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GOVERNMENT SPONSORED ENTERPRISES

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, SECURITIES AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON BANKING AND
FINANCIAL SERVICES

AND THE

SUBCOMMITTEE ON
GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY

OF THE

COMMITTEE ON GOVERNMENT
REFORM AND OVERSIGHT

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GOVERNMENT SPONSORED ENTERPRISES

WEDNESDAY, JULY 16, 1997

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
AND THE
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY,
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT
Washington, DC.

The subcommittees met, pursuant to notice, at 2:05 p.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises], presiding.

Present: Chairman Baker; Representatives Horn, Royce, Lucas, Cook, Snowbarger, Hill, Sessions, Kanjorski, Flake, Maloney of New York, Gutierrez, and Barrett.

Chairman BAKER. Today we have a special construction of the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises in that we are meeting in conjunction with the Subcommittee on Government Management, Information, and Technology of the Committee on Government Reform and Oversight.

So, this is a joint subcommittee hearing, and I extend a welcome to Chairman Horn, who is with us today.

Both Chairman Horn and I are interested in reviewing the features of Government Sponsored Enterprises and hearing from our panels of distinguished witnesses today. I will be in the chair during the testimony of panel one, the General Accounting Office and the Congressional Research Service.

I anticipate learning much from their testimony, in that I understand it gives a comprehensive view of the relationship of the GSEs with their sponsor, the Federal Government.

I think this overview is appropriate, in light of the enormous contingent liabilities to the Government that we face as a result of potentially inappropriate managerial controls. GSE debt guarantees represent a total of nearly $1.8 trillion in contingent liabilities to the American taxpayer.

Having said that, there is nothing that would indicate at the moment that any of the GSEs, which are the subject of today's hearing, do present a current and present danger to the taxpayer, only that this subcommittee's obligation, as one of oversight, will continue to review and analyze the performance of these GSEs and

take into consideration any proposals which might be proposed for ensuring continuing solvency and profitable operation.

[The prepared statement of Hon. Richard H. Baker can be found on page 50 in the appendix.]

With that, I would like to call on Chairman Horn for any comments he would choose to make.

Mr. HORN. Thank you very much, Mr. Chairman. We are pleased to join with our fellow subcommittee today in examining both the theory and the practice of Government Sponsored Enterprises. The Subcommittee on Government Management, Information, and Technology of the full Committee on Government Reform and Oversight is charged with monitoring the economy, efficiency, and management of the Federal Government's various operations and activities. This oversight responsibility extends to entities chartered by the Government.

The Federal Government established the first Government Sponsored Enterprise in 1916. It was a financial entity created to provide long-term real estate loans to farmers and ranchers. Since then, many Government Sponsored Enterprises have been created for other sectors of society that have been inadequately served by the private credit markets, such as home buyers, farmers, students, and colleges.

While Government Sponsored Enterprises are managed and owned privately, they have strong ties to the Federal Government. The enabling legislation of each Government Sponsored Enterprise specifies its general purpose and its authorized transactions. For example, Fannie Mae is chartered to increase housing credit availability by engaging in secondary market and other transactions.

The enabling legislation also identifies Federal agencies responsible for prescribing overall policy and regulations for the Government Sponsored Enterprises, and usually provides that a minority of their board members be appointed by the President or another Federal official.

Government Sponsored Enterprises typically receive their financing from private investors. They issue capital stock and short- and long-term debt instruments, sell asset-backed securities, also known as mortgage-backed securities, and collect fees for guarantees and other services.

Federal legislation confers a number of benefits on Government Sponsored Enterprises that are not provided to private companies. Most enterprises have a direct line of credit with the U.S. Treasury and their securities are exempt from Securities and Exchange Commission registration requirements. Furthermore, their investors' interest income is exempt from State and local taxation.

As a result of such benefits and the similarity between their debt securities and those of the U.S. Treasury, most Government Sponsored Enterprise debt and mortgage-backed securities are perceived by the credit markets to be guaranteed by the Federal Government. This perception allows Government Sponsored Enterprises to borrow in the credit markets at interest rates only slightly higher than the rates paid by the Treasury on its borrowings.

In our oversight role, we need to address a variety of issues regarding the functions of Government Sponsored Corporations and Enterprises. Generally, we need to ask whether they continue to

meet their public policy objectives. We should further consider whether there are areas where the scope of existing Government Sponsored Enterprise activities should be expanded or reduced.

We are joined by two panels of experts today to help answer these and other questions, and we are grateful for all of your participation, and we look forward to your testimony.

So, welcome.

[The prepared statement of Hon. Stephen Horn can be found on page 54 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman.

Mr. Lucas.

Mr. LUCAS. I have no opening statement.

Chairman BAKER. It is not the usual custom for my subcommittee, but we are working with Government Reform today in conducting these proceedings, and I will ask both witnesses to be sworn in before proceeding with their subsequent testimony and the questions to which they might respond later.

If you would, please stand, raise your right hand, and respond appropriately.

[Witnesses sworn.]

Chairman BAKER. Thank you, gentlemen. You are now considered to be under oath.

I also wish to recognize Mr. Royce, who just joined us.

Would you care to make an opening statement, Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman. I want to thank both you and Chairman Horn for holding this joint hearing today.

This is my first hearing as a Member of the Capital Markets Subcommittee, and I am pleased to be able to participate today in what, I believe, is a critical function of this subcommittee and of Congress, and that is the examination and oversight of the Government Sponsored Enterprises.

While the Capital Markets Subcommittee held extensive hearings on the housing-related GSEs last year, I believe that this joint hearing is particularly useful, as it provides us with a more comprehensive view of GSEs and enables us to focus on the fundamental question of whether or not, in today's financial environment, the Government should be sponsoring these privately-held corporations and, if so, what limitations should be imposed to ensure that these enterprises stay focused on the mandates they were given by the Congress?

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Royce.

Mr. Kanjorski, would you care to make an opening statement?

Mr. KANJORSKI. Briefly, Mr. Chairman. I ask that my full statement be made part of the record.

Chairman BAKER. Without objection.

Mr. KANJORSKI. Mr. Chairman, I want to congratulate you and Mr. Horn for having the efficiency of having two subcommittees come together to hold a joint hearing like this.

I think that this will be a great example for a good portion of our fellow subcommittee Members in the House to take note that joint hearings can be very successful.

I look forward to today's hearing and to learning whether or not the GSEs are successful organizations, how we can make them more successful, and whether there are other needs to which the GSE structure could be applied to meet the challenges that we have going into the 21st century.

I think that there are certainly strong positions on these issues on this panel and also the academic panel. I know there are some disgruntled feelings in regard to the success of these organizations.

Finally, I just wanted to caution for the record that, through no fault of anyone here on the inviting of witnesses, we will not have a full, comprehensive review of the problem, because some people who had different views were not available to testify on the second panel. Nevertheless, today's hearing will offer an opportunity for all the Members to come up to speed on Government Sponsored Enterprises and to, more particularly, understand where they are going and how we can better utilize them.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 52 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski, and of course, Mr. Kanjorski is the Ranking Member on the Capital Markets Subcommittee.

I wish to recognize Mrs. Maloney, who is the Ranking Member on Chairman Horn's subcommittee.

Mrs. MALONEY. Thank you very much, Chairman Baker. Although I am here today in my capacity as the Ranking Member on the Government Management, Information, and Technology Subcommittee, I also had the pleasure of serving and working with Chairman Baker on the Capital Markets Subcommittee last year.

In fact, in addition to months of bipartisan work on the Federal Home Loan Bank reform, last year the Capital Markets Subcommittee held 4 days of extensive oversight hearings on Fannie Mae and Freddie Mac. During that time, we heard from GAO, CBO, HUD, and the Treasury Department. It struck me that despite their different perspectives, all of these agencies agreed on one fact: that because of Fannie Mae and Freddie Mac, the United States has the best mortgage markets in the world.

So, if we are here today in large part to determine if and why a GSE should be formed and sustained, then that work of last year gave us a working definition: a GSE should correct a market imperfection or credit gap whose existence is detrimental to an important public purpose like housing or education.

Mr. Chairman, as a means of clarifying this, I would like to use Fannie Mae and Freddie Mac as examples of GSEs that fit that definition.

Before Fannie and Freddie, many institutions, particularly smaller ones, had a problem maintaining a reliable flow of mortgage credit for qualified buyers.

That's because mortgage credit was funded through local deposits. Those institutions in areas with a large volume of home buyers, or a healthy supply of new depositors, could provide ready credit at lower rates. But those lacking these favorable conditions faced a credit crunch and had to charge higher rates.

Of course, because most areas took their turn facing bad economic times, mortgage availability and interest rates varied greatly from region to region.

Worst of all, when a local economy was hit with hard times, and needed the infusion of new capital the most, local mortgage credit dried up. In short, the availability of mortgage credit was not reliable and stable.

Freddie and Fannie changed this by making the home mortgage a nationally-liquid asset.

Today, lenders all of the country know they can readily sell their mortgages at a fair price to one of these two GSEs.

That is because, since Freddie and Fannie are mandated by law to operate in all 50 States, they have the expertise and experience to evaluate and purchase individual mortgages from all over the Nation almost instantaneously. Freddie Mac and Fannie Mae buy mortgages, package them together as securities, sell them to investors, and use the profit generated to buy more mortgages, continuing the cycle and providing more ready cash to local lenders to make more mortgages.

What has this meant for the average home buyer?

It means if you qualify for a mortgage, you can get a mortgage, that there is a system to supply mortgage credit for you, whether you live in New York City or California. And it means, because the rates are lower, more people can qualify.

That is why, today, we have the best housing finance system in the world.

Fannie and Freddie are examples of how GSEs have corrected a market imperfection or a credit gap—in this case, locally-based credit crunches in the home mortgage market—whose existence did harm to an important public purpose. In this case, providing every American family the chance to own their own home.

The second issue we look to today is when a GSE should lose its Government Sponsored status. The answer to that, I think, is straightforward: a GSE should lose its Government Sponsored status when it is no longer needed to correct the market imperfection or credit gap it was designed to address.

Again, I would like to use Fannie and Freddie as examples of GSEs whose presence is still needed.

In regional downturns, our housing public-private partnership GSEs have maintained their presence. They have hard targeting, tougher than any CRA requirement, keeping their loans below the 207,000 conforming limit, and reserving 40 percent of their business for those making the median income or less. On the other side of the coin, we on the subcommittee know the difficulty we have had maintaining much less rigorous CRA requirements in the private sector.

The attention to underserved areas goes beyond regional downturns. In my home town of New York City, where co-op housing has been a path to home ownership for so many, financing has been extremely tough to come by, even through local lenders. This has artificially and unfairly frozen in many co-op owners who would like to sell, and frozen out many prospective buyers.

The private sector, on its own, has not stepped in to solve this problem. Fannie Mae has.

Beginning in 1993, and culminating in the House New York Plan, Fannie Mae has made a major commitment to help revitalize this market and spur new co-op sales, pledging $750 million where nothing had existed before. With the new ability to sell co-op loans to the secondary market, the banks' resources are now being freed up to make more co-op loans.

At the point a regional market or a type of housing stock hits tough times is exactly the point it needs focus and attention from the housing finance market. And it is exactly at that moment that a fully privatized secondary market structure would not work as well.

Having a stable national market for home mortgages that will be there in good times and bad, in booming regions and depressed regions, is a tangible benefit the American people have come to expect. If an American home buyer qualifies for a home loan, they can get a home loan at a nationally dependable fixed rate. Americans benefit from lower rates because of participation in a national market.

On page 70 of the GAO report presented at last year's hearing, the conclusion was made that—and I quote—"Privatization would probably mean that mortgage rates would increase in areas with higher risk, for houses with higher loan-to-value ratios, and in periods of high mortgage demand," end quote.

Put another way, a privatized world would be a far different, more segmented, housing finance system than the reliable and consistent one we have today.

Fannie and Freddie cannot be pulled out of the market. They cannot, by statute, abdicate affordable housing goals.

To the extent some might envision a fully privatized world where you would or could abdicate these roles, we would have a housing finance system less responsive to the needs of the people.

The delicate balance we have today has been a great success for the American consumer, and one I hope we would all be very skeptical of disturbing.

It is not that we should not look at privatization, or continue to evaluate the performances of our GSEs, but that before we take away Government Sponsored status, we should be very careful that the important needs being filled by a particular GSE can, indeed, be filled by the private sector.

Thank you, Mr. Chairmen, and believe it or not, this is not all of my comments. I would like to put the rest of them in the record. Thank you.

[The prepared statement of Hon. Carolyn B. Maloney can be found on page 59 in the appendix.]

Chairman BAKER. Without objection, and Mr. Kanjorski believes you.

Does any other Member choose to make an opening statement?

[No response.]

Chairman BAKER. If not, at this time, it is my pleasure to introduce to the subcommittees Mr. James Bothwell, Chief Economist of the U.S. General Accounting Office, previously Director of GAO's work on financial institutions and financial markets, and he served as the GAO's Deputy Chief Economist.

Mr. Bothwell, welcome.

STATEMENT OF JAMES L. BOTHWELL, CHIEF ECONOMIST, U.S. GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY THOMAS J. McCOOL, ASSOCIATE DIRECTOR, GENERAL GOVERNMENT DIVISION; AND DR. LOREN YAGER, Ph.D., ASSISTANT DIRECTOR, OFFICE OF THE CHIEF ECONOMIST

Mr. BOTHWELL. Thank you very much, Mr. Chairman. It is certainly a pleasure for me to be back here testifying before your subcommittee, and it is a special pleasure for me to be testifying for the first time before your subcommittee, Mr. Horn.

Mr. Chairman, I would first like to introduce my two colleagues, on my right, Tom McCool and Loren Yager. Tom is an Associate Director in our Financial Institutions group at GAO, which does most of our work on GSE issues, and Loren is an Assistant Director in my office at GAO.

Mr. Chairman, I have a somewhat longer prepared statement that I would like to submit for the record, and then summarize, if I could.

Chairman BAKER. Absolutely. Without objection.

Mr. BOTHWELL. Thank you.

Mr. Chairmen and Members of the subcommittees, we are pleased to be here today to discuss the large and growing role of Government Sponsored Enterprises in the Nation's credit markets.

As you are aware, Congress originally created GSEs to enhance the credit available to home buyers, farmers, students, and colleges. Congress established GSEs as federally-chartered, but privately owned and operated corporations, limited their activities to certain economic sectors deemed worthy of public support, and gave them certain advantages to help accomplish their public purposes.

Today, the outstanding volume of federally-assisted GSE credit is large and rapidly increasing. Mr. Chairman, as shown in the first of the five Figures that are attached to the end of my prepared statement—and I would like to draw your attention to those Figures—the volume of GSE credit more than doubled between 1990 and 1996, from $874 billion to almost $1.8 trillion, and is now almost double the outstanding amount of credit made available through all Federal direct loan and Federal loan guarantee programs combined. If you look at that first chart, Mr. Chairman, that bottom line shows the volume of direct Federal loans, and you can see that it has been pretty flat over this period of time.

The second line shows the amount of guaranteed loans, and that has only slightly grown over this period of time, but the top line shows the amount of GSE credit, and that has grown quite rapidly.

As shown in Figure 2, GSE credit has also steadily increased as a percentage of the total net credit outstanding in our economy, from being less than 2 percent in 1970 to over 12 percent in 1996. By contrast, the share of total net credit accounted for by Federal direct and guaranteed loans has declined substantially over the same period, from being almost 13 percent in 1970 to less than 7 percent in 1996, so you almost had a reversal of their roles in terms of the percentage of net credit outstanding over this period.

As shown in the Figure 3, 95 percent of total outstanding GSE credit in 1996 was housing-related, with the remaining 5 percent going for agricultural and educational purposes.

In recent years, housing has also been the only sector where GSE credit has been growing as a percentage of the total available credit outstanding. In particular, as shown in the next figure, Figure 4, the two largest housing GSEs, Fannie Mae and Freddie Mac, have increased their share of total residential mortgage debt from 23 percent in 1990 to over 37 percent in 1996.

By contrast, as shown in the last of the figures, Figure 5, the share of farm credit supplied by the Farm Credit System, which is the largest of the two agricultural GSEs, actually declined between 1985 and 1995, and Mr. Chairman, as you know, Congress passed legislation in 1996 that allowed the two education GSEs, Sallie Mae and Connie Lee, to end their Government sponsorship and become fully private corporations.

Mr. Chairman, while the legal powers, organizational structures, and operating styles of GSEs differ, they have several common characteristics. For example, each was chartered by Congress to help achieve a particular public purpose, each is privately owned and operated, as I mentioned before, and each operates under certain restrictions and obligations which would not apply to a completely private corporation.

Each GSE was also given certain explicit advantages to help achieve its public purpose. Such advantages include exemptions from State and local corporate income taxes, lines of credit with the Treasury Department, and exemptions from SEC registration requirements and fees.

The most important benefit that GSEs receive from their Government sponsorship, however, is an implicit one stemming from investors' perceptions that the Federal Government would not allow a GSE to default on its obligations.

Although GSE obligations are not obligations of the U.S. Government, the lower perceived risk of holding GSE obligations allows GSEs to borrow at lower rates than comparable highly-rated private corporations that do not enjoy Federal sponsorship.

In our recent report on the potential impacts of privatizing Fannie Mae and Freddie Mac, we estimated that this funding advantage saved those two GSEs from about $2 billion to $8 billion in 1995 alone.

Because of their Federal sponsorship, GSEs also involve significant risks and potential cost to taxpayers, including the risk that taxpayers could be potentially liable for a GSE's obligations if it were to get into financial difficulty.

In 1987, Congress, in fact, did authorize $4 billion in financial assistance to the Farm Credit System when it experienced financial stress.

Limited financial and regulatory relief was also provided to Fannie Mae when it suffered losses of $277 million between 1981 and 1984.

So, there is some basis for this investors' perception.

Mr. Chairman, the special nature of GSEs and the potential taxpayer exposure to large, rapidly increasing GSE obligations, raises several important policy issues, including the adequacy of GSE reg-

ulation, the potential for expansion of GSE activities, and potential ways to limit GSE exposures.

Over the past few years, we have performed several major evaluations of the effectiveness of the various GSE regulators, and I brought a few of these evaluations with me today.

Based on these reviews, we developed the following five criteria for an effective GSE regulator: first, objectivity and arm's-length status from the GSE; second, prominence in Government; third, consistency in regulation of similar markets; fourth, separation of primary and secondary market regulation; and fifth, economy and efficiency.

Although Congress has enacted some recent legislative changes to strengthen and improve regulatory oversight of GSEs, our work has shown that none of the three housing GSE regulators, neither the Office of Federal Housing Enterprise Oversight, so-called OFHEO, which oversees the safety and soundness of Fannie Mae and Freddie Mac, nor HUD, which oversees their mission compliance, nor the Federal Housing Finance Board, which oversees the Federal Home Loan Bank System, meets all five of these criteria.

In 1993, we recommended that OFHEO and the Housing Finance Board be merged to better meet these criteria, and our ongoing work continues to support merging the housing GSE regulators and making one agency responsible for both their safety and soundness and mission compliance, and Mr. Baker, as you know, we will be testifying about this topic in more detail at your hearing next week.

Based on our work, we have also developed several criteria that policymakers could use to evaluate proposals to expand the types of products or services that existing GSEs currently offer.

Under our criteria, any new GSE product or service should: first, and perhaps obviously, add value and be consistent with the GSE's public mission; second, be properly priced to reflect risk; third, be within the GSE's areas of expertise; and finally, and perhaps most importantly, avoid competing with products and services offered by fully private companies or member institutions.

Because GSEs have been given the advantages of Federal sponsorship to achieve particular public purposes, we believe that any proposals to significantly expand their existing activities should be required to meet these, or similarly rigorous, criteria before they are approved.

Finally, Mr. Chairman, we have also done work addressing ways that Congress might limit the taxpayers' potential exposure to GSE obligations.

One obvious way to do this is to end their Federal sponsorship. As I mentioned at the beginning of my statement, Congress passed legislation last year that would make two of the GSEs, Sallie Mae and Connie Lee, fully private entities.

In 1996, GAO, the Treasury Department, HUD, and CBO each produced reports that analyzed the potential impacts of privatizing the two largest GSEs, Fannie Mae and Freddie Mac.

While taking such action could eliminate taxpayers' risk exposure to these GSEs, it would also have major impacts on housing finance markets, including a likely increase in mortgage interest rates for certain borrowers.

Our report also discussed some more limited policy options that would reduce the level of taxpayers' risk exposure to these two large and growing GSEs, such as imposing "user fees" or greater restrictions on their housing finance activities.

As with privatization, however, each of these options that we presented at that time had certain benefits, risks, and trade-offs that would need to be considered and weighed carefully.

Mr. Chairman, this concludes my statement, and my colleagues and I would be pleased to answer any questions that you or other Members may have.

[The prepared statement of James L. Bothwell can be found on page 62 in the appendix.]

Chairman BAKER. Thank you very much for your comments.

At this time, I would like to introduce Dr. Thomas Woodward, a specialist in macroeconomics and head of the Income, Finance, and Housing Section of the Economics Division of the Congressional Research Service at the Library of Congress, where he has worked on issues related to macroeconomic policy and financial institutions since 1982.

Welcome, Dr. Woodward.

STATEMENT OF DR. THOMAS WOODWARD, ECONOMIST, CONGRESSIONAL RESEARCH SERVICE

Dr. WOODWARD. Thank you. Mr. Chairman and Members of the subcommittees, good afternoon, and thank you for the invitation to discuss issues related to Government Sponsored Enterprises.

The written version of my testimony is submitted for the record. With your permission, I will summarize my conclusions.

Chairman BAKER. Without objection.

Dr. WOODWARD. Government Sponsored Enterprises, or GSEs, are congressionally-chartered profit-making corporations owned by private shareholders, but operated to serve a public purpose. They differ from other corporations in that they possess certain legal privileges and exemptions not available to other firms, and that they are limited to conducting a narrow range of business activities.

There are five federally-chartered GSEs: the Farm Credit System and Farmer Mac for agricultural credit; and Fannie Mae, Freddie Mac, and the Federal Home Loan Banks for home mortgage credit. Sallie Mae, the GSE for student loans, is becoming a fully private corporation.

The enterprises may use Federal Reserve banks as fiscal agents. Their debt may be purchased without limit by federally-chartered banks and thrifts, and may serve as collateral for public deposits. In most cases, their securities are eligible for Federal Reserve open market purchases. Their earnings are typically exempt from State and local income taxes. And most of them are exempt from the registration requirements of the SEC.

The most valuable benefit is the perception that their debt is guaranteed by the Government. Even though their securities declare that they are not guaranteed, the privileges, the fact that they have special charters, and the history of Government behavior towards the enterprises, have caused market participants to infer a guarantee, which lowers their borrowing costs.

As to when to create or terminate GSE status, most profit-making endeavors will be undertaken without the grant of special privileges, and worthwhile activities will typically yield a profit. A GSE, therefore, is not automatically justified unless there is some identifiable failure of the market to work in a sector of the economy. Even then, a GSE may not be the appropriate remedy. Because such enterprises must earn a profit, they do not work as solutions to all types of public needs.

Presumably, any new GSE or expansion of the mission of an existing one would be built around creating a secondary market for a class of loans not easily sold. Today, however, financial markets are more sophisticated and integrated; problems with regional flows of funds and access to other parts of the credit market have largely disappeared for reasons unrelated to GSEs.

In general, economic considerations point to ending a GSE's special status eventually.

In the case of a GSE that has been unsuccessful in its role in the market, the public policy concern that it was intended to address needs to be addressed in some other way. If successful, the GSE occupies a market without the discipline of competition. This outcome is a market distortion of its own, possibly worse than having an underdeveloped market in the first place. After some period of time, either the GSE needs to be weaned from its charter so that others can enter the market, or competition can be created by chartering competitors with similar privileges.

With respect to regulation, the perception of a Government guarantee of GSE debt affects the incentives that determine the amount that the owners of the firm put at risk in the form of capital or equity. Owners, as usual, prefer to minimize the amount of capital. But creditors, who ordinarily desire greater capital, are indifferent because of the guarantee.

Hence, without regulation, a firm with a guaranteed debt will tend to have insufficient capital, creating greater risks for Government. This suggests that the primary method of financial regulation of GSEs should be in the form of capital standards.

Programmatic regulation most likely needs to take the form of ensuring that the chartered firm remains within the bounds set for its activities until its job is complete. Otherwise, the firm is likely to expand its activities outside the charter.

With respect to the Government's financing costs, the existence of competing GSE debt probably has little effect on the financing cost of the Federal Government. The presence of GSEs might cause an increase in credit demand that drives up all interest rates. But the effect would have to be tiny.

In addition, the availability of GSE debt could reduce the premium that investors are willing to pay for safe Federal securities. But a casual inspection of financial markets suggests it has had little real effect.

With respect to compensation for privileges, the whole idea of granting benefits to the enterprise is to make it successful. Compensation for the privileges simply undoes the benefit.

Thus, the notion of paying for the privileges is inseparable from the issue of continuing GSE status. In the early stages of a GSE's life, a fee would be counterproductive to the whole idea of setting

up the institution and making it successful. Later in the life of the enterprise, a "user fee" for GSE privileges may be used as a substitute mechanism for ending GSE status once the market matures.

That concludes my remarks. I'm available to answer any questions.

[The prepared statement of Dr. Thomas Woodward can be found on page 80 in the appendix.]

Chairman BAKER. Thank you, Dr. Woodward.

Mr. Bothwell, I noted in your testimony and in your charts, significant market share growth of particularly Fannie and Freddie in housing finance.

Under current mechanisms, the Federal Housing Finance Board determines the average cost of housing in the country, that then triggers an automatic increase in the authorized loan limit of Fannie and Freddie. That is not pursuant to a determination that private capital markets have been insufficient in meeting the public's need.

Do you see, in light of the historic growth demonstrated by your data, some necessity for the Congress to look at that automatic loan limit increase, or whether that is an advisable course to follow?

Mr. BOTHWELL. Well, certainly, Congress could look at that issue if it chose to.

I think that the purpose of the adjustment was so that the two enterprises would still be able to buy loans underneath the so-called "conforming limit" adjusted for increases in housing prices.

There was, as you know, a problem with that procedure in that, in years where housing prices went up, the conforming loan limit went up, but we had a year or two where housing prices went down, and they did not adjust downward.

I think, because you and others have raised that issue with the enterprises, that they voluntarily did not adjust upward the conforming limit as much as they would have otherwise to take account of the inflation in housing prices that actually occurred last year. But again, I think this is a policy judgment that Congress will need to make.

Chairman BAKER. I may have offered that question in light of your observation that one of the things the subcommittees have to be sensitive to is encroachment into the private enterprise market, unless there is some demonstration of public necessity, and that formula does not appear to relate to a public necessity as your overview might indicate.

Mr. BOTHWELL. Right.

Chairman BAKER. Another area—without regard to a specific housing GSE, but with regard to the three primary housing GSEs—in your study, can you advise me as to your belief—or observation, rather—with regard to how well each meet their public policy goal as compared to, say, a commercial lending institution?

Mr. BOTHWELL. Are you referring to the GSE regulators for each of the GSEs?

Chairman BAKER. No, the public policy requirement to make credit available to low- and moderate-income individuals, minorities, and others that otherwise may be prejudiced in the traditional private enterprise system. The principle around which the GSEs

really were authorized, to serve those credit needs, and how well they perform that task, as compared with a commercial lending institution.

Mr. BOTHWELL. Well, both Fannie Mae and Freddie Mac have their explicit affordable housing goals. In our report, we mention that they have been meeting those housing goals, and the Federal Home Loan Bank System also has an affordable housing program.

I think it is being modified in H.R. 10, the financial modernization bill that is now before the Congress.

I am sure that there are those who believe that perhaps the goals could be raised some for the moderate- and low-income mortgages purchased by the enterprises, but we really have no position on that.

Tom, do you have anything to add?

Mr. MCCOOL. Yes. I think that the issue, for example, has been recently whether the enterprises should match the market or lead the market, and I think that HUD has, for the moment, chosen to have them match the market, so I think that they have achieved that. The issue about whether they should be asked to lead the market, I think, is still up in the air.

Chairman BAKER. One other question, because I will try to stick to the 5-minute rule here, if I may.

You made reference to the investment portfolio strategies of both Fannie and Freddie, indicating that both, to some extent, seem to be engaged in more portfolio investment strategies yielding higher rates of return, but consequently also resulting in a higher risk profile.

Given that enhanced position, do you have any concerns about the long-term implications of that strategy, particularly as it relates to the necessity of doing it to meet the public policy goals?

Mr. BOTHWELL. The answer to that would be yes.

One of our tenets for good GSE regulation is that there be risk-based capital standards imposed on the GSEs, and as you know, OFEHO has been somewhat late in coming forth in issuing its risk-based capital standards.

The mortgages that Fannie Mae and Freddy Mac hold in their portfolios bring them, of course, more credit risk, but it also brings them more interest rate risk. So, we think it is important that OFEHO try to issue its risk-based capital standards based on its stress testing as soon as they possibly can.

Chairman BAKER. Thank you, sir.

I will now try to keep within 5 minutes and recognize Mr. Kanjorski. It will be the Chair's intention, after Mr. Kanjorski finishes his questions, to recess for a vote, which I understand will take us about 20 minutes.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

First off, has anyone done a model in terms of looking at the financial position of what the GSEs are doing in the credit market, particularly for real estate, and if all the taxes and obligations of a private enterprise were applied, what would be the differential?

Are they still competitive if they kept the rate down, or would they materially have to go up to show a profit?

Mr. BOTHWELL. Mr. Kanjorski, in our report on the potential impacts of eliminating Government sponsorship of Fannie Mae and

Freddie Mac, we say that, if they lost that Government sponsorship, that one of the impacts would be, of course, increased funding costs on those two enterprises, from $2 billion to $8 billion.

They would pass some of that on to home buyers in terms of higher mortgage rates. We think that mortgage rates for borrowers at or below their conforming lending limit, would go up from 15 to 30 basis points.

Mr. KANJORSKI. So, it would cost the average home buyer, the user of a GSE, about 20 to 30 basis points if they were to comply in contributing costs according to obligations that the private sector has? Is that correct?

Mr. BOTHWELL. Yes. We figured out, in more easily understandable terms, for a typical mortgage of $100,000, which is typical of the mortgage that is purchased, that the increase in costs to the borrower would be from $10 to $25 a month. So, over a year, you are talking about a few hundred dollars.

Mr. KANJORSKI. Now, that would be nationwide?

Mr. BOTHWELL. Yes.

Mr. KANJORSKI. Was that looked at on a regional basis?

Mr. BOTHWELL. No, that is nationwide.

Mr. KANJORSKI. Because I am looking at it on a regional basis. In other words, it seems to me that the GSEs were formed because in some areas there was a very active, competitive mortgage market, and in other areas there was not.

Mr. BOTHWELL. Exactly.

Mr. KANJORSKI. So, the differential in mortgage rates would be significant from one State to the other, or from one region to the other.

Mr. BOTHWELL. Yes, sir. That's a national average.

Mr. KANJORSKI. So, we have successfully averaged out, in some respect, the mortgage rate in the country by having a GSE perform that function. Is that correct?

Mr. BOTHWELL. Well, that is not to say that, if the GSEs were privatized, the secondary market would go away. Presumably, there might be an increase in competition in the secondary market, and other fully private firms would come in.

Mr. KANJORSKI. I am relatively satisfied that we have handled the competition on the credit side very well to get a very low-cost product out there to stimulate building, to stimulate home ownership, to do everything that was intended when these organizations were structured.

Has anybody been looking at the other side of that question, in terms of where the distribution of that benefit goes in the economy? I will give you—I am very parochial here.

I represent Pennsylvania, and obviously, Pennsylvania, when you look at the numbers, does not participate in the amount of home building, the amount of mortgages, and some of us tend to think that the reason for that is the lack of economic development in Pennsylvania and some other States that are in rather static form in our economy.

The question is, could we look to the GSE model to provide some targeting of economic stimulus funds outside of the normal things like the Economic Development Administration and the Depart-

ment of HUD and the Department of Commerce and all these other programs?

Instead of having all this mish-mash of programs out there, would it be beneficial for regional economic development and creating a level playing field in the country, to change and enlarge the charters of the GSEs to get much more involved in assisting economic development?

Mr. BOTHWELL. Mr. Kanjorski, that is one of the changes that would be made to the charter of the Home Loan Bank System in H.R. 10.

For certain member institutions with assets of $500 million or less, they would be allowed to receive advances, and have as collateral for those advances its rural development loans and small business loans.

Mr. KANJORSKI. I am very close to that mission expansion, as you know, but do you see that this is also a potential tool that should be used, or do you see a real down-side to that? Are we playing with fire?

Mr. BOTHWELL. Well, again, if Congress deems that there is a legitimate public purpose that is not being adequately served by the private capital markets, or if it just wants to redirect credit resources into particular usage and particular sectors of the economy, a GSE is probably an efficient vehicle to do that, but there are costs to that.

When you redirect credit to a particular sector, it is obviously coming from another sector. Sometimes those costs are hidden and much harder to measure, but if Congress deems that there is a particular public purpose that is not being well-met by private capital markets, a GSE is a logical vehicle.

Mr. KANJORSKI. Thank you, Mr. Bothwell.

Thank you very much, Mr. Chairman.

Chairman BAKER. The hearing will stand in recess for approximately 20 minutes, and we will then reconvene. Thank you.

[Recess.]

Chairman BAKER. I would reconvene our hearing, and a word of explanation to our very patient witnesses.

We have just endured three votes, during one of which, after casting votes, 102 Members or so decided to change their vote. So, it was an unusual event, explaining our rather lengthy delay.

I know other Members are on their way back. I thought I might take advantage of our interim time, while we are waiting on other Members to return, to ask just a few more follow-up questions that I did not get the opportunity to pose the first time around.

Dr. WOODWARD. Mr. Chairman.

Chairman BAKER. Yes.

Dr. WOODWARD. I was wondering if I could have the chance to answer Mr. Kanjorski's question that Mr. Bothwell also answered in the first part of the hearing?

Chairman BAKER. Certainly, for the record, if you would like to proceed.

Dr. WOODWARD. Yes. Thank you.

Mr. Kanjorski asked if the current GSEs would possibly be a model for addressing the needs of certain regions that have problems with economic development.

My answer to that would be no, they probably would not be a very good model, because the kinds of regional disparities that the very successful GSEs that we have have addressed, are very different than the phenomenon that Mr. Kanjorski is talking about.

What happened in mortgage markets was that you had very solid demand for mortgages in certain regions of the country from people who were creditworthy, but who could not access funds because there was a lack of supply within that region.

Typically, when you have regions that need development money, there is a general perception that it is not necessarily a high-return investment, which is kind of different. It is a demand-side phenomenon.

A GSE that makes funds available nationwide is not going to be able to enhance, necessarily, the creditworthiness of those kinds of loans.

Consequently, integrating the national market is not really going to address the problem of a region that needs money for development.

In particular, Mr. Bothwell correctly said that, if the Congress decides that there is a public purpose to be served by trying to allocate credit to those kinds of needs, that is, of course, very appropriate. But, a GSE is probably a very inefficient way of delivering that credit, and that is because a GSE is a profit-making institution. It is not necessarily an efficient way to deliver a subsidy.

We can expect, typically, the subsidy there, the value of the benefits going to the GSE—only part of that will be passed on, and in particular, they are looking to make loans that will earn a profit and earn a high return, so that all the more likely, if they are directed to make loans in a specific area, it is in their interest to try to skim the market for the very best ones, some of which might have been able to access credit anyway. Consequently, it is not nearly as efficient as delivering that credit directly.

Chairman BAKER. Thank you, sir.

A couple of questions.

Both of you seem to indicate that the finding was because of the implicit guarantee backing both—all GSE debt issuance, that they enjoyed favorable pricing in the markets.

To that extent, are there tangible actions that could be taken that would send signals to the markets that these entities do, in fact, stand on their own financial bottom?

For example, the Federal Home Loan Bank and Fannie enjoy, although on a very conditional basis, lines of credit that can be called on in times of financial duress. Neither has found it necessary in the last decade to exercise those lines of credit.

Would it be ill-advised to consider rescinding those conditional lines of credit, in light of the fact that there does appear in the markets the perception that, if there is a difficulty, the U.S. Government will step up and meet the obligations?

Mr. BOTHWELL. Mr. Baker, I would say that there might be some slight effect, but most of the effect of the investors' perception comes about through the Federal charter itself, that these are fed-

erally-chartered entities, and there are GSEs that do not have those lines of credit and they enjoy the same sort of funding advantage.

In addition, if you do start taking away their advantages and the value of those benefits, then you start to lose some of the very reasons why they are in existence, in terms of making home ownership more affordable.

Chairman BAKER. As a follow-up, the Federal Home Loan Bank System was originally intended to be the credit window for the thrift industry. As a result of consolidations and closures of institutions, smaller asset-size banks make up a majority of the membership of that system today.

Absent the provisions of H.R. 10, which create a new mission for the Federal Home Loan Bank, in light of the growth of Fannie and Freddie as the predominant housing GSEs, do you see a future for the Bank System as currently constituted, if the provisions of H.R. 10 are not met? Let me restate—a public necessity for the continuance of the operation of the Federal Home Loan Bank System absent the provisions of H.R. 10?

Either one of you may choose to respond.

Dr. WOODWARD. Well, certainly, in terms of the original purpose of the Federal Home Loan Banks, much of the rationale has disappeared. I would say their primary usefulness at this point is in creating some viable competition for Fannie and Freddie.

The degree to which that depends on H.R. 10 will depend on how much regulatory room they get under the current arrangements.

Chairman BAKER. Mr. Bothwell, any comment?

Mr. BOTHWELL. Well, certainly, with the dramatic change in the thrift industry, the original rationale for that system is much less today.

Congress addressed this somewhat a few years ago when it opened its membership to banks as well as thrifts. Now, a majority of the member institutions are banks and not thrifts anymore.

Chairman BAKER. On that point, don't a significant number of the banks now use the system primarily for liquidity purposes, as opposed to the public policy reasons that are the underpinning of the original charter of the Federal Home Loan Banks?

Mr. BOTHWELL. Yes, sir.

Dr. WOODWARD. I would say that the public policy reason primarily had to do with liquidity though, so that is probably appropriate.

Chairman BAKER. Well, it was—perhaps a slightly different view—to facilitate home ownership through the thrift charter and making portfolio lending a possibility with long-term fixed-rate money being advanced by the bank system.

We have other Members returning, and my time has expired.

Mr. Lucas, would you choose to ask questions?

Mr. LUCAS. Thank you, Mr. Chairman, and having just stepped in, perhaps being a little out of sync with the discussion, I guess kind of a general purpose question of the panel, and either of the gentlemen who care to respond.

It was obvious in the testimony given that clearly there was a view that, if these GSEs did not exist, that there would be, in ef-

fect, a rate increase for the folks who use the services that they fundamentally provide.

Could you touch just for a moment, since the GSEs cover a broad swath of activity out there, what the potential impact, from your perspective, would be in the agricultural sector, since a couple of these entities, such as Farm Credit System and Farmer Mac, certainly are a component?

Mr. BOTHWELL. Mr. Lucas, our estimates are for the impact on homeowners, I do not think we have looked at the impact on agricultural borrowers from Farm Credit.

Is that right, Tom?

Mr. MCCOOL. Yes. We have not looked at that.

Mr. LUCAS. It would be safe to say that the same liquidity situation, the same availability of credit that the GSEs attempt to touch in the direction of homeowners or potential homeowners—those same kind of issues would potentially impact the agriculture sector, too?

Mr. BOTHWELL. Yes.

Mr. LUCAS. The same potential impacts would be out there in the ag community, also?

Mr. BOTHWELL. Yes. You have two agricultural GSEs.

One, the oldest GSE and the largest of the agricultural GSEs, is the Farm Credit System. That is a cooperative system. That GSE is a direct lender to farmers for various types of purposes, and again, they are raising their money in the capital markets and have the implied Government guarantee, so, the money they are raising has a funding advantage that they are passing on, to some extent, to the agricultural borrowers.

The second one is Farmer Mac, which was created in 1988 to establish a secondary market for agricultural loans. So, their operations now are much similar to Fannie and Freddie in the residential housing market. They are buying agricultural loans from the loan originators and then securitizing those loans, and again, they have Federal sponsorship and the lower funding costs, as well, which they are probably passing on, to some extent, to the agricultural borrowers.

Mr. LUCAS. It may have been Dr. Woodward, but one of you, I think, raised the point, either in your oral or written testimony, about the idea of creating competing GSEs to limit some of the—I think the phrase was used—"monopolistic tendencies."

In a sense, in Farm Credit and in Farmer Mac, we have such competition, don't we? Because in the real estate sector, they are both, in a sense—Federal Land Bank and Farmer Mac—providing similar services or, some might say, competing services. Wouldn't that be an example of the point that was raised?

Dr. WOODWARD. That would be an example of the kind of thing we are talking about. Fannie and Freddie also compete to some extent. It is a question, however, of how many institutions you have to have for viable competition.

Also, with respect to the differences in the farm sector and the housing GSEs. When I talked about creating competition, that was in the context of successful GSEs, and I think some people might question whether the Farm Credit System really is a successful GSE or not, given its history.

Mr. LUCAS. Maybe just for a moment, if you would elaborate again on what you would call the definition of a "successful GSE", just remind me.

Dr. WOODWARD. Well, it would be one in which there is, for example, a market failure to identify, typically the one that has to do with credit flows, in which the GSE has truly managed to make the credit flow from one place to another to remedy the failure.

If the real problem is you just want to get some credit to a worthy sector of the economy, not because it is a high rate of return sector, because for other reasons we have decided it is worthy, then probably, you know, a GSE structure is not necessarily a really good way to do it. I am not as conversant with the agricultural GSEs as I am with the housing GSEs, but I think the way some people might look at it, given its history and the bailout that occurred in the 1980's, there is some question of whether that GSE is actually operating to smooth out differences in the flows of funds, or whether it really exists to deliver a small subsidy to farmers.

Mr. LUCAS. Since my time is about to expire, Mr. Chairman, I believe I will pass on the opportunity to delve deeper into this.

Chairman BAKER. Thank you, Mr. Lucas.

Just as a follow-up, to either of the gentlemen, on the point of the Farm Credit System specifically. In the graphs presented to the subcommittees, I believe, in your testimony, Mr. Bothwell, you show that over the last 10–year period the share of Farm Credit lending has declined from 29 percent down to 24, but the interesting thing is the "other" category.

I do not know what that means. I assume that is like commercial paper, a farm implement dealer perhaps?

Mr. BOTHWELL. Yes.

Chairman BAKER. It has grown from 30 percent to 36 percent, while bank lending has increased from 23 to 39.

Mr. BOTHWELL. Yes.

Chairman BAKER. In further explanation of the graph, I am told, although I am not certain it is accurate, that the Farm Credit System tends to lend more to the older, well established, collateralized farm operation, as opposed to the younger, startup, new capital borrower. You may not have the information immediately available, but being interested in all GSE performance and what their public policy mission is, at some future point if you could provide that, it would be helpful, I think.

Mr. BOTHWELL. Sure. I would be happy to.

Chairman BAKER. Did you have a follow-up, Mr. Lucas?

Mr. LUCAS. If I might just for an observation, Mr. Chairman, that tends to be the nature of all financial institutions lending in the ag sector, being very complicated, very capital-intensive, that is the weakness that all financial institutions have.

Chairman BAKER. I agree, and I think it would be interesting to contrast that of the Farm Credit System history with that of commercial banks to see, as I requested on Fannie and Freddie and others with the housing GSEs.

Mr. Cook.

Mr. COOK. Thank you.

I would like to thank each of the panelists for their testimony today, helping me and others understand a little bit more about how the Government Sponsored Enterprises work to help provide financing in certain areas of our economy, and I am certainly interested in the more affordable credit in agriculture and in education.

I do represent the Salt Lake City area, a very urban area, where housing prices have really been skyrocketing and low-income families—and also young families—are really just being priced right out of the market.

I happen to believe that America's overall system of helping people get financing for homes is probably the best in the world.

I am sure there is lots of room for improvement, but I would like to ask each of the panelists, in general terms, if they feel a new housing finance system is needed to help, especially young families and low-income families, getting into homes? Do they believe that the housing-oriented Government Sponsored Enterprises and the system we have today, with those entities, is really the most efficient system of delivering affordable mortgage financing? Is there a better way to go?

I take it there are a lot of concerns you have about the way, particularly the housing ones, are operating, and what would you put in place, if so?

Mr. BOTHWELL. Well, Mr. Cook, as you pointed out, the housing GSEs now account for 37 percent of the total outstanding housing credit. That is a pretty large percentage of the market.

Then you have the guaranteed FHA program, as well, providing assistance to homeowners, usually for the lower value types of mortgages, for the first-time home buyers.

I think a good deal of Government assistance, either directly through guaranteed loans, or indirectly through sponsorship of Fannie and Freddie and the Home Loan Bank System, is being made available to home buyers.

We have one of the highest rates of home ownership in the world, 65 percent, and I agree that home ownership is a laudable public goal, but one has to recognize that this type of assistance also involves costs and diversions of credit from other types of borrowers, such as small businesses, that also—probably—have laudable objectives.

Mr. COOK. Is the problem, if any, in the way that these Government Sponsored Enterprises are operating, or is there a better way to go?

Is there a better financial structure through something similar, or through another Government-type of a program, or should we continue to believe—and I do believe now, in the absence of other evidence, that these Government Sponsored Enterprises are absolutely the best way, and a real part of the success that this country has had, and the success we hope to have in housing. I am just kind of looking to see where you really think we ought to go with this whole question?

Mr. BOTHWELL. In our big report on the potential impacts of privatizing Fannie and Freddie, we discussed the potential benefits and costs of doing that, and the potential impacts.

As I mentioned in my statement, the CBO and Treasury Department also did studies, and they addressed this issue, that we really

did not address in our study, in terms of how much of the subsidy, the implied subsidy through the funding advantage, gets passed along to home buyers and how much gets absorbed, if you will, by the corporations. Dr. Woodward mentioned that as well, and they concluded in their studies that one-third of the subsidy got absorbed by Fannie and Freddie through higher stock prices, or higher manager compensation levels.

Now, if that is correct—and I am not saying that is correct, I am just saying that was the conclusion of those two studies—then that does raise questions about whether or not that is the most efficient delivery mechanism that you have available.

Now, in the case of the education GSEs, the decision was made by the Congress and the Administration that the most direct way to provide credit assistance to students was not through Sallie Mae, but was through direct student loans, and the policy decision was made by the Congress to start funding more student loans directly, and that was partially the reason why Sallie Mae was set on the road to privatization.

So, a decision was made in that case that there was a much more efficient subsidy delivery vehicle there, but we did not reach any conclusion about that with regard to the housing GSEs in our report.

Mr. COOK. OK.

Well, if I could just, in conclusion, say that I happen to think that the Government Sponsored Enterprises are a rather wonderful example—I do not want to wax on too strong, because I realize there are problems, there ought to be some corrections and some reform—but a really great example of where the money comes in through the private sector—individuals, companies, and so forth—and it is just kind of a very nice partnership in the public and private sector to do a very important national goal, or to be a major player in that goal of providing affordable housing.

Mr. BOTHWELL. Yes.

Dr. WOODWARD. If I may, in answer to your question. While there is no doubt that the GSEs have been very successful in what they do in terms of helping funds flow, a lot of what they do is not so much directed at what I think your concern is.

You are asking what more can be done, and specifically, there are some groups of people who may not be able to have access to housing finance now, not because funds do not flow from one part of the country to another, but because, again, they are perceived, for whatever reason, not being quite as creditworthy, either because of their income or credit history or whatever.

In that case, the name of the game is not shaving a small amount off the interest rate that they pay. That is not really going to make it affordable. Their threshold is probably going to be on the downpayment, because if you can make the 20 percent downpayment, you can generally swing the loan.

So, it is in risk management, and that is not what Fannie and Freddie do. Fannie and Freddie get a certain amount of privileges, a certain amount of it gets passed on, they keep a certain amount.

So, that is kind of a nice subsidy that may go to homeowners to the tune of 15 or 20 basis points that is incidental to their real mission of making funds flow.

So, if you are interested in bringing in these other home buyers, you really need to look to whatever entities turn them into better credit risks. That is not Fannie and Freddie. You would be looking at some variant of mortgage insurance and who holds the risk there.

That is where you would want to direct your interest, and that could be done whether Fannie and Freddie exist as private institutions or whether they have Government sponsorship. It really would not make that much difference.

Chairman BAKER. Thank you, Mr. Cook.

Mrs. Maloney.

Mrs. MALONEY. Thank you.

I would really like to begin by quoting from the GAO report, and I quote, "Each GSE was chartered by Congress to help achieve a particular public purpose," and then it goes on, and I would like to ask each of you to discuss whether or not a structured public purpose evaluation, like encouraging housing or education or whatever, should be applied when evaluating the need for, or expansion of, a GSE? I would like you each to—if you would like—to pay particular close attention to the dilemma that we often face as legislators, and that is what may seem like a very valid and necessary public purpose to some of our Members of Congress. To others it may seem like a Government overreach, and I would like to know if you believe there is an objective way to look at this evaluation, or is it always going to involve the differing perspective of the Government's role and our own personal experiences that each of us bring to the table?

I would like to begin with Mr. Bothwell.

Mr. BOTHWELL. Yes.

In my statement, we laid out five criteria that we think are pretty rigorous, and that we believe should be used to evaluate any potential expansion in the activities of existing GSEs.

The first one of those criteria was that it be consistent with the public purpose for the existence of that GSE and add value.

The others are that it be priced properly to reflect risk, so you do not have additional uncompensated risks in the product, that there be expertise, that it be managed and controlled properly, and that it avoid competing with products or services that are already offered by fully private corporations.

So, we think that those are a good set of criteria that policymakers could use to evaluate any potential expansion in the roles or missions or products of GSEs, and as far as the second part of the question, I would say that, yes, how one evaluates a proposed expansion of new activity against those criteria can be pretty subjective.

Mrs. MALONEY. Dr. Woodward, would you like to comment?

Dr. WOODWARD. Yes.

I think we are talking about two possible things here.

First of all, it has to do with evaluating the goal itself. As you say, people may disagree about what the goals should be. As Mr. Bothwell pointed out, there are other uses for this credit, and while there are some objective criteria you can use in terms of returns, in the end that is a matter of judgment, and it is a judgment that rests with the Members of this body. But then, assuming that it

is decided that one of these laudable goals is, for example, subsidizing housing in some way, or pursuing housing goals, then we get into a realm of where more objective criteria can be used. Because you can ask yourself, "If I want to deliver a subsidy, what is the most efficient way to do it?"

Mrs. MALONEY. I would like both of you to comment or describe when, and under what conditions, you think Government Sponsored Enterprises are justified and why?

Mr. BOTHWELL. Congresswoman, I was actually, in preparing for this hearing, looking through the budget, in particular the analytical perspectives portion of the budget on page 148, and there, OMB has actually laid out three program justifications, which I think are actually pretty good.

The first one is—and this is not necessarily just for GSEs, but for any kind of credit program that is federally-assisted or supplied. The first one is that credit assistance should be provided only when it has been demonstrated that private credit markets cannot achieve clearly-defined Federal objectives.

The second justification is that credit assistance should be provided only when it is the best means to achieve Federal objectives.

The third is that credit assistance should be provided only when its benefits exceed its costs.

So, I think the OMB has laid out three pretty good criteria for when one would try to set up a GSE or other type of credit assistance program.

Mrs. MALONEY. My time is up, but I have a few more questions. I am going to submit them to the subcommittees in writing, if that is all right?

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mrs. Maloney.

Mr. Horn.

Mr. HORN. Thank you, Mr. Chairman. I just have a few questions. I am very conscious of the second panel that is coming soon.

Tell me, in terms of the written statement, Dr. Woodward, that you had noted that Government Sponsored Enterprises operate with market privileges that provide them with a certain monopolistic position in the market.

I guess I would ask you, what are the alternatives in introducing competition into GSEs and, thus, minimizing the monopolistic position? What would be the ones you might think of, other things that could be done to level the playing field for some, if you will?

Dr. WOODWARD. Well, I think you probably have three choices.

One is, in one way or another, terminating the charter or the charter privileges.

The second one is the implementation of a fee for the charter privileges, which would slowly raise the cost of the privileged organization until some non-privileged competitors are able to work in the market, compete with it.

The third would be to charter similar organizations with similar privileges. Each one has its advantages and disadvantages. I do not know whether you want me to go into those or not.

Mr. HORN. I think it would be helpful, because the question would be is there any need to do this, and if there were a need to do that, what would you do?

I mean, do you transfer them to another type of Government corporation, or Government Sponsored Enterprise in the form of a corporation, and so on?

Dr. WOODWARD. Well, I think, in the cases of Fannie and Freddie, given what they do, there is ample evidence to suggest that that secondary market is not going to go away and that Fannie and Freddie, being very capably run, could operate in it very well.

So, there would not be, necessarily, any reason to set up any other Government program to do what they do, unless, like I say, if you want to take the money and somehow subsidize housing, and that is a different story. But in terms of the secondary market operations, I think there is a great deal of evidence that that is not going to go away.

Everything that they have done in terms of making sure that money goes from one place to another will continue to happen.

The advantage of a fee, over just strictly privatizing them, is that you can make that adjustment gradual. The fee can be adjusted upward over time until they feel the heat of competition enough that they decide that they would rather not have the charter.

Mr. HORN. When you talk of a fee, are you talking about a certain percentage?

Dr. WOODWARD. In all probably, you would levy a fee of one type on the amount of their direct borrowings outstanding and a lower fee on the amount of the mortgage-backed securities. It would be expressed as a percentage.

Mr. HORN. As a percentage of whatever the value was?

Dr. WOODWARD. Yes.

Mr. HORN. Let me ask you, Mr. Bothwell. In 1993, the General Accounting Office recommended that the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board be merged. Am I correctly informed that the merger has not taken place?

Mr. BOTHWELL. No, it has not.

