indeed enjoying great prosperity in certain areas, you ask people in Silicon Valley, you ask people in Oakland, you ask people in the Washington area, you ask people where there is opportunity for growth, they are not able to afford a home. So that prosperity has almost driven the value of the land itself and house to move and there is great genderfication going on right now, so I do not want it to be missed in this hearing or any other hearing that we have addressed all the housing areas.

Having said that, also, the testimony for all three of you seemed to suggest that the risk of the debt is not—well, I take exception, Mr. Ely, you do not suggest that because your very point is indeed that debt is a risk—but it would seem to me that you are—both of you have indicated, the GAO as well, tell us that the debt itself is not as much of a risk.

Am I right in assuming that?

Mr. MCCOOL. Well, we have not actually made an explicit statement about that, I do not think. I mean, I guess——

Mrs. CLAYTON. Well, let me ask you——

Mr. MCCOOL. The issue really comes down——

Mrs. CLAYTON. Is the debt that Fannie Mae and Freddie Mac hold implied to be risky and therefore we should indeed think about restructuring, changing the structure drastically? Is that a sufficient concern we ought to look at it? Is it fair to compare the debt of those entities with the United States? The debts are quite different, so is it really a serious problem?

Mr. MCCOOL. Well, again, the debt or the securities and mortgages that Fannie and Freddie hold are somewhat more risky than issuing mortgage-backed securities, but the point is that OFHEO is charged with overseeing their activities to make sure that the risks are managed well, hedged well, and that they have a risk-based capital standard in place that would protect the interests of the government. So the risks are relative.

Mrs. CLAYTON. The risks are relative to the management and having instruments——

Mr. MCCOOL. And being well regulated.

Mrs. CLAYTON. How different is that, Mr. Ely, since you think that Fannie Mae and Freddie Mac debt is really troubling and how different is the risk of the banks that have this same—they buy back securities, they have whole loans. My understanding, you represent them. How are you advising them about their debt?

Mr. ELY. Well, I am not advising banks with regard to that. I just——

Mrs. CLAYTON. No, you advise the banks.

Mr. ELY. I am a student of what their practices are. What concerns me about the GSEs, particularly relative to the banks, is twofold. Number one, they are more thinly capitalized, particularly with regard to credit risk. The second thing is that they are less diversified. This is a point that the other witnesses made. Fannie and Freddie are focused on just one sector of the economy.

Mrs. CLAYTON. Let me stop you there. They are less diversified. I thought they were chartered for an explicit mission, to encourage their instruments, and the advantage they had of being chartered to direct most of their attention to the mortgage financing of homes. So their less diversification is consistent with their mission.

Mr. ELY. Well, that is true, but we have to understand that there is a down side to that and that is the lack of asset diversification, the concentration in housing finance.

The fact that they are buying mortgages and guaranteeing mortgages from all over the country helps to diversify that risk, but we cannot lose sight of the fact that they are focused strictly on housing finance whereas commercial banks generally have a broader range of assets. That is why, when you combine the higher capital levels of banks and thrifts with their greater asset diversification and their balance sheets—and also the fact that Federal deposit insurance has been essentially set up as an industry self-insurance mechanism, the banking and thrift industries do not pose the taxpayer risk that Fannie and Freddie do.

Mrs. CLAYTON. Banks do have some subsidy. I do not want you to suggest that they do not have some. I think it is a matter of judgment as to which of the ones pose a risk, but banks do. That is part of what we give the depositor, that the government does indeed back some of their deposits to a certain level. So to suggest that only the entities that are GSEs are posing a great risk, I think that is inappropriate.

Mr. ELY. Well, if I could address that question, I would like to file a paper with the committee which argues that actually the banking industry, the nation's banks and thrifts, do not receive any Federal subsidy at all. If anything, the subsidy actually flows the other way.

Chairman SUNUNU. Thank you, Mrs. Clayton.

Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman.

I would like to follow up on a question that is tangentially related to what we were just discussing. Certainly if you look at the cost of funds relative to capitalization, there is a subsidy going on for the GSEs. I think that is pretty clear.

I am interested in pursuing a point that Ms. Miles raises in her testimony on page 4 in particular, where there seems to be a dynamic here that I was hoping you would comment and elaborate on a little bit and that is as follows.

The magnitude and the value of the subsidy, the implied guarantee, the various government benefits conferred upon the GSEs, clearly grows with their size and that creates an added incentive for these institutions to grow, arguably above and beyond the normal incentive that every corporation has to grow.

When any company grows, certainly a publicly traded company, certainly a company that issues debt, there are a number of market forces that put a check on that growth, that that growth be prudent and that there be sufficient capital to sustain that growth. And if a company does not have—if there are concerns, then the market will impose costs on a company such as a higher cost of funds, a lower price of its share, various mechanisms that the market has to keep that growth in check in a sustainable level.

When we have an implied government guarantee and when the market is convinced that the government is backing these institutions and it would not be allowed to fail, you raise the point that maybe that normal market discipline is weaker than it would be with another company, a company without such an affiliation.

So my question is have we created an inherently unstable dynamic, where we have created extra incentives to grow and we have reduced the market discipline that normally holds that growth in check and requires that to be done in a prudent fashion? Is that not an inherently long-term unstable situation?

Ms. MILES. It certainly can be. Bear one thing in mind. As long as the GSEs do have positive shareholder value, they have plenty of reason to exercise their own discipline and not go into an area where they would jeopardize that. If, however, they lose that value, they then have no reason not to gamble and go in for very big risks, knowing that they have lost everything they can lose. A big risk gives you the opportunity of getting back out of trouble and restoring shareholder value, but if you lose everything, you basically put it back on somebody else.

That is where it becomes very unstable and that was essentially what did happen with the savings and loan industry in the 1980's.

Mr. TOOMEY. So if I could sort of summarize what you are saying, in good times and when things are going well, this dynamic may not be very dangerous. The problem is sort of——

Ms. MILES. When things do not go well.

Mr. TOOMEY.—leveraging up and doubling up your bet when things are looking rather grim.

Ms. MILES. That is correct. The less capital you are carrying the more quickly that kind of situation can come upon you.

Mr. ELY. If I could add something to that, there is a second form of discipline and that is credit market discipline. In other words, the debt markets. One of my real concerns is that the credit markets are not providing the discipline over Fannie and Freddie that they should, which is very important given how highly they are leveraged, because of their implicit Federal guarantee.

Mr. TOOMEY. Al right.

Mr. Ely, you mentioned, if I recall, during your testimony that there are numerous reasons why Fannie Mae or Freddie Mac might run into financial problems, including events outside the U.S. financial system.

Did I understand you correctly? If so, could you elaborate on what some of those exogenous events might be?

Mr. ELY. Well, you know, I could sit here all day long and come up with examples and not hit the mark. One of the problems with the world is that problems can come out of left field that no one anticipated and yet they have a disruptive effect on the market.

The impact of the Russian debt crisis in the summer of 1998 is a very good example. It caught a lot of people unawares. It did have magnification effects in the U.S. financial markets.

Mr. TOOMEY. Specifically did it have any impact on interest rates associated with mortgage-backed securities? Or the whole loan market for that matter?

Mr. ELY. In that particular case, there was a flight to quality, and Fannie and Freddie were beneficiaries——

Mr. TOOMEY. It was actually a good thing for the mortgage-backed securities market.

Mr. ELY. At that time, but there were other credit markets that suffered quite a bit, particularly the junk bond market. Next time, it could play differently.

I will give you one example that I worry about a lot and have written about and that is the Japanese financial situation. You have a country that is increasingly indebted, and with very weak financial institutions.

If there is some kind of accident in Japan, I could see global effects of that. And next time, it may not inure to the benefit of Fannie and Freddie. So we just cannot expect the same kind of reactions to the next crisis that we have had in the past.

Mr. TOOMEY. Thank you.

Thank you, Mr. Chairman.

Chairman SUNUNU. Thank you, Mr. Toomey.

Mr. Minge.

Mr. MINGE. I would like to ask two questions. First, to what extent do you believe the interest rates on residential mortgages are lower because of Fannie Mae and Freddie Mac and the Federal Home Loan Bank institutions?

And I would ask this of any of you.

Mr. Ely, I will start with you.

Mr. ELY. They may be lower, but that is only half the equation. The other question is, and this is one again I have explored a little bit, to what extent are the lower interest rates capitalized or possibly even overcapitalized in housing prices? In other words, you can afford to pay more for a house because the interest rate is lower?

Some work I have done with Fed Flow of Funds Data suggests that at times we have possibly had an overcapitalization of the subsidy in housing prices. Specifically, overcapitalization is reflected in the residual value of land underlying owner-occupied housing.

So it is not enough to say that rates are lower. You also have to look at what the effect of lower rates is on housing prices because if lower interest rates have been capitalized in housing prices, then the beneficiaries of the subsidy, if you will, are the sellers of homes, not the buyers.

Mr. MINGE. I assume that observation, then, would apply to the availability of housing credit generally, that if we have housing programs we might make it easier for people to finance housing which in turn would drive up the price of housing because of greater demand.

I do not want to debate this, except to say that I think that you can take that to its logical extreme.

Mr. ELY. Well, you have put your finger on a fundamental policy issue. The broader a subsidy is the more likely it is to be capitalized in the price of assets. A targeted subsidy is less likely to have that effect, which is why I believe that one of the issues that needs to be addressed in the housing finance area is to what extent the subsidy is misdirected and going to people who do not need it, versus those who are presumably at the cusp of home ownership and therefore warrant a subsidy.

Mr. MINGE. So maybe we should have high interest loans so we do not have a lot of competition for housing and we keep the price of housing down.

Mr. ELY. No, I am not arguing for that at all.

Mr. MINGE. Mr. McCool, let me direct that same—not the little exchange that we have just had, but the question of whether or not——

Mr. MCCOOL. We estimated in our privatization report of 1996 that the housing enterprises probably reduced mortgage rates by something in the range of a quarter—about 25 basis points, about a quarter of a percent.

Mr. MINGE. Ms. Miles.

Ms. MILES. I pretty much agree with that. One of the ways to measure that is to look at the difference between the jumbo market where Fannie and Freddie cannot purchase mortgages and the conforming market, and it is generally 25 to 30 basis points. That might not be the whole story.

In fact, I would argue that the great success story that is involved here is that we have far better integration of housing finance markets and capital markets generally and that is something that has occurred for a variety of reasons. You no longer get the great curtailments of mortgage financing whenever interest rates rise, but you will get some arguments as to whether that was all Fannie and Freddie's doing.

Mr. MINGE. Another question I would like to ask, if I can, and this guy is sitting here with a clock, so I get just a little sliver of this time——

Chairman SUNUNU. I will be as generous as possible.

Mr. MINGE. Well, thank you.

I am concerned with Fannie Mae and Freddie Mac and the others, when they issue their securities and the collateral is series of mortgages that they are holding on residential property, with a right of prepayment under certain circumstances, there may be generally, then the question is do they match that up with the right to call those bonds without penalty?

What have you observed in that respect? And I guess the interest rate risk that we are talking about to some extent is whether or not there is a match between the prepayment risk that occurs and the ability to call bonds so as to issue new bonds at a lower interest rate or more competitive interest rate to keep these interest rates in synch.

Mr. Ely.

Mr. ELY. Well, both agencies do issue callable debt which helps to protect them if rates are going down. They also enter into interest rate swaps to protect themselves if interest rates are going up. If interest rates are going up, the prepayment rate drops off. But what is important to realize here is that these mechanisms do not work perfectly. While callable debt is a good way to handle the increased prepayment rate due to a decline in rates, if rates are moving up, I have a greater concern because that introduces counterparty risk into the equation.

Mr. MINGE. OK. But if the interest rates are moving up, then I suppose that Fannie Mae or Freddie Mac would decide not to call those bonds, leave those bonds out there and homeowners are not going to go out and refinance under those circumstances, so you would have a level of stability just based upon the nature of the market in that setting.

Mr. ELY. That is correct.

Mr. MINGE. I am also quite intrigued with the advantage that you have identified, sort of an arbitrage advantage to Fannie Mae and Freddie Mac investing in their own securities for the purposes of internalizing the interest rate risk is, I believe, how you described it.

Now, maybe I have mis-identified this. To those of us that do not come from such rarified financial backgrounds, it has a certain mysterious side to it and I am wondering if you can offer any additional explanation that would help us better understand how this creates profitability and, secondly, how it increases risk.

Mr. ELY. Well, if you take a look at the two basic risks, the credit risk and the interest rate risk, when mortgages get securitized, mortgage-backed securities are issued and the interest rate and prepayment risks are shifted to whomever buys the mortgage-backed securities.

When Fannie or Freddie buy back their own MBS, they take that risk back in or to use Ms. Miles' term, they repatriate the risk. So they have brought the interest rate risk back on their balance sheet, but they are earning additional interest income spread to compensate for that risk.

The great question is are they earning enough additional spread to compensate for the interest rate risk that they have reassumed.

Chairman SUNUNU. Thank you, Mr. Minge.

Mr. Ryan.

Mr. RYAN. I think that this has been a very helpful hearing. I am on the relevant banking subcommittee which goes over these issues and I do not think I have heard a more in depth discussion about GSE debt per se. So I am intrigued with the depth that we have gone into in this.

Mr. Bentsen basically asked precisely the question that I was going to ask, but I would like to go back to this issue of repurchasing mortgage-backed securities and ask each of you a question.

Number one, I think when you look at GSE debt, and that is the scope of this hearing, you can kind of divide it into two areas, mission critical debt which is used to securitize the secondary market, which would obviously grow as the mortgage market grows, then you have what some people call excessive debt, which is the debt that is issued solely for the repurchasing of mortgage-backed securities or retaining mortgage-backed securities on the books. It involves a new kind of risk, an interest rate risk or a prepayment risk. There is an arbitrage activity that is occurring which clearly is profit derived. I think we have established that here.

