January 29, 2001

Mr. Robert Seiler Jr.
Manager for Policy Analysis
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W., Fourth Floor
Washington, D.C. 20522

Dear Mr. Seiler:

Citizens Against Government Waste (CAGW) appreciates the opportunity to submit formal public comments to the Office of Federal Housing Enterprises Oversight (OFHEO) on its upcoming analysis of the systemic risk potentially posed by the nation's two largest housing government sponsored enterprises (GSE), Fannie Mae and Freddie Mac.

CAGW is the nation's premier nonprofit, nonpartisan taxpayer watchdog group. Established in 1984 following the issuance of President Reagan's Private Sector Survey on Cost Control, popularly known as the Grace Commission, CAGW has been devoted to exposing government waste, fraud, abuse and mismanagement of tax dollars for more than 17 years. The organization is proud to have one million members and supporters nationwide. CAGW is also a leading organization in the Homeowners Education Coalition (HomeEC), a confederation of taxpayer and consumer groups dedicated to stimulating dialogue and debate on reform of the housing GSEs.

CAGW is gratified by OFHEO's study of the potential risks posed by the activities of the enterprises and looks forward to reviewing the final publication. CAGW, along with the other members of HomeEC and a growing number of executive and legislative branch officials, concur that more intensive oversight of the GSEs' operations and financial activities is long overdue.

Fannie Mae and Freddie Mac, established in 1938 and 1970 respectively, were chartered by Congress to create liquidity in residential mortgage markets and to smooth out regional irregularities in credit availability. The GSEs accomplish this by purchasing mortgages from primary mortgage lenders, securitizing them and reselling them to private investors. In this way, risk is diffused broadly in the private sector. The GSEs are widely credited with stimulating the growth of an efficient and vibrant nationwide mortgage finance system. In exchange for advancing this important public policy

agenda, their government charters also conferred upon Fannie Mae and Freddie Mac unique and valuable benefits, such as state and local tax exemptions, exemption from Securities and Exchange Commission registration fees, and lines of credit with the U.S. Treasury worth several billion dollars, resulting in favorable borrowing rates.

These tangible benefits have substantial value. Former OFHEO director Aida Alvarez put it succinctly in 1996 when she testified that "the phrase 'economic subsidy' is appropriate…even though the government writes no checks to either enterprise, because private investors would pay money for the same benefits. When the government provides economic benefits free of charge, it incurs an opportunity cost equal to the value of the benefits." The Congressional Budget Office released a study in 1996 in which it quantified the value of the subsidy at $6.5 billion annually, noting that one-third of the subsidy is retained by the GSEs in the form of profits.

But the GSEs' most lucrative, and controversial, advantage is their implied government guarantee. Though their securities carry an explicit disclaimer that the federal government does not back them, private purchasers of GSE debt believe that the federal government ultimately stands behind these securities and investors behave accordingly. CAGW believes that this widely held perception is the driving force behind the value of GSE securities and that the greatest risk to taxpayers, other financial institutions, and the economy, is rooted in this implied government guarantee.

OFHEO is seeking comments on the issue of systemic risk. For CAGW, as well as the other members of the HomeEC coalition, the issue of risk is viewed as it pertains to taxpayers and the potential for a taxpayer-funded bailout. In particular, CAGW asserts that any analysis of risk should include an examination of the sheer size and composition of GSEs' debt; the inadequate reserves of capital they are permitted to hold to cushion them in times of financial crisis; their expansion into economic sectors which is neither envisioned nor supported by their charters; the lack of meaningful oversight of their activities by a single, properly funded and empowered regulator; and the ways in which the implied federal guarantee could endanger taxpayers should the GSEs stumble or face an unforeseen financial crisis.

Like many observers, CAGW is alarmed at the GSEs' escalating debt. The two largest GSEs, Fannie Mae and Freddie Mac, have outstanding obligations of $2.3 trillion. At current rates of growth of about 20 to 25 percent a year, the debt of Fannie Mae, Freddie Mac and the Federal Home Loan Banks will surpass the interest-bearing publicly-held national debt, which has declined to $2.5 trillion, in the next fiscal year. The GSEs' debt currently exceeds the total amount of corporate debt outstanding, and there seems to be no end in sight. Last year, Fannie Mae Chairman Franklin Raines pronounced that Fannie Mae was prepared to issue unlimited debt and has promised continued double-digit growth indefinitely.

Even though nationwide homeownership rates hover near 68 percent, there are sectors of our society which still lag behind. However, in tracking whether or not Fannie Mae and Freddie Mac benefit those targeted populations – borrowers with lower income

and lower than average homeownership rates – the Department of Housing and Urban Development has concluded that the GSEs consistently underperform *vis a vis* the private sector. In fact, since Fannie Mae and Freddie Mac are now permitted to purchase mortgages as high as $252,700, many critics assert that the GSEs are now catering to higher-income borrowers.

The U.S. housing market is mature and the publicly-held national debt is falling. Given these circumstances, it is difficult to understand how the GSEs can promise double-digit growth unless they break out of the charters. In fact, all evidence points to the alarming conclusion that the GSEs' original mission of promoting affordable homeownership has been jettisoned in favor of the quest for out-sized profits. Surely, it is time to examine whether or not the GSEs ought to be permitted to issue unlimited amounts of debt without prior review by a competent financial regulator.