Mr. HORN. If so, what is GAO's feelings on this one way or the other?

Mr. BOTHWELL. I think this is the subject of a hearing Mr. Baker is going to have next week, but we feel that merging those two entities and creating a single independent, arm's-length regulator, perhaps headed by a board, rather than being within an Executive Branch agency, would better meet those criteria that I discuss in my statement for being an effective GSE regulator. It would be more prominent in Government, it would be arm's-length, and perhaps lead to more consistency in regulation.

Mr. HORN. I will let it stop at that, because most of the questions I have really need the agency head in the room, or somebody that can speak for the agency head.

If I might, Mr. Chairman, I would like to swear the other two witnesses, since they did testify, and if you would just raise your right hand.

[Witnesses sworn.]

Mr. HORN. All right. Thank you.

The clerk can note two witnesses affirmed.

Thank you.

Chairman BAKER. Thank you, Mr. Horn.

Mr. Hill.

Mr. HILL. Thank you, Mr. Chairman.

Has anyone done a study—I guess I would ask Dr. Woodward first and then Mr. Bothwell—but has anyone done any sort of a study to determine how much risk—or I guess I would put it this way—how much of the profits that are currently being earned by the GSEs that are profitable comes from the interest maturity, different interest maturities that might exist on the portfolio loans that they have, that they borrow against?

What I am questioning is, is this—the profit—is it a consequence of leveraging different maturities? Is that contributing to the profit of the GSEs right now?

Dr. WOODWARD. That is part of what has to do with their portfolio, what they hold in portfolio.

If they buy the mortgages and hold them themselves and just borrow in credit markets, they are making a certain amount of profit off of the maturity mismatch. If they package them in mortgage-backed securities and pass them on, then that interest risk is passed on.

So, it is a rough idea of what that amount is that would be the difference that they make on what they hold in portfolio versus the mortgage-backed securities, and they do make more off what they hold in portfolio.

One of the things you will notice is that Freddie Mac, that had a large amount in the mortgage-backed securities, has increased what it holds in portfolio, has increased its profits that way, but also increased some of the risk that it holds.

Fannie at one time did just about everything in portfolio and, over time, was able to decrease its risk exposure by moving more into mortgage-backed securities.

Mr. HILL. In good economic times, that would translate into more profits. In poor economic times, that translates into greater risk, theoretically greater risk to the taxpayers here. Is that correct?

Dr. WOODWARD. Well, it is more risk no matter what the economic times are, but you might wind up burying the costs during certain types of economic downturns.

A very good example of that, if I may. In 1982, I believe if you had taken Fannie Mae's portfolio of mortgages and marked them to market value because of high interest rates, they probably would have been insolvent, but it did not cause problems for them because of the perceived guarantee. As times changed, of course, the valuation of those changed, and they made other adjustments, and they came through it OK, but that is an example of what can happen.

Mr. HILL. Do any of the GSEs use any other form of derivative to hedge that interest rate exposure? Do you know?

Mr. BOTHWELL. Yes, they use derivatives to hedge, and in addition, that is why we think it is so important that the Fannie and Freddie regulator, OFEHO, issue its risk-based capital standards, because those capital standards are going to be derived from a pretty strenuous stress test to ensure that they have adequate capital to withstand a pretty significant adverse change in interest

rates, as well as a pretty significant deterioration in the credit quality of their portfolio and their MBS. I do not know that anyone has actually looked at the distribution of the profit in terms of their book assets and their MBS that they sell to investors, but the difference is certainly seen in their funding advantage.

In our big study of last year, we estimated that on the debt that they issue, they get a funding advantage of from 30 to 106 basis points. On the MBS, it is only 5 to 35 basis points, which reflects the differences.

Mr. HILL. Dr. Woodward, earlier there were some questions about this, and I want to follow up on it.

You were talking about the value of the privilege eventually is lost to customers, and others become the beneficiary, and that it is your view, ultimately, that charters should be either given competition or taken away.

How and when should Congress know when that point is? You know, what kind of measures should there be that those that are making policy would say, "Well, this is the time now that we ought to take that charter away or we ought to force competition."?

Dr. WOODWARD. Well, it is certainly the area where a lot of reasonable people can disagree. I am not sure if I can give you any really good litmus test to follow.

I have heard, I think, some very compelling arguments from a number of people who feel that Fannie and Freddie are ready for graduation, based on the fact that what they primarily do, there is plenty of evidence that it is done. The thing that they were supposed to do, which was to integrate the market, is complete. That it would continue if they were moved to private status, and there is certainly evidence that they have privileges in excess of what they are passing forward to their ultimate customers and that potential competitors are disadvantaged by the privileges.

Mr. HILL. Mr. Chairman, if you would indulge me one last question. It seems to me that there would be costs if Congress said, "OK, we are going to have the private market meet these goals," providing products into low-income areas, geographic diversity, through regulation. And so, if there is some privilege, or some benefit, that accrues to the GSEs to accomplish that same goal, it seems to me that Congress should then say, "Well, what would the regulatory cost be if we were going to go about doing it another way?"

Has there been any analysis done of what that regulatory cost would be if we just totally privatized those functions, trying to accomplish the same goals?

Dr. WOODWARD. Well, some of what you are talking about would happen automatically.

If you are talking about the regional disparities, that was not a matter of trying to make somebody engage in money-losing activities. That was a matter of funds not flowing to where they could potentially have a high return. You would not, presumably, need any regulatory function to ensure that that happens. The disparity in rates of return across the regions would ensure that happens.

In terms of the low-income housing initiatives, that might best be handled by a non-regulatory means. At this point, it is not clear exactly what they are paying for those, but we may think of those

as an example of a fee that is already imposed on the institutions, an in-kind fee. We mandate that they engage in certain activities.

So, we are extracting back some of the value of the privileges, and one of the problems with extracting it in-kind is that you do not know what it costs, and that is one of the things that makes it a clumsy subsidy.

Mr. HILL. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Hill.

Mr. Flake.

Mr. FLAKE. Thank you very much.

Mr. Chairman, as I listen to this discussion, my antennae rises, because I hear a great deal that would suggest that, in some ways, GSEs have outlived their usefulness, or certainly have not fulfilled their mission in some instances, or are viewed as competitors by others who are in the same market.

I guess my concern is that, as I have been able to work with some of these GSEs, Fannie Mae in particular, and have been personally involved as a developer and builder in an underserved, traditionally red-lined community where banks have not historically seen it wise, by virtue of their sense of risk, to want to invest in those communities. Yet, when I have been able to get Fannie Mae involved in the process, or even Freddie, in a particularly huge project that would have gone into foreclosure without their intervention, it seems to me that there is, in some communities, not a competitive advantage that the GSEs have, but in fact, without them, these particular kind of loans would not be made.

I will give you a classic example.

The most depressed part of my district, or what was the most depressed part of my district, represented by high crime and all of the other issues that are attendant to a community that is depressed. When I talked to the leaders in Fannie Mae about my desire to build new housing in that particular community, because no bank at that point would look favorably upon that, they gave me a guarantee that they would, in fact, fund 500 units of housing.

We worked with the State of New York, and were able to get them to become involved in the process where they were willing to assure that the mortgage rates would be low, discounted, and at the same time, down payments would only be 5 percent. And with the synergy of these groups, the banks were not only willing to do it, but were fighting each other for the opportunity to be able to do the loan.

Those 500 housing units in that particular community, turned that community around to such a degree that it made it impossible for a community that could have easily applied for, and qualified for an enterprise zone, to certainly be out of the necessary range to qualify for an enterprise zone.

How do we turn America around? How do we turn urban communities around, if we don't have the institutions that will take the risk? And, by providing the guarantee that we do, we actually put an institution or institutions in place that will say, "Yes, we will take the risk." And we are not doing this on a competitive basis with other institutions.

As a matter of fact, we are doing this because the other institutions would not do it unless we came in and made that guarantee.

So, I am concerned about some of what I hear in this testimony, because I don't think that one can sit here in Washington and necessarily fully appreciate what the GSEs have to do in a community like South Jamaica, as Fannie Mae did, or in Rockaway, what Freddie Mac did, in taking almost 4,000 units of housing, and if that housing had gone down, that whole area would have been destroyed.

So, I would just like to ask you, starting with you, Dr. Woodward. Have you really taken a close look at how this stuff works on a micro basis, and from that micro analysis, would you still conclude that these entities may have outlived their usefulness by having already fulfilled whatever mission we set for them back at the time of the inception?

Dr. WOODWARD. Well, let me give it with reference to the specific example that you have. Now, I am not familiar with that, but my guess is what you might be seeing is what might be called in economics literature "rent seeking."

Mr. FLAKE. Called what? I'm sorry.

Dr. WOODWARD. "Rent seeking." What that phenomenon is, is if the Government is in a position to give favorable treatment to an entity, they will be willing to spend a certain amount of money in order to keep that favorable treatment.

In that sense they can engage in certain activities that may not be making money at all, or maybe making less than the best rate of return, but they earn a great deal of goodwill from it, and therefore increase the chances of perpetuating the privileges that they have.

Mr. FLAKE. But, their goodwill is the difference between whether an individual has an opportunity for home ownership.

Dr. WOODWARD. Oh, yes.

Mr. FLAKE. That goodwill generates for the American taxpayers individuals who otherwise would not be paying taxes, would not be property owners, would not be participating fully in the American Dream. So, the goodwill ought to be worth the fact that you, in fact, put more people into home ownership. Wouldn't you agree?

Dr. WOODWARD. It is certainly valuable, but you have to realize it's always going to be worth less than the value of the privileges. They are never going to pay more for their privileges than the privileges are worth, so what you are getting is a remainder. You are getting a part of what the Government has put into these entities to begin with.

In terms of the recycling and the political situation, maybe that's worth it, but you have to remember the privileges go to these GSEs. The value of these privileges are going to be split four ways.

Part of it will go to the ultimate customers; part of it will go to the owner-stockholders; part of it will go to the officers and employees; and part of it will go to this rent-seeking activity, the goodwill, giving some of it back in order to ensure that they keep the privileges.

Mr. FLAKE. And what is wrong with that. if you open up the doors of opportunity and you turn around communities in this Nation which generate no resources otherwise?

This is a depressed area which generates nothing. There are no homes there. There's nothing there but land that is vacant, that is

fallow, that is undeveloped. There's junk on these lots. Nobody can come in and do anything in that community because it is not attractive enough.

When you put 500 new units of housing in, enough of those kinds of communities around the country, you, in fact, begin to make this America that we dare to talk about in terms of "we." In fact, we talk about it hypocritically, because we really have two nations and it goes all the way back to the Kerner Report. Much of it hasn't changed, because these other entities will not even take that kind of risk, and the Government does get a return.

Even if that mortgage is discounted down to 6.5 or 7 percent, it is not like you are putting people in who are not paying it back. If they are paying that mortgage back, we are getting a certain percentage of that money as well, so the Government is also getting a benefit from that.

The Government is getting a dual benefit from that, because it is not only getting the benefit of the mortgage, it is getting the benefit of people who have now become taxpayers.

Chairman BAKER. Mr. Flake, if I might—not to curtail your statement, but, if I could, I'll give Mr. Bothwell an opportunity to respond before we move on.

Mr. FLAKE. I would be most appreciative if you would, and he looks like he is ready to do that.

[Laughter.]

A wonderful and fair Chairman.

Mr. BOTHWELL. Congressman Flake, I think you raise a good point.

I don't agree that in all cases private markets work effectively or efficiently or adequately. As I said, I think there are legitimate public purposes to be served through credit assistance governmentally-supplied when the Congress believes that there is a legitimate need there that is not being met by the private capital markets.

I think the example you gave is actually a very good one. It's been used a lot in the literature, that when you have areas and inner cities that are depressed and run-down, you just don't see private capital flowing there.

Sometimes it takes a little jump start, a little subsidy, to get it going, to get it turned around, so I think we disagree a little bit there.

Dr. WOODWARD. I am not sure if we disagree on that point.

My only other point is what you are talking about, there is nothing wrong with it. That's great, but remember, you are only getting a fraction back of what you have spent.

If you haven't given the value of the privileges in the first place, you would have more money to spend on those things than you are getting back from the GSEs.

Mr. FLAKE. But what difference does it make whether it is a fraction, if you were getting nothing back, if you did not have an entity that was willing to make that investment?

Ultimately, if you are putting people in homes that are going to be there for the next 100–150 years, and those people are going to

amortize their mortgage over 20–25 years, that stabilizes the community.

We are not talking about a strong rental population necessarily. We are talking about home ownership, and it seems to me that if home ownership represents for the majority of Americans their greatest asset, their first asset-building possibility, because many of them would not develop those assets otherwise. You know what the savings statistics are in this country. They will save though to buy a home, so the long-term benefits are constantly being renewed. They are constantly growing. They are constantly developing.

Those people ultimately will spend out of their profit, go to the marketplace then, when they can afford a conventional mortgage, and they won't need Fannie Mae. They can do conventional, but they have got to have a start somewhere.

Chairman BAKER. Mr. Flake, if I may, I hate to interrupt, but we do have another panel yet to be heard from.

Mr. FLAKE. All right. Give the benediction.

Thank you very much.

Chairman BAKER. Thank you very much. Thank you.

And, if we can call the next round. I thank the witnesses for their participation today.

I will recede from the chair, and Congressman Horn will conduct the second panel.

Mr. FLAKE. Mr. Chairman, CDFI is on the floor right now, so I ask unanimous consent that I might supply questions in writing and that they might be sent back to you.

Chairman BAKER. Without objection.

Chairman HORN [presiding]. Will the second panel please come forward?

Thomas H. Stanton, Fellow, Johns Hopkins University; Dr. Susan Wachter, Professor of Real Estate and Finance, The Wharton School, University of Pennsylvania; and Francis X. Cavanaugh, Public Finance Consultant.

As you know, we have a tradition on the Government Reform Committee that we do swear all witnesses under oath and even the questions they answer in writing later, the oath is assumed to carry forward for the hearing.

[Witnesses sworn.]

Chairman HORN. The clerk will note all three witnesses have affirmed the oath, and we are delighted to have you here on this panel.

We will simply start with Mr. Stanton, who is a Fellow at Johns Hopkins University.

Your testimony automatically goes in the record once I introduce you, and if you could summarize it, it would be very helpful.

Staff have had an opportunity to go through it. Members have gone through it to the extent that they can, and we thank you for spending some time with us on this very difficult subject that has not, frankly, had that much of a congressional review, so thank you for coming.

Mr. Stanton.

STATEMENT OF THOMAS H. STANTON, FELLOW, JOHNS HOPKINS UNIVERSITY

Mr. STANTON. Chairman Horn, Chairman Baker, Members of the subcommittees, thank you very much for the invitation to testify today on the accountability of Government Sponsored Enterprises.

For many people, as we have heard this afternoon, the GSE offers an attractive model for Government involvement in the credit markets. They see the GSE as a way to deliver potentially huge amounts of subsidized credit, maybe hundreds, or perhaps tens of billions of dollars, to selected constituents such as home buyers, farmers, and students, without being constrained by the Federal budget.

The purpose of this testimony today is to highlight the unfortunate fact that there is no free lunch. The GSE is a tool of Government policy, and as such, it involves, quite naturally, costs as well as benefits.

One cost is the financial risk inherent in the implicit Federal backing of GSE obligations.

Effective Federal supervision, and especially prudent capital requirements, are needed to protect the public against risk of financial loss. Any lending institution—a bank, a thrift, or a GSE—will act more prudently when a large cushion of its own shareholder money is at risk in its lending decisions and not merely public money.

Yet, the hidden secret of Government Sponsored Enterprises is the way that they attempt to operate with lower capital requirements than any of their competitors.

The subsidy benefits of GSE lending, as we heard this afternoon, can be seen here and now. By contrast, the costs of financial risk involved in matters such as too little capital involve playing the probabilities of future failure.

As the financial failures of the Farm Credit System and the thrift industry in the 1980's show, the political process has great difficulty trying to benefit those tangible present benefits against the possibility of future losses.

The second cost of the GSE as a tool of Government is the possibility that the Government can create an entrenched monopoly or oligopoly. Especially the investor-owned GSEs use their Government subsidy to dominate their markets. That market power, in turn, allows GSEs to mobilize their business partners, to lobby the Congress and Executive Branch for even more favorable treatment under laws and regulations.

Once we created GSEs, we have often found it difficult or even impossible to restrict or redirect their lending activities, even when the result would be an increase in public benefit.

In other words, the GSE can be a remarkably inflexible tool of Government policy. The easiest parts of the process tend to be the creation of a GSE and the continuing expansion of its powers. It is much harder to go the other way.

This testimony attempts to step back from today's entrenched GSEs and to look at the GSE as an institutional form. It suggest an institutional framework for accountability that draws upon policymakers' experiences with GSEs over the past 10 years, from the failure and Federal rescue of the Farm Credit System in the 1980's,

and the creation of Farmer Mac, the GSE that the Congress permits to operate at truly exorbitant leverage compared to any other financial institutions in the same sector of the economy.

It includes the difficult struggle to create the financial safety and soundness regulator for Fannie Mae and Freddie Mac in 1992.

It involves, with deference, Chairman Baker, the continuing—and I'm worried, forlorn—effort of the Congress and the Federal Housing Finance Board to find a new public purpose for the Federal Home Loan Banks, now that the thrift industry is disappearing.

Finally, last year saw legislation to remove Government sponsorship, at least eventually, from Sallie Mae.

The entire period saw small provisions enacted in legislation that have helped greatly to expand the role of GSEs in the American economy.

Briefly, the written testimony suggests the following framework for accountability:

First, with respect to safety and soundness, Government Sponsored Enterprises structurally resemble banks or, more precisely, savings and loan institutions, in the sense of their dedication to a targeted financial sector whose borrowings are Government-backed, in the case of banks and thrifts, by Federal deposit insurance.

GSEs should be supervised similar to large money center banks and should be subjected to comparable capital requirements, otherwise the Congress risks the specter of invoking Stanton's Law: "In today's efficient markets, financial institutions will shift risk to the place where the Government is least equipped to deal with it." In many sectors of the financial economy today, the Government Sponsored Enterprise is that kind of place.

Second, the Congress needs to pay closer attention to oversight of the public purposes served by Government Sponsored Enterprises.

In addition, it is time to bring GSE securities within the jurisdiction of the Securities and Exchange Commission, so that we can help avoid dysfunctional events such as the Orange County debacle that was based largely upon GSE securities, known as "derivatives." Derivatives can be very useful in the hands of appropriate investors. In the hands of unsuitable investors, they can create considerable damage.

Being subject to the Securities and Exchange Commission will help bring these securities within the ambit of prudent rules, such as investor suitability rules, at relatively negligible cost.

Third, a central body, such as the General Accounting Office, needs to be requested to review the acts of GSEs that may go beyond the scope of their charter act—in legal parlance, so-called *ultra vires* acts.

Especially as GSEs push against the legal limits of their charter acts, there may be temptation to engage in such activities, especially if they are more profitable than any other permitted activities.

Finally, GSE charters would benefit from an exit strategy that is considered before, rather than after, it is needed. We have a bad habit of waiting with outmoded charters, such as the savings and

loan charter in the 1970's, until the institutions hit the wall, as the thrifts did in the 1980's.

Banking legislation, because of the political context of those charters, tends to lag far behind market developments. GSE legislation and its political context is the same way.

One option, at least for newly chartered GSEs, would be 10–year renewable GSE charters, so that the Congress could have an opportunity to review costs, benefits, and developments that affect each GSE in today's rapidly evolving markets.

Many of these ideas are included in a bill introduced in the 104th Congress as S. 2095, the Government Enterprise Standards Act.

Mr. Chairman, I would respectfully ask that S. 2095, and also a paper on GSEs distributed by a panel of the National Academy of Public Administration, be submitted for the printed record.

Chairman HORN. Without objection, they will be put in the record at this point.

[The information referred to, the text of S. 2095 can be found on page 101 in the appendix.]

[The information referred to, "Making Reform Work," can be found on page 137 in the appendix.]

Mr. STANTON. Thank you very much, Mr. Chairman, .

[The prepared statement of Thomas H. Stanton can be found on page 90 in the appendix.]

Chairman HORN. Well, we thank you. We appreciate that summary and we will now to go to Dr. Susan Wachter, Professor of Real Estate at The Wharton School.

STATEMENT OF DR. SUSAN WACHTER, PROFESSOR OF REAL ESTATE AND FINANCE, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

Dr. WACHTER. Thank you, Mr. Chairman, it is a great pleasure to be here.

With your permission, I ask that my full statement be made part of the record.

Chairman HORN. It's automatic under our hearing rules.

Dr. WACHTER. Mr. Chairman, and Members of the subcommittees, I am Chairman of the Real Estate Department and Professor of Real Estate and Finance at The Wharton School of the University of Pennsylvania.

My colleagues and I on the faculty of the Wharton Real Estate Department and Center, focus on a wide variety of housing and urban issues in our research, and it is a privilege to be invited to testify before this joint hearing.

Most of my expertise and underlying research relate to mortgage markets, and thus in my testimony I will discuss the role and nature of those GSEs which support secondary markets for residential mortgages.

In my testimony, I will also specifically refer to a research paper, authored by myself and colleagues, on how full privatization of GSEs could affect the social goals specified in the GSEs' Federal charters. This study, which I request be entered into the printed record, was commissioned by Government agencies on behalf of Congress and published in 1996 by the U.S. Department of Housing and Urban Development.

Chairman HORN. May I ask how long is the study, how many pages?

Dr. WACHTER. It is approximately 20 pages.

Chairman HORN. Fine. Without objection, it will be included in the record.

[The information referred to can be found on page 179 in the appendix.]

Dr. WACHTER. In my testimony today, I will first briefly address those questions posed in your invitation to testify: when, and under what circumstances, should GSEs be privatized or created? How, and for what purposes, should GSEs be regulated? Should financial compensation be required? Are there areas where the scope of GSE activities should be expanded or reduced?

A rationale for the creation of GSEs exists if there are market imperfections that are mitigated by their activities, and if they pass a cost/benefit test.

"Market imperfection," is a technical term used by economists, along with the related concept of externalities. A positive externality is a benefit that goes beyond the individual to society at large. Home ownership itself may be an example of an externality, if neighborhoods are better maintained where home ownership predominates.

In any case, if GSEs' mission is not justified by market imperfection rationales, they should be privatized. Given the possibility of contingent liabilities to the U.S. taxpayers, GSEs must be monitored for financial safety and soundness to minimize risk exposure, as well as for their mission achievement.

It is not financial compensation that should be required from the GSEs, but rather the effective achievement of their mission.

Finally, there may well be conditions under which the scope of GSEs should be expanded. I will suggest one.

The Federal Government provides a number of economic privileges to GSEs, most important of which is the implied Federal Government guarantee, which reduces Enterprise funding costs. In return for these benefits, the GSEs are required by their Federal charters and other statutes to provide public services.

Given the highly developed state of the secondary market for mortgage loans in the United States and integrated national mortgage markets, and the rapid development of both information technology and global financial markets, what purposes are currently served by these economic privileges?

In answering this question, I wish to present my thoughts on the broad social context for public policy goals embodied in the legislative acts. In my view, these public policy concerns are: the worsening problems of concentrated urban poverty in the United States, and the persistent racial and ethnic disparities in home ownership rates. In over 5 decades of increasing home ownership rates, these disparities have not narrowed at all.

Moreover, the concentration of poverty in urban areas has worsened, and continues to worsen over time, along with the social pathologies that result from this concentrated poverty.

The GSEs are required to promote neighborhood reinvestment and to reduce red-lining and discrimination in mortgage lending.

These goals, if achieved, have the potential to revitalize urban America.

GSEs' lower funding costs reduce mortgage market rates and help achieve increased home ownership rates. Furthermore, technological innovations and standardization gains, likely to be attributed to the special status of the GSEs, also help achieve increased home ownership rates. Such innovations are generally facilitated by larger market players who are capable of effecting market transformations and have the incentives to do so. GSEs' innovation has increased the efficiency with which funds have been provided for mortgage markets in the past, and they have the potential to do so in the future.

However, the Federal sponsorship of GSEs also creates significant risks for U.S. taxpayers. There is also a cost in terms of the need to monitor each GSE for safety and soundness. This added cost of Government regulation and the need for efficient and effective oversight is likely to increase with the number of GSEs. Given these ongoing risks and costs, we must clearly define the current public purpose served by GSEs.

Government intervention may be welfare-enhancing, as I stated earlier, where there are market imperfections. The continued Federal sponsorship of GSEs helps achieve the broad public policy goal of access to affordable home ownership through lower funding costs. Thus, to the degree that home ownership is regarded as yielding external benefits to neighborhoods and society beyond those directly enjoyed by individual homeowners, existing market imperfections may justify continued Federal sponsorship of GSEs.

The degree to which continued Federal sponsorship of GSEs contributes to increased home ownership rates is analyzed in our study on the privatization of GSEs. There, my coauthors and I, find that home ownership rates increase by about 1.5 percent in the aggregate, and more for targeted groups as a result of the Federal sponsorship of GSEs.

In other research, I have examined the potential for market failure in mortgage lending deriving from what may be termed "neighborhood effect and information externalities." Because of such externalities, increased lending to currently underserved low-income neighborhoods may be possible without a significant increase in credit risk. Such externalities raise the possibility of a virtuous cycle to reverse the vicious cycle of neighborhood decline. Conventional lenders may, individually, rationally tend to avoid risky neighborhoods. However, such risks may be increased by the actual avoidance.

If individual institutions come together with public and private cooperation, loans and investment in such depressed neighborhoods may be accomplished without significant heightened risk and neighborhoods may be stabilized.

Given the GSEs' size and the extent of their market reach, they may be able to determine where such market imperfections exist, through an analysis of their affordable lending experience. However, given the initial risks and costs, encouraging affordable lending programs through effective regulation of the GSE mission and setting affordable lending goals is important. On the other hand, the GSEs' market orientation is likely to provide incentives to

achieve affordable lending efficiently. In particular, as we discuss in our paper, some FHA functions should be transferred to the GSEs.

To quote: "...existing programs are unlikely to be as efficient and effective as the operation of the GSEs in these areas if the Federal Government is vigilant in the enforcement of the affordable housing mandates imposed upon the GSEs. Simply put, the expertise, incentives, and resources available to the GSEs are sufficient to make them private, efficient, targeted welfare providers."

Thus, I believe it is the GSEs, rather than FHA or direct Government intervention, that are likely to respond to market imperfections efficiently and, possibly, sufficiently well, to make affordable lending an important component of the revitalization of urban America.

Mr. Chairman and Members of the subcommittees, this concludes my prepared statement.

[The prepared statement of Dr. Susan Wachter can be found on page 172 in the appendix.]

Chairman HORN. Well, we are most grateful for that very thorough statement and your various other studies.

Our next witness is Francis Cavanaugh, Public Finance Consultant. Mr. Cavanaugh served in the Treasury for 32 years and as a financial economist and as the senior career executive responsible for policy advice on the management of the public debt and Federal credit programs, including the Government Sponsored Enterprises which are the subject of the hearing today. So, we are delighted to have you share your expertise, including the, I guess, 8 years you spent as Executive Director/CEO of the Federal Retirement Thrift Investment Board.

I note here you administered the Thrift Savings Plan for Federal employees. There's a worthy objective—you should do it for the rest of America and our economy might be working better. So welcome.

STATEMENT OF FRANCIS X. CAVANAUGH, PUBLIC FINANCE CONSULTANT

Mr. CAVANAUGH. Thank you, Mr. Chairman.

In addition to my prepared statement, which you have, I have also dealt with this subject, beyond the brief comments that I will read now, in Chapter 7 of a recent book I wrote on the national debt, which I think the subcommittee staffs have. It's about 15 pages long. I would offer it for the record.

Chairman HORN. Yes, without objection, that will be put in the record.

[The information referred to can be found on page 222 in the appendix.]

Mr. CAVANAUGH. Now before trying to answer the seven questions in your invitation letter of July 10, I need to make some assumption as to the proper role of the Government in credit markets.

My working assumption is something that we have generally given lip service to; there is a presumption in our society that the provision of credit is a private, rather than a public function, and Government should try to assist the development of private credit markets and not displace them. That was the operating presump-

tion of the President's Committee on Federal Credit Programs when I first cut my teeth in this area back under the Kennedy Administration 35 years ago.

I think it is still a good one and I think it is very relevant today, particularly since there is now an apparent consensus for smaller and less intrusive Government and greater reliance on private markets. I'm afraid, however, that the experience of the past three decades with regard to that principle has not been good, as measured by the growing amount of net new borrowing in the United States credit markets required to finance Federal programs.

That Federal share, which includes direct Federal borrowing, guaranteed borrowing, and GSE borrowing—which is the fastest-growing sector—increased from an average of 17 percent of net credit market borrowing in the 1960's, to 27 percent in the 1970's, and to 41 percent in the 1980's. In the 5 years 1991–1995, the percentage was an extraordinary 71 percent. We have reached a point where most of the debt securities available to private investors in the United States are direct or indirect obligations of the Federal Government. This raises serious questions about reduced market discipline in the allocation of credit, and thus potentially a reduction in the credit quality in our economy.

With the Government standing in between the lender and borrower, the lender looks to the Government and doesn't exercise due diligence with regard to the borrower. Then we are relying on the Government to exercise due diligence with regard to the quality of credit, at this point the majority of credit, in the credit markets in our economy.

I don't think that is a proper function for the Government, to be displacing the private market discipline.

While the market impact of direct Treasury borrowing, of course, is declining as the Federal budget deficits decline, borrowing to finance GSE programs continues to grow rapidly. In the fiscal year 1997 budget, estimated net GSE borrowing is $178 billion, and that's new money, which will greatly exceed the current budget deficit estimates that I hear of roughly $50 billion, so the GSEs are emerging as the prime factor in the credit markets.

We have this anomalous situation of, on the one hand, a remarkable political consensus to reduce the size of the Federal Government and the Federal deficit, and thus shift responsibilities to the private sector, but on the other hand a seeming indifference to the growing pre-emption of our private credit markets by the GSEs and, to a lesser extent, by other Federal credit aids.

Nevertheless, my following responses to your questions are based on the assumption that our guiding principle should continue to be that Federal credit programs should encourage, not displace, private credit markets.

With regard to your first question, I would say Congress should create GSEs that issue debt or provide guarantees only in cases where there are credit gaps in our economy which eventually can be filled by the private market without Federal aid. In other words, the GSE structure is the wrong vehicle for credit assistance programs where Congress determines there will be a continuing need for Government subsidies. In those cases a direct loan program would be much cheaper and more effective.

In answer to the second question, I am not aware of any particular credit gaps in our economy which would warrant expansion of existing GSE activities. Indeed, the market development of innovative securitization techniques in recent years has so expanded access to securities markets for private borrowers that the need for GSE credit has been reduced. GSE activities should be contained, if for no other reason than to be able to offer GSEs broader powers as an inducement to privatize.

Now, the third question: Under what circumstances should a GSE be privatized?

GSEs make sense only if they are intended to become totally private, so the timing of privatization should be when the GSE has developed to the point that it has filled the credit gap, as intended by Congress, and it is able to support itself in the market without further Federal subsidies. The alternative of continuing the subsidies, and thus perpetuating a monopoly, defeats the basic purpose of the GSE.

With regard to the fourth question, regulating financial activity of GSEs. A GSE should be encouraged to become financially independent, relying primarily on private audits in accordance with generally accepted standards applied to similar financial institutions in the private sector. These are the standards they must meet when they are privatized. Regulation by Federal agencies within the Administration, in my experience, has been of limited value, in part because these agencies of the Administration are political institutions. Federal agencies are unlikely to have the staff or the financial resources to match the resources of the GSEs or the private accounting firms.

Question number five is: How should the programmatic activity of GSEs be regulated?

As an alternative to attempted regulation by the Administration, which I don't think is very effective, a model that I would offer would be the legislation that Congress enacted to establish the Federal Retirement Thrift Investment Board in 1986.

In that case, Congress wanted to insulate the Board from politics, from the Administration, and even from itself, it said. It insulated the Board from the congressional budget process, but it had to come up with some alternative means of ensuring adequate accountability and professional oversight. So, legislation authorized the Secretary of Labor, who happened to be responsible for regulating private pension plans, to provide for audits of the Board's programs. The Labor Department contracted with private accounting firms for a comprehensive program of annual audits of every aspect of the Board's management and operations. Those program audit reports, some 13 a year as I recall, were extremely helpful to me as Executive Director of the Board, and they were most reassuring to Congress and the public that all was well at the Board.

Frankly, I don't know how else you are going to get the talent that you need to regulate complex bureaucracies today without doing something like that. You need outside talent.

The sixth question: Does the existence of competing GSE debt raise the financing costs of the U.S. Government? If so, by how much?

Clearly, the existence of competing GSE debt does raise the financing costs of the Treasury, both because of the implied Treasury guarantee, which makes it like Treasury's own debt, and because of the many statutory provisions which give GSE debt special characteristics with regard to eligibility for investment and collateral, exemption from SEC and all that sort of thing. So, GSEs are directly competitive with Treasury. There is no question about that.

Measuring the amount of the cost to the Treasury from that competing GSE debt is difficult, I would admit, and the amount varies with market conditions and changes in amounts of new issues and outstanding GSE debt and Treasury debt in the market.

As you noted in your July 10 letter, total net GSE borrowing in the market, including the guaranteed obligations, exceeds $1.8 trillion, while publicly-held Treasury debt is about $3.7 trillion. So, because of the GSE debt, the total Federal securities market has been increased by roughly 50 percent, and no one can tell me that doesn't have a tremendous impact on Treasury borrowing costs.

If the GSEs were privatized, then of course the arithmetic works the other way. You would be reducing the demands by Government in the credit markets by 33 percent, and so there would be an increase in the demand for Treasury securities, obviously, and thus a reduction in the cost of Treasury financing.

How much? Tough to say. For each reduction of 1 basis point, just 1/100th of 1 percent. For example, if we reduced the Treasury's average borrowing cost from 6.01 to 6 percent, that in itself would save the taxpayer $370 million a year.

How many basis points would actually be saved if the GSEs went private and got out of the Federal securities market? I would say several, no more than 10, so clearly the Treasury, in my view, would be saving at least a billion dollars a year. I think that is a conservative estimate.

Finally, the last question: Should the Government receive financial compensation for the special market privileges enjoyed by GSE borrowers and guarantors? Yes, especially since these privileges raise Treasury borrowing costs, as discussed above, and since Treasury is at risk in the event the GSEs get in trouble.

This could be accomplished by charging the GSEs a fee equal to a fraction of a percent of their outstanding liabilities or new commitments, whatever is workable legally. Such a fee could also serve the purpose of encouraging the GSEs to give up their special privileges and go private. A fee that escalated each year should eventually prompt GSEs to stand on their own feet in the competitive private market. At some point it would be more profitable for them to do it, rather than pay an increasing fee. To perpetuate the present situation just gives the GSE that much more of a monopoly position and stifles private competition.

That concludes my prepared comments, Mr. Chairman.

[The prepared statement of Francis X. Cavanaugh can be found on page 211 in the appendix.]

Chairman HORN. Well, I thank you very much, Mr. Cavanaugh.

Let me just ask you one or two questions and then we'll yield 5 minutes to each Member.

You mentioned in your written statement that the Government Sponsored Enterprise structure is the wrong approach for credit as-

sistance programs where Congress determines that there will be a continuing need for Government subsidies. I guess I would ask what kinds of direct Federal loan programs would be potentially cheaper and more effective, in your judgment?

Mr. CAVANAUGH. Well, for any particular area where you want to subsidize with credit assistance programs—recognizing that we already have direct and guaranteed loan programs throughout the entire economy now—perhaps you have within an existing agency, like HUD, a model direct loan program, depending on the nature of the specific credit need.

The enormous advantage would be that any direct loan program would be financed at the Treasury borrowing rate, obviously, which is cheaper than the GSE rate. You save money there.

The other advantage is that from the testimony you heard before, apparently the GSEs, or Fannie Mae and Freddie Mac, keep for their stockholders $1 out of every $3 that are saved through their GSE status. In the case of a direct loan program, you wouldn't have that problem.

The other important aspect is that a direct loan program, unlike the GSEs, would be in the budget, subject to congressional appropriations and the discipline of the budget. When you are talking about permanent subsidy programs, I think there is no other way to do it.

Chairman HORN. The direct loan program we have talked about in Congress, and actually voted on and implemented in some cases is, of course, the student direct loan program, which would get us partly away from the guaranteed loans, where I have felt for a long time, as a former university president, that there is no great incentive for the banks of America to counsel students and to tell them it's a debt, not a grant. The result is that we have a tremendous amount of debt because they simply weren't doing their job. Why should they? We guaranteed them the loan.

Now does any of that psychology apply in some of the options here?

Mr. CAVANAUGH. Well, I think that is a very good point. Of course, primary reliance on guarantees in the student loan program and many other areas, was necessary before the Congress changed the accounting. It used to be that if you made a direct loan of $100 it would be a budget outlay of $100, and the deficit would increase by $100. Then Congress changed that, I guess in 1990, where you said that from now on, we'll score in the budget the present value of the subsidy in the direct loan, or in the guaranteed loan, so going to the guarantee no longer takes you off budget. That equalized the situation, and I think it was a tremendous reform. Now you don't need to wind up with a situation where you get guarantees and a lack of counselling by disinterested banks simply to avoid the budget. That has been fixed.

Chairman HORN. Let me ask you, in your statement you also said that, "Government Sponsored Enterprises should be encouraged to become financially independent and rely primarily on private audits in accord with the generally accepted standards which are applied to financial institutions in the private sector."

I guess I am just curious. Do these enterprises currently have private audits, and if so, by whom?

Mr. CAVANAUGH. I believe they all have audits, but I am not sure of the extent to which they are done by accounting firms commissioned by the GSEs themselves, or of the extent to which there is any requirement for audit reports to Congress for this, that or the other GSE. I think the general situation is that they bring in a private financial auditor as a large private corporation would.

What I am saying here, in response to your question about regulation of GSEs, is that the better approach is to rely on private audits by management consulting firms—not just financial audits—rather than Government regulation.

Chairman HORN. Let me ask one last question to all three of you, and maybe you are not the people to ask it, but I thought I would tap the expertise that is before me, before giving up the questioning.

That is, with Government Sponsored Enterprises, as we call them, and we are talking about the big ones here obviously, in your experience, what are the differences between that and what we have called for 50 or 70 years a "Government Corporation", whether it be the Tennessee Valley Authority, which is a Government Corporation, or the many others that we have spread across the Executive Branch?

We have talked about making the Federal Aviation Administration a Government Corporation. Usually it has been to get around the procurement and the Civil Service requirements, basically, when you looked at a Government Corporation, but how would you differentiate?

I will start with Mr. Stanton at this end.

Mr. STANTON. Mr. Chairman, I believe you have already heard from Harold Seidman and Alan Dean on the Government Corporation.

Chairman HORN. For about 20 years, yes.

Mr. STANTON. For about 20 years.

Chairman HORN. They are excellent people.

Mr. STANTON. The wholly-owned Government Corporation is owned and controlled by the Federal Government under the Government Corporation Control Act. It is an agency of the United States. That would be something like Ginnie Mae, which is part of the Department of Housing and Urban Development.

We have entities that are misnomers called "Mixed Ownership Government Corporations" under the Government Corporation Control Act, such as the Federal Deposit Insurance Corporation, that are funded by assessments—in that case on financial institutions as payment for their deposit insurance—and they operate under greater flexibility, but still they are agencies of the U.S. Government with Presidential appointees.

Then we step across the line, and we have Government Sponsored Enterprises that are privately owned and essentially privately controlled, even though they may have a minority of members of their Boards of Directors appointed by the President or a public official. Those Directors have a fiduciary responsibility to the company and to the shareholders and can get sued if they don't live up to that fiduciary responsibility.

Dating back to the Banks of the United States—I guess the Second Bank of the United States—it's been well demonstrated that

those publicly appointed Directors end up being very much—for purposes of control—like shareholder-appointed Directors because of that fiduciary responsibility, so these are quite different animals.

Ginnie Mae can dispassionately serve its entire legal charter because it is an agency of the United States. Fannie Mae or Freddie Mac have quite different incentives.

I would read you from Freddie Mac's 1996 annual report: "Freddie Mac's disciplined approach to investing shareholder capital and the success of the corporation's core business strategies resulted in a 22 percent return on common shareholders' equity in 1996, the 15th consecutive year that this rate of return has exceeded 20 percent. Disciplined deployment of shareholder capital underlies all of Freddie Mac's activities."

The bottom line, I guess I would suggest to Professor Wachter, is that these institutions conceivably could help poor people in inner cities, but to get a 22 percent return on equity you don't do an awful lot of it.

Chairman HORN. Well, on that point, do we face a danger that we could go the way of the savings and loan industry in the 1970's and 1980's?

Mr. STANTON. The dangers are as follows, and it all depends—the first guarantee of course is management.

The management tends to be more prudent—it is a financial precept—to the extent that you have shareholders' money at stake.

Freddie Mac is probably the thinnest capitalized financial institution in the United States today, and well below 2 percent—I guess it is a little over 1 percent, 1.04 as I recall—I am under oath—as I recall 1.04 percent shareholder capital.

That is very little.

If you have less shareholder capital at stake, you may be inclined to do things that yield higher returns for shareholders, because so much of the public's money is at risk.

Going back to your original question, that is a really different institutional form, to go to Mr. Cavanaugh's point, than the Government agency that delivers direct loans.

It is both better in some ways—it's private—but it is also less effective at serving public purposes because of its profit orientation.

Chairman HORN. Yes, and Dr. Wachter, do you want to add to that?

Dr. WACHTER. Well, actually, I wish to disagree.

Chairman HORN. Good, that's why we have you here.

Dr. WACHTER. I'd say 180 degrees, although not with everything Mr. Stanton says, by any means.

I certainly agree that there is risk exposure and promulgation of careful risk-based capital standards is important with a mixed, quasi-public organization.

If I may just briefly, refer to the S&L question.

Chairman HORN. Sure.

Dr. WACHTER. In some ways the moral hazard problems that we had with the S&L meltdown may be, interestingly enough, less of a problem with Fannie Mae and Freddie Mac, because there are only two of them, and they are relatively transparent. That is not to say that there isn't a problem here and that they must be very

carefully watched and we do need to have the promulgation of those risk-based capital standards.

Second, to answer the question that you raised, Mr. Chairman, on the difference between Fannie and Freddie and Government-owned agencies. I do absolutely agree with Mr. Stanton that these are different than Ginnie Mae, and I also disagree with Mr. Cavanaugh that they are worse than Ginnie Mae. I think they are better potentially, and I do underline "potentially."

I think FHA and Ginnie Mae have a major problem, to which you alluded: these are guaranteed loans, and therefore, lenders tend to push off the risk and not do careful underwriting under these circumstances.

I think we have examples historically of disastrous lending by FHA. Under Section 236, we had high delinquencies, which led to abandoned housing in urban areas that stands there today.

On the other side, if you had some kind of cooperative risk undertaking with Ginnie Mae and with FHA, I think that would be a problem, too. We have seen some problems, because the private sector partners tend to be much faster on their feet. They tend to transfer the risk quite well.

So, I think the interesting Fannie Mae-Freddie Mac answer, which is that you have private fiduciary responsibility to shareholders who are very closely watching for profit, at the same time where you have, hopefully, careful pressure on the mission is a good rule.

However, the implementation of the rule, the implementation of the policy is key. Here I do agree with Mr. Stanton. I do think that the mission could be pushed. I think that there is room to move the envelope here, and indeed, in the past, I think that Fannie and Freddie in the past have been behind the market in terms of lending to low-income and underserved areas.

Chairman HORN. Mr. Cavanaugh, you will have the last word on this question, then I will yield 10 minutes to each of our Members here.

Mr. CAVANAUGH. I don't have much to add. The answers were much broader than the question as I understood it, but with regard to the difference between the types of corporations, I think the TVA and these other Government owned corporations are Federal agencies in a corporate form for accounting and other purposes. It makes a certain amount of sense if it is a business-type enterprise, but I don't see that as a very important thing. It's a matter of form. They are Government agencies and they deal with the budget problems and pressures of other agencies and so on.

When you get to the GSEs, of course that is very different, and their corporate form is much more meaningful. In my mind, the significance is that the GSE ought to be progressing toward the private corporate form in every respect, so that when it comes time to privatize it, it is ready to go, it doesn't need all of the Government bells and whistles and everything else.

Chairman HORN. Well, I thank you.

I now yield 10 minutes to Chairman Baker.

Chairman BAKER. I thank the Chairman for yielding.

Mr. Stanton, do you feel that there is an appropriate role in the market for GSEs, period?

Mr. STANTON. The answer is possibly less of a role than in the past.

Earlier witnesses noted that we once had a differential in mortgage rates. That was largely a function of the fact that by law, savings and loans and banks were limited to serving local areas, so you had the money center areas on the East Coast that had cheap mortgage rates. You had the building going on, first in the Midwest and then the West and the South, and you had tremendous gaps in mortgage rates.

That age is behind us, thanks both to the Home Loan Bank System, Fannie Mae in the 1930's, but more importantly, thanks to getting rid of these restrictions—geographic restrictions—on financial institutions.

Mr. Lucas, Representative Lucas, asked a question about the Farm Credit System.

There is a recent Economic Research Service study out on the rural sector that indicates that in the rural sector, commercial banks are fairly concentrated and in that case, for example, it may be that the Farm Credit System provides a useful alternative delivery system to allow credit to get to rural borrowers if you do have a case of abnormal concentration, so that might be one example.

Also, because I am concerned about safety and soundness, the fact that the Farm Credit System has been through the wringer once gives them a certain amount of prudence that we may not find in some of the other GSEs, and that gives me a sense of confidence.

I need to pick up, if I may, on Professor Wachter's comment that Fannie and Freddie were the answer to the S&L meltdown. That isn't right.

Just as with the Farm Credit debacle, what the answer was to give bank-type regulation to the savings and loan industry, and bank-type capital requirements. That is essentially what was done to the Farm Credit System.

Fannie Mae in 1981–1982, was a big savings and loan in the secondary market with an exorbitant interest rate mismatch, just like some of the worst savings and loans, and the housing GSEs were there, only one or two, and nobody was watching.

If we get down to the core problem with GSEs, and again the Farm Credit System has this less than other GSEs, the core problem is, who reviews whose budget? Do Fannie and Freddie have influence over their regulators' budget? You better believe it. Do the regulators have any influence the other way around? Very little.

There is such an absolute asymmetry of political power that regulation is not merely a technical matter of financial oversight. Regulation is a political contest, and when that regulator comes out with risk-based capital standards, there is almost no constituency that is organized on the side of urging that we make those standards a little higher, and there is a tremendous political force on the side of saying, one should make those standards a little lower.

That regulator politically has almost no constituency.

By contrast, when you look at something like the Farm Credit System and the expansion that has been proposed from time to time of Farm Credit activities, you get the independent bankers out there. You have got a certain political balance that tends to keep things in check, and that is a very healthy system.

That is rather different from the monopoly system we have created—call it technically a duopoly—in the housing finance system.

Chairman BAKER. So you are suggesting that where there is a political balance, it is OK for the GSEs to exist and perform a public policy purpose, and where you perceive there to be a political imbalance, where the power of the GSE—whatever the performance area might be—that in your view is an inappropriate conduct of authority?

Mr. STANTON. I'd state it slightly differently.

It is a lot easier to control against downside risk and to assure public benefit where there is some sort of a balance.

Chairman BAKER. My problem with your observation is that, with regard particularly to Farmer Mac, but to a lesser degree to Farm Credit, I don't look to either for stellar performance recommendations.

I have significant concerns—as perhaps you illustrated with the Federal Home Loan Banks—where is it going and why do we need it?

Those same questions can be asked of others. My point is, that if you believe there should be GSEs at all, I think we first describe what the public policy mission is.

Mr. STANTON. Exactly, yes.

Chairman BAKER. Then we determine if the cost to achieve that public policy mission is warranted in light of whatever risk the taxpayer may assume, and then we should rely, or look toward, responsible regulators to tell us when the financial condition warrants Congressional intervention before bad things happen.

If I am understanding you properly, you do not believe today that the public policy mission is in question or that Fannie and Freddie, at least, are not performing well. Rather, your focus is as to the regulatory oversight and our ability to appropriately gauge the risk?

Mr. STANTON. Yes.

Chairman BAKER. I just want to get your concerns properly in focus.

Mr. STANTON. I think I agree. I think you stated it exactly right.

I would only add that there is a real difference, in my mind, between Farmer Mac and the Farm Credit System.

Chairman BAKER. Insolvency being one.

Mr. STANTON. Tomorrow, as I understand it, in the Senate Appropriations Subcommittee, there is going to be a proposal to expand Farmer Mac lending to small business loans.

This is an institution that is constantly searching for new purposes, and my concern at the same time, is that it gets a tremendous break on capital requirements compared to everybody else.

Chairman BAKER. I can't argue with you very strongly.

Dr. Wachter, in your discussion you illustrated concern as to the minority ethnic credit accessibility and the fact that over some period of time, despite whatever innovations Congress may have proposed, that those disparities have not changed dramatically.

Is it your conclusion that, for us as the oversight committee on the GSEs, that we should look more closely at their performance in these areas in light of shareholder rates of return, or what is the reason for us to be concerned about the GSE performance?

Is it just the inability to meet some artificial goal, or is it the fact that they seem to be profitable and they don't meet the goal?

My concern is that you have to make a profit to engage in the public policy aspect of the social obligations or else you can't perform the public policy mission.

Could you comment?

Dr. WACHTER. Yes. I have no concerns about their—putting it another way—I agree that they should be profitable, so the 20 percent profit is not what I am concerned about. These are shareholder-based institutions and they should have profit incentives.

But, I am concerned that there be a continued focus and attention to their mission and that be discussed in the light of day, that there be set up various goals, that the goals that are set up be discussed in more detail, and that there be some very serious consideration about, not just the numerical goals, but what they serve.

To come back to a point I started out with, which you referred to in your question, disparity in home ownership rates. The disparities across racial and ethnic groups have not narrowed over the last 20–30 years.

Actually, disparities in mortgage application acceptance rates have narrowed some over the last several years and I do believe that this is a good sign, and indeed a desired outcome of public policy legislation, both CRA and mandates, so I think that the mandates are probably having some good effect.

Chairman BAKER. Are you familiar with the Community Investment Program of the Federal Home Loan Bank and its operation?

Dr. WACHTER. I am not sufficiently familiar to comment on that.

Mr. STANTON. I would like to add something. I think it is a great model.

It is basically a 10 percent tax. In other words, what lower income people may need is a break on their mortgage rates, and instead of something such as you have in the Fannie and Freddie charter, which says basically even on their low-income lending they shall make a profit, what the Home Loan Banks have done is pioneer a system where you allow lenders to come in and get subsidized credit.

I think it's a tremendous idea and it might be great to have Fannie and Freddie kick into it too, along the lines of Representative Flake's concerns.

Chairman BAKER. I think that from my experience the CIP program has been one of the better performing aspects of all Federal programs in extension of credit, and frankly beyond just the question of minorities or ethnic questions, it gets to small town water systems, fire prevention, a broad array of what I call "public policy" concerns.

My last question——

Dr. WACHTER. But if I may just follow up?

Chairman BAKER. Sure.

Dr. WACHTER. It can't be simply a subsidy to loans. There are two key factors in terms of borrowing for home ownership among minorities in low-income neighborhoods—one, the down payment.

Chairman BAKER. Sure.

Dr. WACHTER. That is key, as opposed to the interest rate subsidy, but even more than that, the down payment is not the only—

or even, at this point, the most important—it is where loans can be obtained.

It is the specific neighborhood conditions, and local underwriters often use underwriting standards which may be, in fact, pushing the envelope. But we don't know that yet; we don't know enough about what works and what doesn't work.

Fannie and Freddie are in the position to combine the natural experimentation that is now occurring to find out what does work in extending loans to that part of America which is not yet part of the mainstream and not part of the conventional housing finance system.

Chairman BAKER. I would very much like to have as a follow-up, your perspectives on the CIP program at some point, if you have occasion to review it, because I think it is a model which offers a lot of potential and is not so constrained with geographic limits.

Thank you.

Thank you, Mr. Chairman.

Chairman HORN. The gentleman from Oklahoma, Mr. Lucas, 10 minutes.

Mr. LUCAS. Thank you, Mr. Chairman, and thank you, Mr. Stanton, for your observation on the unique circumstances of rural American production agriculture.

I guess I really only basically have one more question, and I think I will direct this to Mr. Cavanaugh, who obviously from his résumé has been involved in the process for a time and has an appreciation of these things. I don't know that, well, really, this is a question I think that's fair, because it goes from one extreme of the equation to the other.

Do you think—just to be up-front and blunt about it—that it is politically feasible or possible, that once a GSE has been created that it will ever be uncreated or have its charter revoked?

Mr. CAVANAUGH. There is nothing in the record to suggest that it would happen.

Mr. LUCAS. But the sun could come up in the West tomorrow too, but it is highly unlikely?

Mr. CAVANAUGH. The logical financial and economic answer would be obviously they are rolling in dough, in great shape, and they have been private for 25 years. If they can't stand on their own two feet in the market now, they never could. But for some reason that doesn't happen.

I would have said the same thing 5 years ago, so to me it is a political question, and I would defer.

Mr. LUCAS. A diplomat through and through. Thank you, Mr. Cavanaugh, and thank you, Mr. Chairman.

Chairman HORN. Well, you are quite welcome.

We do have some questions, if you would indulge us, that we would like to mail to you and if you, at your convenience, could just give us a brief answer or any answer you want. I know you're all busy, but we would be most grateful for your thoughts. Rather than have this go another hour, I think I would rather see some of it in writing, so we will send them to you.

I want to thank the staff that has prepared this hearing for both of our subcommittees: J. Russell George, staff director—in the back there—put your hand up, Russell, the staff director for Government

Management, Information, and Technology; Matt Ryan, professional staff member, right behind me; John Hynes, professional staff member is not with us this evening; Andrea Miller, our staff assistant clerk.

Then, for the minority staff on the Government Management Subcommittee, David McMillen and Jean Gosa, the clerk for the minority.