I would like to ask you does the repurchasing of mortgage-backed securities, specifically the alarming pace of the repurchasing of mortgage-backed securities, I think 4.6 percent in 1992 was retained, now it is about 30 percent of mortgage-backed securities are retained by both Freddie and Fannie, does that in any way notably extend and advance home ownership?

Does it put a new person in a home? Is it mission critical? And then I have a follow-up, but if you can answer that quickly I would appreciate it.

Barbara, why don't we start with you?

Ms. MILES. How brief can I be? I would say no, I do not think so.

Mr. RYAN. That is great. Thanks.

Mr. MCCOOL. We would, I think, agree that there is no clear advancement of the mortgage market by repurchasing mortgage-backed securities.

Mr. ELY. Mortgage repurchases are not mission critical.

Mr. RYAN. OK. So repurchasing the mortgage-backed securities you would then say is clearly done for the ROE, for profit, for the shareholder directive. Would you concur with that?

Barbara.

Ms. MILES. By and large.

Mr. MCCOOL. Again, we have not really studied that specifically, but I would suspect that, again, it is a risk/return tradeoff that is probably driving it.

Mr. ELY. Yes.

Mr. RYAN. OK. So if we are establishing that repurchasing mortgage-backed securities is done with an arbitrage activity for the ROE, it kind of goes down to the issue that we have a contradictory mandate, a structure that is inherently contradictory, Hobson's choice, whatever you may say, mission critical housing mandate by Congress overseen by OFHEO which is to securitize the secondary market, but now you have the repurchasing of these mortgage-backed securities which clearly adds to the ROE, something you cannot really fault a company that has shareholders as well, but something that raises very interesting questions because there is an implied guarantee. Our job is to steward and watch over taxpayer risk.

Do you believe that this prepayment risk is sufficient hedged against? Do you believe that the mortgage-backed security risk, the interest rate risk is sufficiently addressed or do we even know whether it is sufficiently addressed and do you think OFHEO is capable of calculating whether or not that risk is sufficiently hedged or offset?

We will start with you, Barbara.

Ms. MILES. That is really a question I hope you ask OFHEO. They have what looks to me to be a very nice capital standard model. It is not yet in effect, there are a lot of questions about it. By and large, it appears to handle within certain bounds the kinds of limits you would want it to handle.

The question I would have is will it give you a signal quickly enough if things really go badly. And given that we are talking about relatively low capital levels, I cannot give you a good answer to that.

Mr. RYAN. Mr. McCool.

Mr. MCCOOL. Again, I think that that is a question for OFHEO, as Barbara has suggested. And, in fact, I mean, again, this whole idea of the GSEs buying back mortgage-backed securities and having more risk on their portfolio should be certainly into account by their risk-based capital standard. And it is. So a lot of that should all be played out in their risk-based capital standard and in OFHEO's examination process. But that is a question, as I said, to ask them.

Mr. ELY. In my opinion, outsiders cannot judge how well Fannie and Freddie are managing that risk based on the information that is publicly available. I find it troubling that there is not sufficient information available to the public, specifically to the investment community, to judge that risk and its management.

Mr. RYAN. Thank you. I think it is important, and I will briefly summarize here.

Did you want to interject?

Chairman SUNUNU. No, I just wanted to ask specifically can you give an example of what information is not available that would enable that judgment to be made?

Mr. ELY. In my opinion, based on the footnote disclosures that I read, that we get kind of bits and pieces of information. We are not presented with a total picture in a comprehensive way, even though it may be summarized, as to how they are managing the risk and what the risk characteristics are particularly of their counterparties.

Mr. RYAN. If I could interject, I think it also goes to the question that we really do not know how reliable the hedging techniques are. Hedges have obviously advanced since the early 1990's, but no one including OFHEO or any of us know if this is properly hedged, how well the hedges would work and, you know, we had a similar problem where we had paper insolvency of Fannie Mae in the 1980's where you had an interest rate problem, you had an interest rate risk, Freddie did not engage in the same kind of activity and also missed out on having the paper insolvency. So I think it is an interesting issue.

What is interesting that I think we have established here in this hearing is that the debt which is relative to mortgage-backed securities in retaining or repurchasing the mortgage-backed securities, repurchasing is a term that has been in question, but it is a term that is used in Freddie Mac's annual report, so I will use the repurchasing of mortgage-backed securities, the debt associated with that is by and large it seems like our panel has agreed to is excessive debt, non-mission-related debt and debt that is more or less used for profit.

Thank you. I yield back my time.

Chairman SUNUNU. Thank you, Mr. Ryan.

Mr. Ely, for clarification, the example you gave of information that is not disclosed to the extent that you would like it to be to render judgment about risks is counterparty risk. I assume you are talking about the counterparty risk involved in primarily the interest rate swaps that the GSEs use to hedge their debt.

Can you give an example or are there examples of other publicly traded companies that disclose counterparty exposure in their hedging strategies?

Mr. ELY. One could argue that there is no such thing as enough disclosure. It has been my experience, as I read their footnote disclosures, that I do not get as much and I do not get as complete a picture as I would like to see.

Chairman SUNUNU. Is there a difference between getting as much information as you would like and getting as much information as you would get from a comparable firm or from a firm that is not regulated or sponsored in any way by the mortgage-backed securities?

Mr. ELY. In my opinion, bank holding companies basically provide a more complete disclosure than Fannie and Freddie do.

Chairman SUNUNU. Bank holding companies disclose counterparty exposure in interest rate swaps?

Mr. ELY. They provide more insight into the nature of the risks, into the nature of their counterparties, and in other regards to the swaps. You basically get more numbers, you get more detail. Although I will say this, it is not comparable across the different companies. You can find fault with any one company's disclosure.

One difference is that the bank holding companies and other financial firms issue financial statements that are subject to SEC oversight, which is lacking in the case of Fannie and Freddie.

Chairman SUNUNU. Fair point. Thank you.

Mr. Smith.

Mr. SMITH. Mr. Chairman, just briefly.

Again, would you give me your impression of the assumed liability of the Federal Government in terms of what is anticipated from those buying these bundles from Fannie Mae or Freddie Mac? Is there implied liability of the Federal Government in terms of expectations of the government somehow bailing out Freddie Mac or Fannie Mae if they were to go into trouble?

Ms. MILES. I always try to be really careful how I answer that because we officially deny that there is any responsibility at all. But if you take a look at the list of ties, links to the Federal Government, they clearly imply something and the market infers something. The market believes, obviously, in the way they price Fannie Mae and Freddie Mac paper, and for that matter the Federal Home Loan Banks as well, that there is a sufficient nexus that the government would do something. And any time the market believes that relationship is being challenged, things change. We had an example of that in March.

We had a little bit of a decrease in spreads between GSE paper and triple-A paper. Not a big one, but it is still there.

So there is something that is being inferred. I do not want to be in a position of measuring it, but something is there. Beyond some point, presumably, the market perception may also break. At that point, the government might decide to step in. Again, Bert's example of the Farm Credit System.

Mr. SMITH. And Tom and Bert?

Mr. MCCOOL. Well, again, I would echo Barbara's idea that clearly the market perceives there is some connection. But, I mean, the extent to which there is or is not a government bailout should that ever arise is up to the administration and Congress to decide. I mean, that would be a decision for you folks.

Mr. ELY. As I said in my testimony, we have two clear cut examples of a GSE rescue: the Farm Credit System back in 1988 and then the FICO bonds in 1996. When I talk to people in the Wall Street community and ask them this question, they have no doubt in their minds whatsoever that if there was a problem with any of the GSEs, the Federal Government, in one way or another, would ride to the rescue to protect creditors, that is holders of debt and MBS, against any kind of loss.

There is a totally different story for stockholders. Stockholders might get wiped out, but the belief in the credit markets is the Federal Government would ride to their rescue. Given their size today, the government would ride to the rescue sooner rather than later.

Mr. SMITH. It just seems based on your answers, Mr. Chairman, maybe there are two alternative actions of the Federal Government, either to charge Freddie Mac and Fannie Mae a fee for this underwriting, if you will, or to somehow take action to make it clear that they are independent organizations and even though they are a government-sponsored enterprise, the Federal Government is not underwriting any liability that might develop.

If we were to do the latter, what kind of action might the Federal Government take to send out a signal to the marketplace that we are not going to underwrite them if they have problems?

Mr. ELY. I will jump into that. I do not think there is any credible action the Federal Government could take. Fannie and Freddie are government-sponsored enterprises. As long as they are creatures of Congress, they are subject to special Federal oversight. In my opinion, you cannot credibly say that they are not backed by the U.S. Treasury and the U.S. taxpayer.

Mr. SMITH. Then, Mr. Chairman, I would come down on the side of starting to charge them a 1 percent fee for that insurance that probably is more real than implied and, again thank the witnesses and yield back.

Chairman SUNUNU. Thank you, Mr. Smith.

Mr. Bentsen had some follow-up questions.

Mr. BENTSEN. Thank you, Mr. Chairman.

My colleague will probably be getting some mail as a result of this.

Mr. Ely made a good point, we need to remember this, that the fact that the GSEs are in this position today did not just happen out of the blue. It happened because Congress established this with a purpose in mind in the 1930's and with a purpose in mind in the 1960's.

And I know there has been discussion about the fact that banks and thrifts hold a GSE debt in a greater proportion than they would be allowed to hold the debt of a single corporate interest or if it were a loan to an individual. But that is also because Congress in the Bank Holding Company Act and other subsequent acts included GSE debt as a qualified investment, I believe, if I am correct about that.

There are reasons why we did that. We, being the royal we, did that because we believed that through the GSE structure we were in effect establishing a subsidy for the benefit of the American people to get into home ownership.

Has that worked, is the first question.

Second of all, if it could have been done without, which I am not sure that it could have, that you could have had the same stable mortgage market at least up until the 1980's when the mortgage-backed securities market came about in the extent that we see it today, would you have had the same stable interest rate environment for mortgage finance and the ability of Americans to get into homes?

And if that were the case, if in fact we did not need to do this at all, if you can make that argument, would the risk still exist because the ultimate risk we are talking about here is the risk to the American mortgage market.

The systemic risk that might—and I say might—come from Freddie and Fannie has to come from the standpoint that—in two instances, it seems to be, one would be bad management practice on the part of the GSEs themselves, and we assume through shareholder vigilance and OFHEO's job and HUD's job and Congress ultimately that that is watched.

The other is the credit risk associated and interest rate risk associated with the general economy. If we were to eliminate the GSEs tomorrow and assume that there were still 67 percent home ownership rate in the United States, somebody would have to hold that paper, including the banks and thrifts who might not be holding as permitted or qualified investments GSE debt or MBS, but would be holding a very high level of whole loans and portfolios or privately issued MBSs. So the risk would still exist.

Would the systemic risk still exist as well as a result of that, that U.S. banks and thrifts might be more susceptible to a meltdown in the mortgage market?

Mr. ELY. Well, I will stick my neck out on that one.

Obviously, the market would be different. We would see, first of all, a lot of privately issued MBS, just like we do in the jumbo mortgage market now, so there would be at least a geographical spreading of the credit risk.

What we might see is possibly a somewhat less leveraged investment in housing and finance. I, for one, am troubled by the fact that as part of the overall debt build-up in the economy, we are seeing steadily increasing leverage in housing finance. That in itself is potentially destabilizing. So I think we might see greater equity in homes.

But I would like to come back to your point about the subsidy. The question is: should there be a subsidy and, if so, what is the best way to deliver it? This question should be addressed in the coming years in Congress. Do the GSEs represent the best way to deliver the subsidy or are there alternative mechanisms for delivering the subsidy that focus it on those who, for whatever reason, are most deserving of the subsidy?

The CBO study in 1966 suggested that in effect Fannie and Freddie were not very efficient in delivering the subsidy. What they did not say, and I am sorry they did not——

Mr. BENTSEN. Excuse me, in 1996 or 1966?

Mr. ELY. I am sorry, 1996. I misspoke. The study from 4 years ago. What CBO did not get into is the extent to which the subsidy that Fannie and Freddie deliver is going to people that do not need a subsidy. They are middle income and above.

So there really are two policy issues that have to be dealt with here, one of which you touched on and that is the whole issue of financial stability generally, no matter how the financial markets are structured. The other is the issue of what is the best, most efficient, fairest way to deliver whatever housing finance subsidy is needed in this country in order to promote home ownership.

Mr. BENTSEN. Bert, can I just ask you to follow up on that? Would we have achieved the same home ownership rate, say, by 1980 without the GSEs compared to what we did achieve, in your opinion?

Mr. ELY. Sheer speculation, I could not have an answer on that, but I do not believe we had to have the GSEs in order to get home ownership to where it is today. For instance, if we had a subsidy targeted to just those people who are on the cusp of home ownership, where they need a subsidy in order to move from being a renter to a buyer or homeowner, then you would get that increase.

The problem with much of the subsidy today is it is going to people who are going to be homeowners anyway. They may end up being able to afford a somewhat more expensive, larger home, but they still would be homeowners.

So, again, the question is: are there alternatives for delivering the subsidy other than through the GSEs?

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman SUNUNU. Thank you, Mr. Bentsen.

I am sure we could question or badger, depending on your terminology, this panel all day, but that would not be fair to our remaining witnesses.

I want to thank our witnesses on this panel for their testimony and remind members that they have 5 days to submit written testimony for the record and call forward our second panel: Armando Falcon, the director of OFHEO, and William Apgar, the HUD designee to the Federal Housing Finance Board.

Thank you for being here, gentlemen.