It is not solely the acceleration of debt issuance and its sheer volume which pose risks to taxpayers. The composition of the GSEs' debt adds another cause for concern and must be part of any risk analysis. By purchasing mortgages from primary lenders and holding them in portfolio, the GSEs accept the risk that borrowers could default on their loans. When they bundle the mortgages and resell them they ensure that the interest rate risk – the possibility that interest rate fluctuations would lower the value of the securities – will be diffused into the economy and borne by private investors. However, the GSEs have increasingly begun to repurchase their own mortgage-backed securities (MBS), thus "repatriating" the interest rate risk while still carrying the credit risk. In July 2000 testimony before the House Budget Committee, Congressional Research Service financial specialist Barbara Miles put it succinctly, "While it is clear this increases shareholder value, it is difficult to understand what, if anything, it does for mortgage markets." In fact, the repurchase of MBS does nothing to assist a single individual or family on the cusp of homeownership to achieve that dream. It certainly does enrich the stockholders and executives of the GSEs, however.

In addition, Fannie Mae and Freddie Mac are increasingly buying home equity loans, an activity that arguably falls outside their charters. Home equity lending has grown explosively in the last decade. At the end of 1998, consumers had taken out 19 million home equity loans and lines of credit, totaling about $495 billion. Financial experts concur that a vast majority of home equity loans are used for debt consolidation, consumer purchases, and a plethora of other non-mortgage-related expenditures. Home equity loans do nothing to put people into homes. Furthermore, approximately 38 percent of home equity loans outstanding are categorized as "subprime." Though there is heated debate in some circles over the proper definition of a "subprime" borrower, it is inherently riskier to lend money to those with "less than perfect" credit. The attraction of "subprime" lending is high profit.

There are tens of thousands of private commercial lenders willing to provide home equity loans in the current market. This financial sector is mature and highly competitive and is no place for the GSEs, who were chartered for a narrow public policy purpose and should be restricted to that purpose. In 1997, the GAO reported that "non-

mortgage investments were more than double Freddie Mac's capital and more than four times Fannie Mae's capital."

The growing percentage of MBS in the GSEs' portfolios, as well as their growing presence in the home equity and consumer loan market, has without a doubt changed their risk profiles. OFHEO should thoroughly investigate how much of the GSEs' portfolio is comprised of MBS, home equity loans, and other non-mortgage investments, the purchase of which do nothing to deepen homeownership or make it more affordable. The analysis should also determine the extent to which the GSEs' voracious appetites for debt, including home equity loans and consumer lines of credit, have fueled a potentially dangerous escalation in consumer debt since defaults in credit card and other types of consumer debt usually lead the way in an economic downturn.

Their charters permit the GSEs to hold less cash in reserve than private financial institutions to cushion them in times of instability. Private banks and thrifts have risk-based capital requirements of
4 percent. The GSEs, by contrast, have minimum leverage standards of 2.5 percent. A private firm, leveraged to the extent of the GSEs, with scanty cash reserves, would be unlikely to earn AA- ratings from Standard & Poor's, who stated that "both companies maintain capital levels that are relatively low when compared with what Standard & Poor's would expect to see at fully private companies with similar risk profiles at the 'AA-' rating level…Their ability to issue debt instruments with 'agency status' enables Fannie Mae and Freddie Mac to access capital markets even in time of financial stress, resulting in a high level of financial flexibility not experienced by fully private companies."

Listening to Fannie Mae and Freddie Mac officials rationalize their forays into home mortgage insurance, home equity loans and lines of credit, "subprime" lending and automated underwriting, one could easily conclude that their government charters were an infinitely malleable set of loose guidelines. In CAGW's view, this "anything goes" interpretation of their charters is, in and of itself, risky behavior.

The GSEs recognize the lucrative nature of their charters and have begun to leverage their implied government guarantee to move into other areas of business already occupied by healthy private sector companies. Their exemptions and lower costs enable them to undercut their competition unfairly. In fact, if permitted to maraud effortlessly into new business ventures the GSEs will have a strong incentive to dominate that sector and drive out otherwise viable competitors. They are now profit-seeking financial giants in search of profits at the expense of the mission for which they were chartered, to enhance affordable homeownership, has become a shrinking fig leaf to clothe an increasingly bloated Fannie Mae and Freddie Mac. The absence of both normal market discipline and an amply funded regulator with the statutory authority to check excessive growth, coupled with an implied government guarantee, is a prescription for potential disaster.

The possibility of financial missteps on the part of Fannie Mae and Freddie Mac are not an abstraction. Fannie Mae experienced severe problems in late 1970s and early 1980s, and steps were taken by the federal government to mitigate the impact of that crisis. Since that time, they have been blessed, as have all Americans, by a robust economy and their bottom lines reflect that prosperity. Fannie Mae and Freddie Mac officials have spoken so often and reassuringly to Congress and regulators of their expertise in hedging and risk management that it has become a mantra. But hedging and risk management are human endeavors and, as such, are subject to human errors. The near-demise of Long Term Capital Management is the most recent cautionary tale. For all the high-powered expertise associated with that private financial institution, steps still had to be taken to bail it out.

Systemic risk – to taxpayers, the nation's (perhaps the global) banking and financial infrastructure, the housing market and, by extension, the entire economy – is embedded in the conflicted GSEs' charters themselves. Any reform of the GSEs undertaken in the short run must be crafted to put them on a prudent step-down program to full privatization. In the short run, however, Congress and OFHEO must step in to cap their debt, insist upon the same capital requirements as their comparable private sector counterparts must have to cushion them in case of financial stress, and curtail their non-mission-related financial ventures. OFHEO's systemic risk analysis is crucial in order to accomplish both these short-term and long-term objectives.

On behalf of CAGW and its one million members and supporters across the country, thank you for the opportunity to submit these comments. Should you have further questions regarding these comments, please contact us at (202) 467-5300.

Sincerely,

[signed: Thomas A. Schatz]

Thomas A. Schatz
President