We have interns Darren Carlson, Jeff Cobb, John Kim, Grant Newman on both sides.

On the Banking subcommittee, Mr. Baker's staff director is Greg Wierzynski; and we have Pat Cave from Mr. Baker's personal staff; and we have professional staff members Ted Beason, Stefan Jouret, Sarah Dumont, and Terry Birchfield.

Our court reporters have been Mark Mahoney and Sarah Dumont, who is the staff assistant for Banking.

So, we thank you all on the staff and we thank the witnesses of both this panel and panel one. Thank you very much. We have learned a lot.

[Whereupon, at 5:28 p.m., the hearing was adjourned.]

APPENDIX

July 16, 1997

CURRENCY

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U.S. House of Representatives, 105th Congress
Congressman James A. Leach, Chairman
Phone: (202) 226-0471 Fax: (202) 226-6052 Internet: http://www.house.gov/banking

For Immediate Release:
Wednesday, July 16, 1997

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JOINT HEARING ON GOVERNMENT SPONSORED ENTERPRISES
OPENING STATEMENT
CHAIRMAN RICHARD H. BAKER

Today, we convene the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises in conjunction with the Subcommittee on Government Management, Information and Technology of the Government Reform and Oversight Committee. We welcome Chairman Stephen Horn. Both Chairman Horn and I are interested in reviewing the special features of our Government Sponsored Enterprises. This hearing is joined by the Members of both Subcommittees.

Moreover, we welcome representatives of the General Accounting Office and the Congressional Research Service, as well as several experts on the topic. I anticipate their testimony. I hope their testimony gives Members a comprehensive view of the relationship of the GSEs with their sponsor -- the Federal Government.

It is appropriate in light of their enormous contingent liability to the government that we conduct oversight hearings. GSE debt and guarantee obligations represent $1.8 trillion contingent exposure for the American taxpayer.

GSEs are unique entities -- they are privately held corporations limited generally by a Congressional mandate. Congress has granted special market advantages to these entities to carry out these mandates. I appreciate the tremendous benefits that GSEs have provided in the areas of housing, agriculture, and education. However, it is fair and appropriate to ask if they are meeting their mandate and whether changes to their businesses are in order. Congress has an oversight responsibility to look at the GSEs across the board and to be aware of the risks and potential liabilities that GSEs represent.

It is my hope that a few issues will be addressed in this hearing. They include:

- The conditions under which Congress should create GSEs
- Whether the scope of existing GSE activities should be expanded or reduced.
- Whether and under what circumstances a GSE should be privatized.
- How GSE financial and programmatic activity should be regulated.
- Whether GSE debt raises the financing costs of the U.S. government, and if so, by how much.
- Whether the Treasury should receive financial compensation for the special market privileges granted to GSEs.

I look forward to hearing from our witnesses. I thank them for agreeing to testify before the two Subcommittees. In addition, I thank Chairman Horn and the Members of his Subcommittee for agreeing to this joint hearing.

****

STATEMENT OF REP. FLOYD H. FLAKE BEFORE THE BANKING AND FINANCIAL SERVICES COMMITTEE SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENTS SPONSORED ENTERPRISES HEARING ON GOVERNMENT SPONSORED ENTERPRISES JULY 24, 1997

Good morning Chairman Baker and members of the Subcommittee. I am pleased to be here today to join with you in considering the regulatory status of government sponsored housing enterprises. I thank the witnesses in advance for sharing their expertise with us.

I reviewed Ms. Stromberg's report with great interest and believe that it provides a good starting point for our discussion today. However, I believe that any changes in the current regulatory structure in which the ***GSEs***, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, operate should be implemented with careful consideration of the potential effect of these policies on the continued ability of the GSEs to serve communities' affordable housing needs. In addition, I would strongly suggest that any contemplated regulatory changes be reflective of the individual merits and concerns of each ***GSE***.

As a member of the team who drafted the 1992 act creating ***OFHEO*** to oversee Fannie Mae and Freddie Mac, I am pleased to see that they have performed up to, and beyond, the standards we set for them in providing access to affordable housing.

Likewise, I have personally seen the effects of the Federal Home Loan Bank of New York's affordable housing and community development programs in my district in Southeast Queens. Without these programs, many low- and moderate-income families would not be able to realize the dream of homeownership. Again, I would emphasize that any regulatory changes should serve to protect, not jeopardize, this extraordinarily valuable ***GSE*** function.

One instance in which I fear certain regulations may hinder rather than help ***GSEs*** accomplish their mission is a recent provision of H.R. 10 in which Federal Home Loan Banks are required to reduce overall capital investment levels. I am concerned that such reductions in investment authority would adversely impact the funding levels of the Banks' affordable housing programs. I would hope that the witnesses here today will address ways in which we can protect taxpayers while allowing ***GSEs*** to maximize their contribution to community development.

Again, it is a pleasure to be here today. I welcome the witnesses, and await with interest their testimony. Thank you.

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JOINT HEARING:
"Government Sponsored Enterprises"

July 16, 1997

OPENING STATEMENT
REPRESENTATIVE STEPHEN HORN (R-CA)

Chairman, Subcommittee on Government Management,
Information, and Technology

We are pleased to join with our fellow subcommittee today in examining both the theory and the practice of Government Sponsored Enterprises. The Subcommittee on Government Management, Information, and Technology is charged with monitoring the economy, efficiency, and management of the Federal Government's operations and activities. This oversight responsibility extends to entities chartered by the Government.

The Federal Government established the first Government Sponsored Enterprise in 1916. It was a financial entity created to provide long-term real estate loans to farmers and ranchers. Since then, many Government Sponsored Enterprises have been created for other sectors of society that have been inadequately served by the private credit markets such as home buyers, farmers, students, and colleges.

While Government Sponsored Enterprises are managed and owned privately, they have strong ties to the Federal Government. The enabling legislation of each Government Sponsored Enterprise specifies its general purpose and its authorized transactions. For example, Fannie Mae is chartered to increase housing credit availability by engaging in secondary market and other transactions.

The enabling legislation also identifies Federal agencies responsible for prescribing overall policy and regulations for the Government Sponsored Enterprises and usually provides that a minority of their board members be appointed by the President or another Federal official.

Government Sponsored Enterprises typically receive their financing from private investors. They issue capital stock and short- and long-term debt instruments, sell asset-backed

securities (also known as mortgage-backed securities), and collect fees for guarantees and other services.

Federal legislation confers a number of benefits on Government Sponsored Enterprises that are not provided to private companies. Most enterprises have a direct line of credit with the U.S. Treasury and their securities are exempt from Securities and Exchange Commission registration requirements. Furthermore, their investors' interest income is exempt from state and local taxation.

As a result of such benefits and the similarity between their debt securities and those of the U.S. Treasury, most Government Sponsored Enterprise debt and mortgage-backed securities are perceived by the credit markets to be guaranteed by the Federal Government. This perception allows Government Sponsored Enterprises to borrow in the credit markets at interest rates only slightly higher than the rates paid by the Treasury on its borrowings.

In our oversight role, we need to address a variety of issues regarding the function of Government Sponsored Enterprises. Generally, we need to ask whether they continue to meet their public policy objectives. We should further consider whether there are areas where the scope of existing Government Sponsored Enterprise activities should be expanded or reduced.

We are joined by a panel of experts today to help us answer these and other questions. We are grateful for their participation and look forward to their testimony. Welcome to each of you.

Opening Statement of

Rep. Paul E. Kanjorski

Ranking Democratic Member

Capital Markets, Securities & Government Sponsored Enterprises Subcommittee

House Committee on Banking & Financial Services

Joint Hearing on Government Sponsored Enterprises

with the

Government Management, Information & Technology Subcommittee

House Committee on Government Reform & Oversight

July 16, 1997

I want to commend both of our Subcommittee Chairmen, the gentleman from Louisiana (Chairman Baker) and the gentleman from California (Chairman Horn) for the oversight hearing we are having today. I have long believed that the Congress does too little oversight, and today's hearing is evidence that both Subcommittees take their responsibilities seriously.

As the Ranking Democratic Member of the Capital Markets Subcommittee, and a member of the Government Management Subcommittee, I particularly want to thank the Chairmen for their willingness to work together on this joint hearing. When I first discovered that the two subcommittees were planning oversight hearings in the same week I encouraged them to join forces and I sincerely believe that in doing so they have made a better and more effective hearing.

Today we will hear from two panels of witnesses. The first panel will consist of the GAO and a representative of the Congressional Research Service of the Library of Congress, both of whom have done a great deal of work over many years on GSE issues. Mr. Bothwell, the GAO's chief economist has also just completed a review of GSE's for the Capital Markets Subcommittee. The second panel will consist of three academic and professional witnesses. Both panels will provide useful analyses of GSE operations.

I would be remiss, however, if I did not note for the record that due to the short time frame in which this hearing was put together, the second panel of witnesses we will hear from today does not represent a full cross-section of academic and professional opinions on the costs and benefits of Government Sponsored Enterprises. I say this without any disrespect to any of the witnesses who have agreed to testify.

All of the members of our second panel are well known and well respected, but two of them are long-standing, vocal critics of Government Sponsored Enterprises. They are entitled to their opinions, which I am confident they will fully articulate today. Nonetheless, I do not want to give anyone who is reading this hearing record today the impression that their opinions are universally held or accepted. There is a broader range of opinion that we may not hear fully articulated today.

I should also note for the record that the lack of diversity of opinion we will hear on the second panel today is not the result of either Subcommittee Chairman's unwillingness to hear other points of view. In fact, the staffs of both Chairmen worked with my staff to try to obtain additional witnesses. In the very short time frame we had to work with, however, it just was not possible to obtain other witnesses. I look forward to hearing from all of our witnesses today, but I hope that our hearing is merely the beginning, rather than the end of our examination of this important topic.

RICK LAZIO
[illegible]
COMMITTEES
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CHAIRMAN, SUBCOMMITTEE ON [illegible]
[illegible]
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OPENING STATEMENT OF CONGRESSMAN RICK LAZIO
JOINT HEARING ON JULY 16, 1997
CAPITAL MARKETS, SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES SUBCOMMITTEE AND THE GOVERNMENT MANAGEMENT, INFORMATION AND TECHNOLOGY SUBCOMMITTEE

GOVERNMENT SPONSORED ENTERPRISES HAVE BEEN CREATED OVER THE YEARS TO FILL A VOID IN THE PRIVATE MARKETS. THEY ARE A SPECIAL CLASS OF CORPORATIONS BECAUSE THEY ARE PRIVATELY HELD, BUT BACKED BY THE AMERICAN TAXPAYER.

GSEs HAVE EXECUTED WELL THEIR MISSION IN MANY SEGMENTS OF OUR MARKETS. THIS IS ESPECIALLY TRUE IN THE SECONDARY HOUSING MARKET, WHERE THEY HAVE SPURRED THE INVESTMENT OF BILLIONS OF DOLLARS INTO THE MORTGAGE FINANCE ARENA.

WE MUST EXERCISE EXTREME CAUTION WHEN ADJUSTING THE GSEs. OUR EFFORTS OUGHT NOT UNDERMINE THEIR BASIC MISSION OR UNINTENTIONALLY DISRUPT THE MARKETS.

I AM, HOWEVER, CONCERNED ABOUT THE EXPANDING REACH OF THE GSEs. WE SHOULD NOT PROLONG A COMPETITIVE ADVANTAGE IF THE TRADITIONAL MISSION OF THE GSE HAS BEEN FULFILLED. NEITHER SHOULD WE ENDORSE A COMPETITIVE ADVANTAGE IN A MARKET THAT IS WELL-SERVED BY THE PRIVATE SECTOR. FINALLY, I AM CONCERNED THAT THE EFFORTS TO EXTEND THE ROLES OF THE GSEs BEYOND THEIR TRADITIONAL MISSION MAY UNDERMINE THE SUPPORT THEY HAVE LONG ENJOYED.

THANK YOU.

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OPENING STATEMENT
THE HONORABLE CAROLYN B. MALONEY
HEARING ON GSEs
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION AND TECHNOLOGY
July 16, 1997

Thank you Chairman Horn and Chairman Baker. Although I am here today in my capacity as Ranking Member of the Government Management, Information and Technology Subcommittee, I also had the pleasure of serving and working with Chairman Baker on the Capital Markets subcommittee last year.

In fact, in addition to months of bipartisan work on Federal Home Loan Bank reform, last year the Capital Markets Subcommittee held several days of extensive oversight hearings on Fannie Mae and Freddie Mac. During that time we heard from the GAO, CBO, HUD and the Treasury Department. It struck me that despite their different perspectives, all of these agencies agreed on one indisputable fact: that because of Fannie Mae and Freddie Mac, the United States has the best mortgage markets in the world.

So if we are today in large part to determine if and why a GSE should be formed and sustained, then that work of last year gave me a working definition: a GSE should correct a market imperfection or credit gap whose existence is detrimental to an important public purpose like housing or education.

Mr. Chairmen, as a means of clarifying this, I'd like to use Fannie Mae and Freddie Mac as examples of GSEs that fit this definition.

Before Fannie and Freddie, many institutions, particularly smaller ones, had a problem maintaining a reliable flow of mortgage credit for qualified buyers.

That's because mortgage credit was funded through local deposits. Those institutions in areas with a large volume of home buyers or a healthy supply of new depositors could provide ready credit at lower rates. But those lacking these favorable conditions faced a credit crunch and had to charge much higher rates.

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Of course, because most areas took their turn facing bad economic times, mortgage availability and interest rates varied greatly from region to region, and from year to year. Worst of all, when a local economy was hit with hard times, and needed the infusion of new capital *the most*, local mortgage credit dried up. In short, the availability of mortgage credit was not reliable and stable.

Freddie and Fannie changed this by making the home mortgage a nationally-liquid asset.

Today, lenders all over the country know they can readily *sell* their mortgages at a fair price to one of these two GSEs.

That's because since Fannie and Freddie are mandated by law to operate in all 50 states, they have the expertise and experience to evaluate and purchase individual mortgages from all over the nation almost instantaneously. Freddie Mac and Fannie Mae buy mortgages, package them together as securities, sell them to investors, and use the profit generated to buy more mortgages, continuing the cycle and providing more ready cash to local lenders to make more mortgages.

What has this meant for the average home buyer?

It means if you *qualify* for a mortgage, you can *get* a mortgage -- that there is a system to supply mortgage credit for you whether you live in New York City or Baton Rouge or Lakewood, California. And it means because the rates are lower, more people can qualify.

That's why today, we have the best housing finance system in the world.

Fannie and Freddie are examples of how GSEs have corrected a market imperfection or credit gap -- in this case locally-based credit crunches in the home mortgage market -- whose existence did harm to an important public purpose -- in this case, providing every American family the chance to own their home.

The second issue we will look at today is when a GSE should lose its government-sponsored status. The answer to that I think is straightforward: a GSE should lose its government-sponsored status when it is no longer needed to correct the market imperfection or credit gap it was designed to address.

Again, I'd like to use Fannie and Freddie as examples of GSEs whose presence is still needed.

In regional downturns our housing public-private partnership GSEs have maintained their presence. They have hard targeting -- tougher than any CRA requirement -- keeping their loans below the conforming limit, and reserving a significant percent of their business for those making the median income or less. On the other side of the coin, we on this committee know the difficulties we have had maintaining much less rigorous CRA requirements in the private sector.

The attention to underserved areas goes beyond regional downturns. In my hometown of New York City, where co-op housing has been a path to home ownership for so many, financing has been extremely tough to come by -- even through local lenders. This has artificially and unfairly frozen *in* many co-op owners who would like to sell, and frozen *out* many prospective buyers who would like to purchase.

The private sector on its own has not stepped in to solve this problem; Fannie Mae has.

Beginning in 1993, and culminating in the HouseNew York Plan, Fannie Mae has made a major commitment to help revitalize this market and spur new co-op sales, pledging $750 million where nothing had existed before. With the new ability to sell co-op loans to the secondary market, the banks' resources are now being freed up to make more co-op loans, and the message is sent to lenders that these types of loans are a liquid asset.

At the point a regional market or type of housing stock hits tough times is exactly the point it needs focus and attention from the housing finance market. And it is at exactly that crucial moment that a fully privatized secondary market structure would not work as well.

Having a stable national market for home mortgages that will be there in good times and bad, in booming regions and depressed regions, is a tangible benefit the American people have come to expect. If an American home buyer *qualifies* for a home loan, they can *get* a home loan at a nationally dependable, fixed rate. And Americans benefit from lower rates because of participation in a national market.

On page 70 of the GAO report presented at last year's hearing, the conclusion was made that "[privatization] would probably mean that mortgage rates would increase in areas with higher risks, for houses with higher loan-to-value ratios, and in periods of high mortgage demand."

Put another way, a privatized world would be a far different, more segmented housing finance system than the reliable and consistent one we have today.

Fannie and Freddie can't, by charter, pull out of a market.

They can't, by statute, abdicate affordable housing goals.

To the extent some might envision a fully privatized world where they would or could abdicate these roles, we would have a housing finance system less responsive to the needs of the people.

The delicate balance we have today has been a great success for the American consumer, and one I hope we would all be very skeptical of disrupting.

It is not that we shouldn't look at privatization, or continually evaluate the performance of our GSEs, but that before we take away government-sponsored status, we should be very careful that the important needs being filled by the GSE can indeed be filled by the private sector.

Thank you, Mr. Chairmen, and I look forward to the testimony of our witnesses.

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Committee on Banking and Financial Services, and Subcommittee on Government Management, Information and Technology, Committee on Government Reform and Oversight, House of Representatives

For Release on Delivery
Expected at
2:00 p.m., EDT
on Wednesday
July 16, 1997

GSEs

Recent Trends and Policy Issues

Statement of James L. Bothwell
Chief Economist

GAO/T-OCE/GGD-97-76

Mr. Chairmen and Members of the Committees:

We are pleased to be here today to discuss the large and growing role of government-sponsored enterprises (GSEs) in the nation's credit markets. As you are aware, Congress originally created GSEs to enhance the credit available to homebuyers, farmers, students and colleges. Congress established GSEs as federally chartered, but privately owned and operated corporations, limited their activities to certain economic sectors deemed worthy of public support, and gave them certain advantages to help accomplish their public purposes.[1] Today, the outstanding volume of federally assisted GSE credit is large and rapidly increasing. As shown in Figure 1, the volume of GSE credit more than doubled between 1990 and 1996, from $874 billion to almost $1.8 trillion, and is now almost double the outstanding amount of credit made available through all federal direct loan and federal loan guarantee programs combined. As shown in Figure 2, GSE credit has also steadily increased as a percentage of the total net credit outstanding in our economy,[2] from less than 2 percent in 1970 to over 12 percent in 1996. By contrast, the share of total net credit accounted for by federal direct and guaranteed loans has declined substantially over this period from almost 13 percent in 1970 to less than 7 percent in 1996.

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[1]Appendix I provides more details on the creation and operations of each of the major GSEs. Appendix II provides a list of related GAO products.

[2]Total net credit outstanding in the economy includes debt owed by all domestic sectors except financial intermediaries, which are omitted to avoid double counting.

As shown in figure 3, 95 percent of total outstanding GSE credit in 1996 was housing related, with the remaining 5 percent going for agricultural and educational purposes. In recent years, housing has also been the only sector where GSE credit has been growing as a percentage of the total available credit outstanding. In particular, as shown in Figure 4, the two largest housing GSEs, Fannie Mae and Freddie Mac, have increased their share of total residential mortgage debt from 23 percent in 1990 to over 37 percent in 1996.[3] By contrast, as shown in figure 5, the share of farm credit supplied by the Farm Credit System, the largest agricultural GSE, actually declined between 1985 and 1995. And Congress passed legislation in 1996 that allowed the two education GSEs – Sallie Mae and Connie Lee – to end their government sponsorship and become fully private corporations.

While the legal powers, organizational structures, and operating styles of GSEs differ, they have several common characteristics. For example, each GSE was chartered by Congress to help achieve a particular public purpose, each is privately owned and operated, and each operates under certain restrictions and obligations which would not apply to a completely private corporation. Each GSE was also given certain explicit advantages – such as exemptions from state and local corporate income taxes, lines of credit with the

[3] Specifically, of the $3.0 trillion in outstanding mortgage debt at the end of fiscal year 1990, 12.5 percent was in Fannie Mae's portfolio or its guaranteed mortgage pools, while 10.7 percent was in Freddie Mac's portfolio or mortgage pools. By the end of fiscal year 1996, Fannie Mae's share of the $4.1 trillion in outstanding mortgage debt had increased to 22.5 percent, while Freddie Mac's share had risen somewhat less, but still by a substantial amount, to 14.6 percent. During this period, the share of total outstanding mortgage credit supplied by the Federal Home Loan Bank System actually declined from 3.9 percent to 3.7 percent.

Treasury Department, or exemptions from SEC registration requirements and fees – to help achieve its public purpose. The most important benefit that GSEs receive from their government sponsored status, however, is an implicit one stemming from investors' perceptions that the federal government would not allow a GSE to default on its obligations. Although GSE obligations are not obligations of the United States Government, the lower perceived risk of holding GSE obligations allows GSEs to borrow at rates lower than comparably creditworthy private corporations that do not enjoy federal sponsorship. In our recent statement on the potential impacts of privatizing Fannie Mae and Freddie Mac, we estimated that this funding advantage saved the two GSEs from about $2 billion to $8 billion in 1995.[4]

Because of their federal sponsorship, GSEs also involve significant risks and potential costs to taxpayers, including the risk that taxpayers could be potentially liable for a GSE's obligations if it were to get into financial difficulty. In 1987, Congress did in fact authorize $4 billion in financial assistance to the Farm Credit System when it experienced financial stress.[5] Limited financial and regulatory relief was also provided to Fannie Mae when it suffered losses of $277 million between 1981 and 1984.[6]

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[4]Housing Enterprises: Potential Impacts of Severing Government Sponsorship, GAO/T-GGD-96-134, June 12, 1996.

[5]Farm Credit System: Repayment of Federal Assistance and Competitive Position, GAO/GGD-94-39, March 10, 1994.

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

The special nature of GSEs, and the potential taxpayer exposure to large, rapidly increasing GSE financial obligations, raises several important policy issues, including the adequacy of GSE regulation, the potential for expansion of GSE activities, and potential ways to limit GSE exposures. Over the past few years, we have performed several major evaluations of the effectiveness of the various GSE regulators.[7] Based on our reviews, we developed the following five criteria for an effective GSE regulator:

- objectivity and arm's length status from the GSE,
- prominence in government,
- consistency in regulation of similar markets,
- separation of primary and secondary market regulation, and
- economy and efficiency.

Although Congress has enacted some recent legislative changes to strengthen and improve regulatory oversight of GSEs, our work has shown that none of the three housing

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[7]Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks, GAO/GGD-91-90, May 22, 1991; Government-Sponsored Enterprises: The Government's Exposure to Risks, GAO/GGD-90-97, Aug. 15, 1990; FHLBank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness, GAO/T-GGD-95-244, Sept. 27, 1995; Government-Sponsored Enterprises: Development of the Federal Housing Enterprise Financial Regulator, GAO/GGD-95-123, May 30, 1995; Farm Credit System: Farm Credit Administration Effectively Addresses Identified Problems, GAO/GGD-94-14, Jan. 7, 1994; Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness, GAO/GGD-94-38, Dec. 8, 1993; Improved Regulatory Structure and Minimum Capital Standards are Needed for Government-Sponsored Enterprises, GAO/T-GGD-91-41, June 11, 1991.

GSE regulators – the Office of Federal Housing Enterprise Oversight (OFHEO), the Department of Housing and Urban Development (HUD), nor the Federal Housing Finance Board (FHFB)– meets all five of our criteria. In 1993 we recommended that OFHEO and the FHFB be merged to better meet these criteria and our ongoing work continues to support merging the housing GSE regulators and making one agency responsible for both GSE safety and soundness and mission compliance.

Based on our work, we have also developed several criteria that policymakers could use to evaluate proposals to expand the types of products or services that existing GSEs currently offer.[8] Under these criteria, any new GSE product or service should:

- add value and be consistent with the GSE's public mission,
- be properly priced to reflect risk,
- be within the GSE's area of expertise, and
- avoid competing with products and services offered by fully private companies or member institutions.

Because GSEs have been given the advantages of federal sponsorship to achieve particular public purposes, we believe that any proposals to significantly expand their

[8]See, in particular, Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness, GAO/GGD-94-38, Dec. 8, 1993.

existing activities should be required to meet these, or similarly rigorous, criteria before they are approved.

Finally, we have also done work addressing ways that Congress might limit the taxpayers' potential exposure to GSE obligations. One obvious way to do this is to end their federal sponsorship. As I mentioned at the beginning of my statement, Congress passed legislation last year that would make two of the GSEs – Sallie Mae and Connie Lee – fully private entities. In 1996, we, along with the Treasury Department, HUD, and the Congressional Budget Office, produced reports that analyzed the potential impacts of privatizing the two largest GSEs – Fannie Mae and Freddie Mac.[9] While taking such action could eliminate taxpayers' risk exposure to these GSEs, it would also have major impacts on housing finance markets, including a likely increase in mortgage interest rates for certain borrowers. Our report also discussed some more limited policy options that would reduce the level of taxpayers' risk exposure to these two GSEs, such as imposing "user fees" or greater restrictions on their housing finance activities. As with privatization, however, each of the options that we presented had benefits, risks, and trade-offs that would need to be considered and weighed carefully.

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[9]Housing Enterprises: Potential Impacts of Severing Government Sponsorship, GAO/GGD-96-120, May 13, 1996; Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac, Congressional Budget Office, May 1996; Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, United States Department of the Treasury, July 11, 1996; Studies on Privatizing Fannie Mae and Freddie Mac, May 1996, and Privatization of Fannie Mae and Freddie Mac: Desirability and Feasibility, July 1996, United States Department of Housing and Urban Development.

Mr. Chairmen. this concludes my prepared statement. and we would be happy to respond to any questions that you or other members of the committees may have.

Housing GSEs

The two major housing GSEs--Fannie Mae and Freddie Mac--were both created to improve the operations and efficiency of the housing credit markets. Although they were created in different circumstances and have operated differently, their charters and methods of operations have become much more similar.

Fannie Mae was first created in 1938 as a government-held association to buy FHA, and later VA and conventional, loans from originators, primarily mortgage banks, with funds raised by selling bonds. The initial goals of the program were to support the development of a national mortgage market and to improve liquidity through the creation of a resale market for mortgage loans. In the 1950s, Congress began the process of shifting Fannie Mae to private ownership. This was to be accomplished by requiring each mortgage seller to purchase a certain amount of common stock based on the amount of loans it sold to Fannie Mae, which would allow the gradual retirement of preferred stock owned by the Treasury Department.

The Housing and Urban Development Act of 1968 completed the transformation of Fannie Mae into a government-sponsored enterprise. The act separated Fannie Mae into two separate components. One component, Ginnie Mae, remained in HUD to provide support to FHA, VA, and special assistance programs. The other part was the government-sponsored, privately owned, for-profit Federal National Mortgage Association, which was to be concerned exclusively with attracting funding into residential mortgages. To accomplish this purpose, Fannie Mae used funds raised by selling bonds to purchase mortgage loans from originators and held them in its own portfolio.

Congress chartered Freddie Mac in 1970 in reaction to the loss of deposits in the savings and loan industry that was curtailing that industry's ability to fund and originate home mortgages. Its creation ensured that the savings and loan industry had access to funds to continue to fund mortgages. In comparison to Fannie Mae, Freddie Mac did not hold mortgages in its portfolio, but created mortgage-backed securities (MBS) and sold them to investors. However, Freddie Mac guaranteed timely interest and principal payments on these securities.

In the early 1980s, Fannie Mae and Freddie Mac experienced different financial results as short-term interest rates increased. Because Fannie Mae was funding the mortgages in its portfolio with short-term debt, sharp short term rate increases meant that the interest earned on the old mortgages in its portfolio was less than interest expenses on the newly

issued debt. As a result, Fannie Mae experienced total losses of about $277 million between 1981 and 1984. In response to Fannie Mae's financial problems, the federal government provided limited tax relief and regulatory forbearance in the form of relaxed capital requirements. Freddie Mac's different method of operations meant that investors, and not Freddie Mac, bore the risks of changing interest rates. To avoid future losses from interest rate changes, Fannie Mae partially adopted Freddie Mac's strategy of issuing MBS and shifting the interest rate risk to investors.

The activities of Fannie Mae and Freddie Mac have largely converged. The effect of the Housing and Community Development Act of 1992, along with the GSE-related provisions in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), was to make the charters of Fannie Mae and Freddie Mac substantially the same. Both GSEs attempt to smooth the availability of mortgage funds across time and regions and promote liquidity in the secondary mortgage market. In addition to their traditional goal of improving the functioning of capital markets, the charters of both enterprises now include distributional goals. Both Fannie Mae and Freddie Mac have the additional purpose of providing access to mortgage finance for low-income families and underserved areas. A primary difference between the two GSEs continues to be Fannie Mae's relatively greater use of debt-financing to hold mortgages in its own portfolio, although Freddie Mac has increased its portfolio investment share in recent years.

The Federal Home Loan Bank System is the third housing-related GSE. It was established in 1932 to extend mortgage credit by making loans, called advances, to its member institutions, who in turn lend to homebuyers for mortgages. The System consists of 12 federally chartered, privately owned FHLBanks that raises funds by issuing consolidated debt securities in the capital market. The advances are secured by home mortgage loans or such other collateral as U.S. Treasury securities. These advances help member institutions, originally limited to thrifts, by enhancing liquidity and providing access to national capital markets.

With the evolution of national mortgage markets and the contraction of the thrift industry, the original justifications for the Federal Home Loan Bank System to support housing credit and the thrift industry have diminished. Rather than phase down its activities, Congress allowed the Federal Home Loan Bank System to expand its membership pool to include commercial banks, which now comprise 65 percent of the members.

Agricultural GSEs

The largest of the two agriculture GSEs, the Farm Credit System (FCS), raises money through bond sales and makes loans directly to farmers. FCS lends this money to the farming sector through a network of member-owned cooperatives with the purpose of ensuring a stable supply of credit to agriculture. Established in 1916, FCS became insolvent in the mid-1980s when inadequate interest-rate risk management and falling land prices depressed the value of collateral behind FCS credit and created large losses for the

institution. This necessitated a federal bailout through the FCS Financial Assistance Corporation (FAC), which injected funds into FCS by issuing $1.261 billion in bonds.

Unlike direct loans and FCS loans, the other agricultural GSE--Farmer Mac--operates by promoting a secondary market for agricultural loans. Farmer Mac was created in 1987 by the same legislation that provided for the FCS bailout. Its purpose was to create and oversee a secondary market for, and to guarantee securities based on, farm real estate loans. However, unlike the GSEs in the housing sector, Farmer Mac was not able to establish a growing niche in farm credit markets by guaranteeing farm securities. As a result of the decline in Farmer Mac's capital base, the Farm Credit System Reform Act of 1996 expanded its powers. The 1996 Act transformed Farmer Mac from just a guarantor of securities formed from loan pools into a direct purchaser of mortgages in order to form pools to securitize. The expanded powers make it more attractive for banks to participate in Farmer Mac and permit Farmer Mac to act as a pooler. While the new powers are intended to boost Farmer Mac's revenues, it is too early to tell how this will affect Farmer Mac's role in agricultural credit. However, as a direct purchaser of loans with no required subordination, this increased role does have the potential to expose Farmer Mac to greater credit risk than on guaranteed pools, which require loan originators or other entities outside the pool to hold a 10-percent subordinated interest in pooled loans.

Education GSEs

The federal government created two GSEs to increase the availability of credit in the educational sector. The largest one, Sallie Mae, was created in 1972 as a for-profit, shareholder-owned corporation. Sallie Mae purchases insured student loans from eligible lenders and makes secured loans to lenders. It now holds about one-third of all outstanding guaranteed student loans. In 1996 Congress passed legislation establishing a process for restructuring Sallie Mae and ultimately terminating its federal government sponsorship.

The second education GSE, Connie Lee, was created in 1986 to insure and reinsure the financing of postsecondary education facilities. Connie Lee's financial condition has been strong, particularly since 1991, when it obtained the "triple-A" credit rating necessary to engage in the financial guaranty business as a direct writer of insurance. Legislation passed in 1996 privatized Connie Lee by repealing the corporation's enabling legislation and requiring the federal government to sell, and Connie Lee to purchase, the corporation's federally owned stock during fiscal year 1997.

RELATED GAO PRODUCTS

Housing Enterprises: Investment, Authority, Polices, and Practices, GAO/GGD-97-137R, June 27, 1997.

Housing Enterprises: Potential Impacts of Severing Government Sponsorship, GAO/T-GGD-96-134, June 12, 1996.

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

GAO views on the "Federal Home Loan Bank System Modernization Act of 1995", Letter from James L. Bothwell, Director, Financial Institutions and Markets Issues, GAO, to the Honorable James A. Leach, Chairman, Committee on Banking and Financial Services, U.S. House of Representatives, Oct. 11, 1995.

FHLBank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness, GAO/T-GGD-95-244, Sept. 27, 1995.

Housing Finance: Improving the Federal Home Loan Bank System's Affordable Housing Program, GAO/RCED-95-82, June 9, 1995.

Government-Sponsored Enterprises: Development of the Federal Housing Enterprise Financial Regulator, GAO/GGD-95-123, May 30, 1995.

Farm Credit System: Repayment of Federal Assistance and Competitive Position, GAO/GGD-94-39, March 10, 1994.

Farm Credit System: Farm Credit Administration Effectively Addresses Identified Problems, GAO/GGD-94-14, Jan. 7, 1994.

Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness, GAO/GGD-94-38, Dec. 8, 1993.

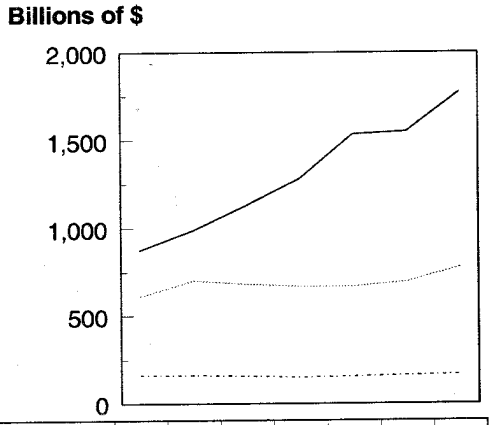
Improved Regulatory Structure and Minimum Capital Standards are Needed for Government-Sponsored Enterprises, GAO/T-GGD-91-41, June 11, 1991.

Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks, GAO/GGD-91-90, May 22, 1991.

Government-Sponsored Enterprises: The Government's Exposure to Risks, GAO/GGD-90-97, Aug. 15, 1990.

Figure 1
Rapid Growth in GSE Credit

Federal Loans & Guarantees & GSE Credit: 1990-1996
In Billions of Dollars



Fiscal Year	90	91	92	93	94	95	96
GSE Credit —	874	988	1,129	1,282	1,533	1,548	1,771
Guaranteed Loans ·····	611	701	680	666	668	693	775
Direct Loans - - -	162	160	156	151	155	160	165

Source: US Budget with GAO adjustment for Sallie Mae's holdings of guaranteed loans.

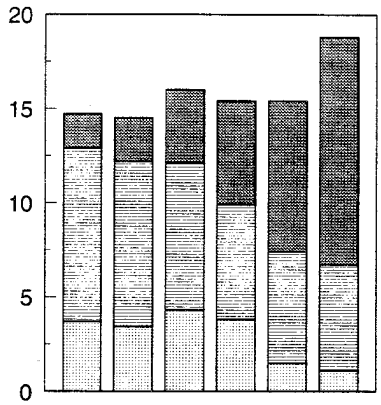
Figure 2

GSE Credit Affects Rising Share of Total U.S. Credit

Federal Loans & Guarantees & GSE Credit: 1970-1996

As a Percent of Total Credit Outstanding

Percent



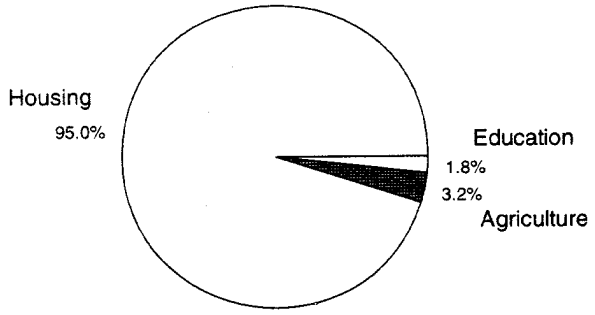
Fiscal Year	70	75	80	85	90	96
Direct Loans	3.7	3.4	4.3	3.8	1.5	1.1
Guaranteed Loans	9.2	8.8	7.8	6.1	5.9	5.6
GSE Credit	1.8	2.3	3.9	5.5	8.0	12.1

Source: US Budget & Federal Reserve Board

Figure 3

Housing Gets Largest Share of GSE Credit

GSE Credit by Sector FY 96



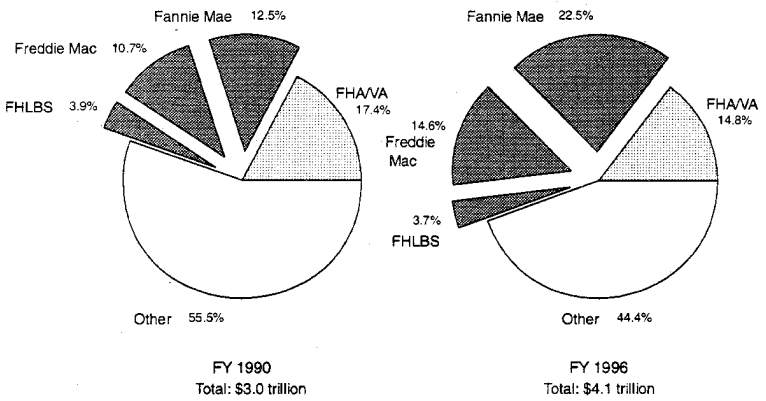
Total: $1.8 trillion

Source: US Budget, FY 1998

Figure 4

GSE Share of Mortgage Credit is Rising

Mortgage Lending Shares: FY 1990 & FY 1996

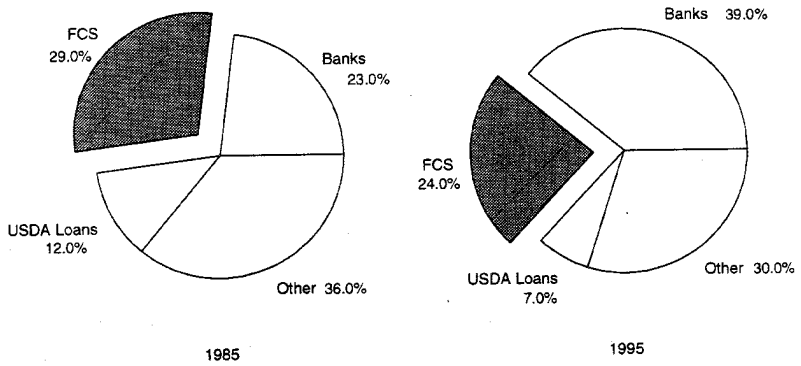


Source: US Budget & Federal Reserve Bulletin

Figure 5

GSE Share of Farm Credit is Declining

Farm Credit Shares: 1985 & 1995



Source: US Budget, FY 1998

Statement of Thomas Woodward
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Congressional Research Service

before the
Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises,
Committee on Banking and Financial Services
and
Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform and Oversight
United States House of Representatives

July 16, 1997

on
Government Sponsored Enterprises

Mr Chairman and Members of the Subcommittees.

Good afternoon and thank you for the invitation to discuss issues related to government sponsored enterprises (GSEs). Specifically, I will address the questions you have posed with respect to the economic issues underlying 1) the decision to create, alter, and end federal sponsorship of enterprises; 2) how such enterprises should be regulated; 3) how they affect government borrowing costs; 4) and whether they should pay compensation to the government for the market privileges they receive.

Government Sponsored Enterprises

Government-sponsored enterprises (GSEs) are a class of special, congressionally-chartered profit-making corporations which are owned by private shareholders but operate to serve a public purpose. They differ from other corporations in *two* ways. **First**, they are granted certain legal privileges and exemptions not generally available to other firms. **Second**, they are specifically limited to conducting a narrow range of business activities.

More than a century and a half ago, virtually all corporations took a form similar to what I have just described, typically with state government sponsorship. But over time, government sponsorship has gone from a common form of organizing corporate activity to an unusual one. Now, most corporations are chartered nearly automatically, without a special act of the legislature, without special privileges, and generally without much in the way of limitations on the business they engage in. Government sponsorship nowadays is undertaken only in exceptional cases.

Currently, there are only five federally chartered GSEs: two related to agricultural credit, the Farm Credit System and the Federal Agricultural Mortgage Corporation (Farmer Mac); and three related to home mortgage credit, the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Banks. The Student Loan Marketing Association (Sallie Mae) is in the process of becoming a fully private corporation.

These GSEs are all designed to integrate certain segments of the loan market into financial markets in general. They are intended to assist in the movement of credit from places where it is abundant into areas where it is needed, both in terms of geographic regions, and in terms of different sectors of the financial markets. The financial GSEs ensure that there will not be significant regional disparities in the cost of borrowing across different parts of the country, and that loans for mortgage and agricultural finance may be funded by investors rather than just by mortgage and agricultural loan institutions.

The privileges conferred on the different GSEs vary. The enterprises are all authorized to use Federal Reserve banks as fiscal agents. The securities that they issue may be purchased without limit by federally regulated financial institutions (principally banks and savings associations). Their debt may serve as collateral for public deposits. In most cases, their securities are eligible for Federal Reserve

serve as collateral for public deposits. In most cases, their securities are eligible for Federal Reserve open market purchases. Their earnings are typically exempt from state and local income taxes. And most of them are exempt from the registration requirements of the Securities and Exchange Commission.

The most valuable benefit conferred on GSEs is not explicit or official. It is the perception that their debt is guaranteed by the government. Even though their securities explicitly declare that they are not guaranteed, because of these privileges, because of the public policy importance of the GSE mission as demonstrated by their special charters, and because of past history of government behavior towards the enterprises, market participants *infer* that the federal government would not allow the GSEs to fail with creditors losing their money. As a result, not only do the GSEs have explicit profit-enhancing privileges, they are also able to attract private market capital at costs below that of non-GSEs.

Creating GSEs

The relative rarity of government sponsorship today is largely due to the general acceptance of the proposition that profit-making activities will be undertaken without the grant of special privileges, and that worthwhile activities will typically yield a profit to those who undertake them.

If those propositions are true, then government sponsorship of an enterprise typically results in an inefficient allocation of society's scarce resources. This undesirable effect of government sponsorship occurs because the privileges hinder competition -- which is a requisite for a healthy market -- and because they generate overinvestment in one segment of the economy relative to others. Moreover, limitations on the permissible scope of activities of a firm stifle innovation and the speedy adjustment to change.

Hence, economic considerations will not generally justify a GSE *unless* there is some identifiable failure of the market to work in a sector of the economy. By identifiable failure, I mean that it is not enough to simply specify a currently unavailable product or service that ought to be possible to produce profitably. In our economic system, the way to address such an absent product is to go into business producing it, not turning to the government to do so. Government involvement is called for when it becomes possible to point to some impediment that prevents the market from properly responding to a need.

Given the nature of the impediment identified, a GSE *may* be a remedy. It also *may not* be. Some impediments require other approaches, such as direct subsidies, government provision of the goods, regulation, or changes in the legal system. A GSE could not be created that could provide for national defense, for example, or to provide assistance to the poor. That is because a GSE is still a business, and businesses have to make money.

The current set of GSEs were all built out of the perceived need to integrate incomplete financial markets. There are four likely reasons for this: 1) the financial sector is heavily regulated, and therefore has a number of impediments to full development of a market; 2) much of the chartering and regulation of institutions is performed on the state level, which makes it difficult for a national market to develop; 3) the low cost of moving funds from one region of the country to the other makes it fairly easy to identify a failure of the market, made apparent by regional disparities in interest rates; and 4) the relatively small physical investment needed to enter the market means that a firm that invests a great deal in creating a new product will be quickly besieged by imitators, and may have to share benefits of its innovations while absorbing the full cost of developing them, reducing any firm's incentive to develop a new market.

Financial markets are now very sophisticated in this country. They are well integrated, and the current implementation of new laws on interstate banking is furthering the integration of loan markets. This all indicates that the economic justification for financial GSEs has probably decreased and will continue to do so.

Their most likely future use would be in the creation of new markets for certain loans. For example, proposals have been advanced for generating a more extensive secondary market for small business loans. Although the growth of interstate banking may obviate the need for such an institution, a GSE designed to securitize small business loans might be economically justified on the grounds the special

designed to securitize small business loans might be economically justified on the grounds the special privileges are needed to help underwrite the cost of getting the market established. No one might now undertake the task of starting a market because, once its profitability is established, competitors will quickly jump in and free ride off of the firm that paid all the costs of developing the new market. Hence, GSE status could act like a patent that gives the incentive to invent by conferring an effective monopoly for a limited time period.

Ending GSEs

In general, economic considerations point to ending a GSE's special status eventually. In the case of a GSE that has been unsuccessful in its role in the market, the public policy concern that it was intended to address needs to be addressed in some other way. The charter, not having worked, serves no economic purpose.

If successful, the GSE occupies a privileged position in the market without facing the discipline of competition. The resulting monopolistic power is a market distortion of its own, possibly even worse than having an underdeveloped market in the first place. After some period of time, either the GSE needs to be weaned from its charter so that others can enter the market, or competition can be engendered by the chartering of competitors with similar privileges.

As a general rule, one should expect that every GSE at some point should either lose its charter privileges, or be given competition by other GSEs producing the same product. It is very difficult to defend on economic grounds the continued privileged status of a successful GSE.

If it continues to operate with market privileges, the successful GSE will have a monopolistic position in the market. With such a position, the full value of its privileges will not be passed on to its customers. Instead, the value of these privileges will be split among four groups: some will accrue to the ultimate customers (typically borrowers whose loans are purchased by the GSEs), some will accrue as extra profits to the owners, some will be absorbed in the form of higher pay and perks for officers and employees, and some will be spent to influence the electorate to continue the privileged status of the institution.

This is also why a GSE is not an especially well-suited mechanism to subsidize the price of the product that the GSE produces. Because of the monopolistic position of most GSEs, the privileges and benefits received by them are unlikely to be fully passed through to customers. If it is desired to subsidize mortgage or farm credit, economic analysis indicates that there are more effective ways of doing so than by setting up or maintaining a GSE.

Regulation

Financial regulation of a GSE is largely justified by the perception of the federal guarantee. It is not just that the government may be on the hook for any losses, but that the presence of a (perceived) guarantee can make losses more likely because of what it does to the incentive to have sufficient capital and to take risks.

Capital or equity is the owners' stake in a firm. Capital serves first as a cushion for losses before losses are absorbed by creditors, and second as incentive for the owners to operate prudently because they lose funds before anyone else. It is in the financial interest of owners to minimize the amount of capital. The less of their own money invested, the greater the return on it, and the less they are exposed to loss. Creditors, naturally, desire greater capital in order to minimize the risks that they face. Hence, even without any regulation, the market forces owners to maintain sufficient capital because creditors will otherwise not provide them with funds.

However, if the government is perceived as guaranteeing the debt of the firm, creditors will be relatively indifferent to the amount of capital it has, while the owners will still desire to keep it at a minimum. Hence without regulation, a firm with a guaranteed debt will tend to have insufficient capital. And with little of their funds at stake, owners are more prone to take risks. This suggests that the primary method of financial regulation of GSEs should be in the form of capital standards.

of financial regulation of GSEs should be in the form of capital standards.

Capital standards, even if they are the only form of regulation, are not simple. The standards are not easy to set. It is hard without market signals to know what sufficient capital is, and separate standards have to be set for on-book and off-book assets.

In terms of programmatic activity of the institutions, some regulation is likely to be required. Since the privileges are given in order to have the firm develop or improve a particular market, its charter usually limits it to these activities. However, there is always an incentives for the firm to expand its activities outside the charter. Some supervision is required to ensure that the chartered firm remains within the bounds set for it until its job is complete. Yet, there is always a danger that programmatic regulation may result in mandates imposed on the enterprise that are only marginally related to its business mission -- a point that I address in more detail later.

Cost to Government

In all probability, the existence of competing GSE debt does not much affect the financing cost of the federal government. There are two potential avenues by which such an effect could occur. First, GSEs could cause a net increase in credit demand that drives up all interest rates, including those of the federal government. Second, the availability of large amounts of (perceived) guaranteed GSE debt could reduce the premium that investors are willing to pay for safe federal securities.

The first of these effects is tiny. The primary effect of GSE's is to shift the allocation of investment funds geographically and institutionally, not to appreciably add to total demand for them. Consequently, there would not appear to be much upward pressure on interest rates in general from GSE financing.

The second effect is potentially serious, but a casual inspection of financial markets suggests it has had little real effect. Since 1980, federal debt quintupled in quantity without any apparent decrease in the interest differential between it and private debt. If this surge in the availability of safe debt securities did not affect the differential, it is unlikely that the availability of GSE debt has.

It must be added, that from an economic perspective, the focus should not be on the cost to the federal government, but on the cost to society. If federal borrowing costs rise because of the activities of GSEs, but total social resource costs of investment go down because funds are more efficiently allocated, then the extra federal borrowing costs are of little consequence. In economics, the overriding principle is one of social costs, not the cost imposed on just one segment of the economy.

Compensation for Privileges

The whole idea of granting privileges to the enterprise is to confer a benefit that helps the enterprise be successful. Consequently, requiring the firm to compensate the government for the privileges simply undoes the benefit. As a general rule, therefore, if a fee is justified, then it is difficult if not impossible to justify the special status and privileges in the first place. And if the privileges are truly necessary, a fee would be inappropriate. Otherwise, the whole exercise is equivalent to a sale of special privileges by the government.

Thus, the notion of paying for the privileges is inseparable from the issue of continuing GSE status. In the early stages of a GSE's life, a fee would not make much economic sense, since the whole idea of privileges lies behind setting up the institution and making it successful. Once the market matures and the GSE has performed its role, the question becomes one of dispensing with the privileges. Thus a "user fee" for GSE privileges is simply a substitute mechanism for ending GSE status. It may be preferable in that it can be applied gradually, slowly weaning the institution from its advantages until its own management decides it would be better off as a state-chartered corporation. It may also be preferable because, being phased in gradually, it can allow competitors take root in advance, instead of unleashing a monopoly on the market straight out.

In addressing the issue of compensation for privileges, it is worth emphasizing that compensation is not

limited to *explicit* user fees. It is also possible to exact compensation "in kind" by imposing mandates on the institution as a quid pro quo for the benefits incurred. For example, requirements placed on banks have been justified on the grounds that the government has conferred benefits on them, and that they therefore have certain social responsibilities in return. And special housing mandates have already been imposed on Fannie Mae and Freddie Mac. In-kind fees are probably the easier to impose precisely because they are not explicit. As such, it is far more likely that existing GSEs will acquiesce to them.

But such mandates can create problems that direct fees do not. For one, their cost (and benefits for that matter) cannot be accurately measured, so that the government has difficulty in knowing what it is getting. For another, they tend to generate cross-subsidies among different groups that can be hard to disentangle. Last, they can make the elimination of the charter much more difficult, since, unlike direct fees, more than a revenue source is being lost, but also a spending program that is inextricably linked to it.

Over the long run, as these mandates are increased and raise the costs of operations and cut into the returns, they have the effect of explicit fees. The monopolistic position of the enterprise erodes as potential competitors innovate enough to lay claim to some of the GSE's market. Since the mandated programs have constituencies, shedding the charter may become impossible. Locked into a limited line of business, the GSE will have few options when competitors skim the best part of the market. The charter, instead of being a fence that keeps competitors out, becomes one that locks it in. At that point, the government might have to live up to the inferred guarantee of the GSE's debt.

Biographical Profile
G. Thomas Woodward

Dr. Woodward is Specialist in Macroeconomics and Head of the Income, Finance, and Housing Section of the Economics Division of the Congressional Research Service, The Library of Congress, where he has worked on issues related to macroeconomic policy and financial institutions since 1982.

He received a B.A. from the College of Wooster (1974), and M.A. (1976) and Ph.D. (1979) from Brown University.

From 1979 through 1982, he was an Economist in the Program Analysis Division of the U.S. General Accounting Office. And during 1991-92 he was Chief Economist of the minority staff of the Committee on the Budget, U.S. House of Representatives.

He has published papers on aspects of productivity growth, hyperinflation, inflation-indexed securities, interest-bearing currency, debt management, and government sponsored enterprises.

Economics Division
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Memorandum August 12, 1997

TO: House Committee on Banking and Financial Services,
Subcommittee on Capital Markets, Securities, and GSEs
Attention: Ted Beason

FROM: Thomas Woodward
Specialist in Macroeconomics
Economics Division

SUBJECT: Questions related to GSE testimony of July 16

This memorandum is in response to the questions you posed as a followup to our testimony of July 16 before the Subcommittee on Capital Markets, Securities, and GSEs.

1) **"You mentioned in your testimony certain characteristics of the 'successful GSE,' such as the failure to pass on the full value of their market privileges to their customers, and instead to use them for extra perks for their officers, greater profits for their owners, and lobbying efforts for continued privileges. Are all GSEs successful?"**

No. There are a variety of ways in which GSEs may be unsuccessful.

First, they may simply fail to do the job they were intended to do. In many ways this was true of the early Fannie Mae, before it acquired the powers it now has. Because it had fewer powers needed to truly integrate markets, mortgage markets were still relatively fragmented as late as the 1960s. In this sense, it was at that time unsuccessful.

Second, they may be created to do a job that is not needed. Secondary markets can develop without conferring GSE status. In addition, many of the reasons why financial markets were fragmented in the past had to do with artificial barriers imposed on depository institutions that prevented them from doing business outside a limited area or from branching across state lines. Now that these barriers are being removed, a great deal of geographic integration can be achieved without special secondary market GSEs. Farmer Mac, for example, is a GSE the utility of which might be questioned. The relative lack of volume of its business suggests that there may not be much potential for a market in securitized farm loans.