Mr. Falcon, since the phrase “That would be a good question for OFHEO” was uttered more than “That would be a good question for the Finance Board,” we will be pleased to begin with your testimony whenever you are prepared.

Again, welcome.

STATEMENTS OF ARMANDO FALCON, JR., DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT; AND WILLIAM C. APGAR, HOUSING AND URBAN DEVELOPMENT DESIGNEE TO THE FEDERAL HOUSING FINANCE BOARD

STATEMENT OF ARMANDO FALCON, JR.

Mr. FALCON. Thank you, Mr. Chairman. I did catch most of those references to OFHEO. I am pleased to begin.

Thank you, members of the Task Force. As you are aware, the Office of Federal Housing Enterprise Oversight, or OFHEO, was established in 1992 as an independent entity within the Department of Housing and Urban Development. OFHEO’s primary mission is to ensure the capital adequacy and safety and soundness of the two government-sponsored enterprises, Fannie Mae and Freddie Mac.

To fulfill this mission, OFHEO has regulatory authority similar to those of other Federal financial regulators, such as the FDIC and the Federal Reserve. Those authorities include annual examinations, broad rulemaking authority, setting capital standards, enforcement actions and research.

Fannie Mae and Freddie Mac were established to create a secondary mortgage market to ensure a ready supply of mortgage funds for affordable housing for American home buyers.

To assist Fannie Mae and Freddie Mac in achieving their public mission, they receive numerous explicit benefits from the Federal Government. The most important benefit the enterprises receive is the special treatment the market bestows on their securities. Because of investors’ belief in an implied U.S. Government guarantee on their securities, the enterprises have been able to borrow money more cheaply and without the practical volume restrictions faced by any fully private triple-A rated company.

This market perception allows the enterprises to safely operate with a higher degree of leverage than fully private firms are able to do. There is no doubt that the GSEs are large and rapidly growing. As they grow, the implications to the economy, if they were to fail, also increases. However, the actual likelihood of any failure depends critically on how they are managed and supervised.

I want to assure you, Mr. Chairman, and members of the Task Force, that Fannie Mae and Freddie Mac are currently in excellent financial condition and OFHEO has a strong regulatory program in place to ensure their continued safe and sound operation. If the need ever arose, OFHEO would move quickly and forcefully to correct any financial problems at the enterprises.

OFHEO supervises the enterprises primarily through its extensive and continuous examination work. Our experts maintain a physical presence at the enterprises at all times and have unlimited access to all levels of management and highly sensitive corporate records. By staying apprised of the enterprises' risk and business activities on an almost real time basis, the examiners are able to evaluate an extensive array of risk related factors and assess the enterprises' financial safety and soundness.

Each quarter, OFHEO examinations staff issue conclusions related to more than 150 separate components of financial safety and soundness and thereby provide me with a comprehensive picture of the enterprises' financial condition.

Examiners meet frequently with management to discuss and assess business strategies and plans, financial performance results, risk management structure and practices, and each enterprises' overall risk profile.

Through our risk focused examination work, OFHEO constantly evaluates such critical areas as the enterprises' overall risk management practices, the composition of the risk profile and significant trends in the enterprises' retained and guaranteed mortgage portfolios, the enterprises' ability to effectively manage interest rate risk and other key financial exposures, the enterprises' ability to efficiently issue debt and hedge financial exposures and the quality of financial performance-related information and market-related information on which the enterprises' board and management rely in reaching key decisions.

In summary, the examination group provides us with an accurate and timely understanding of the enterprises' financial condition.

Fannie Mae and Freddie Mac have two major lines of business. First, they guarantee mortgage-backed securities, which are, of course, securities backed by pools of residential mortgages. Enterprise mortgage-backed securities are highly regarded by investors and can be issued at interest rates very close to those of mortgage-backed securities with an explicit government guarantee.

This guarantee business has been quite profitable for the enterprises, but mortgage borrowers receive most of the benefit from these lower borrowing costs. While there is no precise way to measure these savings, recent estimates have generally centered around 25 to 30 basis points, I think as was mentioned by the previous panel as well.

The enterprises' second major line of business is portfolio investment in mortgage-backed securities and, to a lesser extent, in whole mortgages. The enterprises fund these investments primarily by issuing debt.

Both of these business lines have been growing at the enterprises, particularly their portfolio investment business. Since the end of 1991, the enterprises' mortgage assets have swelled from $155 billion to $900 billion, an increase of approximately 475 percent. A majority of the increase reflects purchases of mortgage securities they had previously guaranteed.

Now, to fund the growth of these assets, the enterprises have increased their debt outstanding at a comparable rate from $164 billion to $963 billion over the same time period.

The guarantee business has also increased significantly. Total mortgage-backed securities guaranteed, both those held privately as well as those held in portfolio, has more than doubled from $731 billion 1991 to over $1.76 trillion today.

Enterprise debt and mortgage-backed securities outstanding now amounts to $2.2 trillion. Adding in the debt of the other GSEs, the total debt of all GSEs rises to $3 trillion.

Federal reserve estimates for holdings of what is known as agency debt, about 85 percent of which is issued or guaranteed by GSEs, shows the following breakdown:

Depository institutions hold 27 percent.

Households, mutual funds, trusts and estates hold 21 percent.

Public and private retirement funds hold 16 percent.

Foreign investors, which includes over 60 central banks, holds 12 percent.

Insurance firms hold 9.

State and local governments hold 5.

The balance remaining is 10 percent.

As should be apparent from this data, a financial crisis at the enterprises could have a disruptive impact on investors and the economy. Accordingly, OFHEO has developed and continues to improve upon a strong supervisory program.

OFHEO is aggressively fulfilling its obligation as a strong and effective regulator. By fulfilling our core mission well, OFHEO protects against systemic risk posed by Fannie Mae and Freddie Mac.

As I have stated before, OFHEO takes a three-pronged approach to accomplish this goal: examinations, capital regulation and research. I have already spoken about our strong examination program, so I will address our capital standards.

OFHEO's minimum capital standard, one that is built on traditional ratio based approaches, ensures a base level of enterprise capital to protect against risk.

Also, we are on track to complete our risk-based capital standard by the end of the year. This standard will be the first to explicitly link capital and risk through the use of a model that simulates financial performance of the enterprises under stress. Let me say here we will complete this rule by the end of the year, Mr. Chairman. While we will have a final capital rule, let me differentiate here between a final capital and a final stress test.

The stress test will be by its nature evolving and constantly changing to take into account the different risk profile of the enterprises at any point in time. The risk-based capital standard has to adjust itself to reflect different activities, different programs of the enterprises, to make sure it always accurately ties capital to risk, given what the risk profile of an enterprise is at any particular point in time.

Any risk-based capital standard like this would be obsolete if it was not constantly evolving, so part of OFHEO's job is to ensure that we consistently and constantly update the risk-based capital requirement, although at the same time accommodating the enterprises' uncertainty as to what their capital requirement will be and how it is calculated. It will be a state of the art capital regulation and I look forward to having it in place, as I am sure the committee does.

Finally, OFHEO is continuing to strengthen its research and analytical capability. We must stay on top of the changes taking place in the quickly evolving secondary and primary mortgage markets. This important research and analysis serves to better inform our examination and capital regulation efforts.

In summary, the enterprises' rapid growth raises important policy issues regarding their mission and the risk they pose to the financial system. However, because OFHEO is fulfilling its responsibilities, this discussion takes place not in a climate of urgency, but at a time when the enterprises are financially sound and well regulated.

Thank you, Mr. Chairman.

[The prepared statement of Armando Falcon, Jr. follows:]

PREPARED STATEMENT OF HON. ARMANDO FALCON, JR., DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT*

Thank you Chairman Sununu, Ranking Member Bentsen, and members of the Task Force. As you are aware, the Office of Federal Housing Enterprise Oversight (OFHEO) was established in 1992 as an independent entity within the Department of Housing and Urban Development. OFHEO's primary mission is to ensure the capital adequacy and safety and soundness of two government-sponsored enterprises (GSEs)—Fannie Mae and Freddie Mac. To fulfill this mission, OFHEO has regulatory authority similar to other Federal financial regulators such as the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve Board. Those authorities include annual examinations, broad rulemaking authority, setting capital standards, enforcement actions, and research.

The Task Force has taken an important step in convening this hearing to consider the economic implications of the size and scope of the housing GSEs activities. Because Assistant Secretary Apgar is here today representing the Federal Housing Finance Board, I will focus my discussion on the two entities within my jurisdiction.

In considering these issues, it is important to understand what the GSEs do and how they operate.

WHO ARE FANNIE MAE AND FREDDIE MAC?

Fannie Mae and Freddie Mac are publicly-held companies chartered by Congress. They were established to create a secondary mortgage market to ensure a ready supply of mortgage funds for affordable housing for American homebuyers. They fulfill this very important public mission by buying mortgages from commercial banks, thrift institutions, mortgage banks, and other primary lenders, and either hold these mortgages in their own portfolios or package them into mortgage-backed securities (MBS) for resale to investors. They have become two of the world's largest financial institutions.

To assist Fannie Mae and Freddie Mac in achieving their public mission, they receive numerous explicit benefits from the Federal Government, including an exemption from state and local taxation, an exemption from the registration requirements of the Securities and Exchange Commission, and each firm has a potential credit line with the U.S. Treasury.

However, the most important benefit the Enterprises receive as a result of their GSE status is the special treatment the market bestows on their securities. Because of investors' belief in an implied U.S. government guarantee on their securities, the Enterprises have been able to borrow money more cheaply and without the practical volume restrictions faced by any fully-private triple-A rated company. This market perception allows the Enterprises to safely operate with a higher degree of leverage than fully private firms are able to do.

There is no doubt that the GSEs are large and rapidly growing. As they grow, the implications to the economy if they were to fail also increases. However, the actual likelihood of any failure depends critically on how they are managed and super-

*This testimony represents the view of the OFHEO Director, which are not necessarily those of the President or Secretary of Housing and Urban Development.

vised. I want to assure you that both Fannie Mae and Freddie Mac are currently in excellent financial condition, are well-managed, and have exceeded minimum capital requirements every quarter that the requirement has been in place. And OFHEO has a strong regulatory program in place to ensure their continued safe and sound operation. If the need ever arose, OFHEO would move quickly and forcefully to correct any financial problems at the Enterprises.

OFHEO supervises the Enterprises primarily through its extensive, and continuous, examination work. Our examiners possess impressive skills and backgrounds, and came to OFHEO from banking and thrift regulatory bodies and from the mortgage industry itself. Our experts maintain a physical presence at the Enterprises at all times, and have unlimited access to all levels of management and to highly-sensitive corporate records. By staying apprised of the Enterprises' risks and business activities on an almost real-time basis, the examiners are able to evaluate an extensive array of risk-related factors and to assess the Enterprises' financial safety and soundness.

Each quarter, the OFHEO examination staff issue conclusions relating to more than 150 separate components of financial safety and soundness, and thereby provide me with a comprehensive picture of the Enterprises' financial condition. These conclusions pertain to such key risk management areas as credit risk, interest rate risk, liquidity risk, information technology, internal controls, business process controls, internal and external audit, management information and process, and board of director governance and activities.

Examiners meet frequently with management to discuss and assess business strategies and plans, financial performance results, risk management structure and practices, and each Enterprise's overall risk profile. These discussions include future trends and management's controls and practices to anticipate and prepare for potentially adverse trends in any risk areas, or combination of risk areas.

Examination teams identify opportunities for improvements in existing Enterprise risk management practices and work directly with management to address identified opportunities to enhance financial safety and soundness. Through our risk-focused examination framework, OFHEO constantly evaluates such critical areas as:

- The Enterprises' overall risk management practices
- The composition, risk profile, and significant trends in the Enterprises' retained, and guaranteed, mortgage portfolios
- The Enterprises' ability to effectively manage interest rate risk and other key financial exposures
- The Enterprises' ability to efficiently issue debt and hedge financial exposures
- The quality of financial performance-related information and market-related information on which the Enterprises' boards and management rely in reaching key decisions

In summary, the examination group provides us with an accurate and timely understanding of the Enterprises' financial condition.

WHAT DO THE ENTERPRISES DO?

Fannie Mae and Freddie Mac have two major lines of business. First, they guarantee mortgage-backed securities: securities backed by pools of residential mortgages. When investors purchase a mortgage-backed security they are entitled to the principal and interest payments made by the mortgage borrower, except for portions earned by mortgage servicers and by the Enterprise which guarantee the payment of principal and interest. In return for the portion the Enterprise earns, they agree to protect investors against losses caused by borrower defaults. Enterprise mortgage-backed securities are highly regarded by investors and can be issued at interest rates very close to a mortgage-backed securities with explicit government guarantees. This guarantee business has been quite profitable for the Enterprises, but mortgage borrowers receive most of the benefit from these lower borrowing costs. While there is no precise way to measure these savings, recent estimates are generally centered around 25 to 30 basis points.

The Enterprises' second major line of business is portfolio investment in mortgage-backed securities and, to a lesser extent, whole mortgages that are purchased directly from lenders and are not parts of pools backing mortgage securities. The Enterprises fund these investments primarily by issuing debt. The characteristics of the debt issues are designed so that, in combination with a variety of derivatives contracts and other hedges entered into by the Enterprises, the values of the debt and the mortgage securities will be similarly affected by interest rate changes. This help protect the Enterprises from a mismatch between the cost of funding its operations and the income derived from those operations.

Another risk in the portfolio business is that changes in borrowers' prepayment behavior, often in response to interest rate changes, are not fully predictable and may affect mortgage security values differently than expected.

Portfolio investment has been more profitable than the guarantee business. This activity may create additional interest savings for mortgage borrowers, though such savings would be much smaller than those created by the guarantee business. Because empirical data on this issue is scarce, OFHEO intends further study of this topic.

Both of these business lines have been growing at the Enterprises, particularly their portfolio investment business. Since the end of 1991, the Enterprises' mortgage assets have swelled from $155 billion to $900 billion, an increase of approximately 475 percent. The majority of the increase reflects purchases of mortgage securities they had previously guaranteed. To fund the growth in these assets, the Enterprises have increased their debt outstanding at a comparable rate from $164 billion to $963 billion over the same period.

Their guarantee business has also increased significantly. Total mortgage-backed securities guaranteed—both those held privately as well as those held in portfolio—has more than doubled from $731 billion in 1991 to over $1.76 trillion today. Although the Enterprises purchased roughly half of the increase in their guaranteed mortgage securities in recent years, the amounts held by other investors has still grown 73 percent to $1.2 trillion over that period.

The Enterprises debt and mortgage-backed securities outstanding now amounts to $2.2 trillion. Adding in the debt of the other GSEs, the total debt of all GSEs rises to $3 trillion, substantially above the total privately held, marketable debt of the U.S. Treasury. (Further detail about Enterprise mortgage portfolios, debt, and mortgage-backed securities outstanding can be found in the attached tables.)

WHO HOLDS THE DEBT?

Federal Reserve estimates for holdings of what is known as agency debt, about 85 percent of which is issued or guaranteed by GSEs, shows the following breakdown:

Depository Institutions	27%
Households, Mutual Fund, Trusts & Estates	21%
Public & Private Retirement Funds	16%
Foreign Investors (including 60+ central banks)	12%
Insurance Firms	9%
State & Local Governments	5%
Others	10%

As should be apparent from these data, a financial crisis at the Enterprises could have a disruptive impact on investors and the economy. OFHEO has developed and continues to improve upon a strong supervisory program.

The Enterprises' business lines will likely continue to grow. Recently Fannie Mae announced its continued desire to double earnings per share over the next 5 years. Freddie Mac has predicted double digit earnings growth over a similar period. These earnings targets will only lead to increased pressure to generate new revenues. The prudence and competence with which the Enterprises manage and balance their assets and liabilities becomes that much more important, the larger they grow.

In order for the Enterprises to continue to grow their asset portfolios, they have expanded the markets for their debt securities, and built demand for debt instruments, such as callable debt, that help them manage interest rate risk. They have expanded their domestic and international investor base, developing new products to appeal to different investor profiles. The introduction of debt issuance programs modeled after those of the U.S. Treasury is the most recent development in these efforts.

WHAT IS OFHEO'S ROLE?

OFHEO is aggressively fulfilling its obligation as a strong and effective regulator. By fulfilling our core mission well, OFHEO protects against systemic risks posed by Fannie Mae and Freddie Mac. As I have stated before, OFHEO takes a three-pronged approach to accomplish this goal-examinations, capital regulation, and research.

I have already spoken about our strong examination program, so I will next address our capital standards. OFHEO's minimum capital standard, one that is built on traditional, ratio-based approaches to regulation of insured depository institutions, ensures a base level of Enterprise capital to protect against risk.

Since our inception, we have imposed and enforced a minimum capital standard on the Enterprises. The Enterprises have met that standard every quarter and we are reviewing the necessity of updating the standard.

We are on track to complete our long-awaited Risk-Based Capital Standard by the end of the year. This standard will be the first to explicitly link capital and risk through use of a model that simulates the financial performance of the Enterprises under stress. This is my top priority and we will meet my deadline.

Finally, OFHEO is continuing to strengthen its research and analytical capability. We must stay on top of the changes taking place in the quickly evolving secondary and primary mortgage markets. This important research and analysis serves to better inform our examination and capital regulation efforts. In summary, the Enterprises' rapid growth raises important policy issues regarding their mission and the systemic risks they pose. However, because OFHEO is aggressively fulfilling its responsibilities, this discussion takes place not in a climate of urgency, but at a time when the Enterprises are financially sound and well regulated.

Table 1

Combined Fannie Mae and Freddie Mac Mortgage Assets, Debt, and MBS
($ in millions)

	Retained Mortgage Portfolio	Debt Outstanding	Total MBS Outstanding[1]
2000*	$900,485	$962,673	$1,240,000
1999	$846,855	$908,330	$1,217,052
1998	$670,185	$747,687	$1,115,494
1997	$481,221	$542,616	$1,055,123
1996	$424,878	$488,251	$1,021,238
1995	$361,217	$419,135	$972,275
1994	$298,228	$350,509	$947,001
1993	$246,799	$251,105	$910,335
1992	$191,748	$195,931	$831,958
1991	$155,650	$164,199	$714,447

1 — Total MBS outstanding net of MBS in portfolio

* As of June 30, 2000

Table 2

Fannie Mae and Freddie Mac Select Financial Data
($ in Billions)

	Fannie Mae				Freddie Mac			
	2Q00	1Q00	4Q99	4Q98	2Q00	1Q00	4Q99	4Q98
Balance Sheet								
Retained Portfolio	$550	$ 537	$ 523	$415	$350	$ 334	$ 323	$255
MBS held in Retained Portfolio (1)	$299	$ 291	$ 282	$197	$226	$ 217	$ 211	$168
Non-Mortgage Investments	$47	$ 38	$ 40	$59	$39	$ 43	$ 32	$45
Total Assets	$609	$ 587	$ 575	$485	$413	$ 406	$ 387	$321
Total Debt	$578	$ 558	$ 548	$460	$384	$ 378	$ 361	$287
Total Stockholder's Equity	$19	$ 18	$ 18	$15	$12	$ 12	$ 12	$11
Off-Balance Sheet								
MBS Outstanding, net (2)	$697	$ 685	$ 679	$637	$543	$ 540	$ 538	$478
Other								
Average Guarantee Fee (basis points	19.60	19.40	19.30	16.50	19.40	19.40	19.50	20.6
Net Interest Yield (%)	1.02	1.02	1.01	0.90	0.75	0.76	0.80	0.84
Single-Family Delinquency Rate (%)	0.42	0.47	0.48	0.58	0.34	0.36	0.39	0.5
Multifamily Delinquency Rate (%)	0.13	0.18	0.12	0.29	0.07	0.08	0.14	0.37

(1) Enterprise holdings of its own MBS.
(2) Total MBS outstanding minus MBS held in Retained Portfolio.
(3) As of May 31, 2000, most recent data available

Table 3

Debt Outstanding
($ in billions)

	FHLB	Freddie Mac	Fannie Mae	Total Debt Outstanding
2000*	$568.44	$384.15	$578.53	$1,531.12
1999	$529.00	$360.70	$547.60	$1,437.30
1998	$382.10	$287.40	$460.90	$1,130.40
1997	$313.90	$169.20	$369.80	$852.90
1996	$263.40	$157.00	$331.30	$751.70
1995	$243.20	$120.00	$299.20	$662.40
1994	$205.80	$93.30	$257.20	$556.30
1993	$139.50	$50.00	$201.10	$390.60
1992	$114.70	$29.60	$166.30	$310.60
1991	$107.50	$30.30	$133.90	$271.70
1990	$117.90	$30.90	$123.40	$272.20
1989	$136.10	$26.10	$116.10	$278.30
1988	$135.80	$22.80	$105.50	$264.10
1987	$115.70	$17.60	$97.10	$230.40
1986	$88.80	$13.60	$93.60	$196.00
1985	$74.40	$11.90	$93.90	$180.20

* As of June 30, 2000

Table 4

Effective Debt Outstanding
First Quarter 2000
($ in Billions)

	Fannie Mae		Freddie Mac		Aggregate	
Total Debt Due Within 1 Year	$	179	$	181	$	360
ST Debt Converted to LT	$	(141)	$	(135)	$	(276)
Effective Variable Rate Debt	$	30	$	-	$	30
Effective Short Term Debt	$	68	$	46	$	114
Total Debt Due After 1 Year	$	351	$	197	$	548
ST Debt Converted to LT	$	141	$	135	$	276
Effective Long Term Debt	$	492	$	332	$	824
% Effective Long Term Debt with call or rate adjustment features		52%		61%		56%

Notes:
Debt financing - debt securities created to finance the purchase of unsecurtized mortgages and mortgae related securities.
Short term (ST) debt converted to Long Term (LT) - The Enterprises use derivatives to convert much of their short term debt into long term debt
Effective variable rate debt - liabilities originally issued as a fixed rate instrument, with an effective variable rate, that include the impact of derivative positions
Effective Short Term Debt - debt maturing in one year or less plus effective variable rate debt
Effective Long Term Debt - debt with an effective repricing date of more than one year; including the impact of derivative financial instruments.
Call or rate adjustment features - debt options that are callable after a specific period prior to maturity or provides interest rate protection similar to callable debt

Table 5

Enterprise Mortgage-Backed Securities Outstanding
($ in Billions)

	Fannie Mae			Freddie Mac			Aggregate
	1Q00	4Q99	4Q98	1Q00	4Q99	4Q98	
Single-Family							
Long-Term	$686	$671	$558	$547	$535	$449	$1,233
Intermediate-Term	$198	$200	$187	$171	$175	$157	$369
ARMs/Floating Rate	$55	$54	$59	$35	$35	$37	$90
Total	$939	$925	$804	$753	$745	$643	$1,692
Multifamily	$37	$36	$30	$4	$4	$3	$41
Total	**$976**	**$961**	**$834**	**$757**	**$749**	**$646**	**$1,733**

Table 6

Enterprise Mortgage-Backed Securities Issuances
($ in Billions)

	Fannie Mae	Freddie Mac	Aggregate
2Q00	$49	$35	$84
1Q00	$39	$28	$67
1999	$301	$233	$534
1998	$326	$251	$577
1997	$149	$114	$263
1996	$150	$120	$270
1995	$111	$86	$197
1994	$131	$117	$248
1993	$221	$209	$430
1992	$194	$179	$373
1991	$113	$93	$206
1990	$97	$74	$171
1989	$70	$74	$144
1988	$55	$40	$95
1987	$63	$75	$138
1986	$61	$102	$163
1985	$24	$42	$66

Table 7

Combined Fannie Mae and Freddie Mac Retained Portfolio
($ in millions)

	Whole Loans	Own MBS Owned[1]	Other Mortgage Related Securities	Total Retained Portfolio
2000*	NA	$525,000	NA	$900,485
1999	$204,252	$492,912	$149,691	$846,855
1998	$213,524	$365,483	$91,178	$670,185
1997	$208,678	$233,844	$38,699	$481,221
1996	$214,466	$183,802	$26,610	$424,878
1995	$215,516	$125,735	$19,966	$361,217
1994	NA	$74,668	NA	$298,228
1993	NA	$40,096	NA	$246,799
1992	NA	$26,929	NA	$191,748
1991	NA	NA	NA	$155,650

1 Fannie Mae MBS in Fannie Mae's portfolio and Freddie Mac MBS in Freddie Mac's portfolio
NA Data unavailable
* As of June 30, 2000

Table 8

Enterprise Retained Portfolio Compostion
($ - Billions)

	Fannie Mae			Freddie Mac			Aggregate
	1Q00	4Q99	4Q98	1Q00	4Q99	4Q98	1Q00
Single Family							
Long-term fixed rate	$440	$426	$319	$254	$243	$192	$694
Intermediate-term fixed rate	$68	$69	$72	$51	$52	$46	$119
Arms/Floating Rate	$16	$14	$12	$17	$17	$10	$33
Total	$524	$509	$403	$322	$312	$247	$846
Multifamily	$15	$14	$12	$14	$12	$8	$29
Adjustments	$2	$1	$0	$3	$2	$0	$5
Total Retained Portfolio	$537	$522	$415	$333	$322	$255	$870

Table 9

	Combined Fannie Mae and Freddie Mac Purchases ($ in millions)			
	Single-family	Multi-family	Total[1]	Mortgage Securities [2]
1999	$548,748	$17,193	$565,941	$268,329
1998	$618,410	$15,338	$633,748	$272,907
1997	$275,081	$8,775	$283,856	$84,233
1996	$287,306	$8,680	$295,986	$81,840
1995	$215,974	$6,531	$222,505	$73,328
1994	$280,792	$4,786	$285,578	$44,369
1993	$518,877	$4,326	$523,203	NA
1992	$439,309	$2,879	$442,188	
1991	$233,280	$3,440	$236,720	

1 Loans purchased from lenders, excludes mortgage securities
2 Not included in totals
NA - Not available before this date

Table 10

	Combined Fannie Mae and Freddie Mac Financial Derivatives ($ in millions)					
	Interest Rate Swaps	Interest Rate Caps, Floors, Corridors	Foreign Currency	Futures, Options, and Forward Rate Agreements	Other	Total
1999	$318,612	$48,886	$12,604	$308,818	$10,294	$699,214
1998	$200,401	$36,345	$14,459	$234,313	$15,277	$500,795
1997	$203,845	$22,095	$11,120	$6,000	$13,888	$256,948
1996	$204,786	$14,395	$2,973	$0	$1,001	$223,155
1995	$171,063	$13,355	$1,224	$29	$999	$186,670
1994	$109,304	$9,363	$1,023	$0	$1,465	$121,155
1993	$67,346	$1,860	$1,023	$0	$1,425	$71,654

Table 11

Combined Fannie Mae and Freddie Mac Capital Summary
($ in millions)

	Core Capital	Regulatory Minimum Capital Requirements	Capital Surplus
2000*	$31,777	$30,836	$940
1999	$30,568	$30,057	$511
1998	$26,180	$25,667	$513
1997	$21,169	$19,785	$1,384
1996	$19,516	$17,983	$1,533
1995	$16,788	$16,035	$753
1994	$14,710	$14,299	$411
1993	$12,489	$10,846	$1,643

* As of March 31, 2000

Table 12

Combined Fannie Mae and Freddie Mac Earnings Components
($ in millions)

	Net Income	Net Interest Income [1,2]	Guarantee Fee Income [2]	Administrative Expenses	Credit Related Expenses [3]
1999	$6,135	$7,820	$2,301	$1,455	$286
1998	$5,118	$6,325	$2,248	$1,286	$603
1997	$4,451	$5,796	$2,356	$1,131	$904
1996	$3,968	$5,297	$2,282	$1,000	$1,017
1995	$3,235	$4,443	$2,173	$941	$876
1994	$3,115	$3,935	$2,191	$904	$803
1993	$2,659	$3,305	$1,970	$804	$829
1992	$2,245	$2,753	$1,770	$710	$777
1991	$1,918	$2,461	$1,467	$606	$789

1 Interest income net of interest expenses, nominal basis
2 Effective 1/1/96, Freddie Mac reports guarantee fees on retained MBS as guarantee fee income. Howeve, in this data, fees on retained MBS have been estimated and reclassified as interest income for to create comparability between the Enterprises.
3 Credit related expenses are defined as mortgage loan loss provision plus real estate owned expenses.