Third, a GSE may be set up to do a job that it cannot do. Although ostensibly created to help funds flow freely to a cash-starved endeavor, a GSE may really be operating to deliver funds to an activity that does not typically earn high enough returns to obtain funds in a truly competitive, efficient, and integrated market. The maximum subsidy a GSE can deliver is the value of its privileges. If its client firms need more than that, it cannot succeed in keeping them afloat. It has been suggested by some analysts that the Farm Credit System may fit this description.

2) **"You stated in your testimony that 'there is always an incentive for the [GSE] to expand its activities outside the charter,' and that '[s]ome supervision is required' to keep the institution within the bounds of its mission. Can you suggest supervisory controls which would prevent a GSE from engaging in, say, arbitrage, before public opinion or expressed disapproval of lawmakers causes the GSE to cease the overstepping activities?"**

All regulation must balance the possibility of two kinds of errors: permitting the institution to do what it should not, and preventing it from doing what it should. Generally, the more the regulator tries to avoid one kind of error, the more likely it makes the other. Greater efforts to preemptively define what amounts to straying from the GSE mission run some risk of hamstringing the GSE in fulfilling its mission.

Instead of changing the *way* in which a GSE is supervised, there is also the option of changing *who* supervises the GSE's fulfillment of its mission. If, for example, housing officials watch over the housing GSEs, their primary concern is to make sure that the housing mission is fulfilled, not whether other activities are avoided. These may be different things entirely; for if the GSEs' arbitrage activities in other fields have no adverse effect on their housing mission, then the supervisory agency may have no particular interest in stopping them. Conceivably, the degree of scrutiny over an expanding scope of GSE investments might be more intense with a different regulator. An independent agency dedicated specifically to GSE regulation would be one possibility. An alternative would be to vest regulatory responsibility in the regulatory entity that oversees the safety and soundness of those institutions that the GSEs would most likely compete with if they overstepped their charters. Other options undoubtedly exist.

3) **"You mentioned in your testimony *potential* need for a GSE to securitize small business loans. Can you explain this further, and point out any other areas that might benefit from the services a GSE can provide?"**

Mortgages are relatively similar to each other in design and maturity structure. Car loans and credit card debt are also relatively uniform. And with a few precautions, loans with standardized characteristics can be

purchased and sold without too much difficulty; they have always held the potential to be liquid assets. But the more dissimilar the various loans of a particular type are, the harder they are to trade in. Every potential buyer must examine the loan carefully and determine whether it has the features desired. This makes most business loans inherently illiquid.

Very large firms can obtain credit by issuing bonds. The rest depend on loans, mostly from banks. Some of the larger firms in this latter category have the option of accessing funds by issuing less-than-investment-grade (junk) bonds. Small firms have few alternatives to bank loans, making them especially vulnerable to credit squeezes. There has long been a hope that business loans could be packaged and resold, easing credit conditions for small firms. But despite various moves to make it easier, a secondary market in small business loans has never really taken off. On occasion, it has been suggested that a GSE could generate such a market. It is by no means clear that it would work.

As a general rule, GSEs have been created in situations in which a particular class of borrowing has been unable to tap into nationwide financial markets. In principle, any class of lending that cannot fully access national markets might be helped by the creation of a GSE. However, many of the barriers that kept depository institutions from reaching a national market have been eliminated. Financial markets are increasingly becoming integrated without the assistance of GSEs. It may now be much more difficult to make a case for a GSE than it was 30 or 50 years ago.

4) **"Please elaborate on the idea of creating competing GSEs to limit the monopoly tendencies of GSEs in their respective markets"**

Once a GSE has become successful in its purpose, its cost advantages serve to limit competition from any other firm without GSE privileges. If the GSE charter continues, and no compensating fees are imposed, the only way in which its monopolistic position can be remedied is to charter competing GSEs.

The problem with this approach is determining how many competitors should be permitted. In a competitive market, firm entry and exit are typically free. This could only be achieved by offering the charter privileges to all qualifying applicants. A limited number could be created; but it could not be known whether the number chosen would be enough. Based on available evidence from the performance of Fannie Mae and Freddie Mac, one competitor is not sufficient.

With many competing GSEs, the government would have to be prepared to permit some to fail. The exit of firms from an industry is as essential to the proper workings of a competitive market as the entry of firms. The possibility -- even inevitability -- of failing GSEs would require

modification of some of the privileges granted to GSEs (e.g., the use of GSE debt as collateral against government deposits).

In the housing area, there currently exists the possibility that the Federal Home Loan Banks may provide competition for Fannie Mae and Freddie Mac. If permitted to expand the scope of their activities, they may be able to provide the competitive pressure necessary to force the pass-through of the full value of GSE privileges to mortgage borrowers.

5) **"Is the major function of the Federal Home Loan Bank System to channel federal subsidies to its members, or to improve the functioning of capital markets? How well is the system performing either of these functions?"**

The contribution of the FHLBs in both these areas is fairly marginal. With respect to subsidies, the value of GSE privileges accrued by the system has been seriously undercut by the obligation to service the debt of REFCORP, a holdover financing mechanism of the S&L cleanup, and by the mandated Affordable Housing Program. What remains of the subsidy is unlikely to be captured by the members; the presence of Fannie Mae and Freddie Mac probably forces the member institutions to pass any remaining subsidy through to borrowers.

With respect to the working of capital markets, interstate banking and the secondary market in mortgages has undercut the need for the FHLBs. The Banks, however, provide options for members that would not exist otherwise, allowing member institutions to hold mortgages in portfolio without giving up the ability to tap funds from other than their depositors. This helps somewhat in providing liquidity and integrating markets

Economic analysis provides a rationale for intervention to improve financial markets. It cannot, however, be used to argue for a subsidy. The latter must be justified on other than economic grounds.

6) **"The National Cooperative Bank is an interesting alternative approach to providing federal credit subsidies in order to improve the functioning of credit markets. The Bank is a private, for-profit finance company that has narrow lending powers and received a long-term federal loan at a below-market rate. Once the loan is repaid, the Bank must stand on its own, so it is subject to market discipline and cannot expand indefinitely by borrowing at subsidized rates, as can a GSE. Do you have any views on when the government should use this approach rather than create a new GSE?"**

The NCB is not generally considered a GSE even though it was chartered by Congress and is limited by its charter to a specific area of

activity. The reason for not characterizing it as a GSE would appear to be that it is not an "instrumentality of the United States," status it lost three years after its establishment in 1978. Its general lack of privileges makes it more akin to Connie Lee before its final privatization. The loan to NCB from the Treasury consists of what was originally stock that was converted to subordinated debt when the charter was changed in 1981. Thus, the approach used with NCB occurred by indirection, starting as one thing and becoming something else. The NCB approach is not so much an alternative to *creating* a new GSE as it is an option available in dealing with an existing GSE.

Because of NCB's small size, it does not offer much in the way of insight into what to do with larger and older GSEs.

The experience with NCB is probably most revealing in what it says about the specific characteristics of the GSE charter that lead to the inference of a federal debt guarantee by financial market participants. There appears to be no such inference in the case of NCB. The characterization of a GSE as an instrumentality of the government -- specifically, the exemption from state income taxes and the treatment of its debt as equivalent to Treasury debt by the Federal Reserve and bank regulatory authorities -- seems crucial to the inference of a guarantee.

Ironically, the existence of NCB, with its relative lack of privileges may simply underscore the market's interpretation of the privileges received by GSEs, reinforcing the notion of a guarantee of them. That is to say, the greater efforts to distance NCB from the government serves to highlight the fact that the government has not made similar efforts with respect to Fannie Mae, Freddie Mac, FHLBs, Farm Credit System, and Farmer Mac. It is the perception of close government/GSE ties that leads to the inference of a guarantee.

Accountability of Government Sponsored Enterprises

Presented to a Joint Hearing of the

Subcommittee on Capital Markets, Securities and GSEs
Committee on Banking and Financial Services
U.S. House of Representatives

and the

Subcommittee on Government Management, Information and Technology
Committee on Government Reform and Oversight
U.S. House of Representatives

July 16, 1997

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Accountability of Government Sponsored Enterprises

Chairman Horn, Chairman Baker, and distinguished members of the subcommittees:

Thank you for the invitation to testify today on government sponsored enterprises (GSEs) and their accountability as instruments of public policy. My name is Thomas H. Stanton. I am a Washington, D.C. attorney who specializes in the design and administration of federal programs, especially with respect to credit and financial institutions. I am a Fellow of the National Academy of Public Administration and teach on the law of public institutions as a Fellow of the Center for the Study of American Government at Johns Hopkins University.

My publications on government sponsored enterprises include a book, A State of Risk (HarperCollins, 1991) and a number of articles. This testimony today represents my personal views and not those of any institution, client or university with which I am affiliated.

I. Introduction

This hearing is an important one. A number of existing government sponsored enterprises are so powerful as to make it difficult to address issues of their public accountability. That fact makes it especially important to step back from today's government sponsored enterprises and to consider the GSE as an institutional form. Then appropriate forms of accountability can be devised to apply to any future GSEs so that we try to avoid missteps of the past.

These issues are especially important in today's marketplace, where alternative forms of government credit support may be much more effective and potentially less risky than attempting to deliver subsidies through a government-sponsored enterprise.[1]

The government sponsored enterprise is an instrument of public policy. GSEs historically have achieved many beneficial results, including market innovations and provision of huge amounts of credit to selected constituencies such as farmers, homebuyers and students. GSE proponents point out that (except for some tax advantages) GSEs have achieved these benefits largely without drawing upon budgeted governmental funds.

The off-budget nature of the federal subsidy for GSEs makes this form of institution attractive to advocates who seek to fund other public purposes such as infrastructure or small business investment. Issues of accountability are important so that the public benefits of GSEs can be enhanced and the public costs can be kept within reasonable limits.

So that we agree about the nature of the institutions called GSEs, it is useful to start with a definition: The government sponsored enterprise (GSE) is a federally chartered privately owned institution that benefits from the perception that the government stands behind its financial obligations. This perception, known as an implicit government guarantee, permits a GSE to raise money at rates close to those of the U.S. Treasury. In return for statutory privileges, including tax benefits and regulatory exemptions as well as reduced borrowing costs, the GSE is confined by its charter to serving specified kinds of borrowers through a limited range of financial services.

Several of today's GSEs -- Fannie Mae, Freddie Mac, Sallie Mae and Farmer Mac -- are investor-owned; others -- the Federal Home Loan Bank System and Farm Credit System -- are owned cooperatively by their borrowers. Two institutions -- the Financing Corporation and Resolution Funding Corporation -- are governmental bodies that were given GSE attributes so that their funding would not appear to be federal borrowing for purposes of the federal budget.

This testimony presents three points for the subcommittees' consideration:

(1) Safety and soundness rules must be designed before rather than after a GSE gains political power.

As a technical matter, successes and failures of federal regulation of banks and other institutions with insured deposits have given us a good sense of the proper framework for supervision of safety and soundness.[2] Yet, many of the attributes of reasonable public supervision of financial soundness, such as an insistence upon prudent capital standards or the systematic review of business activities by federal examiners, may be unattractive to the private owners of a GSE.

(2) The public benefits of a GSE depend heavily upon the quality of ongoing public oversight.

Government sponsored enterprises receive substantial public benefits and are expected to pass on much of that benefit in service to the borrowers and markets specified in legislation. However, legislation is an imprecise tool, particularly in today's rapidly changing markets. Especially as their designated markets mature, GSEs may have an incentive to sell financial services that yield high returns, regardless of whether such services provide public benefits.

(3) GSE legislation should include (1) an exit strategy, and (2) full disclosure of expenditures to influence the political process.

Eventually markets and public priorities may evolve so that the legislative mandate of a GSE becomes irrelevant or even untenable. Many institutions with fixed legislative charters, such as thrift institutions in the 1980s and electric utilities today, help to

demonstrate this process. In today's flexible and technology-driven markets, such institutional obsolescence is likely to occur much more rapidly than ever before. Legislative thought to an exit strategy can help to avoid expensive institutional failures and thus reduce the possible public costs.

Finally, the GSE is a creature of law. Legislative proposals to restrict a GSE's powers or sunset a GSE's charter are likely to be met by a strong reaction from the affected GSE. The private owners of a GSE have a constitutional right to use the political process to protect and even expand their franchise. On the other hand, the public deserves full disclosure about actions of a government instrumentality to influence a possible contest between private shareholder interests and alternative views of the public interest.

All of these points revolve around a common theme: the GSE is an institutional form that embodies an unusual combination of public and private characteristics. A solid framework of accountability is essential to promote the public benefits and limit the potential public costs of such an institution. The following discussion includes consideration of the approach to accountability taken in a recent legislative proposal, the "Government Corporation and Government Sponsored Enterprise Standards Act,".[3]

II. Safety and soundness rules must be designed before rather than after a GSE gains political power.

The 1991 Report of the Secretary of the Treasury on Government-Sponsored Enterprises stresses that federal supervision of GSE safety and soundness is fraught with the danger of regulatory capture:

> "The problem of avoiding capture appears to be particularly acute in the case of regulation of GSEs. The principal GSEs are few in number; they have highly qualified staffs; they have strong support for their programs from special interest groups; and they have significant resources with which to influence political outcomes. A weak financial regulator would find GSE political power overwhelming and even the most powerful and respected government agencies would find regulating such entities a challenge."[4]

The controversy over the 1992 legislation to create today's Office of Federal Housing Enterprise Oversight (OFHEO) yields some important lessons about supervision of safety and soundness of future GSEs:

- One of the most important elements of financial soundness is that owners of a financial institution should have substantial money of their own at risk when making their business decisions. However, the imposition of meaningful capital requirements can threaten the ability of GSE shareholders to enjoy high

leverage and above-normal financial returns on their investments in GSE stock. Once a GSE is entrenched with high leverage, it is likely to object vehemently to increases in capital requirements, regardless of public policy considerations.

- The highly compensated and, in many cases, highly qualified officials of a GSE are unlikely to welcome supervision of their business by federal officials. They are likely to seek to limit the terms of any law that attempts to give discretion to a federal regulator. Thus, the law that establishes OFHEO, for example, circumscribes the agency's discretion to a much greater extent than the laws that govern the federal bank regulators. The law also creates incentives for the affected GSEs to prefer a protracted process before the regulator issues new capital standards.

The Government Corporation and Government Sponsored Enterprise Standards Act, S. 2095 (hereafter simply called the "Government Enterprise Standards Act"), addresses this issue in two ways. First, the bill would require any legislation creating a new GSE to contain provisions for effective federal oversight of safety and soundness. The Secretary of the Treasury, Comptroller General and Office of Management and Budget all would be required to comment upon those provisions.

Second, the bill would require that each new GSE should achieve and maintain a high investment grade rating, from two nationally recognized statistical rating agencies such as Fitch Investors Services or Standard & Poor's. This provision would be administered by the Secretary of the Treasury; costs would be reimbursed by each GSE.

While a high rating is no guarantee of financial soundness, this approach at least provides a redundant system to the regular examination of a GSE by its financial regulator. (The use of two rating agencies also provides useful redundancy at little cost). Experience indicates that some GSEs may not be happy about disclosing information to a federal regulator.[5] The problem of inadequate information disclosure could be expected to become more acute if an institution became financially troubled.

III. <u>The public benefits of a GSE depend heavily upon the quality of ongoing public oversight</u>.

Especially when owned by investor-shareholders, the GSE can be a tricky institutional form to direct for public purposes. The managers of investor-owned GSEs have a fiduciary responsibility to serve their companies and shareholders, and are often paid according to the profitability of their companies. Managers and owners of the investor-owned GSEs thus may have an incentive to serve only the most profitable parts of their charters, regardless of public value.

As Sallie Mae's then-Chief Executive Officer told a Senate oversight subcommittee some years ago:

> "We are a private corporation and as such, with stockholders and bondholders, we have a fiduciary responsibility to those individuals...We are not charged with subsidizing the guaranteed student loan program or subsidizing the students."[6]

More recently, the Congressional Budget Office (CBO) reported that Fannie Mae and Freddie Mac, today's largest GSEs, keep a significant portion of their public subsidies (worth about $ 6.5 billion to Fannie Mae and Freddie Mac in 1995) for shareholders rather than passing them on to homebuyers:

> "The popular perception of Fannie Mae and Freddie Mac as benefactors of home buyers for whom they reduce interest rates and increase home ownership deserves examination. In fact, the housing GSEs are principally a vehicle for delivering a federal subsidy rather than the source of that subsidy. Moreover, the estimates presented suggest that they are not an efficient delivery vehicle because they retain nearly $1 for every $2 they pass through."[7]

The CBO further points out that concern about the apparent imbalance between the costs and benefits of the housing GSEs extends beyond the $ 2 billion a year that they retain:

> "One further concern is that Fannie Mae and Freddie Mac rather than public officials substantially control the amount of subsidy provided to the GSEs."[8]

In other words, unless the Congress provides for ongoing oversight of public benefits, it risks creating new GSEs that evolve to serve private purposes that can crowd out the public benefits. The Government Enterprise Standards Act grapples with this issue but does not resolve it. Ultimately, the Congress will need to decide upon the public purposes served over the life cycle of each GSE; those issues are basically political rather than technical in nature and properly remain with elected officials.

The Government Enterprise Standards Act does suggest two tools to help. First, the bill requires that any statute establishing a new GSE should prescribe the public purposes of the GSE in sufficiently specific terms to enable the Congress to make an oversight determination of the accomplishment of such purposes. This would help to apply some of the logic of the Government Performance and Results Act (GPRA) to GSEs that, similar to government agencies, also are creatures of federal law.

Second, the bill requires ongoing independent review, both by the executive branch and by the U.S. General Accounting Office, to assure that new GSEs confine their activities

A Sallie Mae privatization report relates the desirability of a sunset provision to the life cycle of a GSE:

> "In creating the various GSEs, Congress did not contemplate the need at some point to unwind or terminate their federal charters. However, Congress did not assume the perpetual existence (and continual expansion) of individual GSEs in the context of changing social and economic priorities. The missing element in the GSE concept is the notion of a life cycle for government sponsorship. GSEs are created to increase the flow of funds to socially desirable activities. If successful, they grow and mature as the market develops. At some point, the private sector may be able to meet the funding needs of the particular market segment. If so, a sunset may be appropriate."[13]

The GSE life cycle is an important characteristic that derives from the peculiar legal framework of GSEs.[14] Especially in today's rapidly evolving markets, the language of a GSE charter can prevent a GSE from responding to new and unexpected competitive challenges. From the perspective of public purpose, the life cycle of a GSE means that new market developments may permit fully private firms, without government sponsorship, to serve many of the purposes that the GSE originally was chartered to serve.

The Government Enterprise Standards Act addresses the GSE life cycle in two ways. First, the bill would prescribe that each newly created GSE shall have succession for a period of 10 years, subject to review by the Congress and extensions for additional 10-year periods, unless otherwise prescribed by law. Regular review periods can permit systematic consideration of the state of each GSE and the public purposes that it originally was created to serve.

Second, The bill requires that, soon after a GSE is created, the appropriate Executive Branch agency shall prepare a strategic plan for the removal of government sponsorship. That plan should set standards and propose milestones for the GSE to accomplish its statutory mission and prepare for removal of government sponsorship.

Neither of these provisions provides complete assurance that removal of government sponsorship can be undertaken without political controversy. As the Congressional Budget Office recently noted in this regard:

> "Of course, such options [to prepare for removal of government sponsorship] beg a question: why would the GSEs agree to those policies as a first step toward the withdrawal of their subsidy? That admission simply acknowledges that once one agrees to share a canoe with a bear, it is hard to get him out without obtaining his agreement or getting wet. If the GSEs were to support privatization, they and the

to those that are authorized by law. Some GSEs have tried to push the limits of their charter acts, and this tendency can accelerate for GSEs that find that their charters constrain access to more profitable activities. So far, the government has failed to establish an effective reporting system with respect to GSEs that engage in activities beyond their statutory authority, despite the likelihood that these unauthorized activities may not serve public purposes intended by the Congress.[9]

Finally, it would be appropriate to bring the securities of new government sponsored enterprises within the jurisdiction of the Securities and Exchange Commission. Recently, some GSEs found that they could enhance their earnings by issuing exotic and sometimes unpredictable securities known as derivatives. While derivative securities can be useful tools for the experts who understand their use, they are dangerous in the hands of unsuitable investors.

Derivative securities offered unknowledgeable investors such as the treasurer of Orange County, California, the opportunity to hold securities with high credit quality (because of the government's implicit backing), high financial risk, and potentially high yields. The Federal Home Loan Banks, Fannie Mae, Freddie Mac, Sallie Mae and the Farm Credit System all have issued billions of dollars of so-called structured notes and other derivative securities. The charters of these GSEs exempt them from jurisdiction of the Securities and Exchange Commission. It would not be burdensome for the securities of GSEs to be subjected to SEC jurisdiction.[10]

IV. GSE legislation should include (1) an exit strategy, and (2) full disclosure of expenditures to influence the political process.

At some point, a GSE will have served the public purposes that lawmakers intended. The Treasury Department takes the following position:

> "The Treasury has for a number of years, in Democratic and Republican Administrations, believed that it is appropriate to wean a GSE from government sponsorship once the GSE becomes economically viable and successfully fulfills the purpose for which it was created with Federal sponsorship, or when the purpose for which it was created ceases to exist."[11]

Similarly, the Office of Management and Budget states:

> "GSEs should only be created with a clearly articulated 'exit strategy' and an express sunset date in their charter."[12]

Congress could certainly carry it out without financial disruption."[15]

Both of these provisions are intended to ease this problem by dealing with newly created GSEs whose power is not yet entrenched. They help to couple the concept of ultimate removal of GSE status with the act of creating a GSE.

Finally, the Government Enterprise Standards Act contains a provision for complete disclosure of activities of GSEs to influence the political process, either directly or indirectly. While disclosure cannot prevent application of substantial resources to affect political outcomes, they can help at least to inform the Congress and the public about the magnitude and nature of those resources.

V. Conclusion

The two subcommittees are to be commended for holding this hearing. GSEs can be a powerful tool of government. Yet proper accountability to the government that creates them is essential if we are to promote their public benefits while reducing the potential public costs from their activities. It is the purpose of this testimony to help highlight those issues and to suggest ways that they might be addressed.

ENDNOTES

1. With respect to infrastructure finance, see, Congressional Budget Office, "Alternative Organizational Forms," chapter IV of An Analysis of the Report of the Commission to Promote Investment in America's Infrastructure, February 1994, pp. 52-69. On the way that costs outweigh benefits of recent proposals to expand GSE lending in rural areas, see Economic Research Service and Office of Policy Planning, U.S. Department of Agriculture, "FCS and Commercial Bank Rural Credit Proposals," 1997, pp. 25-34.

2. See, e.g., S. 1621, the "Federal Enterprise Regulatory Act of 1991," drafted by the U.S. General Accounting Office at the request of members of the Senate Committee on Governmental Affairs and introduced on August 1, 1991. See also Thomas H. Stanton, "Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises," The Administrative Law Journal, Vol. 5, No. 2 (Summer 1991), pp. 395-484.

3. Senators Paul Simon and David Pryor introduced S. 2095 on September 19, 1996. The bill was referred to the Senate Committee on Governmental Affairs.

See also, Office of Management and Budget, "Government Sponsored Enterprises (GSE)," Appendix I to Memorandum on Government Corporations, M-96-05, published

December 8, 1995; and Alan Dean, Ronald C. Moe, Harold Seidman, and Thomas H. Stanton, "Government Sponsored Enterprises," distributed by the National Academy of Public Administration, January 1997.

4. U.S. Department of the Treasury, Report of the Secretary of the Treasury on Government-Sponsored Enterprises, (Washington, DC: Government Printing Office), April 1991, p. 8.

5. Thus, the Office of Federal Housing Enterprise Oversight recently reported that there have been "ongoing difficulties with the accuracy, completeness, and consistency of Freddie Mac's data deliveries to OFHEO...." Office of Federal Housing Enterprise Oversight, 1997 Report to Congress, p. 33. OFHEO did not report similar difficulties with Fannie Mae.

6. Edward A. Fox, then president and CEO of Sallie Mae, statement before the Subcommittee on Education, Arts and Humanities, Committee on Labor and Human Resources, United States Senate, Oversight of Student Loan Marketing Association (Sallie Mae), hearing, August 12, 1982, p. 135.

7. Congressional Budget Office, Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac, May 1996, p. xii. The study adds that GSEs may provide some benefits besides conveying a subsidy, but that such benefits are hard to value, especially because they are available from other, fully private firms that operate without government sponsorship.

8. Ibid., p. xiii.

9. Also, in appropriate litigation a court could hold that contracts by a GSE are invalid to the extent that they are not authorized by the GSE's charter act or other law.

10. Even before the Orange County debacle and other evidence of unsuitable use of derivative securities, the Department of the Treasury, Securities and Exchange Commission, and Board of Governors of the Federal Reserve System issued a joint report that stated:

> "The [three federal] Agencies support legislation removing the exemptions from the federal securities laws for equity and unsecured debt securities of Government-sponsored enterprises ("GSEs"), which would require GSEs to register such securities with the SEC."

Department of the Treasury, Securities and Exchange Commission, and Board of Governors of the Federal Reserve System, Joint Report on the Government Securities Market, January 1992, p. xvi.

11. Statement of Darcy Bradbury, Deputy Assistant Secretary of the Treasury for Federal Finance, before the Subcommittee on Postsecondary Education, Training and Lifelong Learning of the Committee on Economic and Educational Opportunities, and the

Subcommittee on National Economic Growth, Natural Resources and Regulatory Affairs of the Committee on Government Reform and Oversight, U.S. House of Representatives, May 3, 1995.

12. The memorandum continues:

"A GSE could be fully privatized when the:

1. Assigned functions themselves are no longer necessary or appropriate for Federal involvement.

2. Business conditions which prompted its creation have changed (i.e., the special privileges bestowed upon them are no longer necessary to perform the functions for which they were created), or

3. A GSE is no longer the most efficient way to achieve the public purpose."

Office of Management and Budget, "Government Sponsored Enterprises (GSE)," Appendix I to Memorandum on Government Corporations, M-96-05, published December 8, 1995, pp. 14-15.

13. Sallie Mae, The Restructuring of Sallie Mae: Rationale and Feasibility, March 1994, pp. 13-14 (emphasis in original).

14. This issue is explored in, Thomas H. Stanton, "Nonquantifiable Risks and Financial Institutions: The Mercantilist Legal Framework of Banks, Thrifts, and Government-Sponsored Enterprises," Chapter 3 in Charles A. Stone and Anne Zissu (Eds.), Global Risk-Based Capital Regulations, Volume I, pp. 57-97 (Homewood, IL: Irwin Professional Publishing), 1994.

15. Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac, p. 44.

II

104TH CONGRESS
2D SESSION

S. 2095

To promote the capacity and accountability of Government corporations and Government sponsored enterprises.

IN THE SENATE OF THE UNITED STATES

SEPTEMBER 19, 1996

Mr. SIMON (for himself and Mr. PRYOR) introduced the following bill; which was read twice and referred to the Committee on Governmental Affairs

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A BILL

To promote the capacity and accountability of Government corporations and Government sponsored enterprises.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the "Government Corpora-
5 tion and Government Sponsored Enterprise Standards
6 Act".

7 **SEC. 2. PURPOSES.**

8 The purposes of this Act are to—
9 (1) ensure that Government corporations and
10 Government sponsored enterprises—

1 (A) are established and conduct their oper-
2 ations in conformance with consistent standards
3 as to the applicability of Federal laws; and
4 (B) are fully accountable for their financial
5 soundness and programmatic activities; and
6 (2) provide an orderly process for privatizing
7 selected Government corporations.
8 **SEC. 3. DEFINITIONS.**
9 For the purposes of this Act the term—
10 (1) "Government corporation" means an agency
11 of the United States within the executive branch
12 that—
13 (A) is designated by law to have corporate
14 form;
15 (B) carries out business type operations to
16 provide goods or services in response to eco-
17 nomic demand; and
18 (C) produces revenues, potentially on a
19 self-sustaining basis;
20 (2) "Government sponsored enterprise" or
21 "GSE" means an instrumentality that—
22 (A) is chartered under the laws of the
23 United States to provide specialized financial
24 services in furtherance of public purposes;

1 (B) is owned wholly or in part by private
2 equity owners; and
3 (C) has a relationship to the Federal Gov-
4 ernment, such as authority to borrow directly or
5 indirectly from the Treasury of the United
6 States, that creates a public perception of im-
7 plicit Federal backing of its obligations or guar-
8 anteed securities;
9 (3) "newly established wholly owned Govern-
10 ment corporation" means a wholly owned Govern-
11 ment corporation which is established under a stat-
12 ute enacted after December 31, 1996;
13 (4) "newly established transitional Government
14 corporation" means a transitional Government cor-
15 poration which is established under a statute en-
16 acted after December 31, 1996;
17 (5) "newly established Government sponsored
18 enterprise" means a Government sponsored enter-
19 prise which is established under a statute enacted
20 after December 31, 1996;
21 (6) "transitional Government corporation"
22 means a Government corporation that is intended
23 to—
24 (A) operate on a profitmaking basis; and

(B) be converted to private ownership when feasible; and

(7) "wholly owned Government corporation"—

(A) means a Government corporation that is wholly owned or controlled by the Federal Government; and

(B) includes a transitional Government corporation except as otherwise provided by law.

TITLE I—CLASSIFICATIONS OF GOVERNMENT CORPORATIONS AND GSES

SEC. 101. CLASSIFICATION.

(a) IN GENERAL.—The Director of the Office of Management and Budget shall—

(1) maintain a list of all Government corporations and Government sponsored enterprises classified according to the definitions of this Act; and

(2) publish such list as a part of the annual budget of the United States Government.

(b) RECOMMENDATIONS.—The Director of the Office of Management and Budget shall make legislative recommendations to the Congress to ensure that this Act applies to entities established under statutes that are enacted or amended after December 31, 1996.

TITLE II—GENERAL PROVISIONS

SEC. 201. RESERVATION.

The Congress expressly reserves the right to alter, amend or repeal any law establishing or governing the activities of a Government corporation or Government sponsored enterprise.

SEC. 202. AFFILIATES.

Each newly established Government corporation or newly established Government sponsored enterprise may establish, acquire or control the activities of a subsidiary or other affiliate only by or under a law of the United States expressly authorizing the action.

SEC. 203. APPLICATION OF THIS ACT.

On and after the effective date of this Act no entity established under Federal law shall be a Government corporation or Government sponsored enterprise without conforming to the requirements and definitions of this Act.

TITLE III—WHOLLY OWNED GOVERNMENT CORPORATIONS

SEC. 301. APPLICABILITY.

This title applies only to newly established wholly owned Government corporations.

SEC. 302. GOVERNMENT CORPORATION CONTROL ACT.

Each wholly owned Government corporation shall be subject to the provisions of chapter 91 of title 31, United

1 States Code, that are applicable to wholly owned Govern-
2 ment corporations under that Act.

3 **SEC. 303. SUNSET.**

4 Except as specifically provided by law, each newly es-
5 tablished wholly owned Government corporation—

6 (1) shall terminate 10 years after the date on
7 which such corporation is established; and

8 (2) may be extended for additional 10-year peri-
9 ods by the Congress.

10 **SEC. 304. GENERAL POWERS.**

11 (a) IN GENERAL.—In order to accomplish its statu-
12 tory purposes and in addition to any other powers that
13 may be authorized by law, each wholly owned Government
14 corporation—

15 (1) may adopt, alter, and use a corporate seal,
16 which shall be judicially noticed;

17 (2) may sue and be sued in its corporate name
18 and be represented by its own attorneys in all ad-
19 ministrative and judicial proceedings, including, with
20 the prior approval of the Attorney General, appeals
21 from decisions of Federal courts;

22 (3) may indemnify directors, officers, attorneys,
23 agents, and employees of the corporation for liabil-
24 ities and expenses relating to corporate activities;

1 (4) may adopt, amend, and repeal bylaws, rules,
2 and regulations governing the manner in which its
3 business may be conducted and the powers granted
4 to it by law may be exercised and enjoyed;
5 (5) may determine the rates or prices of goods
6 or services that it provides, subject to applicable pro-
7 visions of law;
8 (6)(A) may acquire, purchase, lease, and hold
9 real and personal property including patents and
10 proprietary data, as it determines necessary in the
11 transaction of its business, and sell, lease, grant,
12 and dispose of such real and personal property, as
13 it determines necessary to effectuate the purposes of
14 this Act; and
15 (B) shall make purchases, contracts for the
16 construction, maintenance, or management and op-
17 eration of facilities and contracts for supplies or
18 services, except personal services, after advertising,
19 in such manner and at such times sufficiently in ad-
20 vance of opening bids, as the corporation shall deter-
21 mine to be adequate to ensure notice and an oppor-
22 tunity for competition, except that advertising shall
23 not be required when the corporation determines
24 that—

1 (i) the making of any such purchase or
2 contract without advertising is necessary in the
3 interest of furthering the purposes of this Act;
4 or
5 (ii) advertising is not reasonably prac-
6 ticable;
7 (7) with the consent of the agency or Govern-
8 ment concerned, may utilize or employ the services,
9 records, facilities or personnel of any State or local
10 Government agency or instrumentality, or voluntary
11 or uncompensated personnel to perform such func-
12 tions on its behalf as may appear desirable;
13 (8) may enter into and perform such contracts,
14 leases, cooperative agreements, or other transactions
15 as may be necessary in the conduct of its business
16 on a reimbursable basis, with any agency or instru-
17 mentality of the United States, or with any State,
18 territory, or possession, or with any political subdivi-
19 sion thereof, or with any person, firm, association,
20 or corporation;
21 (9) may determine the character of and the ne-
22 cessity for its obligations and expenditures and the
23 manner in which they shall be incurred, allowed, and
24 paid, subject to this Act and other provisions of law

1 specifically applicable to wholly owned Government
2 corporations;
3 (10) may retain and utilize its revenues for any
4 of the purposes of the corporation, including re-
5 search and development and capital investment, and
6 such revenues and funds of the corporation shall not
7 be subject to apportionment under the provisions of
8 subchapter II of chapter 15 of title 31, United
9 States Code;
10 (11) may settle and adjust claims held by the
11 corporation against other persons or parties and
12 claims by other persons or parties against the cor-
13 poration, except that for purposes of the Contract
14 Disputes Act of 1978, the corporation shall be
15 deemed to be the agency head with respect to con-
16 tract claims arising with respect to the corporation;
17 (12) may exercise, in the name of the United
18 States, the power of eminent domain for the further-
19 ance of the official purposes of the corporation;
20 (13) shall have the priority of the United States
21 with respect to the payment of debts out of bank-
22 rupt, insolvent, and decedents' estates;
23 (14) may define appropriate information as
24 Government commercial information and exempt
25 such information from mandatory release under sec-

1 tion 552(b)(3) of title 5, United States Code, when
2 the corporation determines that such information, if
3 publicly released, would harm the corporation's le-
4 gitimate commercial interests or those of a third
5 party;
6 (15) may obtain from the Administrator of
7 General Services such services as the Administrator
8 is authorized to provide to agencies of the United
9 States, on the same basis as those services are pro-
10 vided to other agencies of the United States;
11 (16) may accept gifts or donations of services,
12 or of property, real, personal, mixed, tangible or in-
13 tangible, in aid of any purposes of this Act;
14 (17) may execute, in accordance with its by-
15 laws, rules and regulations, all instruments nec-
16 essary and appropriate in the exercise of any of its
17 powers;
18 (18) may provide for liability insurance either
19 by contract or by self-insurance; and
20 (19) shall pay any settlement or judgment en-
21 tered against the corporation from the funds of the
22 corporation and not from funds made available pur-
23 suant to section 1304 of title 31, United States
24 Code.

1 (b) FEDERAL TORT CLAIMS.—Chapter 171 and sec-
2 tion 1346(b) of title 28, United States Code, shall not
3 apply to any claims arising from the activities of a wholly
4 owned Government corporation.

5 **SEC. 305. OFFICERS AND EMPLOYEES.**

6 Officers and employees of a wholly owned Govern-
7 ment corporation shall be officers and employees of the
8 United States. The corporation shall appoint and fix the
9 compensation of such officers and employees (including at-
10 torneys) and agents of the corporation as are determined
11 necessary to effect this Act, define their authority and du-
12 ties, and delegate to officers, employees, and agents such
13 of the powers vested in the corporation as the corporation
14 may decide, without regard to any administratively im-
15 posed limits on the number or grade of personnel, and any
16 such officer, employee, or agent shall be subject to the su-
17 pervision only of the corporation.

18 **SEC. 306. OBLIGATIONS AND GUARANTEES.**

19 The full faith and credit of the United States is
20 pledged to the payment of all obligations issued or guaran-
21 teed by each wholly owned Government corporation.

1 **SEC. 307. CONTRIBUTIONS TO RETIREMENT AND**
2 **DISABILITY AND EMPLOYEES' COMPENSA-**
3 **TION FUNDS.**

4 (a) RETIREMENT CONTRIBUTIONS.—Each wholly
5 owned corporation shall contribute to the Civil Service Re-
6 tirement and Disability Fund established under section
7 8348 of title 5, United States Code, or other applicable
8 Federal retirement fund, on the basis of annual billings
9 as determined by the Office of Personnel Management, for
10 the Government contribution to the Federal retirement
11 system applicable to the corporation's employees and their
12 beneficiaries.

13 (b) COMPENSATION CONTRIBUTIONS.—Each wholly
14 owned corporation shall contribute to the Employees'
15 Compensation Fund established under section 8147 of
16 title 5, United States Code, on the basis of annual billings
17 as determined by the Secretary of Labor, for the benefit
18 payments made from such Fund on account of the cor-
19 poration's employees.

20 (c) ADMINISTRATIVE COSTS.—The annual billings
21 under subsections (a) and (b) shall include a statement
22 of the fair portion of the cost of administration of the re-
23 spective funds, which shall be paid into the Treasury as
24 miscellaneous receipts.

1 **SEC. 308. FINANCIAL STATEMENTS.**

2 Except as otherwise provided by law, each wholly
3 owned Government corporation shall—

4 (1) maintain a system of accounts and publish
5 its financial statements annually on the basis of gen-
6 erally accepted accounting principles; and

7 (2) be subject to audit on the basis of auditing
8 standards that are consistent with the private sec-
9 tor's generally accepted commercial auditing stand-
10 ards.

11 **SEC. 309. NEW ACTIVITIES.**

12 No wholly owned Government corporation shall en-
13 gage in new types of business activities before such activi-
14 ties are included in the annual budget program that is
15 approved by the Congress.

16 **SEC. 310. REVENUES FOREGONE.**

17 There are authorized to be appropriated to each whol-
18 ly owned Government corporation each year such sums as
19 are determined by the corporation to be equal to revenues
20 foregone by the corporation as a result of the operation
21 of laws that direct the corporation, for reasons of national
22 policy to provide goods or services at prices or rates below
23 a reasonable estimate of the cost of production.

24 **SEC. 311. BUDGET LIMITATIONS.**

25 The funds, accounts, receipts and outlays of wholly
26 owned Government corporations are exempt from any gen-

1 eral budget limitation imposed by statute upon expendi-
2 tures and net lending (budget outlays) of the United
3 States, sequestration order or discretionary spending
4 limit, including application of the Balanced Budget and
5 Emergency Deficit Control Act of 1985 or similar laws.

6 **SEC. 312. PAYMENTS IN LIEU OF TAXES.**

7 (a) EXEMPTION.—Wholly owned Government cor-
8 porations, including their franchises, property and income,
9 shall be exempt from all taxation imposed in any manner
10 or form by any State, county, municipality or local taxing
11 authority, or any subdivision thereof, except—

12 (1) as otherwise provided by law; and

13 (2) each such corporation shall make payments
14 to State and local governments in lieu of property
15 taxes upon real property of the corporation.

16 (b) PAYMENTS.—The corporation shall make pay-
17 ments described under subsection (a)(2) in the amounts,
18 at the times and upon the terms that the corporation de-
19 termines appropriate, and the corporation's determination
20 in these matters shall be final.

21 TITLE IV—TRANSITIONAL 22 GOVERNMENT CORPORATIONS

23 **SEC. 401. APPLICABILITY.**

24 This title applies only to newly established transi-
25 tional Government corporations.

1 **SEC. 402. SUNSET.**

2 Each transitional Government corporation shall have
3 succession for a period of 5 years from the date of enact-
4 ment of the statute establishing such corporation, unless
5 otherwise provided by law.

6 **SEC. 403. PRIVATIZATION PLANNING.**

7 (a) STRATEGIC PLAN.—No later than 4 years after
8 the date of enactment of the statute establishing such cor-
9 poration, and no later than 4 years after the date of any
10 extension of the statute establishing such corporation,
11 each transitional Government corporation shall prepare a
12 strategic plan for privatizing the corporation and submit
13 such plan to the President and Congress. The plan shall
14 provide that proceeds from the return of capital to the
15 United States shall be deposited in the general fund of
16 the Treasury.

17 (b) CONSIDERATION OF ALTERNATIVE MEANS OF
18 TRANSFERRING OWNERSHIP.—The plan shall include con-
19 sideration of alternative forms of privatization, including
20 consideration of the relative benefits and costs of complete
21 or partial sale of corporate assets or of the going concern
22 in 1 or more units to 1 or more privately owned entities
23 established under the laws of a State or of the District
24 of Columbia.

1 (c) CONSIDERATION OF FACTORS.—The plan shall
2 include consideration of relevant factors including assess-
3 ment whether privatization will—
4 (1) result in a return to the United States at
5 least equal to the net present value of the corpora-
6 tion;
7 (2) not result in ownership, control or domina-
8 tion of the assets or of the acquiring entity or enti-
9 ties, as the case may be, by an alien, a foreign cor-
10 poration, or a foreign government;
11 (3) not be inimical to the health and safety of
12 the public or the common defense and security; and
13 (4) contribute to the competitive structure of
14 the relevant market.
15 (d) EVALUATION AND RECOMMENDATION.—The plan
16 shall evaluate the relative merits of the alternatives consid-
17 ered and the estimated return on the Government's invest-
18 ment in the corporation achievable through each alter-
19 native. The plan shall include the corporation's rec-
20 ommendation on the preferred means of privatization.
21 (e) GAO EVALUATION.—No later than 60 days after
22 the submission of the plan to the Congress, the Comptrol-
23 ler General shall submit a report to Congress evaluating
24 the extent to which—

1 (1) the privatization plan would result in any
2 ongoing obligation or undue cost to the Federal Gov-
3 ernment; and
4 (2) the revenues gained by the Federal Govern-
5 ment under the privatization plan would represent at
6 least the net present value of the corporation.

7 TITLE V—GOVERNMENT 8 SPONSORED ENTERPRISES

9 **SEC. 501. APPLICABILITY.**

10 This title applies only to newly established Govern-
11 ment sponsored enterprises.

12 **SEC. 502. SUNSET.**

13 Each Government sponsored enterprise shall have
14 succession for a period of 10 years, subject to review by
15 the Congress and extension for additional periods of 10
16 years, unless otherwise provided by law. The Secretary of
17 the Treasury shall consider the applicable sunset period
18 in determining the maturities of obligations that each Gov-
19 ernment sponsored enterprise may issue. The Secretary of
20 the Treasury shall issue any regulations that the Secretary
21 determines to be appropriate for the implementation of
22 this title.

23 **SEC. 503. FINANCIAL SAFETY AND SOUNDNESS.**

24 (a) REQUIRED PROVISIONS.—The statute establish-
25 ing any Government sponsored enterprise shall address is-

1 sues of financial safety and soundness by including re-
2 quirements that provide for—
3 (1) effective Federal supervision of financial
4 safety and soundness;
5 (2) adequate capital for the GSE; and
6 (3) the GSE to achieve and maintain a high in-
7 vestment grade rating, as prescribed in subsection
8 (b), throughout the existence of the GSE.
9 (b) RATING.—
10 (1) IN GENERAL.—Not later than 1 year after
11 the effective date of the statute establishing each
12 new GSE subject to this Act, the Secretary of the
13 Treasury shall, for each such GSE, contract with 2
14 nationally recognized statistical rating organizations
15 to—
16 (A) assess the likelihood that the GSE will
17 not be able to meet its obligations from its own
18 resources with an assumption that there is no
19 recourse to any implicit Government guarantee
20 and to express that likelihood as a traditional
21 credit rating; and
22 (B) review the rating of the GSE as fre-
23 quently as the Secretary determines is appro-
24 priate, but not less than annually.

1 (2) REIMBURSEMENT.—A Government spon-
2 sored enterprise shall reimburse the Secretary of the
3 Treasury for the full cost of activities under this
4 title, as determined by the Secretary of the
5 Treasury. Such reimbursement shall be credited to
6 the account of the Secretary of the Treasury.
7 (3) COMMENTS.—The Secretary of the Treas-
8 ury shall—
9 (A) submit comments to the Congress on
10 any difference between the evaluation of the
11 rating organizations and that of the Secretary,
12 with special attention to capital adequacy; and
13 (B) report on any actions the Secretary de-
14 termines appropriate to ensure that each GSE
15 continuously maintains a high investment grade
16 rating.
17 (4) REQUIREMENT.—Each such GSE shall
18 achieve and maintain throughout the existence of the
19 GSE 1 of the 2 highest investment grade ratings
20 awarded by each statistical rating organization de-
21 scribed in paragraph (5). The Secretary of the
22 Treasury may waive the requirements of this para-
23 graph by published order on such terms and condi-
24 tions and for such periods of times as the Secretary
25 determines appropriate.

1 (5) DEFINITION.—For the purposes of this sec-
2 tion, the term "nationally recognized statistical rat-
3 ing organization" means—
4 (A) any entity effectively recognized by the
5 Division of Market Regulation of the Securities
6 and Exchange Commission as a nationally rec-
7 ognized statistical rating organization for the
8 purposes of the capital rules for broker-dealers;
9 or
10 (B) an entity similar to an entity described
11 under subparagraph (A), which is designated by
12 the Secretary of the Treasury.
13 (c) REPORTS.—The Comptroller General of the Unit-
14 ed States and the Office of Management and Budget each
15 shall report to the Congress upon the adequacy of provi-
16 sions for effective Federal supervision of safety and sound-
17 ness, including the adequacy of capital standards, con-
18 tained in any bill to create a Government sponsored enter-
19 prise. Each report shall also recommend provisions to be
20 included in such bill to assure compliance with subsection
21 (b).
22 **SEC. 504. PUBLIC PURPOSES.**
23 (a) REQUIRED PROVISIONS.—The statute establish-
24 ing any Government sponsored enterprise shall prescribe
25 the public purposes of the Government sponsored enter-

1 prise in sufficiently specific terms to enable the Congress
2 to make an oversight determination of the accomplishment
3 of such purposes.

4 (b) PLAN FOR REMOVAL OF GOVERNMENT SPONSOR-
5 SHIP.—

6 (1) IN GENERAL.—No later than 1 year after
7 the enactment of the statute establishing a Govern-
8 ment sponsored enterprise, and no later than 1 year
9 after the date of any extension of the statute estab-
10 lishing such Government sponsored enterprise, the
11 Federal agency responsible for supervision of the
12 Government sponsored enterprise, or the Secretary
13 of the Treasury with respect to Government spon-
14 sored enterprises that are not subject to supervision
15 by such a Federal agency, shall—

16 (A) prepare a strategic plan for the re-
17 moval of Government sponsorship from the
18 Government sponsored enterprise; and

19 (B) submit such plan to the President and
20 the Congress.

21 (2) CONTENT OF PLAN.—The strategic plan
22 shall set standards and propose milestones for the
23 Government sponsored enterprise to accomplish its
24 statutory mission and for the removal of Govern-
25 ment sponsorship.

1 (3) REVISION OF PLAN.—The Federal agency
2 or the Secretary of the Treasury, as the case may
3 be, shall update and revise a strategic plan at least
4 every 3 years.
5 (4) GSE VIEWS.—To the extent that the Gov-
6 ernment sponsored enterprise holds views different
7 from those of the Federal agency or the Secretary,
8 the Government sponsored enterprise shall—
9 (A) prepare a strategic plan for the re-
10 moval of Government sponsorship from the
11 Government sponsored enterprise; and
12 (B) submit such plan to the President and
13 the Congress.
14 (c) ULTRA VIRES ACTS OF A GOVERNMENT SPON-
15 SORED ENTERPRISE.—The programs, activities, and
16 transactions of each Government sponsored enterprise
17 shall be subject to review by the Federal agency respon-
18 sible for supervision of the financial safety and soundness
19 of the Government sponsored enterprise, or by the Sec-
20 retary of the Treasury with respect to Government spon-
21 sored enterprises that are not subject to financial super-
22 vision by such a Federal agency. The Federal agency or
23 the Secretary of the Treasury, as the case may be, shall
24 report at least annually to the President and the Congress
25 on any transactions or undertakings which the agency or

1 Secretary determines were carried out or made without
2 authority of law. Such acts shall be null and void except
3 to the extent that the Congress enacts legislation to au-
4 thorize any such act.

5 **SEC. 505. ANNUAL REPORT ON IMPACT OF BORROWING BY**
6 **GOVERNMENT SPONSORED ENTERPRISES ON**
7 **PUBLIC DEBT.**

8 (a) GENERAL REQUIREMENT.—The Secretary of the
9 Treasury shall annually prepare and submit to the Con-
10 gress a report assessing the financial safety and soundness
11 of the activities of all Government sponsored enterprises
12 and the impact of the operations of such corporations on
13 Federal borrowing.

14 (b) ACCESS TO RELEVANT INFORMATION.—

15 (1) INFORMATION FROM GSES.—Each Govern-
16 ment sponsored enterprise shall—

17 (A) provide full and prompt access to the
18 Secretary to its books and records; and

19 (B) promptly provide any other informa-
20 tion requested by the Secretary.

21 (2) INFORMATION FROM SUPERVISORY AGEN-
22 CIES.—In conducting the studies under this section,
23 the Secretary of the Treasury may request informa-
24 tion from, or the assistance of, any Federal depart-

1 ment or agency authorized by law to supervise the
2 activities of any Government sponsored enterprise.
3 (3) CONFIDENTIALITY OF INFORMATION.—
4 (A) IN GENERAL.—The Secretary of the
5 Treasury shall determine and maintain the con-
6 fidentiality of any book, record, or information
7 made available under this subsection in a man-
8 ner that the Secretary determines appropriate
9 for the material submitted by the Government
10 sponsored enterprise involved.
11 (B) EXEMPTION FROM PUBLIC DISCLO-
12 SURE REQUIREMENTS.—The Department of the
13 Treasury shall be exempt from section 552 of
14 title 5, United States Code, with respect to any
15 book, record, or information made available
16 under this subsection and determined by the
17 Secretary to be confidential under subpara-
18 graph (A).
19 (C) PENALTY FOR UNAUTHORIZED DIS-
20 CLOSURE.—Any officer or employee of the De-
21 partment of the Treasury shall be subject to the
22 penalties set forth in section 1906 of title 18,
23 United States Code, if—
24 (i) within the scope of employment,
25 such officer or employee has possession of

1 or access to any book, record, or informa-
2 tion made available under this subsection
3 and determined by the Secretary to be con-
4 fidential under subparagraph (A); and
5 (ii) such officer or employee discloses
6 the material in any manner other than—
7 (I) to an officer or employee of
8 the Department of the Treasury; or
9 (II) pursuant to the exception
10 under section 1906 of title 18, United
11 States Code.
12 (c) ASSESSMENT OF RISK.—
13 (1) IN GENERAL.—In assessing the financial
14 safety and soundness of the activities of Government
15 sponsored enterprises, and the impact of the activi-
16 ties of such enterprises on Federal borrowing, the
17 Secretary of the Treasury shall quantify the risks
18 associated with each Government sponsored enter-
19 prise. In quantifying such risks, the Secretary shall
20 determine—
21 (A) the volume and type of securities out-
22 standing which are issued or guaranteed by
23 each Government sponsored enterprise;
24 (B) the capitalization of each Government
25 sponsored enterprise; and

1 (C) the degree of risk involved in the oper-
2 ations of each Government sponsored enterprise
3 due to factors such as credit risk, interest rate
4 risk, management and operations risk, and
5 business risk.
6 (2) PUBLICLY AVAILABLE INFORMATION.—The
7 Secretary shall also report on the quality and timeli-
8 ness of information available to the public and the
9 Federal Government concerning the extent and na-
10 ture of the activities of Government sponsored enter-
11 prises and the financial risk associated with such
12 activities.
13 (d) ASSESSMENT OF IMPACT.—In assessing the im-
14 pact on Federal borrowing, the Secretary shall report
15 upon the impact of the issuance or guarantee of securities
16 by Government sponsored enterprises on—
17 (1) the rate of interest and amount of discount
18 offered on obligations issued by the Secretary each
19 year; and
20 (2) the marketability of such obligations.
21 (e) DATE FOR SUBMISSION OF REPORT.—The report
22 required by subsection (a) shall be submitted to the Con-
23 gress no later than January 1 of the first calendar year
24 beginning after the date of the enactment of this section,
25 and no later than each January 1 thereafter.

1 **SEC. 506. AUDITS.**

2 (a) IN GENERAL.—Each Government sponsored en-
3 terprise shall have an annual independent audit made of
4 its financial statements by an independent public account-
5 ant in accordance with generally accepted auditing stand-
6 ards. In conducting an audit under this subsection, the
7 independent public accountant shall determine and report
8 on—

9 (1) whether the financial statements of the Gov-
10 ernment sponsored enterprise are presented fairly in
11 accordance with generally accepted accounting prin-
12 ciples; and

13 (2) each transaction or undertaking which the
14 auditor believes was carried out or made without au-
15 thority of law.