Chairman SUNUNU. Thank you, Mr. Falcon.
Mr. Apgar.

STATEMENT OF WILLIAM C. APGAR

Mr. APGAR. Thank you. Since the resignation of Chairman Bruce Morrison on the 4th of July, I hold the delegated authority of Chairman of the Finance Board, and I testify today in that role. I would like to emphasize my intention to maintain the continuity of the Finance Board's recent actions with respect to safety and soundness oversight, as well as actions to foster innovation in the Home Loan Banks and competition among the various GSEs.

I should point out, however, that the board of directors of the Federal Housing Finance Board has not reviewed my testimony, nor does it represent the administration's position.

As you know, Congress created the Federal Home Loan Bank System in 1932 to improve on the availability of funds to support home ownership. The Federal Home Loan Banks are cooperatively owned by their member bank stockholders and they operate by enhancing member lending at the local level.

The Home Loan Banks offer as their primary product a readily available, low cost source of funds, called an advance, to member institutions and housing associates. Advances enhance the lending of members both by passing through the Home Loan Banks' cost-of-funds advantage in the debt markets and by having the Home Loan Banks manage interest rate risk. To the Finance Board, activities that assist and enhance lending by members are consistent with the Home Loan Bank mission.

Congress originally granted access to the Home Loan Bank advances primarily to thrift institutions. In response to the thrift crisis of the 1980's, Congress enacted FIRREA in 1989 to change the Federal Home Loan Bank System, most significantly by expanding membership eligibility to include commercial banks and credit unions.

In 1989, Congress also imposed a $300 million per year assessment on the Home Loan Banks to help pay for the cost of the thrift bailout. In addition, Congress imposed a requirement that 10 percent of Home Loan Bank net earnings go to support the Affordable Housing Program each year. Last year, the system made $199 million in AHP contributions and grants nationwide.

In November 1999, with the enactment of the Gramm-Leach-Bliley legislation, Congress in a singular vote of confidence, made many changes to enhance the capacity of the Home Loan Banks to carry out their housing finance and community and economic development mission.

Gramm-Leach-Bliley charged the system with supporting access to low cost funds for community financial institutions to support small businesses, small farm and small agri-business lending.

Moreover, by changing the fixed $300 million REFCORP assessment to one based on a percentage of Home Loan Bank income by reforming the Home Loan Banks' capital structure, this legislation has truly positioned the Home Loan Bank System to promote competition in housing finance, serve as a central bank for community institutions, and serve under served populations.

I would also stress that through both proposed and final regulation including the recently proposed regulation on a new risk-based capital structure, the Finance Board has implemented all the statutory requirements of Gramm-Leach-Bliley.

As of June 30, 2000, the assets of the Home Loan Bank System totaled $621 billion. There were more than 7500 members on that date.

The bonds issued to support the assets of the bank system are expressly not obligations of the United States, but they do benefit from the favorable investor perception associated with the Home Loan Banks' status as a government-sponsored enterprise.

The Home Loan Bank Act makes it clear that it is the Finance Board's primary duty to ensure the safety and soundness of the bank system and, consistent with that primary duty, to ensure that the Home Loan Banks carry out their housing finance mission.

To control the Home Loan Bank System's risk exposure, the Finance Board has established regulations and policies that Home

Loan Banks must follow to evaluate and manage their credit and interest rate risk. The principal defenses against credit interest rate risk are sound risk-based management policies and practices, vigilant supervision, and over $30 billion in Home Loan Bank System capital.

Among the most notable regulatory requirements are:

Collectively the Home Loan Bank must maintain a triple-A credit rating on their consolidated debt.

Each individual Home Loan Bank must maintain a double-A credit rating.

Each Home Loan Bank must establish and implement risk management policies and controls consistent with Finance Board requirements, file compliance reports and have external and internal auditors.

Each Home Loan Bank and the office of finance must be subject to an annual on-site examination by the Finance Board.

And, finally, the Finance Board has recently articulated a new set of state-of-the-art duties and responsibilities of the audit committee of each of the Home Loan Bank boards of directors along with standards for corporate governance and internal controls that the boards must comply with.

Risk management is central to this oversight. For example, the Finance Board limits the interest rate risk of mortgage-backed securities owned by the Home Loan Banks. Moreover, the size the Home Loan Banks' mortgage-backed securities holdings is limited to no more than three times Home Loan Bank capital or less than $90 billion today.

The general approach of the Home Loan Banks toward managing interest rate risk is to acquire and maintain a portfolio of assets and liabilities, which, together with their associated interest rate exchange agreements, limit the exposure to future interest rate changes.

With respect to credit risk, it is important to note that in the 68-year history of the Home Loan Bank no Home Loan Bank has ever experienced a credit loss on an advance to a member.

While the Home Loan Banks face minimal credit risk on advances, they are subject to credit risk on some investments. Each Home Loan Bank must comply with limits established by the Finance Board and its directors on the amounts of unsecured extensions of credit, whether on or off balance sheet.

The Finance Board also limits the amounts and terms of unsecured debt exposure to any counterpart other than the United States Government. Unsecured credit exposure to any counterparty is limited by the credit quality and capital level of the counterparty and the capital level of the bank.

The Finance Board views these risk management requirements to be more than adequate to protect against any potential loss exposure to the taxpayer.

In exchange for public support, of course, the American taxpayer has the right to expect responsible behavior by the GSEs. It is critically important to protect the taxpayer from any potential loss by monitoring and regulating GSE financial risk. It is also critically important to ensure that the low cost-of-funds and other advantages bestowed on the GSEs are well directed and ultimately reach their intended beneficiaries.

There is a risk that much of the government-owned benefit could be absorbed as profits within the GSE conduit. But one of the unique factors and features of the Home Loan Bank System, namely, its cooperative structure, inherently protects against such an event. Because the members and shareholders are one and the same and because the public benefit of the Federal Home Loan Bank System is delivered by members' retail lending, the members' financial incentives to get the lowest cost of funds is entirely consistent with maximizing public benefit. In addition, mission regulation helps ensure this valuable GSE benefit is focused on assisting member lending.

Mission regulation is closely linked to safety and soundness regulation. Many assets are perfectly safe and sound from a financial point of view, but because the GSEs were created for specific purposes and GSEs are supported by agency debt, only some assets are consistent with the mission of those GSEs.

The Finance Board has been focusing on the Home Loan Bank core mission activities. In the past, some level of non-mission investments were necessary for the banks to meet their REFCORP obligation of $300 million per year and to fund the Affordable Housing Program.

This activity where the Home Loan Banks borrow at close to Treasury rates to purchase higher yielding assets in the capital markets such as MBS and earn a profit from the spread has been the subject of bipartisan criticism for many years. Indeed, the arbitrage issue has been at the top of the list of many Members of Congress and the Treasury Department, and rightfully so.

Five years ago, approximately 40 percent of Home Loan Bank assets reflected core mission activities as we defined here. I am pleased to report that through a combination of advances, growth and Finance Board actions, the ratio is now approximately 75 percent.

Recently, Finance Board actions along with reforms passed in Gramm-Leach-Bliley that eliminated the major drivers of arbitrage, such as the flat REFCORP assessment and subscription-based capital, provide the best opportunity in a decade to focus the activity of the Home Loan Banks on their mission and reduce their dependence on arbitrage investment.

On June 29, the Finance Board passed the Core Mission Assets/Acquired Member Assets rule. This rule establishes a framework for the Home Loan Bank System to pursue a totally mission-related balance sheet. The rule has two parts.

It makes permanent Acquired Member Assets, or AMA programs, such as the so-called Chicago pilot or the Mortgage Partnership Finance, which is the most prominent of acquired mortgage assets. As you know, this as proved to be a very successful program to date involving over $10.5 billion worth of assets.

Each of the 12 member banks is now offering or will soon offer an MPF or similar program that will divide the risk of the mortgage between a member bank and a Home Loan Bank partner. Simply stated, the member bank manages the credit risk and the

Home Loan Bank, experts at hedging interest rate risk, will assume and manage that risk.

These partnerships provide true competition with the secondary market GSEs. Instead of credit risk being concentrated in those two housing GSEs, the risk can now be dispersed through over 7500 Home Loan Bank members.

These programs serve to de-concentrate the risk of a $4 trillion housing finance market and put the rewards in the right place, with those who take the risk, to offer what is truly a third way home for member institutions.

The rule also defines Core Mission Assets as assets including advances, Acquired Member Assets and certain smaller classes of securities. If there is any meaning to the mandate that the Finance Board must ensure mission achievement, it is incumbent on the Finance Board to state in regulatory form which activities and assets actually advance that mission.

The development of the Acquired Member Asset programs will help the Home Loan Banks to develop Core Mission Assets to replace arbitrage investments and at the same time increase competition in the secondary market.

Of course, these new activities must be supported by a strong capital base. For this reason as well as for purposes of capitalizing other new Home Loan Bank activities, Gramm-Leach-Bliley has mandated the establishment of a new risk-based capital structure that will allow the banks to adjust their capital to the actual risk that they have on their balance sheet.

I am pleased to report that on July 13th the Finance Board proposed a state-of-the-art risk based capital rule as required by Gramm-Leach-Bliley which is currently out for a 90-day comment period. The legislation requires the Finance Board to issue its final capital rule in November and we are making progress toward that goal.

In summary, as a result of Gramm-Leach-Bliley and the regulatory initiatives that I have described, the Home Loan Banks can play an even broader and more important role in the future than they have in the past and do so in a way that is mindful of the financial interests of the American taxpayers.

Thank you.

[The prepared statement of William C. Apgar follows:]

PREPARED STATEMENT OF WILLIAM C. APGAR, HUD DESIGNEE TO THE FEDERAL HOUSING FINANCE BOARD

Good morning Mr. Chairman, and members of the Task Force. I would like to thank you for the opportunity to appear today to testify before the Task Force on Housing and Infrastructure of the House Budget Committee on the subject of economic implications of debt held by government sponsored enterprises. I should point out that the Board of Directors of the Federal Housing Finance Board has not reviewed my testimony nor does it represent the Administration's position.

The Federal Housing Finance Board (Finance Board) is an independent agency in the Executive Branch. It is both the mission and safety and soundness regulator for the 12 regional Federal Home Loan Banks (FHLBanks) and the regulator of the Office of Finance, which serves as the debt issuance facility for the consolidated obligations of the FHLBanks. The Finance Board is funded through assessments made on the FHLBanks and is not subject to the congressional appropriations process.

Since the resignation of Bruce Morrison as Chairman on July 4, 2000, I have held the delegated authority of Chairman of the Finance Board as Secretary Cuomo's designee. I would like to emphasize my intention to maintain the continuity of the

Finance Board's recent actions with respect both to safety and soundness and to innovation by the FHLBanks and competition among the government sponsored enterprises (GSEs) as a means of maximizing their public benefit.

Congress created the FHLBank System in 1932 to improve the availability of funds to support homeownership. The FHLBanks are cooperatively owned by their member-bank stockholders and they operate by enhancing member lending at the local level. The FHLBanks offer as their primary product, a readily available, low-cost source of funds, called an advance, to its member institutions and housing associates. Advances enhance lending by members both by passing through the FHLBanks' cost-of-funds advantage in the debt markets, and by having FHLBanks manage interest rate risk. To the Finance Board, activities that assist and enhance lending by members are consistent with the FHLBanks' mission.

Congress originally granted access to FHLBank advances primarily to thrift institutions. In response to the thrift crisis of the 1980s, Congress enacted FIRREA in 1989 to change the FHLBank System, most significantly by expanding membership eligibility to include commercial banks and credit unions.

In 1989, Congress also imposed a $300 million per year assessment on the FHLBanks to help pay for the costs of the thrift bailout. In addition, Congress imposed a requirement that 10 percent of FHLBank net earnings go to support an Affordable Housing Program (AHP) each year. The AHP is designed to enhance the availability of affordable housing for very low- to moderate-income families. Last year the FHLBank System made $199 million in AHP contributions and grants nationwide. The combination of these new financial obligations, the decline in the thrift population, and the time lag for commercial banking institutions to join the FHLBank System and take down advances, understandably drove the FHLBanks in the 1990s to supplement earnings by increasing arbitrage activities.