16 (b) AUDIT BY COMPTROLLER GENERAL.—

17 (1) IN GENERAL.—The programs, activities, re-
18 ceipts, expenditures, and financial transactions of
19 each Government sponsored enterprise shall be sub-
20 ject to audit by the Comptroller General of the Unit-
21 ed States under such rules and regulations as may
22 be prescribed by the Comptroller General. The rep-
23 resentatives of the General Accounting Office shall—

24 (A) have access to such books, accounts, fi-
25 nancial records, reports, files, and such other
26 papers, things, or property belonging to or in

1 use by the GSE and necessary to facilitate the
2 audit; and
3 (B) be afforded full facilities for verifying
4 transactions with the balances or securities held
5 by depositories, fiscal agents, and custodians.
6 (2) REPORT TO CONGRESS.—A report on each
7 such audit shall be submitted by the Comptroller
8 General to the Congress. The GSE shall reimburse
9 the General Accounting Office for the full cost of
10 any such audit as billed therefor by the Comptroller
11 General.
12 (3) ACCESS TO INFORMATION.—To carry out
13 this subsection, the representatives of the General
14 Accounting Office shall have access, upon request to
15 the GSE or any auditor for an audit of the GSE
16 under subsection (a), to any books, accounts, finan-
17 cial records, reports, flies, or other papers, things, or
18 property belonging to or in use by the GSE and
19 used in any such audit and to any papers, records,
20 files, and reports of the auditor used in such an
21 audit.
22 (4) PROGRAM AUDITS.—At least every 3 years
23 the Comptroller General shall conduct program au-
24 dits of each Government sponsored enterprise under
25 this section. Each audit and report by the Comptrol-

1 ler General shall include specifically each transaction
2 or undertaking which the Comptroller General be-
3 lieves was carried out or made without authority of
4 law.

5 **SEC. 507. SHAREHOLDER RIGHTS.**

6 To the extent consistent with Federal law, sharehold-
7 ers in an investor-owned Government sponsored enterprise
8 shall have the rights relative to the GSE and its manage-
9 ment that are accorded to shareholders under the Busi-
10 ness Corporation Act of the District of Columbia.

11 **SEC. 508. JURISDICTION.**

12 All securities issued or guaranteed by a Government
13 sponsored enterprise shall be subject to the laws adminis-
14 tered by the Securities and Exchange Commission.

15 **SEC. 509. EQUITY SECURITIES.**

16 No equity securities issued by a Government spon-
17 sored enterprise shall be lawful investments for—

18 (1) any institution with deposits or other liabil-
19 ities insured or otherwise guaranteed by an agency
20 of the Federal Government; or

21 (2) any Government Sponsored Enterprise
22 other than the Government sponsored enterprise
23 that issues the equity securities.

1 **SEC. 510. FEDERAL INVESTMENTS.**

2 No securities issued or guaranteed by a Government
3 sponsored enterprise shall be lawful investments or accept-
4 ed as security for any fiduciary, trust, and public funds,
5 the investment or deposit of which shall be under the au-
6 thority and control of the United States or any officer or
7 officer thereof.

8 **SEC. 511. TAXATION.**

9 Each Government sponsored enterprise, including its
10 activities, holdings and income, and income from securities
11 issued or guaranteed by a Government sponsored enter-
12 prise, shall be subject to all taxation imposed by Federal,
13 State, and local governments and taxing authorities to the
14 same extent as other business organizations, and income
15 from their securities, are taxed.

16 **SEC. 512. REPORT TO THE CONGRESS.**

17 A Government sponsored enterprise shall submit an
18 annual report to the Congress including—

19 (1) a list including the name and address of
20 each contractor, consultant, agent, or employee paid
21 by the Government sponsored enterprise to engage
22 in—

23 (A) grassroots organizing or campaigning;

24 (B) public relations, media consulting, or
25 image advertising; or

1 (C) lobbying, including the direct and indi-
2 rect lobbying of the Congress;
3 (2) an itemization of all costs associated with
4 activities described in paragraph (1) whether in-
5 curred by the Government sponsored enterprise or
6 by any of its contractors, consultants, agents, or em-
7 ployee listed under such paragraph, including enter-
8 tainment expenses, travel expenses, advertising
9 costs, salaries, billing rates and the total amount
10 billed for services;
11 (3) a description of any lobbying of the Con-
12 gress or the executive branch by employees, board
13 members, or officers of the Government sponsored
14 enterprise;
15 (4) a description of any effort by the Govern-
16 ment sponsored enterprise or its agents to encourage
17 others to lobby the Congress or the executive
18 branch;
19 (5) a list of all charitable donations paid by the
20 Government sponsored enterprise on behalf of Mem-
21 bers of Congress or members of the executive
22 branch;
23 (6) a list of the salaries and other compensation
24 (including the present value of stock options) and

1 benefits paid to the officers and board members of
2 the Government sponsored enterprise; and
3 (7) a list of all Government sponsored enter-
4 prise employees who have been employed by either
5 the Congress or the Federal Government in the 5
6 years preceding the report, and such employees' sal-
7 ary prior to being employed by the Government
8 sponsored enterprise and the salary of each such
9 employee.

10 TITLE VI—GOVERNMENT 11 CORPORATION CONTROL ACT

12 **SEC. 601. DEFINITIONS.**

13 (a) GOVERNMENT CORPORATION.—Section 9101(1)
14 of title 31, United States Code, is amended to read as
15 follows:
16 "(1) 'Government corporation' means a wholly
17 owned Government corporation and a Government
18 sponsored enterprise.".
19 (b) GOVERNMENT SPONSORED ENTERPRISE.—Sec-
20 tion 9101(2) of title 31, United States Code, is amended
21 to read as follows:
22 "(2) 'Government sponsored enterprise' means
23 the Federal Home Loan Banks, the Farm Credit
24 Banks, the Banks for Cooperatives of the Farm
25 Credit System, and such other Government spon-

1 sored enterprises as the Secretary of the Treasury
2 may designate from time to time.".
3 (c) WHOLLY OWNED GOVERNMENT CORPORA-
4 TION.—Section 9101(3) of title 31, United States Code,
5 is amended by adding at the end:
6 "(O) The National Railroad Passenger
7 Corporation.
8 "(P) The Federal Deposit Insurance
9 Corporation.
10 "(Q) The National Credit Union Adminis-
11 tration Central Liquidity Facility.
12 "(R) The Rural Telephone Bank.
13 "(S) The Resolution Trust Corporation.".
14 **SEC. 602. AUDITS.**
15 Section 9105 of title 31, United States Code, is
16 amended to read as follows:
17 **"§ 9105. Audits**
18 "(a) The programs, activities, receipts, expenditures
19 and financial transactions of each wholly owned Govern-
20 ment corporation shall be audited annually by the Comp-
21 troller General of the United States under such rules and
22 regulations as may be prescribed by the Comptroller Gen-
23 eral. The representatives of the General Accounting Office
24 shall have access to such books, accounts, financial
25 records, reports, files and such other papers, things, or

1 property belonging to or in use by the corporation and
2 necessary to facilitate the audit, and they shall be afforded
3 full facilities for verifying transactions with the balances
4 or securities held by depositories, fiscal agents, and
5 custodians. The representatives of the General Accounting
6 Office shall have access, upon request to the corporation
7 or any auditor for an audit of the corporation under this
8 section, to any books, financial records, reports, files or
9 other papers, things, or property belonging to or in use
10 by the corporation and used in any such audit and to pa-
11 pers, records, files, and reports of the auditor used in such
12 an audit. In conducting such audit, the Comptroller Gen-
13 eral may make a contract, without regard to section 3709
14 of the Revised Statutes (41 U.S.C. 5), for professional
15 services with a firm or organization for a temporary period
16 or special purpose.

17 "(b) The Comptroller General of the United States
18 shall make a report to the Congress on each audit con-
19 ducted under this section. The report to the Congress shall
20 contain such comments and information as the Comptrol-
21 ler General determines necessary to inform the Congress
22 of the financial operations and condition of the corpora-
23 tion, together with such recommendations as the Comp-
24 troller General determines advisable. The report shall also
25 show specifically any program, expenditure, or other fi-

1 nancial transaction or undertaking, observed, or reviewed
2 in the course of the audit which, in the opinion of the
3 Comptroller General, has been carried out or made with-
4 out authority of law. A copy of each such report shall be
5 furnished to the President, the Secretary of the Treasury,
6 and to the corporation at the time submitted to the Con-
7 gress.

8 "(c) A Government corporation shall reimburse the
9 Comptroller General of the United States for the cost of
10 the audit as determined by the Comptroller General. Such
11 reimbursement shall be credited to the account of the
12 Comptroller General. An audit under this section is in
13 place of an audit of the financial transactions of a Govern-
14 ment corporation the Comptroller General is required to
15 make in reporting to the Congress or the President under
16 another law.".

17 **SEC. 603. FORMER MIXED-OWNERSHIP GOVERNMENT COR-**
18 **PORATIONS.**

19 Sections 9103–9105 of title 31, United States Code,
20 shall not apply to wholly owned government corporations
21 that formerly were designated mixed-ownership corpora-
22 tions under the Government Corporation Control Act, ex-
23 cept as otherwise provided by law.

SEC. 604. ACCOUNTS AND OBLIGATIONS.

(a) ACCOUNTS.—Section 9107(c) of title 31, United States Code, is amended—

(1) in paragraph (2) by striking "mixed-ownership Government corporation" and inserting "Government sponsored enterprise"; and

(2) in paragraph (3) by striking "Federal Intermediate Credit Banks, the Central Banks for Cooperatives, the Regional Banks for Cooperatives, or the Federal Land Banks" and inserting "Government sponsored enterprises".

(b) OBLIGATIONS.—Section 9108(d)(1) of title 31, United States Code, is amended by striking "mixed-ownership Government corporation" and inserting "Government sponsored enterprise".

TITLE VII—SEPARABILITY

SEC. 701. SEPARABILITY.

If any provision of this Act or the application thereof to any person or circumstances is held invalid, the remainder of this Act, and the application of such provision to other persons or circumstances shall not be affected thereby.

Government-Sponsored Enterprises

Principal Authors

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This is one of 12 issue papers on "Making Reform Work", authored by Fellows of the National Academy of Public Administration and growing out of discussions in several standing panels of the Academy.

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Government-Sponsored Enterprises

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GOVERNMENT-SPONSORED ENTERPRISES

by Alan Dean, Ronald Moe, Harold Seidman, and Thomas Stanton

CHALLENGE

To increase the benefits and reduce the costs and financial risks to taxpayers of using newly created government-sponsored enterprises as instruments of federal policy

The GSE as a Tool of Government

The government-sponsored enterprise (GSE), as distinct from the wholly owned government corporation, is a federally chartered privately owned institution that benefits from the perception that the government stands behind its financial obligations. Although GSEs do not benefit from an explicit federal guarantee, the law creates a so-called implicit guarantee by providing that obligations of a GSE shall have many of the financial attributes of U.S. Treasury obligations. The perception of federal backing permits GSES to raise money in the financial markets at rates close to those of the U.S. Treasury. In return for statutory privileges, including tax benefits and regulatory exemptions as well as reduced borrowing costs, the GSE is confined by its charter to serving specified kinds of borrowers through a limited range of financial services.

Because a number of GSEs have been effective means for carrying out public purposes, there often arise proposals to create new ones. GSEs have achieved many beneficial results, including market innovations and provision of huge amounts of credit to selected constituencies such as farmers, homebuyers, and students. Proponents point out that (except for some tax advantages) GSEs have achieved these benefits largely without drawing upon budgeted government funds. The GSE model has seemed especially attractive in recent years because of the off-budget nature of the federal subsidy for GSEs.

Some recent proposals, such as those to create new GSEs for infrastructure or small business investment, have failed to take account of the limited circumstances in which GSEs are appropriate. In particular, GSEs need to be financially profitable; this means that they are most appropriate in helping to overcome imperfections in the financial markets, rather than serving as a source of credit to borrowers who may not be able to repay their loans in full.

Several of the GSEs -- Fannie Mae, Freddie Mac, Sallie Mae and Farmer Mac -- are structured to be investor-owned; others -- the Federal Home Loan Bank System and Farm Credit System -- are owned cooperatively by their borrowers. Two institutions -- the Financing Corporation and Resolution Funding Corporation -- are governmental bodies that were given GSE attributes so that their funding would not appear to be federal borrowing for purposes of the federal budget.

Because of the implicit federal backing, GSEs have become some of the largest financial institutions in the United States. Fannie Mae and Freddie Mac together fund close to $1.5 trillion of home mortgages, either in their portfolios or through mortgage-backed securities;

the Federal Home Loan Bank System holds over $250 billion of loans to member financial institutions and investment assets; the Farm Credit System holds over $70 billion in assets and Sallie Mae almost $50 billion. Implicit federal backing also enables GSEs to grow rapidly; on average the combined size of the GSEs has more than doubled every five years since Fannie Mae was made a GSE in 1968.

The Issue of GSE Incentives

The disadvantages of GSEs as tools of government relate to the incentives that are inherent in the GSE structure and the lack of accountability of GSEs to the government and taxpayers that create and subsidize them. Consider incentives and accountability.

The major subsidy to a GSE derives from its favorable borrowing costs. This creates perverse incentives insofar as its value to GSE owners increases as a GSE takes financial risks. This means that shareholders in an enterprise benefit from reducing their own equity contribution compared to the volume of GSE business that is backed by the implicit government guarantee. The government has the opposite financial interest because shareholder capital helps to absorb financial losses before holders of GSE obligations call upon the government to honor its implicit guarantee; as with federal deposit insurance, shareholder capital is the "deductible" portion of the insurance policy that the federal government provides for a financial institution.

The failure of the system of federal deposit insurance for savings and loan associations (S&Ls) in the 1980s shows how an implicit government guarantee suddenly can turn into substantial losses at institutions that do not have enough of their own capital at stake in their business decisions. Taxpayers paid for most of the billions of dollars of losses on federal deposit insurance that could not be recovered by selling or liquidating the failed S&Ls.

Existing investor-owned GSEs permit shareholders to leverage their stock to a greater degree than is possible for shareholders of virtually any financial institutions in the United States. At year end 1995, for example, Fannie Mae had a capital ratio (i.e., a ratio of shareholder equity to assets and guaranteed securities) of 1.3 percent; Freddie Mac had capital of less than one percent. By contrast, the government today would require that a bank or thrift institution with federal deposit insurance and a similar book of business should have capital of over four percent.

For investor-owned GSEs, one problem of incentives relates to the potential difference in interests of shareholders from those of the GSE's borrowers. The Congressional Budget Office (CBO) recently reported that the federal subsidy to Fannie Mae and Freddie Mac, estimated at $6.5 billion annually, is very inefficient. The GSEs keep a substantial part of the federal subsidy benefits (more than $2 billion per year) for their shareholders, who receive generous returns on their equity, rather than reducing further the cost of home mortgages.

Managers and owners of the investor-owned GSEs have an incentive to serve only the most profitable parts of their charters, regardless of public value. The U.S. Department of Housing and Urban Development reports that Fannie Mae and Freddie Mac today provide credit for a disproportionately low percentage of low-income and moderate-income homebuyers, compared to other lenders in their markets. To take another example, the Federal Home Loan Banks had an investment portfolio (i.e., a source of income without regard to public purpose) at year end 1995 that exceeded the volume of credit that they provided to their members in furtherance of their statutory purposes.

Indeed, some actions of GSEs can be seriously detrimental to public purposes. The Farm Credit System is a cooperative that is owned and controlled by its borrowers. This GSE provided inexpensive loans, priced below its own cost of funds, to farmers in the late 1970s. The easy credit contributed directly to thousands of farm failures in the 1980s when the agricultural economy declined and farmers could not repay their extensive debts. In the process, the Farm Credit System itself failed. The Congress created an off-budget Farm Credit System Financial Assistance Corporation to lend money to the FCS until the agricultural economy could turn around and the system could return to financial health and repay the assistance.

More recently, GSEs found that they could enhance their earnings by issuing new and sometimes unpredictable securities known as derivatives. While derivative securities can be useful financial tools for the experts who understand their use, they are dangerous in the hands of ordinary investors. Derivatives offered unknowledgeable people such as the treasurer of Orange County, California, the opportunity to invest in securities with high credit quality (because of the government's implicit backing), high financial risk, and potentially high yields. The Federal Home Loan Banks, Fannie Mae, Freddie Mac, Sallie Mae and the Farm Credit System all have issued billions of dollars of so-called structured notes and other derivative securities. The problem of disclosure and accountability for sales to unsuitable investors is compounded because the charters of the GSEs exempt them from jurisdiction of the Securities and Exchange Commission.

The Issue of Accountability

In a 1991 report the Treasury Department commented on the influence acquired by GSEs:

> "The principal GSEs are few in number; they have highly qualified staffs; they have strong support for their programs from special interest groups; and they have significant resources with which to influence political outcomes.""[1]

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[1] U.S. Department of the Treasury, Report of the Secretary of the Treasury on Government-Sponsored Enterprises, April 1991, p. 8.

More recently, the Treasury reported on what it calls "the tension between profit and public purpose":

> "When creating a GSE, Congress defines the problem (i.e., the market imperfection) it seeks to overcome, provides benefits (subsidies), and imposes limitations on the GSE. But if Congress wishes to revise those decisions in response to changing public needs, it no longer has the same freedom of action. In addition to the usual constraints of the legislative process, it must contend with the private interests of the GSE and its shareholders. Congress must consider, and legislate, any such changes through a process in which the GSEs are significant participants. As a private company, the GSE will act to fulfill its fiduciary responsibilities by promoting and protecting the interests of its shareholders."[2]

The diminished accountability of GSEs once they have established themselves makes it difficult to assure that a newly created GSE will continue to provide sufficient public benefits or protect taxpayers against the immense financial contingent liability that the GSE can create. To take a current example, the Congress in 1992 enacted legislation to create the Office of Federal Housing Enterprise Oversight (OFHEO), a new financial regulator for Fannie Mae and Freddie Mac. OFHEO today has less than ten examiners on staff to assess the activities of the two GSEs and their $1.5 trillion of assets and mortgage-backed securities. The entire office has an annual budget of about $15 million -- a minuscule amount compared to the resources that would be allocated by a comparable federal bank or thrift institution regulator to supervise large financial institutions.

With respect to public benefits, the original purpose of the Federal Home Loan Bank System is disappearing along with the savings and loan industry that the banks formerly served. Yet the government has neither an exit strategy for the Federal Home Loan Banks nor, apparently, the political strength to implement such a strategy. Instead, the congressional banking committees have considered, adopted, and failed to enact a number of proposals to engraft new public purposes upon the outmoded framework of the old system.

Fannie Mae and Freddie Mac have expanded their financial activities to the point that they now provide mortgage technologies to facilitate the financing of high-income and other types of mortgages that would appear to be beyond the intended limitations of their congressional charters. Again, in a pattern similar to the gridlock on legislation concerning powers of commercial banks, the Congress has not acted on this issue.

One notable contrast involves the recent legislation to withdraw GSE status from Sallie Mae. The Congress enacted the legislation after extensive negotiations among the affected

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[2] U.S. Department of the Treasury, Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, July 11, 1996, p. 81.

constituencies. Sallie Mae itself promoted the legislation because of a sense that the burdens imposed by its charter, including a special fee that helped to offset many of the advantages of GSE status, outweighed the benefits. Sallie Mae shareholders are scheduled to vote next year on the company's plan for privatization.

Legislation Needed to Provide Guidance About Newly Created GSEs

It is time for legislation that can help to guide policymakers with respect to an appropriate structure for any new GSE that the Congress may decide is an appropriate means to accomplishing a worthy public purpose. The legislation would achieve three purposes: (1) assure that any new GSEs are well capitalized and properly supervised to protect against unnecessary financial risk; (2) provide for an exit strategy so that the government can withdraw its sponsorship from such an enterprise once its public purposes have been accomplished or superseded; and (3) provide for continuing independent analysis of the costs, financial risks and benefits of the activities of each newly created GSE.

The Office of Management and Budget has taken a similar position in its 1995 memorandum on government corporations. This approach is also contained in the Government Corporation and Government Sponsored Enterprise Standards Act (S. 2095), introduced in 1996. In deference to the difficulty of applying reforms to current GSEs, this legislation would apply only prospectively, with respect to any new GSEs that the Congress might decide to create.

Principal authors

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Thomas Stanton: Fellow at the Center for the Study of American Government at Johns Hopkins University. He has written and testified extensively on government sponsored enterprises.

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Federal Credit Programs: The Economic Consequences of Institutional Choices

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This survey of governmental and private institutions does not come at a time when favorable models abound. Nonetheless, there is much to be learned about the way that the choice of an institution relates to factors such as the number of borrowers to be served, the size of the credit subsidy, the government's ability to target the credit and its ability to respond appropriately to changes in the credit markets and evolving public priorities. The economic purposes of a program affect the choice of institutions to implement the program; conversely, the selection of a particular type of institution can determine the economic consequences of the government's involvement in the credit markets.

I. INTRODUCTION

While economists increasingly appreciate the role of institutions in shaping economic outcomes, the insight needs to be shared with Washington policymakers as well. Two recent proposals, to provide federal credit support for infrastructure finance and for small business loans, bear this out.

Both proposals suggest a scattershot approach to use of institutions to deliver a federal credit subsidy. The Commission to Promote Investment in America's Infrastructure submitted its report to the President and Congress in 1993. It recommended creation of two new institutions, a government sponsored enterprise called the National Infrastructure Corporation, and a federally chartered firm called the Infrastructure Insurance Company. The Commission cited estimates of an annual shortfall of "$40 to $80 billion annually to meet critical infrastructure needs," but did not point to clear market imperfections or other grounds for believing that the new institutions could succeed in profitably and safely generating investment funds that the private market had not been willing to provide.[1]

The second proposal is even less focused in approach. Originally envisioned as a way to assist investment in small businesses, the legislation is now known as HR 2600, "The Business, Commercial, and Community Development Secondary Market Development Act." This bill would authorize the Secretary of the Treasury to waive application of a host of federal and state laws and regulations to private or governmental entities that met financial and regulatory requirements. The net result of the bill would be to authorize the Secretary of the Treasury to certify a federal or state department or agency, a bank, thrift institution, government-sponsored enterprise, other private corporation, partnership or sole proprietorship and to waive application of tax and other laws, for the purpose of facilitating investments in "busi-

[1]Commission to Promote Investment in American Infrastructure, *Financing the Future*, (Washington, DC: US Department of Transportation, 1993), p.1.

ness, commercial, and community development debt and equity investments."[2]

In the broad sweep of their suggested solutions, these and other proposals commit two major errors. First, they neglect the need to identify a particular problem and to tailor a specific form of government solution (if any) that is appropriate for addressing that problem.[3] Second, they simply ignore the essential relationship between the form of institution and its economic impact on the marketplace.

The two problems are interrelated. On the one hand, the financial markets of the United States today are much more efficient than ever before. Many formerly formidable market imperfections, such as in the residential mortgage or rural credit markets, have been largely or completely overcome. Thus there are far fewer good opportunities for the government successfully to intervene in the credit markets than in the past. On the other hand, because today's opportunities to overcome market imperfections are infrequent and potentially transitory, the government must pay particular attention to the form of its involvement so that it avoids potentially serious negative consequences.

The purpose of this article is to present an exploratory overview of institutional alternatives and of the strengths and shortcomings of the types of institution that might be used as instruments of federal credit policy. Once policymakers understand the characteristics of each kind of institution, then they can fashion legislation that builds upon the strengths while compensating for some of the shortcomings.

It should be noted that the government could provide a subsidy directly for the intended purposes or to the ultimate borrowers rather than attaching the subsidy to a particular kind of institution. This approach tends to minimize marketplace distortions; however, it also tends to be unacceptably expensive in budgetary terms. In creating new programs, policymakers often favor approaches that do not appear as directly in the government's budget. Today in the United States, implicit guarantees for private institutions provide an especially tempting way for the government to become involved in the credit markets without incurring an immediate budgetary cost.

This article is organized as follows: Section I provides an introduction to the types of institution that the federal government uses to provide credit for public purposes. The most important distinction is between using a government agency or department to provide credit, or using one or more private institutions. Each institutional form has its strengths and limitations; also, the type of federal backing provided to private instrumentalities can profoundly shape their activities, financial structure and accountability. Section II presents some tentative guidelines for designing new federal agencies or instrumentalities to be useful and responsive instruments of government policy. These involve providing for (1) an appropriate public purpose, (2) sunset options and eventual transition of federally chartered special purpose private companies to state-chartered status as general-purpose firms, (3) institutional capacity, autonomy and flexibility, and (4) accountability of mission and financial soundness. Section III is a brief conclusion that likens the enabling laws that shape these institutions to an architectural framework that determines their ability to provide benefits and withstand stresses over the years.

II. THE POLICY CONSEQUENCES OF PROVIDING CREDIT THROUGH GOVERNMENTAL AND PRIVATE INSTITUTIONS

A. Overview

Exhibits 1 and 2 list some of today's major federal credit and insurance programs. Take government agencies first. Government credit programs include direct loans and loan guarantees. Direct loan programs are administered through governmental institutions such as units of the Department of Agriculture, the Export-Import Bank of the United States, the Agency for International Development and the Small Business Administration. Loan guarantee programs are implemented through government institutions and private parties (usually lenders). The government agencies that administer loan guarantee programs include the Department of Education, units of the Department of Housing and Urban Development (which includes the Federal Housing Administration and Ginnie Mae, the Government National Mortgage Association), the Department of Veterans Affairs, units of the Department of Agriculture and the Small Business Administration. The private lenders that participate in loan guarantee programs do not necessarily gain special status as government instrumentalities by doing so. A mortgage company, for example, is not considered to have become an institution imbued with a public purpose when it deals in federally guaranteed or insured VA or FHA loans. It remains a state-chartered private institution that has a contractual

[2]H.R. 2600, "The Business, Commercial, and Community Development Secondary Market Development Act." The bill and its precursors have been the subject of a number of congressional hearings. Claudia Cummins, "House Crafting Own Measure to Spur Small-Business Loans," *American Banker*, September 24, 1993, p. 2.

[3]In his analysis of tools of government, Lester Salamon makes this point: ". . . the key is to fit the characteristics of the tool to the nature of the task." Lester M. Salamon, Ed., *Beyond Privatization: The Tools of Government Action*, (Washington, DC: Urban Institute, 1989), p. 18.

Exhibit 1. Federal Involvement in the Financial Markets

I. *Government Agencies (Including Departments and Corporations)*
These are owned and managed by the federal government
- Department of Agriculture
- Department of Education
- Department of Housing and Urban Development
- Small Business Administration
- Agency for International Development
- Export-Import Bank of the United States
- Government National Mortgage Association (Ginnie Mae)
- Overseas Private Investment Corporation (OPIC)
- Pension Benefit Guaranty Corporation (PBGC)
- Federal Deposit Insurance Corporation

II. *Private Federal Instrumentalities*
These are privately owned and managed enterprises that serve public purposes under authority of federal law.
- A. Initial Capital from Government
  - College Construction Loan Insurance Association (Connie Lee)
  - National Consumer Cooperative Bank
- B. Financial Guarantee (implicit or explicit) from Government
  1. Federal Reserve Banks
  2. Banks, Thrifts, Credit Unions with Federal Deposit Insurance
  3. Government Sponsored Enterprises:
     - Federal National Mortgage Association (Fannie Mae)
     - Federal Home Loan Mortgage Corporation (Freddie Mac)
     - Federal Home Loan Bank System
     - Farm Credit System
     - Student Loan Marketing Association (Sallie Mae)
     - Federal Agricultural Mortgage Corporation (Farmer Mac)

relationship with the federal government but nothing more.

Adding to the complexity, some government agencies are structured as government corporations. These include the Government National Mortgage Association (Ginnie Mae), the Federal Deposit Insurance Corporation (FDIC), the Export-Import Bank of the United States (Exim Bank) and the Pension Benefit Guaranty Corporation (PBGC). Because these corporations are owned and controlled by the federal government, they are federal agencies.[4] Other agencies have some but not all of the attributes of government corporations.

Of the federal insurance programs, the provision of deposit insurance for banks, thrift institutions and credit unions is by far the largest category in Exhibit 2. The federal government provides deposit insurance for banks and thrifts through the Federal Deposit Insurance Corporation and for credit unions through the National Credit Union Share Insurance Fund, which is administered by the National Credit Union Administration Board. These institutions are federal agencies. However, the private institutions with liabilities that are insured by those federal agencies have a special status as federal instrumen-

Exhibit 2. Face Value of Federal Credit and Insurance Programs (Fiscal Year 1992, in billions of dollars)

Program	Face Value
Direct Loans:	
Farm Service Agency, Rural Development	50
Administration	
Rural Electrification Admin. and Rural Telephone	38
Bank	
Export-Import	9
Agency for International Development	16
Public Law 480	12
Foreign Military Financing	9
Small Business	7
Other Direct	3
Inactive	13
Total Direct Loans	157
Guaranteed Loans:	
FHA Single-Family	277
VA Mortgage	135
FHA Multi-Family	71
Federal family education loan program	52
Small Business	13
Farm Service Agency	5
Export-Import	6
CCC Export Credits	4
Other Guaranteed	6
Inactive	17
Total Guaranteed Loans	587
Federal Insurance:	
Banks	1,943
thrifts	618
Credit Unions	218
Total Deposit Insurance	2,779
Pension Benefit Guaranty Corporation	850
Other Insurance	1,080
Total Federal Insurance	4,709
GSEs:	
Freddie Mac	427
Fannie Mae	543
Federal HomeLoan Banks	85
Sallie Mae	43
Farm Credit System	50
Total GSEs	1,148
Total	6,558*

*The total eliminates double counting of Sallie Mae lending with respect to federally guaranteed student loans.

Source: *Budget of the United States Government*, FY 1994, pp. 51, A-1254.

[4]*Cherry Cotton Mills v. U.S.*, 327 U.S. 536, 66 S.Ct. 729 (1945).

talities: they are private institutions whose provision of federally supported credit is considered to embody a public purpose.[5] Those public purposes, and the scope of permitted activities of those instrumentalities are defined (i.e. confined) by federal law. As will be discussed below, their special status distinguishes instrumentalities from ordinary private companies and shapes their incentives and behavior.

Other important instrumentalities are government-sponsored enterprises such as Fannie Mae, Freddie Mac and the Farm Credit System. The federal government charters these institutions and provides an implicit guarantee of their obligations and mortgage-backed securities.[6] The government also charters some corporations such as the College Construction Loan Insurance Association (Connie Lee)[7] and the National Consumer Cooperative Bank, which obtain their funds in the private credit markets without the benefit of an automatically perceived federal guarantee, either explicit or implicit.

B. The use of federal agencies and departments to provide credit

One important issue to policymakers is the potential size of credit programs administered by governmental institutions, compared to those administered through private firms. Until quite recently, the annual government budget process failed to deal with the economic realities of many types of federal credit programs.[8] That meant that government credit programs could become huge, both in terms of numbers of borrowers served and in actual subsidy conveyed through provision of favorable terms.[9]

Today, however, the federal government has begun to impose increased controls upon the allocation of credit subsidies through its loan and guarantee programs. These controls, combined with today's federal budget constraints mean that new credit programs delivered through on-budget federal agencies or departments are not likely to be large. The Credit Reform Act of 1990 requires government departments and agencies to estimate the present value of future expected losses and interest rate subsidies (net of income from fees) for the direct and guaranteed loans originated in each of their programs in the coming fiscal year. The programs are then limited to originating only the amount of credit whose estimated subsidies are budgeted and covered by appropriated funds.

While it remains to be seen how credit reform will be implemented, the net result appears to be to tie many federal credit programs fairly closely to the federal budget process. One salutary result would be an increased ability of federal policymakers to make tradeoffs among various tools of government such as direct and guaranteed loans, grants and tax expenditures. Another consequence is that today's constrained federal budget resources will not permit delivery of substantial credit subsidies through government agencies and departments. Exhibit 2, above, shows how, in face amount of outstanding credit, the provision of direct loans and loan guarantees through governmental bodies ($744 billion) is dwarfed in magnitude by the face value of credit provided through off-budget government-sponsored enterprises ($1.1 trillion)

[5]To avoid encumbering the reader with detail, this article does not discuss other forms of federal instrumentality, such as those that may be agencies or instrumentalities of state governments. Thus, state student loan authorities may be state agencies or nonprofit institutions. They are instrumentalities of the federal government and help to implement the guaranteed student loan program. See Donald Axelrod, *Shadow Government: The Hidden World of Public Authorities*, (New York, NY: John Wiley & Sons, 1992).

[6]For a discussion of the implicit federal guarantee of obligations of government-sponsored enterprises, see Thomas H. Stanton, *A State of Risk*, (New York: HarperCollins, 1991) pp. 41–44.

[7]It should be noted that the federal enabling legislation for Connie Lee contains one provision that purports to disclaim federal instrumentality status for this institution. Despite this disclaimer, Connie Lee does manifest the essential attributes of a federal instrumentality including the provisions of law that confine its activities to specified purposes and that authorize special federal support in the form of the government's purchase of an initial equity interest in Connie Lee. One potential result of this provision may be that, unlike other instrumentalities, Connie Lee may be subject to bankruptcy laws. Congress is not always consistent in defining the legal attributes of federal agencies and instrumentalities.

[8]Congressional Budget Office, *Credit Reform: Comparable Costs for Cash and Credit*, (Washington, DC: December 1989); Barry P. Bosworth, Andrew S. Carron, Elisabeth P. Rhyne, *The Economics of Federal Credit Programs*, (Washington, DC: Brookings, 1987), pp. 150–165.

[9]The New Deal included massive use of federal credit programs to deal with the financial devastation caused by the Great Depression. In 1935, financing activities of a single government agency, the Reconstruction Finance Corporation (RFC), were equal to 5.8 percent of the U.S. gross national product (GNP). During the 31 years until its termination in 1953, the RFC disbursed some $41 billion of credit to support financial institutions, business enterprises, agricultural lenders, railroads, public agencies and for other purposes. Among the successor institutions to RFC activities are government agencies such as the Exim Bank, Ginnie Mae, and the Small Business Administration as well as Fannie Mae in the private sector. James S. Olson, *Saving Capitalism: The Reconstruction Finance Corporation and the New Deal, 1933–1940*, (Princeton, NJ: Princeton, 1988); and Celestea Gentry, "Federal Credit Programs: An Overview of Current Programs and Their Beginnings in the Reconstruction Finance Corporation," (Washington, DC: U.S. Treasury Department, July 18, 1980), unpublished monograph, Office of Corporate Finance.

and federal deposit insurance ($2.8 trillion), for example.[10]

Government departments and agencies have strengths and limitations as institutions providing credit in support of public purposes. The strengths of governmental organizations involve their direct accountability to federal policymakers, responsiveness to changing public priorities, and ability to serve borrowers whose creditworthiness in commercial terms might be considered marginal.

There are also some notable limitations. These relate to the conspicuous lack of operational capacity at some agencies, often including limited resources for staffing and systems. The combination of inadequate resources and managerial inflexibility means that the federal government may lack the capacity to administer some credit programs through government agencies without risking financial breakdown. Recent problems with federal mortgage insurance programs administered by the Department of Housing and Urban Development and student loan programs administered by the Department of Education underscore this point.[11]

1. Organization and accountability of governmental institutions

Federal departments and agencies are governed by federal officials. The most senior officials are appointed by the President of the United States and confirmed by the United States Senate. Other high officials are also "political" appointees. They have non-career status, serve at the pleasure of their superiors and generally leave office when there is a change of political party in the White House.

The remainder of the employees of departments and agencies are generally career civil servants. They are subject to formal merit processes when they are hired, fired, promoted, demoted or otherwise subjected to changes in status. Career civil servants are expected to provide capable professional service in implementing the lawful policies of their political superiors. With some variations, the compensation and benefits for federal employees is capped, with limitations upon the amount of permitted increase each year.

At least in theory, this combination of political and career officials is intended to make federal bureaucracies responsive to changing public priorities, as reflected in the political process, while giving them the professional capacity to carry out their programs. In practice, many federal agencies suffer from multiple layers of political appointees. Political appointees may not have requisite expertise for their appointed positions in government; moreover, they tend to leave their plum positions after fairly short periods of time, to follow other promising opportunities.[12]

Political pressure to constrain the size of the federal work force has resulted in considerable use of contractors by the federal government. Many departments and agencies use contract employees to serve in place of federal employees who cannot be hired because of the limits on federal employment that are imposed as a part of the annual budget and appropriations processes.

The Congress has considerable continuing ability to change the nature of federal programs. Federal departments and agencies may not carry out any activities unless those activities are authorized by law. The congressional authorizing committees and subcommittees keep a close eye on the programs within their jurisdiction and frequently summon executive branch officials for private briefings and public oversight hearings. The authorizing committees wield considerable power; they can report legislation to add, expand, redirect, confine or terminate programs.

Even though an authorizing committee may report laws that are enacted to permit a department or agency to administer a generous program, that program will be moribund unless it receives appropriated funds to pay for its overhead and outlays. This makes the annual budget and appropriations process essential for most departments and agencies. The appropriations committees and subcommittees legislate annually. Appropriations acts specify the total funds and federal staffing available to each program and allocations of those resources, for example between an agency's headquarters in Washington and its field offices. Appropriations laws can be very specific; they may direct an agency to expend resources in certain locations or may expressly prohibit expenditures of funds for specific purposes.

2. The problem of governmental capacity

An increasing constraint upon the ability of the Congress to expand government services to constituents has

[10]The discrepancy in terms of subsidy amount conveyed annually is harder to calculate; the difficulty of predicting the actions of private managers of financial institutions under stress makes it hard to calculate the present value of likely future losses to taxpayers from failures of banks, thrifts and government-sponsored enterprises. Losses from government programs, by contrast, are easier to quantify.

[11]These and other programs are highlighted in, "Progress Report: High Risk Areas for Management Improvement," *Budget of the United States Government, Fiscal Year 1994*, (Washington, DC: Government Printing Office, 1993), pp.105–130.

[12]Many of these points are documented in Ronald C. Moe, "The HUD Scandal and the Case for an Office of Federal Management," *Public Administration Review*, Vol. 51, No. 4, July/August 1991, pp. 298–307.

been political pressure to reduce the federal deficit. Many federal departments and agencies are starved for resources. Even if budgeted funds are available, compensation ceilings may dissuade officials from remaining in government. Disparities in compensation between the governmental and private sectors may be especially large for officials with special technical specialties that the government needs for the effective implementation of its programs.

Five years ago Charles Bowsher, the Comptroller General of the United States, drew public attention to what he called, "an emerging crisis: the disinvestment of government."[13] He pointed to antiquated management and information systems and staff who had inadequate technical capability. Among other consequences that he noted, the savings and loan debacle was exacerbated by the failure of the federal regulator to have access to systems and people with skills of sufficient caliber.

The continuing decline of the capacity of governmental institutions, known to public administration scholars as "hollow government," is partly a product of the divergence among types of congressional committee. The authorizing committees of Congress are reluctant to end many favored programs; the budget and appropriations committees must then allocate diminished resources across the existing programs.

This can have serious consequences for federal management of credit programs. Many programs are unable to provide audited financial statements. Often managers lack the ability to generate essential operational information or even to review and utilize properly the information provided by third parties.

The problem of inadequate resources is compounded by the increasing burden of large numbers of detailed and inflexible input controls that are intended to prevent misuse of government resources. The recent report of the Vice President's National Performance Review points to this problem:

> "The federal government is filled with good people trapped in bad systems: budget systems, personnel systems, procurement systems, financial management systems, information systems. When we blame the people and impose more controls, we make the systems worse."[14]

Yet, even as federal policymakers note the incapacity of many federal institutions to implement their programs effectively, federal policies continue to spur disinvestment rather than renewed investment in management of federal programs. Presidential Executive Order 12837, issued in 1993, requires executive branch departments and agencies to reduce their administrative expenses by fourteen percent over the next five years. This will further restrict outlays for training, systems and other needed activities that have already borne the brunt of disinvestment. The National Performance Review itself calls for a twelve percent reduction in federal staffing over the same period.[15]

3. The tension in role of federal credit programs

One other issue affects the implementation of federal credit programs. That is the matter of strategic direction. The federal government often has difficulty managing the tension between doing good and doing well. For credit programs, this is the tension between the role of lender (who expects its loans to be repaid) and the role of provider (who is eager to provide money for worthy purposes).

The problem is compounded by the tendency of different parts of the government to take conflicting positions in the debate. Many program agencies and departments, with encouragement from their congressional authorizing committees and subcommittees, are prone to see credit programs as a way to support worthy borrowers and public purposes. Many such policymakers see federal credit as a backdoor to providing funds for public purposes that otherwise might not obtain the scarce appropriations. By contrast, the Office of Management and Budget and the Treasury Department, supported by the congressional budget and tax committees, tend to emphasize the need for the government to require borrowers to repay their federal program loans.

One positive result of this tension is the willingness of federal policymakers to use programs to provide credit to borrowers who may in fact be creditworthy, but who do not appear completely creditworthy to commercial lenders. It is possible to underwrite unusual loans or loans to marginal borrowers in such a way as to meet the default rates projected for such loans. In many cases, rigorous application of sound underwriting standards may be the only way to avoid unacceptable losses.[16]

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[13]Charles A. Bowsher, "An Emerging Crisis: The Disinvestment of Government," (Washington, DC: National Academy of Public Administration, December 1988).

[14]*Creating a Government that Works Better and Costs Less: Report of the National Performance Review*, (Washington, DC: Government Printing Office, September 7, 1993), p. 2.

[15]*Ibid.* p. ii.

[16]A recent example of the need for rigorous underwriting comes from the multifamily housing market. In the 1980s, both Fannie Mae and Freddie Mac purchased multifamily mortgage loans. Unlike Fannie Mae, Freddie Mac took substantial losses on its portfolio of these mortgages. By contrast, Fannie Mae kept its underwriting standards, and application of those standards by third party lenders, tightly under control. As one analysis concludes,

> "Interviews with Freddie Mac staff indicate that Freddie Mac did not really develop the special expertise necessary to

A government agency cannot take some of the actions available to a private lender; thus a government agency would probably not have the freedom to adjust its formal underwriting standards to account for a softening market. This is a consequence of the political demands of members of Congress and their constituents, who are likely to try to obtain greater rather than lesser volumes of federal credit for their locations during times of economic stress. However, careful underwriting of loans according to fixed standards and effective supervision of third party loan originators, servicers and guarantors could reduce the cost of continuing a number of federal programs.

Once rigorous underwriting is available, then the program agency will be able to make valuable tradeoffs among categories of eligible borrowers. The agency can indicate to the Congress, for example, its ability to serve many more borrowers with slightly subsidized loans than the number it can serve with greater subsidies. In some cases, it may be able to recommend grants or technical assistance in place of credit to borrowers that exhibit high defaults.

A negative result of this tension would occur if program agencies simply failed to adopt rigorous loan standards and management systems. The problem becomes especially complicated if rigorous program management is seen as a political rather than a mere operational issue. Program officials may fear that calls for sound program management are merely a political gambit by interests hostile to the program's worthy purposes. On the other hand, policymakers, especially those with relevant experience in the private sector, may want to improve the program's actual performance and may be unfairly labelled as adversaries of the program's purposes.

The recent call for reinventing government may provide a welcome opportunity to highlight the logic that is being forced by today's constrained budget resources; effective implementation and operational rigor may be the only way to optimize the use of today's scarce public funds to serve program constituents. It remains to be seen how the National Performance Review will be shaped as it works its way through the political process.

4. Government corporations as a positive model

There are a number of exceptions to this general picture of decline. Some programs fund themselves from user fees, dedicated government funds, or other sources of income that could be obtained without going through the year-to-year appropriations process. In such cases, the authorizing committees may create a government corporation to carry out the potentially self-sustaining activities, without requiring regular federal appropriations.[17] Depending upon their methods of operation, and especially on the extent to which they are held to performance-based standards rather than being controlled by traditional governmental input controls over budget, staffing and other resources, such government corporations may exhibit superior management to many other government agencies.[18] However, they may have less access to resources and therefore less capability than comparable private firms. Like other federal departments and agencies, government corporations may be susceptible to market risk if markets and technologies evolve and competitors innovate in new ways not foreseen in the enabling legislation of the corporations.[19]

The need to remain self-sustaining and the freedom from some of the input controls that impede effectiveness of government organizations has meant that some entities such as the Overseas Private Investment Corporation (OPIC), the Export Import Bank of the US, and the Government National Mortgage Association (Ginnie Mae) have been able to keep much of the institutional tone that other departments and agencies now lack. If the government proposes to create a new credit program, the government corporation provides an attractive institutional structure to consider.

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underwrite and service multifamily loans and was slow to adjust its underwriting guidelines to the softening real estate market of the 1980s."

Denise DiPasquale and Jean L. Cummings, "Financing Multifamily Rental Housing: The Changing Role of Lenders and Investors," *Housing Policy Debate*, Volume 3, Issue 1, (Washington, DC: Fannie Mae, 1992), pp 77-116, at p.110.

This pair of contrasting examples of the need for careful underwriting comes from government-sponsored enterprises. DiPasquale and Cummings note that the federal government's FHA multifamily housing program suffered expensive failures for more fundamental reasons, including flawed design and lack of institutional capacity at HUD. Citing HUD's own statements, they conclude that, ". . . the problems with the multifamily insurance programs appear to have had more to do with HUD's inability to manage the programs than with the risks inherent in rental housing." *Ibid.*, p.107.

[17]National Academy of Public Administration, *Report on Government Corporations*, (Washington, DC: National Academy of Public Administration, 1981), Vol. I at pp. iii-iv.

[18]Harold Seidman and Robert Gilmour, *Politics, Position, and Power*, fourth edition (New York, NY: Oxford University Press, 1986), chapter 11, pp. 249-292, analyzes the distinctions between types of federal agencies, including departments and corporations. For a review of applicability of federal laws to government corporations, see U.S. General Accounting Office, *Profiles of Existing Government Corporations*, study prepared for the Committee on Government Operations, U.S. House of Representatives (Washington, D.C.: GPO, 1989), Appendix B.

[19]See, for example, U.S. General Accounting Office, *U.S. Postal Service: Pricing Services in a Competitive Environment*, March 1992.

C. The use of private companies to provide federal credit

The advantages of using private sector institutions relate to their capacity and their ability to deploy resources efficiently in support of bottom-line objectives. When necessary to achieve profitability, private firms will tend to invest in high quality personnel and state-of-the-art systems that sometimes can be far superior to those found in government.

One disadvantage to using private institutions relates to the way that profitmaking companies are likely to place the financial interests of shareholders above the government's interests in promoting the public benefits of government credit programs; private profit-oriented firms are likely to try to dedicate their resources to serving the most profitable parts of their federal charters. (By contrast, the cooperative form of instrumentality may be more responsive to the requirements of the borrower-owners and may be willing to serve less profitable parts of the market).

Private instrumentalities do not receive regular appropriations of federal funds. That means that they can only deal in loans that are financially profitable, at least in the aggregate. If such loans are subsidized, the subsidies must be paid for by the government. Thus, banks and Sallie Mae deal in profitable student loans that are subsidized and guaranteed by the US Department of Education with appropriated funds.

1. Drawing the line between governmental and private institutions

It was only in the late 1960's that the government addressed the essential difference between public and private entities. The *Report of the President's Commission on Budget Concepts*, published in 1967, clarified that operations of all institutions were to be included in the federal budget unless those institutions were "completely privately owned."[20] As a result of the report, the Johnson Administration moved to end the federal investment in certain institutions of the Farm Credit System. Also, in 1968 legislation the government partitioned the Federal National Mortgage Association into two institutions, a federal agency known thereafter as the Government National Mortgage Association (Ginnie Mae), and a privately-owned government-sponsored enterprise which inherited the name of the Federal National Mortgage Association (Fannie Mae). With some lapses (for example in the case of Connie Lee, the College Construction Loan Association, that has some government equity investment but remains off-budget), the federal Office of Management and Budget (OMB) has adhered to the principles of the commission and its report.

Exhibit 3. Characteristics of Ordinary Companies vs. Government Instrumentalities

Ordinary Companies	Instrumentalities
Authorized to conduct all activities except as expressly prohibited by law.	Authorized to conduct only those activities expressly permitted by their charters.
Can obtain a corporate charter easily and inexpensively by registering with a state's department of corporations.	Must obtain a charter (1) from Congress or a state legislature, or (2) from an administrative agency according to statutory standards.
Can freely enter lines of business except where entry is prohibited by law; can freely stop serving markets or customers.	Can only enter lines of business expressly authorized by law; may be required to serve particular markets or customers.
Can be forced into bankruptcy by unsatisfied creditors.	Probably cannot be forced into bankruptcy, even if insolvent.
Incorporated under state law to serve private purposes.	Incorporated to serve public purposes; are considered instrumentalities of federal or state government.
Often unregulated.	Usually regulated.
Generally have no unique benefits granted by law.	Have unique benefits granted by law to a single company or category of companies.

2. Competitive consequences of federal support of private companies

The activities of private firms involved in federal credit programs are shaped by law rather than merely by the marketplace. Federal instrumentalities differ from ordinary private companies to the extent that they may be vulnerable to political and other unusual forms of risk related to their ties to the federal government.[21] Exhibit 3 provides a good summary of significant differences between governmental instrumentalities and other private companies in the marketplace. The important point to note is the mix of governmental and private attributes of instrumentalities and the way that their distinct legal framework gives instrumentalities some unusual financial and operating attributes compared to the typical private company.

[20] *Report of the President's Commission on Budget Concepts*, (Washington, DC: US Government Printing Office, 1967), p. 30.

[21] Thomas H. Stanton, "Nonquantifiable Risks and Financial Institutions: The Mercantilist Legal Framework of Banks, Thrifts, and Government Sponsored Enterprises," Chapter 3 in Charles Stone and Anne Zissu, eds., *Global Risk Based Capital Regulations*, Vol. I (Homewood, IL: Irwin Professional, 1994).

Most importantly, private instrumentalities gain competitive advantage if they receive federal benefits that are unavailable to others doing business in the same markets. Such special benefits may include provision by the government of tax benefits or low-cost or no-cost federal capital, or a low-cost or no-cost federal guarantee. Such benefits can enable an institution to gain an artificial advantage over private competitors and, if the subsidy is great enough, allow the benefitting company to simply sweep its disadvantaged competitors out of its markets.

The market dominance created by federal subsidies can have positive and negative effects. On the positive side, if the institution operates under legislation that focuses its activities on high priority public purposes, then the subsidy benefits will help support those public purposes. Housing, education and agriculture are some of the sectors of the economy that have benefitted from special federal credit support.[22]

On the negative side, the subsidies flow to a particular institution or type of institution and not directly to the high priority public purposes or borrowers themselves. Unless it is subject to some other constraint, these subsidies may permit the institution to grow much faster and to a much greater size than any of its competitors in the unsubsidized marketplace. This frees the institution from much of the usual market discipline that tends to keep firms lean and efficient when they operate in more competitive markets.

In the case of banks, thrifts and government-sponsored enterprises, the federal backing of their obligations is combined with limitations on the number of such institutions that the government is willing to charter in a given market. Although new technologies and competitors' innovations can erode or eliminate such advantages over time, such federal instrumentalities often have the attributes of dominant firms, especially in their earlier years.

As federally-backed dominant firms, they may acquire longer time horizons and the ability to make longer-term investments compared to firms that are subject to more competitive market forces; on the other hand, they may also begin to relax their competitive edge and display inefficiencies that may make them vulnerable to unusually severe forms of market risk.[23] In addition to creating such unusual vulnerabilities, the existence of federal subsidies that are provided to particular kinds of private institutions means that the extent to which such types of firms are efficient or inefficient, compared to unsubsidized competitors, can become difficult to measure; the problem is compounded if the same market is served by a variety of types of instrumentality, each with its own distinctive combination of subsidies.

3. *The strength of private institutions*

As privately owned and managed institutions, federal instrumentalities can possess considerable capability compared to the governmental agency or department. First, they operate in the private sector, usually on a profit-oriented basis. (Some instrumentalities such as institutions of the Farm Credit System are structured as cooperatives and thus may place less emphasis than investor-owned institutions upon maximizing shareholder returns.) As private sector institutions, instrumentalities are subject to performance controls, in the form of the financial bottom line.

However, instrumentalities may be subject to governmental supervision of their public purposes and other activities. Some regulators may prescribe detailed requirements and limitations similar to those that restrict federal agencies and departments (for example, regulatory limitations upon executive salaries or even the budgets of some government-sponsored enterprises). However, as a general rule, the burdens upon instrumentalities are not as onerous as those applying to governmental bodies.

With the conspicuous failure of the detailed regulatory regimens that confined the thrift industry and the Farm Credit System into the 1980's, government regulators may begin to increase their reliance upon performance-type measures instead.

Most instrumentalities are often free to offer generous compensation to attract capable people with skills relating to financial instruments and products, management information systems, automated financial systems, and other expertise that is needed to provide high quality financial services. Also, they are free to hire, promote and lay off employees according to changes in their business operations.

Compared to government agencies, federal instrumentalities show a striking capacity to grow or shrink in response to changes in economic circumstances. Thus, in 1989, the government finally enacted legislation imposing effective supervision and bank-type capital requirements upon the thrift industry. To meet the new requirements thrifts had to sell off many billions of dollars of mortgages. Fannie Mae and Freddie Mac, the two government-sponsored enterprises that serve the secondary mortgage market, then began to grow by hundreds of billions of dollars as they acquired these and other

[22]Charles R. Geisst, *Visionary Capitalism: Financial Markets and the American Dream in the Twentieth Century*, (New York, NY: Praeger Publishers, 1990).

[23]The most dramatic examples of such vulnerability have come from the thrift industry and the banking industry. See respectively, R. Dan Brumbaugh, *Thrifts Under Siege*, (Cambridge, MA: Ballinger Publishing Co., 1988); and Lowell L. Bryan, *Bankrupt: Restoring the Health and Profitability of Our Banking System*, (New York: HarperCollins, 1991).

mortgages that were sold into the secondary market. Today Fannie Mae and Freddie Mac are the largest financial institutions in the country; Fannie Mae alone holds in portfolio or guarantees over $700 billion of home mortgages and mortgage-backed securities. Both institutions pass on many of their financial advantages (largely federally-backed low borrowing costs and tax benefits) in the form of lower mortgage rates for the American homebuyer. The activities of Fannie Mae and Freddie Mac may lower borrowers' interest rates on eligible fixed-rate mortgages by perhaps thirty basis points, according to one estimate.[24]

4. Accountability to public purposes

The limitations of instrumentalities are related to their strengths. First, these institutions are privately owned and controlled. Investor-owned banks, thrifts and government-sponsored enterprises, for example, have an incentive to serve the most profitable parts of their charter and not necessarily those that may represent a higher priority use of federal credit. This contrasts to the federal agency that is free within the limits of its credit budget to serve all borrowers who are eligible for its services.