In November 1999, by enacting Title VI of the Gramm-Leach-Bliley Act—the first comprehensive legislation since FIRREA to affect the FHLBank System—Congress, in a singular vote of confidence, made many changes to enhance the capacity of the FHLBanks to carry out their housing finance and community and economic development mission as part of the modernized financial services world of the 21st century. Significant, among other changes, is that the FHLBank System has now been charged with supporting access to low-cost funds for community financial institutions to support small business, small farm and small agri-business lending. Moreover, by changing the fixed $300 million REFCORP assessment to one based on a percentage of FHLBank income and by reforming the FHLBanks' capital structure, this legislation has truly positioned the FHLBank System to add value to consumers and to the financial system in three critical areas: providing competition in housing finance; serving as central bank to community institutions; and serving underserved populations. I would also stress that, through both proposed and final regulations, including a recently proposed regulation on the new risk-based capital structure, the Finance Board has implemented all the statutory requirements of Gramm-Leach-Bliley—as well as exercising its discretionary authority to strengthen mission regulation—in a timely and expeditious fashion, and I would like to commend the Finance Board staff on their efforts in this regard.

As of June 30, 2000 the assets of the FHLBank System totaled $621 billion. There were more than 7500 members as of that date. The bonds issued to support the assets of the FHLBank System are expressly not obligations of the United States, but they do benefit from the favorable investor perception associated with the FHLBanks' status as a GSE. The Federal Home Loan Bank Act makes clear that it is the Finance Board's primary duty to ensure the safety and soundness of the FHLBank System and, consistent with that primary duty, to ensure that the FHLBanks carry out their housing finance mission.

As noted, the fundamental business of the FHLBanks is to provide member institutions with advances and other credit products in a wide range of maturities and terms to meet member demand. Lending and investing funds and engaging in off-balance-sheet interest-rate exchange agreements have the potential for exposing the FHLBanks to credit and interest-rate risk. The principal defenses against credit and interest-rate risk are sound risk-management policies and practices, vigilant supervision, and the over $30 billion of FHLBank System capital.

To control the FHLBank System's risk exposure, the Finance Board has established regulations and policies that FHLBanks must follow to evaluate and manage their credit and interest-rate risk. Among the most notable regulatory requirements are:

- The FHLBanks must have, and take whatever actions are necessary to maintain, a triple-A credit rating on their consolidated debt.

• Each FHLBank must have, and take whatever actions are necessary to maintain, a double-A credit rating that is a meaningful measure of the individual FHLBank's financial strength and stability.
• Each FHLBank must establish and implement risk management policies and controls that comport with Finance Board requirements and conduct periodic assessments of these controls.
• Each FHLBank and the Office of Finance must be subject to an annual on-site examination by the Finance Board, as well as off-site analyses.
• Each FHLBank must file periodic compliance reports with the Finance Board.
• Each FHLBank must have both an external and an internal auditor, and the Finance Board has recently articulated a new set of state-of-the-art duties and responsibilities of the audit committee of each FHLBank's board of directors along with standards for corporate governance and internal controls that the boards must comply with.

Managing Interest-Rate Risk. Interest-rate risk is the risk that relative and absolute changes in interest rates may adversely affect an institution's financial condition. The goal of an interest-rate risk management strategy is not necessarily to eliminate interest-rate risk but to manage it by setting appropriate limits.

The Finance Board has adopted comprehensive policies that strictly limit the amount of interest-rate risk a FHLBank may assume. Most of the FHLBanks have adopted internal interest-rate risk limits that are even more conservative than the strict limits required by the Finance Board. To further limit interest-rate risk that could arise when a member prepays an advance, the Finance Board requires that each FHLBank generally charge a prepayment fee that makes it financially indifferent to a member's decision to prepay an advance.

The Finance Board limits the interest-rate risk of mortgage-backed securities (MBS) owned by the FHLBanks by restricting the types of MBS to those with limited average life changes (and hence limited price change) under certain interest-rate shock scenarios. Moreover, the size of the FHLBanks' MBS holdings is limited to no more than three times the FHLBanks' capital (or less than $90 billion today).

The general approach of the FHLBanks toward managing interest-rate risk is to acquire and maintain a portfolio of assets and liabilities, which, together with their associated interest-rate exchange agreements, limit the exposure to future interest rate changes.

Managing Credit Risk. Credit risk is the risk of loss due to default. The FHLBank System protects against credit risk through collateralization of all advances. In addition, each FHLBank can call for additional or substitute collateral during the life of an advance to protect its security interest. In the 68-year history of the FHLBank System, no FHLBank has ever experienced a credit loss on an advance to a member.

While the FHLBanks face minimal credit risk on advances, they are subject to credit risk on some investments. Each FHLBank must comply with limits established by the Finance Board and its board of directors on the amounts of unsecured extensions of credit, whether on- or off-balance sheet. The Finance Board also limits the amounts and terms of unsecured credit exposure to any counterpart other than to the U.S. Government. Unsecured credit exposure to any counterparty is limited by the credit quality and capital level of the counterparty and by the capital level of the FHLBank.

The Finance Board views these risk management requirements to be more than adequate to protect against any potential loss exposure to the taxpayer. Even so, the taxpayer has a right to expect certain benefits for taking any potential risk and for bestowing certain advantages on the GSEs.

Congress long ago decided that promoting homeownership is desirable and worth the cost of granting special advantages to homebuyers, such as the mortgage interest tax deduction, and the establishment of specially advantaged GSEs to facilitate housing finance and other socially desirable activities. In exchange for public support, the American taxpayer has the right to expect responsible behavior by the GSEs. It is obvious that it is critically important to protect the taxpayer from any potential loss by monitoring and regulating GSE financial risk. It is also critically important to ensure that the low cost-of-funds and other advantages bestowed upon the GSEs are well directed and ultimately reach their intended beneficiaries. There is a risk that much of the government-bestowed benefit could be absorbed as profits within the GSE conduit.

One unique characteristic of the FHLBank System—namely, its cooperative structure—inherently protects against such an event. Because members and shareholders are one and the same, and because the public benefit of the FHLBanks System is delivered by members' retail lending, the members' financial incentives to get the lowest cost of funds is entirely consistent with maximizing the public's benefit. In addition, mission regulation helps to ensure that this valuable GSE benefit is focused on assisting member lending.

Congress created GSEs to accomplish statutorily prescribed missions and provided them with advantages, including a U.S. Treasury line of credit, which enables them to benefit from a lower cost of funds and operations. It is up to the regulator to ensure that the public, in turn, receives the benefits of that lower cost and to ensure, consistent with safety and soundness, that the public mission of the GSE is achieved.

Mission regulation, while controversial, is closely related to safety and soundness regulation. Many assets are perfectly safe and sound from a financial point of view. But because the GSEs were created for very specific purposes, and GSE assets are supported by agency debt, only some assets are consistent with the mission of those GSEs.

The Finance Board has been focusing the FHLBanks on core mission activities. In the past, some level of non-mission investments were necessary for the FHLBanks to meet their REFCORP obligation of $300 million per year and to fund AHP. This arbitrage activity, where the FHLBanks borrow at close to Treasury rates to purchase higher yielding assets in the capital markets, such as MBS, and earn a profit from the spread, has been the subject of bi-partisan criticism for many years. Investments supported by agency debt and ultimately guaranteed by the taxpayer simply to earn a profit are much less useful than activities that would more directly benefit members and their borrowers.

Indeed, the "arbitrage issue" has been at the top of the list of concerns of many Members of Congress and the Treasury Department, and rightly so. Five years ago approximately 40 percent of FHLBank assets reflected Core Mission Activity as we have recently defined the term. I am pleased to report that through a combination of advances growth and Finance Board actions, that ratio is now approximately 75 percent.

Recent Finance Board actions along with the reforms passed in Gramm-Leach-Bliley that eliminated the major drivers of arbitrage, such as the flat REFCORP assessment and subscription based capital, provide the best opportunity in a decade to focus the activities of the FHLBanks on their mission and reduce their dependence on arbitrage investments. On June 29, the Finance Board passed the "Core Mission Assets/Acquired Member Assets" rule. This rule establishes the framework for the FHLBank System to pursue a totally mission-related balance sheet. The rule has two parts:

1. It makes permanent the Acquired Member Assets, or AMA programs, and removes the $9 billion cap on the "Chicago Pilot" (MPF), which is the most prominent of acquired member asset programs. MPF has proven to be very successful and has to date acquired over $10.5 billion of assets. Each of the 12 FHLBanks is now offering, or will soon offer, MPF or a similar program that will divide the risks of mortgages between a member bank and its FHLBank partner. Rather than sell the mortgage and all its attendant risks in the secondary market, a FHLBank member will have the option of retaining the credit risk and being rewarded for good underwriting by receiving a credit enhancement fee. The FHLBanks, experts at hedging interest rate risks, will assume and manage the market risk.

These partnership programs provide true competition with the two secondary market GSEs. Instead of credit risk being concentrated in these two housing GSEs, the risks can now be dispersed through the FHLBanks to their 7,500 members. These programs de-concentrate the risks of a $4 trillion housing finance market and put the rewards in the right place—with those who take the risk—to offer what is truly a "third way home."

Rather than rail against the housing GSEs and the advantages they have been afforded, I believe we should instead focus on how to introduce competition among them, decrease risk to the public sector, and focus mission to maximize the public benefit. The FHLBanks' AMA programs accomplish these objectives.

2. The proposed rule defines Core Mission Assets (CMA) as assets (including advances, AMA and certain smaller classes of targeted assets) that the FHLBanks are encouraged to hold. If there is any meaning to the mandate that the Finance Board "ensure" mission achievement, it is incumbent on the Finance Board to state in regulatory form which activities and assets actually advance that mission. Rather than imposing a constraint, the definition of Core Mission Assets simply specifies what we consider to be the most productive, value-added assets as tools for business and capital purchase purposes.

The development of Acquired Member Asset programs will help the FHLBanks to develop core mission assets to replace arbitrage investments and, at the same time, increase competition in the secondary market. By doing so, AMA should increase mortgage market share for depository institutions, help disperse the credit risk of the $4 trillion mortgage market from the two large secondary market GSEs to the more than 7,500 FHLBank member institutions and, most importantly, reduce mortgage costs for American homebuyers.

These new AMA activities must be supported by a strong capital base. For this reason, as well as for the purposes of capitalizing other new FHLBank activities, and creating consistency with rules applied to other regulated financial institutions, Gramm-Leach-Bliley has mandated the establishment of a new risk-based capital structure, that will allow the FHLBanks to adjust their capital to the actual risks that they have on their balance sheets.

Currently, members are required to buy an amount of FHLBank stock based on the size of their balance sheets and the amount of their advance borrowings from the FHLBanks. This has resulted in systematic over-capitalization of the FHLBanks. The FHLBanks have been servicing this excess capital with arbitrage-derived profits. Risk-based capital will match required capital to actual acquired risk and therefore alleviate the need for extraneous arbitrage earnings. Risk-based capital offers greater protection to the System and therefore greater protection to the taxpayer. Another way of looking at the issue of capital is as follows: member institutions can think of the FHLBanks as their capital markets affiliate and make a rational decision as to how much capital they wish to put up for the FHLBanks to be able to conduct members' business. The size of the balance sheet need be no larger than what is actually required for business, not for arbitrary, non-mission related arbitrage. Again, this is another vital tool to minimize risk while assuring maximum pass-through of public benefit. The Finance Board on July 13 proposed a state-of-the-art risk-based capital rule as required by Gramm-Leach-Bliley, which is currently out for a 90-day comment period. The legislation requires the Finance Board to issue its final capital rule by November 12 of this year, and we are making progress toward that goal.

In summary, as a result of both Gramm-Leach-Bliley and the regulatory initiatives that I have described, the FHLBanks can play an even broader and more important role in the future than they have in the past. The FHLBanks have new authority to expand into small business and agricultural lending to their smaller members, to expand non-mortgage lending to all members and to offer new mortgage products that enhance competition among the housing GSEs and disperse the credit risks of mortgage finance. The FHLBanks now have a regulatory incentive to focus on activities that create value for members and thus for consumers, and have the prospect of more permanence in the FHLBank capital base than has previously been the case. In all these ways, the FHLBanks are extraordinarily well-positioned to work with their rapidly growing membership base. Consumers of financial services all across America will benefit if we stay this public policy course and authorize the FHLBanks to play these important roles in the future.

Chairman SUNUNU. Thank you very much, Mr. Apgar.

Mr. Falcon, a lot of discussion in the previous panel centered around matching the GSE portfolios in order to minimize their exposure to risk. To what extent are the long-term assets within the GSE portfolios funded by short-term debt? How well matched are the portfolios?

Mr. FALCON. Right now, Mr. Chairman, we consider the portfolios to be very well matched. The majority of the debt that they issue is long term and the short-term debt that they do have is through the use of derivatives converted to effective long-term debt and then the majority of that long-term debt has callable or adjustment features in it which protect the enterprises from changes in interest rates.

Chairman SUNUNU. How do you quantify or how do you measure the degree to which the portfolio might be mismatched, that there might be some gap in duration?

Mr. FALCON. Well, you have to take into account, Mr. Chairman, the prepayment risk associated with mortgages and there is a well established body of research about prepayment speeds on mortgages. And it depends on the various state of interest rates as to whether or not mortgages will be prepaid at a certain rate, as opposed to earlier rather than later.

Chairman SUNUNU. In trying to forecast prepayment risk, do you benefit from the GSEs' considerable database of information? I would guess that no one has better historical records than the GSEs. Do you benefit from that information in trying to estimate yourself what the potential for prepayment is?

Mr. FALCON. Yes. Absolutely. In fact, we have a broader base than either one of the GSEs, since we have both GSEs' databases. We can look at them in the aggregate in addition to individually.

Chairman SUNUNU. Could you for a little bit of history describe the mismatch that occurred in the early 1980's that was mentioned by the previous panel and the degree to which that could or could not happen again due to changes in the policy at the GSEs?