Thus, the head of one government-sponsored enterprise, Sallie Mae's then President and CEO Edward A. Fox once told a Senate subcommittee:

> "We are a private corporation and as such, with stockholders and bondholders, we have a fiduciary responsibility to those individuals. . . . We are not charged with subsidizing the guaranteed student loan program or subsidizing the students."[25]

In recent years, Sallie Mae's stock has yielded generous returns on equity. For the past five years Sallie Mae has reported a return on common shareholders' equity that averages about 38 percent.[26]

There is a second limitation that is even more serious from the perspective of public accountability. Federal instrumentalities can live or die according to the terms of their enabling legislation. This leads their owners and managers to devote immense resources to dominating their congressional authorizing committees and designated regulators and others in government who might threaten their legal franchise.

Political strength has been a hallmark of private instrumentalities throughout American history. The second Bank of the United States went so far as to plunge the country into depression in the early 1830's as a part of the "Bank War" with President Andrew Jackson.[27] Later in the nineteenth century, the U.S. Pacific Railway Commission (1887) found that the transcontinental railroads had spent very large sums of money improperly to influence legislation.[28] Recently Fannie Mae and Freddie Mac played a dominant role in shaping the 1992 legislation that sought to improve accountability of the two enterprises, create effective federal supervision and impose meaningful capital standards.[29]

If a private instrumentality can develop strong ties with the congressional authorizing committees, then it can become very difficult or impossible for a federal agency to attempt to impose new regulatory requirements except when the instrumentality acquiesces. This relates to the problem of regulatory capture. The thrift industry dominated its nominal regulator, the Federal Home Loan Bank Board (FHLBB), from the time of its creation in 1934. For years, the FHLBB routinely submitted its draft regulations to the thrift industry for review before publishing them; in the early years, the industry trade association actually wrote many FHLBB regulations.[30] The Farm Credit System similarly dominated its federal regulator until the system's financial failure in 1985.

The U.S. Treasury Department warned that any new federal regulator of safety and soundness of government sponsored enterprises (GSEs) would be prone to capture:

> "The problem of avoiding capture appears to be particularly acute in the case of regulation of GSEs. The principal GSEs are few in number; they have highly qualified staffs; they have strong support for their programs from special interest groups; and they have significant resources with which to influence political outcomes. A weak financial regulator would find GSE political power overwhelming and even the most powerful and respected Government

[24]Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises*, (Washington, DC: April 1991), p.138. In recent months, this margin appears to have narrowed significantly.

[25]Senate Committee on Labor and Human Resources, Subcommittee on Education, Arts and Humanities, "Oversight of Student Loan Marketing Association (Sallie Mae)," Hearing, August 12, 1982, p.135 (Statement of Edward A. Fox, Sallie Mae President and Chief Executive Officer). See also, "Sallie Mae: Still a Big Woman On Campus?" *Business Week*, November 15, 1993, p.160.

[26]Moody's Investors Services, *U.S. Government-Sponsored Enterprises (GSEs)*, October 1993, p. 55.

[27]Fritz Redlich, *Men and Ideas: The Molding of American Banking*, (New York, NY: Hafner Publishing Company, 1947), pp. 151-154.

[28]US Pacific Railway Commission, *Report*, (Washington, DC: U.S. Government Printing Office, 1887), p. 121.

[29]Stephen Labaton, "Power of the Mortgage Twins:

> Fannie And Freddie Guard Autonomy," *New York Times* (November 12, 1991) pp. D1, D8; Kenneth H. Bacon, "Privileged Position: Fannie Mae expected to escape an attempt at tighter regulations." *Wall Street Journal* (June 19, 1992), pp. A1, A4; Thomas H. Stanton, "Increasing the Accountability of Government-Sponsored Enterprises: Next Steps." *Public Administration Review*, Vol. 51 (November/December, 1991), pp. 572-574.

[30]Brumbaugh, *Thrifts Under Siege*, p. 25.

agencies would find regulating such entities a challenge. Clearly, it is vital that any GSE financial regulator be given the necessary support, both political and material, to function effectively."[31]

While such political strength does have its limits, the fact is that the major privately-owned instrumentalities are powerful enough to make government supervision difficult at best. This state of affairs is especially risky to taxpayers today because of the increasing extent to which implicit or explicit federal guarantees now back the activities of financial instrumentalities such as banks, thrifts, and government-sponsored enterprises. The economic consequences of such a federal guarantee are clear; the federal government must supervise those guarantees to the same extent that a private creditor would supervise the use of its credit.[32]

If the government provides a federal guarantee (explicit or implicit) that weakens market discipline, then it must substitute effective financial supervision. Otherwise the federal guarantee will create an incentive for instrumentalities to increase the returns of their private owners by increasing financial risks. Financial risk taking is especially likely to reach extreme levels when institutions come under financial stress. Another approach is to utilize risk-sharing and other market-based structures that can provide financial discipline. However, the federal government has not generally adopted such structures to a sufficient extent, and in a number of programs in recent years has actually reduced the amount of risk-sharing required of private lenders and other parties.

Due to the thrift debacle and the perceptions of increasing numbers of failing banks, federal instrumentalities have now come under increased scrutiny. The 1989 Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) was a major first step to imposing accountability upon financial institutions with federally insured deposits. This was followed by the 1991 Federal Deposit Insurance Corporation Improvements Act. One provision of that law requires the federal bank and thrift regulators to close failing institutions before their net worth involves significant chance of loss to the deposit insurance funds. Legislation passed in 1991 and 1992 also increases federal oversight of government-sponsored enterprises (notably Fannie Mae, Freddie Mac, Sallie Mae and Farmer Mac) and establishes new minimum capital standards.

In summary, private instrumentalities offer considerable operating capacity and flexibility compared to today's federal agency or department. However, once instrumentalities have become profitable going concerns, the government can find it quite difficult to influence their activities, either with respect to serving new and evolving public priorities or with respect to reducing taxpayer exposure to their activities.

III. CREATING USEFUL AND RESPONSIVE FEDERAL AGENCIES AND INSTRUMENTALITIES: SOME TENTATIVE APPROACHES

In surveying the performance of government agencies and private federal instrumentalities over the years, several important issues emerge. Tentatively, these might be stated as follows:

- Special purpose institutions, either governmental or private, should be created only to serve specific significant public purposes that are expected to remain of high priority for many years.
- At the time that a special-purpose private corporation is created, the enabling legislation should provide for eventual transition to state-chartered general-purpose status after a specified number of years.
- The enabling legislation for federal credit agencies and private instrumentalities should assure that they have sufficient capacity, autonomy and flexibility to make businesslike decisions in a cost-effective manner.
- Federal agencies and instrumentalities must be properly accountable to the Executive Branch and Congress.

It is useful to consider these issues in some detail.

A. Public purpose

While there are exceptions, the government agency or private financial institution is generally intended to have a long term existence. That means that federal credit agencies and instrumentalities generally are suited to serving longer rather than more transitory public needs. A number of other devices are available such as tax credits that can serve shorter term public purposes without the creation of an entirely new governmental or private institution.

Another aspect of public purpose is also important: It should be well-defined. There needs to be a clear relationship between the public need and the federal program or institution that is intended to meet that need.[33] As noted

[31] *1991 Report of the Secretary of the Treasury on Government-Sponsored Enterprises*, April 1991, p.8.

[32] There is extensive literature on this point. One of the major early works was Fischer Black, Merton H. Miller, and Richard A. Posner, "An Approach to the Regulation of Bank Holding Companies," *Journal of Business*, Vol. 51, March 1978, pp. 379–412.

[33] The Office of Management and Budget attempts to address this point for all federal credit programs:

above, federal credit is most useful if it is targeted to overcome market imperfections.[34] Consider, for example, the recent proposal to create special purpose corporations to provide loans to inner city borrowers.[35] The argument for such new institutions is that ordinary lenders fail to serve creditworthy borrowers in those locations. If a market imperfection does exist, then a federal program can serve these creditworthy borrowers on a self-sustaining basis. By contrast, if a market imperfection does not exist, then there may not be enough creditworthy borrowers in inner cities to permit a government agency or private lender to extend credit without taking unacceptable losses that could threaten the financial viability of the institution.

The prospect of such unacceptable losses is the major disadvantage of creating a loan program where no market imperfection exists. Loan defaults are costly to borrowers as well as the government. If losses promise to be unacceptably high, then a federal grant program would be much more useful than loans, so that the government avoids imposing the costs of financial failure on borrowers who have a high likelihood of being unable to handle too much federal credit.[36]

There can also be problems if the government attempts to supply credit support through a private instrumentality. If no market imperfection exists, then a private instrumentality may find it difficult to thrive in its legally-prescribed market niche without incurring unacceptable financial risks. The history of the most recent government-sponsored enterprise, Farmer Mac, indicates that the company may have significant difficulty competing effectively against the other federal instrumentalities that already serve its potential customers.

B. Sunset options and transition to state-chartered general-purpose status

Public purposes can change profoundly over time. As private markets and technologies evolve, market imperfections tend to erode. Rural borrowers today, for example, have much more extensive access to the financial markets than they had in 1917 when the Farm Credit System began. Similarly, the residential mortgage market today is highly developed compared to the fragmented circumstances of 1938 when the Reconstruction Finance Corporation originally established the Federal National Mortgage Association.

It is not easy for the federal government to terminate a federal institution that fails, and the task may be even harder for one that succeeds. Yet, at some point even a successful government credit program may lose its reason for existence. Once the high-priority public purposes have been met, the government may need to direct its scarce credit resources to new and quite different priorities.

The problem is difficult because of the development of constituencies that have a stake in the continuation of a federal program and the associated governmental or private institutions regardless of changes in public priorities. This issue is compounded for privately-owned companies; they can be expected to resist vigorously any attempt to alter the enabling legislation of the company to the detriment of the owners' private interests.[37]

The matter of changing public priorities is therefore best addressed at the time when a federal program, especially one involving creation of private institutions, is established, rather than afterwards. One option is to place a long-term sunset provision into the charter of most or all newly created federal instrumentalities. The first and second Banks of the United States were chartered for 20-year terms, for example. A second option, that takes account of the concerns of shareholders and some of the other constituent groups, is to combine a sunset provision with provisions to provide for a smooth transition from a special-purpose federal charter to a general-purpose state charter. Under such provisions, for ex-

"... *Objectives of Credit Programs*. Federal credit assistance is intended to meet Federal objectives by providing credit on more favorable terms than otherwise available from private sources. These Federal objectives should be specifically and clearly defined in proposals to establish or expand credit programs and in the materials submitted to the Congress to justify these proposals. Program objectives will specify whether the direct loan or loan guarantee program is intended:

a. to correct a capital market imperfection, which should be defined; and/or

b. to subsidize borrowers or other beneficiaries, who should be identified, when a financial subsidy is the most efficient means of providing a subsidy."

Office of Management and Budget, Circular No. A-70, "Policies and Guidelines for Federal Credit Programs," pp. 3–4.

[34]Barry P. Bosworth, Andrew S. Carron, Elisabeth W. Rhyne, *The Economics of Federal Credit Programs*, (Washington, D.C.: The Brookings Institution, 1987), Chapter 1.

[35]Jerry Knight, "Banker Groups Endorse Clinton Idea", *Washington Post*, December 20, 1992, p. A-18.

[36]For example, easy federal credit contributed to financial failures of agricultural borrowers in the 1980s. In good times these borrowers were encouraged to take on sizeable debt obligations that they could not repay when the agricultural economy went into a downturn. By the mid-1980s, some two hundred to three hundred thousand farmers (about one out of five) were forced out of business. While these failures were due to a number of factors relating to the collapse of farm incomes, it is clear that cheap federal credit exacerbated the results. Kenneth L. Peoples, et al., *Anatomy of an American Agricultural Credit Crisis: Farm Debt in the 1980s*, Farm Credit System Assistance Board (1992), p. 29.

[37]Changes to a federal charter of a private company were litigated, for example, in *Union Pacific Railroad Co. v. U.S.* (*Sinking Fund Cases*), 99 U.S. 700 (1878).

ample, the Secretary of the Treasury could be authorized to guarantee expressly the outstanding obligations of a private enterprise that may have been backed only by an implicit guarantee, on negotiated terms that do justice both to the government and to private investors.

For government corporations (i.e. federal agencies), the charter might expressly provide for the Secretary of the relevant department to explore the possibility of converting the corporation for sale into the private sector and to make appropriate recommendations to the Congress before the sunset date.[38] Both for private and governmental institutions, the Congress always retains the option to renew the relevant enabling legislation before the sunset date, possibly with statutory adjustments to reflect more current public priorities.

C. Institutional capacity

The issue of institutional capacity is important both for government agencies and for private instrumentalities. Take the former first. The problems of federal capacity and disinvestment of government relate to the tendency of policymakers to focus on reducing costs. This results in anomalies such as the restriction of Ginnie Mae to a staff of about 70 people to manage some $426 billion in mortgage-backed securities for which the government guarantees timely payment of principal and interest.[39] Even a modest breakdown in management controls could give rise to program losses that could swamp the short-term economies achieved by constraining Ginnie Mae's staff resources so tightly. By contrast to the current governmental fixation on driving down the near-term cost of inputs, a well-managed private firm looks at the optimal tradeoff of cost and quality of services that it produces and also adopts a longer, more strategic time horizon.[40]

For private instrumentalities, the problem of capacity is somewhat different. Private financial institutions are not encumbered by federal management controls and myopic focus on short-term cost controls; instead the problem of the capacity of federal instrumentalities relates to potential problems in the quality of the overview of the safety and soundness of these institutions by government regulators. Unless deterred by capable federal supervision, private managers of failing institutions can take financial gambles that greatly compound the risk of losses to the federal government.

Moreover, the private federal instrumentality can suffer from impaired capacity if it lacks an adequate market for services within the scope of its legal charter. Banks today suffer from a shrinking market for their traditional services, and this means that many of today's banks may not thrive in coming years.

D. Accountability of mission and financial soundness

Enhancing the capacity of government agencies and private instrumentalities does not mean freeing them from public accountability. These institutions are chartered to serve public purposes and must be held accountable. For government corporations, the National Academy of Public Administration has made a number of recommendations; many of these ideas are now reflected in recommendations of the National Performance Review for improving the flexibility and accountability of all government agencies and departments. Under these recommendations, government agencies would be freed from many of the detailed legal restrictions on staffing and procurement that currently preclude flexible deployment of resources. In place of such rigid input controls, governmental institutions would be subject to performance-based accountability. The report proposes that government departments and agencies be subject to regular review of performance goals and accomplishments,[41] and regular financial audits.[42] A good additional step would be to reduce government hierarchies by eliminating many of today's multiple layers of political appointees.

For private federal instrumentalities, the problem of accountability can be even more acute. Private investors seek profits on their equity in private financial institutions such as thrifts, banks or government-sponsored enterprises. Directors of these institutions owe their fiduciary responsibility to shareholders and the company, and often receive stock options that help enhance their common interests with those of the shareholders. As a result, these institutions tend to serve the most profitable parts of their charters compared to those that may represent a higher public priority. As discussed above,

[38]Thus, the recent legislation creating a government corporation, the United States Enrichment Corporation, requires the corporation to prepare and regularly update a privatization plan and, subject to statutory guidelines, implement such a plan with approval of the President of the United States and subject to a period of congressional review. *Congressional Record*, October 5, 1992, p.H12101 (amendments to the Atomic Energy Act of 1954).

[39]US General Accounting Office, *Government National Mortgage Association: Greater Staffing Flexibility Needed to Improve Management*, (Washington, DC: June 1993).

[40]James Brian Quinn, *Intelligent Enterprise*, (New York, NY: The Free Press, 1992).

[41]This will be required of federal government agencies under the Government Performance and Results Act of 1993, P.L. 103-62, enacted August 3, 1993.

[42]This is required under the Chief Financial Officers Act of 1990, P.L. 101-576.

one of the results of this incentive structure is a tendency of private financial institutions to try to dominate any federal regulation that might otherwise impose policies at variance with the interests of the private owners of the corporation.

Once again, these issues are best addressed before rather than after the government has created a new institution owned by private investors. A bill passed by Congress in late 1992 requiring careful analysis of the proposed structure of federal supervision and financial soundness of any proposed new government-sponsored enterprises was an auspicious start.[43]

The most important issue to consider in this regard relates to the hidden risks of furnishing a government guarantee to a company owned by private investors. Such private use of a federal guarantee requires extensive and careful financial supervision by a federal agency. The odds of any one federally-backed institution failing may be small in any one year; however, if private parties are permitted open-ended use of an unsupervised federal guarantee, then the probability that an expensive failure might occur is greatly magnified.

If the designers of a new private institution cannot be sure that the government can provide effective long-term financial supervision of the proposed instrumentality, then they should substitute a different form of subsidy for the proposed federal guarantee. Such alternatives might include a federal loan or contribution to capital (such as have been provided to Connie Lee and the National Consumer Cooperative Bank, for example) or some form of subsidized interest rate such as through a targeted tax benefit.

Alternatively, the government can use a federal agency, rather than an instrumentality, to guarantee designated kinds of loans (as is currently done for small business loans and student loans, for example). While such guarantee programs do require effective management of financial risk, they do not entail the same magnitude of risk that can be involved in providing deposit insurance or another form of federal guarantee of the obligations of private institutions. Even though a federal agency too can fail financially, in the sense that its programs involve unacceptable losses, a federal agency is unlikely to have either the operating freedom or the incentive to compound such losses in the way that insolvent thrift institutions could multiply taxpayers' exposure to the cost of financial failure.

[43] That bill was attached to a much broader tax bill that President Bush vetoed in late 1992. See H.R. 11, Revenue Act of 1992, Title XIII—Federal Debt Management Responsibility, reprinted in *Congressional Record*, October 5, 1992, at pp. H12395–6.

IV. CONCLUSION

This survey of governmental and private institutions has not come at a time when favorable models abound. Nonetheless, there is much to be learned about the way that the choice of institution relates to factors such as the number of borrowers to be served, the size of the credit subsidy, the government's ability to target the credit and its ability to respond appropriately to changes in the credit markets and evolving public priorities. The economic purposes of a program affect the choice of institutions to implement the program; conversely, the selection of a particular type of institution can determine the economic consequences of the government's involvement in the credit markets.

The enabling legislation for a federal credit agency or private financial instrumentality is the architectural framework for creating the institution. Policymakers can choose the kind of framework most suited to the public purpose of the new enterprise. Most important, the institutions must be designed to have long-term capacity and incentives to serve their public purposes well. The legislation to create new governmental institutions must focus most directly upon the issue of institutional capacity: provision for continuing funding resources, freedom from rigid and outmoded input controls, and provisions for effective performance-based accountability. Legislation to create or expand powers of private instrumentalities also needs to focus upon the issue of governmental capacity. In this case that capacity relates to the continuing ability of the government to influence the activities of the private instrumentalities to protect taxpayer financial interests and to secure long-term service to useful public purposes, all without adding unnecessary burdens that could hamper the effectiveness of the private companies. Government supervisory institutions will need strength but also restraint in order to achieve this necessary balance.

When grounded upon a firm legislative base, governmental and private institutions can provide significant public benefits and survive the challenges of changing markets and public priorities of the kinds that have toppled structures of inferior design in the past.

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RESPONSE TO QUESTIONS OF CHAIRMAN RICHARD H. BAKER
by Thomas H. Stanton

1. QUESTION: GSEs are owned by private investors or they are "cooperatives," in which the members who participate in the GSE support the system through their capital purchases. Does the private investor format create conflicts, which increase the financial risk of the Federal Government?

RESPONSE: Both types of GSE ownership and governance structures, whether investor-based or cooperative, involve divergence of interests between shareholders and the government. Shareholders have an equity interest that allows them to enjoy the financial benefit that may result when a GSE takes added financial risks; by contrast, the government as a guarantor of GSE debt and asset-backed securities does not receive this added financial benefit.

The tension between shareholder interests and the government's financial interests can be seen in the issue of shareholder leverage. Shareholders benefit if they increase leverage and thereby distribute earnings of the company among fewer shares of stock; by contrast, the government incurs financial risk from high leverage because of the reduction in the cushion of shareholder capital that is available to absorb losses before the government may be requested to honor its implicit guarantee.

Investor-owned GSEs tend to come under relentless pressure to increase earnings-per-share. This creates an incentive for an investor-owned GSE to take added financial risks as a way to increase earnings. Cooperative GSEs also may have an incentive to increase earnings. The Federal Home Loan Bank System, for example, has such an incentive because of the fixed REFCORP obligation imposed upon the Bank System.

Cooperative GSEs also have a tendency to view their borrower stock as something other than equity capital. Thus, when the Farm Credit System failed in the late 1980s, borrowers persuaded the Congress to protect their stock from financial loss. Stockholders of the Federal Home Loan Banks have indicated that they may take a similar view of the need to protect their stock from losses that the System might incur.

The point here is that a divergence of financial interests exists between the government and shareholders of a GSE. That divergence derives from the way that the financial role of shareholders differs from the role of the government as a

financial guarantor. These divergences of interest can be managed; however, active management of the government's financial risk position is essential if the government is to avoid exposure to unnecessary losses. The statutory framework that permits the federal government to manage its financial exposure from deposit insurance, at least today, is far superior to the laws that limit the government's ability to manage the financial risk from most GSEs.

2. QUESTION: Studies on privatizing Fannie Mae and Freddie Mac found that the two GSEs earn above-normal profits by retaining about one-third of the federal subsidies they receive. Do you agree? What is the public policy rationale for this outcome?

RESPONSE: The U.S. Department of the Treasury, Congressional Budget Office, and Office of Federal Housing Enterprise Oversight all have reported to the Congress on the high proportion of federal subsidy that the two GSEs retain for shareholders and do not pass on to the residential mortgage market.

This problem derives directly from the fact that the federal government permits the two GSEs to operate as a duopoly (i.e., a monopoly shared by two firms) in a large part of the residential mortgage market. Monopoly status gives the GSEs market power as well as power over the political process. Today's GSEs are subject to too little accountability, either to the marketplace or to the public process that created them.

This monopoly status represents a considerable distortion of the original intention of the Roosevelt Administration when it created the idea of federally chartered secondary mortgage market institutions. The Roosevelt Administration conceived of a system of national mortgage associations, rather than merely two privileged companies.

Title III of the National Housing Act of 1934 provided that any responsible incorporator willing to commit the necessary capital was authorized to obtain a federal charter to become a national mortgage association. Largely because of opposition from the thrift industry, the benefits of a national mortgage association charter were quite limited under the 1934 Act, and no private incorporators ever sought a charter.

Following this setback, the Reconstruction Finance Corporation (RFC), a New Deal federal agency, created the Federal National Mortgage Association, the lineal antecedent of today's Fannie Mae, in 1938 as a corporate subsidiary. The RFC ended and the Congress chartered the Federal National Mortgage Association

in 1954, still as a federal agency; in 1968 the agency's secondary market activities were divided between a newly-chartered GSE, today's Fannie Mae, and the government agency now called Ginnie Mae. The Congress chartered Freddie Mac as a GSE in 1970, and today's secondary market duopoly was permitted to develop.

3. QUESTION: As a mechanism for targeting federal credit subsidies to borrowers who would not otherwise receive credit or who are low-income, how do GSEs compare with federal grants, direct loans, or loan guarantees?

RESPONSE: Professor Wachter testified at the July 16 hearing that Fannie Mae and Freddie Mac "lag" behind other segments of the residential mortgage market in service to low- and moderate-income homebuyers.[1] This should not come as a surprise.

As a general rule, the GSE is not a useful tool for targeting federal credit to a borrower that otherwise would not be considered creditworthy. To the extent that mortgages for low- and moderate-income homebuyers have high loan-to-value ratios (i.e., lower downpayments), they involve increased financial risk.[2] For reasons of fairness, lenders are not able to price such mortgages according to the risk. Thus, it is reasonable that the risk from such high loan-to-value mortgages be borne by a federal agency such as the Federal Housing Administration (FHA) that has access to appropriated public funds.

Unlike a government lending or grantmaking agency, GSEs are not supposed to receive appropriations of public funds; they are supposed to be profitable or at least financially self-sustaining.[3] The charter legislation for Fannie Mae and Freddie Mac, for example, is quite explicit on this point. (See, e.g., Fannie Mae Carter Act, 12 U.S.C. Sec. 1719 (a)(1)).

The statutory purposes of each enterprise state that its activities with respect to mortgages for low- and moderate-income families shall involve "a reasonable economic return that may be less than the return earned on other activities." (Fannie Mae Charter Act, 12 U.S.C. Sec. 1716 (3)). Their charters also limit them to dealing in mortgages, "of such quality, type, and class as to meet, generally, the purchase standards imposed by private institutional mortgage investors." (Fannie Mae Charter Act, 12 U.S.C. Sec. 1719 (a)(1)).

The need to be self-sustaining financially does not entirely explain the reluctance of the two large housing GSEs to bear even the amount of risk that other portfolio lenders are willing to bear in the same markets. The second part of the explanation

relates to the monopoly power of those GSEs, discussed above, and their ability to decide for themselves how much of their public subsidy they wish to retain for shareholders and how much will be used to serve public purposes such as the needs of low- and moderate-income homebuyers and renters.

The Congressional Budget Office points out:

> "Fannie Mae and Freddie Mac largely specialize in mortgage finance for first-quality borrowers rather than assessing and bearing the credit risk for marginal borrowers....[T]he housing GSEs claim to provide public benefits in contributing to the nation's affordable housing goals....Yet evidence is lacking that this benefit exceeds what could be accomplished by fully private firms and by various levels of government with the funds that governments would receive following the repeal of the special exemptions afforded the GSEs under current law."[4]

The problem of using a GSE to deliver credit on noneconomic terms to any significant number of borrowers also relates to the need for a GSE to operate in a safe and sound manner so that taxpayers are not exposed to serious financial risk. The financial failure of the Farm Credit System in the 1980s stands as a warning in this regard.

There is a solution to this problem. The Federal Home Loan Bank System is required to pay a tax of 10 percent of earnings (and a minimum of $100 million annually) into a special affordable housing fund. The money in this fund is used to promote affordable rental housing and to reduce the borrowing costs of disadvantaged borrowers who otherwise might not be able to afford a mortgage.

Given the super-normal profits of Fannie Mae and Freddie Mac referenced in the second question, above, it would not seem inequitable to impose a 10 percent levy upon the two largest housing GSEs as well, to enhance their support for low income housing through a congressionally mandated affordable housing fund.

July 31, 1997

ENDNOTES

1. Nicolas Retsinas, HUD Assistant Secretary for Housing and Federal Housing Commissioner also testified before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises on April 17, 1996, that "[T]he GSEs' purchases of low-income loans continues to lag those of other mortgage market participants including portfolio lenders." (Written Testimony, p. 3).

2. Interestingly, it is the high loan-to-value ratio that correlates with risk. With a suitable down payment, it is the borrower's income stability rather than level of income that tends to relate to the likelihood of default. See, Robert B. Avery, Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner, Division of Research and Statistics, Federal Reserve Board, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," Federal Reserve Bulletin, July 1996, pp. 621-648.

3. These issues are explored in Thomas H. Stanton, "Federal Credit Programs: The Economic Consequences of Institutional Choices," The Financier: Analyses of Capital and Money Market Transactions, Vol. 1, No. 1, pp. 20-34 (February 1994). A copy of that article is included with this response.

4. Congressional Budget Office, Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac, May 1966, p. 31.

RESPONSE TO QUESTIONS OF REPRESENTATIVE FLOYD H. FLAKE
by Thomas H. Stanton

1. QUESTION: Fannie Mae and Freddie Mac, in recent earnings reports, signalled major competition in the market, with traditional conforming mortgage product going to other investors. Doesn't this indicate that there is, in fact, a significant level of competition in the market?

RESPONSE: This is a question that is best answered on the basis of combined expertise in both the economics of industrial organization and the economics of the residential mortgage market. The U.S. Department of Housing and Urban Development commissioned research to bring such expertise to bear and to analyze competition in the residential mortgage market. The study was conducted by Professors Benjamin E. Hermalin and Dwight M. Jaffee of the University of California at Berkeley.

The research, published by the Department in 1996, reaches the following conclusions:

> "(1) There are strong theoretical reasons and strong empirical evidence for believing that Fannie Mae and Freddie Mac are tacitly colluding duopolists in the conforming segment of the conduit market.
>
> (2) There are strong theoretical reasons and strong empirical evidence for believing that the jumbo segment of the conduit market (from which Fannie Mae and Freddie Mac are barred) is competitive.
>
> (3) Fannie Mae and Freddie Mac are able to sustain their duopoly in the conforming segment because there are barriers to entry into this segment. Most of these barriers are a consequence of Fannie Mae's and Freddie Mac's status as government-sponsored enterprises (GSEs).
>
> (4) The other "players" in the markets (e.g., the buyers of mortgage-based securities and mortgage originators) have no market power.
>
> (5) The close substitutes for mortgage-based securities (e.g., securities based on FHA/VA loans) limit the spread that Fannie Mae and Freddie Mac can enjoy despite their duopoly."[1]

In short, Fannie Mae and Freddie Mac benefit from competitive advantages in their charters that are not available to other firms in the residential mortgage market. Today's law creates a dual monopoly (i.e., a duopoly) in the conforming mortgage market that is far less competitive than the market for nonconforming mortgages.

The President and Congress did not originally intend to create such a duopoly. The Roosevelt Administration conceived of the creation of a system of national mortgage associations to serve the secondary market, rather than merely two privileged companies. (See, Title III of the National Housing Act of 1934, as originally enacted).

2. QUESTION: Given that Fannie and Freddie's performance for their shareholders is intricately tied to service to their mission, why should we look upon these two obligations as in tension with each other? We don't have to look at this as a zero-sum analysis, do we? Are we so cynical about public policy that we are reluctant to acknowledge that Congress has done something right here?

RESPONSE: Government sponsored enterprises receive substantial public benefits and are expected to pass them on in service to the borrowers and markets specified in legislation. However, legislation is an imprecise tool, particularly in today's rapidly changing markets. Once the Congress enacts legislation to create a GSE, and especially a powerful one such as Fannie Mae or Freddie Mac, the American people will be best served if their elected representatives maintain a continuing role in assuring that it provides public benefits that outweigh its public costs.

The Department of the Treasury recently reported on what it calls "the tension between profit and public purpose":

> "When creating a GSE, Congress defines the problem (i.e., the market imperfection) it seeks to overcome, provides benefits (subsidies), and imposes limitations on the GSE. But if Congress wishes to revise those decisions in response to changing public needs, it no longer has the same freedom of action. In addition to the usual constraints of the legislative process, it must contend with the private interests of the GSE and its shareholders. Congress must consider, and legislate, any such changes through a process in which the GSEs are significant participants. As a private company, the GSE

> will act to fulfill its fiduciary responsibilities by promoting and protecting the interests of its shareholders."[2]

In other words, unless the Congress provides for ongoing oversight of public benefits, it risks creating GSEs that evolve to serve private purposes that can crowd out the public benefits. To give a recent costly example, some GSEs found that they could enhance their earnings by issuing types of securities known as derivatives. While derivative securities can be useful tools for some experts, they are dangerous in the hands of unsuitable investors such as the former Treasurer of Orange County, California.

Enclosed for the printed record is a report on the role of GSEs in the Orange County debacle, by Randall Smith and John Connor, "Matter of Security: Risky Derivatives Are Huge Source of Funds For Federal Agencies," Wall Street Journal, January 20, 1995, p. A1.

July 31, 1997

ENDNOTES

1. Benjamin E. Hermalin and Dwight M. Jaffee, "The Privatization of Fannie Mae and Freddie Mac: Implications for Mortgage Industry Structure," published in, U.S. Department of Housing and Urban Development, Office of Policy Development and Research, Studies on Privatizing Fannie Mae and Freddie Mac, May 1996, pp. 225-335, at p. 227, (footnote omitted). I commend the entire paper and the accompanying discussion to you and your staff.

2. U.S. Department of the Treasury, Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, July 11, 1996, p. 81.

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Matter of Security

Risky Derivatives Are Huge Source of Funds For Federal Agencies

Investors Learn the Hard Way That 'U.S.-Backed' Is No Guarantee of Safety

'A Hungry System to Feed'

By RANDALL SMITH and JOHN CONNOR
Staff Reporters of THE WALL STREET JOURNAL

Last February, just before the Federal Reserve began jacking up interest rates, a U.S. Army welfare and recreation fund invested $15 million in what looked like a sure thing: A two-year, triple-A-rated, U.S. government-agency note with a tempting initial yield of 4.75%, well above the then-prevailing rate.

But in just three months, the note's yield was reset to 0% under a complex formula, making it dead money to the investor. So far, the Army fund has taken a 7.9% paper loss on the notes, a hefty hit for a short-term note in a supposedly low-risk fund that manages cash balances for Army base golf courses and bowling alleys.

"This is not wonderful," frets fund manager Jeffrey Dalbey.

This security, known as a structured note, wasn't issued by a penny stockbroker or a widget manufacturer. It was the Federal Home Loan Bank System, a lightly supervised, Depression-era creation, which is at the center of the gathering storm about the government's role in issuing such gimmicky and risky securities.

Orange County Connection

The Army wasn't the only investor to be burned by such safe-looking securities. Structured notes issued by the Federal Home Loan Bank System and other federal agencies also played a prominent role in Orange County's bankruptcy filing last month. Similar investments blew up last year in supposedly low-risk funds run by BankAmerica Corp. and Mellon Bank Corp., among others.

But what were government-sponsored agencies doing issuing risky derivative securities in the first place?

"Agencies of the federal government have been pumping this junk out there for a tiny saving in interest costs," says Bert Ely, a consultant on financial institutions in Alexandria, Va. "They're trading on their triple-A. government-sponsored status in a way that I don't think is desirable from a public-policy standpoint. That activity is going to come under close scrutiny this year."

The growing outcry already has slammed the brakes on new issues of structured notes, which until last year were one of Wall Street's most lucrative new products. Unlike conventional fixed-income securities, structured notes pay returns based on changes in some underlying index or formula. Those that torpedoed investors in 1994 typically involved bets on relationships between various interest rates, which made the notes' values and risks hard to figure. A common type of structured note, for example, has a yield pegged to the difference between short-term and long-term interest rates.

What particularly has raised hackles lately is the part played by government agencies as dominant issuers of such risky derivative securities. "The Orange County bankruptcy has intensified" that concern, says Aida Alvarez, director of the Office of Federal Housing Enterprise Oversight, which monitors the Federal National Mortgage Association and the Federal Home Loan Mortgage Corp.

Federal Debt

Government-agency issues of structured notes at year-end 1994

AGENCY	STRUCTURED NOTES OUTSTANDING (billions)	TOTAL DEBT OUTSTANDING (billions)
Federal Home Loan Bank System	$44.3	$147.6
Fannie Mae (Federal Nat'l Mtge. Assn.)*	30.0	225.0
Freddie Mac (Federal Home Loan Mtge. Corp.)	13.2	48.2
Sallie Mae (Student Loan Mktg. Assn.)*	7.5	50.7
Federal Farm Credit Bank Funding Corp.*	5.4	54.0

*Wall Street nicknames.
Source: The agencies

Although these organizations aren't literally government agencies, they issue securities with implied government backing that are known on Wall Street as government-agency securities.

The largest issuer of structured notes is the Federal Home Loan Bank System, an agency originally intended to provide funds to mortgage lenders during the Depression. Nowadays, the system also makes investments to generate a profit in order to pay an annual $300 million interest tab for the cost of the 1989 savings-and-loan bailout. The system—the world's second-largest borrower after the U.S. Treasury last year, according to Securities Data Corp. — has $44.3 billion of such derivative securities outstanding.

Among other things, the controversy over structured notes has exposed a glaring lack of supervision of the Home Loan Banks: A majority of seats on the five-member Federal Housing Finance Board, which supposedly oversees the system, have been vacant for more than a year. Two board members nominated by Presi-

Please Turn to Page A7, Column 1

Matter of Security: Derivatives Fund Many Government Agencies

Continued From First Page

dent Clinton have been held up in Congress.

Criticizing the Home Loan Banks before the Senate Banking Committee on Jan. 5, Frank Newman, who was then acting Treasury Secretary, sarcastically noted the system's heavy issuance of "inverse floaters, range bonds, fairway bonds, a whole range of interesting-sounding things." Mr. Newman then promised a proposal later this year for restructuring and oversight of the agency – "hopefully before it does turn into a problem."

Critics question the aggressive way that these and other federal borrowers handed over their names and credit ratings to Wall Street dealers, giving them a free hand in designing and selling structured notes to the public. It is the dealers, not the agencies, who attach all the bells and whistles to the structured notes and actually sell the notes to investors. The agencies themselves get a slightly lower interest rate in exchange for allowing Wall Street to dress up their debt this way.

Because they have relatively short maturities and interest rates that reset monthly or quarterly, the notes often resemble securities designed for no-risk money-market funds. But they often contain features that make them lose value like riskier, longer-term bonds.

Fewer Facts

What's more, government-sponsored enterprises don't have to register their securities with the Securities and Exchange Commission the same way corporations do. And that means investors may get less information about risk. Many market experts believe such agency notes lulled investors into a false sense of security by their government sponsorship and triple-A credit ratings.

A case in point is a July 13, 1993, letter from Orange County's assistant treasurer, Matthew Raabe, to an investor in the ill-fated municipal investment pool. The letter stressed: "We kept risk low by purchasing United States government securities which are universally accepted as having nearly no risk of default."

The agencies respond that structured notes are simply a way to meet their obligation to lower the cost of the funds they provide. Although the agencies started issuing structured notes in the late 1980s, they didn't do so in large volume until 1992, when the dramatic falloff in short-term interest rates prompted a search by investors for new forms of higher-yielding securities.

Hungry System

Nicolas Retsinas, the interim head of the Federal Housing Finance Board, says use of structured notes has saved the Home Loan Bank System the equivalent of about $90 million annually in interest costs.

"We have a hungry system to feed," said John Darr, the architect of the system's structured-note sales, in an interview last summer. After the Orange County bankruptcy last month, Mr. Darr brushed off questions about the agency's role: "Is it my responsibility to protect people who don't know what they're doing from themselves?"

Jay Roy, president of the Pittsburgh Home Loan bank, who shares responsibility for overseeing the system's financing operations, says he has "no indication" that structured notes were sold to unsuitable investors. He and other system officials say they take steps to make sure dealers don't sell them to investors who don't understand the risk.

But for some time, regulators have been warning investors about the dangers of structured notes–federal or private–which may offer seductively high yields when rates are stable or fall, but rack up wicked losses when rates rise. The SEC issued warnings in 1993, and last year it told money-market funds to dump them outright.

Regulators and Wall Street traders widely agree that underwriters selling structured notes have targeted investors with the lowest risk tolerance, including money-market funds, bank investment funds and investment pools like Orange County's that weren't supposed to be putting principal at risk.

"They've been pawning this stuff off on small banks and savings and loans in the heartland," says Walker Todd, a Cleveland lawyer who used to work at the Federal Reserve. "How seemly is it for an instrumentality of the federal government to be robbing Peter to pay Paul?"

Questions Inside

Even some top officials of the Home Loan Bank System have raised questions. George Barclay, president of the Federal Home Loan Bank of Dallas, says his organization stopped issuing structured notes last year, partly because he sensed that they "were finding their ways into the portfolios of less-suitable investors." To be sure, that is easier for him to say because the Dallas bank hasn't had to issue debt of any kind in that period.

The Home Loan Bank System as a whole has been on a little-noticed borrowing binge in recent years, relying on structured notes for 30% of its outstanding debt. Since the end of 1991, its assets have grown 49% to $230 billion, and its membership by 77% to 5,248 institutions.

Most of the growth has come from commercial banks, which until 1989 fell outside the system's mandate. Commercial banks have signed up in order to gain access to low-cost, longer-term financing in the form of advances from the system. Such advances can be cheaper to obtain than retail deposits. In return, the banks must devote 10% of their assets to mortgage loans.

Critics wonder whether the housing and banking sectors need such federal subsidies. They call the system a bloated, self-perpetuating bureaucracy with its 2,109 staffers and annual operating expenses of $200 million.

A 1993 study by the Congressional Budget Office concluded that the system may have outlived its usefulness. The reason: The growth of the mortgage-securities market has slashed the percentage of mortgages held by banks and savings institutions from 74% in 1977 to 34% in 1992. As a result, the budget office said, "policy makers may want to determine whether the Federal Home Loan Banks are needed in today's market."

Mr. Darr, the architect of the Home Loan Bank's aggressive borrowing, himself has a mixed professional track record. As executive vice president of finance and administration of the Student Loan Marketing Association, he helped pioneer swaps, a successful but controversial derivative market, in the early 1980s. In 1984 he joined Financial Corp. of America, the once high-flying savings and loan run by financier Charles Knapp that eventually collapsed. Mr. Darr left after only five months, joining another savings institution that later failed, and later went to a mortgage-investment fund that didn't meet its growth targets. Mr. Darr concedes that joining Financial Corp. "was a mistake."

In July 1992, Mr. Darr became managing director of the system's office of finance. Although Wall Street dealers pitch structured-note issues directly to individual Home Loan Banks, it is Mr. Darr who acts as the ringmaster for their hundreds of relatively small deals. And it was Mr. Darr who sponsored the shift to smaller, custom-tailored and individually negotiated deals — many involving structured notes. In all, the system has issued structured debt tied to more than 175 indexes.

As federal bureaucrats go, the 50-year-old Mr. Darr is highly paid. He received a 1994 base pay of $239,560, plus an incentive bonus for the previous year of nearly 25%.

Investors in many Federal Home Loan Bank structured notes, by contrast, haven't been so richly rewarded. The Army welfare fund's two-year note, for example, offered a juicy yield of 1.25 percentage points over a short-term bank index — but only if that index rate fell inside a narrow, pre-set range. If the index didn't remain in that range, the note holder would receive zero interest for the next quarter.

When short-term interest rates shot up by 1.5 percentage points last spring, this "fairway bond" ended up in the rough. Despite adjustments to its terms at the Army's request, the yield remains at 0%. Although the Army fund may hold the note to maturity and get its principal back, it is carrying the note at a loss on its books to reflect its current resale value.

Ironically, the Army fund was so safety-conscious that it could invest only in securities issued by the U.S. Treasury or other government agencies. The $400 million Army fund has since changed its guidelines to prohibit notes whose interest rate could fall to zero. While fund manager Mr. Dalbey says he understood the Home Loan note's risks, he just never dreamed that such an outcome was possible. "Our worst case wasn't worst enough," he says.

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The Role and Nature of Government Sponsored Enterprises (GSEs): Market Imperfections and The Evolving Financial Services Industry

by

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Statement for the Joint Hearing on Government Sponsored Enterprises

Before the Capital Markets, Securities and GSEs Subcommittee of the
Committee on Banking and Financial Services
and
Government Management, Information and Technology Subcommittee of the
Government Reform and Oversight Committee

U.S. House of Representatives

Washington, D.C.
July 16, 1997

For Release:
2:00pm Wednesday, July 16, 1997

Chairmen and Members of the Committees, I am Chairman of the Real Estate Department and Professor of Real Estate and Finance at The Wharton School of the University of Pennsylvania. My colleagues and I on the faculty of the Wharton Real Estate Department and Center analyze a wide variety of housing and urban issues, and it is a privilege to be invited to testify before this joint hearing on Government Sponsored Enterprises. Most of my expertise and underlying research relate to mortgage markets, and thus, in my testimony today, I will discuss the role and nature of those Government Sponsored Enterprises which support secondary markets for residential mortgages. In my testimony, I will also specifically refer to a research paper, authored by myself and colleagues, on how full privatization could affect the social goals specified in the GSEs' federal charters. This study, which I request be entered into the record, was commissioned by the U.S. General Accounting Office, the U.S. Department of Housing and Urban Development, the U.S. Department of the Treasury, and the U.S. Congressional Budget Office, and was published in May of 1996 by the U.S. Department of Housing and Urban Development.

In my testimony today, I will first address those questions posed in your invitation to testify. Throughout my remarks, I will speak to the role and nature of the GSEs in a rapidly changing global financial services market. I will address the following questions as they relate to the rapid evolution of financial markets: When and under what circumstances should GSEs be privatized or created? How and for what purposes should GSEs be regulated? Should financial compensation be required from the GSEs for the special market privileges enjoyed by GSE borrowers and guarantors? Are there areas where the scope of existing GSE activities should be expanded or reduced?

A rationale for the creation of GSEs exists if there are market imperfections that are mitigated by their activities. If their mission is no longer justified by such rationales, their privatization should be considered. Given the contingent liabilities to the U.S. taxpayer, GSEs must be monitored for their safety and soundness as well as for their mission achievement. It is not financial compensation that should be required from the GSEs but rather the effective achievement of their mission. Finally, there may well be conditions under which the scope of existing GSE activities should be expanded or reduced; I will suggest one such expansion in my comments below.

The federal government provides a number of economic privileges to the GSEs, most important of which is the implied federal government guarantee which decreases the Enterprises' funding costs. In return for these benefits, the GSEs are required by their federal charters and other statutes to provide public services which include: the facilitation of nationwide homeownership through the purchase and securitization of mortgages; the funding and underwriting of special low income homeownership programs; the promotion of neighborhood reinvestment; and the reduction of redlining and discrimination in mortgage lending.

Currently and historically, special purpose corporations such as the GSEs have had the responsibility to serve home loan borrowers by delivering the benefits of lower-cost capital that derives from the use of secondary markets. On October 28, 1992, Congress passed the Federal Housing Enterprise Financial Safety and Soundness Act, which requires the Secretary of HUD to establish specific affordable and geographically targeted housing goals for GSE mortgage purchases in order to facilitate the provision of credit to

lower income families and communities that have historically been underserved by the mortgage market.

Given the currently highly developed state of the secondary market for mortgage loans in the U.S., and the rapid development of both information technology and global financial markets, what purposes are served by the Charter Acts and the FHEFSSA? In answering this question, I wish to present my thoughts on the broad social context for public policy goals embodied in the legislative acts. In my view, these public policy concerns are centered on the serious and worsening problems of concentrated urban poverty, and the persistent racial and ethnic disparities in homeownership rates. In addition, homeownership is a continuing and basic objective of U.S. housing policy.

GSEs' lower funding costs reduce market mortgage rates and help achieve increased homeownership rates. Furthermore, important technological innovation and standardization gains, likely to be attributed to the special status of the GSEs, lower mortgage rates and help achieve increased homeownership rates. Such innovations are generally facilitated by large market players that are capable of effecting market transformations and have the incentives to do so. Innovation has increased the efficiency with which funds have been provided for mortgage markets in the past, and has the potential to do so in the future. With innovation and standardization has come the integration of the housing finance system into national and international capital markets.

The federal sponsorship, however, of GSEs also creates significant risks for U.S. taxpayers that derive from the federal government's potential liability for the Enterprises' obligations. There is also a cost in terms of the need to monitor each GSE for safety and soundness. This added cost of government regulation and the need for efficient and

effective oversight is likely to increase with the number of GSEs. Given these ongoing risks and costs, we must clearly define the current public purpose served by the GSEs.

Economists generally view government intervention as welfare enhancing when there are market imperfections. The continued federal sponsorship of GSEs helps achieve the broad public policy goal of access to affordable homeownership through lower funding costs. Thus, to the degree that homeownership is regarded as yielding external benefits to neighborhoods and society beyond those directly enjoyed by individual homeowners, market imperfections exist and continued federal sponsorship of GSEs may be justified.

The degree to which continued federal sponsorship of GSEs contributes to increased homeownership rates is analyzed in our study on the privatization of GSEs. There, we find that homeownership rates increase by about 1-1/2% in the aggregate and more for targeted groups. This result is likely to occur through a lower age of first-time homebuyers and, to a lesser extent, through an increase in homeownership among those who otherwise would not have been homeowners in their lifetimes.

In other research, I have discussed the potential for market failure in mortgage lending deriving from what may be termed neighborhood effect and information externalities. The GSEs may be well placed to extend the envelope to determine where such market imperfections exist.

In the presence of externalities, increased lending to currently underserved low income neighborhoods may be possible without a significant increase in credit risk. Externalities raise the possibility of a virtuous cycle to reverse the vicious cycle of neighborhood decline. Conventional lenders rationally tend to avoid risky neighborhoods. However, such risk may be increased by the actual avoidance. Private and public

cooperation and increased neighborhood information may reduce perceived neighborhood risk. I would be pleased to expand upon these concepts.

Given the GSEs size and the extensiveness of their market reach, they may be able to determine where such market imperfections exist, through an analysis of their affordable lending experience. However, given the initial risks and costs, encouraging affordable lending programs through effective regulation of the GSE mission and setting affordable lending goals is important. On the other hand, the GSEs' market orientation is likely to provide incentives to achieve affordable lending goals efficiently. In particular, as we discuss in our paper, some FHA functions should be transferred to the GSEs:

> ... existing programs are unlikely to be as efficient and effective as the operations of the GSEs in these areas if the federal government is vigilant in the enforcement of the affordable housing mandates imposed upon the GSEs. Simply put, the expertise, incentives, and resources available to the GSEs are sufficient to make them private, efficient, targeted welfare provider.

Thus, I believe it is the GSEs, rather than FHA or direct government intervention, that are likely to respond to market imperfections efficiently and sufficiently well to make affordable lending an important component of the revitalization of urban America.

Chairmen, and Members of the Committees, this concludes my prepared statement, and I would be pleased to respond to any questions that you may have.

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Biography

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1997

Susan M. Wachter currently serves as Chairperson of the Real Estate Department (1997-2000), and is a Professor of Real Estate and Finance at The Wharton School of the University of Pennsylvania and is a Professor of City and Regional Planning at the University's Graduate School of Fine Arts. A recipient of the Lindback Award, Anvil Award, and Wharton Undergraduate Teaching Award, Professor Wachter is author or editor of seven books and more than seventy publications on real estate markets, housing policy and the U.S. economy.

Dr. Wachter is currently Co-Editor of *Real Estate Economics*, the leading academic real estate journal, and serves on the Board of Editors of the *Journal of Housing Economics, Journal of Housing Research, Journal of Real Estate Finance and Economics*, and *Journal of Financial Abstracts for Real Estate*.

Dr. Wachter is a Faculty Fellow of the Homer Hoyt Institute and a member of the National Association of Realtors' Academic Council. Dr. Wachter is a past President of the American Real Estate and Urban Economics Association, is currently a member of the Board of Directors of MIG Residential REIT, and is a member of the Board of Directors of Beneficial Corporation, a New York Stock Exchange-listed company.

IMPLICATIONS OF PRIVATIZATION: THE ATTAINMENT OF SOCIAL GOALS

Susan Wachter
James Follain
Peter Linneman
Roberto G. Quercia
George McCarthy

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A commentary on the March 22, 1995 draft of this paper by Anthony M. Yezer begins on page 378, and the authors' response to Mr. Yezer's comments appears on page 382. Fannie Mae's review of the paper begins on page 383.

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Ms. Wachter and Mr. Follain currently serve as members of Fannie Mae's Office of Housing Policy Research Advisory Board; they and Mr. Linneman had current research funding from Fannie Mae during their period of work on the Attainment of Social Goals paper. Mr. Quercia and Mr. McCarthy have received research funding from Fannie Mae in the past.

A draft of this paper was submitted on March 22, 1995 and presented in a seminar at the U.S. General Accounting Office on April 13, 1995. Mr. Yezer's written comments were submitted on June 26, 1995. The final version of the paper and the authors' written response to Mr. Yezer's comments were submitted on July 27, 1995. The Fannie Mae Review was submitted on August 4, 1995.

I. INTRODUCTION

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are shareholder-owned, for-profit corporations chartered by the federal government with special privileges and responsibilities. Among the statutory benefits that federal law confers on Fannie Mae and Freddie Mac are exemptions from state and local taxes, Securities and Exchange Commission (SEC) regulations, and state security laws. These privileges, among others, give government-sponsored housing enterprises (GSEs) "federal agency" status in capital markets and access to funds at favorable rates. Besides conferring special advantages, the federal charters limit the scope of services that Fannie Mae and Freddie Mac may provide to secondary market activity, including the purchase and securitization of mortgages.

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA) calls for study of the desirability of fully privatizing the GSEs, thus repealing their federal charters. The legislation also mandates study of the potential social costs of such restructuring. Privatization may have important consequences for social objectives, currently advanced through special responsibilities, imposed on the GSEs by virtue of their federal charters.

The central objective of this paper is to consider the impact of privatization on the social objectives of the two GSEs. According to their charters and other statutes, the GSEs are to serve public purposes which include (among others):

(1) Promotion of homeownership through the purchase and securitization of mortgages, and promotion of low-income homeownership through special programs.

(2) Promotion of the development of rental housing through multifamily lending programs.

(3) Reduction of redlining and racial discrimination in mortgage lending and promotion of neighborhood reinvestment in the achievement of the above goals.

The 1992 GSE legislation rearticulated the roles of Fannie Mae and Freddie Mac in the promotion of affordable housing. The GSEs have been given interim goals for lending in central cities, rural areas, and other areas defined to be "underserved," and for lending to lower income households. In 1993 the GSEs met the latter, but not the former goal. In 1994 these targets specify that 30% of mortgage loan purchases should be of loans made to borrowers with incomes at or below their areas' median, and those 30% should be in central cities. By 1995 the Secretary of Housing and Urban Development is to replace these interim with permanent affordable housing goals. The 1992 legislation also, more generally, directs the corporations to serve both ownership and rental affordable housing needs.

In their operations, the GSEs have placed different emphasis on the achievement of these goals. On the homeownership side, the GSEs have concentrated on the market for conventional single-family home mortgages and, through their secondary market activity, the GSEs have succeeded in dominating this market. The proportion of mortgages purchased through low-income homeownership programs is low relative to overall GSE conventional activity. On the rental side,

GSE activity has unfolded in a number of multifamily lending programs. The volume of multifamily lending is small compared both with conventional single-family lending and with the overall size of the market for multifamily lending.

In the following, we analyze how complete privatization of Fannie Mae and Freddie Mac could affect the public purposes listed above, and, more generally, the availability of mortgage credit across sociodemographic groups and geographic areas. Given the differences in emphasis, two different approaches are used to assess the effect of privatization on the achievement of goals. On the homeownership side, we focus on the effect of privatization on ownership costs, affordability, and ownership rates due to possible changes in the conventional mortgage market. On the rental side, we examine the GSEs' multifamily lending programs, relative to similar programs under the U.S. Department of Housing and Urban Development (HUD).

We analyze the effects of privatization in homeownership and rental markets in Sections II and III. We discuss the possible impacts of restructuring Fannie Mae and Freddie Mac on redlining and neighborhood reinvestment in Section IV. We present conclusions in Section V.

II. EFFECTS ON OWNER-OCCUPIED HOUSING MARKET

The fundamental question that this section addresses is how full GSE privatization may affect social goals in owner-occupied housing markets. After introducing the role of GSEs in homeownership markets, we analyze this question first by estimating an empirical model. We also evaluate whether GSE special housing programs help achieve social goals and whether existing or new government programs could substitute for GSE activity. We conclude with the policy implications of the analysis for privatization based upon consideration of single-family mortgage markets.

II.1. Effects of Privatization of GSEs on Homeownership

Important determinants in the decision to become a homeowner include factors that affect the relative cost of owning compared with renting, current and lifetime earnings and wealth, and household demographic characteristics.[1] An increase in the relative cost of owning decreases households' probability of becoming homeowners. Changes in earnings and wealth potentially have two effects on ownership: Increased earnings and net assets raise lifetime wealth, increasing the propensity to own; and additional current income and, perhaps more importantly, wealth reduce income and downpayment constraints, thereby also raising the probability of ownership.

By facilitating the flow of mortgage credit over time and between places, secondary market entities may promote ownership, primarily through effects that increase the affordability and decrease the costs of ownership.[2] In general, they may do so by purchasing and securitizing loans originated by primary lenders. This enables mortgage originators to sell loans, which are relatively illiquid assets, thus raising new funds to extend new loans to potential borrowers.

Throughout the 1980s Fannie Mae and Freddie Mac contributed to the growth of securitization and the secondary market. In part, this growth was attributable to the unraveling of the thrift debacle, and, in part, to financial innovations of the GSEs. Within the market for loans below their loan limit, the GSEs now dominate the market. In 1992, of the $183.8 billion in net investment in U.S. residential mortgage debt, Fannie Mae accounted for $98 billion and Freddie Mac $48 billion, 79% of the total.[3]

The original balance in the mortgages that GSEs can purchase is limited by law to specific maximum amounts which are adjusted over time. In 1994, the GSEs could purchase single-family mortgages of up to $203,150. This conforming loan limit is adjusted each year to reflect percent increases in the national average purchase price for all conventionally financed homes.[4] Recently, three-fourths of all conventional (non-government insured or guaranteed) loans have been at or below these limits (Cotterman and Pearce 1994).

The GSEs can purchase loans at or below the conforming loan limit, including loans below the Federal Housing Administration (FHA) ceiling.[5] However, they do not have as great a competitive advantage in this market segment. Loans insured or guaranteed by FHA or by the U.S. Department of Veterans Affairs (VA) can be securitized with further guarantees from the Government National Mortgage Association (Ginnie Mae); these mortgage-backed securities (MBSs) have the full backing of the U.S. Treasury. Because of past actuarial losses and consequent changes in pricing and program provisions for FHA loans, the share of the origination market occupied by FHA/VA mortgages has declined since its mid-1980s peak. Changes that may further reduce the size of the FHA program are currently under consideration. Conventional mortgages have accounted for approximately 80% of total GSE mortgage purchases (Congressional Budget Office 1991). Given this historical and likely future emphasis, the analysis in this section examines the effect of privatization on ownership costs, affordability, and homeownership through projected impacts on the conventional mortgage market.

The GSEs' dominance of the conventional mortgage market is attributable to their size and to the "agency status" which lowers their capital costs. Lower capital costs are reflected in lower mortgage rates to potential borrowers than the market would otherwise require. Studies have generally estimated a disparity ranging from 25 to 35 basis points between fixed-rate loans with balances above and below the conforming loan limit, although a disparity of as much as 50 basis points has been observed (Hendershott and Shilling 1989, ICF, Inc., 1990, Cotterman and Pearce 1994).[6] The removal of "agency status" through full privatization is expected to eliminate this capital cost disparity.

The GSEs control lending risks through underwriting guidelines that have become industry standards. These guidelines and federal law require private mortgage insurance if borrowers do not provide at least a 20% downpayment. Also, at the time of loan origination, borrowers' housing payments (mortgage principal and interest payments, property taxes, and insurance) generally must not exceed 28% of their income. When combined with other obligations, such as credit card debt, these housing costs usually are not allowed to exceed 33% of income. These standards are relaxed

in a number of low- and moderate-income homeownership programs, which are discussed in Section II.4.

II.2. Empirical Analysis of Effects of Privatization on the Conventional Mortgage Market

The 1989 American Housing Survey (AHS), national core, is used to perform the empirical analysis of the potential effects of privatization on the conventional mortgage market.[7] The possible effects that we examine in detail include the impact of full privatization on (1) homeownership costs, (2) mortgage affordability, and (3) homeownership rates. In particular, we analyze how regime shifts in costs and affordability resulting from full privatization may differentially impact ownership rates.

How such shifts will impact ownership will depend on whether we examine "now-own" versus "ever-own" rates. Recent movers and young households may take advantage of interest-rate induced lower costs by moving to homeownership when costs decline, without this affecting "ever-own" ownership rates, that is, the likelihood of owning a home over a lifetime. Similarly, initial responses of recent movers and young households to heightened affordability constraints may cause potential homebuyers to postpone ownership until savings can be adjusted, again without affecting the lifetime probability of becoming an owner (Engelhardt 1993; Haurin, Hendershott, and Wachter 1994). Thus, increased ownership costs and decreased affordability will diminish current ownership rates more than lifetime "ever-own" rates. Also, such shifts will be concentrated among the young and recent movers, although aggregate rates will decrease, both as a consequence of the decrease among these groups and as a consequence of lesser declines among other groups, as well.[8] In our homeownership models, we use several samples, including recent movers, young households, and a cross-section of all households to estimate these differential effects. For each, we analyze possible impacts for targeted socioeconomic groups and underserved areas: by race and low- and moderate-income borrower status, and by central-city location.

The analysis is replicated with baseline conditions and with interest costs and income and downpayment eligibility criteria expected to prevail if complete privatization were to occur. We use the 50-basis-point upper bound of empirical estimates of expected interest rate shifts (see above) to establish a possible range of impact. We also consider the possible effect of shifts in underwriting, attributable to full privatization, on downpayments.

Three scenarios are explicitly considered: (1) a 10% downpayment and a 10.12% mortgage interest rate[9] to reflect the prevailing baseline conditions in 1989; (2) a 10% downpayment and a 50-basis-point increase to a 10.62% mortgage interest rate attributable to the loss of capital cost advantage; and (3) a 50% downpayment increase to 15%, attributable to more rigid underwriting,[10] with a 10.12% baseline interest rate. We believe that a 50% increase in the amount of the downpayment could occur, if interest rates were to remain constant. For marginal households, effects (2) and (3) may hold.

TABLE 1

Homeownership Costs: Change Pre- to Post-Privatization

	Before Tax		After Tax	
	% Change	$ Change	% Change	$ Change
All	2.18	314.47	1.81	238.27
Minority Status:				
White	2.19	312.19	1.80	236.57
Black	2.17	308.29	1.87	245.19
Central City:				
Outside	2.19	325.38	1.82	246.43
Inside	2.16	290.21	1.79	221.73
Low-to-Moderate Income:				
No	2.19	330.19	1.80	246.55
Yes	2.09	216.61	1.89	190.34

(A) Effects of Privatization on Homeownership Costs

To examine the expected effects of privatization on homeownership, we proceed by first estimating homeownership costs. To do so we use, as our base case, costs for first-time homebuyers. We estimate the total and after-tax cost of homeownership before and after full GSE privatization.[11] The 1989 AHS is used in this analysis.[12]

Mortgage contract principal and interest payments, as well as other costs—such as property taxes, insurance, fuel, utilities, and maintenance, are included in the calculation. The prices of housing units purchased by first-time homebuyers in the 1989 AHS are used as the basis of the analysis. The after-tax cost is estimated as the mortgage payment and other costs less the tax savings associated with homeownership. Tax savings are based on the excess of housing deductions (mortgage interest and real estate taxes) plus non-housing deductions (assumed to be 3.5% of household income) over the standard deduction. The total cost of homeownership is assumed to be the after-tax cash cost plus the opportunity cost of the downpayment, amortization, loan fees, and closing costs, less expected equity buildup. Before- and after-tax homeownership costs are estimated by race, central-city status, and poverty status. The analysis is replicated using mortgage underwriting criteria expected to prevail given privatization.

The anticipated changes in homeownership costs are presented in Table 1. Not surprisingly, housing costs are expected to rise under complete GSE privatization, although these changes appear to be small. A 50-basis-point increase in the mortgage interest rate increases housing costs only by approximately 2% for all groups.[13] These results suggest only a marginal impact of privatization on

homeownership costs for first-time homebuyers, and, given the reduced importance of mortgage debt as households age, this impact is likely to be even less for non-first-time borrowers and for older households.[14]

(B) Effects of Privatization on Affordability

Our second goal is to assess the effect of privatization on mortgage affordability. Theoretically, of course, there is some home—and, hence, a mortgage—within the means of any and every prospective homebuyer. What is needed for policy analysis, however, are "what-if" comparisons using some measure for capturing the coincidence, or lack thereof, between consumers' "means" (lifetime incomes and current, liquid assets) and "desires" (housing needs and wants). Following Linneman and Wachter (1989), we employ a measure of (inverse) affordability—the estimated percentage of households constrained in their housing choice by affordability considerations—to see how the different scenarios for direct policy effects on interest rates and/or underwriting standards impact affordability, relative to the base case of otherwise prevailing conditions.

We identify an optimal home purchase price for each household and compare this to the underwriting standard amount that the household can afford to borrow.[15] To do so we use an estimating equation for optimal home purchase prices (i.e., prices of the houses unconstrained consumers choose given the alternatives in their local market) based on an empirical analysis of house prices relative to household demographic variables and market variables for a sample of unconstrained households. We then apply the resulting equation to calculate which households are constrained and nonconstrained among the population. If the predicted optimal home purchase price is more than the maximum house price that households can purchase under the various underwriting criteria scenarios, households are considered constrained under the income, downpayment, or both requirements. Affordability constraint rates are estimated for targeted socioeconomic groups and geographic areas by race, central-city location, and poverty status. The analysis is replicated with the interest rate (10.62%) and downpayment requirement (15%) that may prevail if privatization were to occur. The percentage of families constrained under the three regimes are then compared.[16]

Estimated affordability rates under current and expected downpayment requirements are presented in Table 2.[17] As anticipated, higher proportions of minority and central-city households are capital constrained. Post-privatization, the percentage of capital-constrained households, for all households combined, increases by 2.7 percentage points, from 26.4% to 29.1%. In percentage terms, this 3-percentage-point (approximately 10%) increase in capital-constrained households varies only slightly across socioeconomic groups and geographic areas; for all groups, changes fall within 2.2 to 2.8 percentage points of initial levels.

Estimated affordability rates under current and expected income requirements are presented in Table 3. The percentages of households that are constrained by their current incomes are in all cases but one (low-to-moderate-income households) less than the corresponding estimated percentages of capital-constrained households in Table 2. As expected, in all cases, privatization increases the percentage of households that are income constrained. For all households combined, the percentage of income-constrained households increases from 18.3% to 19.8%. This 1.5-percentage-point

TABLE 2

Affordability Effects of Downpayment Constraints: Pre- and Post-Privatization

	Estimated Percentage of Households With Insufficient Capital To Purchase Optimum Home		Pre- to Post-Privatization Change	
	Pre-Privatization 10% down	Post-Privatization 15% down	Percentage Points	As Percent
All	26.4%	29.1%	2.7%	10%
Minority Status:				
White	25.5%	28.1%	2.6%	10%
Black	29.0%	31.2%	2.2%	8%
Central City:				
Outside	23.0%	25.5%	2.5%	11%
Inside	32.8%	35.5%	2.7%	8%
Low-to-Moderate Income:				
No	27.8%	30.6%	2.8%	10%
Yes	23.5%	25.7%	2.2%	9%

(8%) increase for all households encompasses effects ranging from 1.1 to 1.9 percentage points over the various groups.[18]

(C) Effects of Privatization on Homeownership Rates

The goal of this task is to assess the impact of privatization on homeownership rates. Homeownership rates can vary with differences in the cost of owning relative to renting, household income, and demographic variables. Privatization may affect homeownership rates through higher borrowing costs as well as changed income and downpayment requirements. We examine the decision to own a home by individual households to assess the way privatization would affect such a decision through each of the privatization scenarios.

Homeownership rates are estimated in two steps. First, we estimate a tenure choice equation using four groups of variables (described in detail in the Appendix): (1) income and wealth measured by the permanent income and transitory income components of income; (2) demographic lifecycle factors including age, family type, and household size and race; (3) relative cost of ownership measures—the own/price ratio which incorporates interest costs as discussed above, the value/rent

TABLE 3

Affordability Effects of Income Constraints: Pre- and Post-Privatization

	Estimated Percentage of Households With Insufficient Capital To Purchase Optimum Home		Pre- to Post-Privatization Change	
	Pre-Privatization 10.12% Rate	Post-Privatization 10.62% Rate	Percentage Points	As Percent
All	18.3%	19.8%	1.5%	8%
Minority Status:				
White	18.3%	20.0%	1.7%	9%
Black	14.3%	15.4%	1.1%	8%
Central City:				
Outside	18.2%	19.9%	1.7%	9%
Inside	18.2%	19.7%	1.5%	8%
Low-to-Moderate Income:				
No	8.6%	10.1%	1.5%	17%
Yes	40.1%	42.0%	1.9%	5%

ratio which measures expected price appreciation, and location variables; and (4) income and downpayment constraint measures.[19] Second, using the first-step results, we estimate the predicted probabilities of homeownership and calculate homeownership rates for selected socioeconomic groups and geographic locations under current and expected conditions. (Variable definitions, sample statistics, and results of the tenure logit estimations are presented in Appendix tables. Generally, the results conform to those found in other studies of tenure choice.)[20]

Using these estimates, we calculate predicted homeownership probabilities for selected socioeconomic groups and geographic locations under current and expected conditions. We do this under two scenarios: A, in which interest rates increase by 50 basis points, and B, in which the standard downpayment increases by 5 percentage points.[21]

Tables 4 through 6 report results for the full, recent-movers, and young samples (24 to 29 years of age), respectively. In each case, ownership rates are reported for all households and for groups, by race and by income. Under scenarios A and B, all effects on ownership rates are as anticipated. Generally, the largest impacts derive from shifts in ownership costs (shown as the own/rent price effect) and capital constraints. Overall impacts for recent movers and for young

households are far larger than those for the full sample, as anticipated. For majority, high-income, and all households, using the full sample, measured effects of privatization on ownership rates appear to be small. However, for black and lower income households, in both scenarios A and B, effects are far larger. We find, in particular, own/rent price (ownership costs) effects for minority households and for low-income households are large, reflecting the greater magnitude of mean partial derivatives (and lower base relative ownership costs) for these households, as shown in logit results and sample statistics (which include means used to convert logit coefficient estimates into partial derivatives), provided in the Appendix.

(D) Effects of Privatization on Central Cities

Under the 1992 GSE legislation, the Secretary of HUD must define "underserved" markets in order to formulate permanent mandates for lending to such areas, by 1995. In the absence of this definition, we focus on measuring the simulated effects of scenarios A and B on predicted homeownership rates in central-city locations. As reported in Table 7, homeownership rates in central-city markets lag behind rates in other areas, among all households, recent movers, and young households: in all these samples, central-city ownership rates are significantly lower than those outside central cities. Moreover, in four of these cases, full privatization lowers homeownership rates in central cities more than in areas outside of central cities. For recent-mover and young household simulations, projected homeownership rates in central cities decline more than elsewhere in scenario A but not in scenario B—here higher priced houses outside central cities are responsible for a larger negative downpayment effect.

II.3. The GSEs' Low-Income Homeownership Programs

The GSEs' promotion of low- and moderate-income homeownership has increased over time. In particular, their importance has grown since the passage of the 1992 Housing and Community Development Act. Since 1992 the GSEs are required to meet annual targets for affordable housing. Specifically, the 1994 goals require that 30% of the dwelling units financed by mortgages purchased by the GSEs have to be occupied by low- or moderate-income households, and 30% of the units financed have to be secured by properties in central cities (Canner, Passmore, and Smith 1994).

The GSEs, in cooperation with housing providers, offer a number of low- and moderate-income homeownership initiatives. Fannie Mae offers the Community Home Buyer's Program, the Community Second Mortgage Loans, the Lease Purchase Mortgage Loans, and the Community Land Trust Mortgage Loans. Fannie Mae is active in HUD's Home Equity Conversion Mortgage Program (HECM).

Freddie Mac also offers a number of similar programs. These include the Affordable Gold, the 2- to 4-Unit Properties Pilot, and the Home Works First Time Home Buyer Programs. The corporation also supports several public/private initiatives in a number of states, namely Connecticut, Georgia, Kansas, Massachusetts, Michigan, Missouri, New York, and North Carolina. Freddie Mac has also committed to purchase loans originated under FHA's 203(k) Rehabilitation Mortgage Program.

TABLE 4

Homeownership Rate Effects Simulation Based on Full Sample Means and Models

	Pre-Privatization: 10% Down 10.12% Rate	Post-Privatization—A 10% Down 10.62% Rate					Post-Privatization—B 15% Down 10.12% Rate		
		(i)	(ii)		Pre- to Post-Privatization Change			Pre- to Post-Privatization Change	
		Own/Rent Price Effect	Income Constraint Effect	Combined Effect	Percentage Points	As Percent	Capital Constraint Effect	Percentage Points	As Percent
	(Owner-occupied households as a percentage of total households)								
All	63.56%	62.55%	63.44%	62.42%	-1.14%	-1.80%	62.27%	-1.29%	-2.02%
Minority Status:									
White	66.80%	65.75%	66.66%	65.60%	-1.20%	-1.80%	65.47%	-1.33%	-1.99%
Black	43.89%	41.20%	43.74%	41.06%	-2.83%	-6.46%	41.74%	-2.15%	-4.89%
Low-to-Moderate Income:									
No	71.18%	70.52%	71.70%	70.44%	-0.74%	-1.04%	70.42%	-0.76%	-1.07%
Yes	45.73%	43.35%	45.45%	43.07%	-2.66%	-5.81%	43.26%	-2.47%	-5.40%

TABLE 5

Homeownership Rate Effects Simulation Based on Mover Sample Means and Models

	Pre-Privatization: 10% Down 10.12% Rate	Post-Privatization—A 10% Down 10.62% Rate					Post-Privatization—B 15% Down 10.12% Rate		
		(i)	(ii)		Pre- to Post-Privatization Change			Pre- to Post-Privatization Change	
		Own/Rent Price Effect	Income Constraint Effect	Combined Effect	Percentage Points	As Percent	Capital Constraint Effect	Percentage Points	As Percent
	(Owner-occupied households as a percentage of total households)								
All	34.51%	31.97%	34.17%	31.65%	-2.86%	-8.30%	29.60%	-4.91%	-14.21%
Minority Status:									
White	37.64%	34.52%	37.08%	34.16%	-3.30%	-8.81%	32.39%	-5.07%	-13.53%
Black	16.52%	14.97%	16.34%	14.81%	-1.71%	-13.70%	14.89%	-1.63%	-9.85%
Low-to-Moderate Income:									
No	44.20%	41.52%	43.81%	41.14%	-3.06%	-6.93%	39.22%	-4.98%	-11.27%
Yes	14.77%	13.37%	14.66%	13.27%	-1.50%	-10.12%	12.96%	-2.08%	-14.06%

TABLE 6

Homeownership Rate Effects Simulation Based on Young Households Sample Means and Models

	Pre-Privatization: 10% Down 10.12% Rate	Post-Privatization—A 10% Down 10.62% Rate					Post-Privatization—B 15% Down 10.12% Rate		
		(i)	(ii)		Pre- to Post-Privatization Change			Pre- to Post-Privatization Change	
		Own/Rent Price Effect	Income Constraint Effect	Combined Effect	Percentage Points	As Percent	Capital Constraint Effect	Percentage Points	As Percent
	(Owner-occupied households as a percentage of total households)								
All	33.72%	30.73%	33.17%	30.22%	-3.50%	-10.38%	27.06%	-6.66%	-19.76%
Minority Status:									
White	37.04%	33.33%	36.42%	32.76%	-4.28%	-11.57%	29.93%	-7.11%	-19.20%
Black	12.59%	10.88%	11.94%	10.32%	-2.27%	-18.05%	10.35%	-2.24%	-17.78%
Low-to-Moderate Income:									
No	40.37%	37.20%	39.63%	36.49%	-3.88%	-9.61%	33.36%	-7.01%	-17.36%
Yes	17.55%	15.72%	17.21%	15.42%	-2.13%	-12.13%	14.12%	-3.43%	-19.53%

TABLE 7

Homeownership Rate Effects Simulations For Central City and All Households

	Pre-Privatization: 10% Down 10.12% Rate	Post-Privatization—A 10% Down 10.62% Rate					Post-Privatization—B 15% Down 10.12% Rate		
		(i)	(ii)		Pre- to Post-Privatization Change			Pre- to Post-Privatization Change	
		Own/Rent Price Effect	Income Constraint Effect	Combined Effect	Percentage Points	As Percent	Capital Constraint Effect	Percentage Points	As Percent
	(Owner-occupied households as a percentage of total households)								
(A) Simulation Based on Full-Sample Means and Models									
All	63.56%	62.55%	63.44%	62.42%	-1.14%	-1.80%	62.27%	-1.29%	-2.02%
Central City	49.77%	47.55%	49.50%	47.28%	-2.49%	-5.01%	47.40%	-2.37%	-4.76%
(B) Simulation Based on Mover-Sample Means and Models									
All	34.51%	31.97%	34.17%	31.65%	-2.86%	-8.30%	29.60%	-4.91%	-14.21%
Central City	23.85%	21.91%	23.52%	21.60%	-2.25%	-9.41%	20.64%	-3.21%	-13.46%
(C) Simulation Based on Young Households Sample Means and Models									
All	33.72%	30.73%	33.17%	30.22%	-3.50%	-10.38%	27.06%	-6.66%	-19.76%
Central City	23.77%	21.09%	23.23%	20.61%	-3.16%	-13.30%	19.28%	-4.49%	-18.88%

The GSEs' low- and moderate-income homeownership initiatives have several characteristics in common. Borrowers can obtain financing with loan-to-value ratios up to 95%, and even higher under certain circumstances. Borrowers can put as little as 3% of their loan from personal resources towards a downpayment, plus 2% or more in the form of a gift from a family member, a grant, or an unsecured loan from a nonprofit organization or public entity. Similarly, closing costs can be funded with gifts, grants, or unsecured loans. Borrowers can also use nontraditional methods to demonstrate creditworthiness, such as providing evidence of regular payments to utility companies and current and previous landlords. In most cases, prospective buyers are required to participate in a homebuyer counseling program.

Consistent with legislative requirements, the GSEs' programs are available to low- and moderate-income households. In general, eligible borrowers must have incomes at or below 115% of area median income. Borrowers in some Freddie Mac programs can have incomes up to 120% of area median income. Borrowers in some Fannie Mae programs have the income limit waived if they live in central cities, or in census tracts outside central cities with high concentrations of low- and moderate-income and minority households. The GSEs' programs allow borrowers to use up to 33% (versus 28%) of their gross income for housing expenses (principal, interest, taxes, and insurance). Housing costs and other obligations, such as credit card debt, must not exceed 38% (versus 33%) of gross monthly income (42% in some cases).

(A) Coverage

Despite the number of initiatives begun, the total funding for these programs is currently small as percentage of overall activity. (In 1993, Fannie Mae purchased loans totaling $5 billion under these programs [Annual Report, 1993].) However, secondary market activity targeted to lower income and central-city markets is substantial, separate from these specialized programs. To gauge the potential impact of this activity, it is useful to consider its distribution relative to the overall market. A study by Canner, Passmore, and Smith (1994) puts GSE loan purchase activity into perspective for loans extended to low-to-moderate-income families and to families residing in central cities relative to the overall market. Using 1992 Home Mortgage Disclosure Act (HMDA) data (which are publicly available but do not provide ideal coverage), they find that only 24% of loans purchased by Fannie Mae and Freddie Mac were extended to lower income borrowers, whereas 27% of loans made in the primary market were made to such borrowers. Similar results were found for central-city loan purchases.

These figures are consistent with analysis done by HUD on the topic. Fannie Mae's data for 1993 show that 31.8% of single-family dwellings, 95.4% of multifamily units, and 35.6% of total units financed by its mortgage purchases were affordable to low- and moderate-income families. The comparable figures for Freddie Mac are 28.9%, 94.3%, and 29.2% respectively (HUD 1995, Appendix A, p. 9206). HUD's study, however, shows only 15.9% and 14.4% of Fannie Mae's and Freddie Mac's 1993 business to be in underserved areas. According to 1993 HMDA data, 13.1% of Fannie Mae's single-family business was in underserved areas. The comparable figure for Freddie Mac was 13.6% (HUD 1995, Appendix B, p. 9230). These figures are not equivalent to those of Canner et al.

(1994), because the latter presents the data by central-city/non-central-city location, which is not identical to the definition of underserved areas.

Why is GSE activity in targeted areas not higher? One explanation may be that loans in these locations, to be affordable may carry higher loan-to-value ratios, which increases their risk. The clear relationship between high loan-to-value ratios and high rates of default is shown by the GSEs' own data (Fannie Mae 1993; Freddie Mac 1993).[22] Nonetheless, it is possible that these riskier loans may be purchased at rates that allow higher returns. Beyond a certain point, however, purchase of these loans would be likely to drive up their prices, so that they add to losses. Moreover, private conduits that specialize in underwriting and securitizing these loans may be better able to price their risk, thus contributing to a reduced presence of the GSEs in these higher risk areas.[23]

Beyond profit maximization motives, the GSEs purchase high loan-to-value loans in low-to-moderate-income areas as part of their affordable lending initiatives to satisfy congressional mandates and, more broadly, to fulfill their charters. It is also possible, although untested, that increased liquidity provided through current and future affordable lending initiatives may reverse neighborhood disinvestment and make such loans less risky than in the past. The GSEs have the potential and motivation to test for whether increased neighborhood reinvestment can result from an increased supply of lending.

(B) Impacts of Future Activity

The GSEs' involvement in the promotion and support of low- and moderate-income homeownership is expected to increase in the future. This is because final legislative requirements went into effect in 1995, and their impacts will take some time to work through the system (Canner, Passmore, and Smith 1994). Also, in absolute dollars, this involvement is expected to increase over time because the legislative requirements are expressed as a percentage of the GSEs' overall operations.[24] Finally, the GSEs may learn from the initiatives that they have put into place; the "natural experimentation" these programs allow, if followed by evaluation, may indicate how or whether such activity can be expanded without increasing the risk of lending.

II.4. Would Existing or New Government Programs Be Able To Substitute for GSEs?

The complete privatization of the GSEs may have significant impacts on low-to-moderate income homeownership. Fully privatized GSEs would likely reduce their involvement in special programs, because the legislative mandates to be active in this area, imposed by virtue of federal charters, would be gone. Most importantly, empirical results indicate that central-city, low-to-moderate-income, and minority households' ownership rates would decrease, if the GSEs were to be fully privatized.

Government could expand existing programs or undertake new initiatives to compensate for any resulting decreases in homeownership rates for these groups. However, such programs would have costs, and their success in compensating for losses in ownership is by no means assured in all

cases. One method that could clearly counterbalance any loss in homeownership would be direct subsidies of fully privatized entities targeted to affordable lending. To compensate for declines in homeownership, the federal government could subsidize future affordable housing initiatives undertaken by the fully privatized GSEs, providing bounties for such lending. Because no funds are currently budgeted for the GSEs, new federal funds would have to be appropriated. In the current budgetary climate, Washington is unlikely to come up with the additional funding necessary to compensate for the GSEs' reduced involvement.

The alternative of expanding existing government activity in this area is also possible. Ginnie Mae and FHA mortgage lending insurance programs, currently housed in HUD, are the closest government substitutes to GSEs. However, these programs' share of primary and secondary market activities, respectively, have declined over the past decade. Due to past actuarial losses, FHA pricing has increased. These programs are unlikely to be increased in size and scope to compensate for reduced GSE activity.

Finally, the federal government could require privatized entities to maintain or expand the level of affordable housing activity that GSEs now provide. It cannot be assumed, however, that regulation of fully privatized GSEs to increase lending to targeted populations would achieve funding levels equal to those prevailing today. Requiring explicit minimum purchases of loans from targeted populations as a percentage of overall activity may result in decreased secondary market activity, as fees increase to compensate for increased costs. While the share of secondary market purchases of loans to targeted populations would increase, the overall level of such funding might decrease. Costs may rise if higher risk loans are purchased to meet regulatory obligations. Administrative costs of adhering to regulation may also result in cost increases, passed on to potential borrowers in the form of higher fees. Also, restructuring of GSEs into smaller entities may itself increase insurance costs, through the loss of economies of scale. Finally, for ease of monitoring, regulations would have to be uniform and this would lead to a loss of any efficiencies that otherwise might be achieved through specialization.[25] The efficiency losses in the form of higher costs that such a policy entails would make it an unlikely substitute for GSE mandates.

II.5. Conclusions and Policy Implications for Privatization Based Upon Consideration of Single-Family Mortgages

Our analysis of the impact of privatization of the GSEs on the market for owner-occupied housing assumes that interest rates will rise by 50 basis points and that underwriting criteria will tighten. We believe that these assumptions probably err on the side of overstating the likely effects; however, even these magnitudes yield modest overall market impacts. Housing costs rise by less than 3% and the aggregate homeownership rate declines by less than 1 or 2 percentage points (ever-own probably much less). However, the impact of privatization falls disproportionately across the population. In particular, blacks, residents of central cities, and low- and moderate-income households would be affected more adversely than the general population. Reductions of 10% or more in the homeownership rates among some of these groups are possible.

An interesting question is whether existing federal housing programs would be able to fill the gap left by privatization of the GSEs. Given the results of our analysis, this amounts to knowing whether federal programs would be able to offset all or most of the negative impacts likely to be experienced by minorities, residents of central cities, and low- and moderate-income households.

We believe such programs are incapable of effectively filling the gap for several reasons. First, the fiscal situation seems too severe to permit the enlargement of any existing subsidy programs or the implementation of new subsidy programs. Recall that the subsidy to the GSEs is implicit; no direct financial savings from privatization would result. Second, GSE loan subsidy and guarantee programs are likely to be more operationally efficient than those operated by the federal government. Simply put, the GSEs face a stricter and clearer set of incentives to be efficiently subsidized and to innovate in these markets to accomplish social goals than does the federal government. So even if the funds could be obtained to expand some existing federal programs, we believe that they would likely be less efficiently delivered to beneficiaries than via the GSEs. Finally, regulation to increase social lending may not have the intended outcomes in a fully privatized framework. Interest rate rises, which are likely to result from full privatization and more stringent regulation, will reduce homeownership rates precisely for the groups targeted for increased access to homeownership.

It must be kept in mind that estimates of the impact of privatization are not precise. Nonetheless, our analysis suggests that social policies to enhance homeownership opportunity would suffer if the GSEs are privatized. Especially hard hit would be low- and moderate-income households seeking to become homeowners for the first time. Therefore, *if the impact of privatization on existing social policies is a major criterion in any ultimate decision to privatize the GSEs and if the commitment to these goals remains unchanged, we come down on the side of the status quo or some relatively minor variations to it.*

Thus, in carrying out policy responsibilities associated with federal charters, the GSEs can be viewed as privatized targeted welfare deliverers. We view the affordable housing mandates incorporated into the federal GSE charters as representing one of many potential tools available to the federal government to accomplish its social goals regarding homeownership opportunity. Many other tools also exist and include direct interest subsidies, FHA mortgage insurance, Ginnie Mae, and others. The manner in which the mandates are imposed can be adjusted; for example, the GSEs could be required to offer loans to targeted groups at a reduced rate rather than the current policy of establishing goals as fractions of their total business. Efficient social policy calls for the use of the most efficient tool with which to attain the policy goal. Our sense is that a shift in policy toward the greater use of affordable housing mandates imposed on the GSEs will probably improve the overall efficiency of social policy in this area. We begin the defense of this argument with a list of the key assumptions and conclude with some specific recommendations that follow from it.

(A) Key Assumptions

First, the existing "agency" status enjoyed by the GSEs does grant a subsidy to the mortgage market; the size of this subsidy is estimated to be between 20 and 50 basis points. Second, the subsidy is shared among mortgage borrowers and GSE employees and stockholders. Although it is quite difficult to identify the exact allocation of this subsidy, some of the subsidy surely accrues to GSE stakeholders. Weicher (1994) makes this point as well. Third, bringing about privatization may be a long and difficult process according to Stanton (1996). Stockholders are likely to resist such a move and may be in a position to insist upon some type of payment from the federal government to bring it about. Fourth, the GSEs are very successful organizations that have played major roles in the continued improvement in the efficiency of the mortgage markets. They have made securitization the dominant and low-cost producer of funds for the financing of single-family housing. Fifth, the federal government has no explicit obligation to cover the losses of the GSEs. Finally, social goals regarding the desirability of homeownership and of equal access to mortgage markets by all households remain unchanged.

If one accepts these assumptions, then maintaining or increasing the social responsibilities of the GSEs may be the most cost efficient way of implementing the overall housing objectives of the federal government. There are many ways in which implementing the social responsibilities of the GSEs may be accomplished. One example involves maintaining or increasing the affordable housing goals for the GSEs. Alternatively, the GSEs could be required to subsidize mortgage rates for certain targeted groups and programs. In essence, they would be asked to cross-subsidize loans explicitly for these groups. Either of these approaches would produce less privatized or more public GSEs.

This approach also seems to address one of the problems raised by Stanton (1996), who argues that the GSEs are unlikely to accept privatization without substantial compensation and that the process leading to privatization is likely to be complex and long. An alternative approach to privatization involves an increase in the mandates. By increasing the affordable housing mandates assigned to the GSEs, the federal government reduces the portion of the subsidy implicit in the GSE charters that can be diverted to GSE employees and stockholders. Increased mandates could also be seen as an additional tax upon the GSEs. Regardless of the characterization, the mandates make the federal charter less valuable to the stockholders and make privatization more attractive to GSE stockholders.

The argument just presented can be criticized on several fronts. We address two that strike us as particularly important and worthy of more study. First, hard evidence to support our assumption regarding the efficiency of the GSEs relative to existing housing programs is scarce; therefore, transferring responsibility to them may achieve little in the way of efficiency gains. Furthermore and more importantly, the historical success of the GSEs in innovating does not mean that they can be as successful in the future.

Another criticism of our argument comes from those who prefer that the implicit costs associated with a policy of mandates be made explicit and brought directly into the federal budget

process. As one reviewer put it, "the paper condones putting programs off-budget so that the federal government can create social benefits without directly assuming the costs of providing them." We think this is a misreading of our recommendation. Surely we would prefer a plan in which the implicit subsidy provided to the GSEs is made explicit and brought into the federal budget process. Our sense is that this is very difficult to do, especially since the federal government has no explicit obligation to the GSEs, according to our understanding. Efforts to recapture benefits associated with the implicit guarantee in the past by taxing the GSEs through guarantee fees have failed; perhaps the implicit guarantee ought to be made more specific and the idea of a guarantee fee should be resurrected. Subsidies, whether funded by GSE fees or other sources, could be used as vouchers to encourage homeownership for marginally qualified households in designated areas. However, the alternative of explicit government-administered subsidies to which qualified households would be entitled does not appear to us to provide as efficient an incentive to innovate and experiment. Absent the approach of explicit subsidies and fees, GSE mandates and goals are ways of recovering some of the benefits bestowed on the GSEs. If the costs of these mandates become too onerous, the GSEs will surrender their federal charters.

(B) Recommendations

Thus, despite criticisms, we believe our argument is worthy of serious consideration, and several specific policy recommendations follow from it. First, as is currently planned, a higher portion of GSE business can be targeted to serve households deemed to be in need of special help; these include minorities and lower income households. As noted above, this can be accomplished by increasing housing affordability goals or requiring the explicit cross-subsidization of loans to targeted groups and programs. Second, if the role of FHA is reduced, some of the responsibilities could be assigned to the GSEs. Third, the GSEs could be required to conduct demonstration programs to examine the wisdom of various affordable lending initiatives and nontraditional underwriting criteria and processes. Plans for this, which are underway, could be expanded and accelerated.

Reallocating responsibility for social housing goals in favor of the GSEs will reap some benefits. The overall housing finance delivery system will become less public and more efficient and linked to capital markets; homeownership opportunity should improve, especially for targeted groups. Nonetheless, the shift will not solve all problems faced by households seeking to become homeowners. The main obstacle facing prospective homebuyers is insufficient income and, perhaps, most importantly, wealth. Neither will the shift be accomplished at zero cost; some resources must be devoted to the monitoring of GSE activity to ensure that they do achieve the assigned mandates.

III. THE ROLE OF THE GSEs IN MULTIFAMILY HOUSING MARKETS

Two questions are central to this section. First, how would the privatization of the GSEs affect the availability and affordability of mortgage credit for multifamily housing? Second, if the GSEs are privatized, how would the federal government attain its goals in the area of multifamily housing finance? The following sections provide answers to these questions and recommendations regarding the privatization of the GSEs.[26]

III.1. Comparison of GSE and FHA Multifamily Finance Programs

The purpose of this section is to provide background regarding the existing multifamily programs of the GSEs and their future plans in multifamily housing. In a few instances, comparisons are made to the multifamily programs of FHA, which is the closest government substitute for the GSE programs. The discussion is not intended to provide indepth information about the programs; only a few of the most relevant characteristics are covered.

(A) Size

The current dollar volume of multifamily programs is small in comparison to single-family programs. For example, multifamily loan purchases by the GSEs represented about 3.6% of their total loans purchased in 1993, while most loans purchased were single-family mortgages. Multifamily loans represented about 6% of Fannie Mae's portfolio of mortgages. Only 1.7% of MBSs issued in 1993 were backed by multifamily loans. Multifamily MBSs issued by Fannie Mae were a higher but still low percentage of business in 1988; at that time about 3% of its total securities outstanding were in multifamily MBSs.

More generally, the GSEs play a smaller role in the financing of multifamily housing than they do in the financing of single-family housing. Multifamily mortgage originations in 1993 totaled about $31 billion; GSE purchases of multifamily loans were less than $5 billion, most of which were purchased by Fannie Mae. In contrast, GSE purchases of single-family mortgages were about 59% of single-family originations in 1993.

The small size of the multifamily programs relative to the single-family programs is important to note; however, the comparison probably understates the importance of multifamily programs in a discussion of social goals of the GSEs for a few reasons. First, the current size no doubt reflects the fact that securitization of multifamily mortgages is not nearly as advanced as that of single-family mortgages; in particular, the multifamily mortgage is less standardized and, as a consequence, more difficult to securitize. As these mortgages become more standardized, the size of the multifamily MBS market will probably increase. Second, multifamily construction activity and mortgage originations are at a relatively low level, as they have been since the multifamily building boom of the mid to late 1980s. Although a return to the level of activity in multifamily housing of the early and mid-1980s is still probably several years off, larger volumes of multifamily lending will surely return. Finally, because multifamily housing tends to be less expensive and more likely to serve low- and moderate-income households, multifamily housing will likely continue to play a relatively larger role in the achievement of the GSE affordability goals.

(B) Coverage

An important element in the discussion of privatization is the overlap among multifamily programs of the GSEs and those of FHA. An examination of overlap of the various programs is conducted to identify its extent. Although a discussion of coverage could include a review of a

TABLE 8

Distribution of Multifamily Purchases, 1993

Tenant Income as a Percentage of Median Income of Metropolitan Area	Fannie Mae	Freddie Mac
	(Housing Units)	
< 50%	28,217	8,232
50-60	51,088	12,845
60-80	80,159	32,188
80-100	15,228	20,912
>100 & Missing	11,780	29,055
Total	**186,472**	**103,232**
	(Percent Distributions)	
< 50%	15.13%	7.97%
50-60	27.40%	12.44%
60-80	42.99%	31.18%
80-100	8.17%	20.26%
>100 & Missing	6.32%	28.15%
Total	**100.00%**	**100.00%**

Source: Reports on Interim Goals by Fannie Mae and Freddie Mac, March 1, 1994

variety of criteria such as geography, racial composition, and loan-to-value ratio, the following discussion focuses on the income of the tenants in the program.[27]

The first set of comparisons examines the distribution of the two GSEs' purchases of multifamily mortgages during 1993 by the income of the tenants (Table 8). The distribution is presented in terms of the number of individual housing units underlying the mortgages. For example, purchases by Fannie Mae provided financing for 28,217 housing units in which the tenant incomes were typically at or below 50% of the median income in the metropolitan area. The main story told by these numbers is that the bulk of the GSE activity takes place between 60% and 80% of median income. Forty-three percent of Fannie Mae's business and 31% of Freddie Mac's 1993 business took place in this range. In addition, Fannie Mae's programs generally go more deeply into the income distribution, although only 15% of its units are below 50% of median, which is one of the definitions

TABLE 9

Distribution of FHA Insured Multifamily Business As of 1990–91

Tenant Income as a Percentage of Median Income of Metropolitan Area	Unassisted	Older Assisted	Newer Assisted	Total
		(Thousands of Units)		
< 50%	678	4,648	3,739	9,065
50-80%	1,140	1,026	332	2,498
Others	1,263	363	83	1,708
Total	**3,080**	**6,037**	**4,154**	**13,271**
		(Percent Distributions)		
< 50%	22%	77%	90%	68.30%
50-80%	37%	17%	8%	18.82%
Others	41%	6%	2%	12.87%
Total	**100%**	**100%**	**100%**	**100.00%**

Source: Wallace (1994), pp. 8–9.

of "very low-income" households. We have no information from earlier years with which to compare the 1993 distribution.

A comparison of these data to those for FHA provides several additional insights about the relative coverage of GSE loans as well as the variation among FHA programs. Wallace (1994) is the source of the information in Table 9, which is based upon a survey conducted in 1990–91 of a sample of FHA multifamily properties. The data represent the distribution of tenant incomes among all properties insured by FHA multifamily programs; these represent loans insured over the past 30 or 40 years. They are distributed among three categories: unassisted, older assisted, and newly assisted. Wallace presents this distribution to highlight several important differences. First, FHA-assisted programs focus on serving households below 50% of median income; 68.3% of FHA-insured multifamily loans serve this group. Second, the unassisted FHA loans are distributed much differently; only 22% are distributed to very low-income households. The results suggest that FHA programs that provide some sort of special subsidy to the project or its tenants go much deeper into the income distribution than the GSE programs. On the other hand, the unassisted FHA programs appear to be quite similar to the GSE programs.[28]

TABLE 10

Fannie Mae Multifamily Delinquencies

End of Year	Total Unpaid Balance ($ Millions)	Number of Loans	UPB Serious Delinquencies ($ Millions)	Delinquency Rate (%)
1990	7,457	39	127	1.7
1991	9,015	70	327	3.62
1992	10,867	82	288	2.65
1993	12,570	90	294	2.34
1994	13,368	78	237	1.77

Source: Fannie Mae Investor/Analyst Reports

(C) Default Experience

Calculation of the economic value of the various multifamily programs is well beyond the scope of this paper; however, insights about their relative performance can be obtained by examining information about losses, defaults, and other proxies of the financial performance of the programs. Consider, first, information available about serious delinquencies for the Fannie Mae multifamily portfolio. Although this is a relatively crude proxy because it reveals little about the source of the problems and nothing about the appropriateness of the guarantee fees associated with this business, the information is consistent with a widely held belief: Fannie Mae's multifamily programs have experienced the least costly problems among the three programs under review.

Table 10 presents the number of delinquent loans (60 or more days delinquent), the unpaid balance (UPB) represented by these delinquent loans, and the ratio of the UPB of the delinquencies to the UPB of loans serviced by Fannie Mae. The delinquency rate at the end of June 1994 was 1.77%, which is about the level at the end of 1990. Both are well below the highest rate of 3.62%, which was recorded at the end of 1991. Higher delinquency rates existed in certain regions: rates as high as 5.5% were experienced in the Northeast, Southwest, and Midwest, while delinquency rates in some regions fall below 1%.

We did not have the opportunity to review similar information about Freddie Mac's multifamily portfolio, but other available information paints a picture of its multifamily default experiences. Through the early part of 1989, Freddie Mac's multifamily program showed few signs of trouble. Defaults were infrequent and consistent with expectations. This situation changed in 1989 and ultimately led Freddie Mac to discontinue its multifamily programs until 1993. During this period losses from multifamily programs comprised more than half of total losses from all programs, even though multifamily programs constituted a very small portion of its overall business. Efforts to

explain the causes of the problems and to correct them have been underway within Freddie Mac since 1989. It now appears that the problems stemmed in large part from loans in Atlanta and New York; furthermore, it appears that the losses associated with these problem loans far exceeded previous experience. In some cases, the recovery rates were near zero.

More information is publicly available about the recent dismal performance of FHA's multifamily housing programs than about any other issues under discussion. Two sources of information are particularly insightful. One is the Coopers and Lybrand 1993 study, which reported the market value of the FHA multifamily portfolio at about -$11 billion and recovery rates often less than 25 cents on the dollar. The most detailed analysis of the FHA problems is the Wallace study, which measures the financial distress of FHA's multifamily portfolio. Wallace calculates that 24% of all FHA properties are distressed, and that the rate for older assisted properties is 31%. It would cost more than $1 billion to provide the repairs needed to eliminate his definition of distress.

(D) Future plans

The most important development is the beginning of new risk-sharing arrangements between FHA and the GSEs.[29] Both GSEs affirm their intention to remain in the business of multifamily debt finance. Fannie Mae has committed to provide $50 billion by the close of the decade—a substantial sum. However, this funding leaves Fannie Mae's relative commitment to multifamily programs at about the same level as today. We have found no information indicating the exact financial commitment Freddie Mac will provide. We are only aware of a pledge by the chairman of the Freddie Mac board, Leland Brendsel, for programmatic improvements over time.[30]

(E) Conclusions

Although the evidence available for a systematic comparison of the various multifamily programs is sketchy, several conclusions emerge from a review of the evidence available. Though Fannie Mae has not escaped unscathed, its risk-sharing and delegated underwriting programs and underwriting criteria seem to have been the most effective in controlling its defaults. Second, Freddie Mac's return to the business has been marked by conservative steps, particularly an emphasis on active involvement in the underwriting process. Third, FHA's experiments with risk sharing and delegated underwriting and its coinsurance programs of the mid-1980s have been much more costly than those of the GSEs. Now, FHA has lost its capacity to do much of the underwriting itself. Fourth, judging by recent and past experience, multifamily lending appears to be considerably more risky than single-family lending. For example, comparable numbers to those in Table 10 for Fannie Mae's single-family lending program indicate serious delinquency rates in the vicinity of one-half of 1%, on average. No region has registered average delinquency rates in excess of 1% during the past year. Whether this discrepancy is due to the difficulty of appraising and monitoring multifamily properties, unrealistic underwriting criteria, or cyclical factors is difficult to determine. Lastly, more research about the keys to the successful financial performances of multifamily programs is needed. In particular, we need to know more about the designs of successful risk-sharing and delegated underwriting systems. Such information would reduce the riskiness inherent in multifamily lending and, ultimately, improve the availability of credit to this sector of the economy.

III.2. What Will Be the Impact of Privatization on the Cost and Availability of Mortgage Credit for Multifamily Housing?

The GSEs offer multifamily finance programs for two basic reasons. First, they may generate profits for their shareholders. Second, they fulfill either explicit or implicit mandates associated with the GSEs' special status as federally chartered, government-sponsored credit agencies.

Consider first the profitability of multifamily lending programs to the GSEs. Profits are generated primarily by guarantee fees, minus losses due to default and the administrative expenses associated with underwriting, monitoring performance, and foreclosure. Their principal competition in the multifamily lending market are institutions that originate and hold mortgages in their own portfolios, including commercial banks, thrifts, and insurance companies. Mortgage and investment bankers who are able to securitize private-label pools of mortgages also compete with GSEs.

As in the single-family mortgage market, the GSEs' principal advantage is the lower cost of financing associated with their federal charters. However, they also face some disadvantages. Multifamily lenders who are particularly knowledgeable about the rental housing market in which the property is located and the specific parties involved in the small business represented by the property have an important informational advantage. Such mortgage originators tend to be located in the area or at least have expertise in the local market. This is in contrast to our understanding of the traditional multifamily operations of the GSEs; they rely instead and primarily upon the mortgage originator. To the extent that the GSEs do not currently possess such information suggests that they seem to be at a competitive disadvantage relative to those who specialize in particular rental housing markets, as many banks, insurance companies, and thrifts do. This does not mean that the GSEs cannot invest in the information systems and personnel needed to compete with local originators; indeed, Freddie Mac seems to have moved in this direction in its revived multifamily lending program. In sum, the fact that most multifamily mortgages are not securitized and that most multifamily debt is held by commercial banks, thrifts, and insurance companies suggests that the competitive advantage to the GSEs, at this point, is quite modest.

Given the modest, at best, advantage enjoyed by the GSEs in this market, what motivates their involvement? In our judgement, the mandates associated with their charter are the driving force. These include their general charge to provide financing for housing and the recently enacted and more specific interim affordable housing goals. If the market for owner-occupied housing is strong in the 1990s and if the income-related lending goals are not greatly changed, the GSEs may be able to reach their goals by focusing almost exclusively on single-family lending. However, if the goals are increased or if the market for owner-occupied housing weakens, then they will almost surely require multifamily programs to meet their goals.

The GSEs understand this relationship quite well. They relied disproportionately upon multifamily loan purchases to achieve their goals regarding low-and moderate-income purchases. Although multifamily purchases represented less than one-half of 1% of Freddie's purchases in 1993, they represented 1.8% of the units that satisfied their income goal. Similarly, multifamily purchases

represented 5.7% of Fannie Mae's total purchases in 1993 but 15.7% of the units used to satisfy its low-and moderate-income goal.

It would be interesting to develop a matrix that relates growth in the homeownership rate to the fraction of the goals that can be achieved primarily with single-family lending. This matrix could be further adjusted to show the relationship for different goals. For example, what mix of single and multifamily lending would be required for the GSEs to be able to reach a goal of 35% lending to low- and moderate-income households? We have not had an opportunity to construct such a matrix, but further analysis of this problem ought to consider the development of such a matrix.

What implications do these considerations have regarding GSE participation in multifamily lending as privatized entities? Their involvement will probably decline modestly for properties that serve households near median income and for properties with little signs of financial distress. They may specialize in the purchase of senior pieces of multiclass securities and may even contribute to the further development of multiclass securities. Given that alternatives to the GSEs exist in this portion of the market, such a response will probably have little or no impact upon the availability and cost of credit for the upper portion of the multifamily rental housing market.

The impact on the bottom portion will be more significant. Without the mandates to be active in this portion of the market, we would expect the GSEs to greatly reduce their involvement and, especially, to reduce their lending for projects operated by nonprofit organizations. Their reduced presence will probably not have a major negative impact upon this portion of the market for two reasons. First, as noted above, the involvement of the GSEs is still relatively small. Second, it is already difficult to obtain debt financing to produce affordable housing for tenants in this portion of the market. Debt financing for properties that serve low- and very-low-income households is a risky investment from which many traditional lenders shy away. The difficulties and the risk stem from the growing presence of nonprofit organizations, and the need for multiple layers of subsidies to make investment in this portion of the market both profitable and affordable to low- and moderate-income households will only make this situation more difficult. The absence of the GSEs will simply make this situation a little bit worse.

III.3. Would Existing Programs Be Able To Replace the GSEs?

In principle, FHA's multifamily programs include many of the ingredients needed to replace the GSEs in the low- and moderate-income portion of the market. It has already been shown that the structure of the FHA program is similar to those of the GSEs and, in fact, the unassisted FHA programs serve a distribution of tenants similar to those served by the GSEs.

Despite their similarities, we believe a fundamental difference exists between them.[31] A government-run guarantee program has neither the mandate nor the incentives to manage the multifamily programs as efficiently as the GSEs. The problem is particularly acute in regard to management of distressed properties. Perhaps laws can be passed and funds provided to make its task easier, but a government institution like FHA seems destined to be less aggressive in its re-

sponse to mortgage defaults than a private firm responsible to its stockholders. The result will be higher losses on claims than a private firm would experience.

This may be seen as a strong claim on our part with little hard evidence with which to support it. We acknowledge the difficulty of proving such a claim without a substantial amount of additional research. Nonetheless, some insights can be gained by even a casual comparison of the experiences of FHA and Freddie Mac multifamily programs during the past several years. Freddie Mac's reaction to the losses in its multifamily programs was to shut down its programs and rebuild them. Freddie Mac virtually left the market until it was able to return with a better program. More people were hired and the fundamental approach to multifamily lending changed so Freddie Mac is now more of a primary lender than a conduit. FHA, on the other hand and despite many important changes in its system, was unable to respond as decisively or as independently as Freddie Mac. The result is that the losses to the FHA programs continued to grow long after the fundamental problem was discovered.