Mr. FALCON. Certainly I would never say that anything could never happen again, Mr. Chairman, but I think through our supervisory program I am comfortable with the way they are managing their interest rate risk at the current time.

Certainly—and I worked for the House Banking Committee for 8 years, Mr. Chairman, and worked with that committee to help deal with the savings and loan crisis, so I am well aware of what is required of a regulator in order to try to prevent that from ever happening again with any financial institution.

So I think what you had there was basically, as the previous panel described, you had long-term assets funded with short-term sources of funds. And that is why it is so critical to the enterprises to ensure that there is a match in duration of assets and liabilities.

Chairman SUNUNU. Who had responsibility for oversight at that—and that's before S&Ls even existed, correct?

Mr. FALCON. Yes, Mr. Chairman.

Chairman SUNUNU. So who was primarily responsible for oversight or for trying to help identify whether or not a mismatch existed in the early 1980's?

Mr. FALCON. With the enterprises?

Chairman SUNUNU. Yes.

Mr. FALCON. At that time, I think HUD had some general regulatory responsibility, but I think that was the extent of it.

Chairman SUNUNU. Could you talk a little bit about the risk-based capital stress test? What are the principles that are at the core of that test that you have developed and are in the process of implementing?

Mr. FALCON. I certainly enjoy talking about risk-based capital because I think it would be a very valuable tool for OFHEO in achieving its responsibilities.

It is intended to complement our examination program and our research program. They are all, I think, critical components to OFHEO achieving its mission.

Risk-based capital is simply placing the enterprises' balance sheets under stressful economic conditions, both stressful credit losses as well as big swings in interest rates and then seeing how their balance sheets would fare under a 10-year scenario at those stressful levels.

We are in the process right now of combing through the comments. In fact, we have concluded review of all the comments on the proposal and we are in the process right now of writing a final rule to reflect any changes that have been made and we will also have to make changes to the computer model.

This involves not just writing the rule, but involves writing very sophisticated computer code to make sure that we adequately and properly model the assets and liabilities of the enterprises.

Chairman SUNUNU. What elements of risk cannot be adequately captured in this kind of a model?

Mr. FALCON. I think management and operations risk is certainly one of them, but that is why the risk based capital requirement will have a 30 percent add on in addition to whatever is produced by the stress test. So there is a very generous add on that is included to the stress test capital requirement.

Chairman SUNUNU. Is that 30 percent intended to cover bad management?

Mr. FALCON. No, just to—well, to ensure that if there were any lapses in management or unforeseen circumstances, this is just an add on to ensure that to the next something cannot be modeled in the risk-based capital regulation there is a cushion in addition to that requirement which is produced by the stress test.

Chairman SUNUNU. How does OFHEO deal with oversight of risk management strategies in hedging?

Mr. FALCON. Our examination staff, which I think consists of very talented and experienced examiners, look at the policies of the enterprises and not just their policies but the actual practices of the enterprises in trying to hedge against risk. They will look at very specific transactions that are entered into, to accommodate changes in interest rate.

I think, Mr. Chairman, this will be complemented by our risk-based capital standard, but as great as the risk-based capital standard will be when we get it completed at the end of the year, I do not ever want to downplay how important it is for our examiners to be there at the enterprises, understanding everything that the enterprises do.

We never substitute our business judgment for what they have decided to do in running their businesses, but we certainly look at everything that they do and try to make certain that the risk is properly managed.

Chairman SUNUNU. As the size of the portfolio held by the GSE grows, the GSE needs to engage in a greater volume of interest rate swaps and utilization of option-embedded securities in order to keep that portfolio in balance. Is that correct?

Mr. FALCON. Yes. As they add mortgage-backed securities into their portfolio, their retained portfolio, they do take on the interest rate risk.

Chairman SUNUNU. Does the increase in the utilization of derivatives in that situation in and of itself require a higher level of capitalization or reserves?

Mr. FALCON. I think any increase in the use of derivatives certainly requires increased supervision because you then have to deal with counterparty risk and counterparty risk is dealt with in our risk-based capital standard as well as in our examination program. We will look at the nature of the counterparties, we will try to make sure that there is not any concentration in any one or two counterparties, but, yes, it is an important part of our supervision.

Chairman SUNUNU. Mr. Ely was disappointed that he did not have access to more information regarding that counterparty exposure but for the purposes of regulation, is there any information regarding counterparty exposure that you do not have access to?

Mr. FALCON. No, sir.

Chairman SUNUNU. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman, and thank our panel for being here. I am sorry I missed your testimony.

I want to say I am always happy to see Mr. Falcon testify because a lot of what we are talking about with respect to the GSEs and whether or not there is sufficient oversight and risk-based capital rules and all is sitting on Mr. Falcon's front doorstep and we eagerly await the publication of the final rules with respect to that and I, for one, am eager to see Congress allow Mr. Falcon and the agency that he represents the ability at least to carry out what we passed in 1992 before we go and change it all again, maybe at least for a month or two, if not longer.

Let me ask just a couple of questions.

One, to Mr. Ely's question on derivative information, when OFHEO conducts its analysis of the GSEs, in which case you will be looking at counterparty risk and the like, will that information, will your final analysis including some of that information, become part of the public domain and thus be available to the public, whether it is the general public, concerned investors or whatever?

Mr. FALCON. I think generally I would like to foster greater understanding of the GSEs and the secondary mortgage market. To the extent we can provide any increased transparency to their operations, especially in this area, I think it would be of benefit to the mortgage market and to the public. However, we have to balance that against the requirements of the Trade Secrets Act and ensure that we do not release any proprietary information of the enterprises, but certainly I think that that is a very worthwhile goal.

Mr. BENTSEN. It is tough in the area of derivatives, there is no real Federal standard as it relates to disclosure of derivative investments, even in the banking industry we have had a battle going on over FASB rules and how derivatives should be handled and disclosure rules, but I would hope that OFHEO's analysis that it is disclosed to the public is useful analysis, I guess is the best way to put it.

How would you compare in establishing your risk-based capital standards and your stress test to those that were established under FIRREA for savings and loans? You were involved in the passage of both pieces of legislation as counsel on the banking committee. FIRREA sought to impose tighter investment standards on thrifts both in the purchase of mortgages, mortgage securities, and other types of non-mortgage investments. Do you think the standards you are establishing are comparable to that?

Mr. FALCON. The standards which eventually resulted from FIRREA and FIDCIA were risk-based capital standards, but they were more of a ratio or leverage type risk-based capital standard, where assets were placed in buckets and the buckets had a risk weighting and the resulting capital would be their risk-based capital standard.

This was in addition to the straight forward leverage capital standard that the banks and thrifts have applied to them.

What OFHEO is doing under the 1992 act is something which is entirely different. I do not mean to imply that one is better than the other. I think that comparing banks and thrifts and the enterprises, it may be that one is appropriate for banks and thrifts and this is appropriate for the GSEs. What we do is we actually place the balance sheets of the enterprises under stressful conditions, big interest rate swings, severe credit losses, we give them credit for hedging activities, and we make sure that they can remain solvent over that entire 10-year period under those stressful conditions.

If at any point in any quarter during that 10-year period they do not have sufficient capital to remain solvent, then we will increase their capital requirement to make sure that they always maintain that level of minimum capital.

So we try to simulate through this risk-based capital regulation and the stress test what would happen under severe economic times and I think that is an entirely different way of imposing a risk-based capital requirement and, in fact, we have been educating the banking regulators on how this would work. There may be some aspects of it that they are trying to understand better to see if there is any applicability.

Mr. BENTSEN. Do you take into consideration geographic economic dislocation and how it affects the mortgage portfolio? I know a lot has been talked about the farm crisis and the impact it had on the Farm Credit System in the mid 1980's. Obviously, there was an economic problem broadly in the farm system.

Do you all take into account—I mean, short of just an overall economic decline in the United States, the geographic changes in the real estate market?

Mr. FALCON. Well, the worst credit losses that are built into the stress test actually are the worst credit losses for a specific region of the country, so to the extent that we did pick the severest credit losses for a geographic region of the country and implied those losses and that experience to the entire portfolio of the enterprises, so Congressman, I think in that sense we are trying to not just take a national average of credit experience, but actually a more focused worst case scenario.

Mr. BENTSEN. I just have a couple more questions, Mr. Chairman.

If you find that there is under capitalization or potential under capitalization or non-adherence to stress test risk out there, your examiners are in the GSEs and they find there is a problem with the portfolio or a systemic problem, what authority do you have to correct that problem?

Mr. FALCON. We have pretty broad authority in our statute and we have adequate authority, I believe, to step in and require the corrective action to address the problem and we will move quickly to do that. I would never want to place this committee, this Congress, in any position where they have to consider a deteriorating condition of the enterprises. So we would move quickly, we would move forcefully, utilizing all the authorities we have to ensure that we exercise prompt, corrective action.

Mr. BENTSEN. Do you have similar sort of cease and desist authority in the same way the Comptroller of the Currency or the Federal Reserve has in bank regulation?

Mr. FALCON. Yes.

Chairman SUNUNU. Finally, for Mr. Apgar and Mr. Falcon, there has been a lot of discussion about GSE debt and we will just talk about aggregate debt, both GSE corporate debt and mortgage-backed security debt, and how fast it is growing.

Is GSE debt—the vast majority of which is mortgage debt, I believe, in one way or the other—is it growing more rapidly than housing debt would grow as a whole to meet housing market demand?

The point is—and this is sort of where I think the big question we are leading to is—do the GSEs have access to so much cheap money out there that they have issued a dramatic amount of debt far greater than the demand they have for buying mortgages, either through direct purchase or through the MBS function?

Mr. APGAR. Well, you heard earlier that the mortgage market is a mature market, growing only so fast, and the GSEs for a variety of reasons, the secondary market GSEs particularly, are growing even faster in their purchase of debt.

I think the more relevant question is is it growing faster than maybe Congress or anybody anticipated when they laid down the regulatory frameworks in 1992. And so I think it is a fair question to review whether the oversight mechanisms are appropriate. I have high confidence that in the case of the Federal Housing Finance Board we are doing an adequate job.

I have testified earlier concerning the job that OFHEO and HUD is doing in its oversight of Fannie and Freddie, but I do think it is an appropriate question given the fact that it is growing, I believe, faster than people would have anticipated that would review these regulatory structures.

Mr. BENTSEN. I would just add—and that is a fair question, I agree with you, that is a question we need to be focusing on. But my initial question is a risk-related question.

The argument is that there is substantial risk associated with the rise in GSE debt. The question is is that debt rising to meet housing market demand or is it rising faster than housing market demand would otherwise require?

And if there is a spread there, then is that where the risk would be?

Mr. APGAR. Well, it is clearly——

Mr. BENTSEN. Assuming that the housing market is relatively stable.

Mr. APGAR. It is what does housing market demand require, which is the question of how much do the GSEs need in order to maintain their operations and that is the important question that we have been discussing.

Clearly, in order to maintain their role as secondary market activity, they need to do some purchasing of securities to maintain price and other things. The question is whether they have been involved in excessive purchases, some way defined, and I do not have a specific answer on that.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman SUNUNU. Mr. Smith.

Mr. SMITH. Thank you, Mr. Chairman.

I happen to chair one of the science subcommittees in research and we have been looking at the effect of the new technology and our ability through computers and websites to communicate and I am somewhat familiar with a couple of innovations such as the *muniauction.com* and other websites that tend to make sure that the market is in place as far as buyers and sellers in terms of trying to make this system a little more efficient.

What do you see as the impact of this kind of advance communication in terms of bringing the lowest possible interest rates or the lowest possible—the best possible service to the ultimate homeowner?

Mr. APGAR. Well, as was noted earlier, capital markets are emerging, they are integrated into the world, housing finance markets into the world, capital markets. The innovations in delivery of mortgage products are astounding. And so I think that all enures to the benefit of the American home buyer.

Mr. SMITH. Mr. Falcon, any comments?

Mr. FALCON. I agree generally with what Secretary Apgar said.

Technology as it evolves, and I would recommend to you our annual report which discussed this at some length, could change the way the mortgage delivery system is used right now. I think you are seeing some efforts by the enterprises to try to position themselves accordingly. They are developing relationships with others such as the Freddie Mac-Microsoft joint venture to have a single delivery mechanism for mortgages through the Internet.

So I think it is an area that we are studying carefully.

Mr. SMITH. And, Mr. Falcon, let me ask you a question about hedging. When asked about the credit risk and interest rate risk as a result of mortgages and MBSs in the portfolio, GSEs are quick to point out that they have a great hedging system and so my question is is there an adequate framework in place for OFHEO to assess and review these hedging systems to look at what is going to be the best way to do it? How do you assess it? Are you assessing them?

Mr. FALCON. Absolutely, Congressman. We look at their overall policies with regards to how they use hedging, derivatives for hedging purposes. They engage in derivative usage for hedging purposes and do not engage in the use of derivatives for speculative purposes. And we do look closely at how they use hedges to deal with any possible interest rate risk that they have with respect to their portfolio or any other line of business that they have.

Mr. SMITH. And another question is Fannie Mae has stated on several occasions that a bank or a thrift institution would require much more capital if they were going to meet the risk-based capital requirements of OFHEO. Give me your reaction.

Mr. FALCON. You really cannot compare them, Congressman. They are two entirely different types of capital regulations, the risk-based capital we are working on versus the risk-based capital regulation that banks and thrifts have applied to them. And the nature of their businesses are very different as well. So I do not know that you could readily compare the capital requirements of banks and thrifts to the capital requirement that we will have for Fannie or Freddie under a risk-based capital regulation.

Mr. SMITH. And maybe a final question would be each of your assessment or your evaluation of the ultimate responsibility of the Federal Government, how much of a real obligation would there be for the Federal Government to underwrite, would it be a political obligation?

Do you see anything that is implied in any of the laws or any of the regulations that might go further in implying some underwriting by the Federal Government if the GSEs run into trouble?

Mr. APGAR. Well, as was noted, we are starting with securities that say in plain English that these are not guaranteed by the Federal Government, but that does not undue the 60, 70-year history of Federal involvement in each entity. And so clearly there is an investor perception.

What it would take to change investor perceptions is difficult to assess, but among other things, investors could perceive that because of the size of these organizations alone, independent of this history of Federal involvement, that any substantial financial difficulties because of the magnitude and number of people that would be affected by that would require some Federal action.

Mr. FALCON. I agree totally, Congressman. You could remove the enterprises' line of credit and you could take away their Federal charter, you could subject them to State and local taxation, you could take away all the explicit Federal benefits, but you still have the question before you of would they be considered too big to fail.

This is a question that Congress has before it, not just with respect to Fannie or Freddie or the Federal Home Loan Bank System, but with respect to any large financial institution.

So would repealing the explicit benefits they receive address the issue of the implied Federal guarantee? I am not certain it would because of the issue of too big to fail.

Mr. SMITH. And so to what extent does this implied responsibility of the Federal Government add to the profits of Fannie Mae and Freddie Mac?

Mr. FALCON. It certainly makes our jobs all the more important, to make sure that we are adequately supervising the enterprises. The benefits they receive, as I outlined in my testimony, there is benefit that enures to homeowners. If you look at the comparison of the conforming mortgage interest rate to jumbos, there is certainly a difference in what it would cost the homeowner to get a home loan.

Chairman SUNUNU. If you could elaborate on that, to what extent is that disparity driven by the participation of the GSEs and to what extent is it driven by market liquidity at the sort of higher end and the larger size mortgages that might be less common?

Mr. FALCON. Well, I think certainly the enterprises' lower cost of funds by virtue of the GSE status is what results in some of that differential. Whether or not all of the differential gets passed on to homeowners is a question. I believe it was CBO several years ago opined that roughly half of it was passed on to the homeowners and the rest was for the benefit for shareholders.

I would like to do some more research on the subject, Mr. Chairman, on your specific question.

Mr. SMITH. Mr. Chairman, can I just do a quick final question?

Chairman SUNUNU. Sure.

Mr. SMITH. To what extent is this implied support and underwriting by the Federal Government jeopardizing additional competition or participation in the secondary mortgage market by other totally private organizations?

Mr. FALCON. Well, there is a healthy amount of business done by private label mortgage-backed securitizers and Ginnie Mae certainly engages in mortgage-backed securities of FHA loans. There is an issue here about competition. I am not prepared to say a lot about it, but it is one that I think is appropriate for Congress to consider.

Generally, I think competition is good.

Mr. SMITH. So are you saying it does to some extent give Fannie Mae and Freddie Mac somewhat additional advantage?

Mr. FALCON. Without a doubt, Congressman. The existence of the GSE status on Fannie and Freddie does give them a competitive advantage over any competitor that does not have GSE status. That is certainly true.

Chairman SUNUNU. Thank you, Mr. Smith.

Mrs. Clayton.

Mrs. CLAYTON. Thank you.

To follow up, I think that the reason and the rationale for creating and giving the advantage was that indeed there was a need for generating tools that would enhance the affordability for housing. Is that not right?

Mr. FALCON. Yes. That was Congress' purpose in establishing the GSEs.

Mrs. CLAYTON. And knowingly they gave it an advantage because there was a public good for which there was a need, otherwise, they would not have done that.

Mr. FALCON. Yes, that is right.

Mrs. CLAYTON. All of the previous panelists indicated that the buying back of mortgage-backed securities is perhaps not mission driven and one, I think Ms. Miles, said it may be a wash, yet Mr. Ely argued that the absence of a diversified portfolio increased the risk exposure of the GSEs.

Can it be said that to buy back mortgage-backed securities really decreases or increases the risk?

Mr. FALCON. I think certainly buying back mortgages does help the enterprises in the sense that it increases the liquidity for their mortgage-backed securities. Whether or not that is—it is Congress' judgment to consider whether or not that is or is not a mission-related right of the enterprises to do that, but certainly it is a sound business practice to increase the liquidity of the securities and to the extent that this does increase the liquidity, I do not have a concern about it from a safety and soundness standpoint.

Now, as a mission-related standpoint, that is something I think is appropriate for Congress to consider.

Mrs. CLAYTON. But you do not have any questions about it undermining the mission?

Mr. FALCON. No, ma'am.

Mrs. CLAYTON. You do not question that the buying back would undermine the mission. You do see the value in that it strengthens the liquidity of the GSE and therefore reduces the risk which is the opposite of what Mr. Ely said.

Mr. FALCON. Yes, Congresswoman. It does not undermine the mission of the enterprises.

Mrs. CLAYTON. On the matter of the implied obligation of the U.S. Government to the creditors or the investors of the GSEs, the fact is that the line of credit that has been argued, again, Mr. Ely, really is very low as it relates to the portfolio, so indeed of that being an issue to undermine the government's debt, can you comment on that?

Mr. FALCON. The two and a quarter billion dollars line of credit which each enterprise has is symbolic. Given their size, that amount of money would not really do them much good if they were to experience some severe economic troubles.

Chairman SUNUNU. Mrs. Clayton, if you would yield on that point for a moment?

Mrs. CLAYTON. Yes.

Chairman SUNUNU. That begs the question what does it symbolize?

Mr. FALCON. I remember this came up, Mr. Chairman, in the hearing before Congressman Baker as well. And I think it is a matter for discussion and debate by this Task Force, by the Congress, as to whether or not Congress wants to begin to take away some of the explicit benefits that the GSEs have.

Removing it would take away some of the aura of the implied government guarantee. Would it have any adverse effect on homeowners? That remains to be seen and it might be an avenue for further search.

Mrs. CLAYTON. The implied obligation on the part of the government, is that enforceable?

Mr. FALCON. It is enforceable only by Congress. If something were to happen to the enterprises——

Mrs. CLAYTON. What about a court? Is it enforceable by a court order?

Mr. FALCON. No, ma'am. The statute—in fact, the 1992 act which created OFHEO explicitly says that the liabilities of the enterprises are not backed by the full faith and credit of the Federal Government. It would take an act of Congress to step in and bail out the creditors of the enterprises if it wanted to do so.

Mrs. CLAYTON. Follow on. Should we really be concerned with GSEs, their debt or about their safety and soundness if the two are not the same?

Mr. FALCON. I'm sorry?

Mrs. CLAYTON. Should we really be concerned about the extent of their debt or we should we be concerned about their safety and soundness, the security of the GSEs, since the two are not necessarily the same?

Mr. FALCON. Right. Two issues here. One is the size of their debt. Certainly you would be more concerned about entities like this which have $2.2 trillion in debts and MBS outstanding as opposed to whether or not it was $10 million. So size is important here with respect to the implications to the financial system, should one of the enterprises ever become insolvent.

However, equally or more important is the nature to which those risks are managed and supervised. That is why OFHEO has a very extensive examination program, that is why we have a minimum capital regulation, we will soon have a risk-based capital regulation in place.

I think with the tools and adequate regulation we can ensure that those risks are properly managed and that there is not an undue risk to the financial system. That is OFHEO's role.

Mrs. CLAYTON. You say you can, but you have found that. Haven't you found that they are sound?

Mr. FALCON. Yes, ma'am. Absolutely.

Mrs. CLAYTON. OK. And so the structure or the soundness of the management has been established and you have evaluated that to be the case. Is that correct?

Mr. FALCON. Yes. They are financially healthy. They are well managed institutions.

Mr. APGAR. Excuse me. Just with respect to the Home Loan Bank System, I would echo the same thing. I think today, there is no reason for concern about risks that the system poses to the American taxpayer.

Mrs. CLAYTON. I think also, Mr. Chairman, that the implied advantage given to the GSEs is also an implied advantage given to the consumer and I would just question what the interest rate would be for our loans generated if we did not have that.

So I do not know, since we are looking for studies, we may want to look at what that implication would be and how the interest rate would be somewhere else if we did not have the intervention of GSEs in the marketplace. So I think there is great value in having them there.

Thank you.

Chairman SUNUNU. Thank you very much, Mrs. Clayton.

A few final questions.

Mr. Falcon, you seemed to suggest just a few minutes ago that safety and soundness was not related to the size of the mortgage portfolio held by one of the GSEs. Now, it would seem to me that by purchasing mortgage-backed securities or whole loans and holding them that GSEs expose themselves to the risks we have talked about, interest rate risk and the prepayment risk, that they were not exposed to before they held those securities on their own balance sheet.

So that would impact their safety and soundness, with the appropriate caveat that they would hedge and manage those risks in an appropriate way. But clearly the existence of the portfolio does have an effect on and is intertwined with safety and soundness in your evaluation of that in support of the safety and soundness.

Mr. FALCON. Yes. You are right. What I meant to say, if I did not say it clearly, was the existence of a retained portfolio and their purchase of mortgage-backed securities is not in and of itself unsafe and unsound. It is more a question of how they manage the risk inherent with that activity.

Chairman SUNUNU. And at least in your most recent report, I think it is a 2000 report, you certainly took those increased risks and risk management strategies into consideration in issuing the support for their safety and soundness that you did, correct?

Mr. FALCON. Yes, Mr. Chairman.

Chairman SUNUNU. Could you comment briefly on whether you think there would be some efficiencies to be gained if we combined your mission regarding safety and soundness with the mission regulation of the GSEs?

Mr. FALCON. I am not sure what efficiencies would be gained. There could be some. But I would say that having mission regulation is not essential to an effective safety and soundness regulation. We work well with HUD. We are under the HUD umbrella as an independent agency within HUD and we are constantly discussing GSE issues amongst ourselves.

Chairman SUNUNU. One case, though, where there would seem to be an interrelationship is in the discussion of appropriate investment vehicles and, in particular, the case of the whole cash value life insurance policies. There was a well publicized example, I think, several years back of investment in some equities, tobacco securities or equities or something along those lines.

Those investments are reviewed, as I understand it, by those looking at mission, but they would ultimately have an effect on safety and soundness as well. Could both of you comment on that?

Mr. APGAR. Yes. With respect to non-mortgage investments, you know, clearly, we need to look at the safety and soundness implications and so as we do our non-mortgage investments review, which take place on the HUD side of the ledger, we coordinate very carefully with OFHEO.

Chairman SUNUNU. Why not allow OFHEO to have jurisdiction over those issues as well?

Mr. APGAR. Because there are other issues with respect to non-mortgage investment in terms of what types of—as well as with mortgage investments as to whether or not they enhance the overall effectiveness of the mission, whether they are in the broad public value, we have a three-part test of which safety and soundness is just one of the criteria we use.

Mr. FALCON. And HUD does approach us on these issues and we do offer a very thorough analysis to them about the safety and soundness implications of any activities of the enterprises, Mr. Chairman.

Chairman SUNUNU. There was some discussion on the previous panel about global market disruptions such as the Russian devaluation, the series of Asian currency devaluations, and the fact that these kinds of global economic disruptions or downturns could have an impact on the safety and soundness of the GSEs.

Now, it seems to me in considering both of those crises that the market reaction would be one of a flight to quality, which would have the effect of lowering interest rates or at least supporting demand for both GSE debt and perhaps mortgage-backed securities that are viewed as a generally less risky investment as compared to many others that are in the marketplace.

Mr. Falcon, could you comment on whether or not there are international economic disturbances that have been seen to have a negative impact on the risk profile of the GSEs, one, and, two, are the potentials for global economic disruptions, international disruptions included in the risk-based capital standard that you are soon to release?

Mr. FALCON. Let me start with the risk-based capital standard. We have very lengthy historic data that we use that we built into our risk-based capital regulation, issues like the credit risk where you might have defaults associated with mortgages of the enterprises.

That is built into those numbers that we use to model the likelihood of default and the severity of credit losses in the event that there were defaults on mortgages.

Chairman SUNUNU. Just to be clear, you include historical information about international interest rates and currency values as well?

Mr. FALCON. We think—not specifically international currency values or international economic scenarios. We think that is all built into the historical averages that we use on default rates and loss severities on mortgages that the enterprises are involved in.

We could look at whether or not we would want to include specific international economic problems, but that would require us to get into a lot of speculative modeling on how much of an impact a crisis in Asia might have on mortgage performance in the United States, that kind of very hypothetical exercise. We try to stay away from that and make sure that this rule matches known risk to capital.

On the first part of your question, with respect to the risk to the enterprises from possible international crises and the flight to quality, in 1998 there was such an event and there was a flight to quality and, in fact, Fannie Mae and Freddie Mac used their mortgage portfolio to be the market essentially for their securities. That helped their MBSs, their debt remain very liquid and part of a quality investment.

Chairman SUNUNU. Are there any financial instruments that you are aware of aside from treasuries that have the level of market liquidity that the GSEs' mortgage-backed securities do? I mean even outside of that extraordinary case in 1998.

Mr. FALCON. Sure. Sure. Some would point to some triple-A rated corporate debt of some very large companies.

Chairman SUNUNU. That have higher liquidity, similar liquidity or nearly the same liquidity?

Mr. FALCON. That are regarded as nearly as risk—that have the same risk level as the enterprises. But they trade closely to GSE debt. But none of those come to mind really.

Chairman SUNUNU. Thank you very much.

We thank both witnesses again. And the good news—the bad news, rather, is you are not Alan Greenspan, but the good news is you were able to keep a room full for about 3 hours.

Thank you for your patience and for all of the information you provided the Task Force.

We are adjourned.

[Whereupon, at 1 p.m., the Task Force was adjourned.]

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