What other options might the government pursue? Many have long argued that providing affordable rental housing to low- and very low-income households has little to do with the cost of debt finance. In most situations, this cost for such properties is neither exorbitant nor an indicator of an inefficient market for multifamily debt finance. Instead, a high rent-to-income burden most likely arises for many households because their incomes are too low to afford housing deemed adequate by society and, in particular, by the community in which the property is located. This situation leaves the government with two broad sets of choices. Housing standards can be reduced so that less expensive units can be built and provided to low-income households. Society seems reluctant to take this step. Alternatively, some type of income-assistance program can be implemented. While housing advocates typically favor a housing voucher program as the best way to relieve high rent-to-income burdens—by far the most serious housing problem among low-income renters—limited resources make this solution unlikely.

III.4. Conclusions for Impact on Multifamily Markets: Summing Up

Two questions are addressed in this section. First, how would the privatization of the GSEs affect the availability and affordability of mortgage credit to multifamily housing? We argue that the effect upon the bulk of the rental housing market will be slight. The availability and cost of credit will remain about the same because the presence of the GSEs is still modest in the debt financing of multifamily housing and because competition in this market is still substantial. The cost and availability of funds in the portion of the rental housing market devoted to low-income households would probably suffer a bit, but even here the effect would not be substantial nor would it radically alter the current situation. Obtaining debt financing for many nonprofit-sponsored multifamily housing projects capable of producing affordable housing for low-income tenants would remain a serious challenge. Several recommendations follow from this analysis:

(1) Privatization Should Not Be Driven by Concerns About Multifamily Finance.

This statement may seem obvious given the relatively small size of the multifamily programs; however, the argument is more subtle. The competition faced by the GSEs in the area of multifamily finance is probably stiffer than in the single-family portion of the market. To be sure, the affordable housing goals are probably forcing the GSEs to do more in the area of multifamily housing than they would in a privatized environment, but not enough to play a major role in the privatization decision, which ought to be driven by considerations of the single-family side of the business.

(2) The Risk Sharing Program Could Be Extended and Enlarged.

Along with privatizing the GSEs, serious consideration could be given to increasing the risk-sharing program and assigning even more responsibility to the GSEs in the area of multifamily finance. The responsibilities of FHA would also be redefined. The new FHA would not be involved in direct underwriting of properties, but would work with the GSEs to establish these criteria and pricing policies. FHA would also monitor the behavior of the GSEs; for example, it would investigate foreclosures to ensure that agreed-upon procedures were followed at each step of the lending process. Other than this, FHA's role would consist primarily of subsidizing the GSEs for mortgage lending that promotes objectives of the existing mandates. Follain and Szymanoski (forthcoming) provide more information about the risk-sharing concept and its application to multifamily debt finance.

(3) Demand Side Subsidies Could Replace GSEs and FHA Subsidies for Very Low Income Households.

The GSE multifamily programs do not currently and will probably never provide debt financing at rates low enough to make rental housing affordable to low- and, especially, very low-income tenants. The reduction in cost needed, unless accompanied by government subsidies, would surely be rejected by their stockholders. An alternative is increased reliance on FHA multifamily programs, but they too have suffered heavy losses without greatly impacting markets. In fact, FHA mortgage insurance programs targeted to this portion of the market ought to be reexamined and perhaps eliminated. The savings gained from having fewer claims against FHA's insurance funds could then be targeted elsewhere.

IV. EFFECTS OF PRIVATIZATION ON THE ACHIEVEMENT OF URBAN REINVESTMENT GOALS

In addition to the direct promotion of owner-occupied and rental housing, the GSEs may affect the achievement of other social goals, including increased access to homeownership in areas with high percentages of minority residents and urban neighborhood reinvestment.

The GSEs are currently undertaking initiatives to promote neighborhood revitalization. For example, they consider waivers to the underwriting criteria in their standard and special programs for loans made to stabilize a neighborhood where property values are declining, where lenders demonstrate that loans are part of focused local redevelopment efforts. Also, in response to concerns by

lenders, the GSEs have clarified and revised their underwriting guidelines to offer lenders greater flexibility. Revisions to underwriting criteria have included changes to the allowable loan-to-value and payment-to-income ratios, proof of creditworthiness, property conditions, and the downpayment requirement. Finally, the GSEs are pursuing a number of research efforts to better understand redlining and discrimination issues and ways to address them. Their size is an advantage in these efforts.

Research has not fully explained why disparities exist in mortgage origination and acceptance rates in census tracts with high percentages of low-income or minority residents. Recent studies show that in a model of lending decisions with neighborhood risk variables included, racial composition of areas is not a significant variable in the decision to reject loans (Schill and Wachter 1993, 1994). However, questions remain whether neighborhood risk characteristics themselves may result from the lack of availability of mortgage financing, and what, if anything, can be done to encourage sustainable urban neighborhood reinvestment.

In a regime of fully privatized GSEs, government regulation, subsidies, and program expansion could lead to increased liquidity and increased homeownership in "underserved" areas, if these are social goals. However, incentives and returns to innovations to accomplish these objectives in a way that is sustainable without continued government assistance may be reduced with full privatization. Due to their for-profit status and their size, the GSEs may be better suited than the government or smaller fully privatized GSEs to carry out and evaluate innovation to accomplish these goals. Though uncertain, there is the potential for dynamic externalities arising out of GSE neighborhood reinvestment activities that may be less likely in a regime of full privatization.

V. CONCLUSIONS

The ultimate goal of this paper is to shed light on a complex question: Will the privatization of the GSEs affect homeownership opportunity and access to mortgage markets? Our analysis suggests the answer is the affirmative.[32] The logic underlying this belief is quite straightforward. The current agency status of the GSEs amounts to the subsidization of their mortgage operations. Although the size of the subsidy and the extent to which it is passed on to mortgage borrowers are subject to debate and disagreement, all agree that a significant portion of the subsidy is passed along to borrowers in the form of lower mortgage rates. Therefore, the elimination of the agency status will surely result in higher mortgage rates for most borrowers. Low- and moderate-income households, minorities, and residents in areas defined to be underserved will probably suffer the most.

We further argue that the existing federal programs to encourage homeownership and equal access in the mortgage markets are unlikely to fill the gap left by the reduced role of the GSEs in these areas. One reason is that the funding needed to enhance the existing programs is unlikely to be provided by the Congress given the current fiscal climate. Even if the funds could be obtained, our sense is that existing programs are unlikely to be as efficient and effective as the operations of the GSEs in these areas if the federal government is vigilant in the enforcement of the affordable housing

mandates imposed upon the GSEs. Simply put, the expertise, incentives, and resources available to the GSEs are sufficient to make them private, efficient, targeted welfare providers.

Indeed, currently the role of the GSEs in these areas is being increased with the expansion of the affordable housing mandates imposed upon the GSEs. This could be done along with a reduction in the level of some existing federal programs; for example, some of the functions of FHA can be transferred to the GSEs. The net result of this ought to be a more efficient system to encourage homeownership and equal access to mortgage markets and a net increase in the reliance of these policies upon the private sector. This approach would also amount to a partial recapture of some of the subsidy associated with the agency status bestowed upon the GSEs.

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STATEMENT BY
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BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GSEs
OF THE COMMITTEE ON BANKING AND FINANCIAL SERVICES AND THE
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION AND TECHNOLOGY
OF THE COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT
JULY 16, 1997

Mr. Chairman and members of the subcommittees, my name is Francis Cavanaugh. I served in the U.S. Treasury Department for 32 years (1954-1986) as a financial economist and as the senior career executive responsible for policy advice on the management of the public debt and Federal credit programs, including the Government Sponsored Enterprises (GSEs) which are the subject of your hearing today. From 1986 to 1994 I was the Executive Director and CEO of the Federal Retirement Thrift Investment Board, which administers the Thrift Savings Plan for Federal employees. Since my retirement from Federal service in 1994 I have been a writer and consultant on Federal borrowing, lending, and investment policies.

I will respond briefly to the seven questions you asked me to address in your invitation letter of July 10, and I will be happy to elaborate on any matters you wish to pursue.

Any answers to your questions depend of course on some underlying assumption as to the proper role of the Federal government in the U.S. credit markets. I first dealt with this broader issue 35 years ago as a Treasury Department economist helping to draft the 1962 report of the President's Committee on Federal Credit Programs, which was chaired by the Secretary of the Treasury. That committee recognized that in our society there is a general presumption that the allocation of credit should be a function of private markets and that that function should not be preempted by the Federal government. That principle seems to be even more relevant today, given the apparent consensus for smaller and less intrusive government and greater reliance on private markets.

Yet the experience of the past three decades has not been good, as measured by the growing amounts of net new borrowing in U.S. credit markets required to finance Federal programs. That Federal share, which includes direct Federal borrowing, guaranteed borrowing, and GSE borrowing (which is the fastest growing sector), increased from an average of 17 percent of net credit market borrowing in the 1960s to 27 percent in the 1970s and 41 percent in the 1980s. In the five years 1991-1995, the average was an extraordinary 71 percent.[1] We have reached a

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[1] Francis X. Cavanaugh, *The Truth about the National Debt: Five Myths and One Reality* (Boston, Harvard Business School Press, 1996), 77.

point where most of the debt securities available to private investors in the United States are direct or indirect obligations of the Federal government, which raises serious questions about reduced market discipline in the allocation of credit and thus a reduction in credit quality in our economy.

While the market impact of direct Treasury borrowing is now diminishing, as Federal budget deficits decline, borrowing to finance GSE programs continues to grow rapidly. In the fiscal year 1997 estimated net GSE borrowing of $178 billion will greatly exceed current budget deficit estimates of roughly $50 billion.

Why do we have this anomalous situation of, on the one hand, a remarkable political consensus to reduce the size of government and the Federal deficit, and thus shift responsibilities to the private sector, but, on the other hand, a seeming indifference to the growing preemption of our private credit markets by the GSEs and, to a lesser extent, by other Federal credit aids? Every Federal credit assistance program, be it direct, guaranteed, or GSE debt, reflects continued Congressional dissatisfaction with the private market's allocation of credit resources. This is especially true in the areas of housing, agriculture, and education, but Federal credit aids are also provided in virtually every sector of our economy.

To encourage the development of private credit markets, Federal credit programs should generally be structured so that the government's role can in time be eliminated or reduced. Ideally, the government should "show the way" and then get out of the way. The most-cited model has been the old FHA program of single family home mortgage insurance, which eventually encouraged private lenders to make long-term low-down-payment housing loans on their own without Federal insurance or guarantees. Yet, in spite of that success story, Federal credit programs continue to dominate the housing credit market, primarily because of the growth of GSEs.

Nevertheless, my following responses to your questions are based on the assumption that our guiding principle should be that Federal credit programs should encourage, not displace, private credit markets.

1. When should Congress create GSEs that issue debt or provide guarantees?

Congress should create GSEs that issue debt or provide guarantees only in cases where there are credit gaps in our economy which eventually can be filled by the private market without Federal assistance. In other words, the GSE structure is the wrong approach for credit assistance programs where Congress determines that there will be a continuing need for government subsidies; in

those cases direct Federal loan programs would be cheaper and more effective. In some cases a self-supporting Federal loan guarantee program may be all that is necessary to encourage an adequate flow of private credit.

FNMA could have been a model GSE. When it was first established there were no secondary markets for home mortgages, and FNMA required substantial initial financial support from the Treasury. But in 1970 FNMA progressed from a mixed-ownership corporation to a totally privately-owned corporation, which is now highly profitable and clearly could be self-supporting if the Federal subsidies were removed. Yet FNMA borrowing is still subsidized by the American taxpayer. The effect of continuing the subsidy is to keep FNMA's borrowing costs lower than the borrowing costs of any would-be competitors. Thus private competition is frustrated, the Federal bureaucracy is preserved, and the original purpose of encouraging the development of private markets is defeated. We had a great concept but got lost along the way.

2. Are there areas where the scope of existing GSE activities should be expanded or reduced?

I am not aware of any particular credit gaps in our economy which would warrant expansion of existing GSE activities. Indeed, the market development of innovative securitization techniques in recent years has so expanded access to securities markets for private borrowers that the need for GSE credit has been reduced. GSE activities should be contained, if for no other reason, to be able to offer GSEs broader powers as an inducement to privatize them.

3. When and under what circumstances should a GSE be privatized?

GSEs make sense only if they are intended to become totally private. The timing of privatization should be when the GSE has developed to the point that it has filled the credit gap, as intended by Congress, and it is able to support itself in the market without further Federal subsidies. The alternative of continuing the subsidies and thus perpetuating a monopoly defeats the basic purpose of the GSE, that is, to promote healthy private competitive credit markets. If Congress decides to perpetuate a credit subsidy then the GSE is the wrong vehicle. Such permanent subsidies, which reallocate our nation's credit resources, should be provided not by GSEs but by direct Federal lending programs which are subject to budget and other controls which the GSEs escape.

Every institution needs discipline and accountability, which are provided by competitive market forces in the case of private institutions. For government institutions, the Congressional budget process must provide the discipline. GSEs escape both the

market and the budget disciplines and can be justified only so long as they are truly transitional institutions not yet able to support themselves in the market.

4. How should the financial activity of GSEs be regulated?

GSEs should be encouraged to become financially independent, relying primarily on private audits in accordance with generally accepted standards applied to similar financial institutions in the private sector. These are the standards they must meet when they are privatized. Regulation by Federal agencies within the Administration is of limited value, in part because these agencies are political institutions. Federal agencies are unlikely to have the staff or financial resources to match the resources of the GSEs or the private accounting firms. I do not mean to be critical of current agency staffs. I speak only from my 32 years experience in the Treasury, where I observed many ineffective efforts by Treasury, OMB, and HUD to influence FNMA and other GSE activities. The principal focus of any oversight by the Administration should be to help ensure sufficient financial soundness to minimize the need for recourse to the Treasury.

5. How should the programmatic activity of GSEs be regulated?

Assuming GSEs are created by Congress to fill an identified credit gap in the economy, the definition of that credit gap in the enabling legislation should be clear enough to provide adequate guidance to program auditors. As indicated in the answer to question 4, regulation by agencies within the Administration is likely to be of limited value. The programs of the GSEs should be defined by their statutes, not by regulation.

A model that I would suggest is the legislation that established the Federal Retirement Thrift Investment Board in 1986. In that case Congress wanted to insulate the Board and the Federal Thrift Savings Plan from the Administration and from the Congressional budget process, so Congress had to develop an alternative means of ensuring adequate accountability and professional oversight. Thus the legislation authorized the Secretary of Labor, who is responsible for regulating private pension plans, to provide for audits of the Board's programs. The Labor Department contracted with private accounting firms for a comprehensive program of annual audits of every aspect of the Board's management and operations. These program audit reports, some 13 a year as I recall, were extremely helpful to me as Executive Director of the Board, and they were most reassuring to Congress and the public that all was well at the Board. I believe that Congress should consider applying this approach to the GSEs and to other business-like activities of the government, especially those involving large and complex computerized systems. The recent failures of such systems in several Federal agencies underline

the need for a new approach.

6. Does the existence of competing GSE debt raise the financing costs of the United States government, and if so, by how much?

Clearly, the existence of competing GSE debt raises the financing costs of the United States government. Unlike private corporate securities, GSE securities compete directly with U.S. Treasury securities because they enjoy a privileged position in the market as Federal "agency" securities. They are viewed by the market as backed by the United States government, however indirectly. The market is generally comfortable that Congress would not allow the GSEs to fail, and it views GSE debt as moral obligations of the United States. Since the Treasury is perceived as prepared to stand behind debt securities issued by the GSEs, the GSE securities become close substitutes for Treasury securities in the portfolios of many investors. Also, GSE securities are treated as if they were Federal securities for various collateral, investment, and regulatory purposes. For example they are eligible investments for many international, federal, and state and local agencies, as well as many private institutions, that are not permitted to invest in corporate securities.

Measuring the amount of the cost to the Treasury from competing GSE debt is difficult, and the amount varies with market conditions and changes in amounts of new issues and outstanding GSE and Treasury debt in the market. As you noted in your July 10 letter, total GSE net borrowing in the market, including guaranteed obligations, exceeds $1.8 trillion, while publicly held Treasury debt is about $3.7 trillion. So the total Federal securities market is $5.5 trillion; and privatizing the GSEs would reduce that supply by 33 percent (although the reduction might be very gradual, depending on the treatment of existing securities). Thus there would be a significant increase in the demand for Treasury securities, especially as many financial institutions, public bodies, and other investors would no longer be permitted to invest in GSE securities. Assuming no change in total credit flows, the interest savings to the Treasury would be offset by increased interest costs to the privatized GSEs and to other private corporate borrowers with whom the GSEs would then compete. For each reduction of one basis point (one one-hundredth of 1 percent) in Treasury's average borrowing rate (for example, a reduction from 6.01 percent to 6.00 percent), the Treasury would save $370 million a year on outstanding marketable debt of $3.7 trillion. I would expect that the Treasury would save several basis points, but no more than ten, and would thus reduce its interest costs by at least $1 billion a year. A survey of objective market participants (those who do not do business with the GSEs) should be instructive on this point of cost savings to the Treasury.

7. Should the Federal Government receive financial compensation for the special market privileges enjoyed by GSE borrowers and guarantors?

Yes, especially since these privileges raise Treasury borrowing costs, as discussed above, and since Treasury is at risk that it might be called upon to provide financial assistance to troubled GSEs. This could be accomplished by charging GSEs a fee equal to a fraction of a percent of their outstanding liabilities or new commitments. Such a fee could also serve the purpose of encouraging GSEs to give up their special privileges and go private. A fee that escalated each year should eventually prompt GSEs to stand on their own feet in a competitive private market. Even if a GSE were not privatized, charging it an annual fee could offset its unfair borrowing advantage in the market and thus permit private financial institutions to compete with the GSE.

Mr. Chairman, that concludes my prepared comments. I will be happy to try to answer any questions.

Mr. Cavanaugh's Responses to Supplemental Questions from the Subcommittee on Capital Markets, Securities and GSEs.

Q.1. In general, federal credit assistance can achieve two objectives: improving economic efficiency at no cost by making credit markets work better, or providing subsidies that lower the cost of credit to targeted borrowers. Is there evidence that GSEs have made credit markets work better?

A. Initially, GSEs made credit markets work better, especially for agriculture and housing. They provided secondary markets and access to the national securities markets for loan financing which had been dependent upon cyclical and erratic flows of funds from local lending institutions. Then, as GSEs evolved from secondary markets (buying and selling loans) to primary credit sources with ever-growing mortgage holdings, the GSEs supplanted rather than supplemented the functions of private lending institutions. Finally, guaranteed mortgage-backed securities entrenched the GSEs as virtually the only feasible means of access to national credit markets for conforming mortgages.

Credit markets work well only when there is sufficient competition among lenders to ensure efficiency and reasonable costs of credit. The present monopolistic position of the GSEs has stifled competition and resulted in the excess profiteering demonstrated by the Congressional Budget Office estimates that one out of every three dollars of their federal subsidies are retained by the housing GSEs rather than passed through to the intended beneficiaries. It is unlikely that Congress would ever tolerate such waste elsewhere in the public sector or such monopolies in the private sector.

Q.2. As a mechanism for targeting federal credit subsidies to borrowers who would not otherwise receive credit or who are low-income, how do GSEs compare with federal grants, direct loans, or loan guarantees?

A. GSEs are clearly the wrong mechanism for providing credit to borrowers who are not creditworthy, since such lending activities, by definition, can never be self-supporting. GSEs have proven to be a very costly means of distributing government subsidies. When Congress finds a need for permanent credit subsidies, it should minimize the costs to government of financing and administering the loans. That is, the financing should be done by direct Treasury borrowing, rather than by higher-cost borrowing by GSEs or others; and the loans should be originated and serviced directly by a federal agency, rather than by expensive middle men such as GSEs.

Expanding GSE operations to include borrowers who are not creditworthy has the pernicious effects of (1) excluding from the Congressional budget discipline subsidized loan programs that would otherwise be required to compete for scarce budget resources, (2) increasing the long run costs to taxpayers, and

(3) frustrating efforts to privatize GSEs, since they obviously would terminate their politically popular subsidized loan programs once they were privatized. The principal beneficiaries of programs requiring GSEs to make subsidized loans are of course the GSEs themselves. They can pass on any new program costs to their other borrowers, and their broadened political base helps them become further entrenched as a subsidized federal bureaucracy insulated from both the government budget discipline and the competitive forces of the private market. GSEs are subject only to their stockholders, which is virtually no accountability at all since their monopoly position permits them to continue to enrich their stockholders, at the expense of the Treasury.

As shown in my testimony, GSEs have become the dominant force in U.S. credit markets. Such dependence upon institutions that have little or no accountability raises serious questions about the quality of credit and the viability of U.S. credit markets. Congress has created monsters which now seem to be beyond the control of Congress itself.

The choice among grants, direct loans, or loan guarantees depends on the degree of required subsidy. Loan guarantees are appropriate in cases where the borrower's needs may be met at little or no cost to the government and where the experience with guaranteed loans may in time stimulate private lenders to make such loans without government guarantees, as was the case with the FHA's mortgage insurance program for single family housing for low and moderate income borrowers. Costs of guaranteed loans may be minimized by competition among guaranteed private lenders; there is no such competition in the case of GSE lenders.

Direct loans are appropriate in cases where borrowers' needs cannot be met without significant government subsidies, for example, in the student loan program. Direct loans are clearly preferable to guaranteed loans in cases where the loans are not collateralized and guaranteed private lenders would have little incentive to counsel borrowers or otherwise exercise due diligence when loans are originated.

In some cases the needs may be so great that outright grants are preferable, rather than making loans that are likely to default, as was the case with the old public housing loan program where the government wound up paying the entire cost of principal and interest payments on loans that never should have been made. The purpose served by the public housing loans was to delay the budget impact of the program, which turned out to be substantially higher than if the projects had been constructed with 100 percent construction grants at the outset.

Q.3. You stated in your testimony that you have observed many

ineffective efforts by Treasury, OMB, and HUD to influence GSE activities. Could you please elaborate?

A. These agencies have generally been in the hapless position of having statutory responsibilities to oversee GSE activities, and to come to their rescue when they got into financial difficulties, but little power to influence them. The GSEs have developed powerful political constituencies and are exempt from OMB controls exercised over other federal agencies through the budget and legislative clearance processes. Thus the Treasury has generally been ineffective in its efforts to restrain GSEs from taking excessive financial risks (which were ultimately risks to the Treasury) while seeking to maximize short term growth and profits.

For example, the original purpose of FNMA's secondary market operations was to moderate the cyclical flow of housing credit; so FNMA was to buy mortgages at times when private credit was not available and then sell the mortgages back to the market when private credit flows resumed. Instead, FNMA adopted a "buy and hold" policy, in pursuit of short term profits, in spite of the Administration's condemnation of this policy (as early as in the 1963 report of the Presidents' Committee on Federal Credit Programs). FNMA compounded this problem, to the consternation of the Treasury, by using its short term borrowings to finance the acquisition of long term mortgages, and this misguided mismatch of maturities eventually led to FNMA's insolvency in the early 1980s. (FNMA would have gone down with the savings and loan associations were it not for the fact that its investors were confident that the Treasury could not permit a FNMA default). Similarly, the Administration's concerns about the inadequacy of FNMA's capital in the early 1980s led to a major effort by OMB to review FNMA's financial condition; but a proper analysis was far beyond OMB's limited resources, especially since there was little reason to believe that efforts to curtail FNMA's excessive growth would be successful. Agencies of the Administration lack both the resources and the authority to exert effective control over the GSEs.

Q.4. If the Federal government assessed a fee against the GSEs, would the GSEs simply pass it along to their supposed beneficiaries, or would the charge be absorbed as an expense of doing business?

A. The GSEs would generally do some of both, and the mix would depend on the size of the fee. Nearly all of a small fee, say one-eighth of one percent of new obligations, would probably be passed on as the GSEs sought to maintain profitability; and there should be little or no loss of business, since the GSEs would still be the cheapest source of funds. As the fees increased, the GSEs would be required to absorb an increasing portion of them.

Let us assume that CBO is correct in its estimates that the housing GSEs have a 50 basis point (one-half of one percent) funding advantage, or subsidy, over would-be private competitors and that about 35 basis points are passed on to their borrowers. Then a 50 basis point fee might be similarly divided, with the GSEs absorbing about 15 basis points. Arguably, a GSE could pass on as much as 35 basis points without losing customers, but this is a static analysis that does not recognize that the GSEs would lose some marginal borrowers in response to any significant increase in interest rates, and the GSEs would be forced to become more efficient in response to market competition. So, in this example, the GSEs might well pass on significantly less than 35 basis points to its borrowers.

Mr. Cavanaugh's Responses to Congressman Flake's Questions

Q. Fannie Mae and Freddie Mac, in recent earnings reports, signalled major competition in the market, with traditional conforming mortgage product going to other investors. Doesn't this indicate that there is, in fact, a significant level of competition in the market?

A. As of the end of 1995 Fannie Mae and Freddie Mac had "virtually 100 percent of the market for securitizing conventional mortgages up to $207,000" (conforming mortgages).[1] The borrowing costs of these GSEs have been estimated to be at least 50 basis points below what they would be without the federal funding subsidy.[2] Thus significant competition from the private market is unlikely unless the GSEs are extremely inefficient. Fannie Mae's most recent earnings report does not indicate any significant threat to its monopoly profits, which were $752.7 million in the second quarter 1997, up about 13 percent from the $667.8 million in the second quarter 1996.[3]

Q. Given that Fannie and Freddie's performance for their shareholders is intricately tied to service to their mission, why should we look upon these two obligations as in tension with each other? We don't have to look at this as zero-sum analysis, do we?

A. The tension, or conflict of interests, arises from the fact that Fannie Mae and Freddie Mac, because of their monopolistic position in the market, are able to retain a substantial portion, estimated at one-third,[4] of the federal funding subsidy for the benefit of their stockholders. Thus the GSEs are a highly inefficient means of distributing subsidies intended to benefit housing. The retained amount, an estimated $2.1 billion in 1995,[5] could be used instead to provide additional benefits for housing or for other public purposes if the GSEs were privatized and this waste eliminated. Housing would also benefit from the increased private competition with Fannie Mae and Freddie Mac. These GSEs have served worthy purposes, but extraordinary subsidies to their stockholders can no longer be justified.

cc: Congressman Floyd H. Flake

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[1] Congressional Budget Office, *Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac* (Washington, D.C., GPO, 1996), 3.

[2] Ibid, 45.

[3] *Washington Post*, July 11, 1997, G3.

[4] Congressional Budget Office, op.cit.,19.

[5] Idem.

7 The Federal Preemption of Credit Markets

NOW FOR THE BAD NEWS. In the previous chapters I have attempted to show that there is little basis for the concerns over the national debt as expressed by our political leaders. To tell the whole truth about the national debt, however, I must now focus on a major, related problem that is virtually ignored by those same politicians—that is, the impact of the federal government's total debt activities on U.S. credit markets.

A measure of that impact appears in the documents accompanying the president's annual budget submission to Congress. The measure shows how much of the net new borrowing (borrowing net of repayments) in the U.S. credit markets each year is required to finance the programs of the federal government. Thus it shows the combined impact of new federal borrowing (which is included in the national debt) and federally assisted borrowing (which is not included in the national debt).

Federally assisted borrowing includes government-guaranteed borrowing, such as loans insured by the Federal Housing Administration or guaranteed by the Small Business Administration; borrowing by government-sponsored enterprises (GSEs), such as Fannie Mae (formerly known as the Federal National Mortgage Association), the Farm Credit System, and the Student Loan Marketing Association; and mortgage-backed securities guaranteed by the Government National Mortgage Association and other federal housing agencies.

In fiscal year 1995 net federal borrowing from the public was $171.3 billion, net guaranteed borrowing was $26.2 billion, and net borrowing by GSEs was $158.3 billion. So the total of federal and federally assisted borrowing was $355.8 billion, which was 49.6 percent of total net borrowing in credit markets by domestic nonfinancial sectors of our economy (see table 7-1).[1] That is, after netting out all debt transactions among federal, federally guaranteed, and government-sponsored entities, the net market financing for these federal programs required 49.6 percent of the total credit extended to governments, businesses, households, and foreigners in U.S. credit markets.

There has been a dramatic increase in this federal share of total U.S. credit (see figure 7-1), from an average of 17 percent of net credit market borrowing in the 1960s to 27 percent in the 1970s and 41 percent in the 1980s.[2] In the five years 1991–1995, the average was an extraordinary 71 percent. (The peak was 89 percent in 1992.)[3] We have reached a point where most of the securities available to private investors in the United States are direct or indirect obligations of the federal government. What does this mean? Are the credit markets in the United States now largely nationalized . . . federalized . . . socialized, if you will? Does anyone care?

THE QUIET TAKEOVER

While these numbers appear in the president's budget documents every year, they get little attention from economists, the media, or politicians in the annual budget debates. Network TV is obsessed with government deficits and the federal debt. Yet there is virtually no mention of the borrowings by the GSEs or for the federal loan guarantee programs, which are financed largely outside the budget and are not included in the federal debt. (The only federal credit aids reflected in the federal debt are the $163 billion of government direct loans, discussed in chapter 3.) The federal government's takeover of the U.S. credit markets in recent years must be the biggest and quietest takeover in the country's financial history.

William Simon was the first secretary of the Treasury to call attention to the government's preempting of this growing share of

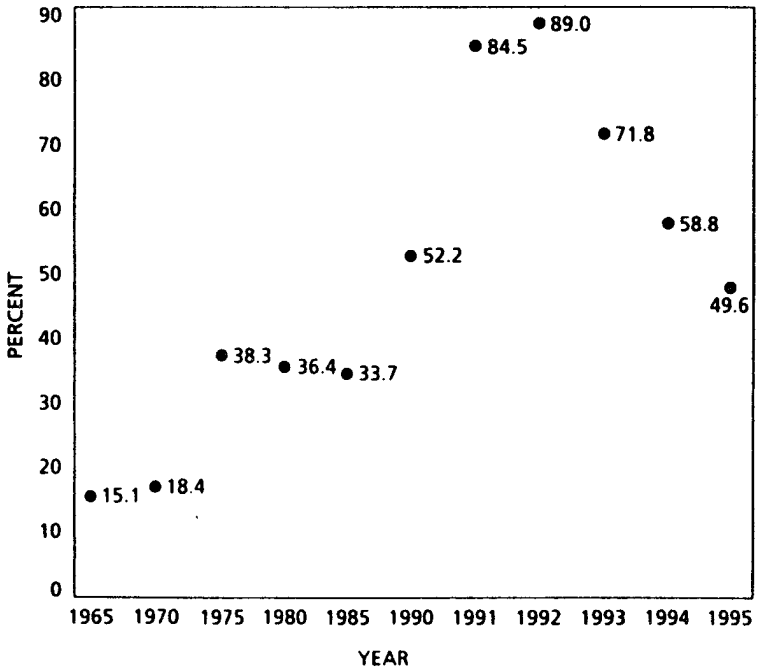
Table 7-1 Federal participation in U.S. credit market, fiscal years 1965–1995 (dollar amounts in billions)

Fiscal year	1965	1970	1975	1980	1985	1990	1991	1992	1993	1994	1995
Total net borrowing in U.S. market[a]	66.7	87.9	169.7	336.3	826.5	722.3	502.0	540.8	578.5	618.4	717.5
Federal borrowing from the public	3.9	3.5	51.0	69.5	199.4	220.8	277.4	310.7	247.4	184.7	171.3
Guaranteed borrowing	5.0	7.8	8.6	31.6	21.6	40.7	22.1	19.7	−2.0	38.7	26.2
GSE borrowing	1.2	4.9	5.3	21.4	57.9	115.4	124.6	150.8	170.2	140.0	158.3
Total federal and assisted borrowing	10.1	16.2	65.0	122.5	278.9	376.9	424.1	481.2	415.6	363.4	355.8
Federal percent[b]	15.1	18.4	38.3	36.4	33.7	52.2	84.5	89.0	71.8	58.8	49.6

Source: Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 1997* (Washington, D.C.: GPO, 1996), 198.

[a]Includes federal and federally assisted borrowing as well as unassisted borrowing by state and local governments, businesses, households, and foreigners in U.S. credit market.
[b]Federal and federally assisted borrowing as a percent of total net borrowing in U.S. credit market.

Figure 7-1 Share of credit market required to finance federal programs



Source: Adapted from the Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 1996* (Washington, D.C.: GPO, 1995), 197.

Note: Market share is measured by net borrowing to finance federal programs (direct federal borrowing, federally guaranteed borrowing, and borrowing by government-sponsored enterprises) as a percentage of net funds raised in U.S. credit market.

the credit markets. He frequently expressed deep concerns about it in his testimony before Congress on the public debt limit and other matters in the mid-1970s. I recall hearing that Democratic Senator William Proxmire of Wisconsin, then chairman of the Senate Banking, Housing, and Urban Affairs Committee, said that "Simon has everyone scared up here." Given the subsequent explosive growth in federal and federally assisted borrowing activities, it seems Congress was not scared enough.

The Republican sponsors of the Contract with America go ballistic over government regulation of private business, but apparently have

no problem with the government's actually usurping the functions of private business—in this case, the shifting of private credit risk from investors and private financial institutions to the federal taxpayer. The apparent explanation for the lackadaisical attitude toward this socialization of credit is that private lenders do not complain about it to their friends in Washington. They are just as happy as they can be, profiting from the business of providing credit effectively secured by Uncle Sam without having to take the risk normally associated with such profits.

The housing industry, the principal beneficiary of federally assisted credit, loves it. All the players—developers, builders, homeowners, realtors, lenders, investment bankers, investors, furniture and appliance store owners, and many others—welcome the reduced costs of housing finance and the shifting of private credit risks to the general taxpayer.

The principal sources of this largess, Fannie Mae and the Federal Home Loan Mortgage Corporation (FHLMC), commonly known as Freddie Mac, are politically powerful institutions with combined lending—which is financed largely with guaranteed mortgage-backed securities—of approximately $1.4 trillion (see table 7-2). The larger of the two, Fannie Mae, ensconced in its palatial headquarters on upper Wisconsin Avenue in Washington (but exempt from D.C. income taxes), is one of the most feared lobbies in town.

These government-sponsored enterprises have the best of both worlds: the pay and perks of giant private corporations and the monopoly, subsidies, and security of government agencies. Although arrangements vary among the GSEs, generally they are authorized to seek loans or other financial support from the Treasury, they are exempt from certain state and local taxes, and their securities are treated as if they were federal securities for various collateral, investment, and regulatory purposes.

Treasury Secretary Simon, who had a strong Wall Street background in the financing of sponsored enterprises, such as Fannie Mae, understood the political realities of congressional support for housing. In the mid-1970s I was asked to review a document prepared for Secretary Simon that discussed the role of the government in support-

Table 7-2 Federal and federally assisted borrowing from the public, fiscal year 1995 (billions of dollars)

Borrower or guarantor entity	Net borrowing in year	Outstanding end of year
Federal agencies[a]	171.3	3,603.4
Government-sponsored enterprises (GSEs)	158.3	1,661.0
Fannie Mae	73.9	836.8
Federal Home Loan Mortgage Corporation	21.0	568.7
Federal Housing Finance Board	63.0	264.6
Farm Credit System	3.3	56.8
Student Loan Marketing Association	2.0	51.7
Adjustments to avoid double counting[b]	−5.0	−117.6
Guaranteed loans	26.2	726.8
Housing and Urban Development	38.2	869.9
Veterans Affairs	−2.9	154.5
Agriculture	−6.4	15.3
Education	9.5	86.1
Export-Import Bank	1.0	17.7
Small Business Administration	3.8	26.4
Other[c]	1.9	20.7
Adjustments to avoid double counting[d]	18.9	−463.8
Total federal and assisted borrowing	355.8	5,991.2

Source: Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 1997* (Washington, D.C.: GPO, 1996), 160–165, 189.

[a]U.S. Treasury debt and minor amounts of other agency debt.
[b]Includes net GSE debt transactions with other GSEs, federal agencies, and federally guaranteed borrowers.
[c]Includes loans for international development, foreign military sales, overseas private investments, and ship financing.
[d]Government National Mortgage Association guarantees of mortgage-backed securities to finance insured housing loans.

ing Fannie Mae and the investors in Fannie Mae's securities. I pointed out that, legally, Fannie Mae's debt was not guaranteed by the government (although the Treasury was authorized to lend to Fannie Mae, and investors viewed this as government protection against a Fannie Mae default). When the document came back with Secretary Simon's scribbled comments in the margin, I saw that he had likened my comments to the droppings of bulls. I was, of course, technically correct; but Simon was right. He recognized that, as a practical political matter, Fannie Mae trades on the Treasury's credit.

While there were some raised eyebrows when a retiring CEO of Fannie Mae, David O. Maxwell, floated away in a $27 million golden parachute,[4] there has been no serious challenge to such extraordinary compensation or to other special privileges and benefits enjoyed by sponsored-enterprise executives. These are the new princes of American finance, living not by their entrepreneurial wits but by the grace of the state. There is something wrong with a system where a federal bureaucrat, the chairman of Fannie Mae, was paid $4.4 million in 1994, which was more than the combined salaries of the president of the United States and his entire cabinet.

Why should we be concerned about the growth of the GSEs and other federal credit assistance programs? One concern is the cost to the Treasury, and thus to the taxpayer, from the competition with the GSEs and guaranteed borrowers in the government securities market. When the Treasury is perceived as prepared to stand behind similar debt securities issued by the GSEs, the GSE securities become close substitutes for Treasury securities in the portfolios of many investors. Thus the Treasury must pay a somewhat higher interest rate on its own borrowings.

The situation is somewhat analogous to that of a person who cosigns the loan of a friend or relative and later finds that he must pay a higher interest rate on his own subsequent borrowings because the cosigned loan increased his contingent liabilities. When you lend your credit standing to someone else you may diminish its value to yourself. While the Treasury's creditworthiness is not diminished, its borrowing advantage is. As shown in table 7-2, GSE debt totals $1.7 trillion, 46 percent as much as the marketable Treasury debt of $3.6 trillion. (If the Treasury were to increase its direct debt in the market by 46 percent, it would clearly have to pay a higher interest rate.) Even if the competition from GSE debt added only one one-hundredth of 1 percent to Treasury's average cost of borrowing (for example, an increase from 6.00 percent to 6.01 percent), the annual interest cost on the government's marketable debt would increase by $360 million.

Another obvious concern is the potential cost to the government from losses on guaranteed loans and GSE losses, which would lead to demands on the Treasury for financial assistance to the GSEs.

Also, the subsidy elements in certain government-assisted loans can have significant effects on the allocation of credit resources. Some loans, such as those for low-income or public housing, have been so heavily subsidized as to be like outright government grants in their economic effects. But many federal credit programs, such as those for moderate income housing, cost the government little and may have only marginal economic impacts.

Since federally assisted credit is largely for private investment in housing, and is also supportive of small business, education, agriculture, and many other private investment areas, it may be viewed as facilitating rather than crowding out private investment. The critical question is whether the right type of private investment is being encouraged by these federal credit programs. Are we diverting too many real resources to, for example, housing and agriculture at the expense of other, perhaps more productive areas of the economy?

THE THREAT TO CREDIT QUALITY

The major concern with the shifting of credit risk from the private sector to the government is the loss of market discipline usually relied on to maintain the quality of credit. Private lenders, who are normally bound to exercise due diligence through careful inspections, appraisals, and credit investigations before extending credit, have less incentive to be so diligent when the government is guaranteeing them against loss. The old rules of "know your customer" and "know your collateral" are relaxed. To an increasing degree the "customer" is now Uncle Sam, not the borrower, and the ultimate "collateral" is the Treasury's taxing power, not the property that is supposedly securing the loan. A resulting decline in the quality of credit could lead to defaults and weaknesses in the national financial structure during periods of economic stress.

Government guarantees are too often perceived as eliminating risk, which they do for the guaranteed lender but not for the economy. To be sure, the spreading of risk through private insurance institutions, based on sound actuarial analysis, is vital to a growing economy. But generally the justification for granting government guarantees is to

facilitate activities that are not insurable or "bankable," that is, would not meet the test of the private market.

These high-risk activities are the very ones that should be subject to the most careful credit investigations and appraisals. Yet because of the government guarantees, lenders have less, rather than more, incentive to devote their credit evaluation resources to such activities. Government guarantees, rather than reducing or shifting risk, actually add risk to the economy.

I am not suggesting that the government should not take risks. There are many successful loan guarantee programs. The most cited example of a good government guarantee program is the FHA single-family mortgage insurance program, which has generally been self-supporting since its inception in the 1930s and has served as a model for private lenders in making long-term, low-down-payment loans without a government guarantee. Even in loan guarantee programs with high defaults, such as student loans, the public benefits may well exceed the costs.

On the other hand, perhaps the greatest example of a government guarantee program gone wrong is the excessive risk creation from federal deposit insurance for savings and loan associations (which is not included in the government's measure of federally assisted credit). The catastrophic failure of savings and loan associations (S&Ls) in the early 1980s, which cost the government an estimated $180 billion (not the $500 billion claimed by some critics), was due in large part to the government deposit insurance.[5] At that time the insurance was irresponsibly increased from $40,000 to $100,000 for each individual account, and the lending powers of the S&Ls were broadened. The S&Ls would not have been able to make the questionable loans that led to their failure had it not been for excessive government insurance. That insurance increase led to a bidding war by S&Ls for the so-called hot money, or brokered deposits, of large depositors throughout the country who had little incentive to question the unsound lending practices of the S&Ls. S&Ls paid higher and higher interest rates to attract short-term deposits to finance their holdings of longer-term loans made earlier at lower rates. Many were transformed from their traditional role as thrift institutions invested in relatively safe home

mortgages to aggressive financiers of highly speculative commercial development projects.

Many complex economic and political factors led to the demise of the S&Ls, but the excessive government guarantees were clearly a principal cause. As stated by the Congressional Budget Office, "Most experts agree that the existence of the federal deposit insurance system and the way in which regulators operated it were major culprits in the thrift crisis."[6] The point was made more forcefully by a well-known expert, Edward Kane, in *The S&L Insurance Mess: How Did It Happen?:*

> An apt name for these insolvent, hellbent-for-leather thrifts is institutional zombies. The economic life they enjoy is an unnatural life-in-death existence in that, if they had not been insured, the firms' creditors would have taken control from stockholders once it became clear that their enterprises' net worth was exhausted. In effect, a zombie has transcended his natural death from accumulated losses by the black magic of federal guarantees.[7]

Thus, the idea of deposit insurance, put into effect in the 1930s to protect the person with a relatively small savings account and to encourage homeownership, was corrupted by political catering to powerful S&L lobbies.

The S&L disaster is a dramatic showing of how excessive government guarantees can lead to a fatal loss of market discipline in the allocation of credit. The debt securities available to private investors are now largely direct or indirect obligations of the federal government. That is the most serious issue raised by the federal government's recent preemption of the bulk of the credit flows in our economy.

THE ROAD TO REFORM

I should note that recent growth has been largely in direct federal borrowing and sponsored-enterprise borrowing rather than in guaranteed borrowing. In the five year period 1991–1995, net federal borrowing was $1,192 billion, net sponsored-enterprise borrowing (the

fastest growing area) was $744 billion, and net guaranteed borrowing was just $105 billion.* Considerable progress has been made in recent years in rationalizing the financing and budget control of federal loan guarantee programs. This progress is due largely to two pieces of "good government" legislation, the Federal Financing Bank Act of 1973 and the Federal Credit Reform Act of 1990, as I'll explain shortly.

During my three decades in the Treasury hardly a month went by that I was not fighting (in a largely losing battle) some proposal to extend the Treasury's credit to yet another sector of the economy through some sort of "off-budget" program of government guarantees, insurance, or direct loans by a new lending entity. Every major program agency provides some form of credit assistance to its constituency . . . housing, agriculture, small business, transportation, education, foreign aid, community development, utilities, and many others. Prior to 1973, most of these credit aids were financed with some sort of government-backed securities issued in the private market so they would not have to be included in the politically sensitive federal budget expenditures; this in turn excluded them from any accounting in the direct federal debt.

The major problems created by these "off-budget" guaranteed securities were (1) the cost of financing was higher, compared with direct loans financed by Treasury borrowing, because private investors demanded far higher interest rates on these fully guaranteed securities than on Treasury securities, which were more liquid and better established in the market; and (2) the programs financed with these guaranteed securities, since the expenditures were outside the budget, were out of control.

To deal with these problems, in the late 1960s I proposed the establishment of a Federal Financing Bank (FFB), which would permit the Treasury to act as an intermediary to consolidate the financing of the various agency-guaranteed securities. Then Under Secretary of the Treasury Paul Volcker (later chairman of the Board of Governors of the Federal Reserve System) provided the leadership in gaining White House and congressional approval of the proposal. Essentially, the FFB, although nominally a bank and a lending institution, was a mechanism to permit the Treasury to purchase agency-guaranteed

securities without changing their off-budget status. Otherwise, the securities would have gone into the marketplace at interest rates much higher than the rates on the Treasury securities sold to purchase them.

Under Secretary Volcker presented the FFB proposal as a federal debt management measure that would reduce the costs to government, and to certain assisted borrowers, of financing loan guarantee programs. The FFB was not presented as a reform measure to curb the growth of loan guarantee programs, but it was clear that the FFB would have that potential. It would expose many "loan guarantee" programs for what they already functionally were—direct loan programs financed in the securities markets with the government's credit to avoid the discipline both of the budget and of the marketplace.

The FFB proposal got mixed reviews on Wall Street. Some investment bankers, including William Simon, who was then at Salomon Brothers, applauded the FFB because it saved money for the government and rationalized the financing of government loan guarantee programs. Salomon Brothers and several other large investment banking firms had been earning substantial fees from the development and marketing of various forms of government-guaranteed securities. Because the FFB eliminated the need for those investment banking services, many of Simon's colleagues did not share in his expression of public-spirited support.

I recall a visit from one irate investment banker who said the FFB was socialized credit. He did not appreciate my response, which was that the socialization of credit occurred when the government guaranteed the ostensibly private securities, thus assuming the risks that the private market would normally assume in a free-market economy. The FFB would rid the market of such guaranteed securities and reduce the cost to the taxpayer of such socialized credit.

The FFB was established in the Federal Financing Bank Act of 1973 and soon became the largest "lending institution" in the nation, with billions of dollars of savings in the interest costs of financing federal loan guarantee programs. Initially, the FFB did not change the off-budget status of the guarantee programs (that would have been politically impossible at the time), but it made them more visible as compared with the various complicated mechanisms used by the

program agencies to secure off-budget financing in the market. Eventually this new visibility led to greater understanding of these programs and to the inclusion of FFB-financed loans in the budget. It also led to the enactment of a requirement in the Federal Credit Reform Act of 1990 (which was initially drafted by Treasury staff in 1986)[9] to include in the budget the estimated present value of costs to government from interest rate and other subsidies in new loans made under both direct and guaranteed loan programs. Thus the budget incentive to use loan guarantees—rather than more efficient and controllable direct loans—was eliminated, and the need for the FFB declined.[10]

It took more than two decades, but the Treasury's original objectives—reducing the financing costs of federal credit programs and ensuring greater budget controls over these programs—were both achieved.

No such progress can be claimed in the area of government-sponsored enterprises. While there has been much discussion of the need to reduce the subsidy to GSEs, for example, by removing their special tax advantages or their financial backing from the Treasury, nothing has been done. The GSEs' popularity with Congress has insulated them from any effort to initiate significant reform.

As this book goes to the printer, federal agencies have not yet completed long-overdue studies on the privatization of Fannie Mae and Freddie Mac. Legislation enacted in October 1992 required that the General Accounting Office, HUD, the Treasury, and the Congressional Budget Office each conduct and submit by October 1994 a study "regarding the desirability and feasibility of repealing the Federal charters of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, eliminating any Federal sponsorship of the enterprises, and allowing the enterprises to continue to operate as fully private entities."[11] (The studies are expected to be completed in the summer of 1996.)

The GSEs continue to be neither fish nor fowl—privately owned but federally sponsored. They remain wards of the state, but very rich wards indeed. They lack accountability. They should be subject either to the discipline of the free competitive market or to the budgetary or other disciplines imposed on other government agencies.

If it is determined that, after decades of experimentation (Fannie Mae and Freddie Mac, the largest GSEs, were established as private entities in 1970), the GSEs cannot stand on their own feet in the market, we should look at other approaches that would reduce their costs to the government and permit private financial institutions to fully compete with the GSEs.

An effective way to accomplish this would be to charge the GSEs guarantee or user fees, which would offset their advantage over competing private institutions that are self-supporting. For example, if average borrowing costs were 7 percent for the GSEs, because the government backing gave them an AAA rating, and 8 percent for similar but self-supporting institutions with an A rating, a guarantee fee of 1 percent would level the playing field. Such fees should be deposited in the Treasury (1) to compensate for the additional borrowing costs incurred by the Treasury in competing with Treasury-backed GSE securities in the market and (2) to provide a reserve against possible losses to the Treasury from any future direct financial assistance to the GSEs.

A good first step is the following 1996 recommendation of the Shadow Financial Regulatory Committee, a private group of recognized experts on U.S. financial institutions:

> . . . that the Credit Reform Act of 1990 be amended to require the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) to measure the annual cost of the credit enhancements that each GSE enjoys. This annual cost should be included in the federal budget and a reserve fund should be established sufficient to absorb the losses that might occur. This is a prerequisite to rationally evaluating the justification for continuing these enterprises.[12]

The committee went on to say that the GSEs' opportunity to borrow from the Treasury and their inferred government guarantees "explain why interest rates on GSE debt average at least 100 basis points below rates paid by private borrowers with similar balance sheets." (One basis point is one hundredth of 1 percent.) On GSE

liabilities of $1.7 trillion, a 1 percent subsidy would amount to $17 billion a year.

OMB and CBO should be able to agree on reasonable estimates of the various GSE interest rate subsidies, which may well be 100 basis points or more for certain maturities or types of some GSE issues but much less for others, based on congressional and administration staff studies that were near completion at the time this book went to press.

A distinction must be made between two subsidy measures: the cost to the government and the benefit to the subsidized borrower. A GSE might benefit from government backing by saving 100 basis points in its borrowing costs, but the cost to government might be estimated to be as low as, say, 35 points, based on estimates that the competition from government-backed GSE borrowings raises Treasury borrowing costs by 10 basis points and that a 25 basis point charge would provide an adequate reserve for losses. Thus a 35 basis point guarantee fee might cover the government costs, but it would leave the GSE with a 65 basis point subsidy advantage over competing private institutions. (Under the Federal Credit Reform Act of 1990, subsidies on direct and guaranteed loans are measured by the estimated costs to government, rather than the benefit to borrower, but these subsidy measures are not for the purpose of establishing fees to be charged borrowers.)

The Shadow Financial Regulatory Committee's recommendation provides for much needed recognition of the GSE subsidies as costs to the federal budget. These costs, however, should be borne by the GSEs rather than the federal taxpayer.

A transition period of several years may be necessary to phase in guarantee or user fees that cover the full value of the various federal credit enhancements enjoyed by each GSE. (Some GSEs have more tax advantages, more preferential treatment of their securities, and greater recourse to Treasury financial assistance than others, and the GSEs vary in the strength of their balance sheets and their acceptance in the securities markets.) GSE stockholder rights would need to be recognized, and in some cases initial fees might apply only to new liabilities rather than to outstanding debt. An initial fee of, say, 25

basis points on some appropriate measure of liabilities for each GSE would seem reasonable. A gradual fee increase over the years would give the GSEs time to adjust and to consider giving up the federal credit enhancements rather than pay the escalating fees. Some GSEs may never sever all ties to the government, but at least they would be established on a more competitive basis in the market and at less cost to the taxpayers.

There should be no question about the fee-paying ability of the major GSEs, Fannie Mae and Freddie Mac, which generally account for about 85 percent of the total outstanding GSE liabilities. Consider the following statement by Standard & Poor's:

> Freddie's advantage is that it can finance purchases of mortgages at quasi-agency rates. The company also generates impressive returns: return on equity [ROE] was over 20% in 1995. The excellent ROE can be partially explained by . . . highly efficient operation and the fact that it competes in essentially a two-company market.[13]

The other participant in the two-company market, what economists call a duopoly, is of course Fannie Mae. In each of the past ten years the ROE has exceeded 20 percent for Freddie Mac and 25 percent for Fannie Mae. A 1991 investment of $10,000 was worth in 1996, $54,615 in the case of Freddie Mac stock and $39,255 in the case of Fannie Mae stock.[14] Surely, both agencies can easily afford to pay, starting now, at least a nominal fee to cover a portion of their substantial costs to the American taxpayer. The purpose of these agencies was to increase the availability of housing credit, not subsidize the price, not enrich stockholders, nor increase the federal budget deficit.

Would such fees or removal of the GSE subsidies increase the cost of housing? Yes. Without the implied U.S. Treasury backing of their securities, the GSEs would have to pay higher interest rates on their borrowings, and that added cost would be passed on primarily to the homeowner, as would any fee. Why abolish such a democratic subsidy that benefits virtually everybody? That's why. If the benefit of a subsidy to private activities goes to virtually everybody and an equal cost is borne by virtually everybody (as taxpayers), the net

benefit to virtually everybody is zero. Indeed, because of the present lack of competition and the administrative costs of the GSEs, there may well be a significant net cost to virtually everybody.

CONCLUSION

The dramatically increased role of federal and federally assisted borrowing in our economy raises serious questions about the viability of private credit markets. We have reached a point where most of the credit market instruments available to private investors are securities issued or guaranteed by federal government instrumentalities. As more and more credit risks are shifted from private lenders to government guarantors, the quality of credit and the economic allocation of credit surely suffer. Government-sponsored enterprises are the fastest growing federal credit aids. Unlike federal direct and guaranteed loans, the GSEs are not now subject to federal budgetary constraints. The government subsidies to the GSEs also insulate them from competition in the private market. After decades of government subsidies, it is time that the highly profitable GSEs began to pay fees to offset their costs to the government and to reduce their unfair advantage in the market.

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